Annual Banking Law Update 2018

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Recent Legal Developments of Special Interest to Banks

Editor: **Charl Hugo**

JUTA

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Preface

In his preface to *Sam the Sudden* (1925) the inimitable PG Wodehouse states that, ideally, an author should be "like the male codfish", which, when suddenly confronted by an offspring of several million little codfish "conscientiously resolves to love them all alike and have no favourites". If I may be allowed to substitute "editor" for "author", generally, I am inclined to say this is true of me and all the *Annual Banking Law Updates* since my direct involvement. However, just as Wodehouse said in relation to *Sam the Sudden*, I believe, should I look back one day, I will have to admit to having been "particularly fond of this one".

The mix of contributions in this volume, *Annual Banking Law Update* (*ABLU*) *2018*, is highly topical. The first two relate to cryptocurrencies (one dealing, from the perspective of various jurisdictions, with the legal position of a person who has entrusted units to an exchange provider which then goes bankrupt (as Mt Gox in Japan), and the other with their potential taxation). The third investigates whether the Australian law relating to "safe harbour provisions" for directors of companies trading while being insolvent should be adopted in South Africa. The prolific recent South African case law relating to the unilateral closure of bank accounts by banks (in the wake of the South African state capture scandal) is the focus of the fourth contribution. The fifth deals with the International Arbitration Act of 2017, and, particularly, how it may have an impact on the financial sector. The South African Reserve Bank has been in "the firing line" during the past year. The independence of the Bank, its litigation against the Public Protector, and calls for the Bank's nationalisation are addressed candidly in the sixth contribution. The National Credit Act remains highly topical in our country. The seventh contribution reflects on case law relating to pre-agreement assessments of potential debtors in the quest of preventing the granting of reckless credit. The final contribution focuses on the fascinating and compelling question of the impact of financial crime, and the measures adopted internationally against it, on traditional trade financing instruments (documentary collections and letters of credit).

Despite the fact that the authors hail from four different countries (South Africa, Japan, Germany and Australia) I am willing to state confidently that all the contributions are eminently relevant to bankers and banking lawyers in South Africa today.

It is not, however, the topicality, internationality or the interesting nature of its content, especially, that sets *ABLU 2018* apart from its predecessors. The upward step (if I may be bold enough to term it so) is that this year the *ABLU* book has for the first time been subjected to a rigorous double-blind peer-review process, and has come through it with flying colours. All contributions were peer reviewed by two leading and respected banking-law experts whose recommendations led to some changes that improved the quality of the final product. In this regard I have been overwhelmed by the response of all involved. My profound gratitude is due to the authors who so readily agreed to provide manuscripts and to do so within the strict timeline required by a project of this nature, and to the peer-reviewers for working through each contribution meticulously while also keeping to the required time lines.

Another first in relation to *ABLU 2018* is the inclusion of a bibliography and tables of cases, legislation and conventions and treaties referred to in the book. I am much indebted to Adami Geldenhuys who did most of the tedious work in this regard. Due to the time constraints that are inevitable in any annual update, however, it was not possible to provide page numbers in the tables and bibliography. Each entry, instead, contains a reference to the author who cited the source, which should be of significant help in tracing what is said of it.

I would also like to thank Juta & Co, and, especially, Linda van de Vijver, who has willingly and professionally assisted me throughout the project. This has been the third consecutive year that Juta has joined hands with the Centre for Banking Law of the University of Johannesburg in producing the *ABLU* book. From my perspective it has been a happy partnership.

Allow me an overt disclaimer containing a covert apology. The severe time constraints relating to the production of a publication of this nature have necessitated a rather robust editing approach – something which has already given rise to some irritation in the ranks of the eminent body of authors. I hope they have forgiven me. Moreover, there may well be some mistakes in the text for which I, and not the author, will eventually have to bear the responsibility. Hopefully they are few and far between. I give you my assurance that I have done the best I could in the time I had.

As in the past I conclude by expressing the hope (with some confidence) that *ABLU 2018* will contribute to a better understanding of banking law in South Africa and will stimulate research in this important field.

Charl Hugo
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27 August 2018

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Cryptocurrencies entrusted to an exchange provider: Shielded from the provider's bankruptcy?

KOJI TAKAHASHI*

Abstract

Cryptocurrency exchanges, *ie* online platforms where customers exchange their cryptocurrencies for other cryptocurrencies or fiat currencies, are routinely targeted by hackers, which often result in a massive drain of cryptocurrencies. The heists can be large enough to bring down the exchanges to their knees. The customers of an exchange who have entrusted it with cryptocurrencies would have a contractual right to claim their return. If the exchange is wound up, however, personal claims (such as a contractual claim) brought in bankruptcy proceedings would not yield to them a full recovery. It is, therefore, practically important to examine whether the cryptocurrencies entrusted to an exchange are shielded from the bankruptcy of the exchange provider, so that the customers can obtain a full recovery. Under most, if not all, legal systems, the answer to this question would be unclear because cryptocurrencies are a novel asset and because the legal relationships between an exchange provider and its customers have not been sufficiently scrutinised. This article will seek to improve legal clarity by presenting an analytical framework, identifying issues, and pointing to possible solutions.

It will begin by examining the law of Japan, possibly the only country in the world where the matter has been litigated. Following a hacking attack, Mt Gox, the world's biggest operator of a Bitcoin exchange at that time, became insolvent. After the opening of bankruptcy proceedings, one of its former customers filed a suit against the bankruptcy trustee in Japan, seeking a full recovery of the Bitcoins he had entrusted to the exchange. Rather than relying on a personal claim, the plaintiff asserted ownership over what he saw as "his Bitcoins". His claim was, however, dismissed by the Tokyo District Court for reasons to be examined in this article. More recently, other customers filed a suit in Japan by trying another legal avenue to obtain a full recovery. They are arguing that their Bitcoins had been held by the exchange on trust for them.

After presenting an analysis under Japanese law, this article will explore its relevance to other legal systems. Since Japanese law belongs to the family of civil law systems, the analysis concerning the ownership of cryptocurrencies would have direct relevance to other civil law systems in the context of *rei vindicatio* (vindication of property). It would also inform the debate whether cryptocurrencies are "property" in terms of the tort of conversion in common law systems. The analysis concerning whether an exchange holds cryptocurrencies on trust for its customers would be useful to all the common law systems of which the law of trusts forms an integral part as well as any civil law systems which, like Japanese law, have introduced the concept of trusts.

* * * * *

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1 Introduction

Cryptocurrency exchanges, *ie* online platforms where customers exchange their cryptocurrencies[1] for other cryptocurrencies or fiat currencies, are routinely targeted by hackers, which often result in a massive drain of cryptocurrencies. The exchanges which came under biggest hacking attacks include Mt Gox (losing Bitcoins[2] worth $473 million in 2014), Bitfinex (losing Bitcoins worth $72 million in 2016), Coincheck (losing Nems worth $523 million in 2018) and BitGrail (losing Nanos worth $170 million in 2018). The heists can be large enough to bring down the exchanges to their knees.

The customers of a cryptocurrency exchange usually entrust their cryptocurrencies to the exchange provider[3] prior to placing an order, so that their order can be swiftly executed. After the execution of transactions, the cryptocurrencies remain entrusted to the provider until such time that customers who have a positive balance on the provider's books request transfers. If, in the meantime, the exchange provider goes into bankruptcy, the customers would have a contractual right to claim the return of the cryptocurrencies they have entrusted. But a contractual claim would only allow recovery *pari passu* ("in equal steps") from the bankrupt's estate. The customers may wish to claim a full recovery as they often see such cryptocurrencies as their own. The merit of their claim will depend on the question whether the cryptocurrencies entrusted to an exchange provider are shielded from the latter's bankruptcy.

Under most, if not all, legal systems, the answer to this question would be unclear because cryptocurrencies are a novel asset and because the legal relationships between an exchange provider and its customers have not been sufficiently scrutinised. This article will consider this question under the law of Japan, perhaps the only country in the world where the matter has been litigated. Two legal weapons likely to be deployed by the customers - ownership-based restitution and trusts – will be examined in turn. After presenting an analysis under Japanese law, this article will explore its relevance to other legal systems.

2 Proprietary restitution under Japanese law

2.1 *Proprietary restitution based on ownership*

When the customers of a cryptocurrency exchange contend that the cryptocurrencies they have entrusted to the exchange provider are shielded from the latter's bankruptcy, they may seek proprietary restitution by asserting ownership over those cryptocurrencies.

[1] In this article the word "cryptocurrencies" refers to either different kinds of cryptocurrencies or units of a specific cryptocurrency, depending on the context.

[2] In this article the word "Bitcoins" is used to refer to units of the Bitcoin cryptocurrency.

[3] This article will focus on centralised exchanges, a type of exchange to which customers can entrust their cryptocurrencies. Towards the future, more use may be made of DEXs (decentralised exchanges) which enable trading without cryptocurrencies being entrusted to them and hence do not attract hacking attacks. But DEXs will not completely replace centralised exchanges since they do not enable trading with fiat currencies.

Such relief was sought in a suit against Mt Gox, which was once the world's biggest provider of a cryptocurrency exchange. In 2014, it became insolvent and bankruptcy proceedings were opened in Japan. Most of the creditors were its former customers who had entrusted it with Bitcoins and fiat currencies and had a contractual right to recover them. Conscious that filing a contractual claim in the bankruptcy proceedings would only yield a partial recovery, one of the former customers filed a suit before the Tokyo District Court against the bankruptcy administrator (hereafter "the Mt Gox case"), seeking a full recovery of what he saw as "his Bitcoins" by asserting ownership over them. Filing such a suit is permissible because a right of proprietary restitution is unaffected by the commencement of bankruptcy proceedings under Article 62 of the Japanese Bankruptcy Act, which provides:[4]

> "The commencement of bankruptcy proceedings shall not affect the right to recover, from the bankruptcy estate, assets that do not belong to the bankrupt."

The Court dismissed the claim[5] by denying that Bitcoins could be an object of *shoyûken,* that is the concept of ownership in Japanese law. In so holding, it relied on the provisions of the Japanese Civil Code which indicate that the objects of *shoyûken* are limited to tangible assets. The relevant provisions read:

> "Article 85: The term '*butsu*' (things) as used in this Code shall mean tangible assets.
>
> Article 206: The *shoyûken* holder of *butsu* shall have the right to freely use, profit from and dispose of them, subject to the restrictions prescribed by law."

In fact, Japan's first modern civil code, the Civil Code of 1890, did not limit the objects of *shoyûken* to tangible assets.[6] The limitation was introduced by the Civil Code of 1896 which replaced the 1890 Code and remains in force to this day. The 1896 Code adopted a two-tier scheme separating the law of property (contained in Part II) and the law of obligations (contained in Part III). It was feared that in this scheme, the notion of "ownership of personal rights" would invite a conceptual confusion. This, among other reasons, lead to limiting the objects of ownership to tangible assets.[7]

On a literal interpretation, "tangible assets" would be limited to solids, liquids and gas, excluding such assets as electricity, heat and light. In the course of the last century, various scholarly opinions were put forward to overcome this statutory limitation. One such opinion says that the words "tangible assets" should be interpreted broadly to cover the types of intangible assets which are amenable to exclusive control in a legal as opposed to factual sense.[8] This interpretation

4 There is no official English translation of Japanese law. All the translation of Japanese legislation in this article is the work of the present author.

5 The judgement of the Tokyo District Court on 5 August 2015 (in Japanese), 2015 WLJPCA 08058001 (accessible by the subscribers of Westlaw Japan).

6 Article 6(1) provided: "*Butsu* are tangible or intangible."

7 Stenographic Records of the Proceedings of the Meetings of the Chief Examiners of the Investigative Committee of Codes (Division of Civil Code) (1893) vol 1 64 [Masaaki Tomii].

8 Sakae Wagatsuma *Shintei Minpô Sôsoku* (Revised Edition on the General Rules of the Civil Code) (1965) 201 *et seq* (in Japanese).

would allow *shoyûken* to be extended to such intangible assets as electricity. Another opinion respects the literary meaning of the words "tangible assets" but suggests that the rules applicable to *shoyûken* should, where warranted, be extended by way of *mutatis mutandis* application to intangible assets.[9]

In the Mt Gox case, the plaintiff argued that Bitcoins were "tangible assets" on the interpretation that this expression covered intangible assets amenable to exclusive control. But the Court rejected this argument in view of the two-tier scheme of the Civil Code and favoured the literal reading.

2.2 *Proprietary restitution with respect to intangible assets*

Proprietary restitution under Article 62 of the Bankruptcy Act (above) is typically based on *shoyûken* and accordingly relate to tangible assets. It is, however, generally accepted that proprietary restitution may be granted under the same provision with respect to such intangible assets as intellectual property rights and receivables.[10] What should matter is, as indicated in that provision, whether the asset belongs to the claimant. The asset would have to be amenable to exclusive control for it to belong to somebody and for it to be recovered by way of proprietary restitution.

On this reasoning, the customers of a cryptocurrency exchange who have entrusted their cryptocurrencies to the exchange provider should, in the event of the provider's bankruptcy, be able to obtain proprietary restitution of their cryptocurrencies from the bankruptcy estate on the fulfilment of two requisites, namely: (i) that cryptocurrencies are amenable to exclusive control; and (ii) the cryptocurrencies entrusted to an exchange provider by its customers belong to the latter. These two requisites will be examined in turn below.

Amenability of cryptocurrencies to exclusive control

In the Mt Gox case, the Tokyo District Court did not merely rule that Bitcoins were not "tangible assets". It went on to consider whether Bitcoins were amenable to exclusive control. The Court answered this question in the negative for the reasons that (i) the transactions of Bitcoins need to be propagated to the network and confirmed by mining, a process which necessarily involves third parties and (ii) an address on the Bitcoin blockchain exhibits no electronic record showing the balance of the Bitcoins therein.

Are these good reasons? The observation made in (i) is factually correct. The miners who validate blocks of transactions could, if they so wish, decide not to process transactions from a specific Bitcoin address. But as long as there are other miners willing to process them, they will be processed sooner or later. More importantly, Bitcoins exist invincibly unlike the digital assets of the pre-

[9] Kazuo Shinomiya *Minpô Sôsoku* (General Rules of the Civil Code) (3 ed 1983) 132 (in Japanese).

[10] *eg* Makoto Ito *et al Jokai Hasan Hô* (Commentary on the Bankruptcy Act) (2 ed 2014) 474 (in Japanese). It does not explain how its proposition is reconciled with the restriction of *shoyûken* to tangible assets.

existing type which are recorded in a centralized registry. While the record of pre-existing digital assets is at the mercy of the administrator of the registry, the transactional record of Bitcoins is unassailable as it is contained in the blockchain and distributed across the network. Furthermore, the transfer of Bitcoins is only possible at the behest of the person who has the knowledge of the private key corresponding to the blockchain address in which they are held. It would, therefore, seem possible to say that Bitcoins and other similarly engineered cryptocurrencies are amenable to exclusive control.

The observation made in (ii) is also factually correct. The balance of Bitcoins in a blockchain address merely represents UTXOs (unspent transaction outputs), which is worked out by referring to all the previous transactions associated with that address. An address on the Bitcoin blockchain, therefore, only conceptually contains Bitcoins and, unlike a bank account, exhibits no electronic record showing their balance.[11] It is, however, no good reason to deny the amenability of Bitcoins to exclusive control because it should suffice to consider the amenability to control of a balance of Bitcoins rather than specific units of the Bitcoin.

To whom do the entrusted cryptocurrencies belong?

In Japanese law, there are currently no specific rules for the assignment of cryptocurrencies. There are, however, rules for the assignment of tangible assets and certain intangible assets. With respect to tangible assets, an assignment takes effect upon an agreement between the assignor and the assignee without any formalities required.[12] With respect to certain intangible assets which are registrable such as carbon emissions allowances and dematerialised book-entry securities, an assignment requires the transfer of registration on the relevant registry in addition to a valid agreement between the assignor and the assignee.[13] With respect to such registrable intangible assets, an account holder is presumed to be in lawful possession of the assets recorded in the account.[14]

[11] It should be noted that the Bitcoin's UTXO architecture is not the only record-keeping model for blockchains. The Ethereum blockchain, for example, keeps the record of each user account showing the most recent balance, as does a bank account.

[12] Article 176 of the Civil Code provides: "The creation and assignment of proprietary rights shall take effect solely by the manifestation of intent by the relevant parties."

[13] Article 50 of the Act to Promote Measures to Counter Global Warming provides in the relevant part: "An assignment of carbon emissions allowances shall not take effect unless the assignee has had an increase in carbon emissions allowances recorded in its account as a result of the transfer of registration … ." Article 140 of the Act on Book-Entry Transfer of Corporate Bonds and Shares provides: "An assignment of book-entry shares shall not take effect unless, upon an application for book-entry transfer, the assignee has had an entry recorded in the holdings column … of its account, showing an increase in the number of book-entry shares in accordance with the assignment."

[14] Article 53 of the Act to Promote Measures to Counter Global Warming provides: "It shall be presumed that the national government and account holders are in lawful possession of the carbon emissions allowances recorded in their accounts." Article 143 of the Act on Book-Entry Transfer of Corporate Bonds and Shares provides: "It shall be presumed that participants are in lawful possession of the rights in book-entry shares recorded in their accounts … ."

The presumption is rebutted where there is no valid agreement to assign the assets to the account holder.

Since the rules for registrable intangible assets promote transparency and transactional certainty, it would be reasonable to suggest that those rules should be applied *mutatis mutandis* to an assignment of cryptocurrencies. On this proposition, an assignment of cryptocurrencies would require the transfer of registration on the blockchain in addition to a valid agreement between the assignor and the assignee. The person who controls the blockchain address[15] in which cryptocurrencies are held would be presumed to be in lawful possession of them. This presumption would be rebutted where there is no valid agreement to assign the cryptocurrencies to that person. The agreement does not have to be expressed but can be inferred from the circumstances including any related contractual terms between the parties.

The providers of a cryptocurrency exchange usually prepare terms of service which the customers must accept before using their service. Under usual terms, exchange providers do not undertake to act as a counter-party to exchange transactions with their customers but provide a multilateral trading facility,[16] that is a facility that brings together multiple third-party offers of selling and buying and facilitates their matching. Thus, for example, the terms of service of Mt Gox which were applicable shortly before it became insolvent stated:[17]

> "Members acknowledge and agree that, when completing Transactions, they are trading with other Members, and Members accept that MtGox acts only as an intermediary in such Transactions and not as a counterparty to any trade."

Under other terms, exchange providers undertake to act as a counter-party to exchange transactions with their customers. Thus, the terms of use of Coincheck provide in the relevant parts:[18]

> "ARTICLE 10-2 SPOT TRANSACTIONS AT SHOP
>
> 1 … (1) Each Registered User shall be allowed to perform spot transactions at the virtual currency shop being operated by the Company, by placing orders to purchase or sell virtual currency through the procedure as specified by the Company. The counterparty in such transactions will be the Company."

[15] by means of the private key associated with that address. This rule would require further elaboration where the private key is intentionally or accidentally disclosed to other persons.

[16] A terminology drawn from the MiFID II (Directive 2014/65/EU on markets in financial instruments) of the European Union.

[17] Terms as of 20 January 2012 (available at http://web.archive.org/web/20140122203409/https://www.mtgox.com/terms_of_service).

[18] The terms applicable as of the time of writing (June 2018) (available on the website of Coincheck: https://coincheck.com). The terms also offer an alternative service whereby the provider undertakes to provide a multilateral trading facility in the following language:

> "ARTICLE 10-1 SPOT TRANSACTIONS AT EXCHANGE
>
> 1. … (2) The Company's responsibility shall be to provide an exchange where virtual currency can be bought and sold based on the orders placed … . Therefore, the Company shall not become a party that is directly involved in virtual currency purchase and sales transactions, unless in exceptional cases… ."

When a customer of a cryptocurrency exchange entrusts the exchange provider with his or her cryptocurrencies, the provider will keep those cryptocurrencies in the blockchain addresses it controls.[19] It will also record those cryptocurrencies in its off-chain books, that is a ledger outside of the blockchain. When an order placed by the customer is executed, the balances on the provider's off-chain books will be adjusted accordingly. But the transaction will not immediately be broadcast to the blockchain network since it takes time and cost to have the transaction inscribed in the blockchain. Where the provider has acted as the counter-party to the transaction, the cryptocurrencies used to fulfil the transaction will eventually be transferred to a separate blockchain address controlled by the provider where it keeps the cryptocurrencies it owns. Where, on the other hand, the provider has merely provided a multilateral trading facility, the cryptocurrencies may be kept in the blockchain address controlled by the provider until such time when customers who have a positive balance on the provider's books request transfers to the blockchain addresses they control.

If the rules for registrable intangible assets are to be applied *mutatis mutandis* to the assignment of cryptocurrencies, the exchange provider to which cryptocurrencies are entrusted would be presumed to be in lawful possession of them while they remain held in the blockchain address controlled by the provider. This presumption would be rebutted if there is no valid agreement to assign those cryptocurrencies to the provider. Is there such an agreement?

Where an exchange provider merely provides a multilateral trading facility, it will not be acting as a counter-party to exchange transactions with its customers. This might lead one to think that no agreement could be inferred to assign the entrusted cryptocurrencies to the provider. If that were the case, however, the assignment of cryptocurrencies would have to take place directly between customers. And it is hard to see how it works because it is often impossible to identify a specific customer with whom specific cryptocurrencies have been exchanged. As stated above, an exchange provider may not transfer cryptocurrencies to blockchain addresses controlled by its customers until such time that customers who have a positive balance on the provider's books make a request for transfer. In these circumstances, it is not possible to infer an agreement between specific customers directly to assign specific cryptocurrencies between themselves. It would be more reasonable to consider that cryptocurrencies are assigned first to the exchange provider when they are entrusted to the latter, which the latter re-assigns to its customers when requests for transfer are made.

Where, on the other hand, an exchange provider acts as a counter-party to exchange transactions with its customers, it would not be difficult to infer an

19 It may be contrasted with the holding patterns of online wallet providers. Some of them, like exchange providers, control the blockchain addresses in which the cryptocurrencies entrusted by their customers are held while others, unlike exchange providers, merely provide software allowing their customers to possess private keys to control the blockchain addresses in which their cryptocurrencies are held. See Raskin, "Realm of the coin: Bitcoin and civil procedure" 2015 *Fordham Journal of Corporate and Financial Law* 969 996.

agreement to assign the traded cryptocurrencies to the provider at the time when the customer's order is executed. But would it be more reasonable to infer an assignment agreement at an earlier point in time when the customer entrusts their cryptocurrencies to the exchange provider? Suppose that before the customer's order is executed, the blockchain for the entrusted cryptocurrency is hard forked and has yielded cryptocurrencies of a new breed. If it is the customer to whom the entrusted cryptocurrencies belong, the exchange provider would be obliged to extract the cryptocurrencies of the new breed and deliver them to the customer. It is a task involving risky operations which an exchange provider would not undertake without charging a sufficient level of fees. In view of the current practice of an exchange provider charging no fees for keeping custody of entrusted cryptocurrencies, it seems reasonable to infer an agreement for customers to assign their cryptocurrencies to the exchange provider at the time when they entrust them to the latter.

From the foregoing analysis, it follows that regardless of whether an exchange provider acts as a counter-party to exchange transactions with its customers or merely provides a multilateral trading facility, the presumption that the cryptocurrencies entrusted to an exchange provider by its customers belong to the provider is not rebutted. It must accordingly be concluded that the customers of a cryptocurrency exchange have no right to obtain proprietary restitution with respect to the cryptocurrencies they have entrusted to the exchange provider.

3 Trusts under Japanese law

When the customers of a cryptocurrency exchange contend that the cryptocurrencies they have entrusted to the exchange provider are shielded from the provider's bankruptcy, they may base their contention on the principle that trust property is shielded from the trustee's bankruptcy,[20] arguing that the provider holds the cryptocurrencies on trust for them. This argument envisages that the provider is acting as a trustee and the customers are acting simultaneously as settlors and beneficiaries.[21]

[20] This principle is enshrined in article 25(1) of the Trusts Act (*Shintaku Hô*), which provides: "Where an order for the commencement of bankruptcy proceedings is made against a trustee, no asset forming part of trust property shall be included in the bankruptcy estate." Procedurally, when a trustee goes into bankruptcy, its duties come to an end (article 56(1)) and the bankruptcy administrator steps in to preserve the trust property until a new trustee is appointed and becomes ready to administer the trust (article 60(4)). Article 56(1) of the Trusts Act provides: "The duties of a trustee shall be terminated on the following grounds ... However, in the case of subparagraph (iii) below, if the terms of trust otherwise provide, such terms shall prevail. … (iii) an order for the commencement of bankruptcy proceedings has been made against the trustee … ." Article 60(4) of the Trusts Act provides: "Where the duties of a trustee have been terminated on the ground stipulated in Article 56(1)(iii), the bankruptcy administrator shall, until a new trustee is ready to carry out the administration of the trust, preserve the assets forming part of trust property and take the necessary steps to hand over the administration of the trust."

[21] In a separate move, a trust bank is planning to offer a scheme whereby an exchange provider (acting as a settlor) assigns the cryptocurrencies entrusted by its customer to the trust bank who

Such an argument was made in a fresh action against the bankruptcy administrator of Mt Gox filed on 19 February 2018 in the Tokyo District Court.[22] Instead of asserting ownership over the Bitcoins they had entrusted to Mt Gox, the former customers argued that Mt Gox had held them on trust for them. As of the time of writing (June 2018), the court has yet to hand down a decision.

The following analysis will consider the merit of such an argument and examine the duties of a trustee to see whether they are compatible with the *modus operandi* of exchange providers.

3.1 *Creation of a trust*

A trust is an arrangement pursuant to which a specific person manages or disposes of an asset in accordance with a specific purpose.[23] The asset can be tangible or intangible since there is no good reason to restrict it to tangibles.[24] It would, therefore, be safe to assume that cryptocurrencies can comprise trust property.

A trust is created by a trust agreement, a will or a unilateral manifestation of intent.[25] Among those methods, the one most relevant to the present discussion is a trust agreement. Thus, a trust is created where there is an agreement between A and B whereby A will assign an asset to B and B will keep it in custody or

is to hold them (as a trustee) for the customer (as a beneficiary) with the aim of shielding the cryptocurrencies from the bankruptcy of exchange provider. See *Nihon Keizai Shimbun* (Nikkei Newspaper), the morning edition of 7 Feb 2018, 7 (in Japanese).

22 *Nihon Keizai Shimbun* (Nikkei Newspaper), the morning edition of 20 Feb 2018, 38 (in Japanese).

23 Article 2(1) of the Trusts Act provides: "The term 'trust' within the meaning of this Act refers to an arrangement created by any of the methods set out in the following Article, pursuant to which a specific person is to manage or dispose of an asset in accordance with a specific purpose (other than the purpose of exclusively promoting his own interests …) and take any other steps necessary to achieve that purpose."

24 The Trusts Business Act (*Shintaku Gyô Hô*) previously provided for an exhaustive list of assets capable of comprising trust property. The list included tangible movables and certain intangible assets such as receivables. By the 2004 amendment of the Act, the list was abolished, paving the way for a trust to be created with respect to other intangible assets such as intellectual property and carbon emissions allowances.

25 Article 3 of the Trusts Act provides: "A trust shall be created by any of the following means: (i) by concluding an agreement with a specific person to the effect that an asset shall be assigned to the latter or encumbered with a security right or otherwise disposed of in favour of the latter and that the latter shall manage or dispose of the asset for a specific purpose and take any other steps necessary to achieve that purpose (hereinafter referred to as a 'trust agreement'); (ii) by making a will to the effect that an asset shall be assigned to a specific person or encumbered with a security right or otherwise disposed of in favour of a specific person and that the latter shall manage or dispose of that asset in accordance with a specific purpose and take any other steps necessary to achieve that purpose; or (iii) by a manifestation of intent by a specific person to manage or dispose of a specific asset he holds in accordance with a certain purpose and take any other steps necessary to achieve that purpose, with the manifestation being evidenced by a notarial deed or any other document or electronic or magnetic record … stating or recording that purpose, the particulars necessary to specify the asset, and other particulars specified by the ordinances of the Ministry of Justice."

dispose of it for a specific purpose.[26] The agreement need not be expressed or use the word "trust." It can be inferred from the circumstances.

It follows that a trust is created between an exchange provider and its customer in favour of the latter (i) when the customer entrusts cryptocurrencies to the provider if there are circumstances which make it possible to infer an agreement between them that the customer will assign the cryptocurrencies to the provider and that the latter will keep them in custody and dispose of them for the purpose of executing the customer's order for exchanging them for other cryptocurrencies or fiat currencies and delivering the latter to the customer; or (ii) when the customer entrusts the provider with fiat currencies if there are circumstances which make it possible to infer an agreement between them that the customer will assign the fiat currencies to the provider and that the latter will keep them in custody and dispose of them for the specific purpose of executing the customer's order for exchanging them for cryptocurrencies and delivering the latter to the customer. If a trust as described above is created, the cryptocurrencies or fiat currencies obtained in the course of the transaction will form part of the trust property until they are delivered to the customers.

There is, however, uncertainty as to what circumstances make it possible to infer a trust agreement. In a leading case, a construction company held in its bank account a sum of money paid by a local municipality as an advance for the building work for which the municipality had engaged the company. The Supreme Court ruled[27] that the money was shielded from the bankruptcy of the company, reasoning that the company held it on trust for the municipality. To reach that ruling, the Court found that there was a trust agreement between the company and the municipality whereby the company was to use the money for the purpose of defraying the cost of the building work. The Court so found notwithstanding that the parties had not used the word "trust" in the construction contract. The Court observed that the construction contract only stipulated that the company could not use the advance for purposes other than to defray the cost of the building work. But it noted that the contract additionally laid down, by way of incorporation of the terms of another contract, (i) that the advance must be deposited in a dedicated bank account, (ii) that the company could only make a withdrawal from the account after submitting documents showing the proper use of the fund to the bank and receiving its verification, (iii) that the proper use of the fund must be inspected by an external auditor, and (iv) that the auditor could demand the bank to suspend withdrawals should it find that the advance was not properly used. It is not clear from the Court's reasoning whether any of such additional elements are indispensable to infer a trust agreement.

In this regard, it is interesting that under the Japanese regulatory rules in force as from 1 April 2017,[28] the providers of a cryptocurrency exchange

[26] *ibid* article 3(i) of the Trusts Act.

[27] The judgment of the Supreme Court on 17 Jan 2002 (56-1 Minshû 20).

[28] These rules are contained in the Payment Services Act (*Shikin Kessai Nikansuru Hôritsu*) which devotes one chapter to "virtual currencies". The words "virtual currencies" are defined in article 2(5) in the following terms. It is a technologically neutral definition but the chapter is

soliciting business in Japan must be registered with the Prime Minister.[29] To be registered, the providers must comply with certain requirements.[30] Among those requirements are (a) to establish a system necessary to ensure the segregation of the fiat currency and cryptocurrencies received from its customers from its own fiat or virtual currencies and (b) to have the status of segregation periodically inspected by an external auditor.[31] Furthermore, (c) the Prime Minister may through his or her officials inspect the business operation of the provider,[32] and, (d) where necessary, order improvement.[33] Among the additional elements mentioned by the Supreme Court, (i) corresponds to (a), (iii) to (b) and (c), and (iv) to (d). To that extent, it would be easier to infer a trust agreement with the exchange providers who have been registered in Japan by complying with the relevant regulations.

primarily aimed at cryptocurrencies. "The 'virtual currencies' within the meaning of this Act are anything described in either of the following subparagraphs. (i) anything having financial value (but only those recorded electronically in electronic devices or other items, excluding the Japanese or foreign currencies and assets denominated in such currencies), which can be used to pay to unspecified persons for goods bought or rented or for services received, which can be sold to or bought from unspecified persons, and which can be transferred by means of electronic data processing systems. (ii) anything having financial value which can be exchanged with unspecified persons for anything described in the preceding subparagraph, and which can be transferred by means of electronic data processing systems."

[29] Article 63-2 of the Payment Services Act provides: "Unless registered with the Prime Minister, no person may engage in the business of exchanging virtual currencies." Article 63-22 of the same Act provides: "Unless registered pursuant to Article 63-2, no foreign provider of a virtual currencies exchange may solicit from persons in Japan the business activities listed in Article 2(7)" [note by the present author: this refers to the business activities related to the exchange of virtual currencies].

[30] Article 63-5 of the Payment Services Act provides: "(1) The Prime Minister shall refuse to grant registration where the applicant is any of the following persons … (v) A corporation which has not established a system necessary to ensure compliance with the provisions of this Chapter". Article 63-17 of the same Act provides: "(1) In any of the following circumstances, the Prime Minister may rescind the registration granted under Article 63-2 … (i) where the provider has become any of the persons described by the subparagraphs of Article 63-5(1)".

[31] Article 63-11 of the Payment Services Act provides: "(1) The provider of a virtual currencies exchange shall, in connection with its business, segregate the fiat or virtual currencies entrusted by its customers from its own fiat or virtual currencies pursuant to the Ordinance of the Cabinet Office. (2) The provider of a virtual currencies exchange shall, pursuant to the Ordinance of the Cabinet Office, periodically undergo an audit by a certified public accountant … or by an auditing firm as regards the status of the segregation laid down in the preceding provision."

[32] Article 63-15 of the Payment Services Act provides: "When the Prime Minister finds it necessary for the proper and secure business operations of a virtual currencies exchange, he or she may order the exchange provider to submit reports or materials concerning its business operations or financial conditions and may have his or her officials enter its place of business or other premises, ask questions about its business operation or financial conditions and inspect its books and other items."

[33] The Payment Services Act provides in article 63-16: "When the Prime Minister finds it necessary for the proper and secure business operation of a virtual currencies exchange, he or she may, to the extent necessary, order the provider to take measures necessary to improve its business operation or financial conditions or any other measures necessary for the purposes of supervision."

3.2 *Compatibility with trustee's duties*

Once a trust is created, the trustee is subject to a range of duties including the duty to avoid conflicts of interest and the duty of segregating trust property from his own property. If an exchange provider holds the fiat currencies and cryptocurrencies entrusted to it by its customers on trust for the latter, it would be subject to such duties. The following analysis will examine whether such duties are compatible with the exchange providers' *modus operandi*.

Acting as a counter-party to exchange transactions

It has been seen earlier that an exchange provider may, depending on the terms of service, undertake to act as a counter-party to exchange transactions with its customers. If the exchange provider is acting as a trustee for its customers, it raises doubt whether such conduct involves the type of conflict of interest which the provider is obliged to avoid. Japanese law indeed prohibits a trustee from acting as a counter-party to the sale or purchase of the trust property.[34] As an exception, however, the trustee can so conduct itself if the beneficiary has given an informed consent.[35]

When a customer of a cryptocurrency exchange places an order in response to the price quoted by the exchange provider, the customer may be deemed to have consented on an informed basis to the provider acting as the counter-party to the exchange transaction. It would, therefore, be safe to conclude that an exchange provider can act as a counter-party to exchange transactions with its customers without failing in its duty as a trustee to avoid conflicts of interest.

Commingling cryptocurrencies in a blockchain address

There are two models for the way in which the providers of a cryptocurrency exchange hold the cryptocurrencies entrusted to them by their customers on the blockchain.

In one model, the cryptocurrencies of each customer are held in a blockchain address which is associated with that specific customer. To avoid delay in executing the customers' orders, the private keys would need to be kept in an online wallet ("hot storage"), though it makes the cryptocurrencies vulnerable

[34] The Trusts Act provides in article 31(1): "A Trustee shall not carry out the following conducts: (i) causing assets forming part of trust property … to be included in the trustee's own property or causing assets forming part of the trustee's own property … to be included in trust property;".

[35] The Trusts Act provides in article 31(2): "Notwithstanding the contrary provisions in the preceding paragraph, a trustee may carry out the conducts listed therein in any of the following circumstances. However, sup-paragraph (ii) shall not apply where the terms of the trust provide that the conduct in question shall not be carried out even in the circumstances set forth in that sub-paragraph … (ii) The trustee has disclosed facts material to the conduct in question and obtained the beneficiary's consent ...".

to hacking attacks. This was the model apparently adopted by Bitfinex,[36] prior to receiving a major hacking attack in August 2016.[37]

In another model, the exchange provider commingles the cryptocurrencies entrusted to it by its customers in blockchain addresses which are not associated with any specific customers. The holdings of each customer are only recorded in the provider's off-chain books. This model allows the provider to leave the private keys in an online wallet ("hot storage") for only so much of the cryptocurrencies as would be sufficient to cover the volume of transactions instructed in normal circumstances. For a bulk of the entrusted cryptocurrencies, the provider can keep the private keys in an off-line wallet ("cold storage"). This arrangement enhances security, which presumably is the reason behind the prevailing adoption of this model. Thus, Mt Gox indiscriminately distributed the Bitcoins entrusted to it by its customers in a number of blockchain addresses and randomly moved them around different addresses to avoid hacking attacks.[38] This model is permissible under the Japanese regulations applicable to the providers of a virtual currencies exchange,[39] which require the providers to segregate the cryptocurrencies entrusted to them by their customers as a whole from their own cryptocurrencies but do not go to the extent of requiring them to segregate the cryptocurrencies of each customer on the blockchain. This model is also permissible under the regulations of other jurisdictions such as New York.[40]

The second model, however, begs the question whether commingling the cryptocurrencies entrusted by different customers in the same blockchain addresses is compatible with the duty of the exchange provider as a trustee. Under Japanese law, a trustee has the duty to segregate trust property from his own property and any other trust property he administers. The required manner of segregation depends on the categories of assets.[41] Thus, to segregate

[36] See an announcement by Bitfinex on 4 June 2015 (https://www.bitfinex.com/posts), which stated, "[s]tarting today we … will separate each user's funds on the public blockchain".

[37] Bitfinex adopted multi-signatures as a measure to limit vulnerability to hacking attacks (In the Matter of BFXNA Inc. d/b/a BITFINEX, CFTC No 16-19, 2016 WL 3137612 (June 2 2016) 3). But it failed to ward off the attack.

[38] This is based on a finding made by the Tokyo District Court in its judgement in the Mt Gox case.

[39] article 63-11 of the Payment Services Act (see note 31 *supra* for the text) and article 20 of the Cabinet Office Ordinance on the Providers of a Virtual Currencies Exchange, read in conjunction with II-2-2-2 of the Operational Guidelines (May 2017) of the Financial Services Agency.

[40] 23 CRR-NY 200.9, which provides for the rules on the custody and protection of customers' assets, does not require the segregation of the cryptocurrencies of each customer on the blockchain. It reads in the relevant part: "(b) To the extent a licensee stores, holds, or maintains custody or control of virtual currency on behalf of another person, such licensee shall hold virtual currency of the same type and amount as that which is owed or obligated to such other person. (c) Each licensee is prohibited from selling, transferring, assigning, lending, hypothecating, pledging, or otherwise using or encumbering assets, including virtual currency, stored, held, or maintained by, or under the custody or control of, such licensee on behalf of another person except for the sale, transfer, or assignment of such assets at the direction of such other person."

[41] article 34(1) of the Trusts Act provides: "A Trustee shall segregate assets forming part of trust property from assets forming part of his own property or any other trust property he

fiat currencies, it is sufficient to account for their quantity by keeping books.[42] On the other hand, the assets which can be registered as forming part of trust property, such as carbon emissions allowances and dematerialised book-entry securities, must be segregated by means of effecting such registration.[43] It has been suggested earlier in this article that the rules for registrable intangible assets should be applied *mutatis mutandis* to determine the owner of cryptocurrencies. However, the registration of cryptocurrencies as forming part of trust property is not possible unless and until the blockchain is so configured as to make it technically possible and the law recognises it as a valid registration. Consequently, cryptocurrencies would fall within the same category as fiat currencies for the purpose of segregation[44] and accordingly, it will be sufficient to account for their quantity by keeping books. It follows that an exchange provider would not be failing in its duty of segregation if it uses off-chain books to account for the quantity of each customer's holdings.

It should be noted that to tolerate commingling cryptocurrencies entrusted by different customers in the same blockchain addresses would not harm the interests of the customers. The law will treat the bulk of cryptocurrencies as being subject to shared interests and deem those interests to belong to each trust property which the exchange provider administers for each customer.[45] Each customer may divide the bulk in consultation with other customers or, failing all other statutorily prescribed manners of division, submit a petition for division to the court.[46]

administers in the manners specified by the following subparagraphs for each category of assets. If, however, the terms of the trust provide for other manners of segregation, such terms shall prevail. (i) the assets which may be registered as forming part of trust property … (excluding the assets mentioned in subparagraph (iii)): by the said registration; (ii) the assets which may not be registered as forming part of trust property … (excluding the assets mentioned in subparagraph (iii)): the manners specified in (a) or (b) below for each category of assets: (a) tangible movables (excluding fiat currencies): by holding the assets in custody in a condition that allows them to be distinguished by appearance from his own property and any other trust properties he administers; or (b) fiat currencies and any assets other than those mentioned in (a): by accounting for their quantity; or (iii) the assets specified by the Ordinance of the Ministry of Justice: in the manners specified by the Ordinance as the appropriate manners of segregation."

[42] article 34(1)(ii)(b) of the Trusts Act (see n 41 *supra*).

[43] article 34(1)(i) of the Trusts Act (see n 41 *supra*).

[44] article 34(1)(ii)(b) of the Trusts Act (see n 41 *supra*).

[45] This is derived from article 18 of the Trusts Act, which provides: "(1) Where an asset forming part of trust property becomes indistinguishable from an asset forming part of the trustee's own property …, it shall be deemed that shared interests in those assets belong to the trust property and the trustee's own property. In this case, the shares of the interests shall be proportionate to the values of the respective assets as of the time when they became indistinguishable from each other. (2) … (3) The two preceding paragraphs shall apply *mutatis mutandis* to the cases where the same person acts as a trustee for two or more trusts and an asset forming part of the trust property of one trust becomes indistinguishable from an asset forming part of the trust property of another trust …. In such a case, the words 'the trust property and the trustee's own property' shall be read as referring to 'the trust property of each trust'."

[46] This follows from article 19 of the Trusts Act, which provides: "(3) Where shared interests in an asset in the possession of a trustee belong to the trust properties of two or more trusts administered by the same trustee, the asset may be divided in the following manners: (i) in

4 The relevance of the analysis under Japanese law to other legal systems

Different legal systems will apply different legal principles to address whether cryptocurrencies entrusted to an exchange provider are shielded from the provider's bankruptcy. This article will focus on the principles related to *rei vindicatio*, tort of conversion and trusts, to see what relevance the foregoing analysis under Japanese law has for these principles.

4.1 *Rei vindicatio*

The legal systems which have inherited the Roman law concept of ownership, *dominium*, would allow a suit to be filed for *rei vindicatio* (vindication of property: an owner's claim against the possessor for the return of the property). Those are typically the legal systems of the civil law tradition.[47] But legal systems of mixed traditions may also recognise this form of relief.[48] The modern Japanese law is rooted in the civil law tradition and the ownership-based restitutionary claim made in the Mt Gox case was the Japanese-law version of *rei vindicatio*. The foregoing analysis under Japanese law concerning proprietary restitution would, therefore, have direct relevance to other legal systems in which this principle may be invoked. Thus, the same issues as examined under Japanese law will confront such legal systems when addressing whether the cryptocurrencies entrusted to an exchange provider by its customers are shielded from the provider's bankruptcy.

The first issue which will be confronted is whether cryptocurrencies can be an object of ownership. The concepts of ownership are different from one legal system to another reflecting the precedents and doctrines behind them. Some legal systems limit the objects of ownership to tangible assets while others extend it to intangible assets.[49] The legal systems of the former type would encounter the same difficulties as experienced under Japanese law. The foregoing

accordance with the terms of the trusts; (ii) in consultation among the beneficiaries of the trusts … ; and (iii) by a decision of the trustee where it is reasonable to consider that the division is necessary in order to achieve the purpose of each trust and it is clear that the division will not harm the interest of the beneficiaries or where there are justifiable grounds for the division in the light of, *inter alia*, the impact it may have on the trust properties, the purpose and manner of the division, and the actual relationships of the trustee with the beneficiaries. (4) In the case falling within the preceding paragraph, if no agreement is reached through consultation under subparagraph (ii) and in no other manners provided by the other subparagraphs is the division possible, the beneficiary of each trust … may submit a petition to the court for the division of the asset subject to the shared interests."

47 *eg* an *action en revendication* in French law, *Herausgabeanspruch* in German law (par 985 of the German *BGB* (Civil Code)) and *Eigenthumsklage* in Austrian law (par 366 of the Austrian *ABGB* (General Civil Code)).

48 *eg* the law of South Africa. See Van der Merwe & Du Plessis (eds) *Introduction to the Law of South Africa* (2004) 218 [CG der Merwe].

49 Akkermans classifies German and Dutch law into the former category, and French law into the latter ("Property law" in Hage & Akkermans (eds) *Introduction to Law* (2014) 71 78). Von Bar and Drobnig add Greek law to the former camp and the law of Portugal, Italy, Austria, Belgium, Spain, and Sweden to the latter (*The Interaction of Contract Law and Tort and Property Law in Europe A Comparative Study* (2004) 317).

analysis under Japanese law would accordingly be of particular relevance to such legal systems. Even in the legal systems which do not limit the objects of ownership to tangible assets,[50] not all intangible assets will qualify as an object. So it will be necessary to consider whether cryptocurrencies can be an object of ownership. Under Austrian law, for example, the General Civil Code defines *Sachen* (things) broadly[51] but it is understood that assets must have the attribute of controllability (*Beherrschbarkeit*) to qualify as *Sachen*. It has been observed that the controllability of cryptocurrencies is evident because the transfer of cryptocurrencies to another address would be impossible without the knowledge of the private key. On that reasoning, it has been suggested that cryptocurrencies can be classified as *Sachen.*[52] This reasoning has a familiar ring to it as a similar question, whether cryptocurrencies are amenable to exclusive control, has been considered in the foregoing analysis under Japanese law.

Whatever the technicality involved in each legal system, cryptocurrencies would be a latest addition to the list of new assets which challenge the conventional boundary of assets deemed to qualify as the objects of ownership. Other such assets include domain names, wireless networks, carbon emissions allowances and data. Such assets have been compelling the law makers of each State to consider *de lege ferenda* (with a view to the future law) whether and how their legal systems should embrace them. Broadening the qualifying assets would cause friction with *numerus clausus*, a principle which says that there shall be no property rights other than those prescribed by legislation.[53] Where necessary, however, the law will evolve to accommodate new assets. The law of Luxembourg, for example, has been amended to allow proprietary restitution of data stored in a cloud computing service in the event that the service provider goes into bankruptcy.[54]

The second issue which will be confronted is whether the cryptocurrencies entrusted to an exchange provider by its customers belong to the latter. Under many legal systems, the rules for the assignment of cryptocurrencies would be

[50] The English word "ownership" is fitting in this context as it covers both tangible and intangible assets. Thus, it is not uncommon to speak of the "ownership" of an intellectual property right.

[51] Par 285 of the *Allgemeines bürgerliches Gesetzbuch* (General Civil Code) provides: "Alles, was von der Person unterschieden ist, und zum Gebrauche der Menschen dient, wird im rechtlichen Sinne eine Sache genannt (Everything which is distinct from a human and serves the use of men is called a thing in the legal sense)."

[52] Völkel "Privatrechtliche Einordnung virtueller Währungen" (2017) 6 Österreichische Bankwissenschaftliche Gesellschaft 385 387.

[53] In Japanese law, it is enshrined in article 175 of the Civil Code, which provides: "No property rights may be created other than those prescribed by this Code or other legislation."

[54] This result would be derived from article 567(2) of the Luxembourg Commercial Code, which provides: "Les biens meubles incorporels non fongibles en possession du failli ou détenus par lui peuvent être revendiqués par celui qui les a confiés au failli ou par leur propriétaire, à condition qu'ils soient séparables de tous autres biens meubles incorporels non fongibles au moment de l'ouverture de la procedure … (Non-fungible intangible movable assets in the bankrupt's possession or detention may be recovered by the person who has entrusted them to the bankrupt or by their owner, provided that they are separable from all other non-fungible intangible movable asset at the time of opening of the proceedings …)." See also Avis du Conseil d'Etat, No 49.937 (12 March 2013).

unclear. As noted in the foregoing analysis under Japanese law, it will often be reasonable to draw an analogy with the rules for the assignment of tangible assets or other intangible assets. Thus, under Austrian law, it has been suggested, by drawing an analogy with the rules for tangible assets, that an assignment of cryptocurrencies would not take effect unless they have been transferred to a new blockchain address under the sole control of the assignee.[55]

The third issue which will be confronted is how the rules for assigning cryptocurrencies are to be applied to the cryptocurrencies entrusted to an exchange provider by its customers. Here, it will be essential to analyse the legal relationships between the exchange provider and its customers. This analysis must be no different from that conducted under Japanese law.

4.2 *Tort of conversion*

For a number of legal systems, notably those of the common law tradition, *rei vindicatio* is an alien concept.[56] In such legal systems, the gap of the missing *vindicatio* may be filled by the tort of conversion.[57] It protects the claimant's right to possession of property.[58] The courts have discretion to order the converted property to be returned to the claimant.[59] This discretion may be exercised, in the event of the defendant's bankruptcy, to allow recovery from the bankruptcy estate.[60]

It has been long debated what intangible assets can be classified as "property" subject to conversion.[61] A line of cases has dealt with assets like contractual rights,[62] information comprising a database,[63] domain names[64] and carbon emissions allowances.[65] In English law, an asset must "be definable, identifiable by third parties, capable in its nature of assumption by third parties and have some degree of permanence or stability"[66] before it can be admitted into the category of "property." In the United States, according to the Court of Appeals for the Ninth Circuit, "property" must be an interest capable of precise definition and of exclusive possession or control.[67]

55 Völkel (n 52) 388.

56 In the English common law, for example, a demand in court which consists in the direct assertion of ownership is not available: See Burrows (ed) *English Private Law* (3 ed 2013) par 17.304 [Donal Nolan & John Davies].

57 *ibid* par 17.309.

58 See Calnan *Proprietary Rights and Insolvency* (2 ed 2016) par 2.132.

59 subsections (2)(a) and (3)(b) of s 3 of the Torts (Interference with Goods) Act 1977.

60 See Calnan (n 58) par 2.108.

61 *eg* Palmer & Kohler "Information as property" in Palmer & McKendrick (eds) *Interests in Goods* (2 ed 1998) 3; Green "The subject matter of conversion" [2010] *JBL* 218 225.

62 *OBG v Allan* [2007] UKHL 21 (English House of Lords).

63 *Your Response Limited* [2014] EWCA Civ 281 (English Court of Appeal).

64 *Kremen v Cohen* 337 F 3d 1024 (2003) (US Court of Appeals for the Ninth Circuit).

65 *Armstrong DLW GmbH v Winnington Networks Ltd* [2013] Ch 156 (English High Court).

66 *National Provincial Bank v Ainsworth* [1965] 1 AC 1175, 1247 (English House of Lords).

67 *Kremen v Cohen* (n 64). The Court also required that the putative owner had established a legitimate claim to exclusivity. But this requirement seems more related to the question of who is the owner than to the question of what are the essential attributes of "property."

Whether cryptocurrencies are "property" has already been a subject of academic discourse for several years.[68] In applying the relevant tests for "property," the foregoing analysis under Japanese law on whether cryptocurrencies are amenable to exclusive control will be informative to the extent similar elements exist in the tests.

4.3 *Trusts*

Historically, the trust is an institution which has been developed in the legal systems of the common law tradition. But a similar institution has been embraced by Japanese law[69] and some other legal systems of the civil law tradition[70] as well as some legal systems of mixed traditions.[71]

The bottom line seems to be shared by all such legal systems: Assets belonging to trust property are shielded from the trustee's bankruptcy.[72] The foregoing analysis of trusts under Japanese law may, therefore, shed some light where trusts are invoked in other legal systems to address the question whether cryptocurrencies entrusted to an exchange provider by its customers are shielded from the provider's bankruptcy.

Care should, however, be taken not to underestimate the differences in the underlying theories of trusts law between the common law and civil law traditions. In the common law systems, where the claimant can show that he has an equitable proprietary interest in an asset that is in the possession of the defendant, the court may declare that the asset is held on trust for the claimant and order the defendant to transfer the asset in specie to the claimant.[73] Equitable proprietary interests are created by the maxim "equitable treats as done what ought to be done", whereas legal proprietary interests can only be derived from the owner. The distinction between equitable and legal proprietary interests is alien to Japanese law and other legal systems of the civil law tradition. These legal systems adopt a unitary concept of ownership, that is an ownership which cannot be divided between equitable and legal proprietary interests.

[68] *eg* Bayern, "Dynamic common law and technological change: The classification of Bitcoin" 71 *Wash & Lee L Rev Online* (2014) 22; Fairfield, "BitProperty" 2015 *S Cal L Rev* 805; Lavy & Khoo, "Who owns blockchains? An English legal analysis" (http://sclbc.zehuti.co.uk/site.aspx?i=ed47875) (2016); Hurich "The virtual is real: An argument for characterizing bitcoins as private property" 2016 *BFLR* 573; Perkins & Enwezor, "The legal aspect of virtual currencies" 2016 *JIBFL* 569.

[69] The history goes back over a century to the enactment in 1905 of the Secured Corporate Bond Trusts Act (*Tanpo-tsuki Shasai Shintaku Hô*).

[70] *eg* France introduced in 2007 the concept of *fiducie* (Titre XIV of the Civil Code), which is structurally a trust.

[71] *eg* the law of South Africa. See Van der Merwe & Du Plessis (n 48) 187 [MJ de Waal].

[72] See, *eg,* s 283(3)(a) of the United Kingdom Insolvency Act 1986; article 2024 of the French Civil Code; article 25(1) of the Japanese Trusts Act (for the text, see n 20 *supra*).

[73] See, *eg, Boscawen v Bajwa* [1996] 1 WLR 328 335 (English Court of Appeal); *Giumelli v Giumelli* (1999) 196 CLR 101 par 3 (High Court of Australia).

In English law, equitable proprietary interests can be created over intangible assets[74] and, therefore, it is probable that cryptocurrencies can be held on trust.[75] Despite the difference in the underlying theories of trusts law, it has been seen in the foregoing analysis that cryptocurrencies can also constitute trust property under Japanese law.

In some legal systems of the common law tradition, an equitable proprietary interest may be imposed by law to create a constructive trust. It will be a difficult question whether the provider of a cryptocurrency exchange is deemed to hold the cryptocurrencies entrusted to it by its customers on trust for the customers. In Japanese law, there is no statutory basis for constructive trusts. That is why the foregoing analysis under Japanese law has focused on the creation of a trust by a trust agreement inferred from the circumstances. That analysis may be useful to other legal systems which allow a trust to be created by an agreement inferred from the circumstances. But its relevance to constructive trusts would be limited since imposing an equitable interest is not the same as inferring an agreement to create a trust.

5 Conclusion

Where the provider of a cryptocurrency exchange goes into bankruptcy, whether the cryptocurrencies entrusted to it by its customers should be shielded from the bankruptcy might be seen first and foremost as a policy question. But the policy hangs in the balance as it is a contest between the interests of two innocent groups of parties, namely the customers who have entrusted their cryptocurrencies and the general creditors of the exchange provider. On the one hand, the customers have a greater stake in the cryptocurrencies they have entrusted than do the general creditors. On the other hand, the customers may be deemed to have taken the risk of the exchange provider's bankruptcy since the custody of cryptocurrencies is a risky operation which attracts many hacking attacks.

Since the policy consideration is indecisive, this article has focused on the legal principles. It has first examined the law of Japan, a country in which the matter has been actually litigated. Where an exchange provider goes into bankruptcy, the most obvious remedy the customers would seek is proprietary restitution. The foregoing analysis has, however, revealed that this remedy is fraught with difficulties. Firstly, while proprietary restitution is typically based on ownership, there is a ruling of the Tokyo District Court holding that cryptocurrencies, being intangible, cannot be an object of *shoyûken*, the Japanese-law concept of ownership. In the foregoing analysis, it has been argued that proprietary restitution should still be possible with respect to the type of intangible assets which are amenable to exclusive control. The second hurdle is put up again by the same court which expressed the view that cryptocurrencies were not amenable to exclusive control. The foregoing analysis has sought to

[74] Calnan (n 58) par 2.69 and 5.42.

[75] For the same view, see Lavy & Khoo (n 68).

demonstrate that this view is not well founded. The third hurdle lies in arguing that the cryptocurrencies entrusted to an exchange provider by its customers belong to the customer rather than the provider. But the foregoing analysis has shown that this argument cannot be supported. It has accordingly been concluded, in the final analysis, that the customers would not be entitled to proprietary restitution.

A more promising avenue for the customers would be to rely on the principle of trusts, according to which trust property is shielded from the trustee's bankruptcy. If it can be argued that the provider of a cryptocurrency exchange holds the cryptocurrencies entrusted by its customers on trust for the latter, those cryptocurrencies will be shielded from the provider's bankruptcy. The fact that cryptocurrencies are intangible does not disqualify them as assets comprising trust property. It will, however, be difficult to figure out whether a trust agreement can be inferred from the relationships between an exchange provider and its customers. The foregoing analysis has suggested that where the exchange provider is registered in Japan, the regulatory requirements which must be complied with are conducive to inferring a trust agreement. Once a trust is created, the exchange provider would be subject to a range of duties as a trustee, such as the duty to avoid conflicts of interest and the duty to segregate trust property from his own property and any other trust property he administers. It has been observed above that those duties are not incompatible with the *modus operandi* of exchange providers even if they act as a counter-party to exchange transactions with their customers and even if, as is usually the case, they commingle cryptocurrencies entrusted by different customers in the same blockchain address.

After conducting an analysis under Japanese law, this article has proceeded to examine its relevance to other legal systems. It has focused on *rei vindicatio*, tort of conversion and trusts as these are likely to be invoked by the customers of a cryptocurrency exchange when they argue that the cryptocurrencies they have entrusted to the exchange provider are shielded from the provider's bankruptcy. Despite significant differences which exist among different legal systems, many similar issues will be encountered, on which the analysis under Japanese law will shed useful light. Thus, the tort of conversion may exist in legal systems to which *rei vindicatio* is not known. But they both give rise to similar issues, namely the issue whether cryptocurrencies can be classified as "property" subject to conversion and the issue whether cryptocurrencies can be an object of ownership. On these issues, the analysis under Japanese law on whether cryptocurrencies can be an object of *shoyûken* and whether they are amenable to exclusive control may be informative. Again, the analysis of trusts under Japanese law may be useful to other legal systems which have the institution of trusts. Under each such legal system, similar issues will arise such as whether cryptocurrencies can comprise trust property and in what circumstances an exchange provider holds the cryptocurrencies entrusted to it by its customers on trust for the latter. Care should, however, be taken not to transpose the conclusions under Japanese law unquestioningly to legal systems of the common law tradition because the underlying theories of trusts law are different.

Given the high frequency of hacking attacks to cryptocurrency exchanges and the large size of heists, the question whether the cryptocurrencies entrusted to an exchange provider by its customers are shielded from the provider's bankruptcy is a question of practical significance. Notwithstanding that, the answer seems unclear in most legal systems. This article has sought to improve legal clarity by presenting an analytical framework, identifying issues, and pointing to possible solutions. It has also highlighted the similarities and differences between different legal systems. It should, however, be noted that even if analysis and solution in each legal system have been clarified, as long as they differ from one legal system to another, the question of conflict of laws cannot be avoided. It is a question which is not addressed in this article but calls for discussions because here, too, there is much uncertainty.[76]

[76] For a discussion in a somewhat broader context, see Takahashi "Implications of the blockchain technology for the UNCITRAL works" in United Nations Commission on International Trade Law *(ed) Modernizing International Trade Law to Support Innovation and Sustainable Development* (United Nations 2017) 81 91.

Income tax and value-added tax implications of cryptocurrencies in South Africa

THABO LEGWAILA*

Abstract

The advent of cryptocurrencies brought to light and had the effect of changing not only the way people think of business, but also the way business transactions are conducted. Tax policy makers, administrators and practitioners worldwide have reactively considered the tax implications of cryptocurrency transactions. Some governments and tax authorities have made announcements on the tax treatment of cryptocurrency in their jurisdictions. South Africa has also followed suit with such pronouncements. The basic consideration of this contribution is whether the current South African tax dispensation caters sufficiently for cryptocurrencies or whether legislative changes are required. The author finds that the general principles applicable to gross income, the general deductions formula and capital gains tax apply to cryptocurrencies, and, furthermore, that the value-added tax, properly applied would provide adequate and equitable application to cryptocurrencies, thereby giving effect to the intention and rationale behind the value added tax system. The author warns against tax evasion brought about by the lure of the cryptic nature of cryptocurrencies.

* * * * *

1 Introduction

Tax laws develop with business practices, economic traits and other contemporary developments. Because taxes are applicable to existing and not future practices, the development of tax law is reactive in nature. Even if an attempt were to be made to legislate proactively, such legislation be speculative, which would result in wasted resources should the expected practices not materialise. It is, however, important that tax laws apply to contemporary, and new and innovative practices alike that should, as a matter of tax policy, fall within the tax net. One of the ways of ensuring this is that tax laws are crafted in a manner that would cover all aspects that fall within the tax policy ambit. General provisions in this regard are preferred over specific provisions. However, if a particular ground-breaking situation or transaction is not catered for or falls outside of the tax net when it should fall within, new avenues of taxation may be necessary to extend the net to cover those exigencies. Alternatively, the current and existing provisions could be extended, legislatively or by interpretation to cover those situations.

Cryptocurrencies are perhaps the best recent example of a development resulting in tax authorities, policy makers and taxpayers alike wondering whether the current laws are adequate, whether new avenues of taxation

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are required, or whether the current ones should be extended by legislative amendments or interpretative tools. This presents a good opportunity to review a country's basic tax law to determine whether it is wide, robust and resilient enough to apply to new unexpected developments in business practices and economic traits. This contribution looks at the South African income tax regime to determine how, if at all, it treats cryptocurrencies.

2 Background understanding of cryptocurrencies

Cryptocurrency (cryptocurrencies in plural) is a new term that was only added to the *Meriam Webster Dictionary* in March 2018 as meaning:[1]

> "any form of currency that only exists digitally, that usually has no central issuing or regulating authority but instead uses a decentralized system to record transactions and manage the issuance of new units, and that relies on cryptography to prevent counterfeiting and fraudulent transactions".

A cryptocurrency is a digital asset[2] that is designed to work as a medium of exchange and that uses cryptography to secure financial transactions, control the creation of additional units, and verify the transfer of assets. Cryptocurrency is a kind of digital currency, virtual currency or alternative currency. The European Central Bank does not regard virtual currencies as full forms of money as defined in economic literature.[3] Virtual currency is also not money or currency from a legal perspective. Instead it is defined as "a digital representation of value, not issued by a central bank, credit institution or e-money institution, which in some circumstances, can be used as an alternative to money".[4] Virtual currency is therefore digital currency that is denominated in its own units of value or with decentralized or automatic issuance.[5]

Digital currency on the other hand is an asset represented in digital form and having some monetary characteristics. Digital currency can be denominated in a sovereign currency and issued by the issuer responsible to redeem digital money for cash. In such case, digital currency represents electronic money (e-money).[6] Cryptocurrencies use decentralized control, as opposed to

[1] *Meriam Webster Dictionary* definition of "cryptocurrency" https://www.merriam-webster.com/dictionary/cryptocurrency (accessed on 03 July 2018).

[2] The term "digital asset", of course, does not clarify the legal nature of cryptocurrencies. This is a complex issue involving questions such as whether this form of property amounts to a personal right (and if so, against whom), or a quasi real right (extending the boundaries of things to digital things), or whether digital assets should be recognised as a new type of legal object. These type of questions fall outside the ambit of this paper, and, it is suggested, do not impact on the tax issues dealt with here. Some questions relating to the nature of cryptocurrencies are explored by Spruyt "An assessment of the emergent functions of virtual currencies" 2018 *TSAR* 707 [**Editorial note**: see also the contribution of Takahashi (1 *et seq* above) who visits, *inter alia*, the question whether the "owner" of units of a cryptocurrency may have a *rei vindicatio*.]

[3] European Central Bank *Virtual Currency Schemes – A Further Analysis* (2015) 4.

[4] European Central Bank (n 3) 4.

[5] Bank for International Settlements *Digital Currencies* (2015) 3.

[6] *ibid.*

centralized electronic money and central banking systems. The decentralized control of each cryptocurrency works through distributed ledger technology (typically a blockchain), that serves as a public financial transaction database. According to Lansky, a cryptocurrency is a system that meets six conditions:[7]

> "1. The system does not require a central authority, distributed achieve consensus on its state [sic].
>
> 2. The system keeps an overview of cryptocurrency units and their ownership.
>
> 3. The system defines whether new cryptocurrency units can be created. If new cryptocurrency units can be created, the system defines the circumstances of their origin and how to determine the ownership of these new units.
>
> 4. Ownership of cryptocurrency units can be proved exclusively cryptographically.
>
> 5. The system allows transactions to be performed in which ownership of the cryptographic units is changed. A transaction statement can only be issued by an entity proving the current ownership of these units.
>
> 6. If two different instructions for changing the ownership of the same cryptographic units are simultaneously entered, the system performs at most one of them."

The functional characteristics of a cryptocurrency are as follows: (i) you can trade and invest in it; (ii) you can use it for transactions (anywhere a coin type is accepted); or (iii) you can break out a graphics processing unit and some software and mine coins.[8] Compared to ordinary currencies held by financial institutions or kept as cash on hand, it may also be more difficult for law enforcers to seize cryptocurrencies due to the complex cryptographic technology involved.

3 Income tax legislative application

3.1 *Gross income*

The starting point in determining the income tax of any person is section 5 of the Income Tax Act (the Act)[9] which provides for the annual payment of income tax in respect of the taxable income received by or accrued to or in favour of any person. Determining the taxable income of a person is prescribed by definitions of "taxable income" which is an amount remaining after allowable deductions from the income of that person. Income is also defined in section 1 as the amount remaining after deducting exempt amounts from gross income. Principles that underlie the basis of taxation in South Africa are laid out in the definition of gross income which makes a distinction between the basis

[7] Lansky "Possible state approaches to cryptocurrencies" (January 2018) *Journal of Systems Integration* 19–31.

[8] "Mining" is the validation of transactions by solving complex mathematical problems. See in this regard Spruyt (n 2) …. See further "How to trade cryptocurrencies – for beginners" https://cryptocurrencyfacts.com/how-to-trade-cryptocurrency-for-beginners/ (02 July 2018).

[9] 58 of 1962. Any references to "section" or "s" in this article refer to sections of the Act, unless expressly stated, or the context indicates otherwise.

of taxation applied to residents and that applied to non-residents.[10] "Gross income" is defined in section 1 as follows:

> "'gross income' in relation to any year or period of assessment, means –
>
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature…"

The definition proceeds to include certain specific amounts that would otherwise be excluded from the definition because of the difficulty in establishing some of the elements of the definition where the legislature thought it proper that such amounts should form part of gross income.

Residence and source

Residents are taxable on their worldwide income while non-residents are taxable on their South African sourced income. [11] A natural person is resident in South Africa if he or she is ordinarily resident in South Africa[12] or passes the physical presence test of residence in South Africa.[13] A company is resident if it is incorporated, established or formed in South Africa or has its place of effective management in South Africa.[14] Income is sourced in South Africa if the originating cause of the income being received is located in South Africa.[15]

The position of a resident receiving income from a transaction involving cryptocurrencies creates no principal challenges. Such person is liable to tax in South Africa, regardless of where the income arises from. However, with

[10] See Oguttu "Ensuing a right balance in applying the residence and source bases of taxation" in Hatting *et al* (ed) *Income Tax in South Africa – The First 100 Years* 1914 – 2014; Stiglingh *et al Silke: South African Income Tax* (2017) 1 – 2.

[11] See s 1: definition of "resident".

[12] See *Levene v IRC* 1928 AC 217; *Cohen v CIR* 1946 AD 174; *CIR v Kuttel* 1992 3 SA 242 (A).

[13] See Croome *et al Tax Law: An Introduction* (2013) 30 – 31.

[14] The Act does not provide a definition of place of effective management but takes cognizance of the guidance provided by the Organization for Economic Co-Operation and Development (OECD) and its commentaries. See a 4(3) of the OECD Model Convention on Income and on Capital (2008); *SIR v Downing* 1975 4 SA 518 (A); Olivier and Honiball *International Tax: A South African Perspective* (2011) 25 – 42; Van der Merwe "The phrase 'place of effective management' effectively explained" 2006 *SA Merc LJ* 121 124 – 125. Oguttu and Tladi "E-commerce: A critique on the determination of a 'permanent establishment' for income tax purposes from a South African perspective" 2009 *Stell LR* 74; Oguttu "The challenges of taxing profits attributed to a permanent establishment: A South African perspective" *Bulletin for International Taxation* (2010) 64(3) 172 – 200.

[15] See *Rhodesia Metals Ltd (in Liquidation) v COT* 1938 AD 282; *Commissioner for Inland Revenue v Lever Bros* 1946 AD 441 at 450; *CIR v Black* 1957 3 SA 536 (A); *Essential Sterolin Products (Pty) Ltd v CIR* 1993 4 SA 859 (A).

regards to a non-resident, the source of the income has to be determined. In relation to cryptocurrencies being used as a trading currency, it is not where the payment is made that determines the source, but the originating cause, that is the activity giving rise to the payment income being earned. If the originating cause of the payment is in South Africa, then the income will be subject to tax in South Africa. If the cryptocurrency is sold as an object of the sale (the *merx*), the challenge will be determining the country where the cryptocurrency is located when sold. If it is not located in South Africa, then the source of the income is not in South Africa. The cryptic nature of cryptocurrencies may conceal the source of the income including the originating cause of the income. Being virtual money, to determine that it is located in South Africa, or in any other place for that matter, may well be impossible. It is accordingly suggested that the taxing right of South Africa in this regard would be limited to income earned by residents from the sale of cryptocurrencies.

Amount in cash or otherwise

Gross income is the total amount received or accrued, "in cash or otherwise". Thus, it includes not only money, but also the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a monetary value.[16] The court held in *CIR v Delfos*[17] that "[t]he tax is to be assessed on all receipts or accruals having a monetary value. If it is something which has no value in money or cannot be turned into money, it is not to be regarded as income".[18] An amount would fall into gross income (being a tangible asset or an intangible right) if it has an ascertainable money value which can be objectively ascertained.[19] The court held in *CSARS v Brummeria Renaissance (Pty) Ltd*[20] that

> "…the question whether a receipt or accrual in a form other than money has a money value is the primary question and the question whether such receipt or accrual can be turned into money is but one of the ways in which it can be determined whether or not this is the case; in other words, it does not follow that if a receipt or accrual cannot be turned into money, it has no money value. The test is objective, not subjective."

Thus, the court in *Brummeria*, in emphasising the objectivity of the money value, overturned the principle that required the value to be capable of being turned into money, thereby extending the range of values that would fall into the definition of "amount".

Based on the aforegoing, when cryptocurrencies are used as a form of currency, for example as payment, such payment would constitute an amount as it clearly

[16] See *Lategan v CIR* 1926 CPD 203.
[17] 1933 AD 242 251.
[18] See also *Stander v CIR* 1997 3 SA 617 (C).
[19] See Haupt *Notes on South African Income Tax* (2018) 19; see also *Lategan* (n 16) 209.
[20] *Commissioner for the South African Revenue Service v Brummeria Renaissance (Pty) Ltd* 2007 6 SA 601 (SCA) (par 15).

has money value, and can be turned into money, as per the decision in *Stander*, notwithstanding *Brummeria*. This would also be the case if it is used as an exchange item in a barter transaction or like-for-like or other exchange transaction. The value of the cryptocurrency would be determinable objectively. If an amount is received in a form other than money, the amount of gross income is established by ascertaining the market value of the taxpayer's right at the date that the taxpayer becomes entitled to the asset received.[21] Thus, the taxpayer could find himself including a different amount from that agreed on, if there is a fluctuation in the value of the cryptocurrency between the date of agreement and the date of entitlement, as is the case with shares, or similar derivative instruments.

Received by or accrued to…

No liability for income tax can arise unless there is a receipt or an accrual of an amount.[22] De Koker and Urquhart[23] correctly point out that

> "[t]wo inferences may be drawn from the disjunctive particle 'or'. In the first instance, the word 'or' does not confer upon the Commissioner a discretion. Wherever the legislature wants to give the Commissioner a discretion, the Act specifically provides for such a discretion. 'Received by or accrued to' can, therefore mean only that whatever is first in time, is part of gross income."

It goes without saying that the Commissioner may not include the amount in a taxpayer's gross income both when it accrues and when it is received.[24] However, if a taxpayer omits to disclose an amount when it accrues, the Commissioner is entitled to tax it when it is received.[25]

An amount is received by a taxpayer if it was received by the taxpayer for the taxpayer's own benefit. In *Geldenhuys v CIR*[26] the taxpayer was a usufructuary of a flock of sheep which she sold with the permission of the bare *dominium* owner. The court held that although the taxpayer physically received the amount, she received the amount not on behalf of herself but on behalf of the bare *dominium* owner. Thus, where a person receives an amount as an agent or trustee, such amount would not form part of that person's gross income.[27] As in the case of shares or foreign currencies, cryptocurrencies can be traded personally or through a broker or agent. Where a broker receives an amount as an agent, such amount would not form part of that broker's gross income. Such is the case where cryptocurrency is received as proceeds of a sale as in the case of *Geldenhuys*.

21 *Lace Proprietary Mines Ltd v CIR* 1938 AD 267.
22 This rule is subject to some exceptions that deem an amount taxable in a person's hands whether or not the amount was actually received by or accrued to that person in terms of the general rules, for example as provided for in section 7. See De Koker *Silke on South African Tax* (2011) par 2.1 for a list of these exceptions.
23 *Income Tax in South Africa* (2003) 4-17.
24 Haupt (n 19) 20.
25 See *Kotze v KBI* 1992 1 SA 825 (T).
26 *Geldenhuys V CIR* 1947 3 SA 256 (C).
27 See Croome (n 13) 68.

The definition of accrual developed over many years. In 1926 the court in *WH Lategan v CIR* held that an amount accrues to a taxpayer in a year when the taxpayer becomes entitled to it, notwithstanding the fact that it may be payable in a future year. In 1933 it was held *obiter* in *Delfos* that an amount will only accrue once the amount becomes due and payable.[28] In 1972, the Appellate Division in *Mooi v CIR,*[29] held that accrual takes place only when the taxpayer becomes unconditionally entitled to the amount. Thus, an entitlement which is contingent on a future event does not result in an accrual until the event has occurred.[30] It is clear that the determination of the accrual or otherwise of an amount in respect of cryptocurrencies does not depend on the cryptocurrency itself, but the underlying agreement between the parties to the transaction giving rise to the transfer of the cryptocurrency. It should, however, be noted that should the nature, character, logistics or transferability of the cryptocurrency delay or otherwise distort the time of transfer of the cryptocurrency, such delay or distortion would not change the accrual of an amount by the recipient thereof, unless such delay forms part of the conditions of entitlement in the terms of the contract.

Excluding receipts and accruals of a capital nature

The definition of gross income specifically excludes receipts and accruals of a capital nature. "Capital" is not defined in the Act and therefore it has been up to the judiciary to develop the guidelines as to what constitutes capital. In this regard, "capital" that is excluded from gross income is distinguished from "revenue" or "income" that is included in gross income. An amount is either capital or revenue, it cannot be both and it cannot be neither – there is no halfway house between the two.[31] However, apportionment is possible where one amount (having regard to its *quid pro quo*) contains both elements of income and capital that are distinguishable.[32]

In determining the nature of a receipt or accrual, the intention of the taxpayer is of paramount importance. In relation to purchase and sale, the starting point is generally to determine the intention of the taxpayer at the time of the acquisition of the asset, and then to determine whether there has been a change of intention prior to disposal of the asset. If there is no change of intention, then the intention at the acquisition of the asset is decisive.[33] Where

28 (n 17) 260 – 262.
29 1972 1 SA 675 (A)
30 684.
31 See *Tuck v CIR* 1988 3 SA 819 (A).
32 See Croome (n 13) 84; Emslie and Jooste "Causation and the issue of apportionment with reference to gross income in South African income tax law" 1989 *SALJ* 292 304. Croome further states the importance of the principles of evidence in this regard that "[w]hat needs to be emphasized is that, should a capital/revenue dispute between a taxpayer and SARS end up in court, the taxpayer bears the onus to prove on a balance of probabilities that the amount is not of an income nature" (85). This is prescribed in section 12 of the Tax Administration Act 28 of 2011.
33 See *CIR v Stott* 1928 AD 252.

there are mixed intentions, the dominant intention is the decisive intention. Emslie[34] states that

> "[f]actors that are typically taken into account in ascertaining intention include the taxpayer's *ipse dixit*, the length of time an asset is held, the frequency of such transactions, the nature of the taxpayer's business, the existence of an income flow from the holding of the asset (e.g. dividends arising from the holding of shares), and the reason for the disposal of the asset. None of these is decisive, and the paramount test is always the taxpayer's intention."

Capital is what produces revenue. The court in *CIR v Visser*[35] stated that:

> "'[i]ncome' is what 'capital' produces, or is something in the nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principal in the hands of one man may be interest or fruit in the hands of another. Law books in the hands of a lawyer are a capital asset; in the hands of a bookseller they are a trade asset. A farm owned by a farmer is a capital asset; in the hands of a land-jobber it becomes stock-in-trade."

A test that is consistently applied by the courts in determining the capital or revenue is whether the taxpayer received the income or had the income accrue to him as a result of having engaged in a scheme of profit-making. In this regard, Emslie states:

> "This means that receipts and accruals bear the imprint of revenue if they are not fruituitous, but designedly sought for and worked for. Even where a business is carried on, receipts or accruals will only be of a revenue nature if the business was conducted with a profit making purpose, i.e. as part of a profit-making venture or scheme".[36]

Where cryptocurrency is used as a currency, the capital or revenue nature will be determined by the underlying *quid pro quo* for which the amount is paid. The method of payment has no impact on the nature of the receipt or accrual. Where a cryptocurrency is held as an investment asset, two scenarios are conceivable. One is where the taxpayer buys and sells the cryptocurrency for a profit. In this case the income received or accrued from the sale of the cryptocurrency will be of a revenue nature and included in taxable income. Applying the factors as outlined by Emslie, the taxpayer would typically hold the cryptocurrency for short periods, have frequent transactions of that nature, have no income flow from holding the asset and dispose of the asset in order to earn a profit. In the totality of factors, the taxpayer would be engaging in the scheme of profit making. The second scenario is where the taxpayer holds the asset as an investment, where the outcome of the factors above are in the opposite of a scheme of profit making. Where the taxpayer holds the cryptocurrency as a capital asset, the receipts and accruals from the disposal thereof would not form part of gross income. However, this does not mean that the income, amounts or gain derived therefrom would completely escape the tax net. Section 26A of

34 Emslie *et al Income Tax Cases and Materials* (2001) 329.
35 8 SATC 271 276.
36 Emslie (n 34) 180.

the Act includes in the taxable income of a taxpayer taxable capital gain of a taxpayer as determined in terms of the Eighth Schedule to the Act.

Section 9(C)(2) provides a time-based deeming provision in respect of equity shares by providing that "any amount received or accrued (other than a dividend or foreign dividend) or any expenditure incurred in respect of an equity share must be deemed to be of a capital nature if that equity share had, at the time of the receipt or accrual of that amount or incurral of that expenditure, been held for a period of at least three years." Based on the similarities in character to equity in instances where cryptocurrency is held as an investment, National Treasury should consider whether it would not be equitable and administratively feasible if the time-based deeming provision were extended to apply to cryptocurrencies.

3.2 *Capital gains tax*

Capital gains tax (CGT) is not a separate tax. It is part of income tax. The taxable capital gain is included in a taxpayer's taxable income and taxed at the rates applicable to that taxpayer. The essential elements for the application of CGT are (i) there must be an asset; (ii) it must be disposed of; (iii) the base cost should be determined; and (iv) the proceeds of the disposal should be determined. Asset is defined in para 1 of the Eighth Schedule[37] to include "(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and (b) a right or interest of whatever nature to or in such property".

At the very least, cryptocurrency is property of a incorporeal nature. The question is whether it is a currency, such that it would be excluded from the definition of asset. Currency is not defined anywhere in the Act, including in the Eighth Schedule. There are instead definitions of "local currency" and "foreign currency". It is a trite rule of interpretation that where a word used in legislation is not defined in that piece of legislation, the ordinary meaning of that word is applied. According to the *Meriam Webster Dictionary* currency is "circulation as a medium of exchange".[38] According to the *Oxford Dictionary* currency is "a system of money in general use in a particular country".[39] Based on these basic definitions, the fact that cryptocurrencies are a medium of exchange, and that they are said to be in general use in South Africa, cryptocurrency is a currency in South Africa. The use of "any" in the exclusion of currency in the definition of asset, it is suggested, seeks to capture a broad range of currencies.

The South African Revenue Service's (SARS's) position is that cryptocurrencies are "neither official South African tender nor widely used and accepted in South Africa as a medium of payment or exchange. As such, cryptocurrencies

[37] All references to "paragraph" or "par" in this section dealing with CGT are references to paragraphs of the Eighth Schedule unless stated otherwise or the context indicates otherwise.

[38] https://www.merriam-webster.com/dictionary/currency (30 June 2018).

[39] https://en.oxforddictionaries.com/definition/currency (30 June 2018).

are not regarded by SARS as a currency for income tax purposes or capital gains tax (CGT). Instead, cryptocurrencies are regarded by SARS as assets of an intangible nature".[40] SARS offers no explanation as to its conclusions on this aspect.[41] The South African Reserve Bank's (SARB's) position with regards to cryptocurrencies is that they are not recognised as legal tender in South Africa and any merchant or beneficiary may refuse cryptocurrencies as a means of payment. SARB states that cryptocurrencies are not guaranteed or backed by SARB as cryptocurrencies operate independently from the central bank. The SARB further alerts the users to the potential risk of fluctuation in its value and that there are currently no specific laws or regulations that govern the use of cryptocurrencies in South Africa.[42]

Other countries pronounced their tax treatment of cryptocurrencies differently and in line with their current practices. The Australian Tax Office (ATO) recognises cryptocurrency as a means of exchange. In its guidance on cryptocurrencies on its website, ATO advises that if "you are involved in acquiring or disposing of cryptocurrency, you need to be aware of the tax consequences. These vary depending on the nature of your circumstances."[43] ATO provides for instances where cryptocurrency could be used in the following instances: in exchange for other cryptocurrency, as an investment, losses or theft of cryptocurrencies and chain splits. ATO states that the general tax implications apply to cryptocurrency transactions.[44]

In the United Kingdom on the other hand Her Majesty's Revenue and Customs (HMRC) states its position on the tax treatment of income received from, and charges made in connection with, activities involving Bitcoin and other similar cryptocurrencies, specifically for VAT, income tax for individuals and corporates as well as capital gains tax. HMRC states that "[a]s with any other activity, whether the treatment of income received from, and charges made in connection with, activities involving Bitcoin and other similar cryptocurrencies will be subject to CT, IT or CGT depends on the activities and the parties involved."[45]

40 SARS "SARS' stance in the tax treatment of cryptocurrencies" (6 April 2018) http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx (3 July 2018).

41 One wonders whether SARS would still not recognise cryptocurrencies as foreign currencies if the other country with which a South African trades recognises it as a currency.

42 www.resbank.co.za/RegulatonAndSupervision (3 July 2018).

43 Australian Tax Office "Transacting with cryptocurrency" (2018) https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia---specifically-bitcoin/?page=2#Exchanging_a_cryptocurrency_for_another_cryptocurrency (3 July 2018).

44 https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia---specifically-bitcoin/?page=2#Exchanging_a_cryptocurrency_for_another_cryptocurrency (3 July 2018).

45 "HM revenue and customs tax treatment of income received from bitcoin and other cryptocurrencies" *Revenue & Customs Brief* 9/2014 https://www.gov.uk/government/publications/revenue-and-customs-brief-9-2014-bitcoin-and-other-cryptocurrencies (4 July 2018); Needham "Tax treatment of cryptocurrencies" (2018) Taxation https://www.taxation.co.uk/Articles/2018/02/06/337578/tax-treatment-cryptocurrencies (12 August 2018)

In the United States, cryptocurrency is generally treated as property (a capital asset like stocks, bonds, and other investment properties). It is not treated as currency like the US dollar. That means it is treated like real estate or gold in most cases, and thus it is subject to the short and long-term capital gains tax in most cases when held for investment. If it is used for transactions, as an individual or business, then other tax rules apply.[46] "Essentially, anything other than buying, holding, or transferring a cryptocurrency is a taxable event (meaning you realize capital gains and losses at fair market value at the time of the event when you trade, sell, or use crypto)."[47]

Suppose SARS' position is prospectively viable and sustained, that would mean that where cryptocurrency is disposed of by a taxpayer CGT is triggered, as the definition of asset includes an asset of an intangible nature. Perhaps SARS' position is in order that cryptocurrencies are subject to CGT, on the basis that if they are of a capital nature and therefore not subject to tax on a revenue basis, they would escape the CGT net. Disposal is defined widely, as any action that results in alienation of or change in an asset would qualify as a disposal.[48] The capital gain would be determined by deducting the base cost of the cryptocurrency from the proceeds derived from the disposal. Base cost is mainly the expenditure incurred in respect of the cost of acquisition or creation of the asset, thus the cost of the cryptocurrency to the taxpayer.[49] Proceeds is the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of a taxpayer in respect of a disposal of an asset.[50] CGT is leviable on residents. Non-residents are subject to CGT only on disposals of

[46] Department of the Treasury and Internal Revenue Service "Sales and dispositions of assets" (Publication 544 2017) https://www.irs.gov/pub/irs-pdf/p544.pdf (4 July 2018); IRS Notice 2014/21 https://www.irs.gov/pub/irs-drop/n-14-21.pdf (4 July 2018).

[47] Basics of cryptocurrencies and taxes https://cryptocurrencyfacts.com/the-basics-of-cryptocurrencies-and-taxes/ (4 July 2018).

[48] "Disposal" is defined in par 1 as "an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is in terms of this Schedule treated as the disposal of an asset, and 'dispose' must be construed accordingly". The paragraph 11 definition of disposal states that "a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes –

(a) the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;
(b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;
(c) the scrapping, loss, or destruction of an asset;
(d) the vesting of an interest in an asset of a trust in a beneficiary;
(e) the distribution of an asset by a company to a holder of shares;
(f) the granting, renewal, extension or exercise of an option; or
(g) the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement."

[49] See Part V of the Eighth Schedule.

[50] See par 35.

"(i) immovable property situated in the Republic held by that person or any interest or right of whatever nature of that person to or in immovable property situated in the Republic including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources; or

(ii) any asset effectively connected with a permanent establishment of that person in the Republic."[51]

An interest in immovable property situated in the Republic includes

> "any equity shares held by a person in a company or ownership or the right to ownership of a person in any other entity or a vested interest of a person in any assets of any trust, if –
>
> (a) 80 per cent or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock; and
>
> (b) in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20 per cent of the equity shares in that company or ownership or right to ownership of that other entity."[52]

The value of cryptocurrencies is independent, and not derived from anything. Therefore, one cannot say that the earnings from the disposal of cryptocurrency by a non-resident could ever be attributable to immovable property in South Africa. This concludes the fact that for non-residents, the source rules in relation to revenue and in relation to capital gains do not create a tax nexus with South Africa.

3.3 *Foreign exchange gains and losses*

Accepting that cryptocurrencies are a currency for South African purposes, gains and losses may be made in the foreign exchange differences where the currency involved is a foreign, and not a local currency. In this regard section 24I(3)(a) provides that in determining the taxable income of any person, there shall be included in or deducted from the income, as the case may be, of that person any exchange difference in respect of an exchange item of or in relation to that person.[53] "Exchange item of or in relation to a person" is an amount

[51] par 2(1) of the Eighth Schedule.

[52] par 2(2) of the Eighth Schedule.

[53] This section is subject to subsection 10A which relates to the calculation of an exchange difference. In terms of section 24I(2), the provisions of section 24I(3)(a) only apply "in respect of any –

(a) company;
(b) trust carrying on any trade;
(c) natural person who holds any amount contemplated in paragraph (a) or (b) of the definition of 'exchange item' as trading stock; and
(d) natural person or trust in respect of any amount contemplated in paragraph (c) or (d) of the definition of 'exchange item':

in a foreign currency which constitutes any unit of currency acquired and not disposed of by that person.[54] "Foreign currency in relation to any exchange item of a person", means any currency which is not local currency.[55] Applying these provisions to the cryptocurrencies means that any gain or loss made on the foreign exchange fluctuations will be included in the income of the taxpayer, or if it is losses, then such losses will be deductible from such income. If the SARS position that cryptocurrencies are not regarded as currency is sustained, then the gains and losses would not be recognised for tax purposes.

4 General deductions

Section 11(a) provides for a general deduction formula in the determination of taxable income as follows:

> "For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived— (*a*) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature."

4.1 *Expenditure and losses*

The requirement that there should be expenditure has been defined by the courts to mean that expenditure is voluntary in nature and losses involuntary.[56] In 2013 the Supreme Court of Appeal in *Commissioner, South African Revenue Service v Labat Africa Ltd* had an opportunity to decide what expenditure meant without direct reference or reliance on the distinction with losses. The court held as follows:[57]

> "The term 'expenditure' is not defined in the Act and since it is an ordinary English word and, unless context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. The Afrikaans text, in using the term 'onkoste', endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended."

With regards to cryptocurrencies, it is important to determine whether the transfer of cryptocurrencies in discharging an obligation to pay would qualify

> Provided that this section does not apply in respect of any exchange item of a person who is not a resident (other than a controlled foreign company), unless that exchange item is attributable to a permanent establishment of that person in the Republic."

[54] s 24I(1): definition of "exchange item".

[55] s 24I(1): definition of "foreign currency".

[56] *Joffe & Co Ltd v CIR* 1946 AD 157.

[57] 2013 2 SA 33 SCA par 12. See also Legwaila "The issue of shares is not expenditure for the purposes of the Income Tax Act: Commissioner, South African Revenue Service v Labat Africa Ltd" 2013 *SA Merc LJ* 318.

as expenditure. Payment by means of cryptocurrencies is an action of spending funds, disbursements or consumption. It entails a reduction of assets or at the very least a movement of assets of the person who expends the funds, as required in the *Labat* case.[58] As regards losses, should a taxpayer involuntarily lose his cryptocurrency or any part thereof, that would qualify as a loss, in the sense of a disbursement of an involuntary nature as was held in *Joffe*.[59]

4.2 *Actually incurred*

The formula further requires that expenditure or losses must be actually incurred and not necessarily incurred or actually paid. It refers to the coming into existence of an absolute and unconditional liability to pay irrespective of the fact that payment may only be made in the future.[60]

The incurral of expenditure is determined by the coming into existence of an unconditional liability. It is not dependent on the item giving rise to the expenditure or loss or how the liability will be discharged or costs defrayed. Therefore, this requirement has no impact on the cryptocurrencies as a means of payment or as a subject of the liability.

4.3 *In the production of income*

Whether expenditure has been incurred in the production of income is determined by examining the act which produces the income and then judging whether the attendant expenditure can be said to be sufficiently close to that act to be regarded as having been incurred in the production of income. Expenditure is regarded as being incurred in the production of income if it is an inevitable concomitant of the taxpayer's income producing operations.[61] The relevant considerations in deciding whether expenditure is incurred in the production of income are the purpose for which expenditure is incurred and what the expenditure actually effects.[62] It is not a requirement that income actually be produced at all. It is sufficient that the expenditure was incurred for the purpose of producing income.[63] It is normal for expenditure to be incurred for purposes of producing income in the current year or future year or years. It is, however, also conceivable that expenditure can be incurred in producing income relating to a previous year of assessment.[64] As Emslie correctly points out in this regard, "[t]here is no 'matching concept' which applies in the calculation of taxable income".[65]

58 Croome (n 13) 133.
59 *Joffe* (n 56).
60 *Caltex Oil (Pty) Ltd v CIR* 1942 CPD 509, 12 SATC 95; *Nasionale Pers BPK v KBI* 1986 3 SA 549 (A); *Edgars Stores Ltd v CIR* 1988 3 SA 876 (A).
61 *Joffe* (n 56).
62 *CIR v Nemojim (Pty) Ltd* 1983 4 SA 935 (A).
63 *Sub-Nigel Ltd v CIR* 1948 4 SA 580 (A).
64 *CIR v Pick 'n Pay Wholesalers (Pty) Ltd* 1987 3 SA 453 (A) 476).
65 Emslie (n 34) 329.

With regards to the closeness of the expenditure to the production of income the court in the leading case of *Port Elizabeth Electric Tramway Co Ltd v CIR*[66] stated as follows:

> "How closely must [the expenses] be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it."

In transactions where cryptocurrency is used as a form of payment, it is the underlying activities of the taxpayer that determine whether the expenditure was incurred in the production of income. However, in the case of a trader in cryptocurrencies, expenditure associated with the purchase of the cryptocurrency would be deductible as incurred in the production of income.

4.4 *Not of a capital nature*

Expenditure of a capital nature is not deductible in terms of section 11(a). The principal test in determining whether expenditure is not of a capital nature is the inquiry whether it should properly be regarded as part of the cost of performing the income-earning operations of the taxpayer, in which case it is not of a capital nature (it is of a revenue nature). If expenditure is to be regarded as part of the cost of establishing or enhancing or adding to the taxpayer's income earning structure or plant or machinery, such expenditure is of a capital nature.[67] Thus, money spent in creating or acquiring an income-producing concern or source of future income is capital expenditure whereas money spent working that source is revenue expenditure.[68]

The requirement that expenditure or losses should not be of a capital nature qualifies the expenditure and not the method or means used, and has no relevance to the method used to discharge that expenditure. Where cryptocurrency is used to acquire a revenue or capital asset, the expenditure will be deductible or not deductible, respectively, based on the intention of the taxpayer, and not the use of cryptocurrencies.

4.5 *Trade requirement*

At the forefront of the general deductions formula is the requirement that a taxpayer should be carrying on a trade. Trade is defined in section 1 as follows:

> "'trade' includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act

66 1936 CPD 241 par 17 – 18.
67 *New State Areas Ltd v CIR* 1946 AD 610.
68 *CIR v George Forest Timber Co Ltd* 1924 AD 516.

> or any copyright as defined in the Copyright Act or any other property which is of a similar nature."

The negative test of trade is contained in section 23(g) that prohibits a taxpayer from claiming deductions in respect of "any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade". While previously expenditure that was not incurred "wholly and exclusively for the purposes of trade" was not deductible, section 20 of the Income Tax Act 141 of 1992 amended the Act to allow for an apportionment of expenditure and losses incurred partly for purposes of trade and partly for non-trade purposes. The Act does not provide any method of apportionment.[69] If a taxpayer can establish a reasonable basis for apportionment, Emslie submits, he would have succeeded in discharging the burden of proof as far as the issue of apportionment is concerned.[70]

The courts have held in particular circumstances that expenditure incurred for the following items was not incurred for purposes of trade: a holiday;[71] philanthropy;[72] the absence in certain circumstances of a profit motive;[73] the purpose of providing a benefit to group companies;[74] and excessive remuneration.[75] Thus, in applying section 23(g) to dual-purpose expenditure, a taxpayer must establish what portion of expenditure was incurred for purposes of trade, which would then be deductible, leaving the balance not deductible because of failing the negative trade test. In this regard, a person who invests in cryptocurrencies and then sells them, without any active trading activity, would not be allowed a deduction as that person would not satisfy the trade requirement. However, a person who buys and sells in the carrying on of a trade would be allowed a deduction to the extent that such expenditure was incurred for purposes of trade.

5 Value-added tax

Value-added tax (VAT) is a tax levied on the value added by each vendor in the production or distribution chain and is imposed each time a taxable supply[76] of

69 Emslie (n 34) 405.
70 405.
71 ITC 734 (18 SATC 202).
72 *CIR v Pick 'n Pay Wholesalers (Pty) Ltd* 1987 3 SA 453 (A).
73 *De Beers Holdings (Pty) Ltd* 1986 1 SA 8 (A).
74 *Solaglass Finance Co (Pty) Ltd v CIR* 1991 2 SA 257 (A).
75 *Case no 9610* 1998 5 JTLR 132.
76 "Supply" ordinarily means to provide, or make available. However the VAT Act expands this definition to cover performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected. The definition states that any derivative of "supply" shall be construed accordingly. See s 1: definition of "supply".

goods[77] or services[78] takes place. It is levied on the supply of goods and services by a vendor of goods or services in the course or furtherance of any enterprise carried on by him.

The general charging provision in the South African Value-added Tax Act[79] (VAT Act) provides for the levying of VAT on the supply by any vendor of goods or services supplied by him in the course of furtherance of any enterprise[80] carried on by him. In order to place the VAT incidence on the consumer, the vendor deducts input tax[81] from output tax.[82] In addition, in order to create a level commercial ground between locally supplied goods and services section 7(1)(b) and (c) of the VAT Act respectively impose VAT on the importation of any goods into South Africa as well as on the supply of any imported services by any person into South Africa.

5.1 *Exemption for financial services*

The VAT Act specifically provides for exemption of certain supplies. The first listed supply is that of financial services. "Financial services" is defined in section 1 of the VAT Act as activities that are deemed by section 2 of the VAT Act to be financial services. Section 2 of the VAT Act, on the other hand, defines financial services as follows:

> "Financial services.—(1) For the purposes of this Act, the following activities shall be deemed to be financial services:
>
> (*a*) the exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise);
>
> (*b*) the issue, payment, collection or transfer of ownership of a cheque or letter of credit;

77 "Goods" means "corporeal movable things, fixed property, any real right in any such thing or fixed property, and electricity". See s 1: definition of "goods". This definition excludes money; any right under a mortgage bond or pledge of any such thing or fixed property; and any stamp, form or card which has a money value and has been sold or issued by the State for the payment of any tax or duty levied under any Act of Parliament, except when subsequent to its original sale or issue it is disposed of or imported as a collector's piece or investment article.

78 "Services" means anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card. See s 1: definition of "services".

79 Act 89 of 1991.

80 The general definition of "enterprise" is in relation to a vendor and means any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a financial concern. See s 1: definition of "enterprise". Enterprise requires continuity. See Van Zyl "The value added tax implications of illegal transactions" 2014 *PELJ* 320 321 – 322. Thus, an isolated transaction or transactions do not qualify as conducting an enterprise for VAT purposes. See s 7(1) of the VAT Act.

81 "Input tax" is a tax payable by a supplier on the supply of goods and services made by that supplier to the vendor. See s 1: definition of "input tax".

82 "Output tax" is a tax charged by a vendor in respect of a supply of goods and services by that vendor. See s 1: definition of "output tax".

(*c*) the issue, allotment, drawing, acceptance, endorsement or transfer of ownership of a debt security;

(*d*) the issue, allotment or transfer of ownership of an equity security or a participatory security;

(*f*) the provision by any person of credit under an agreement by which money or money's worth is provided by that person to another person who agrees to pay in the future a sum or sums exceeding in the aggregate the amount of such money or money's worth;…

(*i*) the provision, or transfer of ownership, of a long-term insurance policy or the provision of reinsurance in respect of any such policy: Provided that such an activity shall not be deemed to be a financial service to the extent that it includes the management of a superannuation scheme;

(*j*) the provision, or transfer of ownership, of an interest in a superannuation scheme;

(*k*) the buying or selling of any derivative or the granting of an option: Provided that where a supply of the underlying goods or services takes place, that supply shall be deemed to be a separate supply of goods or services at the open market value thereof: Provided further that the open market value of those goods or services shall not be deemed to be consideration for a financial service as contemplated in this paragraph".

This definition is subject to an important proviso to the effect that these activities[83] shall not be deemed to be financial services to the extent that the consideration payable in respect thereof is any fee, commission, merchant's discount or similar charge, excluding any discounting cost.[84] The importance of this proviso is that while the provision of the service itself is exempt, any fee, commission, merchant's discount or similar charge in relation thereto are not exempt. Similarly a fee charged for the giving of advice on any of the financial services given will not be exempt, nor are bank charges on an overdraft account, or any account. However, interest on an overdraft account would be exempt.[85]

Zero rating of supplies of financial services takes precedence over exemptions of such supplies. As such a financial service is exempt to the extent that it is not zero rated.[86] Thus, financial services supplied to a non-resident, even if physically rendered in South Africa, would be zero rated if the services are rendered directly to that non-resident and/or any other person and both the non-resident and that other person are not in South Africa at the time the services are supplied. De Koker and Kruger emphasise an important point that[87]

> "[t]he VAT status of financial services can change from exempt to zero-rated when supplied to a recipient in an export country or when physically rendered outside the republic or under any circumstances envisaged by section 11…This status can have important and beneficial consequences for suppliers of financial services,

[83] In particular activities contemplated in paragraphs (*a*), (*b*), (*c*), (*d*) and (*f*) of the definition of financial services.

[84] proviso to the definition of "financial service" in s 2 of the VAT Act.

[85] Stiglingh (n 10) 950.

[86] s 12(a) of the VAT Act.

[87] De Koker and Kruger *Value-added Tax in South Africa: Commentary* (2013) 6-3.

> whose percentage recovery of input tax could be significantly increased if certain of their transactions were identified as zero-rated, that is being taxable as opposed to non-taxable supplies, in appropriate circumstances."

As the VAT Act currently stands, it does not refer specifically to cryptocurrencies. VAT is levied on the supply of goods and services. The salient aspects of the definition of "goods" is "corporeal movable things, fixed property, any real right in such a thing or fixed property or electricity but excluding money".[88] It is accepted that cryptocurrencies are not corporeal things nor fixed property and therefore do not constitute goods. The salient aspects of the definition of "services" is "anything done or to be done, including the granting, assignment, cession or surrender or any right or the making available of any facility or advantage, excluding a supply of goods, money or any stamp, form or card".[89] The supply of cryptocurrency would constitute a supply of services as something is done. While cryptocurrency is, or could be currency, it is clearly not money and therefore is not excluded by the exclusion of money. It is submitted that there is no legal basis to exclude cryptocurrencies from the financial services exemption, based on the ordinary definition of currency. Thus, the supply of cryptocurrencies is exempt from VAT.

If, on the other hand, cryptocurrencies are not accepted as currency then they would not be exempt in terms of the VAT Act and the supply of cryptocurrency would be subject to VAT. Government needs to determine its policy on cryptocurrencies in this regard. Clearly, if the supply of cryptocurrencies would be subject to VAT the VAT could diminish the value of the cryptocurrency and render them commercially not viable.

6 Tax evasion

One of the crucial characteristics of cryptocurrencies is the element of encryption, the concealment of the parties to the transactions, the owners, the participants, miners and the like. It is common knowledge that this secrecy would make it difficult for tax authorities to determine taxable events in respect of taxpayers. The encryption is clearly tempting some taxpayers to question how SARS would know if they were to fail to disclose cryptocurrency related income. In simple terms tax evasion is the illegal non-payment or underpayment of tax.[90] Section 235 of the Tax Administration Act[91] criminalises tax evasion and provides for a sentence of imprisonment upon conviction. It provides as follows:

> "(1) A person who with intent to evade or to assist another person to evade tax or to obtain an undue refund under a tax Act—
>
> (a) makes or causes or allows to be made any false statement or entry in a return or other document, or signs a statement, return or other document so submitted without reasonable grounds for believing the same to be true;

[88] s 1 definition of "goods" in the VAT Act.
[89] s 1 definition of "services" in the VAT Act.
[90] Stevenson and Waite *Concise Oxford English Dictionary* (2011) definition of "tax evasion".
[91] Act 20 of 2011.

(b) gives a false answer, whether orally or in writing, to a request for information made under this Act;

(c) prepares, maintains or authorises the preparation or maintenance of false books of account or other records or falsifies or authorises the falsification of books of account or other records;

(d) makes use of, or authorises the use of, fraud or contrivance; or

(e) makes any false statement for the purposes of obtaining any refund of or exemption from tax,

is guilty of an offence and, upon conviction, is subject to a fine or to imprisonment for a period not exceeding five years.

(2) Any person who makes a statement in the manner referred to in subsection (1) must, unless the person proves that there is a reasonable possibility that he or she was ignorant of the falsity of the statement and that the ignorance was not due to negligence on his or her part, be regarded as guilty of the offence referred to subsection (1).

(3) A senior SARS official may lay a complaint with the South African Police Service or the National Prosecuting Authority regarding an offence contemplated in subsection (1)."

Tax evasion requires intention. An example of evading tax would be where a person receives income or has income accrue to him in the form of cryptocurrency and does not disclose that in the tax return for the particular year, or declares an amount lower than the actual amount received or accrued. SARS' position in this regard is that intention is a wilful act that exists when a person's conduct is meant to disobey or wholly disregard a known legal obligation. Knowledge of illegality is crucial. SARS maintains that even if it accepts a false representation it may still prosecute a taxpayer who disregarded a known legal obligation and that a subsequent audit does not excuse an intention to evade tax.[92] Thus, a person that evades tax in respect of cryptocurrency is exposed to criminal sanctions.

7 Conclusion

The essence of this analysis was to determine whether the South African tax laws are dynamic enough to apply to the new economic instrument of virtual and digital currencies. The application of the laws to cryptocurrencies stretches the analysis to the ability of the SARS to administer the laws amidst the encryption of these currencies. As has been seen, the law is broad enough to apply to cryptocurrencies. Applying the general principles, currently residents are subject to tax on income made on transacting in cryptocurrencies. If cryptocurrency is used as a form of exchange, similar to money, the taxpayer would be taxable on the basis of the underlying transaction. Where it is acquired and disposed of as a capital asset the transaction would be subject to CGT. For non-residents, the source rules in relation to revenue and in relation to capital gains do not create a tax nexus with South Africa.

92 SARS *Short Guide to the Tax Administration Act* (2011) 81.

For deductibility purposes, it is important to determine whether the transfer of cryptocurrencies in discharging an obligation to pay would qualify as expenditure. Payment by means of cryptocurrencies is an action of spending funds, disbursements or consumption. It entails a reduction of assets or at the very least a movement of assets of the person who expends the funds. As regards losses, should a taxpayer involuntarily lose his cryptocurrency or any part thereof, that would qualify as a loss, in the sense of a disbursement of an involuntary nature. The incurral of expenditure requirement has no impact on the cryptocurrencies as a means of payment or as a subject of the liability. In transactions where cryptocurrency is used as a form of payment, it is the underlying activities of the taxpayer that determine whether the expenditure was incurred in the production of income. However, in the case of a trader in cryptocurrencies, expenditure associated with the purchase of the cryptocurrency would be deductible as incurred in the production of income. Where cryptocurrency is used to acquire a revenue or capital asset, the expenditure will be deductible or not deductible, respectively, based on the intention of the taxpayer, and not the use of cryptocurrency. With regards to the trade requirement, a person who invests in cryptocurrencies and then sells them, without any active trading activity, would not be allowed a deduction as that person would not satisfy the trade requirement. However, a person who buys and sells in the carrying on of a trade would be allowed a deduction to the extent that such expenditure was incurred for purposes of trade.

However, as the law stands, it does not apply optimally as it has not been developed in line with these new developments. A few considerations have been suggested, without which the current application would still cater for taxpayers trading or investing in cryptocurrencies, albeit not adequately. In the main, National Treasury and SARS need to provide credible clarity on the tax treatment of these instruments.

The position that SARS has taken of defining cryptocurrency as an intangible asset, and thus not money is aimed at making sure that transactions involving cryptocurrencies are taxable on any gains made therefrom. That also means that expenditure incurred in such transactions would be deductible in terms of the general deductions formula, as would the base cost relating thereto for purposes of the Eighth Schedule. For VAT purposes, transactions involving cryptocurrency would be subject to VAT. This is a convenient position for SARS. It should be noted that the pronouncement by SARS on this has no legal effect. It is merely SARS' interpretation and is challengeable by taxpayers. At best, the pronouncement by the SARS amounts to an advance ruling with no binding effect on taxpayers as per section 82 of the TAA.[93] It is common course that SARS' position is informed by trepidation brought about by the cryptic nature of cryptocurrencies and that with better understanding of the cryptocurrency, SARS should realise that the general principles in the Act would lead to an equitable and appropriate tax system in this respect.

[93] (n 91).

Safe harbour provisions against liability for insolvent trading for South African directors

NATANIA LOCKE*

Abstract

Australia has recently adopted safe harbour provisions to protect directors from liability when they embark on turnaround activity outside of external administration or liquidation. Directors who meet the criteria of the safe harbour will not be subject to liability for insolvent trading. It must be shown that their course of action was reasonably likely at that time to lead to a better outcome for the company than the use of formal insolvency proceedings. This paper compares the Australian insolvent trading provisions with the similar legislative and institutional position in South Africa. A crucial distinction between the Australian insolvent trading provisions and the position in South African law is that the Australian provisions do not require proof of culpability in any form. Furthermore, the South African CIPC is not nearly as active a regulator as the Australian ASIC when it comes to the enforcement of the provisions of the Companies Act. Finally, the scheme of directorial liability for insolvent trading in the Act outside of insolvency leaves much uncertainty. The paper reaches the ultimate conclusion that the differences between the two systems are such that similar provisions are not necessary in the South African context.

1 Introduction

In September 2017 new “safe harbour” provisions were introduced to protect Australian directors from personal liability for insolvent trading when they previously embarked on legitimate, but failed, turnaround measures to save failing companies.[1] The safe harbour provisions form part of a greater endeavour by the Australian government to destigmatise failure and to encourage entrepreneurship and innovation.[2] It was felt that the risk of personal liability for insolvent trading, coupled with uncertainty about the moment insolvency arises, was a key reason why directors sought early voluntary administration of companies as a preferred option to other measures outside of insolvency proceedings.[3]

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1 Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017, sch 1 part 1 commenced on 19 September 2017. The Australian Corporations Act 2001 (Cth) provides for the potential criminal liability of directors for dishonestly allowing the company to trade while insolvent (s 588G(3)). However, this discussion will only focus on the civil liability provisions, as the safe harbour provisions do not apply to criminal liability.

2 Explanatory Memorandum Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 1.

3 Explanatory Memorandum (n 2) 1. Boothman “Safe harbour or shipwreck? A critical analysis of the proposed safe harbour for insolvent trading” 2016 *Company and Securities Law Journal* 520 522 – 524 shows that this is an assumption that is not supported by any real data.

It is a stated objective of the introduction of the safe harbour provisions to encourage directors to embark upon turnaround initiatives outside of formal insolvency proceedings in the appropriate circumstances. The appropriate circumstances are where the initiatives of the directors are reasonably likely to lead to a better return for the creditors of the company than would result from the immediate external administration or liquidation of the company. Two factors inform the objective to promote such action outside of formal insolvency. First, the directors remain in control,[4] and, secondly, the reputational damage of administration may be avoided,[5] which could benefit a turnaround strategy.

It is clear that the introduction of the safe harbour signals a belief that a change of culture is necessary in Australian boardrooms when companies face difficulty. Instead of grasping for external administration or liquidation, it is hoped that the safe harbour would encourage directors to start thinking creatively about how best to save their companies. This might, and often will, include bringing in external assistance in the form of professional advisors. The need for this change of culture is also important from the point of view that large scale corporate disruption as a result of technological innovations seems unavoidable. This disruption will be universal and not bound to jurisdiction. Immediately, an assessment of the culture in boardrooms in times of business and financial uncertainty also becomes of universal concern.

The safe harbour provisions are discussed in more detail below to assess whether similar provisions ought to be considered in the South African context. Australian company law has always been popular for comparative purposes because of its shared origins and the accessibility provided by English text and familiar concepts. Many of the provisions of the Companies Act 71 of 2008 ("the act") were adopted from or based on the Australian example. However, some key differences between the Australian and South African legal positions are set out. Ultimately, the paper concludes that similar measures ought not be considered in South African law.

2 The duty to prevent insolvent trading in Australian law

The policy reason for the duty to prevent insolvent trading is to guard the interests of creditors at the time when the company is nearing insolvency. In this period, the risk of failed business ventures shifts from shareholders to creditors, as the claims of shareholders are generally subordinated in the subsequent liquidation of the company. Creditors are then the residual risk bearers of the failure of the company. It has been acknowledged in Australia[6]

[4] Explanatory Memorandum (n 2) par 1.13 and par 1.31.

[5] Explanatory Memorandum (n 2) par 1.9. See further Harris "Director liability for insolvent trading: Is the cure worse than the disease?" 2009 *Australian Journal of Corporate Law* 266 273.

[6] *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 and *Westpac Banking Corporation v Bell Group Ltd (in liq) [No 3]* (2012) 89 ASCR 1. This does not create an obligation that is directly enforceable by creditors. See *Spies v R* (2000) 201 CLR 603; [2000] HCA 43. For recent criticism of this judicial view, see Hargovan

and elsewhere[7] that creditors are the end beneficiaries of directors' duty to act in the best interests of the company during this period.

The Australian provisions that provide for the personal liability of directors when they trade while the company is insolvent have been described as "arguably the strictest in the world".[8] Section 588G(1) of the Corporations Act 2001 (Cth) sets out the potential circumstances in which a person may be in breach of the duty to prevent insolvent trading. The person must have been a director of the company at the time the company incurred a debt.[9] At the time of incurring the debt, the company must either have been insolvent,[10] or the incursion of the debt must have left the company insolvent. Finally, there must have been reasonable grounds for suspecting that the company is insolvent or would become insolvent as a result of the debt.[11]

It is not actual insolvency that leads to personal liability in terms of these provisions, but reasonable grounds for suspecting that the company is insolvent or would become insolvent. This has led directors taking a cautious approach when their companies are experiencing financial difficulties. In particular, they have preferred to opt for formal insolvency procedures in the form of external administration or liquidation in an attempt to shield themselves from potential personal liability.[12] Furthermore, skilled directors approached to join

and Todd "Financial twilight re-appraisal: Ending the judicially created quagmire of fiduciary duties to creditors" 2016 *University of Pittsburgh Law Review* 135.

7 See Hargovan and Todd (n 6) 138 fn 1 – 4 for a comprehensive list of authority of this view in the United Kingdom, New Zealand, Singapore, Ireland and North America.

8 Martin CJ, Official Opening Address, 2009 IPA Conference 28 May 2009 as quoted by Harris (n 5) 266. On insolvent trading generally, see Austin and Ramsay *Ford, Austin and Ramsay's Principles of Corporations Law* (2015) par 20.080 – 20.150.

9 S 588G (1A) sets out a list of actions that are considered "incurring a debt" for purposes of the insolvent trading provisions. The list includes the payment of dividends, certain reductions of share capital, share buy backs, redeeming redeemable preference shares; financial assistance to acquire shares in the company or its holding company and entering into an "uncommercial transaction" other than by court order or the direction of a prescribed agency. The meaning of "uncommercial transaction" is explained in s 588FB(1). An uncommercial transaction is one where it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction having regard to the benefits to the company, the detriments to the company, the benefits to other parties to the transaction and any other relevant matter. It is not necessary that one of the parties must be a creditor of the company (s 588FB(2)(a)). Also, a transaction may be uncommercial even if it is given effect to because of an order of an Australian court or a direction by an agency (s 588FB)(2)(b)). Anderson "Shelter from the storm: Phoenix activity and the safe harbour" 2018 *Melbourne University Law Review* 999 1015 notes that the inclusion of "uncommercial transaction" in this list covers examples of illegal phoenix activity under the ambit of transactions that would be considered "incurring a debt" for purposes of insolvent trading. Illegal phoenix activity is where the assets of a failed company are transferred to a new company with the objective of avoiding the unsecured creditors of the first company (1013).

10 "Insolvent" in this context refers to the inability to pay debts as they become due and payable (s 95A). For more on this, see Austin and Ramsay (n 8) par 20.100.

11 For a detailed consideration of the difficulties surrounding the inclusion or exclusion of unliquidated amounts under the consideration of "debt", see Powers "The impact of unliquidated claims when assessing solvency: A director's dilemma" 2017 *Australian Journal of Corporate Law* 368.

12 Explanatory Memorandum (n 2) par 1.7.

a company in difficulty, or to join a company at more risk of experiencing liquidity issues in future, may refuse to do so out of fear of personal liability. This fear could also be off-putting to potential investors who may want to appoint directors on the company's board as part of the rescue effort.[13]

Even before adoption of the safe harbour provisions, there were defences available to directors against liability for insolvent trading. As may be expected, it is a defence for the director to show that at the time the debt was incurred she had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent even if it incurred the debt and any other debts at that time.[14] It is further a defence to show that the director had reasonable grounds to believe, and did believe, that a competent and reliable person was responsible for providing her with adequate information about whether the company was solvent, that the other person was fulfilling that responsibility and that the director expected, on the basis of that information that the company was solvent at that time and would remain solvent after incurring the debt.[15] A director will be excused if she can show that because of illness or for some other good reason, she did not take part in the management of the company at the time the debt was incurred.[16] It is a defence to prove that the person took all reasonable steps to prevent the company from trading,[17] which may include steps to appoint an administrator.[18] These defences have not proved to save many directors from liability for insolvent trading.[19] This has been especially true in the context of attempts to rescue the ailing business.[20]

It is possible, even when none of these specific defences apply, to rely on the court's discretion to excuse a director from liability for a civil penalty provision[21] when she acted honestly and having regard to all the circumstances of the case.[22] This provision has been applied before to excuse directors from liability when they embarked on restructuring efforts when the company was strictly speaking trading while insolvent, but only rarely so.[23]

13 so-called angel investors. See Explanatory Memorandum (n 2) par 1.7.

14 s 588H(2).

15 s 588H(3).

16 s 588H(4). See also *Deputy Commissioner of Taxation v Clark* (2003) 21 ACLC 1063; [2003] NSWCA 91. This decision considered whether "some other good reason" would include the situation where a wife in a small business left all company business to her husband regardless of being appointed as a director of the company. The court held that this did not fall under the ambit of the defence.

17 s 588H(5).

18 s 588H(6).

19 See James, Ramsay and Silva "Insolvent trading – an empirical study" 2004 *Insolvency Law Journal* 210 where they discovered that in all of the insolvent cases reported from 1961 until 2004 only 11% successfully relied on one of these defences.

20 See in general Harris (n 5) 282 – 283.

21 See the explanation below (par 2.2) of the meaning of this phrase.

22 s 1317S(2).

23 See *Hall v Poolman* (2007) 215 FLR 243; [2007] NSWSC 1330 par 330 – 339 (only partial relief from liability was granted) and *McLellan v Carroll* [2009] FCA 1415 par 189 – 206. See further

The duty to prevent insolvent trading only applies to directors of companies in Australian law. "Director" is defined in section 9 of the Corporations Act to include *de facto* directors and shadow directors[24] but excluded from potential liability are those more properly described as "officers" of the company.[25] This term usually refers to the senior executive of the company, some of whom may also serve as directors.

Legal persons may be classified as "shadow directors" in appropriate circumstances in Australian law,[26] but in the context of insolvent trading section 588G is rarely used by liquidators to keep holding companies liable. Instead, liquidators rely on section 588V which provides that a holding company may be kept liable for the unsecured debts incurred by its subsidiary at a time when it was insolvent or would become insolvent as a result of incurring the debt and there were reasonable grounds to suspect that the subsidiary was insolvent or would become insolvent.[27] The holding company, or one or more of its directors, must have been aware of the insolvency or pending insolvency of the subsidiary, or it must be reasonably expected that they must have been so aware. Section 588G may, however, still be used by liquidators to hold a legal person liable for debts incurred during insolvency when the legal person would fall under the definition of "shadow director" but could not be said to be a "holding company".[28]

Harris "Reforming insolvent trading to encourage restructuring: Safe harbour or sleepy hollows?" 2017 *Journal of Banking and Finance Law and Practice* 294 299 and Anderson (n 9) 1005 – 1006.

24 "'Director' of a company or other body corporate means … (b) unless the contrary intention appears, a person who is not validly appointed as a director if (i) they act in the position of a director [*de facto* directors] or; (ii) the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes [shadow director]. Subparagraph (b) (ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or company or body [professional advisors such as accountants, consultants, lawyers and in this instance turnaround specialists]." (descriptions added.) See on *de facto* and shadow directors in the South African context Locke "Shadow directors: Lessons from abroad" 2002 *SA Merc LJ* 420 and Idensohn "The regulation of shadow directors" 2010 *SA Merc LJ* 326. The most recent judicial consideration of shadow directors in Australia was in *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2010 28 ACLC 10-010; (2010) 77 ACSR 410.

25 S 9 of the Corporations Act defines "officer" as follows: "(a) a director or secretary of the corporation; or (b) a person: (i) who makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or (ii) who has the capacity to affect significantly the corporation's financial standing; or (iii) [shadow directors as defined above] …". Other officials appointed to oversee the affairs of the corporation at its insolvency or administration are also expressly included later in the definition, including receivers, administrators and liquidators.

26 *Standard Chartered Bank of Australia Ltd v Antico* (1995) 13 ACLC 1381; 18 ACSR 1.

27 See also s 588W. See in general Austin and Ramsay (n 8) par 20.200 – 20.210.

28 A holding company in Australian law is defined with reference to the definition of subsidiary companies in division 6 (ss 46 – 49). A company is a subsidiary of another company if the latter company controls the composition of the first company's board, or is in a position to cast, or to control the casting of more than half of the votes at the general meeting of the first company, or holds more than half of the issued share capital of the first company, excluding any part of the issued share capital that carries no right to participate beyond a specified amount in a

Defences against the liability of a holding company for the insolvent trading of its subsidiary are set out in section 588X and mirror the defences set out for liability in terms of section 588G. Similarly, section 588WA provides for a safe harbour against liability in favour of the holding company when it implemented reasonable steps to ensure that the safe harbour provisions explained below applied to each of the directors of its subsidiary. The holding company carries the burden of proof.[29]

There is some uncertainty whether directors could be held personally liable for insolvent trading by creditors when the debts of the company had been compromised under a deed of company arrangement.[30] A deed of company arrangement is the usual outcome of voluntary external administration unless the company is liquidated. The general view seems to be that the remedy is only available to creditors, ASIC and the company's liquidator on the insolvent liquidation of the company.[31]

Even from this brief discussion a crucial distinction between the Australian insolvent trading provisions and the position in South African law must appear clear – the Australian provisions do not require proof of *culpability* in any form. In fact, even if directors had no control over the debt being incurred they may still be held liable.[32]

2.1 *The safe harbour provisions*

The safe harbour provisions exclude the potential liability of directors for insolvent trading when they can show that, after starting to suspect that the company may become or be insolvent, they started to develop one or more courses of action that were reasonably likely to lead to a better outcome for the company.[33] A "better outcome for the company" means one that is better than the immediate appointment of an administrator or liquidator.[34] Some guidance is provided, without forming an exhaustive list,[35] about what to consider when

distribution of either profits or capital. A subsidiary's subsidiaries are also the subsidiaries of the holding company.

29 s 588WA(2). See also the Explanatory Memorandum (n 2) par 1.94 – 1.95.

30 In *Elliott v Australian Securities and Investment Commission* (2004) 48 ACSR 621, [2004] VSCA 54 par 179 – 185, the Victorian Court of Appeal allowed ASIC to claim compensation from directors on the basis of a breach of the duty to prevent insolvent trading despite the fact that the company entered a deed of company arrangement and that the company was not liquidated. For criticism of this decision, see Anderson and Morrison "Should directors be pursued for insolvent trading where a company has entered into a deed of company arrangement?" 2005 *Insolvency Law Journal* 163. However, nothing in s 588G(2) limits the liability for insolvent trading to liquidation, nor does s 588J, which gives power to ASIC to apply for a civil penalty order on the grounds of a contravention of s 588G(2). See Anderson (n 9) 1005.

31 See Austin and Ramsay (n 8) par 25.090. S 588M allows the liquidator, or a creditor who has received permission to do so from the liquidator or the court, to hold a director liable in terms of s 588G(2). The external administrator is not given this power.

32 See Harris (n 23) 296 and Anderson (n 9) 1006.

33 s 588GA(1)(a).

34 s 588GA(7).

35 s 588GA(2).

deciding whether a course of action is reasonably likely to lead to a better outcome. Regard may be had to whether the director:

- Properly informed herself of the company's financial position;
- Took appropriate steps to prevent misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts;
- Took appropriate steps to ensure that the company kept appropriate financial records consistent with its size and operations;
- Obtained advice from an appropriately qualified person,[36] which operated with sufficient access to company information;
- Developed and implemented a plan for restructuring the company to improve its financial position.

Whether the course of action was reasonably likely to have a better outcome for creditors is determined with reference to the time the decision was taken to embark on the course of action. The Explanatory Memorandum warns against hindsight review of the decision. It is not necessary that the directors keep in mind every possible benefit of administration or liquidation.[37] However, the course of action must be continuously reviewed to decide whether it remains a better route than administration or liquidation. If not, the board should opt for immediate external administration or liquidation.[38]

The director who wants to rely on the safe harbour has to prove the elements of the section.[39] It is therefore crucial that she keeps records of her and the board's actions to show that an actual course of action was pursued with a view of a better outcome.[40] The nature of the action undertaken will depend on the particular circumstances of the company, including its size and operations.[41] However, it must take the form of a pro-active endeavour. As the Explanatory Memorandum puts it: "… hope is not a strategy."[42]

The safe harbour provision is not a defence, but a carve-out from liability.[43] The Explanatory Memorandum states that the person who brings the action for insolvent trading will have to prove to the balance of probabilities that the course of action was not reasonably likely to lead to a better return for creditors.[44] In other words, the directors who want to rely on the safe harbour

[36] Whether the person or entity is appropriately qualified will depend on the size of the company and its operations. See Explanatory Memorandum (n 2) par. 1.69. For larger enterprises one will expect to see a professional with the relevant academic qualifications and experience in restructuring and covered by adequate professional indemnity insurance.

[37] Explanatory Memorandum (n 2) par 1.55 – 1.57.

[38] Explanatory Memorandum (n 2) par 1.59.

[39] s 588GA(3).

[40] Explanatory Memorandum (n 2) par 1.76.

[41] Explanatory Memorandum (n 2) par 1.18.

[42] Explanatory Memorandum (n 2) par 1.19.

[43] See in general Anderson (n 31) 999 1011 – 1012.

[44] Explanatory Memorandum (n 2) par 1.77. For criticism of this approach, see Boothman (n 3) 526 – 527.

need only show that they embarked on a course of action, but the plaintiff will have to show that the course of action was not reasonably likely to have led to a better outcome for the creditors. The legislation is phrased in such a way that liability will simply not follow if the hurdle of the safe harbour is not overcome first.

The intention is that the safe harbour period will start to run when directors begin enquiries about the best course of action to take. The initial garnering of advice from specialists would fall inside the protected period, as well as the time it takes to decide on the best course of action. The implementation of the course of action will fall under the safe harbour, provided it is finalised within a reasonable period of time. The latter will be determined with consideration of the size of operations and the complexity of the actions to be taken.[45] The safe harbour period comes to an end when the course of action is ceased, or when it is finalised, or when it can no longer lead to a better return for creditors than immediate administration or liquidation, or when the company goes into external administration or liquidation. It will also end if the course of action is not implemented within a reasonable period of time.[46]

The debt must have been incurred directly or indirectly in connection with any course of action taken.[47] It is interesting that the Explanatory Memorandum suggests that ordinary trade debts incurred during the safe harbour period would fall under the ambit of this requirement.[48] Without saying so expressly, this might be because of the inclusion of indirect debts under the provisions.

According to the Explanatory Memorandum debts would be covered under the provision even if the course of action ultimately fails and no greater return is realised for creditors than would have been the case in immediate administration or liquidation.[49] The crux is that at the time of the decision to embark on the course of action there must have been such a reasonable likelihood. With this one has to agree, otherwise the safe harbour would become non-sensical.

While the directors operate under the safe harbour, they remain subject to all other duties whether in terms of the common law or statute. Furthermore, they must continue to comply with any continuous disclosure obligations in terms of any law, including disclosure to exchanges. Third parties remain able to apply for external administration or liquidation while directors embark on the turnaround measures.[50]

Reliance on the safe harbour provisions is excluded if the company failed to pay employees' entitlements, including pension payments, as they became due or failed to adhere to their tax reporting obligations.[51] The relief will

[45] Explanatory Memorandum (n 2) par 1.39 – 1.47.
[46] Explanatory Memorandum (n 2) par 1.42.
[47] s 588GA(1)(b).
[48] Explanatory Memorandum (n 2) par 1.48.
[49] Explanatory Memorandum (n 2) par 1.50.
[50] Explanatory Memorandum (n 2) par 1.36 – 1.38.
[51] s 588GA(4). The failure must be one of two or more such failures over a 12-month period ending when the debt is incurred. Failure amounts to less than substantial compliance.

furthermore not be available if the directors failed to assist the administrator, liquidator or controller of the company in formal insolvency,[52] which includes making disclosure of and giving access to relevant documentation and information. Any books or information about a company not disclosed or given to the administrator, liquidator or controller of a company in subsequent administration or liquidation when asked to do so may not be used by a director to prove the existence of a safe harbour.[53] The court is given the power to allow access to the safe harbour provisions regardless of the presence of these failures if it is satisfied that the failures were due to exceptional circumstances or that it is otherwise in the interests of justice to make the order.[54]

2.2 *The civil penalty provisions and the Australian Securities and Investments Commission*

The statutory duties of directors set out in the Corporations Act,[55] including the duty to prevent insolvent trading, are also civil penalty provisions.[56] This means that when they are breached, ASIC may apply for a court order that the statutory duty has been breached. Once the court has made a declaration of a contravention, ASIC may seek a pecuniary penalty order,[57] a disqualification order[58] and/or a compensation order[59] against the delinquent directors.

The power of ASIC to proceed against directors in terms of the civil penalty provisions applies over and above any action taken against them by the company, an external administrator, liquidator or creditors. This is another reason why the Australian system of potential personal liability of directors is much harsher than the system currently in place in South Africa.

3 The South African position

"Business rescue" in the South African context has either a narrow or a broad meaning. Narrowly construed it refers to the formal procedure set out in chapter 6 of the act by which a business rescue practitioner is appointed with

[52] s 588GA(5) read with s 429(2)(b), 475(1), 497(4) or 530A(1).
[53] s 588GB.
[54] s 588GA(6).
[55] A list of civil penalty provisions appears in s 1317E(1). It includes the statutory duty of care and diligence (s 180(1)), the statutory duty to act in good faith in the best interests of the company (s 181(1)(a)), the duty to act for a proper purpose (s 181(1)(b)), the duty not to make improper use of position (s 182(1) and (2)) and the duty not to make improper use of information (s 183(1) and (2)).
[56] s 1317G.
[57] A pecuniary order will be granted if the contravention materially prejudices the interests of the corporation or its members, or materially prejudices the corporation's ability to pay its creditors, or is serious (s 1317(G)(1)). The amount is payable to the Commonwealth and may be up to $200 000.
[58] s 206C.
[59] This is an order to compensate the company for damage suffered by it, which may include profits made by the person as a result of the contravention (s 1317H).

a view of developing a business rescue plan.[60] This formal procedure has the benefit of a moratorium on all legal proceedings against the company or in respect of property in its possession.

The phrase "business rescue" may also have a broader meaning. Apart from the formal business rescue procedure, a company may also reach a compromise between it and its creditors in terms of section 155. This too is a potential rescue mechanism, which may be more appropriate for the company in the circumstances. Even more broadly, the company and individual creditors could come to restructuring agreements regarding the obligations of the company towards those individual creditors. Finally, the company may embark on initiatives outside of arrangements or compromises with creditors to try and steer its way out of financial distress. Many of the reported cases on reckless and fraudulent trading consider actions by directors that would fall in this last category.

3.1 *The position on insolvent liquidation of the company*

The liquidator of a company may hold directors personally liable for debts incurred when the company was insolvent by means of section 424 of the Companies Act 61 of 1973.[61] The section reads as follows:

> "When it appears … that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the Master, the liquidator … any creditor or member or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct."

This section prohibits reckless or fraudulent trading by the company and provides for the personal liability of any person who was "knowingly a party to the carrying on of the business" in the prohibited manner. The remedy is also available to individual creditors of the company. Creditors need not seek consent from the liquidator before instituting action.

ABLU delegates are familiar with the section and its application.[62] Here we will rather focus on the differences between section 424 and the duty to prevent insolvent trading in Australian law. As was clear from the discussion above, the insolvent trading provisions in Australian law do not require proof of culpability and may therefore be considered as strict liability. All that must be shown is that a debt was incurred at a time when the director had

[60] This formal procedure is what is referred to in the Australian context as external administration.

[61] See sch 5 item 9(1) of the Companies Act 71 of 2008, which retains ch 14 of the Companies Act 61 of 1973 with respect to the winding-up and liquidation of the companies.

[62] For an in-depth discussion, see Blackman, Jooste, Everingham, Yeats, Cassim, De la Harpe, Larkin and Rademeyer *Commentary on the Companies Act* (2012 RS 9) ch 14 521 – 554; Meskin, Galgut, Kunst, Delport and Vorster *Henochsberg on the Companies Act 61 of 1973* (2011, SI 33) 911 – 920(3).

reason to suspect that the company was insolvent. Even if the director had no knowledge of the debt and had no control over its incurrence she may still be held liable. The South African provision very clearly requires proof of either recklessness, which has been held to constitute at least gross negligence, or fraudulent trading.[63] The result is that it is much harder to hold a person liable for insolvent trading in South Africa than it is in Australia.

Another key difference is that any person who was knowingly a party to the carrying on of the business of the company during the time the debt was incurred may be held personally liable in terms of section 424. Potential liability is not restricted to directors as in Australia, but may include, for instance, senior officers of the company as well as advisors, which in this discussion may be a consultant or another turnaround professional brought in to advise the struggling company on how to remedy its fortunes. For brevity's sake, I will only refer to directors in this discussion.

Notwithstanding these key differences, section 424 is the section that most closely resembles the Australian provision for which the safe harbour was created in that it is only available to the company's liquidator or creditors.

3.2 *The position on formal business rescue of the company*

Unlike the position in Australian law, the formal business rescue procedure in South African law is not regarded as insolvency proceedings. Furthermore, unlike in Australia, the directors remain in control of the business of the company under direction of the business rescue practitioner.[64] This benefit of informal work-outs in the Australian context is therefore not as relevant here, although many a board may not be keen to dance to the tune of a practitioner.

Directors who act in accordance with the instructions and directions of the practitioner are relieved of their duties in terms of section 76 but remain bound to the duty to disclose personal financial interests in terms of section 75. Importantly for purposes of this paper, they expressly remain potentially liable for acquiescing in the carrying on of the company's business despite knowing that it is contrary to the provisions of section 22(1) and for being a party to an act or omission calculated to defraud a creditor or for another fraudulent purpose.[65]

A business rescue practitioner does not have standing to institute section 424 proceedings, which may be one of the reasons in the appropriate circumstances why business rescue might not be an appropriate course of action for the company compared to liquidation.[66] However, one of the duties of the practitioner is to

[63] Refer to par 4 below for a more detailed discussion.
[64] s 137(2)(*a*) and (*b*).
[65] s 137(2)(*d*).
[66] Other reasons include the clawback of extensive impeachable dispositions or when extensive legal action is foreseen. See, for instance, *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* 2013 4 SA 539 (SCA) par 35.

take action when her investigation into the affairs of the company evidences reckless or fraudulent trading. Section 141(2)(*c*)(ii) provides as follows:

> "If, at any time during the business rescue proceedings, the practitioner concludes that … (*c*) there is evidence, in the dealings of the company before the business rescue proceedings began, of … (ii) reckless trading, fraud or … the practitioner must (*aa*) forward the evidence to the appropriate authority for further investigation and possible prosecution; and (*bb*) direct the management to take any necessary steps to rectify the matter, including recovering any misappropriated assets of the company."

The section does not foresee the practitioner herself to take action against the relevant directors but seems to suggest that this be left to the "management" of the company. This is perhaps not a sensical approach and it might be necessary for the practitioner to commence proceedings on behalf of the company against directors on the basis of section 77(3)(*b*) or (*c*) for acquiescing in the carrying on of the company's business in a reckless, grossly negligent or fraudulent manner as prohibited in section 22(1). The practitioner has full management control of the company in substitution of the board and such may institute derivative proceedings in terms of section 165(2)(*b*). However, the business rescue procedure is supposed to be a temporary and swift process and does not lend itself to lengthy litigation. It is doubtful whether it was really foreseen that such action would be taken by the practitioner.

Since the directors remain bound to section 22(1) it is possible that a liquidator could hold them accountable in a subsequent liquidation, including for their actions during business rescue if their actions meet the requirements of section 424. This could foreseeably be the case when a business rescue is initiated by directors' resolution, which is subsequently set aside by an affected person on the ground that there is no reasonable prospect for rescuing the company.[67] Implied in such a finding is a conclusion that the directors continued trading, albeit inside business rescue, when a reasonable person in their position would have concluded that liquidation was the more appropriate option.

However, it is unlikely that the actions of directors that form part of a legitimate business rescue process that leads to a better return for creditors than the immediate liquidation of the company would be subject to possible liability in terms of sectio 424.[68] Trade creditors who extend credit during the business rescue are protected by the post-commencement financing measures.[69] Moreover, the introduction of the business rescue procedure signalled a desire

[67] s 130(1)(*a*)(ii).

[68] The SCA confirmed in the *Oakdene* decision (n 62) par 26 that the achievement of this goal would qualify as a business rescue. I have argued elsewhere that this objective of business rescue is currently not well-regulated and have made proposals for its improvement. See Locke "The use of the South African business rescue proceedings outside of the return of the company to going concern status" paper delivered at the Australian Corporate Law Teachers' Association, Sydney, 2016.

[69] s 135(2) and (3).

to encourage the rescue of financially distressed companies.[70] It would be counterproductive to continue to expose directors to liability for insolvent trading for actions during the business rescue process.

3.3 *The position outside of formal business rescue of the company*

Section 22(1) of the act prohibits the carrying on of the business of the company in a reckless manner, or with gross negligence, or with the intent to defraud any person or for any fraudulent purpose. The section applies to "the company", by which one may assume is meant the board of directors.[71] Although this subsection does not expressly mention insolvency, the subsequent subsections mention the inability to pay debt expressly as an alternative ground that may lead the Commission to order the company to cease the carrying on of its business. Furthermore, the language is indicative of the same circumstances contemplated by section 424 and some of the case law on that section will probably be used in the interpretation of section 22(1), especially in the interpretation of recklessness and fraudulent conduct in this context.

The section read on its own makes no mention of any potential liability of the directors towards anyone if they act contrary to its provisions. However, the section ought not to be read in isolation but together with sections 77(3)(*b*), 214(1)(*c*) and 218(2). Section 77(3)(*b*) provides that a director of the company will be liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having acquiesced in the carrying on of the company's business despite knowing that it was conducted in a manner contrary to section 22(1). Liability in terms of this provision is owed to the company, making it the proper plaintiff. Moreover, the company will need to show causality between the prejudice suffered and the actions of the directors. Note that "director" for purposes of this liability includes prescribed officers of the company regardless of whether they also serve on the company's board.[72]

Section 214(1)(*c*) is one of the few remaining offence provisions in the act. It states that a person is guilty of an offence if the person was knowingly a party to an act or omission of the company calculated to defraud a creditor or employee of the company, or a holder of the company's securities, or with another fraudulent purpose. This provision is much narrower than section 22(1) in that it only applies to fraudulent actions by persons.

Section 218(2) is one of the most controversial provisions of the act. It provides that any person who contravenes any provision of the act is liable to any other person for any loss or damage suffered by that person as a result of that contravention. Commentators are not in agreement about whether personal liability of directors towards third parties other than the company

70 See Department of Trade and Industry *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (2004) par 4.6.2

71 See also *Rabinowitz v Van Graan* 2013 5 SA 315 (GSJ) par 21; Delport, Vorster, Burdette, Esser and Lombard *Henochsberg on the Companies Act 71 of 2008* (2017, SI 15) 105.

72 s 77 (1)(*a*).

may result from the application of this section when the directors act contrary to the prohibition in section 22(1).[73]

The main voices of opposition to this idea are Stevens and De Beer who posit that section 22(1) is the only one of the mentioned provisions capable of "contravention" as it is put in in prescriptive form.[74] Moreover, since the duty is owed by "the company" they argue that individual directors cannot contravene the section. They support their general argument with reference to the theory of company law that holds "the company" to be a nexus of contracts aimed at greater economic efficiency than individual contracts with the stakeholders of the enterprise.[75] In line with this theory it would be inefficient to allow individual creditors to hold directors personally liable, since that would deplete the pool of potential funds available to the creditors' group as a whole. It would be more efficient if the company acted against errant directors so that funds so collected would be available to creditors equally.

Stevens and De Beer go on to exclude the possibility that section 77(3)(*c*) places an implied duty on the directors of the company to prevent reckless trading that could lead to the availability of section 218(2) to creditors. They are of the opinion that section 218(2) would not be available because the duty in section 77(3)(*c*) is not owed to creditors but to the company.[76]

Even at this juncture it should be evident that the whole attempt at regulating reckless and fraudulent conduct is a mess. Yet, I disagree with the argument that Stevens and De Beer put forward for the following reasons. When section 22(1) refers to "the company" it is referring by implication to the board of directors acting as an organ of the company. A company cannot act without human actors and in the case of reckless trading it is highly unlikely that the general meeting would have been involved in the questionable decisions that led to the allegation of reckless trading. This is supported by the fact that the board of directors is given original authority to conduct the management and affairs of the company.[77] The duty imposed by section 22(1) is therefore really one imposed on the board of directors. This interpretation is supported by section 77(3)(*c*), which places a duty on each *individual* director to prevent the company from trading in the manner prohibited by section 22(1). To say that section 77(3)(*c*) is not prescriptive is with due respect not taking proper account of the context of these provisions. Directors cannot be liable for actions unless they have a duty not to act in the prohibited manner.

[73] See Delport (n 71) 105 – 106, 640, 642; Cassim, Cassim, Cassim, Jooste, Shev and Yeats *Contemporary Company Law* (2012) 587; Locke and Esser "Company law and stock exchanges" 2013 *Annual Survey of South African Law* 265.

[74] Stevens and De Beer "The duty of care and skill, and reckless trading: Remedies in flux" 2016 *SA Merc LJ* 250 274. It seems that Delport (n 71) 641 – 642 agree with their view.

[75] Stevens and De Beer (n 74) 276 – 278.

[76] This reasoning further excludes a reliance on s 218(2) to hold directors liable if their breach of the duty of care and skill caused the person loss or damages. This duty, too, is owed to the company and therefore they argue s 218(2) ought not be available.

[77] s 66(1).

Since the prescriptive provision in section 22(1) applies to the board as a collective and to individual directors by implication, actions contrary to section 22(1) will be a "contravention" for purposes of section 218(2). There is nothing in the wording of section 218(2) to restrict the availability of the remedy to instances where a direct duty was owed to the plaintiff. It seems from a plain reading of the provisions that any contravention of the act that causes the plaintiff loss or damages would be actionable. As the authors correctly observe,[78] wrongfulness is not required by any of the mentioned sections.

It must be noted here that proof of causality of loss or damages is required both in terms of section 77(3)(*c*), where the company is the plaintiff, and in terms of section 218(2), where any other person who suffered loss or damage is the plaintiff. Stevens and De Beer express a contrary view by looking at section 22(1) alone,[79] but section 22(1) does not provide a remedy for breach. The remedies are found in section 77(3)(*c*), usually read with the statutory derivative action,[80] and in section 218(2). Furthermore, even though section 218(2) requires no proof of culpability, the content of section 22(1) means that culpability will be an essential element of the remedy, at least to the extent of gross negligence.[81]

Turning to the policy considerations, the ability of individual creditors to hold directors personally liable has been criticised, also in the context of section 424 of the Companies Act 61 of 1973, for the fact that it would benefit the plaintiff creditor to the potential prejudice of other creditors. Despite these policy objections, access by creditors was allowed without consent by the liquidator. If the legislature intended to amend the legal position and exclude the right of creditors to proceed directly against delinquent directors who have traded recklessly, it is presumed that it would have done so expressly.[82] One would also expect such an objective to have featured somewhere in the legislative policy documents that preceded legislative reform and in some of the commentaries following reform. Instead, there is no mention on any agenda for reform to exclude the ability of creditors to sue for reckless trading.

While the company serves as a vessel for the fair distribution of wealth generally, in the sense that creditors are to be paid in preference to shareholders, company law outside of insolvency provides no distribution rules to apply between creditors. This falls strictly in the realm of private ordering. The

78 Stevens and De Beer (n 74) 271.

79 Stevens and De Beer (n 74) 271.

80 s 165. Apart from shareholders, directors, prescribed officers and employee representatives, s 165(2)(*d*) gives standing to any person who has been granted leave of the court to institute the derivative action. The court must be satisfied that leave would be necessary or expedient to protect a legal right of that person. In my opinion creditors could potentially be granted such leave, also to enforce s 77(3)(*c*).

81 See the discussion in par 4 below.

82 It is a presumption of statutory interpretation that the legislature does not intend to repeal or change existing statutes more than necessary. See *Kent NO v SA Railways* 1946 AD 298 405; Du Plessis *Re-interpretation of Statutes* (2002) 179 and Devenish *Interpretation of Statutes* (1992) 161.

creditors who rely on the reckless trading provisions are typically those who extended credit to the company while the directors knew or ought to have known that the company would not be able to honour its commitments. There was, in other words, a misrepresentation of the ability of the company to honour the terms of the credit extended. The creditor would have access to either contractual remedies or delict, but in theory the prohibition of reckless trading aims to provide a more expedient route to such claimants than the normal common law remedies.

The problem is that the act fails in this endeavour. The scheme implemented in the act already restricts the availability of the remedy to creditors in the sense that section 218(2) requires proof of causality between the plaintiff's loss and the contravention. This effectively removed the major advantage of section 424 of the 1973 act when compared to a claim in delict.[83] Assuming that most claimants will have contracted with the company in the circumstances set out above, wrongfulness would not be difficult to prove. This means that creditors would as easily rely on delict as on section 218(2). It is now much harder to hold directors accountable in South African law, even more so if I am incorrect in my arguments above and it emerges that Stevens and de Beer's interpretation is preferred because then creditors will not have direct access to a remedy against the delinquent directors at all.

If the turnaround activity of the directors led to a compromise in terms of section 155 of act, which bound the company's creditors or a class of them, it seems unlikely that debts incurred in connection with the compromise would give rise to action in terms of section 218(2) or section 424 of the 1973 act in the event of subsequent insolvency of the company. A compromise is contractual in nature and whether the claims of creditors are extinguished after its conclusion will depend on the terms of the contract. It has been held in the context of a compromise in terms of section 311 of the 1973 act that the debt owing to creditors in terms of section 424 was ancillary to the debts owing to them by the company and that it could not exist without them.[84] In other words, once the debts were settled by means of compromise, there remained no debt owing to creditors in terms of which they could pursue action against directors in terms of section 424. There is nothing in the wording of section 155 of the act to suggest that a different interpretation should be given to the compromise provision in the act.

Finally, it is possible that a board takes action to attempt to save a distressed company outside of a formal compromise with creditors, but rather via

[83] Blackman *et al* (n 62) 524 – 525, 536; Meskin *et al* (n 62) 914.

[84] *Ex parte De Villiers NNO: In re Carbon Developments (Pty) Ltd (in liq)* 1992 2 SA 95 (W) 104G -109B (left open on appeal) and *Kalinko v Nisbett* 2002 5 SA 766 (WLD) 777B-C. But see *Pressma Services (Pty) Ltd v Schuttler* 1990 2 SA 411 (C) 416I – 417A and *Lordan NO v Dusky Dawn Investments Ltd (in liq)* 1998 4 SA 519 (SE) 529E-J. However, the view of the former cases is supported because on cession of the claim the person ceases to be a creditor for purposes of s 424. This is the case even if the creditor received a partial payment of the initially owed debt. This view is supported by Blackman *et al* (n 62) 14-529 – 14-530.

individual agreements with creditors or through a change in business practice aimed at improving the business of the company. As explained below, it is submitted that a safe harbour would not be necessary in the South African context to protect directors involved in such activity.

4 Should a safe harbour be created in the South African legislation?

There are several reasons why a safe harbour is not ideal in South Africa. First, the element of culpability that must be proven by a plaintiff already implies that the actions of the directors must be measured against the notional reasonable person of business in the same circumstances. It has been held that "recklessness" does not connote mere negligence but at the very least gross negligence in this context.[85] It is submitted that this culpability element already provides enough protection against liability to directors who legitimately attempt to turnaround the affairs of the company. The relevant evidential test for recklessness in dealings with creditors is as follows:

> "If a company continues to carry on business and to incur debts when, in the opinion of reasonable businessmen, standing in the shoes of the directors, there would be no reasonable prospect of the creditors' recovering payment when due, it will in general be a proper inference that the business is being carried on recklessly."[86]

In *Philotex* this statement was slightly clarified.[87] What needs to be established for purposes of the section is not to show certainty about an inability to pay the incurred debt, but rather that objectively regarded there is a very strong chance that the debt would not be repaid. It is not necessary to establish a director's subjective belief that the debt would not be paid to pass the recklessness test, although the presence of such a belief may point to intentional fraudulent actions. Recklessness is determined objectively but with reference to the circumstances of the director and having the same knowledge or means to gain knowledge as the directors. South African courts acknowledge that risk taking is a reality of business. In *Philotex* this was explained as follows:[88] if a reasonable businessman would foresee material but not high risk of non-payment of a debt and the board nonetheless allowed debts to be incurred, such action might be negligent but would not be grossly negligent for purposes of section 424. However, if a reasonable businessman would foresee in all circumstances that payment would not be made when it fell due, such actions would be reckless and satisfy the requirements of the section. The court went on to emphasise that much would depend on the precise circumstances of each case. *Henochsberg* frames the recklessness test as follows: "carrying on any

85 *Ozinsky v Lloyd* 1992 3 SA 396 (C) 414G; 1995 2 SA 915 (A) 923 and *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* 1998 2 SA 138 (SCA) 144A. See further Blackman *et al* (n 62) 14-534 – 14-543 and Meskin *et al* (n 62) 916.

86 *Ozinsky* decision (n 85) 414G as followed in *Philotex* (n 85) 145H – 147C.

87 *Philotex* case (n 85) 147B – C.

88 146G – 147C.

business of the company recklessly means carrying it on by conduct which evinces a lack of any genuine concern for its prosperity".[89]

An honest endeavour to turnaround the affairs of a business would simply not meet this test but would instead show a genuine concern for the affairs of the business. In this regard, the following was said in *Fourie v Newton*,[90] the facts of which actually concerned a failed turnaround strategy outside of formal insolvency proceedings:

> "In evaluating the conduct of directors, courts should not be astute to stigmatise decisions made by businessmen as reckless simply because perceived entrepreneurial options did not in the event pan out. What is required is not the application of the exact science of hindsight, but a value judgment bearing in mind what was known, or ought reasonably to have been known, by individual directors at the time the decisions were made. In making this value judgment, courts can usefully be guided by the opinions of businessmen …"[91]

In fact, the *Fourie* case clearly illustrates that the element of recklessness is used in South African law to limit liability for insolvent trading when a legitimate but failed turnaround strategy was implemented.

Fraudulent trading implies actual dishonesty or "conscious deceit",[92] although this dishonesty will most often be objectively inferred from the actions of the defendant, rather than by enquiring after her actual frame of mind.[93] Although space does not allow for a full discussion, illegal phoenix activity would probably be considered fraudulent in South African law and would therefore potentially lead to liability.

A second reason pointing against adoption of similar measures is the fact that the South African regulator is not currently as active in the monitoring and enforcement of directorial duties. Although the legislative mechanisms have been put in place for this to be the case,[94] the Companies and Intellectual Property Commission ("CIPC") is not taking a similar role to the active enforcement role taken by ASIC. The 2016/2017 CIPC Annual Report is the latest one that is publicly available.[95] It mentions only 16 matters to date that have been placed on a court roll for litigation with a view of imposing administrative fines.[96] It is entirely relying on information provided by auditors in this regard. It seems that limited independent investigative resources are available at the CIPC.[97] It mentions only one successful case of declaring a

89 Meskin *et al* (n 62) 916.
90 2010 JDR 1437 (SCA).
91 par 45.
92 See *Ozinsky* (n 85) 415B – F and 418C – D.
93 See in general Blackman *et al* (n 62) 14-538 – 14-543 and Meskin *et al* (n 62) 916(1).
94 See s 187.
95 CIPC *Annual Report 2016/2017*, available from http://www.cipc.co.za/index.php/publications/annual-reports/, last visited 28 June 2018.
96 CIPC (n 95) 36.
97 The Annual Report shows that there were 9 investigators in March and April 2016 but that this number decreased to 7 for the remained of the year under review ((n 3) 50 Table 6). There was also a substantial backlog of 189 cases (51).

director delinquent.[98] One further criminal conviction was secured against a director for contraventions of the Companies Act.[99]

The ASIC Annual Report for the same period shows a total of 9011 reports of alleged misconduct, which was 8% lower than in 2015/2016.[100] Of these report, 18% were related to directors' duties or internal disputes, which amounts to 1622. 75% of the cases were either resolved, assessed for no further action, found not to fall within ASIC's jurisdiction or not to have been breaches.[101] 25% of the cases were referred to action by ASIC. That is a total of 2253 cases, although the Report does not indicate how many of these related to directorial misconduct. However, as at 1 January 2018, 19 civil actions by ASIC against directors were pending before the courts.[102]

Furthermore, even in Australia questions have been raised about the differing effect of the safe harbour on large companies and small companies.[103] While directors of large companies typically have limited personal incentive to take the risk of personal liability to save a failing company, directors of small companies are often also major shareholders. Moreover, directors of small companies are often required to provide personal guarantees for the indebtedness of the company in any event, which means that they inevitably stand to account personally for the debts of the company in the event of default. The fear expressed is that the safe harbour will incentivise illegal phoenix activity in these small companies.

If a company was involved in phoenix activity before its liquidation, there will likely be very little left in the corporate kitty to fund a liquidator in pursuing litigation against directors for stripping the company of its assets during pre-liquidation.[104] Even though asset stripping without benefit to the company's creditors would not withstand judicial scrutiny, there might simply not be funds left to pursue the matter.

Generally, it is much harder to keep directors accountable in South Africa than it is in Australia. The inclusion of section 218(2) into the act will likely not be an avenue through which delinquent directors could easily be held to account by persons other than the company. In fact, owing to the failures of the statutory derivative action as it currently stands,[105] it is not even easy for the company to hold directors accountable.

Finally, the formal business rescue procedure is meant to be the preferred vehicle through which to affect the turnaround of a distressed company. Apart from returning the company to solvency, it may also have as an objective to

[98] CIPC (n 95) 39.
[99] CIPC (n 95) 39.
[100] ASIC *Annual Report 2016/2017* 90, available from https://download.asic.gov.au/media/4527819/annual-report-2016-17-published-26-october-2017-full.pdf, last visited 28 June 2018.
[101] ASIC (n 100) 91.
[102] ASIC *ASIC Enforcement Outcomes: July to December 2017* (Report 568, February 2018) 6.
[103] See Andersen (n 9) 1027 – 1029.
[104] Anderson (n 9) 1030 – 1032.
[105] See in general Cassim *The New Derivative Action under the Companies Act: Guidelines for Judicial Discretion* (2016) ch 7.

achieve a better return for creditors than the immediate liquidation of the company.[106] If it is felt in the market that this mechanism does not optimally function to assist the turnaround of companies, it is submitted that one should rather reassess the business rescue procedure and fix it than to attempt to incentivise turnaround actions outside of that mechanism. The same observation applies in the Australian context. However, in the South African context legitimate turnaround actions outside of formal business rescue still fail to meet the recklessness test as explained above.

5 Concluding remarks

The analysis above shows how careful one needs to be when considering the adoption of measures from foreign jurisdictions. Despite all the commonalities between South African and Australian company law, the totality of the regulation and institutional system in Australian law makes for a much harsher scheme of directorial accountability than in South Africa.

The conclusion of this paper is that safe harbour provisions would not suit the South African context. However, that is not saying that the scheme of directors' liability in South Africa should not potentially be reconsidered. Outside of section 424, which has the benefit of extensive case law to assist its interpretation, the system for prohibiting reckless and fraudulent trading in terms of the act leaves much to be desired. It is not at all clear that this system was based on a sound theoretical or policy footing. As it stands, creditors cannot be certain whether they could use section 218(2) directly to hold directors personally liable for acquiescing in reckless or fraudulent trading.

[106] s 128(1)(*b*)(iii).

Closing bank accounts: Recent developments

SAREL DU TOIT*

Abstract

Banks may terminate the bank and customer contract – or close a customer's account – unilaterally in terms of the notice periods specified in the contract or by giving reasonable notice. *Bredenkamp v Standard Bank of South Africa Ltd* (SCA) confirmed the common-law position and set out a number of related principles. Recently aspects of these principles were challenged in court, when clients applied for interim interdicts, requiring banks to keep accounts open against the banks' wishes; much of it happening against the backdrop of extensive media coverage and political turmoil. This contribution first considers the common-law principles and specifically the meaning of "reasonable notice", as well as provisions in various codes of banking practice. It then analyses to what extent the *Bredenkamp* principles were applied correctly in the *Hlhongwane*, *Oakbay Investments* and trio of *Bank of Baroda* judgments. Most of the decisions applied the *Bredenkamp* principles consistently, although emphasis on the bank's regulatory obligations played an important – and welcome – role in some of the recent decisions.

* * * * *

1 Introduction

The political landscape in South Africa changed dramatically in December 2017, with the election of a new leader of the majority party, and in February 2018, with the election of a new President of the Republic. The former Minister of Finance, who featured prominently in one of the cases to be discussed below, and was dismissed in the previous dispensation also returned to Cabinet in 2018. Banking lawyers may speculate about whether recent decisions on closing bank accounts might have played a small part in this shift in power, although in doing so they will most likely overestimate their influence. Banks, bank accounts and high-profile clients have enjoyed substantial media coverage in recent times. This contribution will examine how judgments from November 2016 until March 2018 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] It will start with a brief examination of the common-law principles, the meaning of "reasonable notice", the provisions of the Code of Banking Practice and 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.

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[1] 2010 4 SA 468 (SCA).

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 back to 1923, the matter is explained with reference to cheques: a short notice might 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 United Kingdom:[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."

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.

6 It should be noted that in the circumstances of the cases discussed later in this contribution, 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 18 below. See Hapgood *Paget's Banking Law* (2007) for a similar period in terms of the former (UK) Banking Code.

It is quite conceivable, though, that a sophisticated company might need significantly more time.[10] It is also possible that the circumstances of the case dictate a shorter period or even immediate closure.[11] Circumstances such as those in the three *Bank of Baroda* judgments discussed below,[12] may well point to a shorter period of time or immediate closure.

One should further bear in mind, as pointed out by Schulze,[13] 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 [mandator] (*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 …."

In the circumstances of the *Bank of Baroda* decisions discussed below,[14] the bank should have been able to raise the conduct of the customer as a ground for cancellation in the case of some of the clients. There is no need for an express clause allowing termination of the contract,[15] although such a clause is recommended.[16]

3 Code of Banking Practice (2012)

The Code of Banking Practice contains provisions on closing an account in paragraph 7.3:[17]

> "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

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 par 7-9 below.

13 (n 6) 220.

14 par 7-9.

15 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.

16 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).

17 *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.

> - 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[18] 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 following instances mentioned in the Code in which an account may be closed without giving notice may be relevant in the decisions discussed below: "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".

The Banking Ombudsman Scheme of New Zealand provides the following guidance, after referring to a notice period of at least 14 days:[19]

> "In some limited circumstances, however, a bank can close your account without giving you any notice. These may include:
>
> if a bank is complying with a court order
>
> if you have acted illegally
>
> if you have breached the bank's terms and conditions
>
> if you have acted abusively towards bank staff.[20]
>
> A bank does not have to explain why it is closing a customer's account,[21] although in most cases banks follow good practice and give a reason. This gives the customer an opportunity to respond if the bank has misunderstood the facts of a situation or made a mistake."

As emerges below, these principles are in accordance with the *Bredenkamp* decision[22] and subsequent cases.

4 The *Bredenkamp*[23] principles

The *Bredenkamp* decisions[24] have been discussed before, but as (most) subsequent cases followed the SCA decision, it is worthwhile to revisit the

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

[19] Quick Guide on "Closing accounts" (March 2018) https://bankomb.org.nz/guides-and-cases/quick-guides/bank-accounts/closing-accounts/ (visited 9 August 2018). The Australian Banking Code of Practice (2013) cl 33.1(b) refers to giving reasonable notice when closing an account in credit, whereas the new Banking Code of Practice (1 July 2019) cl 143(a) inserts the phrase "if appropriate" into a similar clause (both Codes are available at http://www.ausbanking.org.au/code/banking-code-of-practice/ (visited 9 August 2018)).

[20] This, according to the website (n 19), is one of the two most common reasons why a bank will close an account in New Zealand.

[21] although it is stated earlier that banks "should not close an account without good reason".

[22] n 1.

[23] *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).

[24] See *Breedenkamp* 2009 5 SA 304 (GSJ) (n 17) 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.

principles emerging from them. 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.[25] As such the court did not consider in any detail domestic and international obligations of the bank flowing from the regulatory environment it finds itself in.[26]

In first of the *Bank of Baroda* decisions,[27] 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.[28]

> "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)".[29]

As indicated by Schulze, however, an absence of reasons may be indicative of an absence of *bona fides*, or even the abuse of rights.[30] 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,[31] but even so, it is unlikely that the outcomes in *Bredenkamp*[32] 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 the court quoted the following passage from *Bredenkamp*:[33]

> "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."

25 Schulze (n 6) 212. See *Bredenkamp* (n 1) par 17-18.
26 But see *Breedenkamp* 2009 6 SA 277 (GSJ) (n 24) 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.
27 *Annex Distribution (Pty) Ltd v Bank of Baroda* [2017] ZAGPPHC 608; 2018 (1) SA 562 (GP) (21 September 2017) par 22; hereafter *Bank of Baroda* (21 September 2017).
28 See par 2 above.
29 See also *Bredenkamp* (n 1) par 7.
30 Schulze (n 6) 221.
31 See *eg* Rautenbach (n 23) 520 *et seq*; Bhana "Contract law and the Constitution: Bredenkamp v Standard Bank of South Africa Ltd (SCA)" 2014 *SAPL* 508 513 *et seq*.
32 See *Bredenkamp* (n 1) par 53. The court stated earlier (par 30): "The case is about fairness as an overarching principle, and nothing more."
33 par 57.

The next principle highlighted by the court is:

> "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."[34]

Once again, the court relies on *Bredenkamp* as authority, where Harms DP concludes:[35]

> "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."

The bank must therefore "consider and assess the reasons for its decision" and "apply its mind to the matter",[36] in coming to a *bona fide* decision.

The judge continues:

> "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:[37]

> "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 is:

> "7. The fact that the client may have difficulty finding another bank does not impose any obligation on the bank to retain the client."[38]

In *Bredenkamp*, Harms DP states:[39]

> "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 statement sums up the *Bredenkamp* decision, and the legal principles upon which the judgment was based:[40]

[34] See *RCG Forex Service Corp v HSBC Bank Canada* 2011 BCSC 315 par 23: "… HSBC does not seriously contend that it seeks to terminate the relationship due to any specific conduct of RCG. It simply wishes to discontinue doing business with RCG as being a customer that exposes it to business risks and results in higher regulatory and compliance costs to HSBC." A "commercially reasonable justification" is, however, not required (par 33.)

[35] par 65.

[36] Schulze (n 6) 221.

[37] par 61; see also par 14.

[38] In *RCG Forex Service Corp* (n 34) par 17 the customer argued that "no other bank offers the same range of foreign currency accounts as HSBC", but the argument did not sway the court.

[39] par 60.

[40] par 65.

> "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 most subsequent cases without much variation.

5 *Hlongwane v ABSA Bank Ltd*[41]

In the *Hlongwane* decision, the applicants brought an application in terms of the Promotion of Access to Information Act[42] against ABSA to make certain records available to the applicants, or first to the court, in the alternative.[43] 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.[44] When asked earlier for the reason, ABSA (somewhat cryptically) stated:

> "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."[45]

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.[46] In a subsequent request in terms of the Act,[47] 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:[48] in terms of the Financial Intelligence Centre Act (FICA),[49] 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

41 [2016] ZAGPPHC 938 (10 November 2016).
42 2 of 2000 s 78(2)(d)(i) and s 82.
43 par 1.
44 par 10-11.
45 par 10.
46 par 12.
47 s 53(1).
48 par 16.
49 38 of 2001.

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.[50]

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.[51] ABSA was entitled to terminate the relationship on proper notice – and "ample notice" had been given.[52] 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."[53]

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".[54] 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 "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".[55]

6 The *Oakbay Investments* case[56]

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.[57] 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."[58]

[50] See par 17-21 for the applicants' submissions and par 22-26 for the respondents' submissions.

[51] 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).

[52] par 29.

[53] 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 27) par 38.

[54] par 31.

[55] par 32.

[56] *Minister of Finance v Oakbay Investments (Pty) Ltd; Oakbay Investments (Pty) Ltd v Director of the Financial Intelligence Centre* [2017] ZAGPPHC 576; [2017] 4 All SA 150 (GP); 2018 (3) SA 515 (GP) (18 August 2017).

[57] For interlocutory issues not discussed here, see par 16 *et seq*.

[58] par 12.

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.[59]

The court heard two main applications and a parallel application, preparing one judgment in respect of all the applications.[60] 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."[61]

The banks supported the application,[62] 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.[63] The court found that the applicant had established the condition precedent for the exercise of the court's discretion.[64] Regarding the second leg of the inquiry,[65] the court correctly held that the question the Minister wants the court to determine, "has been decided previously"; and is not disputed by the Oakbay Group.[66] 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."[67]

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

59 par 13-14, 65-66.
60 par 1.
61 par 2.
62 par 8.
63 par 9.
64 "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.
65 "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 64) 42.
66 par 62; also 63-64.
67 par 79-80.

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 …".[68]

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)[69] – "[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.[70] 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 committee was never approved, the Minister refused to recognise it and did not participate in it and the banks were not influenced in any way.[71] The application for declaratory relief was dismissed.

Standard Bank brought a parallel application for declaratory relief, "couched in broader terms",[72] seeking an order whereby

> "[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."[73]

The application failed because of Standard Bank's failure to join the President and members of the National Executive.[74]

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."[75] As the court granted the applications to strike out,[76] the application was withdrawn.[77]

68 par 67.
69 par 68.
70 par 71.
71 par 75-76.
72 par 3.
73 par 86.
74 See par 89-96.
75 par 4. The application was based on s 40(1)(e) of FICA.
76 See par 31-42.
77 par 43-44.

7 *Annex Distribution (Pty) Ltd v Bank of Baroda* – 21 September 2017[78]

In the first *Bank of Baroda* decision, the bank 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.[79] The applicants sought an order that the Bank of Baroda be 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.[80] 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".[81] 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,[82] although the court applied the same requirements as those for an interim interdict.[83]

The applicants' affidavits disclosed triable issues to be considered in December 2017.[84] The court applied *Bredenkamp* in response, but there was 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" while the applicants have not been "publicly stigmatized in a similarly objective process".[85] 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 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.

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".[86] In addition, some applicants' "loan

[78] n 27.
[79] par 3.
[80] par 1.
[81] par 2, 10.
[82] par 1, 4.
[83] See par 5-9, 11.
[84] See par 12.
[85] *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).
[86] par 14.

facilities had been reviewed fairly recently and they were therefore entitled to arrange their business affairs accordingly". The court found that the period of almost three months was "more than reasonable notice".[87]

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.[88]

> "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."[89]

In addition, the bank alleged that it provided the applicants, long before 6 July 2017, with a "more informal notice" that termination is under consideration,[90] including the following "interactions": the bank 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 from 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.[91]

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:

> "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."[92]

In this context the court referred 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;

87 par 24. This was in respect of the first four applicants' loan facilities.
88 par 30; *RCG Forex Service Corp* (n 34) par 33.
89 See par 33 in respect of the bank's branches and employees in South Africa, and the use of a payment agent.
90 par 30.
91 par 31. This was in respect of the applicants' transactional facilities.
92 par 34.

the Banks Act;[93] the Regulations relating to banks;[94] FICA;[95] and the Money Laundering and Terrorist Financing Control Regulations.[96]

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".[97] 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,[98] 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 considers "[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.[99] 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*[100] 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".[101]

The court concluded that the application to be heard in December had very little prospect of success:[102]

> "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.

93 94 of 1990; see *eg* s 60B.
94 *eg* r 50.
95 38 of 2002; see *eg* s 29.
96 *eg* r 21 read with Guidance Note 3A; par 25 of the Guidance Note deals with politically exposed persons.
97 par 37.
98 par 39.
99 par 39.
100 n 56.
101 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.
102 par 41.

8 *Annex Distribution (Pty) Ltd v Bank of Baroda*[103] – 9 October 2017

The second *Bank of Baroda* decision "follows", in a manner of speaking, the judgment of Fabricius J,[104] with the applicants seeking an order, first, that the urgent application enrolled to be heard on 7 and 8 December 2017, be heard before 30 September 2017 (the date on which the applicants' accounts would have been closed), and secondly, that an interim interdict be granted (see the quotation below). The matter was enrolled for argument by the Deputy Judge President on 28 and 29 September 2017.[105]

The order[106] made by Makgoka J is very similar to the one dismissed by Fabricius J, with mostly inconsequential changes in word order and a few words and phrases:

> "1. Pending the final determination of the application referred to in paragraph 2 of this order, the respondent is interdicted from:[107]
>
> 1.1 de-activating and/or closing the applicants' banking accounts held with the respondent and/or from terminating the banker-customer relationship between the applicants and the respondent for the reasons stated in the termination notices dated 6 July 2017;[108]
>
> 1.2 demanding the first to fourth applicants to repay the sums owed by each of these applicants to the respondent in terms of their loan and overdraft agreements with the respondents for the reasons stated in the termination notices dated 6 July 2017;[109]
>
> 1.3 in any way limiting the manner in which the banking accounts are operated by the applicants so as to ensure that the applicants are permitted to operate the banking accounts in the same manner as they did immediately prior to the notices of termination date[d] 6 July 2017, subject to the respondent's terms and conditions as may be applicable from time to time;[110]
>
> 2. Within 15 days of the granting of this order, the applicants shall launch an application against the respondent for the final relief the applicants deem

[103] [2017] ZAGPPHC 639 (9 October 2017) – hereafter *Bank of Baroda* (9 October 2017).

[104] *Bank of Baroda* (21 September 2017) (n 27).

[105] par 1.

[106] par 87.

[107] In *Bank of Baroda* (21 September 2017) (n 27) par 1 (where the "'interim-interim' relief" sought is set out) reference is made to an "action" rather than an application and the phrase "and restrained" appears after "interdicted".

[108] Apart from minor differences, the new order adds "for the reasons stated in the termination notices dated 6 July 2017". Makgoka J indicated that the relief sought was too broadly stated and thus added this section here and in par 1.2 so that the bank would not be "hamstrung in its interim relationship with the applicants" (par 85).

[109] Here "and overdraft" and "for the reasons stated in the termination notices dated 6 July 2017" are added in the new order, apart from minor differences.

[110] Here the phrase "subject to the respondent's terms and conditions as may be applicable from time to time" is added in the new order. Both orders mistakenly use the word "date" rather than "dated".

> appropriate concerning the validity or otherwise of the termination notices dated 6 July 2017 issued by the respondent;[111]
>
> 3. The interim order referred to in paragraph 1 above shall lapse should the applicants fail to launch the application referred to in paragraph 2 above within the time frame stipulated in the order".

The remainder of the new order deals with costs, and differs from the previous order applied for, but, it is submitted, nothing turns on this and the relief applied for is essentially the same. Despite this, a substantial part of the judgment[112] is devoted to indicating that the judgment was not a "re-hearing" of the decision of Fabricius J, or an "appeal" against the order made in that judgment, and deals at length with "abuse of process" and "*res judicata*/issue estoppel". It is submitted, though, that this is exactly what the judgment amounts to: as can be seen above essentially the same order that has been dismissed previously is applied for, based on the same facts. It is difficult to understand why the matter was heard again. Despite the rather unhappy term "interim interim" relief in the judgment of Fabricius J,[113] the requirements of an interim interdict were applied there[114] – as was subsequently done by Makgoka J. In the judgment of 21 September 2017, the court was fully aware[115] of the implications of the judgment and the fact that the accounts would not be open by the time of the application in December – including the fact that the December hearing might be rendered "meaningless and academic".[116]

Having disposed of the above as preliminary issues, the court revisits the issues dealt with – and disposed of – by Fabricius J. Even if one were of the opinion that there is a clear distinction between the "interim interim" application before Fabricius J and the application for an interim interdict in this case, the case is so similar that it is difficult to see how the court could have come to a different conclusion.

In the 21 September 2017 judgment no relief was sought in respect of the contracts between the applicants and the bank potentially being fully or partially contrary to public policy; any such invalidity would have been an issue to be decided at the main hearing in December.[117] In the 9 October 2017 judgment this changed and public policy considerations played an important role in respect of the termination clause in the loan agreements: "credit

[111] The new order refers to "final relief the applicants deem appropriate concerning the validity or otherwise of the termination notices dated 6 July 2017 issued by the respondent", whereas the application before Fabricius J cross-references specific paragraphs. The court (par 85) did not want to define the type of relief that the applicants will seek in their final interdict.

[112] See par 13 and 18-30.

[113] It is suggested that the application should simply have been for an interim interdict with a view to final relief in December.

[114] *Bank of Baroda* (21 September 2017) (n 27) par 8, 9, 43,

[115] The court in *Bank of Baroda* (21 September 2017) (n 27) par 18 refers to affidavits and annexures of more than 1000 pages, with argument over a whole day.

[116] as submitted by Makgoka J (par 17). Fabricius J rightly calls this a "rather startling and wide-ranging submission" – see *Bank of Baroda* (21 September 2017) (n 27) par 18.

[117] *Bank of Baroda* (21 September 2017) (n 27) par 2, 18, but also see the summary in par 12.

facilities granted in terms of this agreement may be terminated by the bank in its sole discretion by written notice to that effect, either forthwith or from the date stated in such notice".[118] Both the clause and the manner in which it was enforced, were claimed to be against public policy.[119] The court mentioned that the bank placed "heavy reliance"[120] on the *Bredenkamp* decision. It should be noted that *Bredenkamp* is indeed the positive law and as such should be relied upon and should be followed. The court nevertheless distinguished the present case from *Bredenkamp*, first, based on this public policy dimension, whereas no public policy considerations were raised in *Bredenkamp*, and, secondly, because of the *dispute* regarding reasonable notice, whereas such notice was accepted as having been given in *Bredenkamp.* It is submitted that "reasonable notice" was dealt with satisfactorily on 21 September 2017, regardless of the dispute.[121] It is not quite clear from the judgment to what extent the public policy considerations were argued before the court, but it is submitted that the mere fact that they were raised,[122] cannot unsettle well-established banking law in this regard.[123]

Fabricius J stated:

> "The *Bredenkamp* decision needs to be read carefully and in my view it does stand in the way of the relief sought by the Applicants. The enforcement of the present contract does not implicate an identified constitutional value that was unjustifiably affected. No specific infringement of a human right is relied upon in these proceedings …. A bank is entitled to make business decisions. In this case the bank did so and no properly identifiable and pleaded constitutional value was affected."[124]

According to Harms DP in *Bredenkamp*:

> "I would be surprised if the judgment of Ngcobo J[125] holds than an *agreement to pay a loan on demand* or on a given day requires for enforcement an inquiry into the reasonableness of the creditor's decision to rely on the contractual right."[126]

118 par 40.
119 See par 63, 64, 69, 70.
120 par 65.
121 In respect of reasonable notice Fabricius J has already indicated that the effective notice period for all accounts terminating on 30 September 2017 constitutes reasonable notice. And even a period of six days (see *Bank of Baroda* (9 October 2017) par 76) may be reasonable, especially under these extraordinary circumstances – see the discussion in par 2 above.
122 "Bald allegations to this effect would not suffice" – Fabricius J in *Bank of Baroda* (21 September 2017) (n 27) par 25.
123 Such clauses are typical where overdrafts and loans are involved (see Malan, Pretorius and Du Toit (n 2) 317), and probably even more so where sophisticated entities such as the applicants willingly entered into contracts with a bank. (See *B-Filer Inc v TD Canada Trust* 2008 ABQB 749 par 23: "I cannot accept GPAY's assertion that the agreement … is unenforceable because the termination provision is onerous or unreasonable. Mr Grace is a sophisticated business person and has conceded … that he either knew, or could have guessed, that such a term was contained within the contract.") Furthermore, as there was notice given, and given the surrounding circumstances, the enforcement as such is even less likely to be seen as unfair.
124 *Bank of Baroda* (21 September 2017) (n 27) par 12.
125 in *Barkhuisen v Napier* 2007 5 SA 323 (CC).
126 *Bredenkamp* (n 1) par 28 (my emphasis).

Further criticism against the judgment is that the bank's regulatory obligations, including compliance with statutory provisions, and the integrity of the financial system[127] are not considered by the court at all.[128] Increased monitoring cannot be dismissed as merely an "administrative burden".[129] The consequences for employees should quite rightly weigh heavily[130] in any decision to be made, but the balance of convenience (as considered in an application for an interim interdict) may also favour the party "which seeks to uphold and preserve the integrity of the financial system and the Rule of Law".[131] The "parties' commercial interests"[132] should not have been the primary consideration from the point of view of either the bank or the applicants, but issues of public interest should have been considered.[133]

In light of the above, the refusal of the bank to keep open the accounts pending the interim application in December, was not "a particularly unreasonable stance"[134] and the bank had indeed adopted a "sensible and reasonable position".[135] Given the likelihood – let us assume unproven at this stage – of continuing non-compliance with regulatory requirements and possible criminal activity, it might well, it is submitted, expose the bank to delictual liability should it decide not to close the accounts.[136] It is submitted that if a client were to succeed with an interim interdict against a bank on the facts *in casu*, as happened here, it is difficult to envisage *any* circumstances where a court would rule in favour of a bank. The inevitable consequence of the judgment would therefore be that accounts will be kept open for many months following a bank's decision to close such accounts – as long as the client approaches a court for an interim interdict – which in the fast-moving financial world might well mean ample opportunity for harm to the financial system as a whole and for losses to other individuals, corporate entities and the state.

9 *Annex Distribution (Pty) Ltd v Bank of Baroda*[137] – 12 March 2018

The last of the *Bank of Baroda* judgments was heard by Mavundla J, and he managed, quite correctly, to neatly sidestep many of the difficulties raised in

127 See *Bank of Baroda* (21 September 2017) (n 27) par 41.

128 See par 53 and 79 where the bank's argument is set out. A reference to an unnamed regulator is brushed off in par 52. Also see *B-Filer Inc* (n 123) par 37, 41 and 47-52.

129 par 83.

130 par 84.

131 *Bank of Baroda* (21 September 2017) (n 27) par 43.

132 par 84.

133 See *B-Filer Inc* (n 123) par 45 *et seq* where issues of public interest were considered when weighing the balance of convenience for purposes on an injunction in Canada.

134 par 10.

135 *contra* Makgoka J par 12; also par 19.

136 *Cf Petersen NO v Absa Bank Ltd* 2011 5 484 (GNP) in respect of early developments regarding the monitoring of bank accounts.

137 [2018] ZAGPPHC 6 (12 March 2018) (quotations will be from unreported case no 52590/2017 which omits some of the typographical and other mistakes on the SAFLII website).

the judgment of Makgoka J, due to the delimitation of the question under consideration. In a letter dated 12 February 2018 the bank informed the applicants that:

> "The bank is now implementing a rationalisation of its international operations, which includes the closure of the South African branch … Accordingly the bank will terminate its local branch operations with effect from 31 March 2018. As from that date it will no longer provide banking services in South Africa … In order to ensure an orderly closure program the bank will cease accepting any new incremental deposits from, or on behalf of its customers, with effect from 01 March 2018."[138]

In response the applicants approached the court for an interim interdict declaring *inter alia* that, pending the final determination of the relief envisaged in the order of Makgoka J,[139]

> "The respondent is interdicted and restrained from giving effect to and or implementing in any manner its expressed intention to refuse to take deposits and or to terminate its banking operations in the Republic of South Africa to the extent that this may be in conflict with the judgment and order of Makgoka J delivered on 9 October 2017".[140]

The applicants submitted that should the court not grant the relief, it would render their "part B application" academic, that their rights in terms of section 34 of the Constitution, dealing with access to the courts, would be infringed, and that courts considering granting an interim interdict should do so in a way that promotes the objects, spirit and purport of the Constitution.[141] In response the bank pointed out that it does not operate as a clearing bank in South Africa, and that its correspondent relationship with Nedbank has now been terminated,[142] and it is thus "unable to provide any meaningful banking services to its customers"; as it could also not establish correspondent relationships with the other major banks, it "pleads impossibility".[143] The court held:

> "The respondent [bank] without any infrastructure of Nedbank, cannot be expected to service the account of the applicants. Neither can the court compel it to go belly crawling to Nedbank to demand re-installation of the infrastructure. The respondent has every right to terminate any business contract, including that of the applicants."[144]

[138] par 8.

[139] The applicants had already complied with the order of Makgoka J in filing their "part B application", which is yet to be heard (par 6) – and probably never will in light of the 12 March 2018 judgment.

[140] See par 1 for the full order sought by the applicants; also par 10.

[141] par 11; *cf* s 39(2) of the Constitution of the Republic of South Africa, 1996.

[142] In *Bank of Baroda* (9 October 2017) (n 103) par 81 the court emphasized the fact that – at the time – the bank's relationship with Nedbank had not been affected and that Nedbank had not threatened to terminate the relationship.

[143] par 12.

[144] par 16.

The bank further pointed out that "it is not economically viable for it to remain in South Africa"[145] and the decision to exit "is predicated on commercial consideration".[146] As such, the court held that the order by Makgoka J is not linked to the fact that the bank is leaving South Africa and therefore the exit is not "*mala fide* and calculated to frustrate the Makgoka J order, or in contempt thereof."[147]

The court furthermore considered the bank's right to freedom of trade in terms of section 22 of the Constitution, embracing also the choice not to exercise such a trade: "the Courts cannot compel the respondent [bank] to keep the doors of its business open for whatever duration".[148] The bank's right to trade supersedes any of the applicants' rights according to Mavundla J, and thus he did not exercise his discretion in favour of the applicants and declined to grant the interim interdict.[149] It is submitted that the decision is correct. Under any other circumstances, closing accounts when a bank leaves the country, would probably not merit another glance. The only difficulty here was whether the preceding circumstances were making it impossible for the applicants to find other banks to provide them with the necessary facilities.

When considering the interim interdict, the court pointed out that, in respect of the requirement of having no other remedy, the applicants may have a (contractual) claim for damages.[150] It is suggested though (and in all likelihood the court would have agreed), that such a claim is not likely to succeed. There was no breach of contract: the bank gave notice of the closing of the accounts for a period of more than 30 days (the letter was dated 12 February and the accounts were to be closed on 31 March), although new deposits were not accepted from 1 March.[151]

10 "Hard cases"[152]

The outcomes of most cases discussed here, would be acceptable to many people, even if the road to get to those decisions may be less clear, especially in light of media reports and the political context – even when keeping in mind the sensible reminder by Makgoka J in a paragraph entitled "The Gupta link":[153]

145 par 11. The bank only had 16 employees across two branches – par 15.1.
146 par 19.
147 par 19.
148 par 17.
149 par 20.
150 par 14.
151 The positions of the parties on these dates are not apparent from the reported judgment. Fabricius J may have gone beyond the requirments of an interim interdict in his judgment (it does not affect the validity of the judgment in any way – but *cf Bank of Baroda* (9 October 2017) (n 103) par 11) – but the judgment does foreshadow the outcome of an application for a final interdict or even a claim for contractual damages.
152 "Hard cases make bad law" – or so the saying of uncertain origins and meaning tells us (there are many variations): see https://en.wikipedia.org/wiki/Hard_cases_make_bad_law (7 August 2018) for links to the phrase being used by different people in different contexts.
153 *Bank of Baroda* (9 October 2017) (n 103) par 8.

> "But, for us in our capacity as judiciary officers, when adjudicating matters involving members of this family or their associated entities, we must not allow the legitimate public outrage against that family, or even our own inclinations, to influence our judicial-making processes."

As has been argued in this contribution, most of the decisions are legally sound. But what of the more difficult questions: may a bank *always* close a client's account, by giving suitable notice and without reasons, as a strict interpretation of *Bredenkamp* seems to imply? Or, considering some basic examples, to what extent may a bank refuse to open, or later decide to close, clients' accounts for the following reasons: (1) the bank decides not to offer accounts to clients involved in industries, which the bank finds to be morally ambiguous (for example, gambling[154]), but not necessarily illegal; or (2) the bank decides to offer certain accounts only to clients with an impeccable environmental record, but not to those companies who comply with all legal requirements but are not generally regarded as involved in environmentally friendly industries; or (3) the bank decides to offer accounts only to high-net worth clients or medical professionals?[155] It is suggested that these accounts should all be allowed in principle and can be justified on commercial and other grounds, but the regulator would need to keep an eye on access to banking services within the context of financial inclusion to make sure that banking facilities remain available for all clients within the wider industry.

However, a blanket refusal to provide a bank account to a client without any reason or context whatsoever, while continuing to provide banking facilities to clients who, at first blush, do not differ from the client being refused, may well fall foul of the equality clause in the Bill of Rights.[156]

11 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.[157] It is submitted that, with the exception of the second *Bank of Baroda* judgment, 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. A 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

[154] See *B-Filer Inc* (n 123) par 14: "TD [Canada Trust] has a policy that precludes it from providing accounts to businesses that accept payments for online gambling."

[155] See *eg* https://www.investec.com/en_za/banking.html (visited 9 August 2018).

[156] s 9 and 36 of the Constitution, 1996.

[157] 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* (21 September 2017) (n 27) 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.

in light of international guidelines, should be welcomed. Although the current crop of decisions seems to have been put to bed in the third instalment of *Bank of Baroda*, banks should be encouraged to frame their defence within the regulatory context, if relevant, should similar cases be heard in future.

Both the conduct of the banks in the circumstances described above, and the court judgments, should foster the Rule of Law.[158] As the court said in the first *Bank of Baroda* case,[159]

> "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, Mlambo JP held:[160]

> "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."

[158] *Cf* the remarks of Fabricius J in *Bank of Baroda* (21 September 2017) (n 27) par 40.
[159] (21 September 2017) (n 27) par 37.
[160] (n 56) par 71-72.

The International Arbitration Act 15 of 2017: Unpacking the Model Law and the enforcement of foreign arbitral awards under the Act

DAVID BUTLER*

Abstract

Since the commencement of the International Arbitration Act 15 of 2017 on 20 December 2017 South Africa has had different regimes applying to domestic and international arbitration. In the context of an arbitration involving a cross-border dispute, the court's powers of intervention have been restricted and the powers of the arbitral tribunal, subject to any limits imposed by the parties in their arbitration agreement, have been substantially increased. Interim measures, usually required to ensure the effectiveness of the award, are now regulated by the new Act in line with international standards. Where South Africa is not the seat of the arbitration, the Act also corrects serious defects in previous legislation regarding the enforcement of foreign arbitral awards in South Africa under the New York Convention. Since the global financial crisis of 2008, financial institutions have become more aware of the potential benefits of arbitration, compared to litigation, for resolving cross-border disputes in the financial sector. South African lawyers, whether as party representatives or in-house counsel, need a thorough understanding of this Act and international best practice before venturing into the field of international arbitration. Particular care needs to be taken with the drafting of the arbitration agreement and the adaptation of institutional arbitration rules to meet the needs of disputes in the financial sector.

* * * * *

1 Introduction

With the commencement of the International Arbitration Act 15 of 2017 on 20 December 2017, South Africa became a dualistic arbitration jurisdiction, with different regimes applying to domestic and international arbitration. The time is therefore opportune to consider the possible benefits provided by the new legislation in the context of cross-border commercial disputes in the financial sector. As will be seen from the discussion below, where the parties have chosen South Africa as the juridical seat for an arbitration regarding their cross-border commercial dispute, the court's powers of intervention have been restricted and the powers of the arbitral tribunal, subject to any limits imposed by the parties in their arbitration agreement, have been substantially increased.[1] These powers include wide powers to grant interim measures in line with international standards. Interim measures, particularly with a view to

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[1] See 4 below for further details.

ensuring the effectiveness of the tribunal's award on the merits, are regarded as an essential feature for the efficacy of modern arbitration.[2] Where South Africa is not the seat of the arbitration, the Act also corrects serious defects in previous legislation regarding the enforcement of foreign arbitral awards in South Africa under the New York Convention.[3]

Financial institutions have traditionally chosen to take their cross-border commercial disputes to national courts rather than to private arbitration. Partially as a result of the global financial crisis of 2008, financial institutions have become more aware of the potential benefits of arbitration, compared to litigation, for resolving cross-border disputes in the financial sector, particularly when one or more of the parties are based in developing countries.

Arbitral institutions are actively marketing their services to the financial sector[4] and are even adapting their rules to meet the perceived needs of the financial sector.[5] South African lawyers, whether as party representatives or in-house counsel, need a thorough understanding of the new legislation and international best practice before venturing into the field of international arbitration. This contribution examines the potential benefits and possible shortcomings of this legislation taking into account the special needs of the financial sector.

2 The changing attitude of the financial sector towards arbitration

For purposes of this chapter, disputes pertaining to the financial sector must be understood broadly.[6] Such disputes could relate to derivatives, sovereign finance like bonds and capital market instruments, regulatory matters including the application and enforcement of rules of conduct for doing business, international financing by way of loans and security agreements, advisory services provided by investment banks including services relating to mergers and acquisitions and asset management by specialist units. However, as the Model Law as contained in the International Arbitration Act 15 of 2017 is restricted to commercial disputes, a discussion of disputes between financial institutions and consumers is beyond the scope of this chapter.[7] Third-party funding is also beyond the scope of this contribution.[8]

While arbitration has long been used for disputes relating to shipping, insurance and construction projects, it has traditionally been less attractive

[2] See 4.3 below.

[3] The Convention on the Recognition and Enforcement of Foreign Arbitral Awards entered into in New York on 10 June 1958. See 5.4 below.

[4] See *eg* the ICC Commission Report *Financial Institutions and International Arbitration* (2016).

[5] See 5.1 below.

[6] See the ICC Commission Report (n 4) 2 par 5. See also Freeman and Fisher "Arbitration of banking and financial disputes" 3 www.practicallaw.com (23 June 2018).

[7] See Holtzmann and Neuhaus *A Guide to the UNCITRAL Model Law on International Commercial Arbitration* (1994) 71, quoting the Seventh Secretariat Note *Analytical Commentary on Draft Text* (A/CN 9/264 of 25 March 1985) par 18.

[8] See generally Sahani "Judging third-party funding" 2016 *UCLA L Rev* 388.

to banks and other financial institutions. There are at least four reasons for this trend.[9] Firstly, there is the long-standing belief that arbitration does not offer expedited processes, equivalent to summary or default judgment in court, which enable simple debt claims to be dealt with quickly.[10] Secondly, the absence of a binding system of precedent, as provided by the courts in leading jurisdictions like London and New York, was seen as a disadvantage.[11] Thirdly, because of the consensual basis of arbitration, arbitration statutes and rules struggle with consolidation and joinder in the context of multi-party disputes.[12] Fourthly, particularly in a South African context, issues regarding arbitrability can arise in the context of investment disputes[13] and disputes where the validity of administrative action by a state-owned entity exercising public power can arise.[14]

However, it cannot be denied that in appropriate circumstances, arbitration does offer certain advantages, compared to litigation, for the resolution of cross-border commercial disputes in the financial sector.[15] The increasing use of arbitration in the banking and financial sector is indicated by some institutional statistics.[16]

Arguably the most important advantage, particularly in the case of financial disputes involving parties from developing countries, relates to the enforceability of foreign arbitral awards, when compared to a foreign judgment. If the defendant's assets are in a jurisdiction where foreign judgments are easy to enforce, a financial institution may well prefer litigation.[17] However, in the majority of regions where there is no effective treaty for the enforcement of foreign judgments, 159 states are parties to the New York Convention, which makes foreign arbitral awards relatively easy to enforce in these jurisdictions.[18]

9 See Freeman and Fisher (n 6) 2; ICC Commission Report (n 4) 10; Blanke "The promotion and usage of arbitration and ADR in resolving disputes in the financial sector" unpublished paper presented at the UNCITRAL/IDRI conference at Abuja, Nigeria on 14 June 2018 6-11.

10 See Freeman and Fisher (n 6) 2; ICC Commission Report (n 4) 10; Hanefeld "Arbitration in banking and finance" 2013 *NYU Journal of Law & Business* 917 919-920. Compare the discussion in 5.2 below.

11 See Freeman and Fisher (n 6) 2; ICC Commission Report (n 4) 10. See However ICC Report (n 4) 10 on redacted awards.

12 See ICC Commission report (n 4) 10 and compare the discussion in 5.2 below.

13 See the Protection of Investment Act 22 of 2015 s 13. This statute took effect on 13 July 2018. See GN 395 of 2018 in GG 41766 of 13 July 2018.

14 See *Airports Company SA v ISO Leisure OR Tambo (Pty) Ltd* 2011 4 SA 642 (W). Regarding the possibility that a commercial decision taken by a public body under a commercial contract can also amount to administrative action see *South African National Parks v MTO Forestry (Pty) Ltd* 2018 ZASCA 59 (17 May 2018).

15 See generally ICC Commission Report (n 4) 9-10; Hanefeld (n 10) 923-928; Freeman and Fisher (n 6) 2.

16 In 2016 20.5% of new disputes administered under the LCIA related to this sector. (See LCIA 2016: A Robust Caseload 6.) However in the 2107 Annual report of the Singapore International Arbitration Centre 15, banking is still classified under "other" which collectively comprised 4% of the 452 new cases received by SIAC during 2017.

17 Freeman and Fisher (n 6) 2; Hanefeld (n 10) 924.

18 See www.uncitral.org, accessed on 30 6 2018.

The Convention is well known for its pro-enforcement bias: the enforcement of foreign awards can be refused only on limited grounds and the onus is usually on the defendant to establish the ground.[19] It must nevertheless be conceded that the enforcement of arbitral awards may indeed be challenging in some jurisdictions in practice.[20]

Secondly, in jurisdictions where state court judges are generalists, arbitration can offer the benefit of arbitrators with expertise in financial disputes.[21] While a tribunal of commercial arbitrators are all subject to the same standards of impartiality and independence, a party is usually free to appoint an arbitrator of its own nationality,[22] which will at least ensure that the party's business culture and national law is understood by the tribunal.[23] Modern commercial disputes, also in the financial sector, can sometimes be highly complex. It is suggested that an arbitral tribunal is often more capable of dealing with very complex disputes than a state court.[24]

Thirdly, as illustrated by modern arbitration statutes and institutional rules,[25] arbitration is a highly flexible process. As soon as the tribunal has a reasonable understanding of the nature of the dispute, it is able to meet with the parties to design a procedure which is tailor-made for that particular dispute. Modern rules contain examples of techniques which can be used to expedite the proceedings and reduce costs.[26]

Fourthly, arbitration may well be able to offer the parties the benefit of confidentiality, an advantage which may be particularly important in certain financial disputes, for example one relating to mergers and acquisitions.[27] However, as explained below, where confidentiality is important, the parties may need to choose a seat or adapt standard institutional rules to make sure that this advantage is actually obtained.[28]

Lastly, financial institutions sometimes appreciate the finality provided by an arbitral award.[29] An arbitration award cannot usually be taken on appeal to the court at the seat, which only has limited powers to review the award for lack of jurisdiction or a gross procedural irregularity.[30]

19 See 5.4 below.

20 The cause of the potential problem is revealed by a III of the Convention. The conditions for enforcing a foreign award may not be substantially more onerous than for the enforcement of a domestic award, but the NYC does not require the member state to have an efficient process for the enforcement of awards. See also ICC Commission Report (n 4) 10.

21 See ICC Commission Report (n 4) 9.

22 See the Model Law a 11(1).

23 Blackaby and Paratsides *Redfern and Hunter on International Arbitration* (2015) 239.

24 Hanefeld (n 10) 925-926.

25 See the Model Law a 19; UNCITRAL Arbitration Rules a 17.1.

26 See the ICC Arbitration Rules (2017) aa 22 and 24 and appendix IV. See further 5.2 below.

27 Freeman and Fisher (n 6) 2.

28 See 5.6 below.

29 ICC Commission Report (n 4) 9; Freeman and Fisher (n 6) 2.

30 See the Model Law a 34. The English Arbitration Act of 1996 s 69 is the exception: it provides a limited right of appeal to the courts on a question of law on a contract-out basis.

Having examined the potential benefits and pitfalls of using arbitration to resolve cross-border disputes in the financial sector, it is now appropriate to discuss relevant aspects of the new South African legislation.

3 Background to the International Arbitration Act 15 of 2017

UNCITRAL at an early stage of its investigation into promoting greater uniformity in national statutes on international arbitration deliberately chose the format of a model law rather than a treaty as this would facilitate the ability of national states to make adaptations considered essential for local needs.[31] It is also important to note that the project originated from a proposal of the Asian-African Legal Consultative Committee. Thus developing countries were involved in the project from the outset and their needs were properly considered in the drafting of the Model Law.[32]

In July 1998 the South African Law Reform Commission published a report on international arbitration.[33] The report recommended the introduction of the UNCITRAL Model Law[34] on International Commercial Arbitration of 1985 for international arbitration only. The report also recommended improved legislation to give effect in domestic law to South Africa's international obligations in terms of the Convention of the Recognition and Enforcement of Foreign Arbitral Awards, commonly referred to as the New York Convention.[35]

However due to a cabinet reshuffle in 1999, there was a lack of political will to proceed with the legislation, and, subsequently, questions regarding the constitutionality of private arbitration were raised.[36] These concerns have since been laid to rest by the courts.[37]

UNCITRAL amended the Model Law in 2006, in particular by substantially expanding the provisions on interim measures. The SALRC was instructed in 2012 to update its Draft Bill of 1998 and the updated Bill was discussed by a committee of experts in August 2013 before being submitted to the Department

[31] See Binder *International Commercial Arbitration and Conciliation in UNCITRAL Model Law Jurisdictions* (2010) 9-10.

[32] See Binder (n 31) 8-10. The membership of UNCITRAL is also structured in such a way that all regions of the world are duly represented.

[33] Arbitration: an International Arbitration Act for South Africa Project 94 (1998).

[34] UNCITRAL is the acronym for the United Nations Commission on International Trade Law based in Vienna, which was established in 1966.

[35] The third recommendation by the Commission, discussed in ch 4 of its report, was that South Africa should accede to the Convention on the International Centre for the Settlement of Investment Disputes of 1965. This recommendation was subsequently rejected, following a government position paper Bilateral Investment Treaty Policy Review, published by the Department of Trade and Industry in June 2009.

[36] The Minister of Justice, Dr AM Omar MP, an ardent supporter of the Bill, became Minister of Transport after the 1999 parliamentary elections. The doubts regarding the constitutionality of private arbitration were raised by the Chief State Law Adviser in 2006.

[37] See *Lufuno Maphuphuli & Associates (Pty) Ltd v Andrews* 2009 4 SA 529 (CC); *De Lange v Methodist Church* 2016 2 SA 1 (CC).

of Justice.[38] In early 2016, the Bill acquired a new political champion, the Deputy Minister of Justice, John Jeffrey. However, the internal attempt by the Department of Justice to prepare an International Arbitration Bill for introduction in parliament in the first half of 2016 was fatally flawed and the department did not proceed with this version.[39] An improved Draft Bill, which incorporated most of the updates recommended by the SALRC in 2013, was published in early 2017.[40] This draft, following the 2013 update, restricted adaptations to the Model Law to those reasonably necessary for it to operate effectively in South Africa. "Nice-to-have" provisions which could have been controversial and delayed the passage of the Bill were removed.[41]

The objectives of the International Arbitration Act appear from section 3. They are to facilitate the use of arbitration as a means for resolving international commercial disputes; to adopt the Model Law for use in international commercial disputes; and to give effect to South Africa's obligations under the New York Convention.

One specific feature requires particular comment. The SALRC strongly recommended that the Model Law should be contained in a schedule to the Act and not rewritten in the text of the legislation. In effect, this approach amounts to incorporation by reference as opposed to direct adoption. Although most jurisdictions have followed the latter approach when adopting the Model Law,[42] the former approach of incorporation by reference makes it particularly easy for foreign lawyers to identify changes. Rewriting the Model Law in the national drafting style in the text of the legislation also creates potential uncertainty: did the drafter actually intend to depart from the meaning of the original text or not?[43] It is clear from the definition of "Model Law" in the Act that the text contained in schedule 1 is the Model Law as amended by UNCITRAL in 2006 with the adaptations made in the schedule.[44]

Although there are important adaptations and small refinements, South Africa has a particularly pure text of the Model Law,[45] which should be an important consideration in its interpretation.

[38] The meeting was ably chaired by a retired judge of the Supreme Court of Appeal, Justice LTC Harms.

[39] The International Arbitration Bill, as approved by the minister, was published on the website of the Department of Justice and Correctional Services in April 2016 with the reference 03081se.

[40] The notice of intention to introduce the Bill in the National Assembly was published as GN 217 of 2017 in GG 40687 of 15 March 2017.

[41] The 1998 Draft Bill contained several provisions aimed at promoting the use of conciliation in the context of an arbitration agreement. These were drastically reduced in post-2013 versions: compare the International Arbitration Act 15 of 2017 ss 12 and 13. The 1998 Draft Bill also provided that the default power to appoint an arbitrator should be vested in an arbitral institution to be designated by the chief justice, rather than the court. This provision was also later removed.

[42] See Binder (n 31) 17-18.

[43] See the SALRC report (n 33) par 2.9, 2.13-2.16.

[44] s 1 "Model Law".

[45] *Cf* the text in sch 1 with the Rwandan Law 5 of 2008 and the Mauritian International Arbitration Act 37 of 2008, as amended. Rwanda and Mauritius are the other two African jurisdictions to date which have adopted the 2006 version of the Model Law.

4 Characteristics of the UNCITRAL Model Law

The SALRC was of the opinion that the drafters of the Model Law had four main aims.[46] The first was the liberalisation of international arbitration by limiting the role of national courts and emphasising party autonomy. It should be noted that although the process is described as "international arbitration", the arbitration typically takes place under the national arbitration law of the juridical seat and the enforcement of a foreign arbitral award will be subject to the arbitration law of the place of enforcement. Party autonomy is one of the fundamental principles of arbitration law and can be defined as the freedom of the parties to decide on the procedure by which their disputes are resolved through arbitration, subject only to such safeguards as are necessary in the public interest.

The second aim follows on from and qualifies party autonomy, namely the establishment of a core of mandatory provisions to ensure due process. Although Roman Dutch law has always required that the arbitration process be fair, a concept which must now be determined in the light of constitutional values,[47] the Model Law is more specific in this regard than the Arbitration Act 42 of 1965. Several of the provisions relating to due process impose duties on the arbitral tribunal or individual arbitrators regarding their conduct.[48]

The third aim was to provide a procedural framework, so that should the parties fail to agree on the procedure, the arbitration could be successfully completed.[49] In short, the legislation must contain default provisions[50] which confer sufficient powers on the arbitral tribunal so that it can conduct the process efficiently and make an award, even when the parties have failed to include such powers in their arbitration agreement.

The final aim was the inclusion of provisions to facilitate the enforcement of arbitral awards and to deal with certain controversial issues. The New York Convention is only concerned with the enforcement of foreign arbitral awards.[51] The Model Law, in provisions closely based on the corresponding provisions of the Convention,[52] facilitates the enforcement of an award made in an international commercial arbitration, irrespective of the seat of the arbitration. Thus an award made in an international arbitration with its seat in a Model Law jurisdiction is enforceable under the Model Law. Moreover, parties wishing to enforce a foreign award in a Model Law jurisdiction which

46 SALRC Report (n 33) par 2.7.
47 See the *Lufuno* case (n 37) par 221.
48 See the Model Law aa 12(1), 18 and 24.
49 A clause in a cross-border commercial contract stating: "Disputes - arbitration Gauteng" is an enforceable arbitration agreement, but would be heavily dependent on the default provisions of the Act for its efficacy.
50 Default provisions are those which apply unless excluded or modified in the arbitration agreement, as opposed to mandatory provisions which the parties are not free to modify by agreement.
51 See further the definition of foreign arbitral award in a I of the Convention.
52 See aa 35 and 36 of the Model Law which correspond to aa III to VI of the Convention.

is also a party to the Convention, will usually be able to choose between the Convention and the Model Law for enforcing the award.[53] A good example of a provision clarifying a controversial issue is provided by article 9 of the Model Law. This provision makes clear that it is not inconsistent with an arbitration agreement for a national court to grant interim measures in support of an arbitration subject to that agreement.[54]

When the provisions of the 2006 version of the Model Law are compared to South Africa's Arbitration Act of 1965, which now only applies to domestic arbitration,[55] the two most striking differences are the reduced powers of the court and the increased powers of the arbitral tribunal under the Model Law. The most substantial change made to the Model Law by UNCITRAL in 2006 was the considerable expansion of the provisions dealing with interim measures. South Africa has accepted these amendments with important qualifications. Interim measures play an important role in the use of arbitration for the resolution of disputes in the financial sector. These aspects of the Model Law will be discussed in more detail below. It is, however, first necessary to consider how the Model Law ought to be interpreted in a South African context.

4.1 *Interpreting the Model Law*

In the long interval between the publication of the SALRC's Draft Bill in July 1998 and the commencement of the International Arbitration Act 15 of 2017 on 20 December 2017, the various South African versions of the Model Law were mainly of academic interest, for the simple reason that they did not yet represent South African law. However, case law on the Model Law dates back in some other jurisdictions to 1986. Those involved in the legislative process in South Africa were mainly interested in judgments that could indicate birth defects in the text of the Model Law, as adopted elsewhere, unless appropriate changes were made. Such cases exist, for example in India.[56] The Model Law as contained in schedule 1 is now law in the republic.[57] How should South African courts and arbitral tribunals with their seat in South Africa set about applying the Model Law and to what extent is foreign case law relevant for this purpose?

Guidance on interpretation may be found in article 2A of the Model Law, introduced as part of the 2006 amendments. Article 2A(1) reads as follows:

> "1. In the interpretation of this Law, regard is to be had to its international origin and to the need to promote uniformity in its application and the observance of good faith."

[53] a VII.

[54] See Holtzmann and Neuhaus (n 7) 332.

[55] See the International Arbitration Act 15 of 2017 s 4(1).

[56] See Nariman "Ten steps to salvage arbitration in India: the first LCIA-India arbitration lecture" (2011) 27 *Arb Int'l* 115-127. The Indian Arbitration and Conciliation Act of 1996 was subsequently substantially amended by the Arbitration and Conciliation (Amendment) Act 3 of 2016.

[57] s 6 read with the definition of "Model Law" in s 1.

Questions concerning matters governed by the Law which are not expressly settled in it must be settled in conformity with the general principles on which the Model Law is based.[58]

The need to promote uniformity was part of the rationale for the preparation of the Model Law. The inclusion of this provision in the text of the Model Law is an appropriate reminder to national courts when applying the Model Law. UNCITRAL has established the CLOUT data base to facilitate access to the decisions of national courts on the Model Law in the states which have adopted it.[59] It is obviously preferable for the court to engage in comparative research rather than to embark on a frolic of its own. Moreover, modern institutional rules for international arbitration increasingly emphasise the need for international arbitration proceedings to be conducted without unnecessary delay and expense.[60] Against this background the inclusion of a provision to observe good faith, which appears to be directed at the parties, comes as a timely reminder. In a South African context, the court has nevertheless on occasion referred to the difficulty of developing the common law to compel the parties to negotiate in good faith,[61] notwithstanding the Constitutional Court's support for the desirability of doing this in appropriate circumstances.[62] The requirement of good faith by a party participating in arbitration therefore requires further clarification and development, both in the context of constitutional values[63] and having regard to how the term is interpreted in other Model Law jurisdictions.[64]

The International Arbitration Act expressly permits reference to UNCITRAL's *travaux préparatoires* in the form of the reports of UNCITRAL and the reports and analytical commentaries of the UNCITRAL Secretariat for purposes of interpreting the Model Law.[65]

[58] See a 2A(2). A 2A is clearly based on a 7 of the United Nations Convention on Contracts for the International Sale of Goods of 1980.

[59] See www.uncitral.org/uncitral/en/case_law.html (1 July 2018). See also UNCITRAL's *2012 Digest of Case Law on the Model Law on International Commercial Arbitration*, which is arguably the most user-friendly way of accessing national case law up to 2012 on the various provisions of the Model Law.

[60] See *eg* the UNCITRAL Arbitration Rules (2010 a 17(1).

[61] See *Roazar CC v The Falls Supermarket CC* 2018 3 SA 76 (SCA).

[62] See *Everfresh Market Virginia (Pty) Ltd v Shoprite Checkers (Pty) Ltd* 2012 1 SA 256 (CC) par 71-72, per Moseneke DCJ.

[63] *Cf* the minority judgment in the *Everfresh* case (n 63) par 22-23, where it is stated by Yacoob J that contract law can no longer confine itself only to a colonial legal tradition. See also Rycroft "Settlement and the law" 2013 *SALJ* 196-199.

[64] However, at least one other model law jurisdiction, namely Rwanda, omitted a 2A when it adopted the Model Law by means of the Law on Arbitration and Conciliation in Commercial Matters 5 of 2008.

[65] s 8. The SALRC originally recommended a specified list of UNCITRAL documents which could be consulted. See the report (n 33) 32-33.This approach became impractical in view of the number of reports generated in the course of compiling the 2006 amendments. S 8 deliberately omits any reference to the reports of Working Group II, as these reports are only authoritative to the extent that they are adopted by UNCITRAL in its own reports.

4.2 *Balanced powers for the court*[66]

Article 6 permits a jurisdiction adopting the Model Law to specify the court which is to perform certain functions under the Model Law. The drafters of the Model Law envisaged that a national legislature could designate an arbitration institution instead of the court to undertake some of these functions.[67] To avoid possible controversy, article 6 of the South African version allocates the powers to the relevant division of the High Court.

"Court" is defined in article 2(c) of the Model Law to make it clear that it excludes the "court" of an arbitral institution like the ICC's International Court of Arbitration. The South African version has been further amplified to clarify the position of foreign courts: "'court' means a court referred to in article 6(1) and includes, where appropriate, a body or organ of the judicial system of a foreign State".

One of the objects of the Model Law was to limit the involvement of national courts in international commercial arbitration.[68] Article 5 plays a crucial role. It provides:

> "*In matters governed by this Law*, no court shall intervene except where so provided by this Law." (My emphasis.)[69]

The powers of the court in matters governed by the Model Law may be summarised as follows. The Model Law gives the court certain powers in relation to the appointment of an arbitrator and a challenge of an arbitrator or the termination of an arbitrator's mandate (articles 11, 13, and 14). The court also has the power to enforce the arbitration agreement (article 8), the power to order interim measures of protection (articles 9 and 17J), the power to review an arbitral tribunal's ruling on its own jurisdiction in certain circumstances (article 16(3)), the power to grant assistance in taking evidence (article 27), certain powers to enforce interim measures ordered by an arbitral tribunal (articles 17H and 17I) and certain powers regarding the setting aside, recognition and enforcement of the arbitral award (articles 34-36).

The crucial phrase in article 5 is "In matters governed by this Law". The current South African Arbitration Act, now restricted to domestic arbitration, confers powers on the court in respect of matters which are not governed by the Model Law, for example section 20 ("Statement of case for opinion of

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66 For a useful discussion from a South African perspective see Christie "Arbitration: party autonomy or curial intervention II: international commercial arbitrations" 1994 *SALJ* 360-372.

67 See for example the Mauritian Arbitration Act ss 12 and 14, where the court is replaced by a designated arbitral institution, the Permanent Court of Arbitration ("PCA") in the Hague.

68 See the SALRC Report (n 33) par 2.7 and 2.116.

69 See further on a 5 Binder (n 31) 50-54; Christie (1994) 111 *SALJ* 362-365; and, from an African perspective relating to Nigeria, Asouzu "Arbitration and judicial powers in Nigeria" 2001 *J Int'l Arb* 616 635-639. Asouzu, *International Commercial Arbitration and African States* (2001) 172 states that minimum judicial intervention in arbitration is an aim of the Model Law. He adds that certainty and predictability as to the circumstances in which the court will intervene "is epitomised by its Article 5".

court … during arbitration proceedings")[70] and section 8 ("Power of court to extend time fixed in arbitration agreement for commencing arbitration proceedings"). It was the intention of the SALRC that these and other powers of the courts relating to arbitration proceedings and not contained in the Model Law should not apply to an international commercial arbitration falling under the South African version of the Model Law.[71] Section 4(1) of the International Arbitration Act has been worded accordingly. Article 5 is also worded in the form of an absolute prohibition. Therefore, where article 5 applies, the court cannot intervene. The wording of article 5 can be contrasted to the corresponding provision of the English Arbitration Act, which states "in matters governed by this Part, the court *should* not intervene" (my emphasis). Although there is a strong general principle against intervention, the use of the word "should" implies that the court might possibly intervene in situations other than those specifically provided for in the Act.[72]

It should be noted that under South African law, an arbitration agreement does not deprive a court of its ordinary jurisdiction in relation to a dispute.[73] This basic proposition is not altered by the Model Law, even though a court may be obliged to stay a court action in relation to that dispute by virtue of the Model Law.[74] If the court stays the action, its jurisdiction, although sometimes latent, remains intact.[75] However, the court's powers of intervention are indeed restricted by the Model Law. Under the Model Law, the court's powers of intervention and supervision are normally intended to be exercised at the post-award stage.[76] Where, exceptionally, the Model Law permits a court to intervene during the arbitral proceedings, there is usually no right of appeal against the court's decision.[77] These restrictions also prevent the possibility of a right of appeal being abused as a means of delaying the arbitral process. However, a

[70] For the case law on s 20, see Butler "Arbitration" in *LAWSA* (3 ed) Vol 2 par 131; *Telcordia Technologies Inc v Telkom SA Ltd* 2007 3 SA 266 (SCA) par 143-156; *Road Accident Fund v Cloete* 2010 6 SA 120 (SCA) and *Padachie v The Body Corporate of Crystal Cove* 2016 ZASCA 145 (30 September 2016).

[71] See s 3(1) and sch 1 a 9(5) of the Draft Bill, read with the SALRC Report (n 33) par 2.30-2.32, 2.117 and 2.144-2.147.

[72] See Reid "The UNCITRAL Model Law on International Commercial Arbitration and the English Arbitration Act: Are the two systems poles apart?" 2004 *J Int'l Arb* 227 229-230 regarding s 1(c) of the English Arbitration Act.

[73] See *Parekh v Shah Jehan Cinemas (Pty) Ltd* 1980 1 SA 301 (D) 305E-G. See also the Australian decision of *Timoney Technology Limited v ADI Limited* (7883 of 2007) 2007 VSC 402 (17 October 2007) par 68.

[74] a 8(1).

[75] *Parekh v Shah Jehan Cinemas (Pty) Ltd* (n 73).

[76] See also Gaillard and Savage *Fouchard Gaillard Goldman on International Commerical Arbitration* (1999) 631-632, who state in relation to international arbitration generally, that although the courts will sometimes assist in setting up the arbitral tribunal, once the arbitral tribunal is constituted, the courts are generally required to refrain from interfering in the arbitral proceedings, until called on to enforce or set aside an award.

[77] See aa 11(5), 13(3), 14(1), 16(3) and the additional a 17J(4) of the South African version.

decision by the court on the recognition and enforcement of an award under article 36 or the setting aside of an award under article 34 is subject to appeal.

It must also be remembered that the court's powers under the 1965 Act are not exhaustive and that the court also has certain powers of supervision and intervention under the common law. For example, the court is prepared to intervene and review a procedural ruling by the tribunal while the arbitration is still in progress, although this power will ostensibly only be exercised in exceptional circumstances.[78]

Moreover, when a court is permitted by the Model Law[79] to intervene in an arbitration prior to the award, it is the arbitral tribunal, rather than the court, which has the discretionary power to decide to continue with the arbitration during the court proceedings and to make an award. This power will typically be exercised, after consulting the parties, where the tribunal is of the view that the approach to the court is without merit and is being used by a party as a delaying tactic. In sharp contrast, a South African court, under the common law, will not hesitate to interdict an arbitration from proceeding while related court proceedings are pending.[80]

A very important restriction to the powers of the court in an international arbitration which has been achieved by the International Arbitration Act and the Model Law is the removal of the court's discretionary power not to enforce a valid arbitration agreement which covers a dispute.[81] Under the Arbitration Act of 1965 the court can exercise its discretion in two situations. If an application is made to court to stay court proceedings because the matter is subject to an arbitration agreement, the court may nevertheless decline a stay if there is a sufficient reason not to refer the dispute to arbitration.[82] Alternatively, the court may on application order that the arbitration agreement should cease to have effect on good cause shown.[83] The extent of this discretion has recently been limited by the reinterpretation of these provisions in the light of constitutional values. In view of the importance of party autonomy and unless constitutional norms have been infringed, the court will not be justified in exercising its discretion to exclude arbitration unless "a truly compelling reason exists".[84]

Under the South African version of the Model Law, which is closely based on the New York Convention in this respect, the court before which the action has been brought is required to stay those proceedings on the application of a party unless "it finds that the agreement is null and void, inoperative or incapable

78 See the SALRC Report (n 33) par 2.145 citing *Tuesday Industries (Pty) Ltd v Condor Industries (Pty) Ltd* 1978 4 SA 379 (T). See also *Badenhorst-Schnetler v Nel* 2001 3 SA 631 (C).

79 See aa 8(2), 13(3) and 16(3).

80 *Sherwood Eleven Thirty Investments CC v Robridge Construction CC* 2001 4 SA 741 (W) 746B and 747D.

81 See sch 1 a 8(1) and s 16(1) and (4).

82 s 6.

83 s 3(2).

84 *De Lange v Methodist Church* (n 37) par 36 and 37.

of being performed".[85] This is one of only three procedural routes by which a court can be required to pronounce on the validity of an arbitration agreement prior to the award. The second is in the context of a review by the court of a ruling by the tribunal as a preliminary question on its own jurisdiction.[86] Finally, when the court is required to exercise its default power to appoint an arbitrator under article 11(3) of the Model Law, before exercising the power, the court must first be satisfied that there is a valid arbitration agreement.[87]

The first two routes will now be briefly discussed. Regarding article 8, it must be asked what level of investigation the court should make concerning the validity of the arbitration agreement. The drafters of the Model Law deliberately decided not to insert "manifestly" before the phrase "null and void, inoperative or incapable of being performed".[88] It is submitted that Born is correct when he concludes that article 8(1) permits full judicial consideration of the validity of the arbitration agreement at an interlocutory stage, but does not require it.[89] Nevertheless, the Court of Appeal in Singapore has decided that validity under article 8(1) must only be established on a prima facie basis, because of the desirability of deferring to the tribunal's power to rule on its own jurisdiction.[90] It is submitted that the application of a prima facie test by the court should depend on the circumstances. The tribunal cannot finally rule on its own jurisdiction under the Model Law: its decision is subject to court review.[91] The prima facie test will be appropriate where the validity of the arbitration clause is dependent on the same facts as one of the substantive issues in dispute. The court would be unable to determine the validity of the arbitration clause without trespassing on the terrain of the arbitral tribunal. Where the validity of the arbitration clause is not linked to the substantive issues in dispute, it will usually be preferable for the court to determine the validity itself.[92] If the matter is left to the arbitral tribunal, the tribunal's decision can be brought back to the court on review and if the court disagrees with the tribunal's decision, the arbitral proceedings will have

[85] a 8(1). The UNCITRAL version of a 8(1) requires the court to refer the parties to arbitration unless it finds the condition in the text has been fulfilled. The South African amendment is intended to reflect existing South African practice. The amendment requires the court to stay the court proceedings, which will in effect compel the parties to resort to arbitration.

[86] a 16(3).

[87] See the decision of the Supreme Court of India in *Jagdish Chander v Ramesh Chander* (4467/2002), 26 April 2007 par 8(i) and 11, where the dispute resolution clause only referred to the possibility of the parties agreeing to go to arbitration in the future.

[88] Holtzmann and Neuhaus (n 7) 303. Article 8(1) of the South African version reads in part: "A court before which an action is brought in a matter which is the subject of an arbitration agreement shall, if a party so requests …, stay those proceedings and refer the parties to arbitration unless it finds that the agreement is null and void, inoperative or incapable of being performed."

[89] Born *International Commercial Arbitration* (2014) 1084-1085.

[90] *Tomolugen Holdings Ltd v Silica Investors Ltd* 2016 1 SLR 373; *Wilson Taylor Asia Pacific Pte Ltd v Dyna-Jet Pte Ltd* (1234 of 2015) [2017] SGCA 32 (26 April 2017).

[91] a 16(3).

[92] The circumstances could be different if there will be a long delay before a date can be obtained for a full consideration of the matter by the court. At least under a 16(3) the decision of the court is not subject to appeal.

been a waste of time and money.[93] Nevertheless in *Dell Computer Corp v Union des Consommateurs*,[94] the Supreme Court of Canada has held that as a general rule in a case involving an arbitration clause, a challenge to the arbitral tribunal's jurisdiction should first be resolved by the arbitral tribunal. The court should only refrain from referring the matter to the arbitral tribunal if the challenge is based solely on a question of law.

It is submitted that article 8 only applies when a substantive action or application regarding a matter covered by an arbitration clause is made to the court. The court should not be approached directly with an application for declaratory relief regarding an objection to the arbitral tribunal's jurisdiction, including a challenge based on the validity of the arbitration clause. An application for declaratory relief` should be dismissed on this basis alone.[95] It is submitted that the use of applications for declaratory relief to determine the validity and scope of an arbitration clause should be firmly discouraged by the South African courts.[96]

The second route is available where the arbitral tribunal has ruled on the jurisdictional issue as a preliminary question.[97] To discourage the abuse of an application to court as a delaying tactic, the application must be brought within 30 days of receipt of notice of the tribunal's decision, the decision of the court is not subject to appeal and it is for the tribunal to decide whether or not the arbitration should continue while the action is pending.

The South African version of article 16(3) contains one significant departure from the original text.[98] UNCITRAL's original text only permits an application to court where the tribunal finds that it has jurisdiction.[99] This could, however, cause problems when jurisdiction is challenged on several related grounds, with the challenge being only partially successful, because some of the grounds are rejected. In *Badenhorst-Schnetler v Nel*,[100] for example, the tribunal's conclusion

93 *Cf* Gaillard and Savage (n 76) 410-413 regarding the policy considerations as to the stage at which the court should be permitted to rule on the validity of the arbitration agreement.

94 2007 SCC 34 (13 July 2007) par 84.

95 *El Nino Ventures Inc v GCP Group Ltd* [2010] BCSC 1859. *Dens Tech-Dens kg v Netdent-Technologies Inc*, Court of Appeal of Quebec, Canada, (2008) CLOUT case No 1016, adopts the same approach. Compare however *Jean Estate v Wires Jolley LLP* [2009] ONCA 339, where the restricted availability of a 8, as advocated in the text, was overlooked.

96 Even before the advent of the International Arbitration Act, this statement finds support in both judgments in *Zhongji Development Construction Engineering Co Ltd v Kamoto Copper Co SARL* 2015 1 SA 345 (SCA).

97 See a 16(3). Where the tribunal rules on the jurisdictional issue in an award, which is also permitted by a 16(3), the ruling can be challenged by applying to the court at the seat to set aside the award. The challenge could be based on the invalidity of the arbitration agreement under a 34(2)a)(i), or because the tribunal is exceeding its jurisdiction (a 34(2)(iii) or because the dispute is not arbitrable (a 34(2)(b)(i).

98 In the original version, a 16(3) states: "If the arbitral tribunal rules as a preliminary question that it has jurisdiction…". In contrast, the South African version reads: "If the arbitral tribunal rules on such plea as a preliminary question …".

99 See Holtzmann and Neuhaus (n 7) 486-487.

100 *Badenhorst-Schnetler v Nel* (n 78).

that it did not have jurisdiction on one issue precluded it from coming to a correct and fair decision on the remaining issues. The South African amendment to article 16(3) removes this problem.

4.3 *Increased powers for the arbitral tribunal*

The South African Arbitration Act 42 of 1965 in section 14(1) lists a number of specific procedural powers which the arbitral tribunal has, unless excluded in the arbitration agreement. Some of these powers may be exercised by the tribunal on its own initiative, whereas others may only be exercised on the application of a party. The Act contains no statement of a general principle as to how the tribunal may or should conduct the hearing.[101] Therefore, it is assumed that the tribunal lacks powers which are not included in the list.[102]

The Model Law first stresses the principle of party autonomy: subject to the mandatory provisions of the Model Law,[103] the parties are free to agree on the procedure to be followed by the arbitral tribunal in conducting the proceedings.[104] In the absence of such agreement, and subject to the same mandatory provisions, article 19(2) gives the arbitral tribunal the general power to conduct the proceedings in such manner as it considers appropriate. This approach is in stark contrast to that of the Arbitration Act of 1965. The general power in article 19(2) includes the power to decide on the admissibility, relevance and weight of any evidence.[105]

An important duty is imposed on the arbitral tribunal by article 18 as to how it must conduct the proceedings: the parties must be treated with equality and each must be given a "full opportunity" to present its case. The term "full opportunity" must obviously be understood to be subject to the requirement of reasonableness: the tribunal does not have to sacrifice procedural efficiency in order to accommodate unreasonable demands by a party regarding procedure.[106] As a result, in the interests of legal certainty, the South African version of article 18 substitutes "full" with "reasonable".

In addition to the general power in article 19(2), the tribunal is given a number of specific powers, which are not conferred by the 1965 Act. These

[101] See Butler (n 70) par 114.

[102] The absence of the power to grant interim measures is conspicuous. Hence the arbitral tribunal lacks the power to order security for costs, unless this power is conferred by the parties' agreed rules (*Petz Products (Pty) Ltd v Commercial Electrical Contractors (Pty) Ltd* 1990 4 SA 196 (C)).

[103] These provisions are aa 18, 23(1), 24(2) and (3), 27, 30(2), 31(1), (3) and (4), 32, and 33(1)(a), (2), (4) and (5). See UN doc A/CN.9/264 of 25 March 1985 read with Holtzmann and Neuhaus (n 7) 583.

[104] a 19(1).

[105] This latter provision is in line with the South African common law, which gives an arbitral tribunal a wide discretion regarding the admissibility of evidence, subject to the arbitration agreement and requirements of due process. See *Dexgroup (Pty) Ltd v Trustco Group International (Pty) Ltd* 2013 ZASCA 120 (20 September 2013) par 20.

[106] See Holtzmann and Neuhaus (n 7) 551. Other important procedural safeguards are imposed by a 24.

include the power to grant interim measures contained in article 17[107] and the power to appoint an expert witness, which is conferred by article 26.

Another important provision which has no equivalent in the 1965 Act is article 16 of the Model Law, referred to above, which deals with the power of the arbitral tribunal to rule on its own jurisdiction and in that context, the severability of the arbitration clause.[108] A jurisdictional ruling as a preliminary question is subject to immediate court review. The measures designed to prevent this right of court review from being abused as a delaying tactic have been set out above.[109] Before either exercising its power to rule on its own jurisdiction or taking a decision on whether or not to continue with the arbitration while a court review is pending, the tribunal should always first ask the parties for their views.[110]

4.4 *The concurrent jurisdiction of the court and the arbitral tribunal to grant interim measures*

Since the beginning of this century, if not before, the availability of appropriate interim measures has been seen as a prerequisite for the efficacy of international arbitration. The 1985 version of the Model Law simply confirmed that it was not inconsistent with an arbitration agreement for a court to grant interim measures,[111] without providing any indication of the extent of such powers. In addition, a terse provision conferred a clearly limited power on the arbitral tribunal to grant interim measures.[112] Interim measures were the major focus of the 2006 amendments. A new Chapter IVA on Interim Measures was added to the Model Law and the content of this chapter now constitutes at least 25% of the Model Law by volume. Substantial powers are now given to the arbitral tribunal to grant interim measures, with some guidance as to how these powers should be exercised.[113] The term "interim measure" is comprehensively defined, and includes the power to issue an anti-suit injunction.[114] Guidelines

[107] Aa 17 and 17A-17J replaced the brief provision on the tribunal's power to grant interim measures in the original a 17 and deal with this aspect in detail. See further 4.4 below.

[108] The doctrine of severability in the context of an allegedly void main contract was rejected in *Wayland v Everite Group (Pty) Ltd* 1993 3 SA 946 (W), but has subsequently been accepted in *Zhongji Development Construction Engineering Co Ltd v Kamoto Copper Co SARL* (n 96) par 30 and *North East Finance (Pty) Ltd v Standard Bank of South Africa Ltd* 2013 5 SA 1 (SCA) par 19-20. The power of the arbitral tribunal to rule on its jurisdiction, subject to court control was strongly reaffirmed in *Radon Projects (Pty) Ltd v NV Properties (Pty) Ltd* 2013 6 SA 345 (SCA) par 28-31.

[109] See 4.2 above.

[110] Very useful practical guidance is also provided to the tribunal by the international arbitration practice guideline Jurisdictional Challenges (29 November 2016) of the Chartered Institute of Arbitrators, available at www.ciarb.org.

[111] See a 9.

[112] See the 1985 text of the Model Law, a 17.

[113] See the Model Law (2006 version) aa 17 and 17A.

[114] See a 17(2). Whereas the definition in UNCITRAL's version is apparently exhaustive, the definition in the South African version is not. The latter definition commences "An interim

are also provided on how the tribunal should exercise its discretion to grant interim measures, including whether or not there is a reasonable possibility that the requesting party will succeed on the merits of the case.[115] As decisions on interim measures are normally made at an early stage of the process and only on the information then available, the tribunal is not prejudging the merits of the case. Provision for court enforcement of interim measures granted by the tribunal is also made.[116] An exhaustive list of grounds on which a court may refuse the application is also provided, which are specifically adapted to the circumstances of interim measures.[117] The International Arbitration Act 15 of 2017 adopts the 2006 amendments in Chapter IVA subject to two major reservations and one minor refinement.

The first major reservation concerns the omission of articles 17B and 17C on "preliminary orders". During the 2006 revision process the issue as to whether or not the Model Law should empower the arbitral tribunal to be able to grant interim measures on an *ex parte* basis (i.e. without notice to the party against whom the measure is sought) was hotly debated. Ultimately, a compromise was reached. The tribunal was empowered to grant "preliminary orders" on an *ex parte* basis, but such measure could not be enforced, particularly by the court, until the arbitral tribunal had converted it into an interim measure, after hearing both parties. The strongest argument for rejecting articles 17B and 17C is that they clearly do not achieve their intended purpose. As explained by the respected American commentator, Gary Born,[118] *ex parte* relief is based on the applicant's belief that the other party cannot be trusted to comply with its obligations and must be legally compelled to take certain actions immediately, without the opportunity to evade its obligations. The preliminary orders provided by articles 17B and 17C have no direct coercive effect and therefore cannot accomplish the purpose of *ex parte* relief.

The second major reservation concerns the provision on interim measures granted by a court in article 17J. UNCITRAL adopted a "lowest common denominator" approach by providing that a court has the same power to order an interim measure in relation to arbitration as it has in relation to court proceedings, without considering which interim measures are appropriate for a court to grant in the context of arbitration proceedings. While the court and the arbitral tribunal have concurrent jurisdiction to grant interim measures, from a policy perspective it makes sense to encourage the parties to approach the tribunal rather than the court, where appropriate. The SALRC followed this approach in 1998. It also exhaustively defined the measures which it would

measure includes any temporary measure …".

115 See a 17A. This factor is particularly relevant when the tribunal is asked to order security for costs against a claiming or counter-claiming party.

116 See the Model Law (2006 version) aa 17H and 17I.

117 See a 17I , which is obviously based on the grounds in a 36 on which a court may refuse to recognise and enforce an arbitral award.

118 Born (n 89) 2510.

be appropriate for a court to grant.[119] This provision has been included as article 17J instead of the UNICITRAL version.

The minor refinement concerns the express regulation of security for costs against a claiming or counter-claiming party. The arbitral tribunal has the power to grant security for costs unless the parties agree otherwise. The possibility of the court ordering security for costs has been expressly excluded.[120]

5 The potential advantages of the new legislation for the financial sector

The International Arbitration Act 15 of 2017 gives parties involved in cross-border commercial transactions the reassurance that South Africa's international arbitration legislation now fully complies with international standards. Nevertheless, financial institutions which are parties to such transactions need to give careful thought to the drafting of the dispute resolution clause. This section deals with what are arguably the main points which require consideration. Where necessary, the interaction between the Act and the parties' agreement and selected rules are discussed.

5.1 *The need for care in drafting the arbitration agreement*

Several of the factors which will require consideration relate to matters that ought to be dealt with by the drafter of any arbitration clause for a cross-border transaction. The first choice that will have to be made is between institutional or *ad hoc* arbitration.[121] In brief, with institutional arbitration, the arbitration is administered by a specific arbitral institution under its rules. With *ad hoc* arbitration, there is no administering institution, but the parties will typically choose to make use of the UNCITRAL Arbitration Rules, which are designed for *ad hoc* arbitration. In the financial sector, there seems to be a strong preference in favour of institutional arbitration.[122] Although certain arbitral institutions specialising in disputes in the financial sector have been established,[123] they generally have a modest caseload. The discussion proceeds on the premise that the drafters will choose a generalist arbitral institution and its rules.

Careful thought needs to be given to the juridical seat of the arbitration, as this will determine both the applicable arbitration law and the court with

[119] See the report (n 33) par 2.140-2.158 and a 9 of sch 1 of its Draft Bill.

[120] See sch 1 aa 17(2)(e) and 17J(1)(b). These provisions follow the recommendations of the SALRC in its report (n 33 par 2.152) as a result of the hostile reaction of the international arbitration community to the decision by the UK House of Lords to order security for costs in an ICC arbitration *in Copeé-Lavalin SA NV v Ken-Ren Chemicals and Fertilizers Ltd (in liq)* (1994) 2 All ER 449 (HL).

[121] Freeman and Fisher (n 6) 3.

[122] ICC Commission Report (n 4) 8.

[123] *eg* PRIME Finance, the Panel of Recognised International Experts in Finance, based at the Permanent Court of International Arbitration in The Hague. See further www.primefinancedisputes.org/ (2 July 2018); Freeman and Fisher (n 6) 14-16; Hanefeld (10) 931.

supervisory jurisdiction.[124] Notwithstanding the fact that a majority of African jurisdictions now have modern arbitration legislation[125] and the existence of several established and competent African-based arbitral institutions with suitable rules,[126] European-based practitioners acting for a party in an arbitration with an African connection are still strongly inclined to recommend a European seat.[127] A possible compromise is a European seat with an African venue.[128] The arbitration could then physically take place at an African arbitration centre,[129] but the supervisory court would be that of the European seat.

If the amount justifies it, financial institutions generally favour a tribunal of three arbitrators, as opposed to a sole arbitrator, with one arbitrator appointed by each party. The two arbitrators will then jointly appoint the presiding arbitrator.[130] Parties need to be aware that some institutional rules only allow the parties to nominate arbitrators for approval and appointment by the institution.[131]

As explained above, under the Model Law, a national court may only intervene in an arbitration regarding a matter dealt with by the Model Law, when so provided by the Model Law.[132] As a result applications to court for declaratory relief regarding the scope and applicability of the arbitration agreement are not appropriate and should be dismissed as being procedurally irregular. The court can become involved if asked to stay an action or application for substantive relief regarding a matter subject to an arbitration agreement.[133] In dealing with the application for a stay, the court may have to consider if the matter falls within the scope of the agreement, but it is unnecessary for the court to investigate whether or not there is a dispute. It is submitted that several cases decided under the Arbitration Act to the effect that a matter cannot be referred to arbitration in the absence of a dispute have no application under the International Arbitration Act.[134] It is for the arbitral tribunal, not the court, to consider the quality of any defence. If the arbitral tribunal makes a

124 See the Model Law a 20, read with aa 1(2) and 6.

125 11 states have adopted the Model Law and 17 the OHADA Uniform Act on Arbitration. The original Uniform Act of 1999 has recently been updated with effect from 15 March 2018.

126 *eg* CRCICA in Cairo, AFSA in Johannesburg and KIAC in Kigali.

127 This was the view of several European-based participants at the SOAS Arbitration in Africa Conference held in Kigali Rwanda on 3-4 May 2018.

128 See the Model Law a 20(2).

129 *eg* using the excellent facilities of CRCICA in Cairo.

130 ICC Commission Report (n 4) 8; Freeman and Fisher (n 6) 4.

131 See *eg* the ICC Rules aa 12.3, 12.4 and 13; the LCIA Rules a 5.7 and the SIAC Rules aa 9.2 and 9.3. The institution will normally respect party nominations but can prevent the appointment of nominees who are objectively unsuitable.

132 a 5. See 4.2 above.

133 a 8.

134 See *eg Body Corporate of Greenacres v Greenacres Unit* 17 CC 2008 3 SA 167 (SCA) par 9; *Body Corporate Pinewood Park v Dellis (Pty) Ltd* 2013 1 SA 296 (SCA) par 7. Compare *Halki Shipping Corporation v Sopex Oils Ltd* (1998) 2 All ER 23 (CA) 48b–h 56d–e, which was decided under the English equivalent of a 8 of the Model Law.

ruling on its own jurisdiction, including the scope of the arbitration clause, as a preliminary question during the arbitration the court may then intervene to review that ruling.[135]

5.2 *"Summary judgment" and expedited arbitration proceedings*

One of the main justifications for the traditional preference of financial institutions for using the courts instead of arbitration is the ability of courts to deal swiftly with uncontested debt claims[136] and to dispose of claims against financial institutions, which clearly lack merit, quickly by procedural mechanisms like judgment by default and summary judgment.[137] Although arbitration legislation and rules give arbitral tribunals wide discretionary powers to dispose of a dispute expeditiously and in a cost-effective manner, they may well be wary of using such powers to provide a remedy akin to summary judgment because of their duty to treat the parties with equality and to give each party a reasonable opportunity to present its case.[138] The tribunal's powers to proceed in the absence of a party are only available where the party, despite having received due notice, is in default.[139]

These concerns of financial institutions can be adequately addressed by means of appropriate provisions in the dispute resolution clause.[140] For example, the clause can be worded in such a way that uncontested claims are outside the scope of the arbitration clause.[141] Alternatively, the arbitration clause can be widely worded to cover all claims relating to the contract, whether disputed or not.[142]

Another possibility is an asymmetrical arbitration clause, which requires the borrower to litigate any disputes in a particular national court, while giving the financial institution the unilateral option to refer a dispute to arbitration. This in effect gives the lender a choice between litigation and arbitration, depending on the nature of the dispute. This choice can be made once the lender wants to proceed with a claim or after a dispute has arisen. Although the validity of such clauses has been rejected in some jurisdictions,[143] such a

135 a 16(3) and 4.2 above.

136 ICC Commission Report (n 4) 4; Hanefeld (n 10) 919.

137 Freeman and Fisher (n 6) 7.

138 Freeman and Fisher (n 6) 7.

139 Model Law a 25(b) and (c) and the UNCITRAL Arbitration Rules a 30(1)(b). In such circumstances the claimant must naturally still present sufficient evidence to justify an award in its favour.

140 ICC Commission Report (n 4) 4.

141 In *North East Finance* (n 108) par 4 the arbitration clause contained a proviso "excluding the failure to pay any amount due unless the defaulting party has, prior to the due date for such payment, by notice in writing to the other party disputed liability for such payment".

142 See *eg* the model arbitration clause with the UNCITRAL Arbitration Rules, which subjects "(a)ny dispute, controversy or claim arising out of or relating to this contract …" to arbitration.

143 See Petit *et al* "Asymmetric arbitration agreements a global perspective" Oct 2017 *NRF International Arbitration Report* 25 26, who refer to case law in France and Russia. Blanke (n 9) 15 states that a similar problem exists in Germany.

clause relating to a commercial dispute has recently been held to be a valid arbitration agreement by the Supreme Court of Singapore[144] for purposes of an international arbitration.[145] The South African courts have apparently not needed to consider the validity of such a clause in the constitutional era. If the parties are of equal bargaining position there is no reason to believe that the clause will be regarded as contrary to public policy, given the importance attached to party autonomy.[146]

Although arbitral tribunals may well be wary of using general powers to dispose of manifestly unmeritorious claims or defences in an expedited manner, the arbitral agreement or the applicable rules may contain specific provisions authorising such procedures. In *Travis Coal Restructured Holdings Llc v Essar Global Fund Ltd*, [147] Travis sought to enforce an ICC award obtained in New York against Essar Global in London. Essar Global, amongst other defences, contended that the arbitral tribunal, comprising eminent international arbitrators, had exceeded its powers by disposing of certain defences in a summary manner in the arbitration proceedings. Essar Global also had an application pending in the courts of New York to set aside the award. The English court held that in essence it had to decide whether the procedure adopted by the tribunal was within the scope of its powers and substantively fair, irrespective of Essar Global labelling the process as summary judgment proceedings.[148] The arbitration clause was in a guarantee that contained a sub-clause which specifically authorised the use of expedited proceedings.[149] The defences dealt with in an expedited fashion were covered by waivers and disclaimers in the guarantee and the tribunal allowed an oral hearing where it heard one witness from each party. The court concluded that the tribunal had made every effort to conduct the arbitration in an expeditious and cost-effective manner in the particular circumstances and that it had been fair to both parties.[150] In short, the use of a summary process in appropriate circumstances

[144] See *Wilson Taylor Asia Pacific Pte Ltd v Dyna-Jet Pte Ltd* [2017] SGCA 32. The clause gave one party a unilateral election to refer disputes to arbitration. The other party could only refer disputes to court. On appeal to the Supreme Court, the validity of the clause was not strongly challenged. The court (par 13) accepted an in-depth comparative survey of decisions on asymmetrical arbitration clauses in Commonwealth jurisdictions by the court below (see *Dyna-Jet Pte Ltd v Wilson Taylor Asia Pacific Pte Ltd* (2016) SGHC 238 par 64-113) as correct.

[145] The (Singapore) International Arbitration Act 23 of 1994, as amended, adopted the Model Law for international arbitration.

[146] *Cf* the *Lufuno* case (n 37) par 220 where the court stressed the importance of party autonomy in this context. For an earlier decision see *Hellas House (Pty) Ltd v Rikki-Rand (Pty) Ltd* 1982 4 SA 709 (C).

[147] (2014 FOLIO 326) 2014 EWHC 2510 (Comm) (24 July 2014).

[148] par 44.

[149] The sub-clause, quoted in par 45 read: "The arbitrators shall have the discretion to hear and determine at any stage of the arbitration any issue asserted by any party to be dispositive of any claim or counterclaim, in whole or part, in accordance with such procedure as the arbitrators may deem appropriate, and the arbitrators may render an award on such issue."

[150] par 47 and 50.

will not amount to a lack of due process, where the tribunal has the express contractual power to follow this approach.[151]

Certain institutional rules now contain express provisions regarding the use of summary proceedings[152] or the early dismissal of claims and defences.[153] Anecdotal evidence exists that South African lawyers tend to prefer ICC arbitration clauses. The ICC updated its arbitration rules in 2012, giving particular emphasis to making arbitration under the rules quicker and more cost-effective.[154] The rules were amended again in 2017, the main amendment being to introduce Expedited Procedure Rules, which apply by default to disputes not exceeding US $ 2,000 000.[155] Persons using the ICC Rules need to pay careful attention to the practice note published by the ICC Court in October 2017, which was intended to provide parties and arbitral tribunals with practical guidance concerning the conduct of arbitrations under the ICC Rules.[156] Of particular importance to the point under discussion is Part VI C of the practice note, which explains how a party should set about obtaining the expeditious determination of manifestly unmeritorious claims or defences by using article 22 of the ICC Rules, which sets out the broad principles for the conduct of the arbitration.[157] The practice note contains important guidance on how the tribunal should handle the application procedurally, in order to ensure due process. If the tribunal deals with the application in an award, the ICC Court undertakes to apply its well-known scrutiny process on an expedited basis.[158]

In short, lawyers drafting contracts for cross-border transactions when acting for financial institutions should carefully consider including express provisions in the arbitration clause to empower arbitral tribunals to deal expeditiously with dubious claims and defences. Nevertheless, it is clear that the ICC Court, which is still globally regarded as the pre-eminent arbitral institution, believes that manifestly unmeritorious claims and defences can be dealt with expeditiously and effectively under its standard arbitration rules.[159]

[151] See Freeman and Fisher (n 6) 7-8.
[152] See the Stockholm Chamber of Commerce Arbitration Rules (2017) a 39.
[153] See the SIAC Arbitration Rules (2016) rule 29. The tribunal must give the parties the opportunity to be heard before deciding on the application. According to the SIAC Annual Report 2017 11, four such applications had been granted between when the Rules took effect in 2016 and the compilation of the report. See also Freeman and Fisher (n 6) 8.
[154] See aa 22 and 24, read with appendix IV of the 2012 Rules on case management techniques. These provisions were retained in the latest 2017 Rules.
[155] See the ICC Rules (2017) a 30 and appendix VI.
[156] See Note to Parties and Arbitral Tribunals on the Conduct of the Arbitration under the ICC Rules of Arbitration (30 October 2017) available at https://iccwbo.org/publication/note-parties-arbitral-tribunals-conduct-arbitration/ (2 July 2018).
[157] See par 59-64 of the practice note. As pointed out above, a 22 must be read with a 24 and appendix IV.
[158] See the practice note par 64.
[159] See also Freeman and Fisher (n 6) 8.

5.3 *Interim measures*

As stated above, the arbitral tribunal and the court have concurrent jurisdiction to grant interim measures in support of an international arbitration.[160] Institutional rules dealing with the granting of interim measures recognise the obvious fact that the arbitral tribunal can only be approached by a party for interim relief once the tribunal has been appointed.[161] Parties may nevertheless prefer to approach the tribunal rather than going to a national court. To deal with the need for interim measures in the time between the commencement of the arbitration and the appointment of the tribunal, several sets of institutional rules now make provision for the appointment of an emergency arbitrator.[162] The sole function of the emergency arbitrator is to deal expeditiously with an application for interim measures before the appointment of the tribunal. Where the applicable rules make provision for an emergency arbitrator, parties need to be aware that a court may decline to exercise its powers to grant an interim measure because of the availability of this provision in the rules.[163]

In a South African context, the International Arbitration Act also encourages the parties to approach the arbitral tribunal rather than the court. Basically, one of three exceptions must apply before the court will intervene.[164] The first is where the arbitral tribunal has not yet been appointed and the matter is urgent. It is submitted that where the applicable rules make provision for an emergency arbitrator, the party requiring interim relief should rather follow that route, unless one of the other two exceptions apply. The second exception is where the tribunal is not competent to grant the order. This exception will apply where the tribunal lacks the power under the relevant rules or under the Act.[165] The third exception applies where "the urgency of the matter makes it impractical to seek such order from the arbitral tribunal". It is submitted that this exception will apply even where the tribunal has the power to grant the relief. For example, the tribunal has the power to grant interim measures to prevent the dissipation of assets, but not to grant such relief on an *ex parte*

[160] See 4.4 above.

[161] See *eg* the LCIA Arbitration Rules (2014) a 25.3 and the ICC Arbitration Rules a 28.2.

[162] See the SIAC Arbitration Rules (2016) rule 30.2 and sch 1; the ICC Rules (2017) a 29 and appendix V and the LCIA Rules (2014) a 9B. Both SIAC and the ICC included provisions for an emergency arbitrator in the previous edition of their rules in 2010 and 2012 respectively.

[163] In *Gerald Metals SA v Timis* (HC-2016-002321) 2016 EWHC 2327 (CH) (22 September 2016) par 9, the court, in response to a request by Gerald Metals to exercise the court's statutory powers to issue a freezing injunction, held that it was only where the powers of the emergency arbitrator or a tribunal appointed in the ordinary way were inadequate or the practical ability to exercise the powers effectively and timeously is lacking that the court will intervene. (It must be noted that this ruling was influenced to some extent by the particular wording of s 44 of the English Arbitration Act of 1996.) See also Freeman and Fisher (n 6) 7.

[164] See sch 1 a 17J(2).

[165] Although the statutory powers of the tribunal in a 17(2) are in broad terms, they only apply unless otherwise agreed by the parties. It is submitted that an agreement to use rules conferring more limited powers would have this effect.

basis.[166] In these circumstances, it seems that because of urgency and the need for *ex parte* relief, it is more practical to approach the court.

Finally, in exercising its powers, it is submitted that the tribunal must pay careful attention to the wording of the applicable rules, read with the provisions of schedule 1 articles 17 and 17A regarding the scope of its powers and factors to be taken into account when exercising them. The tribunal must bear in mind that it is conducting an international arbitration. It is not in principle obliged to take into account how a local court would exercise the power in litigation before that court. Nevertheless, a court asked to enforce the tribunal's order has the power to reformulate it, to the extent that it is incompatible with the powers of the court.[167]

5.4 *Enforcement of foreign awards*

The success of the New York Convention must at least in part be attributed to the advances made by the Convention, when compared to its predecessor, the Geneva Convention on the Execution of Foreign Arbitral Awards of 1927. Sanders identified the main improvements in the New York Convention regarding the recognition and enforcement of foreign arbitral awards as being the elimination of the need for double *exequatur*; the limitation of the grounds on which enforcement could be refused by a court to seven specified grounds; and in the case of the five grounds for refusal which must be raised by a party, the shifting of the onus of proving that ground to the party resisting enforcement. The cumulative effect of these changes was to give the Convention a pro-enforcement bias.[168]

The Recognition and Enforcement of Foreign Arbitral Awards Act 40 of 1977, which was enacted to give effect to South Africa's accession to the New York Convention, was strongly criticised by the SALRC as being seriously defective in giving effect to South Africa's obligations under the Convention.[169] For example, it appeared to give the court a discretion to enforce a foreign award, instead of imposing an obligation, unless one of the seven defences was proved.[170] Another of the statute's idiosyncrasies was that if an award was made in a foreign currency, it had to be converted into local currency at the exchange rate prevailing at the date of the award.[171] Whether intended or not, this provision since 1977 has mainly operated in favour of locally based defendants. Another obstacle to enforcement was created by the Protection of Businesses Act 99 of 1978 in that certain awards, particularly those concerning transactions relating to raw materials or substances from which physical things are made, could only be enforced with the written consent of the Minister of

[166] See sch 1 a 17(2) and 4.4 above.
[167] See sch 1 a 17I(1)(b)(i).
[168] See Sanders' foreword to the *ICCA Guide to the Interpretation of the 1958 New York Convention* (2011) v.
[169] See the Commission's report (n 4) par 3.14-3.18.
[170] s 2(1).
[171] s 2(2).

Trade and Industry.[172] This provision was obviously contrary to South Africa's obligations under the Convention.

The International Arbitration Act 15 of 2017 repealed the 1977 Act and replaced it with legislation which does comply with South Africa's obligations under the Convention.[173] In addition, the Protection of Businesses Act was amended so that it no longer applies to arbitral awards.[174]

South African courts have a good record in enforcing Convention awards, judging by the few reported cases.[175] Nevertheless, certain challenges remain. The Supreme Court of Appeal has recently decided that an arbitral award does not create a new debt for purposes of the Prescription Act 68 of 1969.[176] As a result, prescription on the original claim starts to run again from the date of the award. In the context of the enforcement of a foreign arbitral award, the position is more complex, particularly if the substantive claim is not subject to South African law. It then appears that the foreign substantive law would determine the time when the claim prescribes.[177] In the interests of legal certainty, this is an issue which requires clarification in any revision of the South African legislation on prescription.

South African lawyers who need information on the Convention and the case law in other jurisdictions will find a wealth of information relating to these subjects on a comprehensive new website.[178]

5.5 *Multiparty arbitrations*

Transactions in the financial sector often involve several different agreements between multiple parties.[179] Arbitration agreements are based on consensus and an arbitral tribunal cannot order consolidation of separate arbitrations or the joinder of a party to an arbitration without the agreement of all the parties

[172] s 1.

[173] ss 14-19.

[174] s 21 and sch 4.

[175] See *eg Phoenix Shipping Corporation v DHL Global Forwarding SA (Pty) Ltd: MV Cos Prosperity* 2012 3 SA 381 (WCC); *Seton Co v Silveroak Industries Ltd* 2000 2 SA 215 (T); *Balkan Energy Ltd v Government of Ghana* 2017 5 SA 428 (GJ).

[176] *Brompton Road Body Corporate v Khumalo* 2018 3 SA 347 (SCA) par 6-7. Older cases taking a different view were held to be no longer good law (par 12). See Mustill & Boyd *The Law and Practice of Commercial Arbitration in England* (1989) 409 for the different position in English law.

[177] See also Blackaby and Partasides (n 23) 231 who point out that in the area of conflict of laws one system may classify time limits as a matter of procedure whereas another system may classify time limits as a matter of substantive law.

[178] See www.newyorkconvention1958.org (1 July 2018). This website has the *UNCITRAL Secretariat Guide on the Convention on the Recognition and Enforcement of Foreign Arbitral Awards* (2016) and 2535 cases from national jurisdictions on the Convention, amongst other information. The website was developed and is maintained by by Shearman & Sterling and Columbia Law School, in cooperation with UNCITRAL.

[179] Freeman and Fisher (n 6) 5 use as an example a syndicated loan comprising a facility agreement, an intercreditor agreement, security arrangements and a guarantee from the holding company of the borrower.

concerned.[180] With a view to reassuring potential foreign users, the International Arbitration Act 15 of 2017 confirms this position.[181] Multiple parties to transactions involving different contracts need to be aware that provisions in several sets of institutional arbitration rules regarding joinder and consolidation are both terse and rather limited. The UNCITRAL Arbitration Rules, for example, only permit the joinder of a third party to arbitration proceedings if the third party is also a party to the arbitration agreement.[182] The drafters of the contracts should therefore consider including linked arbitration clauses in the different contracts, providing for common institutional rules and the same seat. They should also be satisfied that either the provisions of the chosen rules are extensive enough for their purposes or insert rules in the dispute resolution clause, which rectify the perceived deficiencies.[183] The drafters also need to be aware of special provisions in their preferred institutional rules dealing with the appointment of the arbitral tribunal in a multi-party arbitration.[184]

5.6 *Confidentiality*

As stated above, one of the perceived benefits of arbitration for resolving disputes relating to transactions in the financial sector is that of confidentiality.[185] While arbitration proceedings are normally held in private, drafters of arbitration clauses for contracts in this sector need to be aware that there is no duty of confidentiality under the law of some popular arbitration seats[186] and that certain institutional rules are either silent or intentionally leave the matter of confidentiality to be decided by the arbitral tribunal in consultation with the parties.[187] Some legal systems like England regard a duty of confidentiality to be a natural consequence of an arbitration agreement, subject to certain

[180] A party may agree to joinder provisions in institutional rules by agreeing to use those rules.

[181] s 10.

[182] See the UNCITRAL Arbitration Rules (2010) a 17.5. For an example of a guarantor signing an arbitration agreement between the other two parties see *Compania Espanola de Petroleus SA* 527 F2d (2nd Cir 1975), which was criticised on other points in *Government of the United Kingdom v Boeing* 998 F2d 68 (2nd Cir 1993).

[183] See *eg* the SIAC Arbitration Rules (2016) rules 6-8, which are considerably more detailed than the comparable provisions of the LCIA Arbitration Rules a 22.1(viii)-(x).

[184] All institutional rules contain such provisions, usually in response to the decision of the French Cour de Cassation on 7 January 1992 in *BKMI and Siemens v Dutco* to the effect that it is a strong principle of public policy that all parties be treated equally in relation to their right to contribute to the constitution of the arbitral tribunal. See Devolvé "Multipartism: The Dutco decision of the French Cour de Cassation" 1993 *Arb Int'l* 197 198; Freeman and Fisher (n 6) 6.

[185] See 2 above.

[186] *eg* the United States and Sweden: see Blackaby and Partasides (n 23) 128.

[187] The UNCITRAL Arbitration Rules, beyond providing for the privacy of the hearing in a 28.3 are silent. The ICC Arbitration Rules (2017) provide for the privacy of hearings in a 26.3. However, it is up to the tribunal under a 22.3, on the application of a party, to give directions regarding confidentiality of the arbitral proceedings, if this is necessary to protect trade secrets and other confidential information.

exceptions.[188] Other institutional rules contain detailed provisions on confidentiality.[189]

Drafters of contracts who are considering choosing South Africa as the seat of their international arbitration need to be aware of the relevant provisions of the International Arbitration Act 15 of 2017. Prior to the commencement of the Act, the legal position regarding the confidentiality of arbitration in South Africa was unclear.[190] Section 11(2) logically only imposes a duty of confidentiality where the arbitration proceedings are held in private. This duty of confidentiality is subject to certain exceptions.[191] Section 11(1) envisages a different system for arbitrations to which a public body[192] is a party. Such arbitrations must be held in public, "unless for compelling reasons, the arbitral tribunal directs otherwise". It is submitted that section 11(1) is a mandatory provision. It is also submitted that when applying section 11(1), the tribunal could decide that the compelling reasons to proceed in private, for example the need to protect sensitive commercial information of one of the parties, only apply to part of the proceedings. It then seems logical that the tribunal can validly direct that only that part of the proceedings shall be held in private. Although section 11(2) does not state so expressly, party autonomy justifies this provision being treated as a contract-out provision.

6 Concluding comments

It is submitted that the International Arbitration Act 15 of 2017 provides a sound basis for an international arbitration with its seat in South Africa, as well as providing the necessary court support for the enforcement of arbitration agreements, the recognition and enforcement of foreign awards, and the provision and enforcement of interim measures in an international arbitration. This applies whether the seat of the arbitration is in or outside South Africa.[193] It would nevertheless provide additional confidence regarding South Africa as a seat for international arbitrations if special court rules for court applications pertaining to arbitration were to be made.[194] This would give foreign parties

[188] *Emmott v Michael Wilson & Partners Ltd* (2007 FOLIO 1521) 2008 EWCA Civ 184 (12 March 2008) par 105-107.

[189] See *eg* the LCIA Arbitration Rules a 30 and the SIAC Arbitration Rules rule 39.

[190] In two South African cases where the issue has arisen, namely *Replication Technology Group v Gallo Africa Ltd* 2009 5 SA 531 (GS) and *MV Alina II, Transnet Ltd v MV Alina II* 2013 6 SA 556 (WCC), it was unnecessary for the court to decide whether or not a general rule existed, as the relevant information was in any event subject to disclosure under at least one exception to the English rule.

[191] The duty applies to documents not otherwise in the public domain, except to the extent that disclosure may be required by reason of a legal duty or to protect or enforce a legal right. The provision is based on the LCIA Arbitration Rules (2014) a 30.1.

[192] As defined in s 1 of Act 15 of 2017.

[193] The relevant provisions of the Model Law have extraterritorial application: see the International Arbitration Act sch 1 a 1(2).

[194] It is submitted that such rules could be drafted in terms of the Rules Board for Courts of Law Act 107 of 1985, as amended, s 6(1)(t) and 2(a). These provisions made it unnecessary to deal

particularly the assurance that any necessary court proceedings, whether of a supportive or supervisory nature, would be conducted expeditiously and efficiently. Developments in arbitration practice, including the application of institutional rules, are also providing for expedited arbitration proceedings, in circumstances where the financial sector has previously stayed away from arbitration.[195]

As with other cross-border commercial disputes, where both the claim and defence have some merit, the lawyers acting for the parties should seriously consider mediation, before resorting to arbitration.[196] However, in order to retain maximum flexibility for the financial institution when the dispute arises,[197] it is not necessary to provide specifically for mediation in the dispute resolution clause. The parties are in any event free to consider resorting to mediation at any stage.

with this matter in the International Arbitration Act 15 of 2017 and an attempt to include such a provision could have delayed the passage of the legislation. Special rules exist in jurisdictions like England and Hong Kong.

195 See 5.2 above.

196 Blanke (n 9) 15.

197 See the discussion in 5.1 and 5.2 above.

The South African Reserve Bank: A central bank in the firing line

JOHANN DE JAGER*

Abstract

In recent times, central banks worldwide have assumed greater prominence as a result of their expanded roles and contributions towards keeping the globally interconnected financial systems operating as efficiently and effectively as possible. In fulfilling its primary role, a central bank is required to act as a centre of autonomy in the management and control of its domestic economy and financial system. The South African Reserve Bank ("SARB" or "Bank"), the central bank of the Republic of South Africa, is accordingly, in terms of legislation, afforded a measure of independence by Government. Possibly as a result of the increased prominence of the SARB in the financial system of this country, it occasionally finds itself in the proverbial firing line of authorities, politicians and public opinion. In this presentation recent actions by the Public Protector involving the Bank and calls for the nationalisation of the SARB, as well as matters connected therewith, are discussed and considered in an endeavour to determine the impact (if any) thereof on the operations of the Bank.

* * * * *

1 Introduction[1]

In recent times, central banks worldwide have assumed greater prominence as a result of their expanded roles and contributions towards keeping the globally interconnected financial systems operating as efficiently and effectively as possible. In fulfilling its primary role, a central bank is required to act as a centre of autonomy in the management and control of its domestic economy and financial system.[2] The South African Reserve Bank ("SARB" or "Bank"), the central bank of the Republic of South Africa ("RSA"), is accordingly in terms of legislation afforded a measure of independence by Government.[3]

Possibly as a result of the increased prominence of the SARB in the financial system of this country, it occasionally finds itself in the proverbial firing line

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1 Much of what follows below up to the end of paragraph 4 is also dealt with in De Jager "Room to manoeuvre: The concept of central bank independence and the South African Reserve Bank" in Hugo and Kelly-Louw (eds) *Jopie, Jurist, Mentor, Supervisor and Friend: Essays on the Law of Banking, Companies and Suretyship* (2017) 79 *et seq.*

2 Charles Goodhart in his foreword to Lastra *Legal Foundations of International Monetary Stability* (2006) vii; Geoffrey Miller in his foreword to the same publication xi.

3 s 224(2) of the Constitution of the RSA 1996 (Act 108 of 1996 – "Constitution").

of authorities, politicians and public opinion. In this article recent actions by the Public Protector involving the Bank and calls for the nationalisation of the SARB, as well as matters connected therewith, are discussed and considered, in an endeavour to determine the impact (if any) thereof on the operations of the Bank.

2 Governments and the economy

Government, like others worldwide, is ultimately responsible for monetary and fiscal matters in the economy of the RSA. In a general sense, such matters involve measures by means of which sustainable development and growth of the economy of this country may be achieved, for the benefit of all its inhabitants. Economic growth, in turn, involves price stability, job creation and the building and maintenance of vital infrastructure, of which a stable financial system forms a vital part.[4] Governments, by adjusting spending and tax rates and determining monetary policy, are able to slow down or speed up their economies' rate of growth, thereby affecting the level of prices and employment. An inherent danger of this is that Governments, consisting of decision-makers who are subject to political election cycles, are prone to grow their respective economies faster than capacity limits allow and to fund budget deficits by means of the creation of excessive liquidity. Although this may result in positive effects in the short term on growth and employment, it results in higher inflation, the costs of which are usually paid by the economy and the general public that it serves in the medium or longer term. It accordingly creates a potential inflation bias, making it difficult credibly to guarantee actions by Governments, which validates low inflation over time.[5]

Since high inflation may give rise to instability and is not conducive to long term growth in the economy and employment, there is a need for Governments to implement measures to address their conflicting priorities in policy making and to achieve price stability by anchoring prices against inherent swells in inflationary pressures. In this regard, central bank independence emerged as a suitable anchor. Handing decisions on monetary policy over to a central bank, which enjoys a substantial measure of independence from short-term political pressures, is therefore regarded worldwide as an efficient way of binding Governments to tolerate whatever measures are necessary to reduce inflation and achieve price stability, no matter how unpopular these measures may be.

[4] Kganyago (Governor of the SARB) "South Africa's crisis of confidence and the policy response" (2017) 8 (an address delivered at the CEEF Africa Annual Banquet in Johannesburg on 19 June 2017).

[5] Inflation is the process of continuously rising prices, or equivalently, of a continuous decrease in value of the currency: Newman, Milgate and Eatwell (eds) *The New Palgrave Dictionary of Money & Finance* (1992). As far back as the early 19th century David Ricardo, an influential British political economist, warned of the great danger if government was entrusted with the power of issuing paper money: Ricardo *Plan for the Establishment of a National Bank* (1824) 15. The situation is exacerbated by the fact that the anchors which previously held prices stable in earlier eras, first the gold standard and then the Bretton Woods system, no longer exist.

3 Central banks, independence,[6] price stability and emergency liquidity

3.1 *Independence and price stability*

The concept of a central bank functioning independently from Government originated a long time ago.[7] During the past two decades measures were introduced by Governments worldwide to establish price stability as the primary mandate of central banks and to grant them independence in the pursuit of this objective.[8] In this context, central bank independence means the freedom of monetary policymakers within those institutions to conduct monetary policy (and where applicable, exchange rate policy) free from political or governmental influence. This worldwide prioritisation of price stability coincided broadly with the popularity of inflation targeting among central banks to achieve their objective. Central bank independence, from then on, became a means by which a Government could demonstrate the strength of its commitment towards price stability.

3.2 *Emergency liquidity*

Apart from monetary policy, central banks are also concerned with other functions, such as financial stability and the provision of emergency lender of last resort liquidity ("LOLR"), which functions are usually interrelated and complimentary to each other. Central banks, as the ultimate creators and suppliers of high powered money, are ideally suited to address emergency liquidity situations because of the immediacy of the availability of central bank credit. They thus always constitute dominant agencies responsible for the stability of the payment system, provision of liquidity assistance to financial institutions and markets, as well as systemic stability. Therefore, to this day, LOLR remains a major rationale for most central banks worldwide.[9] In practice, central banks provide LOLR assistance in a manner properly adapted to suit their particular needs and circumstances in times of inordinate financial stress. Nevertheless, LOLR generally consists of the provision of emergency liquidity by means of collateralised lines of credit to individual financial institutions which become illiquid, but not necessarily insolvent, and whose illiquidity threatens to spread to other institutions (the contagion problem), posing a threat to financial stability. It is generally aimed at maintaining or

6 The terms "central bank independence" and "central bank autonomy" are used interchangeably in central bank literature to refer to the same concept: Lastra *Central Banking and Banking Regulation* (1996) 10.

7 Keynes "Minutes of evidence: Royal Commission on Indian Currency and Finance" (1926) in Moggridge (ed) *The Collected Writings of John Maynard Keynes* (1981) Vol 19 512.

8 Blair, Cranston, Ryan and Taylor *Blackstone's Guide to the Bank of England Act* (1998) 12; Cranston *Principles of Banking Law* (2002) 118; Bibow "A post Keynesian perspective on the rise of central bank independence: A dubious story in monetary economics" (October 2010) *Working Paper No 625 Levy Economic Institute of Bard College* 4.

9 Lastra (n 2) 113.

restoring confidence and re-establishing credibility in a bank or banks and the financial system.[10]

A widely recognised problem for central banks worldwide is that the assurance of a readily available LOLR safety net to financial institutions in distress may give rise to moral risk. It has the potential danger of encouraging such institutions to conduct their business by engaging in irresponsible, careless or imprudent management practices in the unjustified belief that they could rely on being bailed out by the central bank if they encountered financial difficulties. It could give rise to an increase in turbulence and instability in the market and a reduction in the incentive for banks to hold adequate liquidity, thereby passing that risk on to central banks. Moreover, knowledge by members of the general public that emergency liquidity assistance was being afforded to an institution, which was holding their deposits, normally resulted in a loss of confidence in such an institution, causing a run on it by them to withdraw their deposits.[11] This gives rise to further loss of liquidity, thereby worsening the liquidity crisis at the particular institution that the LOLR assistance endeavoured to address in the first place. Accordingly, LOLR assistance is not guaranteed and usually provided under conditions of strict confidentiality.[12]

4 The South African Reserve Bank

4.1 *Origin, objective and powers*

The SARB was first established in Pretoria in 1921, under the Currency and Banking Act.[13] Clothed with legal personality and in its capacity as an executive organ of state,[14] the Bank functions as the central bank of the RSA in terms of the South African Reserve Bank Act,[15] read with sections 223 to 225 of the Constitution.[16] The primary objective of the Bank as stated in the SARB Act

[10] The theoretical foundations of LOLR were first set by Henry Thornton, a banker and economist, in 1802, and then by another banker and economist, Walther Bagehot, in 1873. See in this regard Lastra (n 2) 114 n20; De Jager "Central bank, lender of last resort assistance: An elusive concept?" 2010 *De Jure* 232.

[11] As demonstrated by the facts in Northern Rock where the bank experienced a run on it following a BBC broadcast to the general public that Northern Rock had sought and was to be provided with LOLR assistance by the Bank of England: *SRM Global Master Fund LP; RAB Special Situations (Master) Fund Ltd and Dennis Grainger v The Commissioners of Her Majesty's Treasury*, a judgment delivered on 28 July 2009 under the Neutral Citation Number: [2009] EWCA Civ 788 par 13.

[12] Confidentiality with regard to such operations helps to prevent knowledge of specific LOLR operations from giving rise to panic, a rise in borrowing costs or the loss of reputation: De Jager (n 10) 234 and 243.

[13] 31 of 1920.

[14] s 239(b)(i) of the Constitution.

[15] 90 of 1989 – "SARB Act".

[16] S 223 confirms the SARB as the central bank of the RSA, which needs to be regulated in terms of an Act of Parliament (currently the SARB Act).

and the Constitution is to protect the value of the currency of the RSA.[17] This objective is similar to the object of price stability, since price stability as an object focuses on preserving the domestic value of a currency for purposes of stable prices and low inflation. The central banks of many countries worldwide have either the preservation of the value of their currencies or price stability as their primary, or part of their primary, objective. Ultimately, this monetary objective forms part of the greater whole economy and has the same final objective as the other components of total macro-economic policy, namely, the accomplishment of the highest growth rate in the long term. The SARB Act and the Constitution confirms this economic principle in prescribing that the protection of the value of the currency should be done in the interest of balanced and sustainable economic growth in the RSA. Economic growth should therefore not be regarded as a separate goal, but rather as a stated legitimate aim or consequence of the primary objective which could serve as a policy constraint on monetary authorities in their efforts to achieve price stability.

In practice, the SARB conducts monetary policy within a flexible inflation-targeting framework in terms of which it endeavours to maintain the consumer-price inflation within a designated target range, set by Government after consultation with the Bank. In the process, a flexible framework is maintained which takes cognisance of the impact of monetary policy on cyclical growth and employment for purposes of minimising the impact of decisions on those factors as far as possible. This flexible approach also allows for the implementation of monetary policy in a manner that takes specific account of issues relating to financial stability.[18] With regard to the external value of the currency, the SARB maintains a floating exchange rate policy in terms of which no exchange rate targets are set and value is determined by the market. The Constitution further confirms that the powers and functions of the SARB are those customarily exercised and performed by central banks. These powers and functions must however be determined by an Act and must be exercised or performed subject to the conditions prescribed in terms of that Act.[19]

4.2 *Independence*

The Constitution determines that the SARB, in pursuit of its primary object, must perform its functions independently and without fear favour or prejudice, but that there must be regular consultation between the Bank and the cabinet member responsible for national financial matters (the Minister of Finance in

[17] s 3 of the SARB Act and section 224(1) of the Constitution; South African Reserve Bank (SARB) *Excellence in Price and Financial Stability* (2015/16) Annual Report 8.

[18] In terms of s 12 and s 21 of the Financial Sector Regulation Act 9 of 2017 the SARB is responsible for protecting and enhancing financial stability in the RSA.

[19] s 225 of the Constitution. S 10 of the SARB Act sets out some powers and duties of the Bank.

this case).[20] The requirement of regular consultation with the Minister does not compromise the Bank's independence. It confirms the ultimate responsibility of Government with regard to monetary policy and gives effect to the principle that the Bank and Government have a strong interest in sharing information and maintaining close dialogue on matters involving macro-economic policy and in particular, monetary policy.[21] The Constitution is the supreme law of the RSA and any law or conduct inconsistent with it is invalid and the obligations imposed by it must be fulfilled.[22] Government (or any other party for that matter) is obliged to honour and give effect to the independence of the Bank and is prohibited from interfering in the exercise by the Bank of monetary policy, or to amend or withdraw the relevant powers of the SARB at any time without first amending the Constitution.[23]

4.3 *Emergency liquidity assistance*[24]

The SARB Act provides for LOLR emergency liquidity assistance in that it generally authorises the SARB to provide secured loans.[25] Like in the case of other central banks, information with regard to the provision by the Bank of LOLR assistance is not readily available in the public forum, since the SARB adheres to, and is bound by legal and customary principles of confidentiality in this regard.[26] In compliance with these principles, the LOLR assistance provided by the SARB to Bankorp Limited ("Bankorp" – often somewhat incorrectly referred to as the "ABSA lifeboat") was provided confidentially and finer details thereof remained undisclosed in the public domain for years. It

[20] s 224(2) of the Constitution. "Consultation" means that the consulting parties must engage in a meaningful joint consensus-seeking process and attempt to reach consensus in respect of the matters consulted. See *Atlantis Diesel Engines* (*Pty*) *Ltd v NUMSA* 1995 1 BLLR 1 (A); 1995 3 SA 22 (AD); 1994 *ILJ* 1247 (A) 1253; *UPUSA v Grinaker Duraset* 1998 2 BLLR 190 (LC); 1998 *ILJ* 107 (LC).

[21] *In re Certification of the Constitution of the Republic of South Africa, 1996* 1996 4 SA 744 (CC).

[22] s 2 of the Constitution.

[23] It constitutes a declaration of independence of the highest order vested in the SARB in respect of its conduct of monetary policy in pursuit of its goal of protecting the internal value of the currency in the RSA. Examples of an explicit constitutional provision enshrining the independence of a central bank are extremely rare internationally: Blair *et al* (n 8) 10; Malan & Pretorius "The Reserve Bank, banks, and clearing houses in South African law: Part 1" 2001 *SA Merc LJ* 35 40.

[24] What follows below until the end of par 5, unless otherwise indicated, is based on affidavits, transcriptions of the PP and various other documents that formed part of the formal applications giving rise to the judgments of the High Court mentioned in par 5.3 below.

[25] s 10(1)(f) of the SARB Act.

[26] s 33 of the SARB Act consists of a secrecy clause which, subject to certain exceptions, prohibits the disclosure of any information relating to the affairs of the Bank.

contributed to speculation and controversy and eventually became a matter of interest for a "bounty hunter",[27] a judge[28] and a panel chaired by a judge.[29]

In 1985 Bankorp, at the time one of the five major banks in the RSA, experienced severe financial difficulties which threatened to render it incapable of continuing to operate as a bank, thereby posing a material contagion and systemic risk. The financial difficulties were largely the result of a substantial portfolio of ever increasing non-performing assets ("bad debts"), eventually expected to reach R1 635 million. Confronted with the problem, the SARB agreed to extend emergency liquidity to Bankorp, by means of collateralised lines of credit, for the sole purpose of eventually writing off R1 125 million of the bad debts of Bankorp. Briefly stated, the aforesaid provision of emergency liquidity was generated by the SARB in terms of three separate written agreements advancing three sequential loans (first at 2% and later at 1% rate of interest) eventually totalling R1,5 billion to Bankorp. At the insistence of the SARB, the proceeds of the loan were utilised by Bankorp to purchase Government bonds at market value. As security for the loans, all rights and title of Bankorp to the bonds (excluding the right to earn interest on them) were ceded by Bankorp to the SARB. This enabled Bankorp, as beneficial owner of

[27] This terminology was used by the Public Protector with reference to a former M16 spy who, in 1977, approached Government claiming that his company, CIEX, had information that substantial amounts of Government money had been siphoned into foreign banks or into illicit projects which could be recovered by CIEX at a fee, which included a percentage of all monies recovered. Government was presented with a secret report by CIEX ("CIEX Report"). The secret CIEX Report, without any substantiation, contained sweeping claims about large sums of misappropriated Government money, which allegedly could be recovered from various domestic and international entities. It included a sum of R3,2 billion, purportedly recoverable from ABSA (based on the financial assistance provided to Bankorp). The CIEX Report was never intended to be disclosed to the SARB. It covertly and overtly advised Government on methods to bring the SARB under Government control, to manage the replacement of its serving Governor at the time, and suggested certain actions by means of which ABSA could be coerced into paying back the aforesaid amount. Mr Manuel, the Minister of Finance at the time, in his evidence before the Public Protector, on 31 May 2016, stated that the CIEX Report did not qualify as a report, but was merely a collection of thoughts.

[28] Judge Heath was appointed by the President in terms of the Special Investigations Units and Special Tribulations Act, 74 of 1996 ("SIU Act"), to investigate and report on the matter ("Heath SIU"). The Heath SIU finalised its investigation and issued its final report to the President on 1 November 1999. Despite having the legal mandate to do so, the Heath SIU declined to institute civil proceedings to recover any funds. It made it clear that any such recovery would have dire consequences for the economy and would not be in the public interest. It found that any such recovery would likely require the SARB to step in again to prevent a run on the banks and could well commit it to another bailout of much greater proportion.

[29] The panel, chaired by Judge Davis, consisted of a professor from the University of London, a financial sector advisor from the IMF and three chartered accountants. It was appointed by the Governor of the SARB on 15 June 2000 to investigate and report on the Bank's role with regard to the financial assistance package to Bankorp. In the panel's subsequent report ("Davis Report"), it concluded that although the form and structure of the Banks's financial assistance was seriously flawed, that it was justified in the interest of protecting the stability of the domestic banking system; and, moreover, that ABSA could not be regarded as the beneficiary of the SARB's assistance package to Bankorp.

the bonds, to earn a higher market related interest on the bonds and to utilise this income to write off its bad debts. When Absa Bank Ltd ("ABSA") paid fair value for Bankorp, on 1 April 1992, a portion of Bankorp's portfolio of bad debts still existed and the income stream was still required to continue the writing off of the same. The value of the income stream was therefore factored into the purchase price of Bankorp. By means of a further written agreement the SARB allowed ABSA proverbially to step into the shoes of Bankorp and for the Bank's financial assistance to continue (subject to the cap) for the same purpose as before. On 21 October 1995 the interest earned in terms of the interest rate differential arrangement reached the cap of R1 125 million and the SARB's assistance was terminated. The capital sum of R1,5 billion, plus the interest charged by the Bank on the loan, was then repaid in full to the SARB.

5 The Public Protector

5.1 *Legal construct*

The office of the Public Protector ("PP") is a state institution created to strengthen constitutional democracy.[30] It has the power, as regulated by the Public Protector Act,[31] to investigate any conduct in state affairs, or in the public administration in any sphere of Government, that is alleged or suspected to be improper or to result in any impropriety or prejudice, to report on the conduct and to take appropriate remedial action. The PP is intended to operate as last form of defence against bureaucratic oppression and corruption and malfeasance in public office that are capable of insidiously destroying the nation.[32] In appreciation of this role, the Constitution guarantees the independence, impartiality, dignity and effectiveness of this functionary, as indispensable requirements for the proper execution of its mandate.[33]

5.2 *Investigation and reports*

The investigation of the PP that forms the subject of this article originated from a complaint received from H (in November 2010), alleging that Government had unduly failed to recover money from ABSA, arising from the Bankorp loan, as suggested in the CIEX report. H claimed that ABSA had made provision for the repayment of the loan and all that was needed was for Government to ask for

[30] The office of the Public Protector is represented and functions by means of the natural person (functionary) appointed as the Public Protector from time to time. In the period under discussion it first involved Adv T Madonsela and, in the latter part of 2016, her successor Adv B Mkhwebane. For purposes of this article, when reference is made to the Public Protector, it is done with reference to the institution as a legal person and not to the natural person representing it. This is done for efficacious reasons and to avoid this article unjustifiably being construed in any way as any form of personal attack on anyone.

[31] 23 of 1994.

[32] *Public Protector v Mail and Guardian Ltd* [2011] JOL 27350 (SCA); 2011 4 SA 420 (SCA) par 6.

[33] s 181(1)(a) and 182(1) of the Constitution; *Economic Freedom Fighters v Speaker of the National Assembly; Democratic Alliance v Speaker of the National Assembly* 2015 3 BCLR 268(CC).

it.[34] Accordingly, the starting point for the investigation, as stated by the PP, was to determine the veracity of the claim and the reason why Government had not recovered it.[35] The SARB learnt about the investigation in July 2011, through the media. From the outset the SARB raised concerns with the PP about its authority to investigate a matter that had occurred before the PP's office was established, based on a complaint received more than two years after it had happened. Despite not being satisfied with the reasons proffered by the PP, the SARB provided such assistance as was required by the PP in its investigation. The (then) Governor Marcus, and former Governor Mboweni, met with the PP on 2 September 2013. They were informed that the investigation was concerned only with the propriety of Government in "not implementing the CIEX Report" in 1999 and not the "ABSA Lifeboat". In their evidence, they made it clear that CIEX was a secret report handed to Government that never had anything to do with the Bank. Former Governor Stals met with the PP on 8 September 2016, at which meeting the PP confirmed that it was not investigating the "ABSA Lifeboat" but rather Government's failure to implement the CIEX Report. Dr Stals nevertheless explained the LOLR financial assistance provided by the Bank to Bankorp, as alluded to in par 4.3 above, in great detail. The PP concluded the meeting with the remark "if we get evidence that it [the loan] was paid, case closed".[36] The SARB shortly afterwards provided the PP with an affidavit by the Chief Financial Officer of the Bank at the time, together with supporting documentation, indicating that the full amount plus the interest thereon was repaid in October 1995. Thereafter, the SARB did not hear from the PP again on the matter until the release of its provisional report.

On 21 December 2016, the PP released its provisional report ("Provisional Report") and called for comments from affected parties. Briefly stated, the remedial measures of the PP in the Provisional Report called upon the SARB, within 90 days, to adopt legislation and consider reviewing its lending policies to prevent and bring an end to the "anomaly" of LOLR assistance. Furthermore, it instructed the National Treasury and the Bank to institute legal action against ABSA to recover R1 125 million plus interest on it. The SARB provided the PP with extensive comments on the Provisional Report, indicating the flaws in fact and in law in the report and its suggested remedial actions.[37] Afterwards, the Bank did not meet with, or hear from the PP again, until its final report was issued. Sometime during the period after the SARB's

34 A claim that was subsequently disputed by ABSA.

35 Information provided by the PP during the questioning of Mr Manuel on 31 May 2016.

36 Similar to the meeting of the PP with Ms Marcus and Mr Mboweni on 2 September 2013, the proceedings at this meeting were recorded by the PP, transcribed, and a copy of the transcription provided to the Bank.

37 In summarised format, the SARB maintained in its response to the PP that the Provisional Report was fundamentally flawed. It went beyond the jurisdiction of the Public Protector, was based on incorrect facts, confused the roles of the Government and the Bank and the remedial action it proposed was constitutionally invalid. As a result, the Preliminary Report should not be finalised in its current form. The errors in the Preliminary Report were so serious that if they remained in a final report, they would likely bring instability to the South African financial

submission to the PP of its comments and before the release of its final report ("Final Report"), the PP broadened the focus of its investigation to include the primary function of the SARB. This was done without any notice or interaction with the Bank. In this period, the PP met with the State Security Agency ("SSA") and twice with the Office of the President ("Presidency"). Meetings were held with the latter on 25 April 2017 and again on 7 June 2017. The PP disclosed in its Final Report that she had met with the SSA, but failed to disclose the meetings with the Presidency. Although no formal minutes of these meetings were kept, it became evident that the vulnerability of the SARB formed a topic of discussion between the PP and the SSA. Apart from this, the reasons for and nature of the meetings remain obscure.

The Final Report was without prior notice to the SARB issued by the PP at a press conference held on 19 June 2017. The remedial actions imposed for purposes of addressing the "maladministration" suggested in the Final Report, briefly stated, directed the President to reopen the Heath SIU in order for it to recover "misappropriated funds" of R1 125 million from ABSA. In addition, the Chairperson of the Portfolio Committee on Justice and Correctional Services was instructed to embark upon a process of amending section 224 of the Constitution in order for it, *inter alia*, to determine that the SARB's primary object was to promote economic growth in the RSA, while ensuring that the socio-economic well-being of its citizens is protected. The release of the Final Report posed material risks to the SARB as well as the financial system and resulted in immediate and damaging consequences for the RSA.[38]

5.3 *Court proceedings*

The above actions of the PP culminated in two court actions: *South African Reserve Bank v Public Protector* ("Proceeding 1"),[39] brought by the SARB on an urgent basis before a single judge, and *ABSA Bank Ltd and related matters v Public Protector* ("Proceeding 2"),[40] brought by ABSA, the SARB and the Minister of Finance before three judges.

Proceeding 1 was concerned solely with setting aside the remedial action of the PP directing the unlawful amendment to section 224 of the Constitution.[41]

markets and would require the SARB to take immediate urgent action in the courts to prevent the implementation of the remedial action pending a review of the final report.

38 It led to a depreciation of the Rand, a substantial increase in the sale of Government bonds by non-resident investors and a material decrease in the value of banking sector shares, ABSA and Standard Bank being affected the most. On 20 June 2017, Standard & Poor Global Ratings warned that the RSA's credit rating could be downgraded further if Government were to act on the Public Protector's remedial action. After this warning, the Rand further depreciated. The ratings agencies made it clear that the independence of the SARB and its policy framework was one of the strongest pillars supporting the RSA economy and underpinning their rating assessment.

39 [2017] JOL 38388 (GP).

40 [2018] 2 All SA 1 (GP).

41 Remedial actions of the PP were binding and needed to be complied with, unless set aside by a competent court: *Economic Freedom Fighters* (n 33) par 76.

Despite initially opposing the application, the PP eventually conceded the unlawful nature of its remedial action and consented to the relief sought. In its judgment the court remarked that the PP's explanation and begrudging concession of unconstitutionality offered no defence to the charges of illegality, irrationality and procedural unfairness leveled by the Bank (predominantly based on the legal considerations discussed in par 5.4 below). The court found it disconcerting that the PP seemed impervious to the criticism raised by the Bank against its actions, or otherwise disinclined to address it. It cautioned that the PP risked the charge of hypocrisy and incompetence if it did not hold itself to an equal or higher standard than that to which the PP holds those subject to its writ. The relevant remedial action of the PP was set aside and the PP was ordered to pay the costs of the Bank.[42]

Proceeding 2 was concerned with setting aside the remaining remedial actions in the Final Report. The matter was opposed by the PP and heard in early December 2017. The SARB's founding affidavit was again predominantly based on the legal aspects mentioned in par 5.4 below. Amongst other things, the Bank called upon the PP, in its responding affidavit, to provide and explain the rationale behind the PP's undisclosed and unrecorded meetings with the Presidency and the discussion of the vulnerability of the Bank with the SSA. After an aborted attempt at having the hearing postponed, the PP filed its answering affidavit, as ordered by the court. The answering affidavit contained no credible explanation or information on the issues raised. The PP suggested that material findings in the Final Report were based on inputs provided by Dr M, an expert in economics and finance. However, facts indicated that the PP only met with Dr M after the founding affidavits of the SARB and the other applicants in the matter had been filed with the court and served on the PP.

On 16 February 2018 the court gave judgment and held, *inter alia*, that the facts indicated that the PP did not fully understand its constitutional duty to act impartially and to perform its functions without fear, favour or prejudice. The PP failed to realise the importance of explaining its actions with regard to the undisclosed meetings with the Presidency, which were veiled in obscurity because no records or transcripts were disclosed. The PP also failed to make a full disclosure when it pretended, in its answering affidavit, that it was acting on advice received with regard to its averments relating to economics prior to finalising its report. The court expressed the need to show its displeasure with the unacceptable way in which the PP conducted its investigation as well as its persistence to oppose all three applications to the end. This was achieved by means of the award of a *de bonis propriis* cost order.[43] The court also set aside the remaining remedial actions in the Final Report. The PP was ordered to pay the

[42] Proceeding 1 par 59.

[43] It constitutes a penal order in terms of which a party is required to pay for costs out of his or her own pocket as a penalty for some improper conduct. It may be awarded against a public official who acted inappropriately in gross disregard of his or her professional responsibilities: *Pheko v Ekurheleni Metropolitan Municipality* (No 2) 2012 2 SA 598 (CC) par 51; *Steinbank v SA Apartheid Museum at Freedom Park* 2011 BCLR 1058 (CC) par 52.

costs of ABSA, on an attorney and client scale. The PP was further ordered to pay 85% of the costs of the Bank on an attorney and client scale. Furthermore, the functionary who at the time acted as, and represented the PP, in her personal capacity, was ordered to pay the remaining 15% of the costs of the SARB at the same scale. The Minister of Finance did not request any cost order.[44]

5.4 *Legal considerations*

As a result of its vast powers, importance and constitutional independence, activities of the PP must be conducted lawfully, otherwise the PP falters and the nation loses an indispensable constitutional guarantee.[45] The requirement of legality in respect of the PP's activities gives effect to the rule of law in relation to all other exercises of executive public power. As a general principle, the rule of law provides the major justification for constraining the exercise of official power, promoting the core values of the separation of powers, legality, procedural fairness, impartiality, certainty and access to justice.[46] The PP's exercise of its core powers and functions was reviewable on the basis of the principle of legality that stems from the founding constitutional value of the rule of law.[47] Important considerations in this regard, referenced against the actions of the PP in the matter as mentioned in para 5.2 above, are discussed hereunder.

Separation of powers

The doctrine of the separation of powers is guaranteed in the Constitution.[48] It requires constitutionally established institutions to respect the confines of their own powers and not to interfere unjustifiably in the domain of others. Any investigation by the PP into matters which fall within the special expertise of a particular decision-making body like the SARB, must be conducted with a level of deference. Decisions of the Bank should be treated with the appropriate respect and due weight should be given to findings of fact made by those with special expertise and experience.[49]

Modern day central banks conduct new and well established functions as part of complicated, ever evolving, multi-layered modern financial systems involving other financial intermediaries, complicated financial instruments and the like. Whenever justified, the PP will only be able to conduct a proper

[44] Proceeding 2 par 131.

[45] *Mail and Guardian* (n 32) par 19.

[46] Woolf, Jowell and Le Sueur *De Smith's Judicial Review* (6 ed) para 11-059. See, too, Wade and Forsyth *Administrative Law* (10 ed) 29.

[47] *Minister of Home Affairs, Director-General of the Department of Home Affairs v The Public Protector of the Republic of South Africa* (Case No: 308/2017) an unreported judgment on 15 March 2018 (SCA) par 56.

[48] s 1(c) of the Constitution.

[49] *Marota Mamone v Commission on Traditional Leadership Disputes and Claims* 2015 3 BCLR 268 (CC) par 79.

investigation into anything in this field if it acquires adequate knowledge of the same, or gains access to persons with interrelated skills. This would most likely always involve an extensive in-depth investigation into the issues and reliance on information pertaining to more than one discipline or single viewpoint.[50] In the unlikely event that an investigation by the PP into monetary affairs and the provision of emergency liquidity by the SARB was warranted by circumstances, it was impossible for the PP to take any informed decisions and to issue legally binding directives in the matter on the basis of the superficial "investigation" as evidenced by the Final Report.

The mandate of the PP is to investigate and, where necessary, remedy maladministration in institutions. It is not authorised to second-guess the lawful business and expert determinations made by the Bank.[51] Although the SARB is not immune to investigations by the PP, such investigations are limited to alleged unlawful activities conducted by the Bank as envisaged in terms of the PP Act. The PP is not constituted as some extraordinary overall review body authorised to at will investigate, pronounce on, and, in its sole discretion, set aside or alter the valid powers and objects of other constitutional institutions such as the SARB - even more so when those powers are entrenched in the Constitution. The PP is prohibited from interfering in the exercise by the Bank of such powers, or to amend or withdraw them at any time. This can be achieved only by amending the Constitution, which can only be legally achieved with a supporting vote of at least two thirds of the members of the National Assembly. The PP has no authority to instruct the National Assembly to do so.[52]

Legality

In order for the protective measures afforded to the PP in the Constitution to apply, the PP (as a creature of statute) is required to exercise its powers strictly within the proverbial four corners of the Constitution and the PP Act, subject to other applicable legislation and the common law.[53] Otherwise its activities do not constitute lawful actions which merit legal recognition and protection.[54] The PP Act vests the PP with wide powers of investigation on its own initiative or on receipt of a complaint. Such investigation is, however, limited to purported unlawful matters committed in the public sphere, resulting

[50] Goodhart (n 2) viii.

[51] *Economic Freedom Fighters* (n 33) par 50.

[52] s 74(3)(a) of the Constitution.

[53] The SARB Act and the Prescription Act 68 of 1969 are examples of relevant legislation.

[54] *Mail and Guardian Ltd* (n 32) par 19. A case in point on the matter of other legislation binding the PP, is the Prescription Act. Even if it was accepted that some sort of claim existed in respect of the LOLR assistance provided to Bankorp, then such a claim would long ago have prescribed in terms of that Act. The PP acted beyond the scope of its powers when it ignored the prescription provisions imposed by the said Act on the basis that "it deprives society of the improvement of living standards" and directed payment by ABSA of an amount based on a long extinguished claim

in prejudice.[55] Owing to somewhat contradictory statements by the PP during the investigation, the exact scope of the investigation of the PP was difficult to determine with precision. However, it was at all times, in the understanding of the Bank, in some form or another related to maladministration by Government and or the Bank in failing to recover purported public funds advanced by the SARB to Bankorp ("targeted offence").[56]

The principle of legality also entailed that every exercise of public power by the PP into the targeted offence be rational to avoid capricious or arbitrary actions. At the end of its investigation, despite a considerable measure of undisputed evidence that ABSA owed nothing based on the loan in question, the PP without any justification ignored such evidence and ordered ABSA to repay an amount of R1 125 million to Government. The PP also, without justification and prior notice to the Bank, arbitrarily broadened the scope of its investigation to include the primary function of the Bank, in respect of which no indication of any impropriety existed. It then continued, without any lawful or credible basis and clearly without an adequate understanding of the issues involved, to strip the SARB of its primary power. The law requires that a rational relationship must exist between the remedy which is adopted and the achievement of a legitimate official purpose. Decisions of the PP must therefore be rationally related to the purpose for which the powers were given to ensure that its actions bear a rational connection to the facts and information available on which the PP purported to have based its actions - the issue being whether a rational objective basis exists justifying the connection made by the PP between the materials made available to it and the conclusion arrived at.[57]

The PP's investigation *in casu* was, in terms of the PP Act, limited to an investigation into the targeted offence. It cannot with credibility be maintained that any rationality existed between the uncontested evidence provided to the PP, to the effect that nothing was repayable by ABSA, and its remedial action ordering the repayment of a non-existing debt. Furthermore, it is virtually impossible to identify any rationality between the PP's investigation into the targeted offence and its subsequent remedy requiring the amendment of section 224 of the Constitution.

[55] An important further limitation is that except in special circumstances, within the PP's discretion, an investigation shall not be entertained unless it is reported to the PP within two years from the occurrence of the incident or matter concerned: s 6 of the PP Act. Moreover, the PP Act is not retrospective. Therefore the PP is not authorised to investigate any alleged offence committed before its office was established. The investigation into the targeted offence related to events that started in 1985 and terminated in October 1995, based on a complaint received in November 2010.

[56] s 6(9) of the PP Act.

[57] *Minister of Defence and Military Veterans v Motau* 2014 5 SA 69 (CC) par 98; *SA Predator Breeders Association v Minister of Environmental Affairs* [2011] 2 All SA 529 (SCA); *Medirite (Pty) Ltd v South African Pharmacy Council* [2015] ZASCA 27 (20 March 2015)par 10; *Trinity Broadcasting (Ciskei) v Independent Communications Authority of South Africa* 2004 3 SA 346 (SCA) par 21 and 44; *e.tv (Pty) Ltd v Minister of Communications* 2016 6 SA 356 (SCA) par 38.

Procedural fairness

Procedural fairness is a concept quite separate and distinct from the merits of a matter. If the principles of natural justice are violated in respect of any decision it is immaterial whether the same decision would have been arrived at even if there was no departure from this essential principle of justice. The decision will remain invalid.[58] Procedural fairness in an investigation by the PP should, *inter alia*, be concerned with giving interested parties a clear indication of the scope and ambit of its investigation and affording them an opportunity to participate in the decision-making processes, and, crucially, should allow them an opportunity to change or influence the outcome of decisions that may affect them.[59] An important component of fairness is compliance with the *audi alteram partem* principle. Although procedural fairness is a flexible concept, where a right to be heard exists and is not given effect to, it is not legally justified to argue that a hearing would have made no difference. The PP Act obliges the PP, during an investigation, when it appears that any person is being implicated in the matter being investigated and such implication may be to the detriment of that person or an adverse finding pertaining to that person may result, to afford such a person the opportunity to respond in connection therewith.[60]

The PP was obliged in law to inform the Bank of the widening of its investigation as suggested above, to inform the SARB of its intention to subject the primary role of the Bank to an investigation and to afford the SARB an opportunity to provide input to influence the decisions of the PP. If the PP had adhered to its legal obligations in this regard, bearing in mind the blatantly wrong nature of its decisions, it should in all reasonability not have been too difficult for the SARB to provide the PP with an abundance of material to indicate the errors in its ways. Nevertheless, it would at the very least have afforded the Bank an opportunity to take immediate urgent action in the court to prevent the implementation of the remedial action pending a review. Thereby, the eventual damage to the economy of the RSA caused by the Final Report could have been avoided. The duty to provide reasons for an administrative decision constitutes a centralised element of the constitutional duty to act fairly. The Final Report contained many unsubstantiated findings by the PP. The PP's failure to give reasons, which involves proper or adequate reasons, should ordinarily render any disputed decision reviewable. Such decisions would normally be void and cannot be validated by different reasons given afterwards, even if such reasons show that the decision in question may have been justified. Later reasons are not the true reasons for the decision, but rather an *ex post facto* rationalisation of a bad decision.[61] The PP's attempt to justify its unsubstantiated findings in the Final Report by pretending that

[58] *Mail and Guardian* (n 32) par 19.
[59] *Joseph v City of Johannesburg* 2010 3 BCLR 212 (CC).
[60] s 7(9)(a) of the PP Act.
[61] *National Lotteries Board v South African Education and Environment Project* 2010 4 SA 504 (SCA) par 27; *Jicama 17(Pty) Ltd v West Coast District Municipality* 2006 1 SA 116 (C).

evidential material, obtained *ex post facto* the Final Report, served as a basis for its findings and remedial actions in the report only contributed to the unlawful nature of the already unlawful decisions in the Final Report.

Impartiality

The PP needs to fulfil its duties and responsibilities with an open and enquiring mind that displays independence and impartiality. Independence and impartiality are fundamental not only to ensure justice in a particular case, but also to individual and public confidence in the administration of the PP Act. Without that confidence the PP cannot demand the respect and acceptance that are essential to its effective operations. Although the law requires that the PP operate independently and impartially, it also requires it to act in a manner perceived to operate as such. Many of the actions of the PP in this matter gave rise to the reasonable inference that the PP was not fulfilling its duties in an independent and impartial manner.[62]

Certainty

In this respect, the *functus officio* doctrine is of relevance. It is based on the legal principle that it would be untenable if an official entity like the Heath SIU, upon completion and finalisation of its investigation, was free to reconsider and change its decisions at will, resulting in parties with an interest in the subject matter of the investigation, like ABSA and the Bank, not being afforded the finality necessary for them to arrange their affairs appropriately. Therefore, once the Heath SIU had concluded its investigation into the Bankorp matter and handed its final report to the President (as envisaged in terms of the SIU Act),[63] the parties affected by the investigation were for purposes of legal finality and certainty entitled to rely on the fact that the matter was closed.[64] The PP's remedial order instructing the reopening of the Heath SIU for purposes of recovering the funds in question was unlawful and unenforceable. In effect the PP's remedial action could be construed as an unlawful attempt to review and set aside the earlier decision of the Heath SIU (reached after an investigation) not to recover these funds.

6 Shareholding in central banks[65]

6.1 *Origins*

Central banks were initially established by Governments because it was regarded advantageous to have centralised monetary reserves and the control of currency

[62] *Mail and Guardian* (n 32) par 19.
[63] s 4(1)(g) of the SIU Act.
[64] *Ka Mtuze v Bytes Technology Group* 2013 12 BCLR 1358 (CC) par 18.
[65] What follows below until the end of par 6, unless otherwise indicated, is based on De Jager "Shareholding in the South African Reserve Bank: a unique and awkward concept" in Visser and Pretorius (eds) *Essays in Honour of Frans Malan: Former Judge of the Supreme Court of Appeal* (2016) 57 and the references and authorities quoted therein.

and credit vested in a central bank which had the support of the state and was subject to some form of governmental supervision and participation. Many of the first central banks were established by Governments vesting existing privately owned joint-stock companies (banks), modelled on the ultimate goal of profit maximisation through shareholder control for their exclusive benefit ("ownership model"), with certain privileges, such as the sole right of note issue. As the number of older privately owned central banks gradually assumed more powers and responsibilities of a public interest nature, the implications of profit maximisation and shareholder exclusivity on the non-profitable public interest nature of central bank business led to insurmountable difficulties. This led to a general worldwide reform in respect of existing central banks with private shareholder structures, whereby they were nationalised or partly nationalised by their respective Governments to suit their countries' particular public interest needs. This reform resulted either in the abolishment of the existing private shareholder structures of central banks, or, in the case where such private shareholder structures were retained, the realignment of shareholders' rights in sync with the public interest nature of central banks. Both instances involved abandonment of the profit maximisation motive. In the case of the realignment of central bank shareholders' rights, they were severely restricted in comparison to the rights of shareholders in ordinary companies.

6.2 *Governance principle*

Shareholding in a central bank is based on the recognised principle that the more representative a board of a central bank is, the more likely it is of gaining the support and acceptance of the general public in the pursuit of monetary policy. It is therefore based exclusively on principles of shared community representation and participation in the supervision of a central bank for purposes of increased independence, transparency and accountability, in the ultimate interest of the general public within the jurisdiction it operates. Shareholding improves the governance and enhances the autonomy, transparency and accountability of a central bank and supports the effectiveness of its institutional structure.

7 SARB shareholding, governance and management

7.1 *Concept*

The SARB is one of the few central banks in the world which maintains a legal structure that provides for private shareholding. The structure gives effect to the fundamental principles of central banking and considerations of public interest that militate against a central bank being owned and controlled by its private shareholders. This may largely be due to the fact that the SARB was right from the outset established as a central bank with a private shareholding structure without a profit maximising goal. The introduction of the system of private shareholding in the Bank was therefore never done with a profit motive in mind, but primarily with a corporate governance objective. The primary stakeholders of the SARB consist of the general public in the RSA (as the beneficiaries of monetary policy and financial stability) and Government. In the final analysis, the Bank is ultimately accountable to them. The rights of SARB shareholders are accordingly codified, set and limited by the SARB Act and the regulations made in terms thereof ("Regulations"), beyond which parameters no other shareholders' rights legally exist.[66]

7.2 *Shares*

The Bank has an authorised (and issued) share capital of two million rand, divided into two million ordinary shares of one rand each, which may be acquired, held and disposed of by the general public, subject to limitations set by the SARB Act.[67] In terms of the SARB Act no shareholder, together with his, her or its associates may hold more than 10,000 shares in the Bank.[68] The term "associate", in relation to a SARB shareholder is defined and in general refers to close relatives of a particular shareholder and persons (natural or legal) who may be directed, controlled or influenced by the shareholder in question.[69] Shareholders receive a fixed dividend at a rate of ten cents per annum per share, provided that profits are realised.[70] Voting is restricted to one vote for every 200 shares held, with a maximum of 50 votes per individual shareholder (together with his, her or its associates), which votes may be exercised at meetings of shareholders of the Bank.[71] In addition, persons not ordinarily resident in the Republic have no voting rights.[72]

Shareholders are able, together with members of the general public and serving directors on the Board, to nominate persons for consideration and possible designation by a panel ("panel") as suitable candidates for potential appointment into existing vacancies on the Board.[73] At the annual ordinary general meeting of shareholders of the Bank ("OGM"), held once a year, shareholders are entitled (provided that relevant vacancies exist) to elect a maximum of seven (shareholder appointed) non-executive directors to the Board from a list of potential candidates confirmed by the panel.[74] Shareholders have no powers to terminate the office of any director. Furthermore, the

[66] The current regulations relating to the South African Reserve Bank, made in terms of section 36 of the SARB Act by the Minister of Finance, are published in Notice R808 in *Government Gazette* No 33552 of 13 September 2010.

[67] s 21(1) of the SARB Act. Other central banks with some form of private shareholder structure are the central banks of Belgium, Greece, Italy, Japan, San Marino, Switzerland, Turkey and the twelve Federal Reserve Banks in the United States of America. The Bank for International Settlements ("BIS"), which may be regarded as a kind of central bank for central banks, also has a shareholding structure.

[68] s 22(1)(a) of the SARB Act.

[69] definitions in s 1 of the SARB Act.

[70] s 24 of the SARB Act.

[71] s 23 of the SARB Act.

[72] s 23(3) of the SARB Act.

[73] s 4(1A) of the SARB Act. The panel is constituted in terms of section s 4(1D) of the SARB Act and consists of the Governor of the SARB (as Chairperson), a retired judge and one other person nominated by the Minister of Finance, as well as three persons nominated by NEDLAC.

[74] r 7 of the Regulations.

business conducted by shareholders at the OGM consists of the presentation and discussion of the annual report and audit report, the appointment of auditors and the approval of their remuneration, special business (limited to the prescribed business conducted at the OGM) of which proper notice was given and any further business arising from such items.[75]

7.3 *Negative shareholder activism*

Around 2006 it become apparent that certain shareholders in the SARB were circumventing the then existing restrictions in the SARB Act on shares that could beneficially be held by a single person. It was done by acquiring SARB shares in the names of family members, friends and the like, and then exercising control over the shares. As beneficial shareholder of a large concentration of SARB shares, such single shareholders then sought to exert undue influence over the affairs of the Bank for personal gain. A prominent scheme of this nature involved German nationals, who over time accumulated a sizable percentage of the Bank's share capital (through family members and associates) and actively agitated together with other like-minded shareholders for the nationalisation or expropriation of those shares.[76]

The above-mentioned actions led to amendments to the SARB Act and the making of the current Regulations, which included the insertion of the definition and concept of associates of shareholders when determining the maximum threshold of shareholding by a single SARB shareholder (as referred to in par 7.2 above), as well as the introduction of provisions whereby undue concentrations of SARB shares could be regularised, either on a voluntary basis or by means of a court process.[77] Starting in March 2014 and finally ending on 24 July 2017, the SARB embarked upon such a process of regularising its shareholding by ending all unlawful holdings of SARB shares above the legal limit. At first it involved the disposal of shares by shareholders on a voluntary basis. In the final stage of the process, it involved the involuntary sale of 149,200 shares by the Bank on behalf of defiant shareholders (including the family member associates of the foreign shareholder mentioned above) in terms of an order of court obtained by the Bank.[78]

7.4 *Governance and management*

As part of its governance, the supervision of the Bank is the responsibility of a board consisting of fifteen directors ("board"), of whom eight (including the governors) are appointed by the President of the RSA and seven non-executive

[75] r 7.3 of the Regulations.

[76] See par 8.2 below.

[77] South African Reserve Bank Amendment Act 4 of 2010, promulgated on 13 September 2010. On the same date the (new) regulations came into operation, repealing and replacing the existing regulations.

[78] *The South African Reserve Bank v Barit* [2016] ZAGPPHC 950 (4 November 2016).

directors by private shareholders in the Bank.[79] The board and the shareholders have no authority over, and play no role in the crucial function of monetary policy or the management of the SARB. Monetary policy is conducted independently in committee by the monetary policy committee ("MPC") of the Bank, consisting of the governors and designated senior officials of the SARB. The management of the business of the SARB vests with the governors who are clothed with decentralised original powers of management.[80] Moreover, all directors are required to exercise their duties on behalf of the SARB.[81]

8 Nationalisation

8.1 *Concept*

In the absence of specific official information in this regard, nationalisation is considered in accordance with the broadly recognised concept that it entails Government taking control over an institution. It is achieved either by appropriation or confiscation, or by the purchase of assets from the targeted institution's legal "owners". Confiscation and appropriation is normally not achieved by mutual agreement and usually involves uncompensated seizure. Otherwise, in terms of the most commonly used method of nationalisation, control is obtained by Government buying all or part of the shares in the institution, at a price close to the market price. It is usually achieved in terms of legislation.[82]

In the above context, a general perception appears to be that Government would by means of the nationalisation of the Bank be able to appropriate "ownership" of the SARB from its private shareholders, thereby rendering it firmly within Government's grasp. However, this concept of shareholders being owners of the company in which they hold shares is based on the outdated historical ownership model of a company.[83] The history of corporate law has been one of increased flexibility for directors and management and decreasing rights for shareholders. In terms of prevalent principles of corporate law, companies are not "owned" by their shareholders (or anybody else for that matter). Companies are regarded as incorporated bodies which bring together

[79] s 4(1)(a) & (b) of the SARB Act.
[80] s 4A(2) of the SARB Act.
[81] s 4(2)(aA) of the SARB Act.
[82] Jean-Pierre DuPois (OECD) "Privatisation and nationalisation" (2005) a paper delivered at the fourth meeting of the TFHPSA, hosted by the IMF Washington DC on 3-6 October 2005, 6. In the case of the SARB it will require legislative intervention, since the SARB Act does not provide for Government to acquire all or part of its shares. In terms of the SARB Act Government and its associates would actually be prohibited from acquiring and holding more than 10,000 Bank shares. See par 7.2 above.
[83] On the basis of the primacy of shareholders, they were by virtue of their deemed ownership entitled to the sole control of the company for purposes of having it serve their interests alone (to the exclusion of all others): Dine "Company law developments in the European Union and the United Kingdom: confronting diversity" 1998 *TSAR* 245; Parkinson *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1994) 76.

a range of stakeholders in addition to shareholders, who all have valid interests in the company. Moreover, the unique public interest nature of the SARB not only militates against it being owned, but constitutionally renders the Bank incapable of being legally owned by anyone.[84]

Irrespective of the manner by means of which Government may potentially change the shareholder structure of the SARB, it will in practice add little, if anything material to Government's existing powers in terms of the SARB Act. As indicated before, shareholders of the SARB have extremely limited powers, which do not include any powers of management or control over the Bank. Nationalisation will therefore not result in any change to the existing status of Government in this regard and will not henceforth render the Bank subject to the "ownership" of the former, subject to its sole control. What it will actually achieve is effectively to terminate shareholder participation in the supervision of the SARB, thereby ending a long established mechanism designed to enhance the effectiveness of the Bank's institutional structure.

8.2 *Implications*

The acquisition of SARB shares by Government would in terms of relevant law most likely qualify as a form of expropriation, since it will involve the acquisition of rights in property by a public authority. In terms of the Constitution, property may be expropriated only in terms of a law of general application for a public purpose or in the public interest and subject to compensation that is just and equitable. The amount of the compensation, and the time and manner of payment, moreover, must have been agreed to by those affected, or decided or approved by a court.[85]

A number of the shares of the Bank are still held by the aforesaid German nationals and any transaction of this nature would evidently also be governed by the existing BIT. Although the BIT does not override the Constitution or any other local law, it binds the RSA on what may be described as the international forum.[86] Failure to observe the provisions of the BIT will result in the RSA incurring liability under the BIT. Affected German nationals could potentially have a claim against the RSA. In terms of the BIT it is evident that purchase by the Government of the SARB shares held by the German nationals will qualify

[84] Velasco "The fundamental rights of the shareholder" (2006) 40 *University of California Davis Law Review* 407; De Jager "The South African Reserve Bank: An evaluation of the origin, evolution and status of a central bank (Part 1)" 2006 *SA Merc LJ* 167.

[85] s 25 of the Constitution.

[86] BIT refers to the bilateral treaty between the RSA and Germany concerning the Reciprocal Encouragment and Protection of nestmenst sgned on 11 September 1995. The BIT became binding on the RSA when it was approved in 1997 by the National Assembly and the Council of Provinces in terms of the Constitution. Although the BIT was cancelled in October 2013 by the Minister of Trade and Industry, a 13(3) of the BIT determines that in respect of investments made prior to the date of termination of the BIT, the provisions of aa 1 to 12 of its 13 articles shall continue to be effective for a further period of twenty years from the date of its termination.

as expropriation of the same. The BIT prohibits expropriation unless it is done in the public interest and against compensation.[87]

The SARB Act does not provide for a method in terms of which the value of the Bank's shares should be determined in circumstances of them all being acquired by Government. The German nationals have over a number of years until present been lobbying for the nationalisation of the SARB and the purchase of their shares by Government, calculated at a net asset value price ("NAV") of all the assets of the Bank including the foreign reserves of the RSA. The argument appears to be based on a judgment of the Arbitration Court in The Hague.[88] It clearly constitutes an ingenious scheme designed at generating an enormous profit for shareholders involved in the scheme at the expense of the RSA general public.

9 Conclusion

The SARB does not function in a vacuum, but within the economy and financial system of the RSA, where its activities directly and indirectly affect the general public, consisting of a widely diverse society of natural and legal persons operating within the underlying political and economic culture prevalent in the RSA. It could therefore be expected that the Bank would from time to time face challenges from within the society that it serves and affects.

The Bank enjoys the highest degree of constitutional independence with regard to the conduct of its activities conducted in respect of monetary policy matters. In terms of the doctrine of the separation of powers, which is guaranteed in the Constitution, it enjoys protection from undue interference in the conduct of all its activities. However, whenever faced with unjustified and unlawful challenges the legal structure in terms of which the SARB functions (although essential) alone is not sufficient to protect the Bank. The SARB has no inherent coercive powers to safeguard itself and its activities against such challenges and needs to be able in terms of the rule of law to rely on the courts for suitable relief. Otherwise, a gap exists between the legal institutional prescriptions pertaining to the SARB and their practical impact, which could have serious damaging implications on the Bank and the country. The judgments by the court in Proceeding 1 and Proceeding 2 above, in setting

[87] par 4.2 of the BIT.

[88] A 54 of the BIS Statutes determines that any disputes between the BIS and its shareholders should be referred for final decision to The Hague Tribunal. On 8 January 2001 the BIS decided to restrict the right of shareholding in the BIS exclusively to central banks and mandated the payment of an amount of CHF 16,000 per share to private shareholders, calculated by means of a discounting of dividends to perpetuity method. Certain of the private shareholders challenged this method and insisted that the value of the shares be determined with reference to the NAV of the BIS. The matter was heard by The Hague Tribunal, which on 19 September 2003 rendered a final award in favour of the private shareholders. Based on the NAV of the BIS, discounted by 30%, it ordered the BIS to pay the shareholders an additional CHF 7,977.56 per share plus interest: Press Release of the Permanent Court of Arbitration, The Hague, 22 September 2003.

aside the relevant unlawful "remedial measures", have effectively nullified the potential of extremely ill-considered unjustifiable actions by the PP posing any further serious threats to the Bank, the financial system and the economy of the RSA. The judgments also served to confirm that the rule of law was still strongly embedded in the legal culture and constitutional structure of this country.

Calls for the nationalisation of the SARB appear to be based on the application of concepts of the outdated "ownership" model of a company to the Bank. It appears unjustifiably to ascribe the phenomenon of shareholder primacy to shareholding in the SARB. With regard to the public interest nature of central banks, which need to function in the interest of everyone in the RSA, it is then incorrectly assumed that the Bank is "owned" and controlled by its private shareholders, for their own private purposes. Based on this incorrect premise, the need is identified for Government to step in and take over "ownership" and control of the Bank, for purposes of ensuring that the SARB is managed and controlled in a manner that fulfils the needs of the general public. However, in reality shareholders are not the owners of the Bank and their powers, which do not include any powers of control and management of the SARB, are extremely limited in terms of the SARB Act and Regulations. The Bank has since its establishment until present always functioned in the public interest and never in the sole interest of its shareholders. The executive management of Bank, which includes policy making and the execution thereof, is the preserve of the Governor and Deputy Governors (who are appointed by the President) and its operations are determined by the Constitution and the SARB Act, as supervised by its board.

Any change or termination of the shareholder structure resulting in shareholders losing their limited rights will not result in any material change in the current role of Government in respect of the SARB. Moreover, any endeavour to change the shareholding structure of the SARB at this point in time has the potential of raising the level of risk and uncertainty for the RSA in both a financial and economic policy sense. This heightened exposure to risk is unwarranted given the country's fragile economic situation. Nationalisation of the SARB in terms of some form of appropriation of the Bank shares would most likely constitute an expensive and protracted exercise involving the BIT and possibly the courts. This is because SARB shares trade for much less than the price at which some existing shareholders (such as the German shareholders and their associates) are willing to sell their shares. The buying-out of existing shareholders could therefore involve a costly exercise which could result in the payment of large sums of taxpayers' money to effect cosmetic changes that will have no bearing on the manner in which the SARB is already managed and controlled, carries out its mandate or executes its responsibilities.

Pre-agreement assessment as a measure to prevent reckless credit: The importance of the *Shoprite* judgment

CORLIA VAN HEERDEN*

Abstract

The National Credit Act 34 of 2005 aims to prevent consumer over-indebtedness by addressing the granting of reckless credit as one of the main causes of over-indebtedness. It has consequently introduced a mandatory pre-agreement assessment obligation on credit providers in terms whereof they have to evaluate the financial position of consumers who wish to take up credit. During this process they must, *inter alia*, assess the consumer's general understanding and appreciation of the risks and costs of the proposed credit, and of the rights and obligations of a consumer under a credit agreement; the consumer's debt repayment history as a consumer under credit agreements as well as his existing financial "means, prospects and obligations". This assessment has to be undertaken at the time when the credit agreement is entered into or the amount approved in terms of a credit agreement is increased. Credit providers are allowed to use their own evaluative mechanisms as long as they comply with section 81(2) of the Act read with the 2015 Final Affordability Regulations and the evaluation results in a fair and objective assessment. The recent decision by the National Consumer Tribunal in *National Credit Regulator v Shoprite Ltd* [2017] ZANCT 98 (5 September 2017) and the pertinent aspects of pre-agreement assessment it has dealt with is analysed and criticised in this contribution.

* * * * *

1 Introduction

The National Credit Act 34 of 2005 (the "Act" or "NCA") which came into full effective operation on 1 July 2007 constitutes a wholesale replacement of the previous framework for credit regulation in South Africa.[1] One of the hallmarks of the Act is the novel provisions it introduced to prevent the granting of "reckless credit" - one of the root causes of consumer "over-indebtedness".[2] According to section 79(1) of the Act a consumer is over-indebted "if the

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1 The South African credit market was previously regulated in terms of the Credit Agreements Act 75 of 1980 and the Usury Act 73 of 1968.

2 Van Heerden and Renke "Perspectives on the South African responsible lending regime and the duty to conduct a pre-agreement assessment as a responsible lending measure" 2015 *International Insolvency Review* 67. The provisions of the NCA relating to reckless credit and over-indebtedness of course only applies if the Act applies to a credit agreement in respect of which such allegations are made. In terms of s 78(1) the debt relief provisions in the NCA pertaining to reckless credit and over-indebtedness, as provided for in Part D of Chapter 4 of the Act, are only aimed at natural persons and do not extend to juristic persons. Certain types of credit agreements are further excluded from the application of the reckless credit provisions in the Act - see s 78(2).

preponderance of available information at the time a determination [of over-indebtedness] is made indicates that the particular consumer *is or will be unable to satisfy in a timely* manner *all* the obligations under all the credit agreements to which the consumer is a party, having regard to that consumer's - (a) financial means, prospects and obligations; and (b) probable propensity to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, as indicated by the consumer's history of debt repayment."[3]

The Act not only prohibits[4] reckless lending but also introduces measures aimed at prevention[5] of reckless credit granting and measures that are, *inter alia*, aimed at alleviating[6] over-indebtedness occassioned by such credit granting. In the context of prevention of reckless credit granting, the Act's introduction of a duty to conduct a pre-agreement assessment (also generally referred to as an "affordability assessment") prior to entering into a credit agreement to establish whether the consumer will be able to afford the proposed credit, serves as a "filter" to prevent reckless credit granting and constitutes the basis on which to flag credit extension as "reckless" in three instances as set out in section 80 of the Act.

The significance of the duty to conduct a pre-agreement assessment becomes evident when one considers its role in relation to each of the types of reckless credit identified in the Act. The first type of reckless credit granting for purposes of the Act entails the situation where the credit provider extends credit *without conducting any prior pre-agreement* assessment.[7] Any credit so extended is *per se* reckless as the credit provider's failure to conduct a pre-

[3] author's emphasis.

[4] s 81 (3) stipulates that a credit provider must not enter into a reckless credit agreement with a prospective consumer.

[5] These include various disclosure requirements, limitations on cost of credit, a statutory *in duplum* rule and mandatory pre-agreement assessment. See, generally, Renke *An Evaluation of Debt Prevention Measures in terms of the National Credit Act 34 of 2005* (LLD Thesis, University of Pretoria, 2012) for a detailed discussion.

[6] s 83(2) provides that if a court or the National Consumer Tribunal declares that a credit agreement is reckless in terms of s 80(1)(a) (type one reckless credit) or 80(1)(b) (type two reckless credit) the court or Tribunal has the discretion to make an order

(a) setting aside all or part of the consumer's rights and obligations under *that* agreement, as the court determines just and reasonable under the circumstances; or

(b) suspending the force and effect of that credit agreement in accordance with s 83(3)(b)(i).

s 83(3) further provides that if a court declares that a credit agreement is reckless in terms of s 80(1)(b)(ii) (type three reckless credit), the court-

(a) must further consider whether the consumer is over-indebted at the time of those court proceedings; and

(b) if the court concludes that the consumer is over-indebted, the court may make an order-

 (i) suspending the force and effect of that credit agreement until a date determined by the court when making the order of suspension: and

 (ii) restructuring the consumer's obligations under any other credit agreements in terms of s 87.

See further s 84 for the effect of a suspension of a reckless credit agreement.

[7] s 80(1)(a).

agreement assessment before extending credit to the consumer is inexcusable.[8] The second type occurs where, *even though the credit provider conducted a pre-agreement assessment*, it disregarded the fact that the preponderance of available information indicated that the consumer was generally ignorant regarding the risks, costs and obligations under "a credit agreement".[9] The third type of reckless credit occurs where, *despite the fact that a pre-agreement assessment was conducted* which indicated that the granting of credit under the specific credit agreement would cause the consumer to become over-indebted, the credit provider nevertheless disregarded such information and extended the ill-fated credit to the consumer who could clearly not afford it.[10] It is further important to note that the reckless credit extension as envisaged by section 80 must have existed (occurred) at the time when the credit was extended[11] – thus a determination of whether credit was granted recklessly, as contemplated by the Act, entails a "set point" determination that is conducted with regard to the time of *conclusion* of the specific credit agreement and essentially hinges on whether a pre-agreement assessment was conducted, and if so, whether or not its outcome militated against the granting of the said credit.[12] This determination differs from a general determination of "over-indebtedness" in terms of section 79(1) as set out above, which is made at the time when a court or the Tribunal hears a matter involving an allegation that a consumer is over-indebted and which determination thus generally occurs at a later stage *after* the conclusion of a credit agreement.

2 Pre-agreement assessment (affordability assessment)

The obligation to conduct a pre-agreement assessment is set out in section 81(2)(a) of the Act which prohibits a credit provider from entering into a credit agreement without first taking *reasonable steps* to assess the proposed consumer's:

[8] The financial position of the consumer is irrelevant to this type of reckless credit.

[9] s 80(1)(b)(i).

[10] s 80(1)(b).

[11] author's emphasis.

[12] s 80(2) provides that when a determination is to be made whether a credit agreement is reckless or not, the person making the determination must apply the criteria for reckless credit as contained in s 80(1) as they existed at the time the agreement was made and without regard for the ability of the consumer to meet the obligations under the agreement or understand or appreciate the risks, costs and obligations under the proposed credit agreement at the time when the determination is being made. This means that if the consumer has since entering into a reckless credit agreement become able to afford the credit or has been educated on his risks, costs and obligations under the agreement, it does not negate the fact that the credit, at the time of conclusion of the agreement, was extended recklessly. Thus, granting of reckless credit cannot be remedied or ratified *ex post* the conclusion of the agreement. See further Van Heerden and Beyers "Dynamic affordability assessment in the context of the South African National Credit Act 34 of 2005" 2016 *JIBLR* 39.

(a) *general understanding and appreciation* of the risks and costs of the proposed credit, and of his rights and obligations under a credit agreement;

(b) *debt repayment history* as a consumer under credit agreements;

(c) *existing financial means, prospects and obligations*; and

(d) if the consumer applies for credit for a commercial purpose, whether there is a reasonable basis to conclude that such commercial purpose may prove to be successful.[13]

From the aforementioned it is clear that the mandatory pre-agreement assessment obligation imposed on credit providers is broader than merely assessing affordability by looking at the consumer's income and expenses. It also, *inter alia*, includes having regard to the consumer's understanding of the obligations, costs, and risks that such proposed credit entails, and requires consideration of the consumer's credit history. However, insofar as the part of the assessment that relates to considering the consumer's income and expenses is concerned section 81(2)(c) specifically requires consideration of the consumer's existing "financial means, prospects and obligations" as described in the Act. In this regard section 78(3) provides that

> "'financial means, prospects and obligations', with respect to a consumer or prospective consumer, *includes*
>
> (a) income, or any right to receive income, regardless of the source, frequency or regularity of that income, other than income that the consumer or prospective consumer receives, has a right to receive, or holds in trust for another person;
>
> (b) the financial means, prospects and obligations of any other adult person within the consumer's immediate family or household, to the extent that the consumer, or prospective consumer, and that other person customarily -
>
> (i) share their respective financial means; and
>
> (ii) mutually bear their respective financial obligations; and
>
> (c) if the consumer has or had a commercial purpose for applying for or entering into a particular credit agreement, the reasonably estimated future revenue flow from that business purpose."

Notably, thus, the Act requires not only consideration of the consumer's means (income) and obligations (expenses) but also of *future* prospects, that is "the possibility that something good may happen in the future".[14] The Act also requires the consideration of an adult member of the consumer's immediate family or household's "financial means, *prospects and obligations*" under the circumstances set out in section 78(3)(b)(i) and (ii) and not only such person's

[13] s 81(2)(b). See further *Desert Star Trading 145 v No 11 Flamboyant Edleen CC* [2010] ZASCA 148 (29 November 2010) par 14 and 15.

[14] as per the definition of "prospects" in the *Oxford Dictionary* available at https://www.oxforddictionary.com accessed on 4 July 2018. The NCA contains no particular definition of "prospects". Hence it should be afforded its ordinary grammatical meaning – which is clearly quite broad.

income. It is submitted that this means that where, for example, a spouse contributes to certain financial obligations of the consumer's household, such contribution has to be taken into account when the financial means, prospects and obligations of the consumer applying for credit are assessed. Such contribution may thus augment the said consumer's income. However, where the spouse is over-committed this will place a burden on the prospective consumer's income, and may have the effect of decreasing the amount of the consumer's income that can be taken into account for purposes of servicing instalments on the proposed credit agreement. Thus, the mere fact that a consumer is married or cohabits with another does not necessarily mean that this will have a positive effect and augment the consumer's available (disposable) income. '

Section 81 also places a reciprocal obligation on consumers to co-operate in the prevention of reckless credit granting by stipulating that when applying for credit, and while that application is being considered by a credit provider, the prospective consumer must "fully and truthfully" answer any requests for information made by the credit provider as part of the pre-agreement assessment. It is, however, a complete defence to an allegation of reckless credit if the credit provider establishes that the consumer failed to answer fully and truthfully to any such request for information made by the credit provider and if a court or the National Consumer Tribunal[15] determines that the consumer's failure to do so *materially* affected the ability of the credit provider to make a proper assessment.[16]

Since the introduction of the mandatory requirement of pre-agreement assessment, the issue of whether a credit provider has extended credit recklessly has thus essentially turned on whether such credit provider appropriately conducted a pre-agreement assessment as mandated by the Act prior to extending credit to a consumer in a particular instance. Initially the Act did not prescribe any specific assessment model that had to be applied by credit providers in order to comply with the pre-assessment duty imposed by section 81.[17] It was originally provided that a credit provider could determine its own evaluative mechanisms or models and procedures to be used in meeting its assessment obligations under section 81 as long as it resulted in a "fair and objective assessment".[18] The Act, however, does not contain any indication of

[15] The Tribunal was established in terms of s 26 of the NCA. See s 27 regarding its functions and s 83 as well as ss 149 - 152 regarding the orders it can make.

[16] s 81(4). For a detailed discussion of this defence see Van Heerden and Boraine "The money or the box: perspectives on reckless credit in terms of the National Credit Act 34 of 2005" 2011 *De Jure* 396-397 and 400; Kelly-Louw "A credit provider's complete defence against a consumer's allegation of reckless lending" 2014 *SA Merc LJ* 24ff. See further *Standard Bank Ltd v Kelly* [2011] ZAWCHC 1 (25 January 2011); *Horwood v Firstrand Bank Ltd* [2011] ZAGPJHC 121 (21 September 2011).

[17] Van Heerden and Renke (n 2) 76.

[18] This provision had to be read with s 61(5) which provides that a credit provider may determine for itself any scoring or other evaluative mechanism or model to be used in managing, underwriting and pricing credit risk, provided that any such mechanism or model is not founded or structured upon a statistical or other analysis in which the basis of risk categorisation, differentiation or

exactly what is meant with the words "fair and objective assessment". It was further provided that the National Credit Regulator[19] could publish non-binding guidelines proposing evaluative mechanisms, models and procedures, to be used in terms of section 81.[20] Such guidelines were, however, not published until May 2013[21] with the result that in the first few years that the Act was in operation credit providers to a large extent had a *carte blanche* in how they structured and conducted their section 81 assessments. Due to the lack of guidance in the Act and the lack of guidelines by the National Credit Regulator, the civil courts had to assist during these times in providing some guidance on when a proper assessment for purposes of section 81 could be said to have been conducted. [22]

The requirement of pre-agreement assessment has, however, evolved considerably since it was first introduced.[23] This evolution followed upon the enactment of the National Credit Amendment Act 19 of 2014.[24] Section 48 of the National Credit Act was amended to provide for the Minister of Trade and Industry, on recommendation of the National Credit Regulator,[25] to prescribe criteria and measures to determine the outcome (*sic*) of affordability assessments.[26] Sections 82(1) and (2) of the Act were substituted to provide that a credit provider may determine for itself the evaluative mechanisms or models and procedures to be used in meeting its assessment obligations under section 81, *provided* that any such mechanism, model or procedure results in a fair and objective assessment which *must not be inconsistent with the affordability assessment regulations*[27] made by the Minister of Trade and Industry.[28] In conjunction with the amendments introduced by the Amendment Act a set of

assessment is a ground of unfair discrimination prohibited in s 9(3) of the Constitution of 1996. The original s 82(1) was subject to s 82(2)(*a*) which provided that the National Credit Regulator could pre-approve the evaluative mechanisms, models and procedures to be used in terms of s 81 in respect of proposed developmental credit agreements.

19 The National Credit Regulator was established by s 12 of the National Credit Act as primary enforcer of the Act. See s 13 to 15 in relation to its functions.

20 If a credit provider had repeatedly failed to meet its obligations under s 81 or customarily used evaluative mechanisms, models or procedures that did not result in a fair and objective assessment, the Regulator could in terms of s 82(4)(a) and (b), apply to the Tribunal for an order in terms of s 82(4) requiring that credit provider to apply any guidelines published by the Regulator in terms of s 82(2)(b) or any alternative guidelines consistent with prevalent industry practice.

21 For an overview of these guidelines see Van Heerden in Scholtz *et al Guide to the National Credit Act* (2008) par 11.5.6(b). These Affordability Assessment Guidelines eventually culminated in the Final Affordability Assessment Regulations discussed below.

22 Van Heerden and Renke (n 2) 77. For an overview of the case law during this period dealing with reckless credit see Van Heerden (n 21) par 11.5.6(a).

23 For a detailed overview of the evolution of the pre-agreement assessment obligation and the developments that occurred as a precursor to the enactment of the National Credit Amendment Act 19 of 2014 see Van Heerden (n 21) par 11.5.6.

24 published in GG No 38557 of 13 March 2015.

25 s 24 of the NCA Amendment Act.

26 s 15(c). Obviously the Minister cannot determine the outcome of these assessments but merely how the assessments must be conducted.

27 author's emphasis.

28 s 24 of the NCA Amendment Act.

"Final Affordability Assessment Regulations"[29] were introduced that came into operation in September 2015. These regulations, as discussed below, constitute binding subordinate legislation that sets out the minimum standards with which credit providers now have to comply in conducting the pre-agreement assessment envisaged by section 81(2).[30] Thus, since 13 September 2015, a credit provider must conduct a pre-agreement assessment in accordance with section 81(2) read with these regulations. It is, therefore, still possible for credit providers to use their own assessment mechanisms and procedures as long as they result in a fair and objective assessment and comply with section 81(2) and the Final Affordability Assessment Regulations.

3 The Final Affordability Assessment Regulations

In terms of the Final Affordability Assessment Regulations (the "Regulations") a credit provider is obliged to take "practicable"[31] steps to assess the consumer's, or joint consumers',[32] discretionary income to determine whether the consumer has the "financial means and prospects" to repay the proposed credit.[33] As a first step the credit provider is required to validate the consumer's gross income. The regulations specify the specific documentation to be obtained for such verification with regard to consumers who receive a salary from an employer, those who do not and consumers that are self-employed.[34]

Regulation 23A(8) requires the credit provider to make a calculation of the consumer's "existing" financial means, prospects and obligations. When calculating the consumer's existing financial obligations the regulations compel the credit provider to utilize certain minimum expense norms (Table 1) contained in the Regulations (which table is broken down by monthly gross income for certain specified income bands).

[29] as published in GG No 38557 of 13 March 2015. The coming into operation of the Regulations were postponed for six months to give credit providers the opportunity to align their assessment mechanisms and procedures with the Regulations.

[30] Where allegations of reckless credit are made relating to a pre-assessment which was conducted prior to 13 September 2015 such compliance must be measured with regard to s 81(2) only as well as the requirement that it must be a fair and objective assessment. The Regulations do not have retrospective effect.

[31] There appears to be a discrepancy between the NCA and the Regulations in this regard as s 81(2) of the NCA requires the credit provider to take "reasonable" steps to assess the aspects mentioned in s 81(2).

[32] "Joint consumers" are defined in the Regulations as "consumers that are co-principal debtors who are jointly and severally liable with regard to the same credit agreement and apply jointly for the credit agreement excluding the surety or a credit guarantor under a credit guarantee".

[33] r 23A(3).

[34] r 23A(4). Where the consumer's monthly gross income shows material variance, r 23A(5) stipulates that the average gross income over the period of not less than three pay periods preceding the credit application must be used.

Table 1: NCR minimum expense norms

Income Band	Minimum income	Maximum income	Minimum monthly fixed factor	Monthly fixed factor: percentage of amount above band minimum
1	R0.00	R800.00	R0.00	100%
2	R800.01	R6 250.00	R800.00	6.75%
3	R6 250.01	R25 000.00	R1 167.88	9.00%
4	R25 000.01	R50 000.00	R2 855.28	8.20%
5	R50 000.01	Unlimited	R4 905.38	6.75%

Regulation 23A(10) stipulates that the following methodology must be applied when using Table 1: The credit provider must ascertain the consumer's gross income; thereafter statutory deductions and minimum living expenses must be deducted to arrive at a net income, which must be allocated for the payment of debt instalments. When existing instalments are taken into account, the credit provider must calculate the consumer's "discretionary income"[35] that will be available to enable the consumer to satisfy the proposed new debt. It is to be noted that the credit provider may on an exceptional basis, accept the consumer's declared minimum expenses which are lower than those set out in Table 1, provided that the credit provider sees to it that a questionnaire (as set out in Schedule 1 to the Regulations) is completed by the consumer or joint consumers to serve as proof that the consumer's living expenses are lower than the minimum prescribed by Table 1.[36]

Regulation 23A(10) must be read with regulation 23A(12) which obliges the credit provider, when conducting an affordability assessment, to: calculate the consumer's discretionary income; take into account all *monthly*[37] debt repayment obligations in terms of credit agreements as reflected on the consumer's credit profile held by a registered credit bureau; and take into account maintenance payments and other necessary expenses.

Regulation 23 specifically requires the credit provider to take into account the consumer's debt repayment history (not merely how many transactions are listed in his name) as a consumer under credit agreements as contemplated in section 81(2)(a). The credit provider must ensure that this requirement is performed within seven business days immediately prior to the initial approval of credit or the increasing of a credit limit, and within fourteen business days with regards to mortgages.[38]

35 *ie* the consumer's "disposable income".
36 r 23A(11). The words 'the questionnaire set out in the Schedule, as issued from time to time…' imply that the questionnaire may be amended from time to time.
37 author's emphasis.
38 r 23A(13)(a) and (b).

The Regulations further provide that in order to avoid "double counting" in calculating the consumer's discretionary income, where a credit agreement is entered into on a substitutionary basis in order to settle one or more existing credit agreement(s), a credit provider must record that the credit being applied for is to replace other existing credit agreements (for example a consolidation agreement).[39] In addition regulation 23, echoeing the provisions of the Act that already exist in this regard, mandate the disclosure of the "credit cost multiple" and the "total cost of credit" to the consumer.[40]

The Regulations further confirm the obligation of consumers to co-operate during pre-agreements assessment by spesifically requiring that the consumer must disclose accurately to the credit provider all his or her financial obligations to enable the credit provider to conduct the affordability assessment and must for such purpose also provide authentic documentation to the credit provider.[41]

The Regulations thus constitute a drastic intervention in the context of pre-agreement assessment as they impose specific onerous obligations on credit providers and significantly impede their ability to employ their own assessment mechanism and procedures as was the case prior to the coming into operation of the 2014 Amendment Act and the Regulations. Credit providers must thus now make sure that their assessment mechanisms and procedures are aligned not only with section 81(2) but also with the Regulations. It is, however, not only the mere introduction of more onerous obligations by the Regulations that have met with criticism, but also, *inter alia*, the practical application of Table 1. It has been pointed out that a practical explanation of how to apply Table 1 is absent from the Regulations thus making it unclear for a credit provider how to apply the Table.[42] Another problematic aspect is that nowhere in the Regulations is an explanation provided of the purpose of the "monthly fixed factor" mentioned

39 r 23A(14)(a). In addition r 23A(14)(b) states that the credit provider must take practicable steps to ensure that such credit is properly used for such purposes. It is, however, unclear how compliance with this latter requirement will be enforced.

40 In terms of r 23A(15) a credit provider must: disclose to the consumer the credit cost multiple and the total cost of credit in the pre-agreement statement and quotation; ensure that the credit cost multiple disclosures for credit facilities is based on one year of full utilization up to the credit limit proposed; ensure that the attention of the prospective consumer is drawn to the credit cost multiple and that the cost of credit as disclosed, is understood by the prospective consumer; disclose a total cost of credit which includes but is not limited to the following items: the principal debt; interest, initiation fee (if any); service fee aggregated to the life of a loan; and credit insurance aggregated to the life of a loan as set out in section 106 of the Act.

41 r 23A(6) and (7).

42 It is important to point out that the mandatory utilization of Table 1 was first introduced in guidelines published in September 2013 in which the consumer's annual income was used as basis for the selection of income bands contained in the Table. In the said guidelines an example was provided as to the practical application of the Table which indicated that, as a general guideline, should the prospective consumer have an annual gross income of R24 000 the credit provider may not accept annual necessary expenses of less than R14400 (being the amount indicated as annual minimum living expenses for that income band) plus R648 (being 6.75% of R9600) The annual income bands and annual living expenses mentioned in this first version of Table 1 were subsequently revised and the Table 1–version contained in the Regulations contain income bands based on monthly income and refer to monthly living expenses.

in the Table and exactly how the amounts in the Table should be calculated to assess the affordability. Other points of criticism include that the income bands and designated living expenses in Table 1 do not take into account that the profiles for consumers within a specific income may differ substantially and that this may significantly influence their living expenses, and that the Table does not incorporate any "adversity buffer".[43] It has also been pointed out, with respect to the minimum living expenses as prescribed by Table 1, that these does not mean that the credit provider can just take them into account without requiring from the consumer to furnish information about his living expenses. The consumer should still be requested to provide details of his actual living expenses and the credit provider should take them into account. The Table merely caps those living expenses at a minimum meaning that the amount set out in Table 1 is the lowest amount that may be used for the affordability calculation unless the consumer completes the prescribed questionnaire to justify that his expenses are lower than the minimum amounts indicated in the Table. However, it has been observed that in practice the problem may arise that credit providers incorrectly use the Table without assessing the consumer's actual living expenses.[44] Recently the requirement of validating the consumer's income as set out in the Regulations also came under attack.[45]

4 The expanded jurisdiction of the National Consumer Tribunal in matters involving reckless credit

As reckless credit constitutes "prohibited conduct"[46] for purposes of the Act, the National Consumer Tribunal, established in terms of section 26 of the Act, initially had jurisdiction to hear complaints regarding the granting of reckless credit referred to it by the National Credit Regulator as primary enforcer of the Act. In some instances, it was also possible for consumers, upon a non-referral by the Regulator, to refer such complaints to the Tribunal directly.[47] In this context the Tribunal could make a finding of prohibited conduct and, *inter alia*, order the cancellation of the registration of a credit provider who (repeatedly) extended reckless credit to consumers and/or impose an administrative fine on such a credit provider.[48] Notably the civil courts were also empowered to adjudicate reckless credit matters that came before them and impose civil

[43] Van Heerden and Beyers (n 12) 39.

[44] Van Heerden and Steennot "Pre-agreement assessment as a responsible lending tool in South Africa, the EU and Belgium: Part 1" 2018 *PELJ* 1.

[45] See *Truworths Ltd v Minister of Trade and Industry* 2018 (3) SA 558 (WCC) where the High Court set aside r 23A(4). See also the subsequent *Guidelines for Ascertaining Consumers' Gross Incomes and Discretionary Incomes for the Purposes of Regulation 23A of the National Credit Regulations including the Affordability Assessment Regulations* issued by the Department of Trade and Industry as published in Government Gazette No 41604 of 4 May 2018

[46] Note that reckless credit is prohibited but a reckless credit agreement does not constitute an unlawful credit agreement for purposes of s 89 of the Act.

[47] s 141(1).

[48] ss 57, 150 and 151.

penalties as set out in section 83 of the Act upon credit providers who were found to have engaged in reckless credit.[49] Thus, although both the Tribunal and the courts could adjudicate on reckless credit, their powers differed in terms of the relief they could provide. However, when the Amendment Act of 2014 came into operation on 13 March 2015 the jurisdiction of the Tribunal with regards to reckless credit was expanded as a result of amendments to section 83 which also gave the Tribunal the power to impose the same type of civil sanctions that previously fell within the exclusive jurisdiction of the civil courts.[50] Whether this was a wise intervention is not the topic of the current discussion. However, the point is that since its jurisdiction was increased by the Amendment Act the Tribunal has become even more of a "force to be reckoned with" in relation to the granting of reckless credit by credit providers. That the Tribunal is taking its role in this regard seriously appears from the important judgment it recently handed down in *National Credit Regulator v Shoprite Checkers Ltd.*[51]

5 National Credit Regulator v Shoprite Checkers Ltd

5.1 *Facts*

In the *Shoprite* matter the National Credit Regulator referred complaints to the Tribunal that Shoprite (the respondent) had entered into reckless credit agreements with consumers which made them over-indebted. It was alleged that this was as a result, specifically, of the respondent *not taking reasonable steps to assess* the relevant consumers' debt repayment history (as a consumer under credit agreements) and their existing "financial means, prospects and obligations". The Regulator put forward details and information about a number of consumers with whom the respondent allegedly entered into reckless credit agreements, the main contention being that these consumers all had "negative disposable income" and thus that the respondent's conduct in entering into credit agreements with them was reckless.[52] It was accordingly alleged that the respondent had repeatedly contravened section 81(3), read with sections 80(1)(b)(ii)[53] and 81(2)(a)(ii) and (iii) of the Act.[54]

Specifically, the Regulator submitted that the respondent granted credit recklessly to consumers (a) who were over-indebted *before* the respondent granted them credit, in that they had insufficient income to meet their monthly expenses, debt obligations and instalments to the respondent; and (b) who had adverse credit listings against their credit bureau records (facts pertaining to

[49] See footnote 5 above regarding the remedies provided for in s 83.

[50] See s 25 of the National Credit Amendment Act 19 of 2014.

[51] [2017] ZANCT 98 (5 Sept 2017).

[52] The Regulator's evidence pertinently showed that a number of consumers with whom the respondent had entered into credit agreements, had negative disposable incomes in that their expenditure exceeded their incomes at the date of entering into the agreements.

[53] *ie* the third type of reckless credit discussed above in par 2.

[54] par 43 to 47.

their debt re-payment history; emoluments attachment orders which reflected on the salary advice; arrears on a clothing account; and threatened legal action by a credit provider).[55]

The respondent, though agreeing with the Regulator that the listed consumers had negative disposable incomes, took issue with the Regulator's view that a negative disposable income means that the consumer was, or was about to become, over-indebted, and that granting credit to those consumers would make them (more) over-indebted, and that entering into a new credit agreement with them would therefore constitute reckless credit.[56] The respondent accordingly provided the Tribunal with a detailed explanation of its affordability assessment mechanisms and procedures indicating how it applied such assessment mechanisms and procedures to the factual scenarios of each of the consumers in question, asserting that it resulted in fair and objective assessments.[57]

The main tenets of the respondent's credit granting system (affordability assessment mechanisms and procedures) entailed the following steps: the first round of information gathering; a credit bureau (ITC) check through a computerized link; a second round of information gathering including verification of pay and identity numbers; **c**onsideration of the credit application by respondent's credit granting department; assessing the consumer's credit worthiness and credit record; and **c**onducting a *pro forma* affordability assessment utilizing a customized computerized credit granting system (UCS) taking into account the consumer's income (as apparent from his or her pay slips and/or bank statements) or other sources of income resulting in a *pro forma* calculation. A negative *pro forma* calculation result (a negative disposable income figure) from the customized computerized credit granting system, however, did not mean the end of the road for the consumer and a refusal of the credit application.[58] The respondent set out three reasons justifying its departure from what the *pro forma* affordability calculation in the system may indicate, namely:[59]

(a) It may be appropriate to "adjust" certain expenses from the ITC system namely: payments for short-term commitments such as for insurance, pay TV or cellular telephones; instalments for credit agreements where there are only up to four instalments remaining; *or* instalments where it appears that the credit bureau records are not up to date;

(b) The fact that the consumer has a good payment history and is up to date with his payments or not materially in default (three months or more in arrears); and

55 par 50.
56 par 61.
57 par 52 and 53.
58 par 55 to 56.
59 par 57.

(c) The fact that a consumer's "financial means" and "prospects might be "influenced for the better" due to the consumer being married or in some form of partnership.

The respondent submitted that it followed the above process for the consumers in question, and added back instalments due and payable to certain credit providers where only a few instalments were left thus reducing the consumers' expenses as reflected by the credit bureau. It further disregarded instalments where it formed a view that the ITC system was not updated or that the information might be incorrect thus reducing the consumers' expenses as reflected by the credit bureau. It took into account credit available to a consumer (for example an amount available on a home loan) which could increase the consumer's income and improve affordability. It disregarded month-to-month insurance and what it viewed as "discretionary expenses" thereby reducing the consumer's expenses as reflected by the credit bureau. Where it formed a view that the consumer had a good repayment history it further disregarded threats of legal action against a consumer and an emoluments order on his salary slip. It took into account marriage, a spouse's, or life partner's, income and disability grants (referred to as "improved means"). The respondent submitted that the above resulted in fair and objective assessments of the relevant consumers' affordability and on this basis denied that it had entered into reckless credit agreements with the consumers as alleged.

5.2 *Tribunal's judgment*

The Tribunal pointed out that the Act, under section 82 allows a credit provider to determine its *own evaluative mechanisms* when conducting affordability assessments under section 81, *provided* the evaluative mechanisms result in a *fair and objective assessment* and therefore it had to determine whether this was indeed the case. It stated, however, that before getting into whether the respondent's evaluative mechanisms resulted in fair and objective assessments, it would first consider whether the respondent entered into reckless credit agreements with consumers. The Tribunal referred to section 80(1)(b)(ii) and section 79(1) and remarked that the provision in section 80 is quite complex in that it has a "*timing component* - the point at which the consumer gets assessed namely the time when the determination is made"; and an "*evaluation or assessment component* - whether the consumer is or will be unlikely to meet his or her obligations under all his or her credit agreements taking into account financial means prospects and obligations and probable propensity to satisfy in a timely manner all the obligations under all the credit agreements". It indicated that the respondent focused on what it postulated as the "*ultimate question"* of over-indebtedness namely "*whether the consumer is unable to satisfy in a timely manner all the obligations under the credit agreements to which the consumer is a party, or will be unable to do so if the proposed new credit is granted."* In the Tribunal's view, by focusing on this "ultimate question" the respondent de-emphasised the components pertaining to the timing of the assessment and to quite a large extent also the aspect of *"financial means, prospects* *and obligations"*. The Tribunal indicated that this resulted in the respondent "shifting the point" at which the assessment has to be made to a point in the future when the consumer would have (presumably) paid off the instalments still due on other credit agreements, accessed funds from other credit lines, cancelled short-term commitments, and the like; and constructing "financial means, prospects and obligations" without a reasonable and objective basis – "as it is not certain that the above can actually be brought about for the consumer to pay for the new credit."[60]

The Tribunal subsequently referred to section 81(2) and remarked that on reading the plain text of this provision the word "existing" qualifies the words "financial means", "prospects" and "obligations". It follows that the meaning of "existing" is that financial means, prospects and obligations *as at the time of entering into the credit agreement* have to be taken into account and not *future* financial means, prospects and obligations - "i.e. as at the time by when the consumer might have paid up his or her furniture accounts, unilaterally defaulted on their insurance and other month-to-month commitments, or taking into account unverified income without (also) taking into account possible concomitant expenses against such income and taking into account income from another source of credit that might very well increase the consumer's debt obligations." The Tribunal accepted, as stated by the respondent, that a consumer's financial means and prospects might "be influenced for the better" because of being married or in a life partnership due to the ability to draw on joint resources. However, it remarked that the mere fact of a marriage or the existence of a life partnership is not sufficient on its own, and relying on this factor without requiring concrete and specific proof of income of the spouse or life partner and his or her expenses was not justifiable. Thus, the Tribunal indicated that the correct application of section 81(2)(iii) is for a credit provider "to verify and not to merely assume" the additional income of the spouse, life partner or other household member and to also determine what obligations that individual has to meet from the *verified* income. It pointed out that the respondent did not do this and did not deny that for the consumers concerned, the assessment through its customized computerized credit granting system resulted in a negative *pro forma* calculation. The Tribunal remarked that the respondent rather opted to explain to the Tribunal how it "addressed" the negative *pro forma* calculations and *"influenced them for the better"*. In some instances this process even resulted in changing an initial negative *pro forma* calculation to a positive one allowing the respondent to enter into the credit agreement with the consumer. The Tribunal further stated that according to the respondent it applied the "fair and objective assessment" to depart from a negative *pro forma* affordability calculation through making three types of "downward adjustments" as listed by the respondent that may be added back (namely short term commitments such as pay television subscriptions and short term insurance premiums; credit transactions where only a few

[60] par 62 to 68.

instalments are left; and where it is clear that the ITC system has not been updated and the information in question is out of date). It remarked: "This approach by the Respondent, erroneous in the view of the Tribunal, led the Respondent to conclude that ... a consumer whose expenses exceed his or her income might still be able to maintain a good repayment record". For these consumers though the ability to meet obligations under the credit agreement and to maintain a good repayment record was premised on and subject to cutting back on items of expenditure, unilaterally re-scheduling debts, and/or relying on family members for support. This in effect means, in the words of the Tribunal, that on the "*preponderance of available information at the time a determination ...* the consumer at the time of entering into the agreement actually does NOT have the financial means and prospects and the extension of credit to the consumer is reckless. Furthermore it causes the consumers to be worse off in respect of existing financial obligations which by following Respondent's system of disregarding short-term and other commitments to be in a position to pay Respondent the instalments (sic) due under the new credit agreements." Therefore the Tribunal, considering the apparent position the consumers found themselves in after the assessment (without going into detail on this aspect), held that the respondent's evaluation mechanisms, or models and procedures did not bring about "fair and objective *result*"[61] to all parties concerned. The Tribunal indicated that consumers' pre-existing commitments and future commitments were "being sacrificed" in favour of the consumer entering into a new credit agreement with the respondent; pre-existing credit obligations were disregarded contrary to the provisions of the Act; and credit bureau information was adjusted by the respondent to enable it to grant credit where the information pointed to the contrary. It stated that this enabled "the Respondent's credit granting department to grant credit and not to evaluate the consumer's ability to afford the credit applied for *at the time it is applied for* as required in the scheme of the NCA". The Tribunal stated that in its view, a fair and objective assessment result is not a result that necessarily favours the respondent entering into credit agreements with consumers. A fair and objective assessment result is when the consumer who was granted credit has the financial means and prospects on the "*preponderance of available information at the time a determination"* without the respondent having to "influence" the consumers' financial means and prospects "*for the better"* and disregarding consumers' obligations, short-term or otherwise.

What was even more troubling to the Tribunal was that even after the respondent had *"*addressed*"* the negative *pro forma* calculations and "influenced them for the better" the majority of these consumers still had negative affordability figures. Thus, the Tribunal found that the respondent had indeed repeatedly contravened section 81(3), read with section 80(1)(b)(ii) and 81(2)(a)(ii) and (iii) of the Act by entering into credit agreements with the relevant consumers. The Tribunal furthermore found that the respondent's

[61] author's emphasis.

evaluation mechanisms or models and procedures used in meeting its assessment obligations under section 81, did not result in fair and objective assessments "as through the machinations it described to enter into credit agreements with consumers meant them having to sacrifice meeting their obligations under existing credit agreements and other short-term financial obligations".

Notably one of the orders sought by the Regulator was that if (as per section 83(3)(a) of the Act) the Tribunal considered that the relevant consumers were over-indebted as at the time of the Tribunal proceedings, then it should make orders in section 83(3)(b)(ii)[62] suspending the force and effect of the credit agreements for a period determined by the Tribunal and restructuring the consumers' obligations under the reckless credit agreements. The Tribunal pointed out that it is only if, and once, the Tribunal concludes that the consumer is over-indebted that it can make the aforesaid order as set out in section 83(3)(b)(i) and (ii). The respondent argued, however, that the Regulator did not make any allegations or provide evidence as to the levels of indebtedness of the relevant consumers at the time of the Tribunal proceedings. Hence it was not competent for the Tribunal to make an order in terms of section 83(3)(b)(i) and (ii). The Tribunal thereupon considered the provisions of section 85[63] of the Act, concluding that debt counsellors "make the determinations of over-indebtedness in terms of section 86(7) and the Tribunal takes that forward in terms of section 83(3), i.e. whether to suspend the force and effect of the agreements and whether to restructure the consumer's obligations under the credit agreement under section 87."[64] It thus held that the assessment of over-indebtedness fell outside the scope of the present proceedings and that an appropriate order would be for the Tribunal to refer the consumers to a debt counsellor to make the required assessments and report back to the Tribunal.[65] The Tribunal further significantly remarked:[66]

[62] See footnote 6 above for the provisions of s 83(3).

[63] S 85 provides that "[D]espite any provision of law or agreement to the contrary, in any court proceedings in which a credit agreement is being considered, if it is alleged that the consumer under a credit agreement is over-indebted, the court may-

(a) refer the matter directly to a debt counsellor with a request that the debt counsellor evaluate the consumer's circumstances and make a recommendation to the court in terms of section 86(7); or

(b) declare that the consumer is over-indebted, as determined in accordance with this Part, and make any order contemplated in section 87 to relieve the consumer's over-indebtedness."

[64] S 86(7)(c) indicates that the court may restructure/re-arrange an over-indebted consumer's obligations under a credit agreement by extending the period of the agreement and reducing the amount of each payment due accordingly; postponing during a specified period the dates on which payments are due under the agreement; extending the period of the agreement and postponing during a specified period the dates on which payments are due under the agreement; or recalculating the consumer's obligations because of contraventions of Part A or B of Chapter 5, or Part A of Chapter 6. S 87 empowers a magistrate's court to re-arrange a consumer's debt.

[65] par 100 to 106. S 85(b), however, empowers a court, as alternative to referring a matter to a debt counsellor, to declare a consumer over-indebted and restructure his credit agreement debt, Whether the Tribunal has similar powers is debatable and falls beyond the scope of this contribution.

[66] par 108.

> "It must however be noted that the consumers who have been found to have been granted credit recklessly by the Respondent may not even be aware of this matter. They have not been cited in any way as parties and were not involved in the proceedings in any way. The possible consequences of having their financial situation assessed and found to be over-indebted have serious implications for the consumers concerned. These consumers may not want their financial situation assessed in any way. It must therefore clearly be noted that these consumers must voluntarily agree to the process of having their financial situation assessed by a debt counsellor. Should any of them refuse or not wish to cooperate in any way then they cannot be forced to do so and the matter ends there for that particular consumer. Although Section 83(3)(a) of the Act requires the Tribunal to consider whether the consumer is over-indebted it could never have been the intention of the legislature that they could be forced to have their financial affairs assessed. They must further be informed by the debt counsellor exactly what the implications may be if they are found to be over-indebted and of the possible suspension order that the Tribunal may make."

The Regulator also sought an interdict[67] restraining the respondent from, in future, granting credit recklessly to "consumers generally, to those who are in arrears on other accounts and/or to those who have adverse credit bureau listings or judgments". The respondent objected to the imposition of such an interdict, firstly, because no allegation was made or evidence adduced that it had granted credit to anyone with adverse judgments listed on a credit bureau and, secondly, on the basis that granting such an interdict "would override the more nuanced assessments which are required by section 79(1) of the NCA". The Tribunal agreed that the order sought for an interdict amounts to unduly fettering the provisions of section 79(1), which do not prohibit the extension of credit to consumers in arrears on other accounts and those who have adverse credit bureau listings or judgments against them and subsequently refused to grant such an interdict.

6 Discussion

The *Shoprite* judgment is important mainly in the following respects:

(a) The Tribunal held that the consumer's financial means, prospects and obligations as they "exist" *at the time of entering* into a proposed credit agreement must be taken into account; hence no unwarranted "downward adjustments", by adding back certain payments or ignoring or adjusting information that reflects on the consumer's credit bureau records, may be made to augment the consumer's pro forma disposable income with which to service the proposed new credit agreement. So, for example, the credit provider may not take into account payments on obligations that will in the near future cease (*ie* within 4 months from date of assessment), or adverse listings that may not have been updated by credit bureaux or incorrect information reflected on the records of such bureaux. Accordingly, where assessment results show a negative disposable income for the consumer

[67] In terms of s 150(b) of the Act the Tribunal is empowered to grant interdicts.

the credit provider is not allowed to adjust such result to a favourable one in the aforesaid manner and to subsequently grant credit to the consumer.

(b) It was held that a "fair and objective assessment" as indicated by section 82 does not mean a result that would *favour* the granting of credit.

(c) It was held that the credit provider, when making an assessment, had to verify any financial means, prospects and obligations of spouses and similar persons that it took into account to establish the proposed consumer's financial means, prospects and obligations. Also, the Tribunal pointed out that taking account of the spouse's financial means, prospects and obligations does not necessarily have the effect of influencing the proposed consumer's position for the better, as in some instance it may actually have the effect of decreasing the proposed consumer's financial means, prospects and obligations.

Given that the *Shoprite* matter concerned the third type of reckless credit described above (namely that the credit provider conducted assessments but disregarded the preponderance of available information, and entered into credit agreements that would make the consumers concerned (more) over-indebted) it is necessary to consider what this third type of reckless credit, as set out in section 80(1)(b)(ii), practically entails. It is also necessary to determine what the words "fair and objective assessment" as provided for in section 82 means. Having regard to this type of reckless credit the following questions must be asked:

(a) Was an assessment conducted by the credit provider?

(b) Did the assessment comply with section 81(2) and the Regulations?

(c) Was it a fair and objective assessment?

(d) Did the preponderance of available information referred to during the assessment show that the consumer would become over-indebted (or more over-indebted) if he entered into the proposed new credit agreement?

(e) Did the credit provider nevertheless disregard the outcome of the assessment (*ie* the preponderance of available information) and grant the proposed credit to the prospective consumer?

From the aforesaid it is clear that during this assessment process to screen for this type of reckless credit, the credit provider must first ensure that it conducts a pre-agreement assessment before entering into the proposed credit agreement. The credit provider will necessarily have to consider whether, having regard to the outcome of the assessment it conducted, and the preponderance of information available to it during such assessment, the credit which it proposes to extend to the consumer will be reckless because a consideration of the outcome of the assessment shows that taking up such new credit will make the consumer over-indebted. This means that the credit provider will have to revert to the description of "over-indebtedness" in section 79 and, based on the outcome of the assessment, should consider whether the effect of entering into the proposed credit with the consumer would be that the consumer "is or will be unable to satisfy in a timely manner all the obligations to all the credit agreements to which the consumer is a party". In order to reach such conclusion section 79 requires the credit provider to have regard to the consumer's financial means, prospects and obligations. In addition he must have regard to the consumer's probable propensity to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party - and he must do this by having regard to the consumer's history of debt repayment (which will be reflected on the consumer's credit bureau records). Thus, what is required is a two-stage approach, namely that the credit provider should first assess the consumers "affordability", and once he has done so, the credit provider should purposively apply his mind to the information he collected on the consumer's financial means, prospects and obligations, and to whether or not the consumer's debt repayment history points towards a probable propensity to satisfy in a timely manner all his credit agreement obligations as they arise, including the proposed credit. If the outcome of the credit provider's fair and objective assessment and the consideration of such outcome shows that the consumer *will be* over-indebted if the credit is extended, the credit provider should refrain from granting the proposed credit. It thus appears that this type of reckless credit requires the consumer's likelihood of over-indebtedness to be considered by the credit provider when conducting the pre-agreement assessment, and considering its outcome, and that, if such credit is nevertheless extended, the consumer's state of over-indebtedness is again considered, this time by the court or Tribunal when it has to decide whether to grant relief in terms of section 83(3)(b). This the over-indebtedness of the consumer is first considered for purposes of prevention of reckless credit granting and if the credit is subsequently extended recklessly then the consumer's over-indebtedness is considered for purposes of alleviating his unfortunate position.

The requirements of the pre-agreement assessment as mandated in terms of section 81(2) read with the Regulations have been set out in detail above, also indicating the methodology to be applied. It has also been noted that where a credit provider takes the financial means, prospects and obligations of a spouse or similar person into account it may not necessarily free up more disposable income for the consumer concerned, but, depending on the circumstances, it may actually decrease the consumer's disposable income available for servicing new credit agreements. It is further submitted that the credit provider is obliged, as a result of section 78(3)(b), to take such spouse's financial means, prospects and obligations into account when considering the financial means, prospects and obligations of the proposed consumer.[68] Given that section 81(2) read with the Regulations has the effect that the proposed consumer's income and obligations must be verified, and because the spouse's financial means, prospects and obligations are *included* in the proposed consumer's financial means, prospects and obligations by virtue of section 78(3), it is submitted that the Tribunal's finding that the spouse's financial means, prospects and

[68] This obligation only applies when the conditions set out in s 78(3)(b)(i) and (ii) are present and will thus not apply if, for instance, the consumer and his spouse live apart.

obligations should also be assessed and verified, cannot be faulted. It is, however, submitted that this does *not* mean that the credit provider will also have to consult the spouse's credit bureau records as section 81(2)(b) only sets such a requirement: in respect of the prospective consumer.

Further, section 81(2) indeed requires an assessment of the consumer's "existing" financial means, prospects and obligations. As pointed out section 80(2) requires these criteria to be considered as they "existed at the time the agreement was made". And although section 79(1) requires a determination of over-indebtedness to be made at the time that the allegation of over-indebtedness is raised, this third type of reckless credit requires of the credit provider to consider the issue of the likelihood of the consumer's over-indebtedness at an earlier point, namely at the time that it has completed its pre-agreement assessment and before it enters into a credit agreement with the consumer. It is, however, submitted that the requirement to assess "existing" financial means, prospects and obligations does not necessarily mean that the credit provider cannot take into account that an existing obligation is a once-off obligation, or that it will be paid off in the near future freeing up money to be allocated to payment of the instalments of the proposed new credit agreement, or that it must disregard income that may in the near future accrue to the proposed consumer and that can be used to repay such proposed new credit. It is submitted that the inclusion of the word "prospects" connotes some consideration during the assessment process of what may happen to the consumer's financial position in the future and is wide enough to accommodate, for example, taking into account that certain payments that are reflected as expenses that "exist" at the time the pre-agreement assessment is conducted, are once-off or will cease in the near future. Failing to do so would foreclose access to credit to many consumers who have actual prospects of improving their financial position within a short time after applying for credit. The question is, however, where to draw the line. If a once-off payment means that the consumer will not have enough money to service the new credit agreement at the time that the first instalment under such new agreement becomes due, then surely such consumer is over-indebted, if only temporarily. And also, if payments in respect of existing debts are only going to cease four months into the future it means that for the first four months of the new agreement the consumer might not have enough money with which to service the debt -meaning that he is at risk of defaulting from the start of the agreement. It would then seem as if the "prospects" contemplated by section 78(3) would point to prospects that would realize before the first payment in terms of the new agreement is due. Thus, this aspect of pre-agreement assessment remains challenging and leaves one to wonder to what extent future prospects will be allowed to influence a determination whether to grant credit under peril of it being regarded as reckless credit. Further, it may indeed appear that the consumer has listed obligations that are "discretionary" in the sense that they can be disregarded to free up more available disposable income, for example luxury items that are not a necessary part of the consumer's living expenses. As such it may happen that a consumer who is assessed and at first glance appears to have a negative disposable income may actually be able to afford new credit if some items on his expense list are deleted, resulting in the negative disposable income being adjusted so that it becomes positive disposable income. However, it is submitted that it will not be competent for the credit provider to delete such items unilaterally from the consumer's expenses during the assessment process, and that if the credit provider opines that certain expenses are discretionary and that it should be deleted from the consumer's list of expenses, then the credit provider should engage with the consumer before disregarding those amounts and adjusting the outcome of the assessment. It is of course also possible that the consumer's credit records were not updated by the credit bureau to reflect that certain debts have been paid-off, or that the information reflected on those records were otherwise incorrect (for example reflecting a monetary expense that the consumer never had) and where there is evidence to support this the credit provider will be justified in disregarding such information that is outdated and/or incorrectly reflected on a credit bureau record. Accordingly, it is submitted that the Tribunal's interpretation of the word "existing" is too narrow.

As regards the requirement that a pre-agreement assessment should result in a "fair and objective assessment" it is submitted that these qualities relate to the nature of the assessment itself .– Notably the Act requires the assessment to result in a fair and objective "assessment," not a fair and objective "result". Thus, it is submitted that this requirement speaks to the procedural aspects of the assessment and not the "outcome" of the assessment. As such it is submitted that the credit provider is required, *inter alia*, not to discriminate during the assessment,[69] to comply with the aspects of the assessment process as prescribed by the Act and Regulations (which include to apply the methodology prescribed by the Act and consult the consumer's credit bureau records); and also to consider the information provided to it for assessment purposes objectively. In any event one can argue that a fair and objective assessment process is likely also to yield a fair and objective result. It is further submitted that it first has to be determined whether the credit provider indeed conducted a fair and objective assessment, and thereafter, whether the credit provider disregarded the outcome of such fair and objective assessment which showed that the consumer would become over-indebted (or more over-indebted). Thus the Tribunal's approach to first determine whether credit was granted recklessly and thereafter to consider whether the assessment yielded a fair and objective result is questionable.

The *Shoprite* judgment also highlights the peculiar and paradoxical nature of the third type of reckless credit set out in section 80(1)(b)(ii), namely that a credit provider can engage in reckless credit granting by entering into a credit agreement that causes the consumer to become over-indebted, yet, if the consumer is no longer over-indebted by the time a court or the Tribunal adjudicates the matter then the civil debt relief as set out in section 83(3)(b)(ii)

[69] See s 61(5).

cannot be granted. So if the rare occasion transpires that a consumer became over-indebted as a result of credit that was extended recklessly and happened to "overcome" such over-indebtedness during the course of the credit agreement that fact does not retro-actively operate to purge that specific credit agreement of its recklessness. Thus it appears that in such instance the only penalty that would be competent would be for the Tribunal to impose an administrative penalty on the credit provider and/or to cancel its registration if it repeatedly engages in such conduct. The third type of reckless credit is thus "committed" if at the time of entering the credit agreement the preponderance of available information showed that the consumer would be over-indebted, and it is not dependent on a finding that the consumer is indeed over-indebted, or still over-indebted at the later stage when a court or Tribunal has to determine whether credit was granted recklessly. Such latter determination of over-indebtedness is then only relevant to the relief in accordance with section 83(3), namely suspension of the reckless agreement and restructuring of the consumer's other credit agreements that, in the words of the Tribunal, were "sacrificed" to enable the consumer to enter into the new and reckless credit agreement.

As regards the Regulator's request for an interdict to prevent the respondent from granting reckless credit in future it is submitted that the Tribunal correctly refused to grant such an order. In any event the Act interdicts such behaviour *ex lege* by prohibiting the extension of reckless credit.

7 Conclusion

In the *Shoprite* judgment the Tribunal has illuminated a number of crucial aspects relating to pre-agreement assessment in the context of the third type of reckless credit prohibited by the Act. This judgment will definitely have a dampening effect on the extension of the third type of reckless credit as it will cause many credit providers to revisit their current assessment practices. It is submitted that the Tribunal's judgment, although it can for the most of it technically not be faulted, fails to take into account that credit providers operate on the basis of business models that allow for a certain measure of risk-taking. Requiring them to adhere so strictly to the assessment criteria laid down by the Act that there is little opportunity for reasonable deviation, seriously curbs their risk appetite and might have a detrimental effect on access to credit. It is therefore hoped that the Regulator, in the interests of a sustainable credit market, will issue some guidance on the question as to the exact significance of the word "prospect" as it appears in section 78(3). It is further suggested that the regulator should also address the issue of incorrect or outdated credit records and on what basis they may be disregarded by the credit provider during pre-agreement assessment. As much as one can comprehend the Tribunal's argument that expenses that will cease at some future point cannot merely be adjusted and can agree with its viewpoint that emoluments attachment orders cannot be ignored, it is difficult to comprehend how it can be expected of credit providers not to disregard incorrect credit bureau information or threats of legal action that have not materialised.

Traditional trade finance instruments a high risk? A critical view on current international initiatives and regulatory measures to curb financial crime

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Abstract

This paper examines critically the claim or perception that traditional trade finance instruments pose a particularly high risk in terms of financial crime such as money laundering, terrorism finance, or sanctions violations. The fundamentals of documentary collections and letters of credit are briefly explained so that their role in international trade and trade finance can be appreciated. Further, the paper introduces, concisely, some important types of financial crime, and then refers to governmental and international organisations and their recent initiatives to address the threat of financial crime with regard to international trade and banking. The paper assesses the effectiveness and usefulness of these attempts to curb the misuse of the established trade finance system. Finally, the paper highlights some of the negative effects and consequences that increased legislative and regulatory activities have had in this context, particularly on legal certainty, the increased costs for banks and international traders due to compliance matters, the subsequent industry response of de-risking (such as the refusal of finance requests and the termination of customer or correspondent banking relationships), and, eventually, the worrisome trend towards clean payment (advance payment or open account) transactions.

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1 Traditional trade finance instruments: Transactions that pose high risks *per se*?

In international commerce, traditional trade finance instruments such as documentary collections and commercial letters of credit play an important role for both sellers and purchasers of goods and services, but also for the global commercial exchange in general. During the past several years, however, the perception has arisen and claims have been made that these documentary trade finance products carry an increased and disproportionate risk of involvement and facilitation of financial crime. For example, the Financial Transactions and Reports Analysis Centre of Canada, led by Canada's

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Department of Finance, recently published a guidance document[1] aimed at countering money laundering and terrorism financing, in which the use of letters of credit is listed, generally, as a "high-risk [indicator]". Similarly, in a guidebook for bank supervisors the World Bank described several banking services to "pose higher risks", among them "[i]nternational trade finance and letters of credit".[2] Moreover, in surveying the international banking and trade sector, representatives from major international banks and other organisations noted in 2017 that "[t]here is a perception that Trade Finance is a 'higher risk' area of business from a financial crime perspective".[3] Similar remarks and notions are discernible at conferences, workshops or public meetings within the banking and trade sector, and other relevant publications.

Such claims that discredit traditional trade products motivated outspoken trade finance experts like Sindberg to write, mockingly, of a "high risk ghost in trade finance"[4] and voice the opinion that "regulators, auditors, compliance officers etc […] have constantly labelled Trade Finance as a High Risk area – and that without any kind of evidence to that effect".[5]

2 Fundamentals of documentary collections and commercial letters of credit

International trade transactions usually need finance and other support (transactional, technical, or otherwise) by banks in facilitating payment. However, if so-called "clean payment" is agreed upon by the parties, that is advance payment or open account terms (either payment in advance of dispatch or payment after goods have been received),[6] the parties may only need limited assistance, *ie* wiring the money at the appropriate time and to the specified bank account. In such instances, banks engaged with the money transfer will have limited information and data regarding the underlying transaction. However, if the parties opt for documentary collection or a letter of credit to support their trade transaction, the involvement of banks will focus on documentary aspects and be more substantial. For purposes of this paper, only a concise introduction to documentary collections and letters of credits is provided, as

1 FINTRAC *Risk-Based Approach Guide* (June 2017).

2 Chatain, McDowell, Mousset, Schott and Van der Does de Willebois *Preventing Money Laundering and Terrorist Financing – A Practical Guide for Bank Supervisors* (2009) 223 (alteration by me).

3 The Wolfsberg Group, ICC and BAFT *Trade Finance Principles* (2017) 6 par 1.3 (alteration by me).

4 Sindberg "The high risk ghost in trade finance" www.lcviews.com/index.php?page_id=600 (02-07-2018).

5 Sindberg "Combating trade based money laundering: Rethinking the approach" www.lcviews.com/index.php?page_id=599 (02-07-2018) (omission by me).

6 Aside from the receipt of the actual goods, this could also mean that *documents* relating to the goods, especially transport and insurance documents, have been handed over. This, in many instances, confers ownership and (constructive) possession and therefore can be equated to delivery of the goods themselves.

there are excellent and more detailed treatments of the topic available.[7] For ease of reference, documentary collections and letters of credit will be referred to in this this paper collectively as "traditional trade finance products or instruments".

Traditional trade finance instruments utilise the services of banks in the sense that they receive, examine, and forward documents which relate to the purchased goods, and effect or receive payment at the appropriate point in time. The underlying transaction, on the other hand, is of no immediate interest to the bank. The most relevant documents are transport, storage, and quality/quantity documents (*eg*, bills of lading, warehouse receipts, certificates of quality or quantity relating to facts such as origin, purity, grade, class, amount and weight), insurance documents (cover notes or policies), and documents originating from the seller (packing notes, commercial invoices, or other assurances as agreed upon). If the documents tendered by the beneficiary (*ie*, the seller) comply with the stipulations in the letter of credit, the bank will honour its undertaking – in most cases, that is, make immediate payment.[8] In a documentary collection in its most simple form, the role of the bank is somewhat reversed in the sense that the bank itself offers documents with which it has been entrusted by the seller, to the buyer, and releases them upon payment[9] of the contract price. The documents required in a documentary collection are often similar to the documents called for in a letter of credit.

As indicated above, documentary collections and letters of credit are based on the fundamental notion that a bank will not concern itself with the actual underlying trade transaction. A bank will only refer to the documents specified in the application for these trade products, and will only examine these documents, *ie* check whether the documents are appropriately worded and seem to comply on their face. The actual underlying trade transaction, on the other hand, is largely irrelevant for the facilitating bank. This notion is evident in several ways: international practice rules specifically tailored to govern documentary collections (*eg*, the *Uniform Rules for Collections* (*URC 522*))[10] or commercial letters of credit (*eg*, the *Uniform Customs and Practice for*

7 See, *eg*, Hugo "Payment in and financing of international sale transactions" in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 394 399 *et seq* (for documentary collections) and 403 *et seq* (for commercial letters of credit); DiMatteo *International Contracting* (2016) 126 *et seq* (for documentary collections) and 138 *et seq* (for commercial letters of credit); Ehrlich and Haas *Zahlung und Zahlungssicherung im Außenhandel* (2010) 317 *et seq* (for documentary collections) and 37 *et seq* (for commercial letters of credit).

8 Letters of credit can also be drafted so that the bank's obligation is not to make payment directly but, for example, to accept a draft (and pay it upon maturity of the instrument) or to incur a deferred payment obligation (and pay at the due date).

9 Documentary collections can be designed differently, so that documents will not only be released against payment (so-called D/P collection) but against acceptance of a draft (so-called D/A collection).

10 ICC Publication 522. Aa 10 (b) ("Documents vs Goods/Services/Performances") and 12 (a) ("Disclaimer on Documents Received") state respectively that "[b]anks have no obligation to take any action in respect to the goods to which a documentary collection relates" and that they "must determine that the documents received appear to be as listed" – otherwise, as expressly so stipulated, "[b]anks have no further obligation in this respect".

Documentary Credits (*UCP 600*))[11] make it plain that the banks' involvement in the transaction is limited, principally and practically, to the examination and handling of documents (and payment based on the result of these examinations). The same holds true for the (few) instances in which countries have enacted domestic provisions or law, for instance the People's Republic of China[12] or the United States of America,[13] and, of course, international case law,[14] which confirm that the role of banks in documentary collections and letters of credit is restricted to the examination and the exchange of documents.

Importantly, the pricing policies of banks and other financial institutions that are involved in the issuance and facilitation of traditional trade finance products, clearly reflect the above expectation. It is the expectation that the involvement in the trade transaction is limited to the checking of documents, without investigating the underlying transactions to which these documents may relate. Typically, banks neither have the expertise nor sufficient interest to go "beyond the documents". Their mandate is restricted to the examination of documents, the forwarding of such documents, and the facilitation of payment in appropriate situations based on these documents. Therefore, the charges banks collect from customers and other parties involved in a trade finance transaction are relatively low. If banks were expected to delve into the underlying transaction, analyse the goods shipped and the quality thereof, and so forth, the charges would be considerably higher. Accordingly, it must be appreciated that banks involved in documentary collections and documentary credits are doing more than just wiring money from one account to another – yet they are still not concerned, and should not be, with the underlying transaction itself, but only with the documents relating to it.

In the facilitation of international trade and payment, local banks rely on so-called correspondent banks with which they have correspondent banking relationships. Through these intermediaries the local banks can offer advice, assistance, and services to parties located abroad, and in regions, areas or

[11] ICC Publication 600. Aa 4 (a) ("Credits v Contracts") and 5 ("Documents v Goods, Services or Performance") respectively clarify that a commercial letter of credit is "by its nature […] a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract […]", and "[b]anks deal with documents and not with goods, services or performance to which the documents may relate".

[12] The *Rules of the Supreme Court of the People's Republic of China Concerning Several Issues in Hearing Letter of Credit Cases* (2005) refer in a 2 ("Application of International Rules or Practices") to the *UCP* directly, and state in a 5 ("Time for Honour of Letter of Credit Undertaking") that an issuer has to honour its documentary undertaking "if the documents appear on their face in compliance" and that a Chinese "court shall not give effect to a defence based on the underlying transaction".

[13] Likewise, the Uniform Commercial Code (UCC) Revised Article 5 (Letters of Credit) in the United States of America provides in Section 5-108 (a) that "an issuer shall honor a presentation that […] appears on its face strictly to comply with the terms and conditions of the letter of credit".

[14] See, for example, the English case of *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; or the South African case of *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd* [2002] ZASCA 5 (12 March 2002).

jurisdictions in which they themselves do not have a presence (*ie*, do not operate a local branch or subsidiary).[15] This is vitally important for traditional trade products for which, in many cases, banks need to be able to provide services across borders and in multiple jurisdictions. Examples are the exchange or transmission of documents in a documentary collection by the remitting bank to a collecting bank,[16] or the advice or confirmation of a letter of credit by a bank operating in the jurisdiction of the beneficiary.[17] Without a network of trusted correspondents this would be impossible.

Regarding compliance issues in relation to the combatting of financial crime in the context of this paper it is important to note that the utilisation of traditional trade instruments will require the banks to examine documents relating to the underlying transaction. These documents provide banks with transactional oversight and data regarding the names and identities of the parties involved, the goods and respective shipping routes, and other financial arrangements and transactional patterns. Data gathered and documents examined during documentary collections or a letter of credit transaction can then supply information which can be examined for compliance purposes relating to the combatting of financial crime, that is checking it against databases and lists and comparing it with existing customer profiles and previously established and recorded transactional patterns.

On the other hand, as pointed out above, if the trade parties settle for clean payment terms (providing for open account or advance payment), the involvement of banks is limited considerably and they are deprived of almost all transactional data and insight.

3 Fundamentals and important types of financial crime

Financial crime denotes the use of the financial system and financial institutions to facilitate crime. While it is difficult to define the term "financial crime" with precision,[18] it is possible and helpful to list several types of crimes that typically fall within its ambit.[19] For purposes of this paper, sophisticated and refined definitions are not necessary but a short introduction to some of the crimes and offences will suffice.

15 See Basel Committee on Banking Supervision *Guidelines Sound Management of Risk related to Money Laundering and Financing of Terrorism* (June 2017) 23 Annex 2 par 2.

16 See Hugo (n 7) 399.

17 See Hugo (n 7) 405-406.

18 Gilligan "The problem of, and with, financial crime" 2012 *Northern Ireland Legal Quarterly* 495 500 *et seq*.

19 BAFT *Guidance for Identifying Potentially Suspicious Activity in Letters of Credit and Documentary Collections* (March 2015) 6; Byrne and Berger *Trade Based Financial Crime Compliance* (2017) 45.

3.1 *Corruption and bribery*

Corruption is "a serious problem in many countries around the world"[20] and "a complex concept that is affected by linguistic usage, ethical perspectives and cultural nuances",[21] and because of this, "anti-corruption conventions have not attempted a general definition of corruption".[22] Nevertheless, scholars have tried to define corruption in general terms and, according to Carr and Stone, these definitions "rotate around economic or other gains made by an individual in a position of power as a result of that individual's role within an organisation or institution".[23] Similarly, bribery could be defined as a person offering, giving or promising to give a financial or other advantage in exchange for the improper performing of a specific function or activity.[24] Scholars have described the concept of financial advantage in this regard as a "relatively straightforward concept".[25] No attempt should be made here to provide a general definition of corruption or bribery; rather one may accept that corruption and bribery, in the present context, denotes the illegal exercise of power by a (state) representative or (public) office bearer to gain material advantages, or the payment for such abusive and illegitimate exercise of power, respectively.

3.2 *Money-laundering activities*

Money laundering refers to the activity of inserting funds that stem from illegal activities (drugs or arms trade, tax evasion, fraud, corruption, bribery, or other crimes) into the regular financial system with the aim of obfuscating the origin of the funds.[26] To hide the fact that the source of the money was a criminal act, money laundering operations typically use seemingly legitimate businesses or transactions so that the existence of money, often cash, can be explained.[27] Once circulating in the regular financial system and thus "laundered", the funds can be used freely, that is spent, transferred, or invested, all within the banking system. Because of the serious implications of money laundering, many domestic and international efforts of combatting financial crime focus, to a significant degree, on money laundering and the prevention thereof. Scholars

[20] Quah *Different Paths to Curbing Corruption* (2013) 1.

[21] Carr and Stone *International Trade Law* (2018) 678. In this regard, see Loughman and Sibery *Bribery and Corruption Navigating the Global Risks* (2012) 269 for what they perceive to be the "most common corruption risks in Africa".

[22] Carr and Stone (n 21) 679.

[23] Carr and Stone (n 21) 679.

[24] See Heimann and Pieth *Confronting Corruption* (2018) 31; Uff *Construction Law* (2017) 20 (with reference to the UK Bribery Act of 2010, section 1).

[25] Lee and Tankel "Bribery" in Wilmot-Smith (ed) *Wilmot-Smith on Construction Contracts* (2014) 493 496 par 19.13.

[26] Ellinger, Lomnicka and Hare *Ellinger's Modern Banking Law* (2011) 92; Zentes, Glaab, Becker and Heemann *AML in der Bankpraxis* (2014) 13 par 16/1; UNCITRAL *Recognizing and Preventing Commercial Fraud* (2013) 6.

[27] BAFT *Combatting Trade Based Money Laundering: Rethinking the Approach* (August 2017) 3.

estimate that in large industrialised countries laundered money amounts to billions annually.[28]

3.3 *Violation of sanctions and terrorism financing*

Violation of sanctions and financing of terrorism are two other main aspects of financial crime that have seen much and far-reaching developments, both on domestic as well as international fronts. In the context of financial crime, sanctions mean formal prohibitions imposed by governments or competent international bodies against dealing with certain persons, commercial entities, regions or countries. Sanctions can relate to all transactions *per se*, or be limited to certain persons and entities, transactions and services, sectors, goods, or threshold amounts.[29] The imposition of economic sanctions will typically have a stifling effect on the respective entities or countries,[30] and the mere rumour of a fresh series of sanctions, or additional measures of economic isolation, that a financially-powerful country (*eg*, the United States of America) or entity (*eg*, the European Union) is allegedly contemplating can have tremendous repercussions for the concerned parties. Merchants and banks are likely to scale down their commercial engagements and contractual obligations, refrain from forging new business deals, or at least factor-in the risk of possible economic sanctions and uncertainty as well as related transactional problems and costs.

The financing of terrorism, a concept that is often widely defined and politically influenced,[31] is also strongly prohibited based on domestic or international statutes, regulations or conventions. Often, the countermeasures

28 Zentes, Glaab, Becker and Heemann (n 26) 13 par 16/1. Loughman and Sibery (n 21) 3 state, overall, that "[b]ribery and corruption has a very detrimental effect on an economy" (alteration by me), and that "[t]he impact of bribery and corruption can't be understated" (at 4; alteration by me). See also Heimann and Pieth (n 24) 39-40.

29 Hocke, Sachs and Pelz *Außenwirtschaftsrecht* (2017) 913 par 79; Bertrams *Bank Guarantees in International Trade* (2013) 345-346.

30 Stalls writes of "powerful impact": see "Economic sanctions" 2003 (Fall Issue) *University of Miami International and Comparative Law Review* 115 118. Commercial and financial transactions with Iran or Iranian entities are still, at least in part, subject to sanctions and restrictions. Therefore, for example, the German trade association VDMA, representing companies from the mechanical and engineering industry, reports that difficult financing conditions and remaining US sanctions prevent the realisation of economic potential of the Iranian economic market; see VDMA Arbeitsgemeinschaft Großanlagenbau *Lagebericht 2017/2018 Beiträge zum Industrieanlagenbau* (2018) 20.

31 The concept of terrorism and the use of this label in a political context is subjective and can be highly problematic. To use a South African example, one may consider the prominent case of the former president of the Republic of South Africa, the late Nelson Rolihlahla Mandela, whose public portrayal and international appreciation over the past decades was deeply influenced by the current political circumstances. See also the remarks regarding liberation movements and express references to anti-colonial struggles in Weißer "Transnational organised crime and terrorism" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 84 96-97.

directed at money laundering activities are also aimed at terrorism financing.[32] This is explained by scholars who point out that "[t]he ease with which money may be transmitted from jurisdiction to jurisdiction means that money laundering and the financing of terrorism usually involve a number of financial centres. […] It follows that money laundering and the financing of terrorism will only be effectively disrupted if all jurisdictions play their part in the fight against both activities."[33]

Apart from the types of financial crime referred to above, other offences such as serious fraud, export controls violations,[34] anti-boycott violations,[35] tax evasion, and capital and foreign exchange control measures violations[36] can be addressed by laws and regulations aimed at combatting financial crime.

Because many of the mentioned types of financial crime are facilitated across borders, or pose a serious threat on a wider, international level, the responses by governments and law enforcement are also often coordinated and aligned along international standards, or at least strive to be.

Particularly in developing countries the effect of financial crime, especially corruption and bribery, fraud against provincial or state government, tax evasion, or money laundering offences connected to these offences, can have serious practical implications for the local population.[37] Scholars point out that "corruption brings about diversion of financial resources from the national budget to private spending purposes".[38] If money destined for state coffers does not end up in the hands of parliament or trustworthy public officials, but disappears into the pockets of criminals, society will likely be harmed and suffer from insufficient infrastructure, public services and the like.

32 Lawack "The South African banking system" in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 63 99; De Koker and Turkington "Transnational organised crime and anti-money laundering regime" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 241 par 12.1 ("money laundering control became fused with the combating of financing of terrorism"; "money laundering and terrorism financing are linked in the global standards and in practice"); Zentes, Glaab, Becker and Heemann (n 26) 14 par 16/2; Ellinger, Lomnicka and Hare (n 26) 106 par (iii). See also Tricks *A Practitioner's Guide to Demand Guarantees* (2017) 163 par 10.6.2.

33 Ellinger, Lomnicka and Hare (n 26) 93 (alterations by me).

34 Altmann *Außenwirtschaft für Unternehmen* (2001) 599 *et seq*; Vento and Ohara "Practical considerations and risks for US companies contracting across borders" in Venoit, Brannan, Beaumont, Ness and Oles (eds) *International Construction Law* (2009) 13 21-22.

35 Vento and Ohara (n 34) 22-24; Altmann (n 34) 613 *et seq*; Jungkind and Cramer "Boykott-Verbot versus Sanktionslisten-Screening" 2016 *AWPrax* 417.

36 Ailshie and Eisenegger "International financial considerations" in Venoit, Brannan, Beaumont, Ness and Oles (eds) *International Construction Law* (2009) 165 185 *et seq*; Häberle *Handbuch für Kaufrecht, Rechtsdurchsetzung und Zahlungssicherung im Außenhandel* (2002) 635 par 6.7.2; Graf von Bernstorff *Forderungssicherung im Außenhandel* (2017) 34-36.

37 Heimann and Pieth (n 24) 14 par 3. See also the remark made specifically regarding bribery and corruption in Uff (n 24) 20-21.

38 Yikona, Slot, Geller, Hansen and Kadiri *Ill-Gotten Money and the Economy: Experiences from Malawi and Namibia* (2011) 5.

4 International efforts and initiatives against financial crime

International efforts and initiatives against financial crime within an international context are driven by nation states and their governments, international organisations,[39] and private initiatives, among them the United Nations, the European Union, and various groups comprising experts and representatives of stakeholders and industry experts.[40]

Of considerable importance are the United Nations, with its respective initiatives, bodies and offices such as the UN Security Council responsible for, inter alia, international sanctions or, for example, the United Nations Office of Drugs and Crime (UNODC) involved in the creation of the UN Convention against Corruption[41] and the drafting of model legislation and provisions on money laundering and terrorism financing. [42] With their far-reaching mandate under the Charter of the United Nations (articles 39 and 41),[43] the UN Security Council can impose economic sanctions and subsequently request all member states to implement and enforce them internationally.[44]

The European Union has issued legislation in the form of directives and regulations aimed at money laundering, terrorism financing and other aspects of organised crime for member states to implement and enforce across the

[39] Scholars have highlighted the involvement of international organisations especially regarding corruption and corruption prevention: see Makowicz "Der holistische Ansatz für Export Compliance Management" in Summersberger, Merz, Jatzke and Achatz (eds) *Außenwirtschaft, Verbrauchsteuern und Zoll im 21. Jahrhundert – Festschrift für Hans-Michael Wolfgang* (2018) 73 78 par 4.

[40] By no means could a paper such as this list all parties and organisations involved in this field. Therefore, brief introduction of some of the more relevant organisations should suffice.

[41] Adopted by the United Nations General Assembly in October 2003 as Resolution No. 58/4. For this aspect, see Heimann and Pieth (n 24) 103 *et seq*; Loughman and Sibery (n 21) 36-37; and Kubiciel and Rink "The United Nations Convention against Corruption and its criminal law provisions" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 219 *et seq*.

[42] Madsen "Historical evolution of the international cooperation against transnational organised crime" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 3 15 par 1.4.2. See, for example, the UNODC Model Legislation on Money Laundering and Financing of Terrorism (December 2005) or the UNODC Model Provisions on Money Laundering, Terrorist Financing, Preventive Measures and Proceeds of Crime (April 2009).

[43] A 39 reads: "The Security Council shall determine the existence of any threat to the peace, breach of the peace, or act of aggression and shall make recommendations, or decide what measures shall be taken in accordance with Articles 41 and 42, to maintain or restore international peace and security." A 41 reads: "The Security Council may decide what measures not involving the use of armed force are to be employed to give effect to its decisions, and it may call upon the Members of the United Nations to apply such measures. These may include complete or partial interruption of economic relations and of rail, sea, air, postal, telegraphic, radio, and other means of communication, and the severance of diplomatic relations."

[44] See Majlessi "Use of economic sanctions under international law: A contemporary assessment" in 2001 *Canadian Yearbook of International Law* 253 258 *et seq*; Pyka *Wirtschaftssanktionen der Vereinten Nationen und der Europäischen Union* (2015) 44 *et seq*; Birkhäuser *Sanktionen des Sicherheitsrats der Vereinten Nationen gegen Individuen* (2007) 22-23.

continent.[45] Certain European Union pronouncements, especially directives, require the individual member states to implement the European measures into their own domestic legal systems in order for them to be effective. Taking into account the combined economic importance of the member states of the European Union, its legislative and regulatory efforts do carry substantial weight.

Established by several industrialised nations in the late 1980s,[46] the Financial Action Task Force (FATF) is described as "the lead institution for international initiatives"[47] to fight money laundering and terrorism financing offences. As an intergovernmental organisation, FATF coordinates international policy making and enforcement, and issues authoritative guidelines and recommendations, which in turn are then used as models and adopted, implemented and enforced by the international community, individual countries and their respective governments.[48]

The Basel Committee on Banking Supervision was founded in the 1970s by industrialised countries and their central banks to address the increasing interconnectedness and interdependence of international banking operations,[49] which is done through research and the issuance of highly influential recommendations and guidance papers. Among the recent activities relevant for this paper are, for example, the publication of guidelines relating to risk management in the context of money laundering and terrorism financing.[50]

The United States of America has been the "first jurisdiction to tackle money laundering",[51] and remains very active with numerous offices, bureaus, and entities engaged in combatting financial crime. The regulatory activities of the USA are closely watched by experts around the globe and often used as a yardstick, adopted, implemented, or otherwise complied with,[52] as many of their financial institutions and market places play, "[d]espite Washington's current protectionist leanings",[53] a major role in international trade and finance.

Aside from the actors and institutions mentioned above, several private initiatives such as the Wolfsberg Group, the American lobbying organisation Bankers Association for Finance and Trade (BAFT) and the International Chamber of Commerce (ICC) have contributed to the field, either individually or collectively,[54] with research, recommendations, and guidance papers. In light

[45] Hecker "The EU and the fight against organised crime" in Hauck and Peterke (eds) *International Law and Transnational Organised Crime* (2016) 63 78-81.
[46] Stroligo, Intscher and Davis-Crockwell *Suspending Suspicious Transactions* (2013) 5-6.
[47] Ellinger, Lomnicka and Hare (n 26) 94.
[48] Stroligo, Intscher and Davis-Crockwell (n 46) 6; Ellinger, Lomnicka and Hare (n 26) 95; De Koker and Turkington (n 32) 247 par 12.3.3.
[49] Ellinger, Lomnicka and Hare (n 26) 77.
[50] Basel Committee on Banking Supervision (n 15).
[51] A claim made by Ellinger, Lomnicka and Hare (n 26) 93.
[52] See Schoppmann *Compliance als Organisationspflicht bei Kreditinstituten* (2014) 12 and 16.
[53] HSBC *Global Report – Navigator Now, Next and How for Business* (2018) 6 www.business.hsbc.com/trade-navigator (02-07-2018) (alteration by me).
[54] The Wolfsberg Group, ICC and BAFT (n 3), the so-called "Wolfsberg Principles".

of the remarkable legislative and regulatory activities, and the large number of intergovernmental and non-governmental organisations and their research and policy-guidance output, it is becoming increasingly difficult to assess, and comply with, all current expectations and legal requirements. Accordingly, experts conclude that "far reaching regulations have changed the compliance and risk management landscape".[55] Many banks and companies struggle to introduce and operate appropriate internal compliance programmes and mechanisms to ensure that all their activities are in line with applicable rules and regulations.

For purposes of this paper, it is not necessary to distinguish clearly between applicable legislation and regulatory measures, violation of which may result in criminal or administrative penalties, and recommendations, sourcebooks, guidance or position papers by non-governmental or lobbying organisations, that attempt to articulate best practices or recommendations and the violation of which cannot, directly, lead to criminal or administrative liability. What is important to note, at this point, is the fact that some referenced guidance, recommendations or position papers by certain organisations do in fact carry substantial weight. They do not have the force of law, of course, but they will often be appreciated and used by regulators, bank examiners and law enforcement as blueprints for appropriate behaviour and compliance. Therefore, despite the lack of legal force some recommendations or guidance papers ought to be seen as authoritative and highly significant, because they, effectively, articulate or shape the expectations of law enforcement, bank examiners, and regulators. Scholars emphasise the influence that such organisations, for example the Basel Committee on Banking Supervision, can have in this regard. As Ellinger, Lomnicka and Hare put it "[the Basel Commitee] has neither formal legal status nor authority, but its recommendations (so-called 'soft law') are enormously influential and are followed by banking regulators throughout the world."[56]

Overall, it is evident that the area of compliance with measures aimed at countering financial crime is complicated to navigate. It has been acknowledged, therefore, that "the legal environment is increasingly complex. In addition to the array of national and international laws, regulations, and other authorities that govern transnational criminal law enforcement, one must consider the independent activities of influential transnational actors."[57]

4.1 *Data, due diligence, and the risk-based approach*

Certain issues and concepts permeate almost all modern initiatives of financial crime prevention and compliance with measures aimed at combatting financial crime. Most important, it is the notion that data and information relating to the

[55] FATF *Discussion Paper No.1 - Global Impact and Unintended Consequences for Exclusion and Stability* (2014) 4, available at https://classic.regonline.com/custImages/340000/341739/G24%20AFI/G24_2015/De-risking_Report.pdf (02-07-2018).

[56] (n 26) 77 (insertion by me).

[57] Kuester "Transnational influences on financial crime" 2013 *University of Miami National Security and Armed Conflict Law Review (Symposium Edition 2013-2014)* 71 79.

identity of parties, their transactions and business pattern must be scrutinised and used to identify signs or evidence relating to financial crime, as well as the risk-based approach[58] which is linked to the particular level of due diligence and scrutiny that is appropriate for a specific customer or transaction. Typically, there is a distinction made between regular due diligence, which can be either heightened (typically referred to as enhanced, raised, elevated, or escalated) or, in some cases, even lowered when appropriate. Due diligence can relate both to the customer, meaning the person or entity for whom the bank provides a service, or the transaction that is being facilitated by the bank. Most recent regulations, initiatives and approaches contain elements relating to customer profiles and respective data, the so-called "know your customer or client" (KYC) requirements, and recommend or require information gathering at the point in time in which the person or entity becomes a customer (the so-called on-boarding stage), but also at regular intervals during the customer-bank relationship (on-going or constant monitoring), for instance when transactions are requested or executed, or other significant changes in the customer profile or its commercial activities occur.

4.2 *Risk indicators of financial crime*

The risk-based approach and the variable levels of due diligence are typically linked to collections or lists of risk indicators (so-called red flags), the presence of which may be used to estimate the likelihood or chances of a certain customer or transaction being criminally motivated and the potential risks associated with that, which in turn will determine the appropriate level of due diligence required to satisfy regulators' and examiners' compliance expectations under a maintained and executed compliance programme or applicable legal regime. Prominent examples of such risk indicator lists have been issued, for instance, by FATF,[59] or by the United Nations Commission on International Trade in regard to commercial fraud.[60]

However, domestic bodies or government agencies have also issued lists of risk indicators, such as the United Kingdom's Financial Conduct Authority

[58] For the introduction and application of the risk-based approach within the South African context, regard may be had to Hugo and Spruyt "Money laundering, terrorist financing and financial sanctions: South Africa's response by means of the Financial Intelligence Centre Amendment Act 1 of 2017" 2018 *Journal of South African Law (TSAR)* 227 236 *et seq*; and Spruyt "The Financial Intelligence Centre Amendment Act and the Application of a Risk-Based Approach" in Hugo and Du Toit (eds) *Annual Banking Law Update (ABLU)* (2017) 19 21 *et seq*. See, generally, Heimann and Pieth (n 24) 131-132.

[59] FATF has included risk indicators in many of its publications, for example in FATF *Report on Money Laundering/Terrorist Financing Risks and Vulnerabilities Associated with Gold* (July 2015) 20-23; FATF *Report on Risk of Terrorist Abuse in Non-Profit Organisations* (June 2014) 68-73; FATF *Report on Money Laundering and Terrorist Financing Vulnerabilities of Legal Professionals* (June 2013) 77-82; and FATF *Money Laundering & Terrorist Financing Through the Real Estate Sector* (June 2007) 34-37.

[60] UNCITRAL (n 26) 11 *et seq*.

(FCA),[61] the Monetary Authority of Singapore (MAS),[62] the Financial Transactions and Reports Analysis Centre of Canada,[63] or the American Federal Financial Institutions Examination Council (FFIEC).[64] In South Africa, for instance, the Financial Intelligence Centre's Guidance Note 7[65] provides several possible risk indicators that relate to, *inter alia*, the question whether the customer's product has "a 'cooling off' period which allows for a contract to be cancelled without much formality and a refund of moneys paid",[66] or whether "the client's product selection [is] rational with a view to support their business or personal needs".[67] In Germany, for example, the "Anhaltspunktepapier Geldwäsche" was issued by the competent German authority[68] in conjunction with representatives from major banks, insurance companies, and financial institutions, and updated recently.[69] It contains indicators which may point to money laundering, among them a section specifically dealing with commercial letters of credit and documentary collections. According to that paper, possible indicators of money laundering can be the use of trade finance instruments in transactions which concern countries that are considered "politically and economically"[70] stable if the particular industry does not, typically, utilise traditional trade finance products for such transactions. One of the other mentioned indicators is the utilisation of "letters of credits and other international trade finance products if the use of such instruments is, in consideration of the known commercial activities of the customer, unusual".[71] A similar list of indicators was issued by German authorities which relates to possible terrorism financing transactions.[72] Among numerous other potentially suspicious facts or behaviour, the mere request by a bank customer to "invest money with the instruction to generate no or only little interest (Islamic Banking)"[73] is listed as a possible red flag.

[61] FCA *Thematic Review – Banks' Control of Financial Crime Risks in Trade Finance* (July 2013) 46-48.

[62] MAS *Guidance on Anti-Money Laundering and Countering the Financing of Terrorism Controls in Trade Finance and Correspondent Banking* (October 2015) 19-21.

[63] FINTRAC *Guideline 2 – Suspicious Transactions* (June 2017) par 7-8.

[64] FFIEC *Appendix F – Money Laundering and Terrorist Financing "Red Flags"*.

[65] Financial Intelligence Centre *Guidance Note 7 on the Implementation of Various Aspects of the Financial Centre Act, 2001 (Act 38 of 2001), October 2017*.

[66] 17.

[67] 20 (insertion by me).

[68] The German "Zentralstelle für Verdachtsmeldungen".

[69] Bank-Verlag *Mitarbeiterinformation zur Abwehr von Geldwäsche und Terrorismusfinanzierung* (2018) 171.

[70] My translation. The original German (184 par 5.3) reads "politische und wirtschaftliche Verhältnisse eine sichere Form der Zahlungsabwicklung zulassen".

[71] The translation is mine. The original German (184 par 5.1) reads "Verwendung von Akkreditiven und anderen Methoden der internationalen Handelsfinanzierung, wenn solche Instrumente bei den bekannten geschäftlichen Aktivitäten des Kunden unüblich sind".

[72] See Bank-Verlag (n 69) 201 *et seq*.

[73] The translation is mine. The original German (205 par 2.1) reads "Anlage von Geldern mit der Maßgabe, keine oder nur geringe Zinseinkünfte zu erzielen ('Islamic Banking') ".

As expressly pointed out, for example by the MAS in its risk indicator list "Guidance on Anti-Money Laundering and Countering the Financing of Terrorism Controls in Trade Finance and Correspondent Banking", the presence of a particular risk indicator cannot be treated as conclusive evidence:

> "Banks should pay attention to the following red flags when processing trade finance transactions of their customers as they could be indicative of a transaction being used for financial crime purposes. These examples are not exhaustive, and the presence of a single red flag indicator does not mean that the transaction is illegal. A confluence of multiple indicators would nonetheless suggest that the transaction is suspicious, and appropriate due diligence measures, including [Suspicious Transaction Report] filing, should be adopted by the bank."[74]

In practice, risk indicator lists play an important role for banks when operating a compliance programme and conducting due diligence compliance checks.

5 The effectiveness and usefulness of increased efforts and initiatives aimed at combatting financial crime

Although it is difficult, if not impossible, to measure precisely the effect of recent efforts and initiatives to combat financial crime, it is probably reasonable to assume that the increase in regulatory expectations and scrutiny has had a positive impact in that it reduced the number of criminal transactions processed or facilitated through the established formal financial system. This assumption is based on the notion that increased scrutiny will, naturally, uncover illegal transactions, and deter criminals from utilising the financial system and trade finance products for criminal purposes. In 2015, BAFT reported the following:

> "Regulators have focused intense scrutiny on trade finance as a potential conduit for financial crimes, including money laundering and terrorist financing. Bank examiners have heightened their expectations concerning customer due diligence, sanction filtering, and suspicious activity identification related to trade finance. "[75]

All this is likely to have contributed to curbing or reducing instances of financial crime.

Harsh penalties and sanctions can, and have been, imposed on banks, financial institutions, companies and persons that violated laws and regulations aimed at fighting financial crime which include, *inter alia*, substantial monetary fines,[76] suspension of banking licences or the threat thereof,[77] freezing of assets, closer scrutiny and the permanent or temporary embedding of dedicated compliance examiners into a bank or financial institution, or measures aimed

74 MAS (n 62) 19 (alteration by me).

75 BAFT (n 19) 1 (their footnote omitted).

76 Various examples are supplied, for example, in Vogt "Compliance mit US-Sanktionsregelungen zu Iran mit extraterritorialer Wirkung" in Huck and Kurth (eds) *Compliance aus dem Blickwinkel des internationalen und europäischen Wirtschaftsrechts* (2013) 97 101-102; and Fleischmann *Globalisierbarkeit von Compliance-Erwartungen?* (2016) 140-143.

77 Habib Bank, for example, surrendered its banking licence for New York State after repeated money laundering offences and an agreement to close, permanently, its branch in New York City. See April 2018 *Documentary Credit World (DCW)* 30.

at personnel such as travel bans for senior executives and the risk of personal arrests, mandating that specific banking officers and management personnel be terminated or additional compliance personnel be hired. Besides that, more informal punishment or pressure can include the banning or overlooking of bidders or bids in or from certain countries or regions,[78] the rejection or revocation of insurance cover for engineering or construction projects, export transactions[79] or ocean voyages,[80] or actions such as the disconnection from the important SWIFT communications network.[81] In addition, reputational damage caused by allegations of compliance violations can be devastating for a bank, financial institution, company, or natural persons who will encounter difficulties after having been associated with financial crime. In consideration of this, one could come to the conclusion that increased and stricter initiatives aimed at combatting financial crime have had, and will continue to have, a crime-reducing and thus positive effect.

However, one should also be cognisant of other data when assessing the effectiveness of increased regulatory expectations and enhanced scrutiny efforts. The ICC, in a comprehensive international survey, discovered that "nearly 20% [of banks] said they have no visibility on whether their efforts linked to monitoring due diligence and transactions have improved results, or not".[82] Also, it remains doubtful whether traditional trade finance products such as documentary collections and letters of credit, in the first place, merit scrutiny and attention on the present scale – especially because such enhanced scrutiny and regulation has had, and is likely to have in the future, some serious unintended practical consequences that are explored immediately below.

6 Unintended consequences of increased and stricter compliance rules and regulations: Legal uncertainty, increased cost for compliance matters, de-risking, and clean payment trading as an emerging alternative

Stricter and expanding compliance requirements relating to the combatting of financial crime have given rise to several unintended consequences for international banking and trade finance. A serious problem is the element of uncertainty that originates from the flexible and discretionary approach that

[78] See, for example, Fleischmann (n 76) 148-149; and Heimann and Pieth (n 24) 213.

[79] Heimann and Pieth (n 24) 213.

[80] This makes international shipments, and thus a significant aspect of international trade, virtually impossible, and has been applied in the past, for example, against Iranian entities.

[81] The Belgium-based Society for Worldwide Interbank Financial Telecommunication (SWIFT) operates an international network for secure and authenticated communication and messaging. The network is primarily used by banks and financial institutions, and carries electronic communications relating to finance, trade, international payments, letters of credits, and other inter-bank messages. Many Iranian banks were disconnected from the SWIFT network from 2012-2016, a move that severely impeded their ability to carry out international transactions. Sudanese banks suffered from a similar fate until 2017; see Bälz and Mujally "Handel mit Sudan" 2017 *Recht der Internationalen Wirtschaft (RIW)* 201.

[82] ICC *2018 Global Trade – Securing Future Growth* (2018) 50 (insertion is mine).

many recent regulatory measures and initiatives take. While many concepts and notions, most importantly the emergence of a risk-based approach, allow for checks and responses which are potentially more in line with the likely, actual risk of a particular customer or transaction,[83] they introduce a considerable element of uncertainty. It falls on the bank or financial institution to assess correctly the level of risk associated with a particular customer or transaction, and subsequently to carry out the appropriate risk detection and mitigation activities.[84] If the initial risk classification (low or high risk?), or whichever the applicable categories in a given jurisdiction or compliance regime are, fails, then the subsequent actions taken by the bank or financial institutions are likely to be insufficient (problematic transaction wrongly identified as low risk and thus escaped further scrutiny) or unwarranted and excessive (low risk transaction subjected to too-intense a scrutiny or even unnecessarily reported to the competent authority as suspicious). The problem is that if the initial risk classification exercise fails, either the transaction or the customer may not have been properly scrutinised, and resources dedicated to financial crime compliance – scarce as they are – are being applied inefficiently. It remains a reality that each case of a customer relationship or a transaction is different, and the risk-based approach necessitates decision making on a case-by-case basis.[85]

6.1 *Uncertainty*

Even if the bank applies the available indicators of financial crime in accordance with applicable legislation and regulations, it is not always clear what exact steps need to be taken subsequently. Depending on the applicable compliance regime, for example, "enhanced due diligence" needs to be conducted or "appropriate measures" may have to be taken in relation to a particular transaction or customer. What exactly such elevated due diligence or appropriate measures are, however, is often left open to interpretations by bankers or their lawyers and advisers and, ultimately, bank examiners, financial auditors, and courts. Therefore, Byrne and Berger have spoken of an "unsettling element of vagueness", and have expressed the following criticism:

[83] This notion is aptly explained by Spruyt (n 58) 21 par 2 who writes: "[a]n effective AML/CFT [anti-money laundering/counter-terrorism financing] framework should rather ensure that resources are effectively channelled to and concentrated on areas that represent a higher risk of abuse. 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." (alterations, insertion, and omission of his footnotes by me.)

[84] Spruyt (n 58) 21 par 2.

[85] See, for example, Scherp *Bank & Compliance Mitarbeiterinformation zur Verhinderung von Betrug und sonstigen strafbaren Handlungen* (2018) 18.

> "A bank must take 'appropriate' measures, it must exercise 'due diligence', and act 'reasonably'. There is, however, no clear definition as to what is sufficient or satisfactory. Whether intentional or not, this approach leaves the bank potentially exposed if certain steps are not taken […]. Given the importance of (legal) certainty for commercial transactions and banking and finance in general, this is worrisome."[86]

But uncertainty in the context of compliance with measures against financial crime also stems from the fast pace[87] with which compliance requirements and regulatory expectations emerge, and from the large number of actors and sources (governments, inter-governmental bodies, international organisations and initiatives) that issue relevant lists of sanctioned entities or goods, literature with guidelines and principles, and authoritative interpretations or best-practice formulations. Since banks active in international trade and trade finance are necessarily operating in several jurisdictions, either directly through branches and subsidiaries of their own or through correspondent intermediaries, their compliance tasks are considerably more complex because they need to ensure compliance in all operative jurisdictions and markets. In this regard, one author concludes that "[t]he extent of the due diligence will depend on the bank's internal procedures and the local regulations applicable to the bank. […] Since the regulations will vary from country to country, it is not possible to set out a single standard"[88] for financial crime compliance. If one applies this thought to the African continent in particular, one will have to agree with the negative assessment of the president of the African Export-Import Bank, Benedict Oramah, who observed that "[t]he compliance cost is high. Africa is fragmented – it has 55 countries".[89] Especially in consideration of financial inclusion and the continent's need for access to banking facilities and trade support, this is clearly problematic.

The compliance matrix is further expanded by extraterritorial application of laws and regulations by some countries, most notably the United States of America (also referred to as long-reach or long-arm approach or legislation) in matters of, inter alia, sanctions.[90] By treating transactions that are nominated

86 Byrne and Berger (n 19) 62 par 3.6.1 (omission by me).

87 Kuester (n 57) 78 speaks of "the fast-moving pace of change in world-wide financial crime regulations".

88 Tricks (n 32) 170 par 11.2.2 (omission, alteration and insertion by me).

89 Interview by Manders in 2018 *Global Trade Review May Issue* https://www.gtreview.com/news/africa/exclusive-afreximbank-president-unveils-new-initiatives-and-thoughts-on-africas-trade-finance-gap (02-07-2018) (alteration by me).

90 See Dixon *International Law* (2013) 156-158; Haellmigk "Das aktuelle US-Iran-Embargo und seine Bedeutung für die deutsche Exportwirtschaft" 2018 *Corporate Compliance Zeitschrift (CCZ)* 33; Huck "Extraterritorialität US-amerikanischen Rechts im Spannungsverhältnis zu nationalen, supranationalen und internationalen Rechtsordnungen" 2015 *Neue Juristische Online-Zeitschrift (NJOZ)* 993; Battini "Globalisation and extraterritorial regulation: An unexceptional exception" in Anthony, Auby, Morison and Zwart (eds) *Values in Global Administrative Law* (2011) 61 63 *et seq*; Vento and Ohara (n 34) 29; Byrne and Berger (n 19) 64 par 3.8; and generally Huck and Kurth *Compliance aus dem Blickwinkel des internationalen und europäischen Wirtschaftsrechts* (2013).

in US-Dollars, in some cases irrespective of where contract formation takes place, where goods or services are exchanged or delivered, and where parties are domiciled, to be subject to US-American law, the United States of America, effectively, imposes its own compliance expectations onto the global financial network and international banking and trade.

Uncertainty due to complex and extensive, ever-changing compliance requirements is especially challenging for smaller banks and such established in emerging countries that do not have the financial or operational capacity to react immediately, many of which "find recent regulatory complexity challenging".[91]

Additionally, the stricter and more intense scrutiny of customers and transactions in international trade finance has led to an increased number of hits or alerts, correct or incorrect, when conducting manual or automated checks on transactions, customers or their trade partners. The fear of failing to report a suspicious transaction, and the subsequently danger of fines and other sanctions, may motivate what is sometimes referred to as "over-reporting". This can be due to an overzealous reporting culture in a bank or financial institution or, for example, due to an unadjusted or incorrect application of "fuzzy search" options which, for example, may capture a variety of ways of spelling the name of a person[92] or entity and therefore yield numerous hits. These hits become so-called false positives if subsequent manual checks are not carried out properly to reduce the alerts to relevant cases only.[93] Investigating unnecessarily large numbers of suspicious transaction reports drains resources, both at the compliance stage internally at banks, and also subsequently when competent authorities investigate the received reports.

6.2 *Increased costs*

Another unintended and negative consequence of more intense regulatory activity, which in turn leads to more compliance-oriented efforts by banks, financial institutions, and companies, is an increase of the overall costs to conduct business. The implementation of new and stricter compliance measures within a bank and enhanced checks and scrutiny of international trade finance transactions comes with a price tag, as compliance protocols are designed and implemented, expert staff is hired, databases and third-party automated checking applications are subscribed to, and other external expertise is sought. Banks are likely to pass on the increased transactional costs to their immediate customers. These immediate customers will themselves attempt to avoid being affected by such additional costs, and thus initiate a ripple effect whereby the

[91] IFC *De-Risking and Other Challenges in the Emerging Market Financial Sector* (2017) 18.

[92] Consider the following example that revolves around the spelling of a very common name which knows many variations, such as Muhammad, Muhamad, Mohammad, Mohamed, Mouhamed, etc.

[93] Burkert-Basler and Nawrotzki "EU-Sanktionslistenprüfung" 2016 *AWPrax Service-Guide* 23 26.

added transactional costs are relayed along the business chain, in many cases ending with the consumer of imported goods or services.

However, in some cases the additional expenses related to stricter regulatory measures and compliance expectations are too significant to be passed on – adding them to the overall costs for a particular trade finance product such as a commercial letter of credit or documentary collection service would render them too expensive. This can result in down-scaling or even termination or discontinuation of customer and correspondent-bank relationships due to increased due diligence requirements to maintain customer accounts or correspondent relationships, or the decision to refrain from forging new relationships with potential customers and correspondents because the prospect of conducting enhanced due diligence exercises in a significant and continuous manner cannot be justified financially or from an operational perspective – this phenomenon is called "de-risking".

6.3 *De-risking*

De-risking describes a process whereby banks or financial institutions (or even companies) terminate commercial relationships, or decide not to seek new relationships, with parties from certain regions or countries, or from certain sectors and industries.[94] De-risking can range from refusing a particular finance request, declining the application of a prospective customer to open an account or access banking facilities, or even the termination of an existing customer or correspondent-banking relationship. This way banks, effectively, reduce or eliminate their potential exposure to what is perceived as a risk from a compliance perspective. Accordingly, the number of correspondent-bank relationships has declined sharply in recent years.[95] However, this means that certain countries or regions will increasingly lack access to trade finance products,[96] or where parties located in these countries or regions do manage to access trade products, will face increased costs and cumbersome application procedures. This problematic development is also discussed by Wass, who reports the following:

> "De-risking has had unintentional and costly consequences, especially in Africa, Central and Eastern Europe, and Asia Pacific. Among the biggest losers are small businesses that can't access working capital or trade finance. As correspondents depart, they've left holes in the funding space, cutting credit lines and withdrawing finance."[97]

[94] FATF (n 55) 5.

[95] See the extensive literature review provided in IFC (n 91) 16-17.

[96] See Woodsome and Ramachandran *Fixing AML – Can New Technology Help Address the De-Risking Dilemma?* (2018) vii, who state that "small and fragile countries have been especially affected" by the decline in correspondent banking relationships; and ICC (n 82) 97: "Coupled with the continued retreat of many global banks from the continent due to business, regulatory and KYC compliance considerations, many local banks in Africa suffered from inadequate correspondent banking lines and insufficient foreign currency liquidity to finance trade."

[97] Wass "Could regtech bridge the trade finance gap in emerging economies? " 2018 *Global Trade Review* www.gtreview.com/news/fintech/could-regtech-bridge-the-trade-finance-gap-in-emerging-economies (02-07-2018).

A recent statement by the Financial Stability Board (FSB) generally confirmed this assessment by warning that

> "[t]he reduction in correspondent banking relationships may affect trade finance transactions that rely on correspondent banking arrangements to be processed, and may thereby impact some countries, especially those that depend on trade for their development or the access to basic supplies."[98]

Especially smaller banks are likely to struggle to meet all compliance requirements by establishing and maintaining a comprehensive compliance programme, and are more likely to withdraw from certain jurisdictions or refuse certain customers. Yet it has been noted that de-risking is by no means restricted to small banks, and that some larger financial institutions have also chosen this approach in response to the increasing compliance expectations.[99] Overall, and without particular distinction between small or large banks, it has been argued that "uncertainty about exposure to risk and the costs arising from a tightening of the regulatory environment have been important factors influencing current de-risking decisions".[100]

6.4 *Clean payment (advance payment and open account trading) as an emerging alternative*

In light of this trend, local businesses active in the international sale of goods and services might have to decrease, or possibly even cease, their own trade activities, or consider alternatives. One emerging alternative is to adopt clean payment trading such as advance payment or open account terms and this development, in fact, has been noticed within the international trade and banking industry.[101] As was indicated above, advance payment and open account trading reduces the involvement of banks. Instead of handling and examining documents relating to the underlying trade transaction, clean payment agreements deprive banks of a significant portion of the data derived from trade documents and thus insight into the underlying transaction.[102] The scholars Ehrlich and Haas point out that the involvement of banks in advance payment or open account schemes is, typically, limited to the funds transfer, and can mean that the banks do not know whether a legitimate – or in fact *any* – underlying transaction exists between the sender and the recipient of the money.[103] This is confirmed as follows in a publication of the Wolfsberg Group, ICC and BAFT:

[98] Financial Stability Board *Action Plan to Assess and Address the Decline in Correspondent Banking* (2018) 8 (alteration by me).

[99] Woodsome and Ramachandran (n 96) 2.

[100] FATF (n 55) 6.

[101] See, for example, ICC (n 82) 14. It should be acknowledged, however, that the increase in open account transactions is not exclusively due to de-risking trends but may be motivated by several factors (*inter alia*, the rise of discrepancies in letter of credit presentations).

[102] BAFT (n 27) 2-4.

[103] Ehrlich and Haas (n 7) 344 par 4/3. The original German reads "Die Banken werden mit der Abwicklung eines solchen Geschäfts i.d.R. erst dann befasst, wenn ihnen der Auslandszahlungsauftrag des Käufers zugeht. Welche Zahlungsmodalitäten Käufer und

> "Participants to an Open Account Trade transaction do not look to banks to provide financing related to each specific purchase, and generally finance the transaction out of their own cash flow or through other arrangements. Banks will likely be indirectly involved in the financing of the trade transaction through bank-provided overdraft facilities, revolving lines of credit, post shipment or inventory financing, but will not have information as to the specifics of the trade transaction as is the case in documentary trade. […] The seller and buyer will generally not provide the banks handling the Open Account payment with supporting documentation; in the majority of cases, banks will have little inherent opportunity, need, or cause to understand the nature of the underlying trade transaction, or to review any trade-related documentation (e.g., contracts, invoices, shipping documents)."[104]

Therefore, it is obvious that the data gathered in a clean payment transaction is less detailed in comparison to data and information collected and reviewed in transactions supported by documentary collections or letters of credit.

6.5 Unmitigated trade risks and reduced transactional insight

The move towards open account and other clean payment trading terms as a result of de-risking strategies of banks and financial institutions is problematic in two ways which concern the parties themselves, but also the system of combatting financial crime in general.

First, conducting international trade on a clean payment basis exposes the trading parties to considerable risk of insufficient or non-performance. This risk can materialise to the disadvantage of the seller when opting for open account terms, that is the seller or service provider not being paid (in full and on time) after it has relinquished control over the goods or services. When choosing advance payment terms the contract risk falls on the buyer, who may not receive satisfactory merchandise or services after having parted with its money. The respective risks, either on the seller or the buyer, would have been prevented or at least mitigated by the utilisation of documentary collections or letters of credit – without immediate payment[105] the bank will not release the trade documents to the buyer (documentary collection transaction), and without tendering compliant documents the bank will not honour a letter of credit (letter of credit transaction).

Secondly, as was pointed out, open account transactions reduce the involvement of banks and their handling of documents with the direct result of no, or severely reduced, transactional insight. If the parties engage banks solely for the purpose of wiring the appropriate amount, then

Verkäufer hinsichtlich eines Zahlungszieles, der Gewährung von Ratenzahlungen usw. vereinbart haben, erfahren die Banken nicht. Dort, wo eine diesbezügliche Angabe nicht aus devisenrechtlichen Gründen unumgänglich ist, brauchen die Banken nicht einmal zu wissen, ob der Zahlung überhaupt ein Warengeschäft zugrunde liegt."

[104] The Wolfsberg Group, ICC and BAFT (n 3) 65 par. 1.5 and 1.6 (omission by me).

[105] or acceptance of a draft if so agreed upon.

> "banks usually have only the name, address and account number of the payment originator (buyer) and name and account number of the payment beneficiary (seller). The payment is typically processed without human intervention via systems in the bank's wire transfer department."[106]

The data and information that is usually gathered through the trade finance instrument will not be available to the bank. Without information relating to the underlying transaction and its parties there can be no effective monitoring of compliance with measures aimed at combatting financial crime. BAFT has provided two instructive tables indicating visibility, or lack thereof, for the most common transaction types encountered in international trade, which clearly show the poor potential for scrutinising documents and identifying some of the financial crime indicators (and thus criminal transactions) in open account or advance payment transactions (as opposed to documentary collections and letter of credit transactions).[107]

The drive towards clean payment terms, obviously, directly undermines the initial intention of obtaining more transactional scrutiny by imposing stricter and more extensive compliance requirements on banks involved in traditional trade finance and respective products such as documentary collections and letters of credit. It stands to reason that the increase of legislative and regulatory activity may, because of de-risking trends, practically lead to less insight in many instances. BAFT has summarised this very issue, aptly, as follows:

> "The only role for the bank [in an open account transaction] is processing the payment to settle the transaction. The bank has no knowledge or visibility to the underlying trade transaction as it was not bank-intermediated, and therefore, has limited ability to identify illicit trade behaviour."[108]

One may wonder whether the current international approach to financial crime and traditional trade finance instruments that is defined by accelerated legislative and far-reaching regulatory activities, and the subsequent unfortunate trends of de-risking and the rise of clean payment trading, could and should be reconsidered in order to achieve the initial goal of transactional oversight and compliance with measures against financial crime.

It is not suggested that such and respective due diligence should be stopped for trade finance products. However, the current focus on traditional trade finance products such as documentary collections and letters of credits is probably ill-placed and does not represent the most efficient way of channelling and applying compliance resources.

7 Conclusion

Compliance with measures aimed at combatting financial crime is a changing and evolving field, shaped by various governmental and non-governmental actors, whose actions may or may not have direct legal force but nevertheless

[106] BAFT (n 27) 4.
[107] BAFT (n 27) 13-14.
[108] BAFT (n 27) 2 (insertion by me).

impact upon the compliance regime and translate into respective expectations. Changing and expanding financial crime legislation makes it increasingly difficult and cumbersome for banks and other parties involved in international trade and international trade finance to comply with applicable laws, regulations, and codifications of best practice. In many cases, banks have responded by limiting their risk exposure and involvement with respect to certain customers, correspondent banks or markets. Significant de-risking decisions have been reported in international banking and trade finance which, in turn, have contributed to the emergence of clean payment trading terms in international contracts. Clean payment transactions, regrettably, deprive banks of transactional oversight and therefore limit their capabilities of identifying and reporting financial crime. The unintended consequences of de-risking and clean payment terms run counter to the initial aim of increasing customer and transactional monitoring and insight to scrutinise data for signs of financial crime. Therefore, re-adjusting the focus of compliance with measures aimed at combatting financial crime should be considered since the current emphasis on documentary collections and letters of credit is not, arguably, the most efficient way of approaching the threat of international financial crime within the international banking and trade sector.

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