

**SIMULATED CONTRACTS AND THE TRANSFER OF
OWNERSHIP AS A FORM OF REAL SECURITY
IN SOUTH AFRICAN LAW**

by

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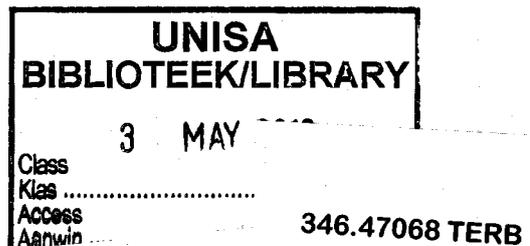
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SUMMARY

Money lenders frequently use sale and lease back agreements as an alternative to other more conventional forms of security. These agreements are popular because they are simple and inexpensive to put in place. Unfortunately, South African courts give legal effect to the true intention of contracting parties. Sale and lease back agreements are often held to be simulated contracts and as such they are enforced as disguised pledges. One of the few alternative security options available to money lenders, is a notarial bond registered in terms of the Security By Means of Movable Property Act 57 of 1993. This act has been criticised for creating an ineffective form of security that is costly and cumbersome to put in place. It is suggested that the current security options available to money lenders are supplemented with the creation of a more user friendly public register for the registration of security interests.

KEY TERMS

sale and lease back agreements; simulated contracts; reservation of ownership; cession; pledge; *constitutum possessorium*; real security; principle of publicity; special notarial bond; general notarial bond; public register.



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1. INTRODUCTION

In modern day business, a need exists for businesses to convert as many of their assets into working capital as possible. One way of achieving this is to use the traditional method of pledging business assets as security in order to obtain credit. Unfortunately, often the pledgeworthy assets form an integral part of the day to day business activities of a business and are consequently required by the business to continue its trade. The business is forced to retain possession of the assets to utilise them in the generation of income and pledging the assets becomes impractical.

In order to accommodate business requirements, financial institutions and money lenders have looked at alternative forms of security when granting working capital credit to businesses. One such alternative is for the money lenders to acquire ownership of the identified assets, as opposed to possession in terms of a pledge. This is achieved by purchasing certain of the business' assets and then selling the same assets back to the business by way of an instalment sale or lease agreement. This arrangement between the money lender and its client is commonly referred to as a sale and lease back agreement. The acquisition of ownership is intended to provide the financial institution or money lender with a form of real security. Should the client breach its obligations in terms of the instalment sale or lease agreement, or should the client be liquidated or sequestrated, the financial institution or money lender would in theory be entitled to enforce its rights as owner of the assets and realise the assets to recover any shortfall in respect of the amount initially advanced to the client.

The sale and lease back structure has not proved to be a practical solution, as it is an established principle of South African law that a court

will investigate the substance of a transaction and give legal effect to the true intention of the parties.¹ Where the parties to such a sale and lease back agreement intend a security arrangement and disguise it as a transfer of ownership, the agreement is a disguised transaction and has been described as a dishonest transaction “in as much as the parties to it do not really intend it to have, *inter partes*, the legal effect which its terms convey to the outside world.”² Due to a strict enforcement of this principle by our courts, they have classified the sale and lease back security arrangement set out above as a disguised pledge. The courts have therefore refused to acknowledge the financial institution or money lender’s ostensible right of ownership, and they have reduced this right to that of a pledgee without possession of the asset.

In spite of the approach of our courts, financial institutions and money lenders still heavily rely on the sale and lease back arrangement when granting credit to businesses. The reason for their decision is based on practicalities. The alternative way for financial institutions and money lenders to secure suitable real security is to employ the services of a notary to draft the necessary documentation for the registration of a notarial bond over the assets in question. Due to the shear volume of these type of credit applications, the financial institutions and money lenders seem to prefer to take their chances with the interpretation of a court of the sale and lease back agreement than to go through the inconvenience of having to register a notarial bond each time credit is granted.

¹ *Zandberg v Van Zijl* 1910 AD 302.

² *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369 at 395.

2. HISTORICAL PERSPECTIVE

2.1 APPROACH OF COURTS AND THE RESPONSE OF LEADING ACADEMICS

When our courts determine what the true intention of the parties to an agreement is, they will have regard to the substance rather than the form of the contract. Scott³, in considering the position, expresses the view that in order to determine the substance of an agreement the courts adopted two approaches: an “old fashioned” approach and a more “modern” approach.

Scott states that the “old fashioned” approach is based on the Roman law test which regards every juristic act as simulated when its economic and practical consequences are not in consonance with the normal legal consequences of the juristic act which the parties purport the act to be. This “old fashioned” approach was adopted by the court in *Skjelbreds Rederi A/S v Hartless (Pty) Ltd.*⁴ In this matter a *peregrinus* cedent ceded a foreign claim to an *incola* cessionary in order to enable an action to be brought to found jurisdiction in a South African court by the cessionary against another *peregrinus*. The cedent was a *peregrinus* and was accordingly unable to approach the South African court to found jurisdiction. Although the deed of cession did not require the cessionary to account to the cedent it was later established that this obligation did exist. The court examined the deed of cession carefully and came to the conclusion that the written agreement was not a true reflection of the real intention of the parties. In form it was a cession but in substance it amounted to nothing more than a mandate to the cessionary to enforce the cedent’s claim. The court held that:

³ Scott “Cessions Intended to Serve Secondary Purpose for Ultimate Benefit of Cedent” 1992 *THRHR* 615.

⁴ 1982 (2) SA 710 (A).

“The truth of the matter is that the respondent will not be entitled to retain the proceeds of the claim that was purportedly ceded to it out and out, and that the claim therefore is, as far as the respondent (cessionary) is concerned, but an empty shell, having no economic content. In the circumstances there seems to be little reason to believe that the respondent was truly intended to be a cessionary that would have the rights suggested by clause 2 of the agreement.”⁵

Scott⁶ defines the “modern” approach as follows:

“... a juristic act is regarded as simulated only when, on the whole, it appears that the parties faked an intention (e.g., where they are not bona fide) to conclude the juristic act which they supposedly entered into...”

The “modern” approach has been adopted in *Hippo Quarries (Tvl) (Pty) Ltd v Eardley*.⁷ In this matter a cessionary had supplied goods to a company and the transaction was secured by a deed of suretyship signed by a director of the company. The company was liquidated and the cessionary instituted action against the director as surety, but withdrew the action when it was realised that the suretyship was in favour of the cedent, a company associated to the cessionary. The cedent then executed a deed of cession in which it purported to cede its rights against the director to the cessionary. The court held that:

“The aim is to discover the true intention of the parties to the disputed cession. That enquiry, like any enquiry into intention, is a purely factual one. If found to be feigned the simulation is disregarded.”⁸

⁵ 1982 (2) SA 710 (A) at 734 H.

⁶ Scott 1992 *THRHR* 615 at 620.

⁷ 1992 (1) SA 855 (A).

⁸ 1992 (1) SA 855 (A) at 873 G.

The court further held that:

“Motive and purpose differ from intention. If the purpose of the parties is unlawful, immoral or against public policy, the transaction will be ineffectual even if the intention to cede is genuine. That is a principle of law. Conversely, if their intention to cede is not genuine because the real purpose of the parties is something other than cession, their ostensible transaction will likewise be ineffectual. That is because the law disregards a simulation. But where, as here, the purpose is legitimate and the intention is genuine, such intention, all other things being equal, will be implemented.”⁹

Scott supports the view that the “modern approach” is the correct. She agrees that the statement of the court is the correct approach to simulated contracts and should be preferred to that of the court in the *Skjelbreds* case. Scott’s view is however not shared by all. In the 1992 edition of the *Annual Survey of SA Law*¹⁰ the question is asked whether the parties truly intended a transfer of rights where the parties agree that the cessionary will not gain a beneficial interest in the right. It was concluded that the only intention of the parties was to circumvent the law by way of the alleged cession of the right. The conclusion submitted was that the *Hippo* matter is one where form prevailed over substance and that the correct way of reaching the same result would have been to bring an application for rectification of the contract of suretyship in order to reflect the cessionary as the true creditor.

Simulated contracts have furthermore been considered by our courts when dealing with the sale and lease back structure. As long ago as 1893 it was said about this structure that:

⁹ 1992 (1) SA 855 (A) at 877 C-E.

¹⁰ *Annual Survey of South African Law* (1992) at 73.

“There is not a more common device than that by which a pledge of goods is effected under the guise of a sale.”¹¹

As South African commerce developed, it became clear that an alternative form of real security was required to ensure the smooth running of the wheels of commerce. Van der Merwe¹² points out that, the courts on occasion accepted this new security arrangement and upheld sale and lease back transactions as transactions reflecting the true intention of the parties. The most recent judgement¹³ dealing with this issue however indicates that the courts are not prepared to accept that security as such is an acceptable *causa* for the transfer of ownership.

The Appellate Division considered these simulated transactions in *Goldinger's Trustee v Whitelaw and Son*.¹⁴ In this case G purchased wagons from W on credit with the intention of selling the assets at a later stage. When G found himself in financial difficulty prior to paying for the wagons in full, W agreed to repurchase the wagons from G for the balance due to him by G. G remained in possession of the wagons in order to try and sell them on W's behalf. When G was sequestrated W tried to recover the wagons in an action based on the strength of his ownership. The court held that:

“No doubt the parties thought that by going through the form of a sale they could secure the benefits of a pledge. But in that they were mistaken. So that the respondents not having insisted upon themselves detaining the wagon, could claim no lien upon it. But the point so far as

¹¹ *Hofmeyer v Gous* 1893 SC 115 at 117.
¹² *Van der Merwe Sakereg* (1989) at 689.
¹³ *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A).
¹⁴ 1917 AD 66.

their present claim is concerned is that the *dominium* did not pass to them...”¹⁵

In a minority judgement Solomon AJ held that the court *a quo* was in a better position to determine the intention of the parties and that the parties indeed intended a sale and not an unenforceable pledge.¹⁶

In *K & D Motors v Wessels*¹⁷ the court held that:

“... in deciding whether an agreement which purports to be a contract of sale is not a disguised contract of loan and pledge, it is certainly relevant to inquire whether the so called purchaser requires the goods said to be bought either for use or for resale, and whether the seller wishes to dispose of the goods or whether the seller merely requires financial accommodation, which the purchaser is prepared temporarily to advance but not without some form of assurance of repayment other than the financial stability of the seller.”

This line of thought was adopted by the Appellate Division in *Vasco Dry Cleaners v Twycross*.¹⁸ In this case V sold his dry cleaning business to K. The sale was subject to a reservation of ownership clause. In order for K to be able to pay V, K sold a portion of the dry cleaning equipment to D for the same amount as K still owed to V. D immediately resold the equipment which was essential for the continuance of K's business back to K. This subsequent sale was subject to a reservation of ownership clause. K remained in possession of the equipment throughout the period and ownership could therefore only be transferred by way of *constitutum possessorium*. K subsequently sold the entire business, including the equipment, to P who was unaware of the arrangement

¹⁵ 1917 AD 66 at 79.

¹⁶ 1917 AD 66 at 83.

¹⁷ 1949(1) SA 1 (A) at 14.

¹⁸ 1979(1) SA 603 (A).

between K and D. K was in breach of his agreement with D and D claimed the equipment from P by way of his *rei vindicatio*.

It is clear that the intention of D and K was to supply D with surety for the loan granted by him, while K remained in possession of the assets. In order to determine whether ownership indeed passed to D, the Appellate Division recommended the following:

“The question here was not so much whether, if the contract were a genuine agreement of sale, transfer of ownership of the machinery could be effected by means of a *constitutum possessorium*. The question was rather whether, having regard to all the attendant circumstances, the true transaction ... was one of sale or pledge. And in this single inquiry not the least important circumstance was the suspicious feature that the contract was so framed that in terms thereof the only way in which ownership of the machinery could have been transferred to the plaintiff was by the device of *constitutum possessorium*.”¹⁹

The court further held that:

“The true inquiry ... was whether, despite the clear warning signal conveyed by a *constitutum possessorium* as a vital cog in the machinery of the contract, the underlying transaction was one of sale or pledge.”²⁰

The court held that because the purchaser of the equipment had never seen the equipment and he did not need the equipment, and because the value of the equipment was unknown to him, the parties did not intend a sale but the true construction of their agreement was that of a pledge.

¹⁹

1979(1) SA 603 (A) at 615 C-D.

²⁰

1979(1) SA 603 (A) at 615 E-F.

The effect of the judgement was that , while the pledge may be good inter se, without possession the pledgee (D) lost his preference when a bona fide third party (P) obtained real rights in the article pledged.²¹ This could hardly have been the intention of the parties. As Van der Merwe²² points out, what the parties intended was not a form of pledge in terms of which the possession in the object should have passed to the money lender, but rather a form of security created by the passing of the ownership in the object to the money lender.

Van der Merwe²³ is of the opinion that our courts are loath to acknowledge a transfer of ownership in such security arrangements because the principle of publicity that exists in the law of mortgage and pledge is not adhered to.²⁴

In the *Parton* case²⁵ , the court was confronted with an enquiry similar to the one in the *Vasco Dry Cleaners*²⁶ case. A sold some sewing machines to B Company on credit. The purchase price was payable within 120 days of the first statement of account. B Company sought an extension of time within which to pay and offered six post dated cheques to A as payment. A agreed to grant the extension of time on condition that an instalment sale agreement was signed between A and B Company which would replace the original credit agreement. B Company was liquidated before full payment in terms of the instalment sale agreement could take place. A applied for an order for the return of the sewing machines in terms of the instalment sale agreement. The court concluded that the instalment sale agreement was a novation of the earlier credit agreement between the parties and that the instalment sale agreement was effectual to re-vest ownership of the equipment in A.

²¹ 1979(1) SA 603 (A) at 611 H.

²² *Annual Survey of South African Law* 1979 at 224.

²³ Van Der Merwe *Sakereg* (1989) at 694.

²⁴ See paragraph 3 hereunder for a discussion of the principle of publicity.

²⁵ *Parton and Colam NNO v GM Pfaff (SA) (Pty) Ltd* 1980 (4) SA 485 (NPD).

²⁶ 1979(1) SA 603 (A).

The court used the same principles as set out in *the Vasco Dry Cleaners* case and held that:

“The fact that financial accommodation on one side and security on the other were involved are, in the circumstances of the present case, not only consistent with, but supportive of, a bona fide agreement which was intended by the parties to novate the earlier agreement.”²⁷

It is clear from the cases cited above that the courts will scrutinise the facts in each matter before determining whether an agreement of sale can be constructed. If the facts indicate that the intention was to sell the asset in question, the courts will accept that a transfer of ownership took place and that the creditor (purchaser) has acquired real security without being in possession of the asset.

This subjective approach by the courts is open to criticism. Cronjé and Van der Spuy²⁸ states that:

“Dit mag in 'n gegewe geval baie moeilik wees om op die feite vas te stel wat die ware toedrag van sake is, en 'n mens sou selfs kon redeneer dat die Vasco Dry Cleaners- en Parton- saak na die ander kant toe beslis kon gewees het”.

Sonnekus²⁹ is critical of so-called “lease back transactions”. He believes that after the *Vasco Dry Cleaners* case, these security arrangements are not worth the paper they are written on. He acknowledges that these transactions are very popular with financial institutions and money lenders but cautions that they will not survive the test of a critical court or

²⁷ 1980 (4) SA 485 (NPD) at 490 E.

²⁸ Cronjé & Van Der Spuy “Die aanwending van Eiendomsreg tot Sekerheidstelling by Roerende Sake” 1981 *THRHR* 168 at 171.

²⁹ Sonnekus “Die Notariële Verband, 'n Bekostigbare Figuur teen Heimlike Sekerheidstelling in Suid Afrika” 1993 *TSAR* 110.

an insolvency procedure. Sonnekus is of the view that any attempt to circumvent the principle of publicity when securing a debt impacts on the fundamental principles of security law and undermines the law of insolvency.³⁰ Sonnekus does suggest some solutions to this problem.³¹

2.2 SOUTH AFRICAN POSITION PRIOR TO SECURITY BY MEANS OF MOVABLE PROPERTY ACT BECOMING EFFECTIVE

In terms of our common law, real rights over movable property were only acknowledged if such property was pledged, and the pledged property was in the physical possession and control of the pledgee.³² For this reason a written pledge agreement, even if registered, did not give the pledgee stronger rights than a pledgee who established a pledge by physical control.³³ Sonnekus³⁴ states that such an agreement did not have an impact on the real rights of the parties, but the publicity attached to such an agreement had an effect in the insolvency process. In this respect Sonnekus states that in the *Loudon* case³⁵ it was held that a customary rule in the Cape had developed, in terms of which the holder of a hypothec, that did not have physical control over the assets, only received preference during the insolvency process if his hypothec over the movable assets had been registered.

In Natal the possession was somewhat different. It would appear that a misinterpretation of the rule *mobilia non habent sequelam* in various Natal judgements resulted in the notarial bond over movable property in Natal experiencing an interesting development.³⁶ In the matter of *Turner Brothers v Colville and Green*³⁷ the court incorrectly held that our

³⁰ Sonnekus 1993 *TSAR* 110 at 111.

³¹ See paragraph 6 hereunder.

³² Sonnekus 1993 *TSAR* 110, at 127.

³³ *Woeke v McDowell* 1911 CPD 352 at 353.

³⁴ Sonnekus 1993 *TSAR* 110, at 127.

³⁵ 1829 1 M 380 at 390.

³⁶ Sonnekus 1993 *TSAR* 110 at 129.

³⁷ 1883 NLR 6.

common law acknowledged that a registered notarial bond over specific movable assets procured a real right in favour of the pledgee, even though the pledgee had never acquired possession or control over the asset. This position was confirmed in the Natal Insolvency Act of 1887.³⁸

The Insolvency Act of 1916³⁹ determined that a general notarial bond over movable property did not procure any preferent rights in favour of the mortgagee. Unfortunately, the legislator did not deal with a special notarial bond over specified movable assets. In 1926 the Insolvency Act of 1916 was amended in order to achieve clarity in respect of the position of these special notarial bonds. Sonnekus⁴⁰ states that the legislator again failed in its intention and that this amendment merely had the effect of a registered special notarial bond over movable property not excluding the assets from the free residue of the estate. Sonnekus further states that the amendment did not change the common law position in terms of which the mortgagee had preference in respect of the free residue.

Since 1930 the Natal courts confirmed that, notwithstanding the possible intention of the legislator, the preference a registered notarial mortgagee traditionally had over specific movable assets remained in place.⁴¹ This interpretation resulted in the enactment of the Notarial Bonds Act (Natal) 18 of 1932. This act provided that a special notarial bond over specific movable assets in that jurisdiction granted the mortgagee the same rights and protection as if the mortgagee was a pledgee and in possession and control of the pledged assets. This act effectively created a real right in favour of the mortgagee, a position far stronger than the mortgagee's common law position.

³⁸ Act 47 of 1887 (N). For a discussion of this act, see Scott 1981 *De Jure* 143-145; Sacks 1982 *SALJ* 609-610; Sonnekus 1983 *TSAR* 250 and 1993 *TSAR* 131; Van der Walt, Pienaar and Louw 1994 *THRHR* 620-622.

³⁹ Act 32 of 1916.

⁴⁰ Sonnekus 1993 *TSAR* 110 at 131.

⁴¹ Sonnekus 1993 *TSAR* 110 at 131.

The Insolvency Act 24 of 1936 did not make reference to special notarial bonds over specific movable assets. Sonnekus⁴² is of the view that this exclusion did not entitle such a mortgagee to a preference over the free residue of the estate. The Act did however mention general notarial bonds over unspecified movable assets, and in terms of section 102 of the Act, such a notarial bond ensured that the mortgagee had preference over the concurrent creditors in respect of the free residue of the estate.⁴³

In 1992 the Appellate Division had the opportunity to consider the rights of a special notarial mortgagee over specific assets of an insolvent estate in the matter of *Cooper v Die Meester*.⁴⁴ In this matter a creditor registered a special notarial bond over specific movable assets of A. On sequestration of A's estate the curator of the insolvent estate refused to acknowledge that the creditor had any preference in terms of the special notarial bond. The creditor approached the Master of the Supreme Court who acknowledged that the creditor was a preferred creditor in respect of the free residue. The curator appealed to the Free State Provincial Division of the Supreme Court against this decision of the Master, but the appeal was turned down.⁴⁵ The curator referred the matter to the Appellate Division where it was held that a special notarial bond over specific movable assets outside the Natal jurisdiction did not procure a right of preference for the mortgagee, should the mortgagee fail to acquire physical control of the assets. The creditor had no right of preference over the free residue of the insolvent debtor's estate. The effect of the *Coopers* case was that a general notarial mortgagee had

⁴² Sonnekus 1993 *TSAR* 110 at 132.

⁴³ Sonnekus 1993 *TSAR* 110 at 132.

⁴⁴ 1992 3 SA 60 (A).

⁴⁵ *Cooper v Die Meester* 1991 3 SA 158 (O).

preference over a special notarial mortgagee, who was treated as a concurrent creditor.⁴⁶

The *Coopers* judgement brought clarity in respect of the position of a special and general notarial mortgagee, but unfortunately caught many insolvency practitioners and money lenders unaware. It was inequitable that a special notarial mortgagee in Natal had preferent rights and that these rights were not available to mortgagees outside this jurisdiction. It was further unacceptable that a general notarial mortgagee had preference over a special notarial mortgagee. In 1993 the legislator addressed this problem by introducing the Security by Means of Movable Property Act 57 of 1993.⁴⁷

3. SECURITY BY MEANS OF MOVABLE PROPERTY ACT 57 OF 1993

The Security By Means of Movable Property Act came into effect on 7 May 1993. Section 1(1) of the act determines that where a notarial bond over corporeal specified movable property is registered, it is deemed that such property is pledged to the mortgagee and that the property is duly delivered to the mortgagee. The effect of this section of the act is to create a fictitious pledge which is similar to the position that existed in Natal in terms of the Notarial Bond (Natal) Act 18 of 1932. The act however repeals The Notarial Bonds (Natal) Act 18 of 1932.

Section 1(3) of the act provides that it has retrospective effect. Any special notarial bond registered prior to the introduction of the act grants the same rights to the mortgagee as those registered after the act coming into effect. These rights are defined to be the same as that of a

⁴⁶ For a further discussion of the *Coopers* case, see Van der Spuy 1992 *De Jure* 496, Scott 1992 *De Jure* 506, Cilliers 1992 *THRHR* 682, Février-Breed 1993 *THRHR* 144 and Sonnekus 1993 *TSAR* 110.

⁴⁷ For a more comprehensive summary of the position of notarial bonds registered before the enactment of the Security by Means of Movable Property Act, see Scott 1995 *THRHR* 672.

general notarial bond holder in terms of section 102 of the Insolvency Act 24 of 1936, that is, the mortgagee has a right of preference in respect of the entire free residue of the insolvent estate.

Section 5 of the act provides that ~~the act~~^{it} does not impact on any mortgage, hypothecation, pledge, tacit hypothec, preference, lien or right of retention acquired by the State or a body constituted by statute and supported by public funds.

Van der Walt, Pienaar and Louw⁴⁸ point out that a number of problems and criticisms still exist after the introduction of the act:

1. In modern day commerce, goodwill of a business, debtor claims, and liquor licenses are all considered to be incorporeal assets of that business. These assets form a very important part of the asset base of the business and have a determinable monetary value. It is therefore particularly limiting that only corporeal assets can be registered as security in terms of the act. The criticism against including incorporeal assets is that these assets are not always definable. This should be a practical consideration to be considered by the notary responsible for the registration of the notarial bond, and should not stand in the way of including these assets as a form of real security under the act.⁴⁹ Scott⁵⁰ echoes the criticism of Van der Walt, Pienaar and Louw as discussed above. She mentions that it is theoretically and practically unacceptable that an act professing to deal with security by means of movables omits to deal with security by means of claims (incorporeal rights).

⁴⁸ Van der Walt, Pienaar and Louw "Sekerheidstelling deur middel van roerende goed-nog steeds onsekerheid!" 1994 *THRHR* 614.

⁴⁹ 1994 *THRHR* 614 at 617.

⁵⁰ Scott "Notarial Bonds and Insolvency" 1995 *THRHR* 672.

2. Section 5 of the act creates a right of preference in favour of the State. This arrangement undoubtedly detracts from the value of creating security by way of special notarial bonds.⁵¹

3. The status of special notarial bonds registered in Natal in terms of section 1 of the Notarial Bonds Act (Natal) 18 of 1932 is uncertain. Should a strict adherence to the law in respect of interpretation of statutes be adopted, it would seem as though rights created in terms of the Natal act will still be applicable.⁵²

Sonnekus⁵³ has added his voice to the choir of critics and makes the following critical comments about the act:

1. The act regrettably does not introduce a user friendly administration process.⁵⁴ A prospective mortgagee who intends to rely on an asset as security will first have to do a search in all the various South African deeds registers in order to determine whether the specific asset has been hypothecated to another creditor. Should this not be the case, the proposed mortgagee is then forced to register a notarial bond in the register in the area where the debtor lives and conducts his business. Once such a registration takes place, the registration is valid for the entire Republic of South Africa. Sonnekus⁵⁵ mentions that the procedural limitations were not considered by the legislator and that it remains a costly⁵⁶ and arduous process to register such a notarial bond.

⁵¹ 1994 *THRHR* 614 at 617.

⁵² 1994 *THRHR* 614 at 622.

⁵³ Sonnekus *Sakereg Vonnisbundel* (1994) 754-760.

⁵⁴ Sonnekus *Sakereg Vonnisbundel* (1994) at 758.

⁵⁵ Sonnekus *Sakereg Vonnisbundel* (1994) at 758.

⁵⁶ Any general or special bond passed before a notary public attracts a stamp duty of 20c per R100. In addition, the notary public will charge a basic fee of R300 for bonds up to and including R100 000, and R400 for bonds exceeding R100 000. An additional scheduled amount is then added to the notary's basic fee. This additional amount is based on a sliding scale, depending on the value of the bond. For a R1 000 000 bond the additional amount will be R5 155.

2. No obligation is placed on the mortgagee to remove the special notarial bond once the underlying debt is discharged.⁵⁷ The deregistration of the bond might therefore not occur immediately once settlement of the principal debt takes place and consequently a misrepresentation in respect of the credit worthiness of the mortgagor will exist. The act places the onus on the mortgagor to ensure that the register reflects his true credit position. Sonnekus⁵⁸ is of the view that an additional obligation should be placed on the mortgagee to be more active in removing the bond from the deeds register once settlement takes place.

3. There is no reason why the State should acquire an advantage above other creditors. The State should be subjected to the normal risks and procedures of commercial practice. In spite of the State's position of power the act allows that undisclosed security arrangements with the State have preference over notarial bonds registered in terms of the act. The State should be forced to conduct its affairs with the same amount of care as other creditors. There is no incentive for the State as a credit supplier to monitor its debtors as other money suppliers would. Sonnekus⁵⁹ argues that the State should have the same obligation as other money suppliers to guard against any indication that a mutual debtor might be facing insolvency, and that once this takes place, the State's ranking should be determined by the normal insolvency procedure.

4. PRINCIPLE OF PUBLICITY

Due to the absolute effect of a real right there is a responsibility on all third parties to acknowledge and adhere to such a right. This requirement will only be fair if the existence of the real right is known to

⁵⁷ Sonnekus *Sakereg Vonnisbundel* (1994) at 758.
⁵⁸ Sonnekus *Sakereg Vonnisbundel* (1994) at 758.
⁵⁹ Sonnekus *Sakereg Vonnisbundel* (1994) at 759.

third parties. It is because of this knowledge requirement that the principle of publicity plays a very important role in the South African legal system. The principle of publicity determines that the relationship between a legal entity and its assets must, as far as possible, be visible to the public at large. Third parties should be able to determine from the visible facts what the relationship between the legal entity and its assets are.

In the case of ²moveable property the principle of publicity is adhered to through physical possession of the asset. The physical control indicates the relationship between the holder and the asset. With immovable property the principle of publicity is adhered to through registration of a real right in the deeds register. The deeds register is accessible to the public and such registration serves as notification of the real rights in the property to all third parties. Physical control of ²moveable property, and registration of immovable property, creates the impression that the person who is in control of the asset, or in who's name the asset is registered, is the owner of the asset. A change in real rights is dependent on a change in control over moveable property, and a change in registration in respect of immovable property.

Does not make sense

Where physical control is not transferred from one party to the next, as in the case of delivery via *traditio longa manu* and *constitutum possessorium*, delivery and change of physical control does not have a publicity function.⁶⁰

In South African security law the principle of publicity is entrenched to ensure that the legal consequence of security agreements between parties are publicised to any third party who may be interested.⁶¹ The

⁶⁰ For a further discussion of the principle of publicity see Van Der Merwe *Sakereg* 1989 13-15 and Kleyn and Boraine *Silberberg and Schoeman's The Law of Property* 3rd edition (1992) 63-66.

⁶¹ Sonnekus *TSAR* 1993 110 at 117.

principle therefore has a definite public interest function in that it alerts third parties to the fact that certain assets of a proposed debtor are encumbered in favour of another creditor. Thus, should one creditor take security in some of the unencumbered assets of a mutual debtor so that the assets become encumbered, it is in the interest of all mutual creditor's that this security arrangement must be brought to the attention of other creditors. This will prevent the other creditors from relying on the fact that these assets will be available when enforcing their claims against the debtor. It is for this reason that unpublicised security arrangements are criticised by Sonnekus.⁶² Such "secret" rights of one creditor is in direct conflict with the rights of any unsecured creditor of a mutual debtor ^{who} ~~that~~ has no knowledge of the extent of such rights. Sonnekus indicates that the high value placed on the publicity principle is reflected in other legislative regimes. In the German system, the German legislator punishes secret security arrangements with a legislative penalty. The creditor and holder of such secret right is forced to contribute 25% of the value of the right to the free residue of the debtor's estate during the insolvency process.

The publicity principle manifests itself in common law examples of security rights. When a bond is registered over movable or immovable property or a pledge is secured by the pledgee when obtaining possession of the asset pledged, or a right of retention is enforced, a factual position is portrayed to the outside world in terms of which the rights of the creditor is clearly identifiable. In all the examples, save for the bond over movable property, the creditor has possession of the asset and this alerts potential credit grantors to the fact that the asset is encumbered. In the case of a bond over immovable property, the publicity principle is satisfied by registration of the creditor's right in the deeds register. The public at large has access to this information. The publicity principle has a community function: the factual position warns

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Sonnekus *TSAR* 1993 110 at 119.

third parties that the debtor does not have unencumbered rights in the asset.

5. SUMMARY

Financial institutions and money lenders frequently use sale and lease back agreements as an alternative to other more conventional forms of security. These agreements are popular because they are simple and inexpensive to put in place. Unfortunately, South African courts give legal effect to the true intention of contracting parties. Sale and lease back agreements are often held to be simulated contracts and as such they are enforced as disguised pledges. Van der Merwe⁶³ and Sonnekus⁶⁴ both feel that the courts are unwilling to enforce a *rei vindicatio* created by a sale and lease back agreement because the agreement does not comply with the principle of publicity.

One of the few alternative security options available to financial institutions and money lenders, is a notarial bond registered in terms of the Security By Means of Movable Property Act 57 of 1993. This act has been severely criticised for a number of reasons.⁶⁵ Most importantly, this form of security is costly and cumbersome to put in place.

Sonnekus⁶⁶ further expresses the view that the publicity method created by the act is ineffective. Once registration of the security is achieved, it is difficult for interested parties to gain access to the information in the register.

⁶³ Van Der Merwe *Sakereg* (1989) at 694.

⁶⁴ Sonnekus 1993 *TSAR* 110 at 111.

⁶⁵ See paragraph 3 for a summary of some of the criticism raised against this act.

⁶⁶ Sonnekus "Sekerheidsregte - 'n Nuwe Rigting?" 1993 *TSAR* 230 at 247.

6. RECOMMENDATIONS

The criticism raised against the Security By Means of Movable Property Act and the risk of having a security arrangement between a money lender and a debtor classified as a "simulated" contract by our courts can only be addressed by the introduction of new or amended legislation. It is essential that any new legislation must create a publicity method that is effective, easily accessible and cheap to implement. It is suggested that these goals ~~are~~ achieved in one of two ways:

can be achieved

1. One solution will be for the legislature to confirm the reservation of ownership in favour of money lenders when agreements similar to the sale and lease back arrangement are entered into. This will be achieved by the creation of a public register in which these security arrangements are documented. This confirmation of ownership has partially been achieved by the legislator in the Credit Agreements Act 75 of 1980, where the reservation of ownership in favour of money lenders on new assets is dealt with. This act however, does not provide for publication of the reservation of ownership in a public register and therefore does not comply with the publicity principle.

It is suggested that the registration procedure for the proposed new register must be kept as simple and as cheap as possible. If this is achieved the register will deserve the support of financial institutions and money lenders. In order to avoid fraud, and to ensure that the register is properly administered, it is suggested that all registrations of real rights confirming the reservation of ownership in this register are attended to by notary publics. The notary's fee and the stamp duties on such a registration should be determined by the legislator. *why?*

It is strongly suggested that such costs should be less than the costs currently applicable to the registration of notarial bonds. In order for the register to be of practical value, the legislator must further ensure

that a reservation of ownership on even the smallest of transactions is achievable at reasonable cost.

It is further suggested that the legislator considers a standard format for the registration of these rights. An uncomplicated prescribed form, similar to the one used for the registration of Close Corporations, is suggested. The form should require the signature of both parties before it is lodged with the notary public. For the proposed register to be successful, it is imperative that the prescribed form is kept as simple as possible.

In order to fully comply with the principle of publicity, it is suggested that the register utilises modern day information technology. It is anticipated that the register can be made more accessible and user friendly if "read only" access was available through the internet. Internet software and running costs are relatively inexpensive and can be made compatible to almost all of the modern day computer networks. Most of the South African deeds registers have already been computerised and internet link-ups should therefore be possible at minimal costs. The end user will benefit as a result of the easy and inexpensive access to these registers from any internet site in the world. Registration of these real rights will also be easier than the current practise. Theoretically it can be done from the notary's internet linked office computer. In order to prevent fraud or unauthorised amendments to the register, it is suggested that the register is password protected. Only the notary publics will have passwords and the ability to register new rights or change the register.

Sonnekus⁶⁷ points out that there are ways to protect the privacy of the debtor in such a register and that full disclosure of all the

Is this your recommendation or Sonnekus?

⁶⁷

Sonnekus 1993 *TSAR* 230 at 248.

elements of the debt need not be public knowledge. Sonnekus refers to section 9 of the *Uniform Commercial Code* of the American legal system in terms of which only the details of the debtor and creditor are supplied, together with the specific "security interest". In order to make access as simple as possible it is suggested that the register is alphabetised in accordance with the debtors name. The only other details required in the register are the name of the creditor and a description of the asset which forms the subject of the reservation of ownership.

2. A second solution will be for the legislature to introduce a public register for the registration of preferent claims. The registration will not be limited to real or personal rights, but will be available for the registration of any claim against the estate of the debtor. The historical encountered problems with rights attached to physical assets, such as a later replacement of an asset, the fact that an asset is not identifiable and the fact that an asset might only come into existence at a later stage, are thereby negated. Sonnekus⁶⁸ points out that such a register will serve as a warning to other creditors that a preferent right exists against the free residue of the debtor's estate. The intention with the introduction of such a register is not to substitute notarial bonds but to compliment it with an alternative form of security. Such a register will introduce a form of security which is not dependent on a specific, identifiable asset, and which will hopefully be cheaper and more easily accessible than the current deeds registers.

Sonnekus⁶⁹ is confident that such a register will comply with the principle of publicity and that it will create rights with preference in terms of the *prior in tempore* principle. The mechanism suggested

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Sonnekus 1993 *TSAR* 230.

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Sonnekus 1993 *TSAR* 230 at 248.

to protect the privacy of the debtor as explained above will also apply to this register. In this register the only details that need to be disclosed are the names of the debtor and creditor, as well as the specific "security interest" or claim value.

How will this be determined?

Sonnekus⁷⁰ further suggests that in such a register, the creditor must be forced to assist the debtor in removing the registered preferent claim once the underlying debt is settled. This can successfully be achieved by introducing a punitive measure in the proposed legislation. The penalty should not only apply to the debtor and creditor, but to any party ^{who} that frustrates the updating of the register. This will ensure that the register remains updated and that third parties are able to correctly ascertain what preferred claims exist against the free residue of a debtor's ³ estate.

Sonnekus does not make specific practical suggestions in respect of the administration of this register. It is suggested that the recommendations in respect of notarial administration, cheap cost structures and internet access, as more fully explained in option 1 above, should also apply to this register.

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Sonnekus 1993 *TSAR* 230 at 250.

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