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FINANCE & BANKING ALERT

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Cession in security: Discretionary rights

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Cession in security: Discretionary rights

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A cessionary is often entitled to determine whether a cedent has complied with its obligations contained in a cession agreement. A clause of this nature is typically contained in a security cession agreement, although it can also be contained in an out and out cession agreement. The distinction in law between a security cession and an out and out cession, and the nature of a security cession, has been analysed in previous articles written by the author.

In this article, we consider the nature of a cessionary's rights to determine the cedent's compliance with its obligations contained in a security cession agreement. However, the principles discussed in this article are equally applicable to a lender's rights to similarly determine a borrower's compliance with its obligations in a loan agreement. These rights are sometimes described as unilateral rights, which although not incorrect, may not reflect the true nature of these rights as all rights are, in a sense, unilateral in that rights are exercisable by a party unilaterally.

A more accurate description of rights of this nature is discretionary rights in that a cessionary or lender exercises its discretion to determine the cedent's or the borrower's compliance with its contractual obligations.

It is often the case in secured lending transactions where the parties negotiate the terms of a loan and cession in security, that the cessionary wishes to exercise its discretionary rights in its sole discretion, and the cedent requires that the cessionary exercises its discretionary rights reasonably. Examples are if the security cession agreement entitles the cessionary, in its discretion, to (i) appoint an independent auditor to value the security; (ii) require the cedent to perfect or protect the security; or (iii) transfer the ceded right to itself or a temporary repository on the cedent's default. May the cessionary exercise these rights in its sole discretion, which may be subjective, or is it obliged to act reasonably. South African case law contains the applicable common law principles.

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Cession in security: Discretionary rights ...continued

The building society, to which the respondent had applied for a loan, initially approved the loan application, but later exercised its rights to withdraw from the approval as it was permitted to do under the terms of its approval, on the basis that an investigation of the property yielded defects.

In *Dharumpal Transport (Pty) Ltd v Dharumpal* 1956 (1) SA 700 (A) the Appellate Division (as it then was) held that it could determine if the discretion granted to a seller of busses to approve of the suitability of a proposed guarantor, was exercised *arbitrium boni viri* (loosely translated as reasonably).

In *Remini v Basson* 1993 (3) SA 204 (N) the Natal Provincial Division (as it then was) considered whether a suspensive condition in an agreement of sale of property that required the purchaser to raise a loan against security of a first mortgage bond to be registered against the property, was fulfilled. The building society, to which the respondent had applied for a loan, initially approved the loan application, but later exercised its rights to withdraw from the approval as it was permitted to do under the terms of its approval, on the basis that an investigation of the property yielded defects. The court held that the building society's right to resile from any loan agreement that may have been concluded with the respondent could only be for a reason which had to be measured or tested objectively by the standard of *arbitrium boni viri* (loosely translated as reasonableness), or at least it should not be unreasonable.

In *NBS Boland Bank Ltd v One Berg River Drive CC and Others; Deeb and Another v Absa Bank Ltd; Friedman v Standard Bank of SA Ltd* 1999 (4) SA 928 (SCA) the Supreme Court of Appeal upheld an appeal against a decision that a clause in a mortgage bond that conferred an unfettered power on a mortgagee to vary the interest rate was invalid and unenforceable. The court held that the Roman Dutch rule against substantive discretionary rights applied only to the right to determine the price in sale agreements or the rental in lease agreements. The court further held at paragraphs 24 and 25 that:

"... where a party is given the power to fix his own prestation, or to fix a purchase price or rental, a stipulation conferring upon a contractual party the right to determine a prestation is unobjectionable."

"All this does not mean that an exercise of such a contractual discretion is necessarily unassailable. It may be voidable at the instance of the other party. It is, I think, a rule of our common law that unless a contractual discretionary power was clearly intended to be completely unfettered, an exercise of such a discretion must be made arbitrio bono viri ..."

Cession in security: Discretionary rights ...continued

The reasonableness of a cessionary's actions when exercising its discretionary rights will be determined with reference to its conduct in the circumstances then prevailing.

If a cessionary is granted the discretionary right to determine whether the cedent has rendered the agreed performance, such right may be validly exercised. The discretionary right may be fettered by contractual provisions to that effect, in which instance the cessionary must abide by such provisions and act reasonably in the exercise of its right. If the discretionary right is unfettered, the cessionary must similarly exercise its right reasonably.

The interpretation of court judgments by academic writers is that the following types of discretionary rights are acceptable, namely, clauses that: (i) limit a party to a range of alternative choices/options; (ii) require a discretion to be exercised having regard to factual or objective criteria; (iii) provide for disputes to be resolved objectively, where such disputes arise from exercising a power. A distinction is furthermore drawn between substantive discretionary rights and incidental discretionary rights. In law, if a substantive discretionary right is permissible, then it follows that the incidental discretionary right that flows from the former right, should similarly be permissible. [*Van Huyssteen, Lubbe, Reinecke 'Contract General Principles' (Juta, Fifth Edition, 2016)*]

The weight of authority is therefore that an unfettered discretionary right must be exercised by the holder, reasonably. The reasonableness of a cessionary's actions when exercising its discretionary rights will be determined with reference to its conduct in the circumstances then prevailing. It may be that a cedent seeks to attack a cessionary's exercise of its discretionary right as being unreasonable on the grounds that when measured or tested against the standard of reasonableness, it fails the test. In order to avoid such contestation, it is advisable that the security cession agreement contains provisions of the types in (i), (ii) and/or (iii) in the preceding paragraph, which determine the cessionary should exercise its discretionary rights.

In *NBS* the court unfortunately declined to express a view as to whether an absolute discretion which conferred on a party the right to determine the performance of the other party, would conflict with public policy, or such absolute discretion may only be assailed if that right is exercised in bad faith. It remains to be seen how our courts will deal with these issues.

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