7 DECEMBER 2020

FINANCE & BANKING ALERT

IN THIS ISSUE

Cession in security: Avoiding pitfalls

A cession in security of personal rights, designed to provide security to a cessionary (a lender) for the cedent's (borrower's) obligation to repay a loan, may ironically, expose the cessionary to risk if certain pitfalls are ignored.

CDH
CLIFFE DEKKER HOFMEYR

CLICK HERE

For more insight into our expertise and services

Cession in security: Avoiding pitfalls

The first pitfall is where common law or statutory restrictions on cessions in security are ignored.

A cession in security of personal rights, designed to provide security to a cessionary (a lender) for the cedent's (borrower's) obligation to repay a loan, may ironically, expose the cessionary to risk if certain pitfalls are ignored.

In this article, some pitfalls that could invalidate a cession in security are discussed, in no particular order of priority. The nature of cession in security is discussed by the author in a previous article.

The first pitfall is where common law or statutory restrictions on cessions in security are ignored. At common law, personal rights are freely cedable unless common law or statutory restrictions apply. Cessions in security of rights that are made in contravention of such restrictions are invalid from the moment the cessions are purportedly effective. An example of a common law restriction is discussed, followed by two examples of statutory restrictions.

In terms of South African common law, the rights to insurance policy benefits may not be capable of cession in security if the nature of the policy is such that the contractual relationship between the insurer and insured constitutes the insured as a *delectus personae*; in other words, the nature of the policy excludes the transfer of the personal rights created by the policy because only the insured and no other third party (such as a cessionary) can enjoy such rights. The identity of the insured may therefore materially affect the insurer's ability to perform under the policy, or such identity may be regulated by legislation. The *delectus personae* principle was recently confirmed as still being part of South African law in *Propell Specialised Finance v Attorneys Insurance Indemnity Fund NPC* 2019 (2) SA 221 (SCA).

Annuities or benefits, or rights thereto, may not be assigned, pledged, ceded or otherwise transferred generally, which includes as security for a debt, in terms of section 2(1) and (2) of the General Pensions Act 29 of 1979, unless the exceptions in section 26 or 40 of the Maintenance Act 99 of 1998 apply.

A spouse who is married in community of property may not, without the consent of his or her spouse, *inter alia*, pledge or cede in security (i) any shares, stock, debentures, debenture bonds, insurance

CDH
CLIFFE DEKKER HOFMEYR

Cession in security: Avoiding pitfalls

...continued

The second pitfall is the adverse effect of a contractual prohibition on cession.

policies, mortgage bonds, fixed deposits or any similar assets, or any investment by or on behalf of the other spouse in a financial institution, forming part of the joint estate, in terms of section 15(2)(c) of the Matrimonial Property Act 88 of 1984 (Matrimonial Property Act); (ii) listed securities in order to buy other listed securities in terms of section 15(7)(a) of the Matrimonial Property Act; (iii) a deposit held in his or her name at a building society or bank in terms of section 15(7)(b)(i) of the Matrimonial Property Act; (iv) building society shares held in his or her name in terms of section 15(7)(b)(ii) of the Matrimonial Property Act.

The second pitfall is the adverse effect of a contractual prohibition on cession. Agreements often prohibit parties from ceding their rights thereunder to a third party. The prohibition is styled either as a blanket prohibition, or parties may cede their rights only if the counterparty(ies) consent. We discuss the legal effect of such a contractual prohibition on cession in security, and not the common law regarding the nature and enforceability of such prohibitions. In these instances, a cedent would act contrary to, and in breach of, the contractual prohibition if it pledged and ceded in security, its rights to a principal debt to a cessionary. The purported cession is contractually invalid, and the aggrieved counterparty(ies) would be entitled to invoke its default rights under the agreement. If, however, the cedent obtains the prior written consent of the counterparty(ies) to the agreement for the intended cession in security, then the cession will be valid. At common law, a cession in security is valid if the cedent and cessionary are *ad idem* as to the nature of the cession, and notice to the debtor or the debtor's consent, is not required. However, a prohibition on ceding rights does affect the validity of a purported cession in security.

The third pitfall is the adverse effect of a prior cession in security on a new purported cession in security, where both cessions are created in respect of the same right. An example is where a cedent, as security for a secured debt, pledges and cedes in security to a cessionary, its rights to its shares in a company. Later, the same cedent seeks to pledge and cede in security, its rights to the same shares to a different cessionary as security for a different secured debt. The context is that security agreements often state that if rights to a principal debt purportedly pledged and ceded in security, were in fact already encumbered as security for a different secured debt, that any reversionary interests the cedent may have in that principal debt are then pledged and ceded in security to the cessionary. As discussed in a previous article, the cedent's reversionary interests is its interest in its debtor performing under the contract between the cedent and its debtor. Reversionary interests can itself be pledged and ceded in security for an obligation, to either the cessionary that holds cession of the right of action of the principal debt, or to a different cessionary as security for a different obligation. A prior cession in security of a principal debt may render the new, intended cession in security worthless because the rights purportedly ceded were already ceded to a different cessionary, and the absence of a clause such as the one discussed in this paragraph means that not even the reversionary interests will in

Cession in security: Avoiding pitfalls

...continued

The third pitfall is the adverse effect of a prior cession in security on a new purported cession in security, where both cessions are created in respect of the same right.

those circumstances have been ceded in security. The new cessionary's knowledge of a prior cession is thus important so that the correct aspect of the personal right, namely, the right of action or the reversionary interests, are encumbered. The cedent should be required to disclose the existence of any prior cessions to the cessionary, who should conduct a thorough due diligence on it. A clause stating that the reversionary interests are pledged and ceded in security if the rights to the principal debt are already ceded in security to a different cessionary may however be invalid if the agreement containing the principal debt prohibits cession. The invalidity can be cured by obtaining the prior written consent of the counterparty(ies) to the agreement, to the intended pledge and cession in security.

The fourth and last pitfall is if the scope of the cession incorrectly captures the parties intentions. This may occur on one of two levels. First, if one party intended an out and out cession of a right, and the counterparty intended a cession in security of that right, there will be dissensus in respect of a material aspect of the agreement, which will render the agreement unenforceable. Second, the parties may have different intentions as to the scope of the cession in security if, for example, the cedent intended to exclude from the cession in security its claims against third parties for breach of contract, while the cessionary intended to include it. Again, there will be dissensus in respect of a material aspect of the agreement, which will render the agreement unenforceable.

A warranty by the cedent that the cession in security is enforceable will be cold comfort to the cessionary if a court finds it to be unenforceable because (i) it contravened common law or statutory restrictions on cessions in security; (ii) of the adverse effect of a contractual prohibition on cession; (iii) of the adverse effect of a prior cession in security on a new purported cession in security; or (iv) the scope of the cession fails to correctly capture the parties intentions. A cessionary can avoid the risk of its security interests in personal rights being rendered invalid and therefore unenforceable if the content and structure of the cession in security avoids the pitfalls discussed.

Adnaan Kariem

CLIFFE DEKKER HOFMEYR

OUR TEAM

For more information about our Finance & Banking practice and services, please contact:

Deon Wilken
National Practice Head
Director
T +27 (0)11 562 1096
E deon.wilken@cdhlegal.com

Stephen Boikanyo
Director
T +27 (0)11 562 1860
E stephen.boikanyo@cdhlegal.com

Adnaan Kariem
Director
T +27 (0)21 405 6102
E adnaan.kariem@cdhlegal.com

Bridget King
Director
T +27 (0)11 562 1027
E bridget.king@cdhlegal.com

Jacqueline King
Director
T +27 (0)11 562 1554
E jacqueline.king@cdhlegal.com

Izak Lessing
Director
T +27 (0)21 405 6013
E izak.lessing@cdhlegal.com

Mashudu Mphafudi
Director
T +27 (0)11 562 1093
E mashudu.mphafudi@cdhlegal.com

Pierre Swart
Director
T +27 (0)11 562 1717
E pierre.swart@cdhlegal.com

Jennifer Begg
Associate
T +27 (0)21 481 6361
E jennifer.begg@cdhlegal.com

Kuda Chimedza
Associate
T +27 (0)11 562 1737
E kuda.chimedza@cdhlegal.com

Stephanie Goncalves
Associate
T +27 (0)11 562 1448
E stephanie.goncalves@cdhlegal.com

Andile Sangweni
Associate
T +27 (0)11 562 1046
E andile.sangweni@cdhlegal.com

BBBEE STATUS: LEVEL TWO CONTRIBUTOR
Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

JOHANNESBURG
1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa. Dx 154 Randburg and Dx 42 Johannesburg.
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

CAPE TOWN
11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

STELLENBOSCH
14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com

CLIFFE DEKKER HOFMEYR