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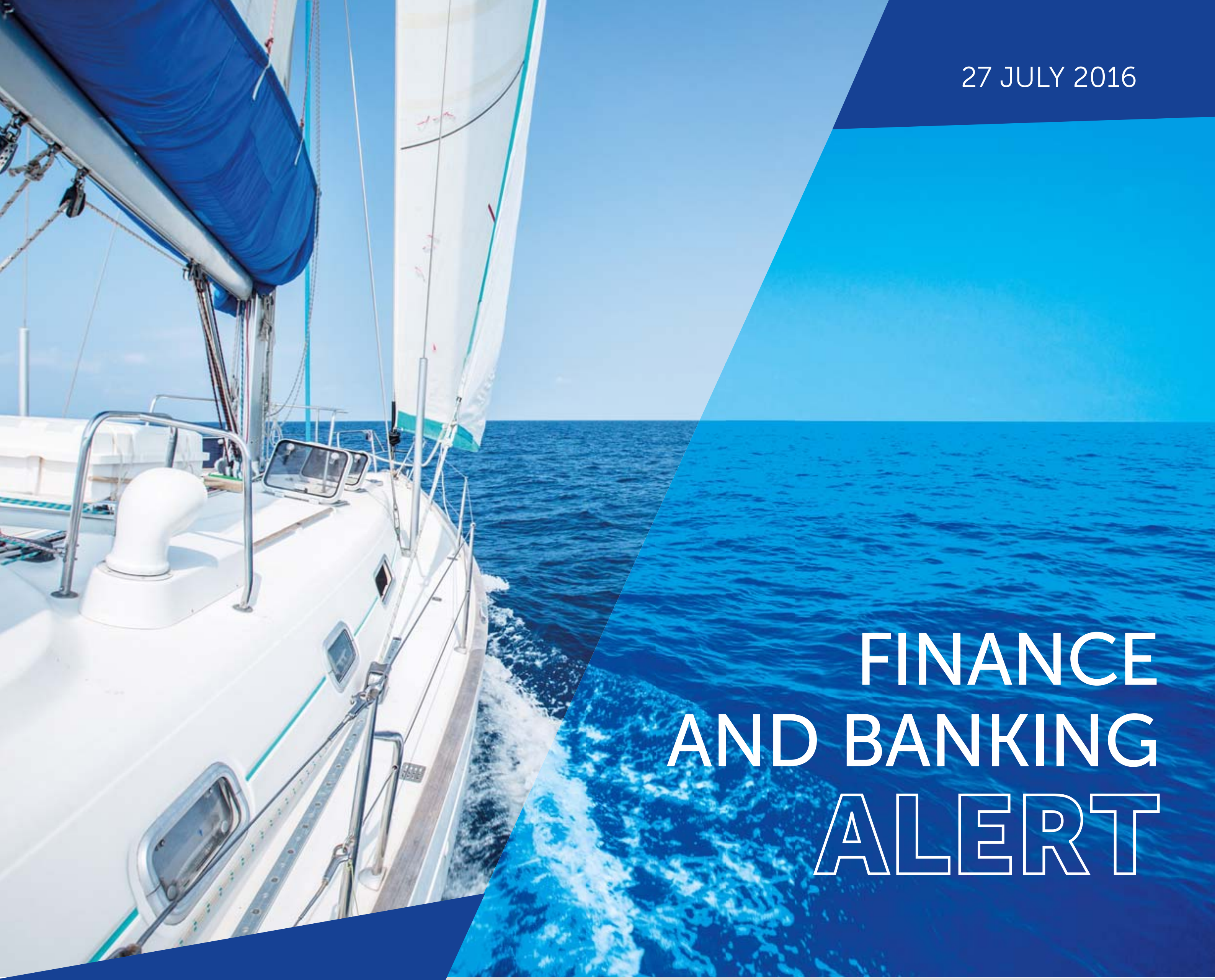

# FINANCE AND BANKING ALERT

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### A FAIR PRICE FOR PLEDGED ASSETS

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CLIFFE DEKKER HOFMEYR

# A FAIR PRICE FOR PLEDGED ASSETS

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**In a loan transaction, a lender often requires security for the borrower's obligation to repay the loan.**

The security is provided by the borrower and/or third parties granting the lender rights in respect of their assets or property. The rights to the asset are ceded in security and pledged to the lender (pledged assets) as credit support for the borrower's repayment obligations. In law, the borrower (cedent) retains ownership of the pledged asset and the lender (cessionary) acquires security rights thereto. The rights are therefore appropriated to the debt and are enforceable on the borrower's default or insolvency. The security is meaningful if the pledged asset value is at least equal to the debt so that the lender recovers the amount advanced.

Over the last few decades a number of seminal judgments have confirmed the principles that govern a lender's rights to realise the pledged asset and the value thereof on borrower default. We discuss some but not all of these judgments in this article. The terms creditor and lender on the one hand, and borrower and debtor on the other hand, are used interchangeably.

In law, a distinction is drawn between an agreement whereby a creditor transfers ownership in a pledged asset given in security for a debt to itself (retain(s)) for no value, and one where fair value or a fair price is given. The former agreement is known as a *pactum commissorium* and the latter as a conditional sale. A related issue is when and in what manner to establish the fair value or the fair price of the pledged asset. Structurally, unpaid debt is settled either by the creditor disposing of the pledged asset on the open market and using the proceeds to settle the debt, or by transferring ownership of the pledged asset to itself. If it is retained, the amount the creditor owes the debtor for the pledged asset is set-off at common law against the principal debt. Often a court order is needed to perfect the security rights.

In *Graf v Buechel* 2003 (4) SA 378 (SCA), the Supreme Court of Appeal (SCA) considered, among other things, a *pactum commissorium* and a conditional sale. The respondent was the sole shareholder of a company, which had converted from a close corporation, and borrowed money from the appellant to fund the purchase of a property on which it was to develop a hotel, against security of a mortgage bond registered over the property. If property development conditions were not met by an agreed date, the loan was repayable. The conditions were not met and the repayment date was extended by agreement. As further security, the respondent left share certificates, share transfer forms and a cession of loan claims in trust with attorneys. The company failed to repay the loan, was wound-up and the pledged shares were

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*The court confirmed the principle that an agreement whereby a creditor retains a pledged asset given in security for a debt for itself for no value is a pactum commissorium and is invalid and unenforceable.*

transferred into the creditor's name. The appellant sought to undo the transfer on the basis that the agreement permitting it constituted a *pactum commissorium* and was therefore invalid.

A few months later in *Bock and Others v Duburoro Investments (Pty) Ltd* [2003] 4 All SA 103 (SCA), the SCA again considered, among other things, a *pactum commissorium* and a creditor's rights to take over a pledged asset at a fair price. The appeal concerned the release of sureties from their obligations. In this case, the appellants were part of the controlling structure of a listed company. Two other entities in that structure borrowed from banks and pledged shares in the company to the banks as security. When the borrowers defaulted on repaying the loans, the banks called up the loans and took over the pledged shares. The borrowers were credited with the share value and the banks sought to recover the balance from the sureties. The share pledge allowed the banks to either dispose of the shares to a third party or to retain the shares for themselves. In either case, the qualification was that it must be "at a fair price". The sureties alleged that by crediting the borrowers with the share value, the banks acted to their prejudice which released them from the suretyships.

The SCA outlined the common law principles as follows. The court confirmed the principle that an agreement whereby a creditor retains a pledged asset given in security for a debt for itself for no value is a *pactum commissorium* and is invalid and unenforceable. The main reason for this is that our courts have held that a *pactum commissorium* is unduly oppressive to debtors. An agreement whereby a creditor realises a pledged asset given in security for a debt by disposing of or retaining the pledged asset at a fair price is a conditional sale, and constitutes a valid and enforceable agreement. The fair price is determined at the default date when the debt falls due and not the pledge date. As our courts have not, in this context, distinguished between a disposal and a retention, the principle that the creditor should realise the pledged asset at a fair price must be observed in either case. If the realised pledged asset yields an excess over the debt, the creditor must pay the excess to the debtor. Likewise, if the value of the pledged asset is less than the debt, the debtor is liable for the difference. A creditor's conduct prejudices a surety, thereby releasing the surety from his obligations, only if the creditor breached a legal duty.

The fair price will be determined with reference to the facts of a particular case. The old Roman-Dutch authorities on which our law is based, described this requirement as being that a 'just price' for the pledged asset must be given at the time the debt becomes payable. Ideally though, the fair price or method to determine the fair price should be agreed, failing which, it should be determined by an independent, appropriately

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*Creditors should ensure that when they realise pledged assets given in security for a debt, the fair price or fair value is given at the default date when the debt falls due.*

qualified expert. It is submitted that if the agreement is silent as to the fair price or the method to determine the fair price, the common law position may be applied. The Appellant Division (as it then was) in *Sun Life Insurance Co of Canada v Kuranda* 1924 AD 20, held in the context of a conditional sale, that an asset's value for which there is a free market is, on the face of it, the value that it will fetch on the market on the day in question.

Creditors should ensure that when they realise pledged assets given in security for a debt, the fair price or fair value is given at the default date when the debt falls due. Such fair price or fair value must be what purchasers would be willing to pay for it on the open market on the day of sale. If the agreement permits the creditor to take over or retain the pledged asset as its own, we suggest that the fair price be based on a market valuation of what purchasers would pay for it.

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