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Cession in security: Identifying the most suitable basis

A borrower's obligation to repay a loan can be secured using different forms of security rights and quasi-security rights, with some rights being asset backed and others not.

The theoretical basis of the pledge and cession *in securitatem debiti* (cession in security) of rights in South African law is one of two theories. The advantages, disadvantages and practical consequences of applying these theories to a cession in security, are considered. Although a basic, limited discussion of the nature of the cession theories is provided, its true theoretical nature, given its complexity, is best left to an academic treatise. Aspects of cession in security have been thoroughly analysed in previous articles.

In a cession in security, the cedent pledges its personal right in the debt owed to the cedent by its debtor (principal debt) and cedes (transfers) such right to the cessionary (ceded right(s)) to secure the fulfilment of an obligation owed by the cedent or a related party to the cessionary (secured debt). It is based on the common law principle, established by the Appellate Division (as it then was) in *National Bank of South Africa Ltd v Cohen's Trustee*[1], that one debt, the principal debt, can be used to secure the repayment of another debt, the secured debt.

CESSION IN SECURITY STRUCTURING

A cession in security can be structured by applying either the pledge theory (so named because of its resemblance to the pledge of corporeal assets) or the *pactum fiduciae*/outright cession theory (referred to as the *pactum fiduciae* theory). In *Grobler v Oosthuizen*[2] the Supreme Court of Appeal held that the parties' intention determines the character of the cession in security. If, however, the parties did not elect to apply either theory or their intention is unclear, as is often the case, the default legal position according to *Grobler* is that the pledge theory applies to the cession in security.

[1] *National Bank of South Africa Ltd v Cohen's Trustee* 1911 AD 235
[2] *Grobler v Oosthuizen* 2009 (5) SA 500 (SCA)

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Grobler settled the courts' vacillation between these theories and its application, which had continued for decades prior to 2009. Recently, in 2022, the Supreme Court of Appeal in *Engen Petroleum Ltd v Flotank Transport (Pty) Ltd*[3] confirmed the position in *Grobler*.

The theories of cession in security differ in respect of the basis on which personal rights are used as security, and the aspects of personal rights that are in law ceded in security. In a cession in security based on the pledge theory, the cedent retains its *dominium* or reversionary interest in the principal debt. The cedent pledges its right of action (the right to collect or enforce the principal debt) in that principal debt to the cessionary as security to repay the secured debt. The pledge is given effect to by a cession. It is thus only the procedural aspect of the principal debt that acts as security whilst legal title to the substantive right remains vested in the cedent. Once the cession in security is effective, the cedent has no legal standing to enforce the principal debt against its own debtor until the cedent has repaid the secured debt. The cession is complete and perfected when the parties consensually agree to the cession. Delivery of documents evidencing the ceded right is not required to perfect the cession but if the right is constituted (as opposed to evidenced) by a document, then the case law is to the effect that delivery is required. In a cession in security based on the *pactum fiduciae* theory, the cedent divests itself of its right to the entire principal debt (both the *dominium* or reversionary interest and the right of action) by ceding out-and-out (transferring) the entire right to the cessionary who acquires legal title to it, subject to the condition that once the secured debt is repaid, the cessionary must re-cede the ceded right to the cedent. The cedent thereby acquires a personal claim against the cessionary for the recession of the ceded right (recession claim).

PLEDGE THEORY ADVANTAGES

The pledge theory has numerous advantages. The cedent remains the holder of the reversionary interest in the principal debt, which is an asset in its estate. The cedent can use its reversionary interest as further security for existing or new loans, which facilitates lending cycles. In our article titled *Cession in security: The real meaning of reversionary interest* dated 8 July 2020, the meaning of reversionary interest is discussed. The cession in security constitutes the cessionary as a secured creditor on the cedent's insolvency in respect of the ceded rights. A lender as cessionary is thus, on the cedent's insolvency, put in the best position the law permits it to be, to recoup some or all of its losses incurred (due to the cedent as borrower failing to repay the loan) from the realised ceded rights. Academic proponents of the *pactum fiduciae* theory criticise the pledge theory as being a legal impossibility as one cannot, they

[3] *Engen Petroleum Ltd v Flotank Transport (Pty) Ltd* (876/20) [2022] ZASCA 98 (21 June 2022)

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contend, have a real right of pledge over personal rights arising from the principal debt. This aspect, and the counter arguments, are beyond the scope of this article.

PACTUM FIDUCIAE THEORY DISADVANTAGES

The *pactum fiduciae* theory has numerous disadvantages. The cedent forfeits its principal debt to the cessionary and hence cannot use it for commercial purposes. If the cessionary goes insolvent the principal debt falls into the cessionary's insolvent estate and the cedent ranks as a concurrent creditor of the cessionary in respect of its recession claim if it took no security for its recession claim. These consequences would be especially unfair to the cedent if it was repaying the secured debt at the time of the cessionary's insolvency. Academic proponents of both theories acknowledge this as the central weakness of the *pactum fiduciae* theory. At least one renowned academic, Professor GF Lubbe, has in fact concluded that this theory is flawed as a security measure because of the cessionary's insolvency risk.[4] Furthermore, if the principal debt's value exceeds the secured debt's value, the difference is excess value that the cedent could have, but for the application of the *pactum fiduciae* theory, used commercially to raise further loans. Additionally, whether such excess value can legally act as security is doubted as the secured debt would at that point already be secured. In other words, the excess value secures no debt and is therefore not accessory in law to the secured debt as it should be. In our article titled *The nature of cession in security* dated 20 September 2017, the legal requirement that security rights must be accessory to the secured debt is discussed. While the *pactum fiduciae* theory removes the risk of the cedent's liquidation for a lender as cessionary because the principal debt becomes an asset in the cessionary's estate, the aforementioned disadvantages outweigh such benefit.

The parties to a loan transaction should give careful consideration to the issues in this article when deciding on which theory to apply to their cession in security.

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[4] GF Lubbe (original text by PM Nienaber) *'Cession' in The Law of South Africa* vol 3 3 ed (LexisNexis, 2013) at paragraph 180

Sustainable *finances vs green loans*: Key differences to look out for

Environmental, social and governance (ESG) is not a new concept in South Africa but has of late become something of a buzzword, with funders and governments alike making a shift towards a more environmentally sustainable way of investing.

The worldwide commitment to sustainable investing was cemented by the Paris Agreement in which governments all over the world (including South Africa) agreed to implement a 40-gigatonnes reduction in greenhouse gas emissions levels by 2030.

The European Union (EU) Taxonomy has also played a big role in advancing sustainable financing through the introduction of a classification system. This clearly outlines the activities that can be regarded as environmentally sustainable for investment purposes across the EU and provides market participants and consumers with a common understanding and language regarding environmental sustainability in their business endeavours. Certain local funders, such as Nedbank, have also developed their own internal classification system, based to an extent on the EU Taxonomy.

Although South Africa has not formally implemented its own legal classification system, the South African National Treasury is working towards this, having issued a draft South Africa Green Finance Taxonomy in March 2022 and a media statement to that effect on 1 April 2022.

GENERAL PRINCIPLES

To give effect to the commitments undertaken in the Paris Agreement, investors have implemented various framework funding provisions geared towards sustainability, the most pertinent of which are sustainability-linked loans and green loans.

Sustainability-linked loans are debt instruments made available to a borrower for general corporate purposes but which provide an economic benefit to the borrower for achieving negotiated sustainability performance targets. Green loans,

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on the other hand, are debt instruments whose proceeds are used for a pre-specified green purpose or project which is beneficial to the environment. Key identifiers for environmental betterment include reduced greenhouse gas emissions, improved energy efficiency ratings, efficient water use, socio-economic advancement and empowerment, the use of recyclable materials, the conservation and protection of biodiversity, and the achievement of a recognised ESG certification.

KEY DIFFERENCES BETWEEN SUSTAINABILITY-LINKED LOANS AND GREEN LOANS

Sustainability-linked loans

As alluded to above, sustainability-linked loans mirror standardised loans advanced to corporations for general corporate purposes. The major distinction is that when a sustainability-linked loan is advanced to a borrower, it generally contains certain ESG targets which, if met by the borrower, may induce a certain economic benefit in its favour. The pre-determined targets are not a contractual obligation but rather an incentive for the borrower to advance the ESG sustainability cause.

The benefit accruing to the borrower in the event of meeting such targets is often a margin adjustment in line with the borrower's performance insofar as environmental sustainability is concerned. There is, however, no penalty imposed should the borrower not meet its targets.

Green loans

Conversely, green loans are advanced for a specified green purpose which benefits the environment and typically emanate from sectors with heavy capital expenditure requirements in green areas, such as the renewable energy sector. The proceeds of the loan must be used for clearly identified sustainable objectives and failure to use the proceeds accordingly attract a financial penalty for the borrower or project company in question.

The obligation to meet pre-determined sustainability performance targets is embedded in the loan agreement itself, making the fulfilment of such targets a contractual obligation and not merely an incentive, as is the case with sustainability-linked loans.

MARKET DEVELOPMENTS

The first ever African sustainability-linked bond was issued by the South African water utility Rand Water, as advised by CDH, which was the largest South African rand denominated sustainability-linked bond issued to date.

CDH also advised Harmony Gold Mining regarding its green loan of R1,5 billion to fund Phase 2 of its Solar PV Strategy (up to 137MW of peak generation capacity).

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Although the South African sustainability-linked debt market is still in its developmental phase, we are seeing a rise in the demand for sustainability-linked corporate financing at an accelerated rate, especially amongst corporations in South Africa.

BENEFITS OF SUSTAINABLE FINANCE

The benefits of sustainable finance are undeniable. The accelerated growth in sustainable finance has prompted many investors to reconsider their investment theses and borrowers to adapt their operations to be more sustainable. Some of the benefits of sustainable finance for lenders and borrowers alike include:

- the establishment of a more meaningful and positive impact on the world at large;
- cost saving and efficiency considering the return received on the usage of recyclable materials, for instance;
- innovation;
- competitiveness as sustainable practices advance the investor and borrower as compared to non-sustainable counterparts; and
- risk mitigation.

CONCLUSION

In conclusion, with countries across the world facing an energy crisis, ESG and similar sustainable financing initiatives are having a significant impact on not only economies, but also the environment. We anticipate that green loans and sustainability-linked loans will continue to shape investment theses, drive the switch towards a more sustainable way of conducting business, and contribute to the emergence of new regulations aimed at improving sustainability. The prospect is an exciting one where a new breed of environmentally conscious corporates will emerge, and this will benefit the world at large.

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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.

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