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ECONOMIC EMPOWERMENT THROUGH BUSINESS LOANS- A CRITICAL LOOK AT CREDIT PROTECTION LAW FOR SMALL, MICRO AND MEDIUM ENTERPRISES IN SOUTH AFRICA AND AUSTRALIA.

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I hereby declare that I have read and understood the regulations governing the submission of LLM dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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CHAPTER 1

I. INTRODUCTION

a) Overview

The question to be answered in this dissertation is whether the National Credit Act 34 of 2005 (the NCA), promotes or impedes the sustainable growth of the South African economy. This question will be answered through exploring the importance of the contribution made by small, micro and medium enterprises (SMMEs) to the economy. This research question is premised on the findings in structural change theory of development economics.[1] This theory advances the view that for a developing country to obtain sustainable growth of its economy there needs to be a decline in the number of microenterprises over a period of years and an increase in the number small and medium enterprises (SMEs).[2] This dissertation interrogates whether the NCA supports this kind of sustainable growth of the South African economy. The hypothesis proposes that the NCA impedes the sustainable economic development of South Africa. In support of this, I have examined the NCA and the protection that it affords to SMEs in South Africa. Specifically, I have examined the extent to which the NCA permits lending to SMEs by financiers, in contrast to the permission given to financiers to lend to microenterprises. In addition, I have examined the extent to which the NCA protects SME borrowers in cases where the SME qualifies for a loan, so bringing it within the provisions of NCA. This is then contrasted with the protection extended by the provisions of the NCA to microenterprises. In this investigation, I have undertaken a review of case law in South Africa to substantiate my view that the NCA inhibits sustainable growth of the South African economy. The decisions raise some important considerations, including problems caused by the concept of separate legal personality of juristic persons run by an individual in the context of borrowing, the extent to which credit guarantees offered by these individual owners should be legally enforceable and the ambiguity of developmental loans envisaged by the NCA. To address these problems, I have looked to foreign jurisprudence, especially the legal protection offered to SMEs in Australia when taking out a loan. A comparison between South African law and Australian law suggests how access to credit by SMEs and microenterprises can be improved to ensure sustainable economic growth of the economy.

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[1] Syrquin M, 'Patterns of structural change', in Chenery H et al (editor) *Handbook of Development Economics*, volume 1 (1988) 203-273.

[2] Ibid

b) Research Methodology

A doctrinal, desktop-based research method is used. The main documentary data analysed to answer the research question is primary legislation, specifically the NCA and the Usury Act 73 of 1968. Secondary sources, such as commentaries and publications by various researchers will be explored. Further documentary data will include empirical data collected in secondary sources. Other persuasive legal texts will be utilised, such as the Australian Securities and Investments Commission Act 2001 (Cth) (the ASIC), The Australian National Consumer Credit Protection Act 2009 (the ACCPA) as well as the Australian Code of Banking Practice (the COBP).

c) Limitations to the Study

The main limitation to this dissertation has been determining the exact number of SMMEs that exist in South Africa. Studies so far undertaken have used different methodologies and research strategies and their objectives may have differed to the objectives of this paper.[3] Despite the growing amount of literature and research that is being conducted regarding SMMEs, there is still very little known about them. This is largely a result of the high number of unregistered SMMEs that exist. A further limitation on the research is that each survey contains different definitions of small, micro and medium business. For example, the South African General Entrepreneurial Monitor (GEM) measures different types of entrepreneurship and not the number of businesses to enable international comparisons. In contrast the department of trade and industry's (DTI) definition of small business is used to determine the number of small businesses in South Africa; and this is the definition used in the National Small Business Act 102 of 1996 (the Small Business Act).

[3] Underhill Corporate Solutions 'Literature Review on Small and Medium Businesses Access to Credit and Support in South Africa' December 2011 available at @*http://www.ncr.org.za/pdfs/Literaturepercent20Reviewpercent20onpercent20SMEpercent20Accesspercent20topercent20Creditpercent20inpercent20Southpercent20Africa_Finalpercent20Report_NCR_Decpercent202011.pdf* accessed on July 25 2018.

II. SMEs AND SMMEs IN SOUTH AFRICA

a) The importance of SMEs in structural change theory of sustainable growth

Development economics is a branch of economics that focuses on improving fiscal, economic and social conditions in developing countries.[4] Development economics determines the sustainability of the economy in a developing country by looking at the quality of life of the individuals within the country and at the Gross Domestic Profit (GDP).[5] Development economics presupposes that an economy is sustainable when the wealth distribution in the country is visible amongst the people of the country.[6] The structural change theory of development economics envisages the achievement of sustainability envisaged by development economics through various stages of industrial change.[7] These stages of industrial change are illustrated by the growth of Europe. At the start, agricultural activities were taken over by technological advances, meaning that much of the labour force was retrenched; however, these people were then absorbed by manufacturing companies and were exposed to more business skills.[8]

In the first stage, the economic activity mainly comprises agricultural activities, small-scale manufacturing and service provision businesses.[9] In this stage, the national economy generates a low GDP, making self-employment necessary.[10] In the second stage, there is a migration from small-scale production and service enterprises to small manufacturing businesses, beginning when the national income and GDP of an economy increases, allowing for the country and its people to have access to more modern technologies which in turn enable innovation.[11] Microenterprise numbers should decrease with a shift to finding stable jobs within manufacturing industries and other service enterprises.[12] In the third stage, there should be a migration toward entrepreneurship − opportunity entrepreneurship, rather than necessity entrepreneurship.[13] Usually the businesses started in this stage are large enterprises or enterprises that are able to compete efficiently because

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[4] Syrquin M op cit note 1 at 265
[5] Syrquin M, op cit note 1 at 265.
[6] Syrquin M op cit note 1 at 267.
[7] Owosuyi IL, The pursuit of sustainable development through cultural law and governance frameworks: A South African perspective (2015) PER vol.18 n.5.
[8] Berry et al, The Economics of SMME's in South Africa December 2002 available at *semanticscholar.org* accessed on August 18 2018.
[9] Syrquin M op cit note 1 at 268
[10] Syrquin M pp cit note 1 at 269.
[11] Syrquin M pp cit note 1 at 270.
[12] S. Kuzents, 'Modern Economic Growth' in in Chenery et al *Handbook of Development Economics* (1988), Kuznets observed the tendency for the self-employment rate to decline with economic development.
[13] Syrquin M op cit note 1

they are run by people who have worked within the industry and have seen an opportunity gap in that industry ie competition increases in the market.[14] Accordingly, the crux of the structural change theory is that sustainable growth of a developing country's economy ensues only once necessity entrepreneurship declines. The growth of microenterprises within industries such as retail, repairs, accommodation (small service enterprises) and agriculture are indicators that necessity entrepreneurship persists in that economy.

b) International Perspectives of the Value of SMME to an Economy

The Global Economic Monitor (the GEM) releases bi-annual reports on economic development in mature and emerging economies. The data collected is relied on by many international organisations, including the World Bank, for the reason that the findings of GEM are arguably a good indicator of economic practices which are sustainable. GEM conducted research into the effect that entrepreneurship had on economies, concluding that there were two different types of entrepreneurship in the world's economies: opportunity entrepreneurship and necessity entrepreneurship.[15] The former refers to an active choice made by businessmen to start an enterprise for an underexploited business opportunity.[16] The latter occurs where people have to become entrepreneurs because there is no other money-generating activity available to them.[17] The outcome of a survey in 11 countries, from both mature and developing economies showed that necessity entrepreneurship had no effect on economic growth.[18] In contrast, opportunity entrepreneurship was found to have a positive impact on the growth of a country's economy in a direct relationship to the growth of the GDP. Necessity entrepreneurship would more often than not refer to start-up businesses or microenterprises in concentrated markets. To maintain consistency, I will refer to necessity entrepreneurship as microenterprises and opportunity entrepreneurship as referring to SMEs.

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[14] T. Schultz, 'Education Investment and Returns' in Chenery et al *Handbook of Development Economics* (1988), 543-630.
[15] Acts Z, 'How is Entrepreneurship Good for Economic Growth?'(2006), *Innovations Journal* at 99.
[16] Ibid
[17] Acts Z op Cit note 15 at 97
[18] Acts Z op cit note 15

Research shows that SMEs contribute to economic growth for a variety of reasons, as they create jobs for the semi-skilled and unskilled labour force that would otherwise remain jobless.[19] The Organisation for Economic Cooperation and Development (OECD) reports that SMEs are key generators of employment and income and are generally drivers of innovation and growth.[20] This is because SMEs employ more than half of the labour force in the private sector in OECD countries.[21]

III. SMES AND MICRO-ENTERPRISES IN SOUTH AFRICA

a) What is an SMME in South Africa?

The Small Business Act defines a small business as a separate and distinct business entity, including cooperative enterprises and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or subsector of the economy mentioned in column I of the Schedule in the Small Business Act.[22] The Small Business Act also includes within its definition of small business a small, very small, micro and medium enterprise.[23] The schedule of the Small Business Act determines when an enterprise will fall into any of the four categories. For different industries in the economy, the annual income threshold for each category will be different [24]. An example of this, is that in the retail, motor service and repair industry, a very small business has an annual turnover of less than R3 million, but in the catering, accommodation and trade industry, a very small business should have a turnover of less than R100 000.[25] For each industry that is included in the Small Business Act, a small business is categorised as having an annual turnover of more than R1 million and less than approximately R5 million.[26] From the definitions provided in the Small Business Act, there is a great deal of uncertainty regarding how a business will be categorised, which, in turn, affects how statistics are to be collated and presented. Nonetheless, I have used statistics from the DTI in

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[19] Devey R *Second Best? Trends and Linkages in the Informal Economy in South Africa* (Unpublished BA Masters thesis, University of Cape Town, 2006)
[20] Meeting of the OECD council at ministerial level 'Enhancing Contributions of SMME's in i Global and Digitalized Economy' June 2017 available *@https://www.oecd.org/mcm/documents/C-MIN-2017-8-EN.pdf* accessed on July 21 2018.
[21] Ibid
[22] S1 of the National Small Business Act 102 of 1996.
[23] Ibid.
[24] See the schedule of the National Small Business Act.
[25] Ibid
[26] Ibid.

determining the landscape of the SMME sector in South Africa. The DTI categorises businesses using the definition in the Small Business Act.

b) A Brief History of South Africa's Economy and What it Meant for SMMEs

One of the economic models, which could be used to describe the South African economy is known as the dual economic model.[27] Dualism, as a general term, refers to the conceptual division of something into two contrasted or opposed aspects.[28] In a dualist approach to the South African economy, the economy is considered as two parallel economies within one economy, referred to as the formal and informal economy. For the purposes of SMEs and micro-enterprises, the dualistic model is best suited as a descriptor of the South African economy. My reason for this is that within the multitude of micro-enterprises and small businesses, there are a large number that remain unregistered entities as required by the Companies Act.[29] The high number of unregistered businesses along with their location and consumer base are indicators that these businesses operate in a separate economy.[30]

The duality of the economy is not a result of the new democratic dispensation but rather a product of the apartheid era between 1948 and 1994 when racial segregation was rife. In 1994 South Africa became a democratic nation. However, the racial segregation of the apartheid era period meant that the majority of South Africans, referred to hereafter as the previously disadvantaged people, were excluded from economic activity that occurred in the formal economy.[31] During apartheid, previously disadvantaged persons did not receive skills training to enable them to work in the formal economy and were primarily exposed to inferior 'bantu education'. With little formal skills training and a poor scholarly education, most previously disadvantaged persons turned to entrepreneurial activities.[32] From these entrepreneurial activities, grew an informal economy in South Africa, one which persists today, with many business owners,

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[27]Bojabotseha TP, 'Dualism and the social formation of South Africa' (2011) Vol 1 (3) *African Journal of Hospitality, Tourism and Leisure*.
[28] Ibid.
[29] The Companies Act 71 of 2008.
[30] Statistics South Africa 'Survey of employers and the self employed' (2013) available @ http://www.statssa.gov.za/publications/P0276/P02762013.pdf accessed on July 21 2018.
[31] *White Paper on National Strategy for the Development and Promotion of Small Businesses in South Africa*. (Notice 213 of 1995, published on March 20 1995).
[32] Devey R op cit note 19

employees and consumers of products and services offered. [33] Under the segregation laws of apartheid the informal economy was mostly contained in the rural areas, attributed mainly to the consumer base of these businesses residing in rural areas.[34] However, when these laws were removed, many previously disadvantaged persons moved to urban areas, to seek employment in the formal economy.[35] Unable to find jobs, usually on account of the lack of space within the formal economy for employment and a lack of education and skills, most remained in urban areas and started small businesses.[36] Many parts of urban areas then became peri-urban areas and the informal economy expanded.[37]

Being aware that the formal economy could not support the large number of unemployed persons at the end of apartheid and recognising the large number of micro-enterprises that existed at the wake of democracy, the Government decided to support this sector of the economy.[38] The rationale was thought by some to have resulted from a belief that micro-enterprises were a vehicle to redress racial income inequalities and to be a means for economic redistribution within South Africa.[39] During the years 1994-2003, the Government's main reasons for focusing on SMME economy were attributed to the ability of SMMEs to promote employment and redistribute wealth amongst South Africans.[40] This resulted in the publication of the White Paper on National Strategy for the Development and Promotion of Small Businesses in South Africa 1995 (SMME White Paper).

The focus of the SMME White Paper was for Government to create an enabling legal framework for SMMEs to operate within; facilitate access to information and advice for entrepreneurs; and to improve access to finance and affordable physical infrastructure. In terms of the legal framework, the Small Business Act was promulgated in 1996 and the rest of the objectives of the SMME White Paper now find expression in the Integrated Small Business Development Strategy for 2005 to 2014. The Strategy is based on increasing financial and non-financial support; creating demand for small and micro-enterprise products and services and reducing the regulatory

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[33] Ashman S et al, 'The crisis in South Africa: Neoliberalism, financialization and uneven and combined development' (2011) Vol 47 *The Socialist Register*.
[34] Rogerson CM 'Urban poverty and the informal economy in South Africa's economic heartland' (1996) Vol 8 No *Environment and Urbanisation* pg 167-169.
[35] Ibid
[36] Rogerson CM op cit note 34
[37]Rogerson CM op cit note 34
[38] White Paper on National Strategy op cit note 26
[39] Berry et al op cit note 8.
[40] Ibid

constraints on these enterprises. It is evident that the Government has, for the duration of our democracy, believed that funding small and microenterprises and making funds more accessible to these enterprises would have had a positive impact on the economy, through reducing unemployment levels and increasing the GDP of South Africa.[41] The reform of credit laws in relation to juristic persons could therefore be said to be partly as a result of this belief. Where small businesses may contribute to the GDP of South Africa and to employment, the statistics show that the types of businesses which contribute most to the economy are the ones which are excluded from the scope of the NCA by virtue of its threshold and classification in terms of the Small Business Act.[42]

c) Overview of the Current SMME Sector in South Africa

There are about 2.2 million SMMEs in South Africa. In terms of the geographical location most are housed in Gauteng (46 per cent) and the Western Cape (16 per cent). In the seven-year period between 2008 and 2016, the number of SMME's in Gauteng and Limpopo grew by a cumulative total of 30 per cent. However, the percentage economic contribution by these SMMEs to the GDP was significantly lower than the percentage growth in the number of SMMEs.[43]

As of the last quarter of 2017, the QLFS released by Statistics South Africa today, indicated a decrease of 351 000 people in the total labour force of South Africa (formal and informal employment).[44] In the formal sector, employment declined by 135 000 persons while employment in the informal sector increased by 119 000 persons. The decrease in the formal sector employment was due to a decline in the rate of employment in the finance, trade, private household and mining industries. In the informal sector there was an increase in employment in the community, social, personal service, manufacturing, agricultural and construction industries. Of the total labour force, the demographics pertaining to skill/education level have had a negative variance within a 10-year period from 1994-2014. In terms of skilled employees, there was a

[41] Ibid .
[42] Underhill corporate solutions op cit note 3.
[43] Bureau for Economic Research, The Small, Medium and Micro Enterprise Sector of South Africa, commissioned by the Small, Medium Enterprise Agency of South Africa January 2016 available @ *http://www.seda.org.za/Publications/Publications/Thepercent20Small,percent20Mediumpercent20andpercent20Micropercent20Enterprisepercent20Sectorpercent20ofpercent20Southpercent20Africapercent20Commissionedpercent20bypercent20Seda.pdf* accessed on 27 July 2018.
[44] Stats South Africa, Quarterly Labour Force Survey 7 August 2017 available @ *https://www.statssa.gov.za/publications/P0211/P02112ndQuarter2017.pdf* accessed on July 28 2018.

growth from 20.6 per cent in 1994 to 25.2 per cent in 2014 of those who gained employment in the formal sector. Low-skilled employees employed in the formal sector dropped from 32.4 per cent in 1994 to 28.5 per cent in 2014.[45] In South Africa, micro and small businesses contributed to around 27 per cent of the GDP in 2006. The contribution of small firms to employment in South Africa was small because of lack of growth. According to the DTI, most small firms go out of business within a short period of time.[46]

Of the 2.2 million SMMEs in South Africa, most (944 500) operate in the domestic trade (wholesale and retail) and accommodation sector of the economy, followed by the community, social and personal services sector.[47] Businesses in these sectors employ between 1 to 10 people. In looking at the annual turnover of SMMEs, the data shows that, at the top end, SMMEs in the mining sector had an average turnover of R16 million (annualised) in the first quarter of 2015, compared to only R360 000 in the community and social services sector. However, the statistics show that the mining sector has the fewest number of entities.

[45] Ibid
[46]Bureau for Economic Research op cit note 43
[47] Bureau for Economic Research op cit note 43

Table 6: SMMEs by economic sector

SMMEs	Number (2008Q1)	Number (2015Q2)		
	Total	Total	Formal	Informal
Total	**2 182 823**	**2 251 821**	**667 433**	**1 497 860**
Agriculture	87 820	56 774	0	0
Mining	2 696	2 199	0	2 199
Manufacturing	267 817	201 459	62 657	138 801
Electricity, gas & water	4 252	7 456	6 656	801
Construction	252 233	299 242	77 098	222 143
Trade & Accommodation	974 083	944 467	186 798	757 669
Transport & Communication	122 370	133 134	56 620	76 514
Finance & Bus. Services	236 740	271 712	172 423	99 289
Community	227 243	305 624	105 181	200 444
Other	7 569	29 754	0	0

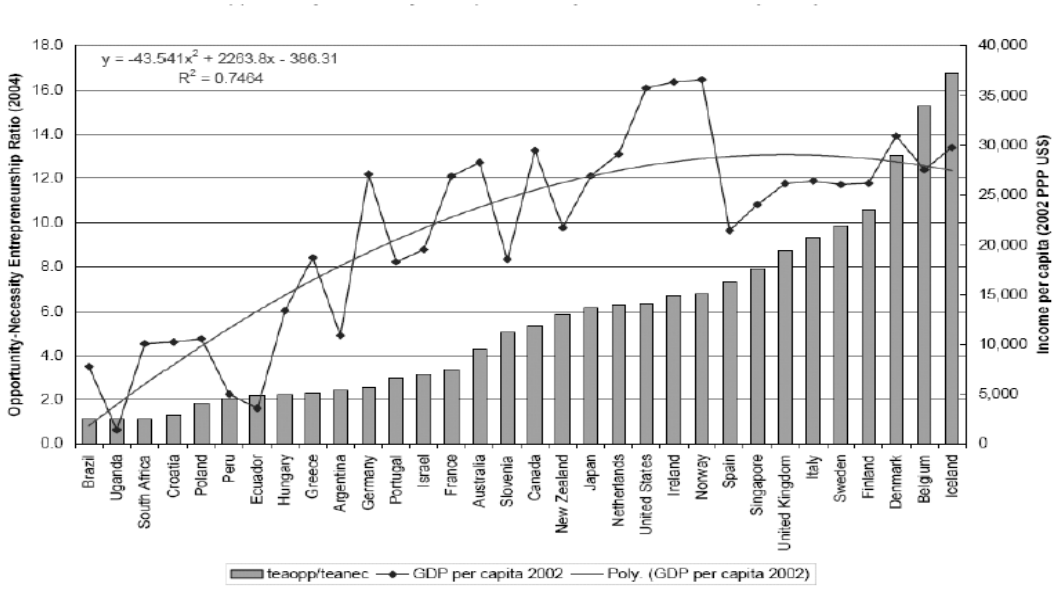
Table extracted from the 2016 SMME survey conducted by SEDA[48]

Of the 2.2 million SMMEs in South Africa, there are more microenterprises than SMEs (See Graph 1 below). Microenterprises have low barriers to entry, meaning that most of enterprises are run by one person (the owner); additionally the lack of technology and lack of growth of these enterprises means that employment levels remain relatively flat throughout the lifespan of the microenterprise. This means that in a country like South Africa, unemployment levels remain quite high because there are no businesses with the scope or capacity to absorb the number of unemployed persons.[49] The extract below from the GEM survey, shows the level of opportunity entrepreneurship in 30 countries, ranking these countries from highest to lowest. The X-axis of the graph shows that South Africa has a very low level of opportunity entrepreneurship, with the business sector populated with microenterprises in the small trade and manufacturing industries, which is one indicator that South Africa is not developing as rapidly as other world economies. The recommendation made in the GEM report was that developing countries, with high levels of

[48] Available at Bureau for Economic Research, The Small, Medium and Micro Enterprise Sector of South Africa, commissioned by the Small, Medium Enterprise Agency of South Africa January 2016 available @ *http://www.seda.org.za/Publications/Publications/Thepercent20Small,percent20Mediumpercent20andpercent20Micropercent20Enterprisepercent20Sectorpercent20ofpercent20Southpercent20Africapercent20Commissionedpercent20bypercent20Seda.pdf*

[49] Berry et al op cit note 8.

microenterprises, should develop the small and medium sector by reducing the number of microenterprises[50]



Graph 1: An extract taken from the GEM survey: How Is Entrepreneurship Good for Economic Growth Report, which shows opportunity entrepreneurship ranking from the lowest to the highest.[51]

IV. THE NATIONAL CREDIT ACT AND JURISTIC PERSONS

The NCA is the primary source of credit consumer protection legislation for natural persons in South Africa. However, the definition of consumer in the NCA includes both natural and juristic consumers, but the way in which the NCA is applicable to natural consumers is different to its application to juristic persons.[52] For the NCA to be applicable to a loan taken out by juristic persons the juristic person must have less than a sector specific annual turnover.[53] Moreover, where a juristic person takes out a loan in what is considered to be a large or intermediate loan agreement, the NCA will not apply to that loan contract, regardless of the turnover of the juristic person.[54] This limited and ambiguous application of the NCA to juristic persons prevents sustainable growth

[50] Meeting at the OECD op cit note 20.
[51] Acts Z op cit note 15.
[52] S6 of the NCA.
[53] S4(1)(a)(i) of the NCA.
[54] S4(1)(b) of the NCA.

of the small and medium enterprise sector. A major hurdle to the development of the SMME sector is that only microenterprises are afforded protection by the NCA when borrowing money, because of the sector specific annual turnover threshold. However, once the microenterprise starts producing improved turnover, the NCA is of little use, especially where a microenterprise may need a large loan to grow into a small or medium business. In turn, this prevents the kind of development promoted by structural change theory.

The purpose of the NCA is to achieve the kind of sustainable development envisaged by developmental economics. However, when members of juristic persons try to enforce the NCA in the courts of South Africa, a recurring theme is that the courts are restrained by the legal principle of separate legal personality of juristic persons. Hence, the promotion of the purpose of the NCA is often invalidated to ensure that the legal principle of separate legal personality is maintained. The purposes of the Act set forth below are what I consider to be the most important, and those have been considered as important in the High Court.[55] These socio-economic purposes directly promote the goal of sustainable growth envisaged by developmental economists. These purposes are:

> 'The purposes of this Act are to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry, and to protect consumers, by-
> (a) promoting the development of a credit market that is accessible to all South Africans, and in particular to those who have historically been unable to access credit under sustainable market conditions;
> (c) promoting responsibility in the credit market by-
> (i) encouraging responsible borrowing, avoidance of over-indebtedness and fulfilment of financial obligations by consumers; and
> (ii) discouraging reckless credit granting by credit providers and contractual default by consumers;
> (g) addressing and preventing over-indebtedness of consumers and providing mechanisms for resolving over-indebtedness based on the principle of satisfaction by the consumer of all responsible financial obligations.

The NCA applies to credit agreements concluded with a juristic person, with an annual turnover of less than R1 million per annum and where the credit agreement can be classified as a small or

[55] *African Dawn Finance Property Finance (2) (Pty) Ltd v Dreams Travel and Tours (CC) and other*s [2011] 45 ZASCA. High Court judgment overruled by SCA is significant in this respect.

intermediate credit agreement as defined in the NCA[56]. The current monetary threshold for a small credit agreement is R15 000 or less.[57] The current monetary threshold for an intermediate credit agreement is more than R15 000 but less than R250 000.[58] The National Credit Act defines a 'small business' with the same meaning as provided for in the Small Business Act.[59] The NCA creates a special category of credit agreements, which are termed developmental agreements for the purposes of developing a small business.[60]

The NCA provides little explanation as to whether a small business which concludes a developmental agreement with a credit provider is treated the same as a juristic person. However, because developmental agreements are considered a statutory exception, I assume that the legislature intended consumers of developmental credit for small businesses to be protected differently to juristic persons taking out an ordinary loan for business use, in terms of the protection afforded to them by the NCA. The protection offered to developmental credit consumers is at the discretion of the National Credit Regulator.[61] What constitutes a developmental agreement is at the discretion of the National Credit Regulator[62] and little information is available on this. For the purposes of this dissertation I will examine credit agreements concluded with juristic persons as standard credit agreements in terms of section 8 of the NCA and refer to developmental agreements separately.

If the NCA only governs credit agreements with juristic persons which have an annual turnover of up to R1 million, the necessary implication would be that only 'small businesses' which fall into the micro and very small category in terms of the Small Business Act, would be regulated by the NCA. This means that businesses in certain sectors will not be offered any protection for taking on loans and that in reality all SMEs are excluded from the protection offered by the NCA for loans.

For businesses that meet the annual turnover threshold and where the credit agreement is not considered to be for developmental purposes, their agreements are classified as small and

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[56] S 9 of the NCA.
[57] Item 3(1) of the General Notice Number 28893,June 2006.
[58] Item 3(2) of the General Notice Number 28893, June 2006.
[59] S1 of the NCA.
[60] S 10 of the NCA.
[61] S 76 and S 64 of the NCA.
[62] S 10 of the NCA does not set out what a developmental credit agreement actually is, just when a developmental agreement can be concluded.

intermediate credit agreements.[63] These juristic persons are offered a very limited protection under the NCA, which differs greatly from that applicable to developmental credit consumers and to natural consumers. For example, juristic persons are not offered the protection of the NCA from over-indebtedness and from being victims of reckless lending[64] and negative marketing practices.[65] This excludes juristic persons from the protection afforded by section 89(2)(b) of the Act against unlawful credit agreements resulting from unlawful advertising. Juristic persons are further excluded from the protection of section 90(2)(o), which outlaws variable interest rates from a credit agreement. Additionally, any protection offered to natural consumers under Chapter 5, part C, on consumer liability, interest, charges and fees, does not extend to juristic persons.

In the chapters that follow, I will fully address the issues of juristic persons being treated differently to natural persons and differential treatment depending on industry and turnover, with emphasis on the effect on the economy. Thereafter, the example of how Australian law has dealt with the issue of the natural and juristic person divide will found my views on how the NCA can be amended to support sustainable economic growth, specifically identifying how the NCA should be amended to include those businesses in sectors which contribute the most to the GDP; and in addition, to identify how the individuals behind the sole trader can be protected.

V. STRUCTURE OF DISSERTATION

Chapter one has set out the research question of this paper. In this chapter, I explained the scope of the research question with a description of SMMEs and their position in the economy. Additionally, I explained how the National Credit Act relates to this research question. Lastly, I set out the current situation of the SMMEs in South Africa and their contribution to employment and economic growth.

Chapter Two will set out the history of credit protection law in South Africa and explore the history of the NCA and its predecessor, the Usury Act of 1968. I shall also explore case law dealing with these two Acts, leading to the introduction of the NCA and the reasons that the legislature decided to treat natural persons differently to juristic persons. Thereafter, I have illustrated through

[63] S9 of the NCA.
[64] Chapter 5, part C of the NCA.
[65] Chapter 4 part C of the NCA.

the use of case law, how juristic persons are disadvantaged due to the lack of credit protection offered to them.

Chapter Three will set out the ASIC Act (Cth), the NCCPA as well as the Australian Banking Code to examine how credit laws which relate to small businesses have enabled the small business economy of Australia to grow rapidly and to contribute significantly to the economy.

Chapter four is the conclusion of the dissertation. In this chapter, I have set out possible solutions to ameliorate against the issues raised in Chapter One and Chapter Two. The solutions proposed involve adapting some of the standards used in Australia in its regulation of small business finance. In this Chapter, I have briefly mentioned the Conduct of Financial Institutions Bill, 2018, the Code of Banking Practice in South Africa and the Financial Advisory and Intermediary Services Act 37 of 2002.

CHAPTER 2

I. INTRODUCTION

The NCA was enacted in 2005 and came into effect in 2007, intended to be the single piece of legislation that would govern consumers and credit providers. The NCA repealed the Usury Act.[66] The NCA is most known for its provisions on the cost of credit, reckless lending and over-indebtedness.[67] The inclusion of these provisions in the NCA were directly related to the weaknesses identified in the Usury Act.[68] However, these were issues that affected both consumers in the SMME credit market and in the consumption market.[69] In this chapter, I will discuss the Usury Act in some detail along with the exemptions issued thereunder. The purpose of this discussion is to highlight how the Usury Act failed to make credit available to SMEs, despite this being a primary reason for the 1992 exemptions. Thereafter, I shall explore how the NCA came to be promulgated and the reason for juristic persons effectively being excluded from its provisions. It is against this background that I begin to describe the legal framework available to protect SMMEs. Specifically, I discuss the contrast between the protection offered to natural persons under the NCA as opposed to common law protection offered to juristic persons. This is done through critically evaluating decisions by the High Court and Supreme Court of Appeal. Through these cases, I strive to illustrate how the law provides no assistance to support the growth of SMEs. The harm is caused through the law not protecting juristic persons, which creates a loophole for credit providers to take advantage of the owners or members of juristic persons, as will be demonstrated through the case law. I shall deal briefly with developmental credit agreements for small businesses and the manner in which this category of agreement could benefit microenterprise credit lending. The overarching goal of this chapter is to promote critical thinking about the wording of the NCA, the way that courts interpret the NCA and in what way this could impact on financial lending to SMEs.

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[66] S172(4)(a) of the NCA.
[67] Renke S et al 'The NCA: New parameters for granting credit in South Africa' (2007) *The Obiter*. 232
[68] Bamu P et al 'The NCA: will it increase access to credit for small and micro enterprises?' (2007) *Journal of Law, Democracy & Development* at 40.
[69] Daniels RC 'Financial Intermediation Regulation and the Formal Micro-Credit Sector in South Africa' (2010) *Development Southern Africa Journal* at 833

II. THE HISTORY BEHIND THE NCA

All people and entities that were involved in the consumption of credit products were protected by the Usury Act. The Usury Act is the predecessor of the NCA and constituted one of the first pieces of consumer credit legislation in South Africa.[70] Under the Act, there was no distinction between lending to enterprises and lending to natural persons. In the *AAA Investments Case (Micro Finance Regulatory Council v AAA Investments (Pty) Ltd and Another* 2006 (1) SA 27 (SCA)) [71], in which the decision of the Supreme Court of Appeal setting aside the decision of the High Court was upheld by the Constitutional Court, it was held that the Usury Act served as a tight control on all contracts of credit which were a vehicle for advancing money.[72] All contracts, regardless of who the borrower was or what the purpose of the loan was, were therefore regulated by the Usury Act.[73] This meant that the same clauses of protection offered by the Usury Act to natural persons were also extended to juristic persons. The Usury Act regulated money lending transactions, credit transaction and lease transactions, all of which implied that a sum of money was extended to a borrower by a lender and the repayment of such money was delayed until a later date.[74] In any credit transaction, one person will always be in a weaker position than the other, usually this will be the borrower.[75] The Usury Act purported to mitigate against this imbalance of power, through regulating the cost of finance and regulating credit contracts.[76] The most significant protection offered by the Usury Act was that credit providers were prohibited from charging excessive or usurious interest rates to consumers.[77] Credit providers were obliged to adhere to the cost of finance which was prescribed from time to time by the Minister of Finance in South Africa.[78]

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[70]Vessio ML *The NCA 34 of 2005: Background and Rationale for its Enactment, With A Specific Study of the Remedies of the Credit Grantor in the Event of Breach of Contract* (unpublished LLD thesis, University of Pretoria, 2015) 195.
[71] *Micro Finance Regulatory Council v AAA Investment (Pty) Ltd and another* 2006 (1) SA 27 (SCA)
[72]*AAA Investments (Proprietary) Limited v Micro Finance Regulatory Council and Another* (CCT51/05) [2006] ZACC 9 para 6.
[73] The first version of the Usury Act came into operation for the whole of South Africa as early as 1926, Act 37 of 1926.
[74] *AAA Investments* supra note 72 para 5.
[75] Ibid.
[76] *AAA Investments* supra note 72 para 6.
[77] Ibid.
[78] S2 and 3 of the Usury Act.

Further protective measures included a cap on the amount of the principal debt that the Usury Act applied to − R500 000.[79] In any contract which was concluded for a money-lending transaction, the following particulars had to be contained within the document: the cash amount borrowed; the principal debt; the annual finance charge rate; the amount of finance charges and the amount of each instalment; the due date for the instalments and the date on which the principal debt was due.[80] The Usury Act allowed for variable interest rates, which had to be stipulated in the contract.[81] A major criticism levelled against the Usury Act was that it was a very complex piece of legislation and that despite its protective measures, there was no penalty for non-compliance.[82] Many credit providers contravened the Usury Act by not disclosing fees to consumers.[83] In addition, credit providers did not fully explain the contracts to consumers and many consumers did not fully understand the cost of credit, resulting in over-indebtedness[84]

The government was also dissatisfied with the amounts of lending to microenterprises. Credit providers had stated that they were not willing to lend to microenterprises and to poor people.[85] This was because the interest caps were too low in relation to the risk of lending to these people and enterprises, as well as to offset the high transaction costs.[86] In 1988, section 15A was introduced into the Usury Act permitting the Minister of Finance to exempt certain categories of moneylenders from the provisions of the Usury Act. In the year 1992, the Minister of Finance exempted loans under R6 000 under this provision.[87] The result was that a microlending sector boomed overnight. More and more people became involved in lending to microenterprises and poorer South Africans. However, the exemption also meant that none of the protective measures under the Usury Act were applicable to contracts concluded for amounts of R6 000 or less. Credit providers could charge usurious interest rates on small loans and grant an unlimited number of loans to people borrowing small amounts of money.

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[79] Vessio ML *The NCA 34 of 2005: Background and Rationale for its Enactment, With A Specific Study of the Remedies of the Credit Grantor in the Event of Breach of Contract* (unpublished LLD thesis, University of Pretoria, 2015) 195.
[80] Ibid
[81] Ibid
[82] Louw MK 'The Prevention and Alleviation of Consumer Over-Indebtedness' (2008) *SA Merc LJ* 200
[83] Ibid
[84] Ibid
[85] *Micro Finance Regulatory Council v AAA Investment (Pty) Ltd and another* 2006 (1) SA 27 (SCA) para 4.
[86] Ibid
[87] RP Goodwin-Groen 'The NCA and its regulations in the context of access to finance in South Africa' available at *http://www.finmark.org.za/wp-content/uploads/2016/01/Rep_NCA_AccesstoFinance_2006.pdf*. Accessed on 1 August 2018.

In the same year, 1992, the Government began talks on the National Strategy for the Growth of the SMME sector, and the promulgation of Small Business Act.[88] The exemption seemed like a step in the right direction, given that these SMMEs did not have to provide any collateral for these loans.[89] The reality, however, was that credit providers were granting loans without any assessment of the affordability of the loan to the client, which resulted in over-indebtedness.[90] In addition, credit providers did not seek information from the clients regarding the purpose for which the loan was taken; this had the effect of small loans being used for consumption purposes by salaried workers and other natural persons.[91] The exemption was set at a very low amount and so small and medium businesses did not benefit from it.[92] Credit providers were still unwilling to provide loans to small and medium businesses if they could not charge usurious interest rates. To develop, these businesses required amounts of R10 000 to R500 000.[93] If credit providers had lent to small and medium enterprises, the owners of the enterprise would have been protected by the Usury Act.

The 1992 exemption resulted in a large microcredit industry and in an over-indebted population.[94] People, whether natural consumers or business owners, were not making enough income to repay the loans. The loans were not big enough to allow the micro-enterprises to expand into small businesses. In the result, consumers were faced with a debt spiral ie they would take out more loans to pay off earlier loans. Credit providers implemented multifarious techniques to ensure that they got their money back, including withholding a person's identity document so that they would be able to withdraw cash from a debtor's personal bank account.[95] By the year 1994, the government had realised the impact of the exemption, and, believing that increasing the minimum exemption amount would reduce over-indebtedness, the Government issued another exemption notice in 1999.[96] Loans of R10 000 or less and which were to be repaid within a period of 36 months were exempt from the provisions of the Usury Act.[97] In addition, the Micro-Finance

[88] Ibid
[89] Louw MK op cit note 82
[90] Bamu P et al pp cit note 68
[91] Louw MK op cit note 82 at 202.
[92] Bamu P et al op cit note 68 at 37.
[93] Ibid
[94] Ibid
[95] Ibid
[96] Shoombie A 'Getting South African banks to serve micro-entrepreneurs: An analysis of policy options' (2010) *Development Southern Africa Journal*.755
[97] Ibid

Regulation Council was set up, to ensure that all credit providers who were offering these small loans were registered providers.[98]

The DTI had mandated the Rudo Research and Training Committee to elicit recommendations on how to protect consumers in credit and micro or personal loan transactions.[99] The committee interviewed 18 different groups of credit consumers,[100] including government consumer desks, trade unions, academics and general consumers. The general consensus was that the exemption notice of 1999, resulted in loans being uncapped, which meant that lenders and credit providers, were in some instances, charging 102 to 200 per cent interest.[101] The conclusion reached was that all interest rates for all loans should to be regulated. This could best be done through creating clear interest rate formulae. However, according to Professor Kelly Louw, in other research that was conducted by DTI in 2003, it was found that under the Usury Act, where there were prescribed interest rates on certain credit products, the credit providers regarded the maximum amount chargeable as the prescribed interest rate.[102] Consumers would still end up being over-indebted because of all of the other costs associated with borrowing money, such as transaction costs and administrative charges.[103] Often credit providers would charge consumers high service fees, in addition to other types of fees.[104] The DTI then proposed that the NCA would prescribe cost of credit: the NCA would prescribe the formulas for calculating interest and would prescribe administrative fees and other costs of credit.[105]

Various weaknesses were identified in the Usury Act, through assessments done in the SMME sector. These assessments included the Business Regulatory Review by Ntsika Enterprise Promotion Agency[106] and the Policy Board for Financial Services and Regulations *Report on SMEs Access to Finance in South Africa*.[107] In 1994, the South African Law Reform Commission had notified the DTI of weaknesses in the consumer credit protection legislation after the commission had seen the information from the SMME reviews.[108] The DTI, which is responsible for the

[98] *AAA Investments (Proprietary) Limited* supra note 72 para 9.
[99] Vessio ML op cit note 79
[100] Louw ML op cite note 82 at 214
[101] Shoombie A op cit note 96 at 756
[102] Louw KM op cit note 82 at 203
[103] Vessio ML op cit note 79
[104] Vessio ML op cit note 79
[105] Louw MK op cit note 82 at 214
[106] Goodwin Groen RP op cit note 87 at 12
[107] Ibid
[108] Goodwin Groen RP op cit note 87

oversight of the credit market in South Africa and particularly, ensuring that access to credit is improved for developmental purposes,[109] felt that there needed to be a review of the credit law. As a result of the problems reported by the South African Law Reform Commission, compounded by a poor legislative framework, the DTI set up a technical committee to undertake a credit law review in 2004.[110] The result of this review was the promulgation of the NCA. It was the technical committee that suggested that the NCA restrict credit provision to natural persons but not to juristic persons.[111] In addition, the committee recommended that the focus of credit regulation should be shifted from price control to the protection against over-indebtedness, and to the regulation of undesirable lending practices. The rationale for this distinction was the belief that if the NCA were to apply to contracts concluded with juristic persons, it would inhibit the flexibility and innovation of SMME finance.[112] In other words, credit providers would be discouraged from lending to microenterprises and other small businesses.

III. PROTECTION AGAINST USURIOUS INTEREST RATES AND COST OF CREDIT FOR JURISTIC PERSONS?

a) Section 6 of the NCA

Juristic persons are excluded from the provisions in the NCA which pertain to the cost of credit[113] Juristic persons include all such (artificial) persons, regardless of their turnover or the amount of the credit agreement.[114] In terms of this section, credit providers are prohibited from charging consumers any cost which is not stipulated in the regulations. This limits charges of interest, service fees and initiation fees. In addition, credit providers may not charge consumers more than the prescribed maximum of credit for a particular credit product as set out in the regulations of the NCA. Importantly this section sets out that credit providers must show consistency in how they calculate the cost of credit for each consumer. In other words, credit agreements for credit products which are substantially similar in the ordinary course of the credit providers' business, must be

[109] Ibid
[110] Goodwin Groen RP op cit note 87
[111] Daniels RC op cit note 69
[112] *Credit Law Review: Summary of Findings of the Technical Committee* (August 2003) ('*Summary of Findings of the Technical Committee*') (also available at *http://www.thedti.gov.za//ccrdlawreview/forward.htm)*
[113] S6 of the NCA.
[114] Ibid

charged with the same interest rate and additional charges.[115] Ergo, consumers must be treated with a degree of similarity.[116] The NCA also introduced the statutory *in duplum* rule, which meant that all amounts which could be charged by the credit provider as accruing during the time that the consumer was in default under the credit agreement might not, in aggregate, exceed the unpaid balance of the principal debt under the credit agreement as at the time that the default occurred.[117] Credit providers are prohibited from unilaterally increasing any service fees or interest rate.[118] They are obliged to notify the consumer of such an increase, setting out the particulars of the charge concerning fees or a change in the frequency of payment.[119] In the case of juristic persons credit providers were given *carte blanche* in determining what rate of interest would be applicable to any or all credit agreements.

d) How does the cost of credit become an issue for juristic persons?

The position of juristic persons regarding the cost of credit was set out in the case of *African Dawn Finance Property Finance (2) (Pty) Ltd v Dreams Travel and Tours (CC) and others*[120]. The issue before the South Gauteng High Court and thereafter the Supreme Court of Appeal (SCA) was when an interest rate would be usurious. Dreams Travel, a fashion business of sorts, had required a loan of R5 million to import a particular style of jeans into South Africa. After having been refused the loan by several banks, Dreams Travel then approached African Dawn Finance, who agreed to provide them with the loan, provided that Dreams Travel would agree to the terms set out in the credit agreement in terms of which Dreams Travel would pay an interest rate of 5 per cent per month on the principal debt. If Dreams Travel did not pay the principal debt and the interest by the dates stipulated in the credit agreement, the interest rate would then increase to 6.5 per cent per month.[121] The High Court was seized with the matter when Dreams Travel had not met the payment deadlines and was being charged the higher of the interest rates. [122] The SCA had

[115] S100 (2) of the NCA.
[116] Ibid.
[117] S103(5) of the NCA.
[118] S104 of the NCA.
[119] S104(1)(a) and (b) of the NCA.
[120] *African Dawn Property Finance* supra note 55.
[121] *African Dawn* supra note 55 at para 7.
[122] *African Dawn* supra note 55 at para 11.

set out the pleadings on behalf of the parties in the High Court in its judgment. [123] Dreams Travel sought a declaration that the interest rate of 5 per cent per month was usurious and against public policy, and prayed that the court reduce the interest rate to 15.5 per cent per annum or alternatively subject the remainder of the principal debt to the highest rate payable under the NCA, which they estimated was about 28 per cent per annum.[124] The High Court concluded that what African Dawn was requesting in interest amounted to roughly 78 per cent per annum,[125] and found that this was usurious for two reasons. The first was that even requesting 60 percent per annum was unreasonable, given that it was more than twice the declared maximum permissible interest rate chargeable under the Usury Act and about four times greater than the maximum permissible interest rate under the NCA.[126] The second reason was that the interest rate stipulated was in contravention of public policy and thus unlawful because Dreams Travel, desperately needing the loan after being rejected by other finance providers, had less bargaining power than African Dawn.[127] This meant that the borrower was in a position where it would agree to any terms of an agreement. The High Court then made a finding in favour of Dreams Travel that an interest rate of 28% per annum would be justified.[128]

The SCA overturned the decision of the High Court on the basis that the credit agreement did not fall within the scope of the NCA and that the rate of 28 per cent per annum which was fixed by the High Court, was done so with reference to the maximum annual finance rate set in terms of the Usury Act prior to its repeal.[129] As the Usury Act no longer applied and the NCA did not apply, 28 per cent could not be used a benchmark required by public policy.[130] The SCA had noted previous findings that the mere fact that an amount of interest seemed high was insufficient to render the transaction usurious.[131] The SCA unequivocally stated that there was no definite principle which determined the ground for the application of the common law rule of usury . The common law involved examining whether the transaction has demonstrated extortion, oppression

[123] The original judgment from the High Court could not be located, therefore I refer to the proceedings in the High Court as it is set out in the judgment of the SCA.
[124] *African Dawn* supra note 55 at para 11.
[125] Ibid
[126] As set out in *African Dawn* supra note 55 para 17.
[127] As set out in *African Dawn* supra note 55 para 31.
[128] *African Dawn* supra note 55 at para 14.
[129] *African Dawn* supra note 55 para 17.
[130] Ibid
[131] *African Dawn* supra note 55 at para 19.

or something akin to fraud, which were not capable of an easy or exact definition.[132] Therefore, the SCA found that there was no fixed customary rate, which could be used as a standard to determine when an interest rate would be usurious.[133] The sole issue was the impact that the interest rate would have on the credit provider and on the provider's risk and profit.[134] The general position was that the juristic person bore the onus of proving there was extortion, oppression or something akin to fraud, failing which the court would assume that the loan was worth the rate of interest fixed to the borrower.[135] The SCA took the view that courts would focus on the need for social and commercial certainty when asked to declare that any particular rate of interest is illegal.[136] This required that interest rates be charged according to the risk to the lender, which was dependent on the amount of security the borrower could provide.[137] The SCA concluded that a court could not by a mere decision or a series of decisions authoritatively declare what a usurious interest rate would be.[138] For a court to do so, would run counter to the spirit, purport and objects the Constitution.[139]

Both the High Court and the SCA judgments in *African Dawn* failed to acknowledge that the NCA was not excluded because the sum of the credit agreement was too large or because of the asset value of the entity exceeded R1 million, but the NCA was excluded from the interest rate cap because Chapter 5, part C of the NCA did not apply to any juristic entity. In my view, the courts failed to read the NCA thoroughly. In neither judgment was the exclusion of juristic persons from Chapter 5, part C mentioned. The fact that the judiciary has overlooked this might indicate that the exclusion of juristic persons from this section is arbitrary. In my opinion, the High Court followed the correct approach in determining whether the interest rate applied was usurious, and it was correct to look to the NCA to determine what would be an acceptable interest rate, given public policy.[140] Surely, the NCA provides an indication of what constitutes the public interest. The SCA stated that the interest rate prescribed by the NCA on short term agreements would be a better comparator than the 28 per cent interest rate. However, I am unable to see how this is a

[132] *African Dawn* supra note 55 at para 29.
[133] *African Dawn* supra note 55 at para 26.
[134] Ibid
[135] Ibid.
[136] *African Dawn* supra note 55 at para 27.
[137] *African Dawn* supra note 55 at para 30
[138] *African Dawn* supra note 55 at para 26
[139] *African Dawn* supra note 55 at para 27.
[140] *African Dawn* supra note 55 para 12 and para 17.

better comparison given that short term credit agreements in terms of the NCA are capped at a maximum of R8 000, which is to be repaid within six months. Dreams Travel had taken out a loan of R5 million, stating the purpose of the loan to be for business development. The NCA was enacted to alleviate over-indebtedness and to create a credit market that was accessible to all South Africans after a period in which these interests were not protected. The interest rate formulas that it provides are an indication of the maximum rates that can be charged before a transaction is deemed reckless or condemning a consumer to a position of over-indebtedness. In addition, the High Court had looked at the bargaining power of the borrower, whereas the SCA had ignored this element despite its supposed concern for the transformation of contract law . Bargaining power should be a relevant circumstance in determining when an interest rate is usurious. In addition, the SCA pointed out that the interest rate would depend on the risk to the credit provider, which in turn depended on the security provided by the creditor. The members of Dream Travel had signed three credit guarantees, all of which were for their personal property.[141] Despite the guarantee, the credit provider still charged an interest rate that amounted to 78 per cent per annum. The finding by the SCA is flawed in my opinion in that it unequivocally protects the interests of commercial certainty for credit providers at the cost of protecting SMMEs and other owners of SMMEs.

The protection offered under the NCA to natural consumers, in contrast to the common law position available to juristic persons, results in great social and economic injustice. Natural persons have certainty as to what interest rate they can be charged, the service fees and initiation fees. Natural consumers are protected by the statutorily enforced *in duplum* rule. Juristic persons lack certainty when they enter into credit contracts. In the result that juristic persons enter into credit agreements on unfavourable terms and the only way to challenge this, is through costly litigation. However, the SCA judgment in *African Dawn*, suggests judicial unwillingness to rule on the fairness of interest rates. The exclusion of juristic persons from the NCA also makes it difficult for courts to apply standards of equity and fairness to credit transactions. As explained earlier, interest rates were capped because of the effect that uncapped interest rates had had on the levels of over-indebtedness. This was an injustice that was faced by natural consumers and juristic persons. The distinction between the two in the NCA seems quite superfluous when juristic persons are often controlled by a single natural person who uses personal means to finance the operation of the SMME. In fact, the distinction would incline South African citizens to obtain loans in their

[141] *African Dawn supra* note 55 at para 4.

personal capacity rather than in [142] the name of the juristic entity, particularly in the case of microenterprises.

In the interest rate formulas provided in the regulation, 'RR' represents the current repurchase rate which is used by the Reserve Bank of South Africa − this rate is currently (January 2019) 6.75%. If a natural consumer takes out a loan for the development of a small business or an unsecured credit transaction, the maximum interest rate payable will be [(6.75 x 2.2) + 20%] per year.[143] In addition, on these two types of credit products, the consumer will pay the following maximum fees: On unsecured credit transactions:

a) R150 per agreement, plus, 10% of the amount of the agreement in excess of R1 000;

(b) But never to exceed R1 000.[144]

Developmental credit agreements for the development of a small business:

a) R250 per credit agreement, plus, 10% of the amount of the agreement in excess of R1 000;

(b) But never to exceed R2 500.[145]

If people seek out personal loans to fund SMMEs, they are likely to become over-indebted and have to seek debt restructuring orders, which will then exclude them from obtaining any further finance. For most SMEs which require much larger amounts of finance it would be very risky to secure their debts with personal property, as seen in the *African Dawn case.* SMMEs, under both the common law and the NCA, are offered little chance to finance their businesses affordably thus precluding their growth and expansion.

IV. PROTECTION AGAINST RECKLESS LENDING FOR JURISTIC PERSONS?

a) The Position of the NCA on Reckless Lending

Credit providers must take reasonable steps to assess whether a potential borrower fully understands the potential risks and costs of the proposed credit agreement, as well as their rights and obligations under the agreement.[146] The assessment should take into account the consumer's

[142] Interest rate as of 2018
[143] Regulations of the Natural Credit Act.
[144] Ibid
[145] Ibid
[146] S81(2)(s)(i) of the NCA.

debt repayment history, his/her existing means, prospects and obligations.[147] Where the credit provider has failed to conduct this assessment, the credit agreement will be deemed one of reckless lending by the court.[148] A credit agreement will also be deemed reckless lending where, despite the preponderance of information indicating to the credit provider that the borrower did not understand or appreciate the nature, risks, costs, obligations, or that entering into the agreement would have made the borrower over-indebted, the provider concluded the agreement.[149] Where credit is granted recklessly in either of these circumstances, the court can make an order setting aside all or part of the consumer's rights and obligations under the agreement or can suspend the force and effect of the agreement.[150] If the consumer is over-indebted at the time of the court hearing, the court can order the restructuring of the borrower's obligations under any other credit agreement that the borrower has entered into.[151] Over-indebtedness has become a legally applicable concept as a result of the NCA, in terms of which a court can make a finding that a borrower is over-indebted, determined by examining whether at the time of the hearing, the borrower is able to satisfy the obligations of the credit agreement, taking into consideration the borrower's financial means, prospects and obligations.[152] Stephan Renke et al, make the argument that the provisions in the NCA which prohibit certain marketing practices are intended to prevent consumers becoming over-indebted.[153] by disallowing consumers to take up credit which they cannot afford. In addition, these authors state that whilst the *in duplum* rule is intended for the same purpose,[154] juristic persons are excluded from the provisions of negative marketing regardless of the annual turnover.[155]

A court assessing a borrower's 'financial means, prospects and obligations' will consider the estimated future revenue of the commercial or business venture for which the debt may have been incurred.[156] According to ML Vessio, this means that credit providers will have to analyse the risk factor of the new enterprise, which may include a feasibility study, in order to assess

[147] S81(2)(a)(ii) of the NCA.
[148] S83 of the NCA.
[149] Ibid.
[150] S83(2)(a) and (b) of the NCA.
[151] S83(3)(b)(i) of the NCA.
[152] S79(1)(b) of the NCA.
[153] Renke S et al op cit note 67.
[154] Renke S et al op cit note 67
[155] S78(1) of the NCA.
[156] 78(3)(c) of the NCA.

whether financing the consumer will entail reckless credit.[157] This is perhaps a way in which natural consumers who own businesses might be protected. This supports my proposition that more people will take out personal loans to protect themselves in the event of business failure. Conversely, protection of personal assets by using the vehicle of a juristic entity to take credit, is often rendered nugatory as sole owners often sign as sureties for the loans of the juristic entity, resulting in credit providers first claiming the debt from the surety before the juristic entity is declared as insolvent.[158] Micro and small business would be better advantaged by taking out personal loans, because a juristic entity does not have the advantage of the provisions regarding both over-indebtedness and reckless lending. Therefore, it is of little relevance to them whether credit providers undertake an assessment of their business.

Vessio argues further that the fact that the reckless lending provisions do not apply to juristic persons means that the NCA creates a loophole for abuse by 'desperate' non-juristic persons seeking credit by incorporating a company or forming a partnership, which is not a difficult task, enabling them to gain access to credit within 'the guise of the corporate veil' where it has been denied to a natural person.[159] The corporate veil protects the natural person from liability for debts incurred by the business on insolvency under the doctrine of limited legal liability. Therefore, according to Vessio, loans can be taken for consumptive purposes under the guise of a business loan. This is relevant to the discussion because it underlines how little support the NCA affords juristic persons. Natural persons will only be enticed to form companies to open the door to obtaining loans from reckless credit providers. Even if the natural person is theoretically protected by the concept of limited legal liability, in practice, the owner will be liable as surety on insolvency. It would be in the best interests of the business owner to take out a personal loan rather than a loan in the name of the business as they would have more effective recourse against the credit provider in terms of the NCA.

[157] Vessio ML 'Beware the provider of reckless credit' (2009) *TSAR* (2). 274
[158] Stoop PN et al 'the national credit act regarding suretyships and reckless lending' PELJ 2011 (14) (2). 67
[159] Vessio ML op cit note 157 at 277

V. HOW ARE JURISTIC PERSONS ABLE TO PROVIDE SECURITY FOR A CREDIT AGREEMENT?

As set out in Chapter one, the NCA will not apply to juristic persons, in two instances. The first is when the annual turnover or monetary asset value of that juristic person does exceeds R1 million, and the second is when the annual threshold of the juristic person is below R1 million but the credit advanced exceeds R250 000.[160] For small and medium enterprises this is particularly problematic because where their main agreement does not fall under the scope of the NCA, ancillary agreements will not be covered by the provisions of the NCA.[161] This raises other questions. If a microenterprise takes out a loan which constitutes a smaller or medium agreement, their ancillary agreements will also be governed by the NCA. However, where the microenterprise in itself is not covered by the provisions of cost of credit, reckless lending and over-indebtedness, does it mean that the credit guarantee will also not have these protections, despite the main agreement falling within the scope of the NCA. Under section 8(5) of the NCA, a credit guarantee is defined as that which, in terms of the agreement, a person undertakes to satisfy upon demand any obligation of another consumer in terms of a credit facility or a credit transaction to which the NCA applies. This section does not state 'the *extent* that the NCA applies to the main agreement (author's emphasis). There is therefore an ambiguity created even for personal guarantors of small and medium loans. When a credit agreement is concluded with a juristic person, the credit guarantee will be provided by a natural person in most instances. The purpose of a credit guarantee is to provide a credit provider with a form of security that, should the principal debtor – in this case the SMME – default on the repayment of the loan, that the credit provider would be able to recover their money from another party.[162] The person who stands as a surety for the debt of a juristic person is a member of that juristic person but despite being a natural person is offered no protection under the NCA in respect of the large amounts loaned to the juristic person. In the discussion that follows, I have identified two High Court judgments which examine the fairness of this differentiation and the constitutionality of these sections.

[160] S4(1)(a) and S4(1)(b) of the NCA.
[161] S4(2)(c) of the NCA.
[162] Renke S et al op cit note 67

In the case of *Standard Bank of South Africa Ltd v Hunkydory Investments 194 (Pty) Ltd*[163], the constitutionality of the sections in the NCA which treat juristic persons differently to natural consumers was brought into question. In particular the defendants argued that the section which stated that the NCA only applied to a surety agreement if it applied to the primary agreement was unconstitutional in relation to juristic persons because there was already limited application of the NCA to a credit agreement concluded with a juristic person. This meant that sureties for juristic person credit agreements were given less protection than any other surety. The court held that the essence of the NCA was to prevent the reckless extension of credit from credit providers to consumers who could not afford the credit.[164] The court went on to deal with the constitutionality of the exclusion of juristic persons through the lens of section 9 of the Constitution.[165] In determining this question, the court applied the well-known *Harksen v Lane*[166] [1997] ZACC 12 dictum that where a provision results in differentiation between people or classes of people, it will not fall foul of the equality provision if it can be shown that there is rational connection between the differentiation in question and the legitimate governmental purpose for which that provision was enacted to further or achieve[167] If this rational connection can be shown then there is no breach of section 9 of the Constitution. The court then concluded that there was a rational connection to the purpose for which these provisions were enacted.[168] The court did not set out what the government purpose was for this differentiation. The court simply ended the matter by holding that the defendants had raised no defence of merit.[169]

In *Absa Bank Ltd v Lowting and others,*[170] individual members of a close corporation named Pradz Trading CC approached Absa Bank for a loan. The amount borrowed exceeded R250 000.[171] The NCA therefore, did not apply to the principal debt. Absa Bank had, however, furnished these members with a number of documents to sign without explaining to them the legal implication of such documents.[172] In addition, Absa Bank had failed to provide Pradz Trading with

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[163] *Standard Bank of South Africa Ltd v Hunkydory Investments* 194 (Pty) Ltd and Another (6408/2008) [2008] ZAWCHC 125; 2010 (1) SA 627 (C) (10 October 2008)
[164] *Standard Bank* supra note 163 at para 20
[165] The Constitution of the Republic of South Africa, 1996
[166]*Harksen v Lane* (1997) 12 CC
[167]*Standard Bank* supra note 163 para 22
[168] *Standard Bank* supra note 163 para 26
[169] *Standard Bank* supra note 163 para 27
[170] *Absa Bank Ltd v Lowting and Others* (39029/2011) [2013] ZAGPPHC 265
[171] *Absa Bank* supra note 170 at para 1.
[172] *Absa Bank* supra note 171 at para 55.

a pre-agreement disclosure, as required by section 92 of the NCA.[173] One of the documents that was signed was a personal suretyship for the debt incurred by Pradz Trading CC.[174] The juristic entity defaulted on its repayment of the loan and Absa Bank lodged a claim against the sureties. However, the NCA was found not to apply to the credit guarantee on account of the provisions section 8(5). This meant that Absa Bank could institute legal proceedings against these members without giving them notice or following any other debt recovery procedures.[175] In dispensing with the matter, the court *suo motu* raised a number of concerns over the constitutionality of section 4(1) and 4(2)(c),. The court set out the equality provision of the Constitution and the purposes of the NCA. It then went on to say:

> 'The circumstances of this case demonstrate that the specific goals of the NCA are not achieved when sureties, in the position of the defendants . . . are not protected by its provisions. In the opinion of the court, this issue should enjoy judicial scrutiny.'[176]

This decision highlighted the imbalance of power between credit providers and owners of SMME's. The court found that the members who had signed the surety agreement had no matriculation certificate and did not understand the processes of banks, *despite* the fact that they were members of a close corporation (court's emphasis).[177] The Court stated that this was the defendants' first foray in business and they would have not known any better that they were signing as sureties; they did not even have the funds to be a surety.[178] This case is a salutary reminder that the purpose of the NCA is to protect consumers from being exploited, particularly those previously disadvantaged by lack of education. However, by not protecting juristic persons, the NCA allows for credit providers to take advantage of these natural persons. Without full credit assessments, individuals are coaxed into signing their personal assets over and are then offered no protection by the NCA. The High Court summed up this issue well when it said:

> 'The court observes that [it] seems to defeat the objects of the NCA when sureties and co-principal debtors who are natural persons, have no protection when a bank enters into large agreement with a juristic entity which is a mere shell (as in this case). In such circumstances where the sureties and co-principal debtors, more often than

[173] Ibid.
[174] *Absa Bank* supra note 171 at para 53.
[175] As set out in S129 and S130 of the NCA
[176] *Absa Bank* supra note 171 para 51.
[177] *Absa Bank* supra note 171 at para 128
[178] *Absa Bank* supra note 171 at para 57.

> not are natural persons, the banks may see a loophole to advance exorbitant amounts of credit to juristic entities such as close corporations and have the members sign suretyship and co-principal debtor agreements in the full knowledge that they will not be able to repay the credit granted. The court takes judicial notice of the fact that close corporations are often the vehicle utilized to conduct business by individuals with small businesses limited means. This is an issue which should be further investigated by the courts.'[179]

An important point set out by the High Court in this case was that institutions, specifically banks, should welcome the framework of the NCA as a means of bridging the socio-economic inequalities in a *substantive* manner (court's emphasis). The NCA should be used as means of reforming the credit industry, if for no other reason than to remedy sustained inequalities which lead to unrest and social instability. These things the court says are in no way good for the development of business.[180] The *Lowting* case marks a significant shift in judicial thought, compared to the *Hunky Dory* case. The former highlights the need to protect individual business owners. More importantly, through doing so, it allows the SMEs to borrow larger sums of money. As set out earlier, even under the Usury Act, SMEs required larger loans than microenterprises but credit providers were always skeptical about lending these amounts. In the current trend, it would seem that credit providers, even established banks, are willing to lend to these SMMEs. However, the catch is that the members of these juristic persons are standing surety for the debts, rendering vulnerable their personal assets should the surety agreement be enforced and the assets (usually their homes) sold in execution. In the case of large loans, the guarantee enjoys no protection from the NCA, but in practice the bank's that lend large amounts will offer the same protection to large loan sureties, as they do for small loan sureties, even though there is no statutory obligation to do so. This applies both to pre-agreement notifications as well as notification of a claim being instituted against the guarantor. For small loan sureties, we need to go a step further than this. The protection offered to small loan sureties needs to include being protected with the provisions on reckless lending, over-indebtedness and cost of credit. Most SMMEs' owners are people who were previously disadvantaged and lack the best financial knowledge. By protecting these individual

[179] *Absa Bank* supra note 171 at para 55.
[180] *Absa Bank* op cit note 171 at para 78.

business owners, it means that credit providers will have to start undertaking reasonable assessments of the juristic persons prospects of repaying the loan.

VI. CREDIT AGREEMENTS FOR THE DEVELOPMENT OF SMALL BUSINESSES

The NCA creates a special category of credit agreements, namely 'Developmental Credit Agreements', which are treated differently to the credit agreements listed under section 8.[181] Developmental agreements are defined in the NCA as 'an agreement which satisfies the criteria set out in section 10.[182] This section provides that a developmental credit agreement can only be extended by a provider who has registered as such, in terms of section 41 of the NCA and where that agreement is for the purposes of developing a small business.[183] Credit agreements for the development of a small business, remain an unexplored field in South African economic and legal academia. In terms of the NCA, a credit provider who purports to provide developmental credit must apply for such registration to the National Credit Regulator (the NCR).[184] In terms of this section, credit providers who are already registered in terms of section 40 of the NCA must apply for supplementary registration as a developmental credit provider. The NCR is tasked with setting out the conditions under which a developmental credit provider may be granted a licence.[185] However, in setting these conditions, the NCR must keep in mind the need to create an accessible credit market, which is responsible, effective and efficient in serving the needs of previously disadvantaged persons and low-income persons and communities.[186] Developmental credit providers have different responsibilities to ordinary credit providers. The NCR may determine that the forms used by the developmental credit provider satisfy the section 61 requirement that they be written in a plain and ordinary language. In addition, this class of credit provider may not have to report to the national credit register when it enters into a credit agreement.[187] This means that, if the NCR is satisfied, the credit provider will not have to furnish the details of the people or juristic persons to which it provides credit.[188] The operation of the developmental credit provider

[181] S10 of the NCA
[182] S1 of the NCA.
[183] S10 of the NCA.
[184] S41 of the NCA
[185] S13(b) of the NCA
[186] S13(a)(i) and (ii) of the NCA.
[187] S69(6) of the NCA.
[188] S69(6) of the NCA.

is largely left to the discretion of the NCR. For example, the prohibitions on negative marketing practices don't apply to this group of lenders, if the NCR has pre-approved a form of advertising to be used by the credit provider concerned. That credit provider may then only use that form of advertising.[189] In addition, the NCR may pre-approve evaluative mechanisms that the credit provider uses to conduct his reasonable assessment of the borrower's ability to fulfill the obligations under the credit agreement.[190] The consumer of developmental credit is protected under the cost of credit provision, specifically with regard to varying interest rates, which is impermissible in a developmental credit agreement.[191] However, as set out earlier, the interest rate that is applicable to developmental credit agreements is the maximum interest rate allowed by the NCA.

Developmental credit agreements for small businesses could be used as a tool to profitably serve the microenterprise sector. This is because these agreements are protected under the reckless credit and over-indebtedness provisions and the interest rate is capped. In my opinion, the NCA needs to delineate when a developmental loan agreement differs from an ordinary loan extended for the purpose of the business: ie is it developmental only when the entity is first beginning its operation, or can a microenterprise approach the provider when it merely requires more capital to grow? Where more developmental agreements are used to service the microenterprise sector, it would force the credit providers to make reasonable assessments of the viability of the business. The power of the NCR to create a more responsible credit market for developmental credit agreements would open the way for prescribing guidelines as to which types of start-up enterprises should be granted credit. This could increase opportunities for more manufacturing and technology based businesses to open, which would in turn promote the business economy of South Africa.

VII. CONCLUSION

The discussion in this chapter illustrates how the credit protection of juristic persons has weakened since the demise of the Usury Act, under which juristic persons were treated much like natural persons with regard to uniformly enforced interest rate caps and prescribed formalities. However, the technical committee excluded juristic persons from most of the important forms of protection

[189] S76(6) of the NCA.
[190] S82(2) of the NCA
[191] S103(4) of the NCA.

offered by the NCA. Whilst credit providers are supposed to lend to juristic persons by virtue of the fewer formalities involved, microenterprises and small businesses need legal protection to sustainably grow (ie without risking personal assets or becoming over-indebted as a result of the high interest rates). As much as courts have justified the usurious interest rates charged by credit providers in transactions with SMEs, the owners of the juristic persons with which the credit agreement is concluded are also taking a risk and are more likely to be financially vulnerable than the credit provider. In addition, if the law were to ensure that loans were not granted recklessly to juristic persons , it would in my opinion, increase the chances of SMMEs being able to get larger companies to provide security for the loan. If a large company can see that a credit provider is willing to support the developmental needs of a micro or small entity, it is more likely that a larger company will also see value in partnering with the business. The lowering of risk would also result in decreasing the cost of credit on the principal debt. Decided cases suggest that courts are driven to make conservative judgments in the interest of legal and commercial certainty. However, the *obiter* comments from the judges in all the cases mentioned suggest that there is a need for the law to consider the socio-economic reality in which the juristic persons and their owners, find themselves.

CHAPTER 3

I. INTRODUCTION

Prior to 1968 the Australian government had not given much attention to the small business sector, as its significance to the economy had not been recognised.[192] In 1968, the first expert group was appointed by the Australian government to explore the issues facing small businesses and the ways in which the government could assist small businesses improve efficiency. This was a landmark inquiry and the report it generated is known as the Wiltshire Committee Report.[193] This report has become the basis upon which many public policy considerations for small businesses are based. Of significance was the recommendation that the role of government intervention should be a motivational one, by which the government was encouraged to create institutions which were focused on motivating the managers of small businesses.[194] The Australian government reacted to this submission by developing specific schemes to assist small businesses, most notably the Business Enterprise Centres, embracing income assistance for unemployed persons starting their own business ventures. These schemes assessed the viability of the businesses and provided income for these persons for up to a year to allow for the individual to focus on growing the business; issued loan guarantees for small businesses seeking additional finance and provided business incubators.[195] From what I have observed in my research, the Australian government has had little role in financing small businesses. Nonetheless, the schemes adopted by the Australian government were successful in allowing small businesses to flourish, with a growth from 550 000 small firms in 1984 to about 2 million small firms in 2016.[196]

In this chapter, I will provide an overview of the small business sector of Australia, focusing on the contribution of these businesses to the GDP and employment rate. Worth noting are the sectors in which the small businesses have proven to be most successful. Thereafter, I shall explore lending to small businesses and the regulatory framework which governs this practice. I highlight the policy reasons for protecting small businesses in credit lending transactions and the reasons why small businesses are treated distinctly from individuals, touching on the protection

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[192] Schaeper M ' A brief history of small businesses in Australia, 1970-2010' (2014) 2(1) *Journal of Entrepreneurship and Public Policy*, 222.
[193]Known as the Wiltshire Report tabled in 1971.
[194] Schaeper M op cite note 192 at 226.
[195] Schaeper M op cite note 192 at 229.
[196] Schaeper M op cite note 192

available to individual consumers. It is of particular interest to gauge the way the rules applicable to individual consumers under the National Consumer Credit Protection Act[197] (NCCPA) and the National Credit Code (NCC), have been modified in their application to small businesses albeit under a different regulatory framework.

II. OVERVIEW OF SMALL BUSINESSES IN AUSTRALIA

The Australian business economy is made up of 2 million small businesses, according to the most recent study conducted by the Australia Bureau of Statistics.[198] In terms of this report, a small business is defined as that which either has an annual turnover of less than A$2 million or a business which has less than 20 employees. This definition means that businesses with more than 20 employees but with a turnover of less than A$2 million will still be considered to be a small business. In addition, this report focuses on those businesses which are registered with the Australian government and which are responsible for paying a goods and service tax (GST).[199] For the purposes of the Australian Bureau of Statistics, small businesses include microenterprises which employ 0-4 employees. However, 'nano-businesses', which are those that do not pay any GST and do not have any employees, are excluded from this count.[200]

The 2 million small businesses, accounted for 93 per cent of all Australian businesses, when considered according to their turnover of being less than A$2 million. Roughly 80 per cent of the small businesses are microenterprises and 7 per cent of all businesses in Australia have a turnover greater than $2 million.[201] Most of the small businesses (roughly 61 per cent) have a turnover which is more than A$50 000 but less than $200 000 per annum.[202] In addition, small businesses account for 97 per cent of the total employment of all Australian businesses.[203] Medium sized firms − employing more than 20 people but less than 199 people − account for 2.4 per cent of the total employment.[204] Large firms, employing more than 200 people, account for 0.2 per cent

[197] National Consumer Credit Protection Act 2009 (NCCP Act). It came into force on 1 April 2010.
[198]The Australian Small Business and Family Enterprise Ombudsman 'Small Business Counts, Small Business in the Australian economy' (2016)
[199] Wiltshire Report op cit note 193 at 7.
[200]Gillfillan G, 'Definitions and data sources for small business in Australia: a quick guide' (2015) @ https://parlinfo.aph.gov.au/parlInfo/download/library/prspub/4228541/upload_binary/4228541.pdf;fileType=application/pdf on 25 November 2018.
[201] The Australian Small Business op cit note 198.
[202] Ibid
[203] Wiltshire Report op cit note 193 at 9.
[204] Wiltshire Report op cit note 193 at 8.

of total employment.[205] Small businesses account for 33 per cent of Australia's GDP and are responsible for employing 40 per cent of the workforce.[206] The small business sector has the greatest contribution to the GDP in the agriculture, forestry and fishing industries, followed by the construction, real estate, rental and hiring services and the professional service industry.[207] In these industries, small businesses add more value to the GDP than the medium and large sector.[208]

As a result of the contribution that small businesses make to the Australian economy in terms of both value add and employment, the extension of credit to these businesses, is seen as an important act.[209] A small business loan is one that does not exceed A$2 million.[210] In 2016, the Australian Bankers Association produced an economic report on the small business sector in Australia, in which it made the following conclusions[211]:

- Interest rates to small businesses were at a generational low.
- The loans that were to be repaid by small businesses were less than A$100 000.
- Almost half of all small businesses had a loan facility other than a credit card.
- There were about one million small business loans granted by Australian banks, which amounted to A$251 billion owing to banks.

III. WHY REGULATE CREDIT TO SMALL BUSINESSES?

From an economic perspective, small businesses in Australia are successful. Defaulting on loan repayments and over-indebtedness are not common issues faced by small businesses.[212] Historically, they have faced the challenge of unequal bargaining power with the credit provider.[213] The small business might agree to standard-term contracts when desperate for a loan, and little information might be made available to the small business before concluding the loan agreement.

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[205] Ibid
[206] Wiltshire Report op cit note 193 at 6.
[207] Wiltshire Report op cit note 193 at 12.
[208] Wiltshire Report op cit note 193 at 13.
[209]Andrew Godwin, Jeannie Paterson and Nicola Howell 'Credit for Small business, an overview of Australian Law regulating small business loans', (2017) 1.
[210] Australian Bankers' Association, Economic Report 'The small business sector in Australia', (May 2016), available at *https://www.ausbanking.org.au/images/uploads/ArticleDocuments/134/AB126420_Economic_Report__Small_business_sector_in_Australia_-_May16.pdf* accessed on 15 November 2017.
[211] Wiltshire Report op cit note 193 at 8.
[212]Phil Khoury, 'Independent Review – Code of Banking Practice' (2017). 50.
[213] Parliamentary Joint Committee on Corporations and Financial Services, 'Impairment of Customer Loans'. Executive Summary

Small businesses in general are often owned and operated as sole traders, which means that one individual is liable for the debts of the business.[214] Alternatively, small businesses are undertaken through a company in which there is a single shareholder or the shareholders are made up of a family.[215] In Australia a company is a separate legal entity, meaning that the shareholder[s] is offered limited liability protection in respect of the debts of the company. However, this does not preclude the shareholder (who is often the director as well) from being personally liable for debts of the business for which he may have signed for as a surety.[216] In many cases, this security is granted against personal assets such as the shareholder's family home.

Standard loan agreements imposed on these small businesses and their owners unilaterally have benefited the credit provider. Unlike large enterprises, small businesses owners often lack the expertise needed to negotiate their loan terms and have limited resources to seek financial and legal advice to assist in this process.[217] This asymmetry of information between the credit provider and the small business had the result that the loan agreement was often written in terms which were most favourable to the credit provider.[218] The implication of this is that risk is shifted from the lender to the borrower.

The regulatory framework which protects small businesses in credit lending transactions was adopted upon consideration of a need for a balance between protecting the interests of small businesses whilst still ensuring that the commercial interests of the credit providers are adequately protected.[219] This balance is particularly relevant in the case of start-up businesses where there is no established track record in terms of cash flow or profit.[220] A further consideration was that the small businesses required different and a greater diversity of transactions than an ordinary consumer of credit. Small businesses often require repeat transactions and perhaps a variation in the size of the loan.[221] Therefore, the ordinary protection which exists for ordinary consumers in NCCP and NCC would be irrelevant or inappropriate for small businesses.

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[214] Godwin A et al 'Credit for Small business, an overview of Australian Law regulating small business loans', (2017)1
[215]Ibid
[216]Ibid
[217]Phil Khoury, op cit note 212
[218] Ibid
[219] Ibid
[220]Phil Khoury, op cit note 212 at 49.
[221] Godwin A et al op cite note 214.

IV. HOW ARE INDIVIDUALS PROTECTED?

The NCCPA was enacted on 1 July 2010. The NCC is the first schedule of the NCCPA and together they form the first national consumer credit legislation in Australia. Prior to 2010, each state had its own consumer credit legislation with provisions similar to those the NCCPA and NCC. The NCCPA and the NCC apply to the provision of credit if and when the credit contract is entered into or proposed to be entered into, and the following is applicable:[222]

- The debtor is a natural person or a strata corporation; and
- The credit is provided or intended to be provided wholly or predominantly:
  (i) for personal, domestic or household purposes; or
  (ii) to refinance credit that has been provided wholly or predominantly to purchase, renovate or improve residential property for investment purposes; and
- There is a charge to be made for providing the credit; and
- The credit provider provides the credit in the course of a business of providing credit carried on in this jurisdiction or as part of or incidentally to any other business of the credit provider carried on in this jurisdiction.

There may be instances in which the predominant purpose of the loan was for personal purposes but that in some way the loan was also used for business purposes.[223] A common example of this is when a loan is taken to purchase a motor vehicle which is to be used for both private and business purposes. The credit provider may protect itself from the application of the NCCPA and NCC, by ensuring that the consumer signs a business declaration.[224] If more than half of the credit that was extended is used for business purposes, the NCC does not apply.[225] In some instances, credit providers coax vulnerable consumers into signing a business purpose declaration so that they may avoid having to comply with the NCC. However, if a credit provider knew or could reasonably be construed as knowing that the purpose of the loan was for personal, domestic or household utility

[222] S5 of the NCC.
[223] Legal Services Commission of South Australia 'Laws that protect consumers when borrowing @ https://www.lawhandbook.sa.gov.au/print/ch10s04.php accessed on December 10 2018.
[224] S13 of the NCC.
[225] S5(4) of the NCC.

and they allowed the consumer to make such a declaration, there would be an offence committed.[226]

The NCCPA and the NCC impose a responsible lending regime on credit providers. The purpose of these obligations, it to reduce the number of prejudicial or inappropriate loans being advanced to consumers. Before entering into a credit contract with a consumer, the credit provider must undertake an assessment as to whether the credit contract will be suitable for the consumer.[227] This assessment should include:

- Making reasonable inquiries about the consumer's requirements and objectives in relation to the credit contract;
- Making reasonable inquiries about the consumer's financial situation; and
- Taking reasonable steps to verify the consumer's financial situation.

A credit contract will be unsuitable for a consumer if it is likely that the consumer will be unable to comply with his/her obligations under the contract or could only comply with the obligations if they incurred substantial hardship.[228] Substantial hardship would occur where the consumer could only comply with the obligations under the contract if the consumer had to sell his/her principal place of residence.[229] This provision in the NCCPA therefore directly addresses the issue of asset-based lending. This is when the lender advances money to a consumer without conducting a proper assessment into repayment of the loan but nevertheless finds safety in there being some equity available should the consumer default on the loan.[230]

V. SMALL BUSINESSES REGULATED UNDER THE NCCPA AND THE NCC

In 2012, the Australian government undertook reform of its financial and credit regulation, an aspect of which pertained to extending the protection under the consumer credit regime to small businesses.[231] The green paper highlighted credit fees, misrepresentation by credit providers and failure by credit providers to follow the instructions given by the consumer as reasons why the

[226] Godwin A et al op cite note 214
[227] S28 of the NCCPA.
[228] S131 of the NCCPA.
[229] S131 (3) of the NCCPA.
[230] Godwin A et al op cite note 214.
[231] *National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012.*

consumer credit regime should be extended to small businesses.[232] The proposals included, creating a new credit regime specifically tailored to small businesses or having limited application of the current regime, under the NCCPA, extended to small businesses.[233] The credit providers argued that extension of the existing consumer regime to small businesses would result in small businesses having to pay more for credit and would diminish the accessibility of the credit market.[234] Businesses required funds for growth, whereas individuals required funds for consumption purposes.[235] The assessment required for business risks was therefore substantially different to the assessment required for consumption lending.[236] Consumers run into financial difficulties by reason of unemployment, illness or over-extension. Businesses run into financial difficulties often for more complex reasons. This meant that the responsible lending regime under the NCCPA was not so easily extended to businesses.[237] Credit providers would have to incur a greater cost in assessing the suitability of a small business consumer for credit as there were more variables to consider than with an individual consumer.[238] This would mean increased cost for the small business. The proposed amendment of the NCCPA and the NCC included credit providers having to obtain a separate licence to provide small business loans.[239] In 2013, the Australian government announced that it would not make any change to the legislation, a major reason being that there had been no market failures under the current credit regime that protected small businesses. In doing so, Australia followed the leading countries in the world, such as America, where there consumer credit acts only apply to natural persons and specifically exclude small businesses.[240]

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[232] Ibid
[233] Ibid
[234] Beaty A et al 'Consumer credit & privacy reform agenda (part 2 of 2)' (February 2012) *Australian Law and Finance Bulletin* 122
[235] Deitz A et al 'Applying consumer principles to small business lending: a solution without a problem' (December 2012) *Australian Law and Finance Bulletin* 118.
[236] Ibid
[237] Ibid
[238] Ibid
[239] *National Consumer Credit Protection Amendment* op cit note 231
[240]Cantore and Marshall 'Businesses are people too' (2014) 42 *Australian Business Law Review* 113 at 116

VI. HOW ARE SMALL BUSINESSES PROTECTED?

There is no single comprehensive credit consumer legislation framework in Australia which applies to small businesses. From a regulatory perspective, small businesses are supported by a framework which focuses primarily on the underlying credit contract and the circumstances which led to the conclusion of the contract. Although the general law of contract applies (the common law principles) to a large extent, the Australian legislature has tried to create certainty for small business consumers by enacting the rules applicable to small business credit contracts and individual consumer credit consumer contracts. The Australian Securities and Investment Commission Act (ASIC Act),[241] sets out rules pertaining to unfair contract terms and unconscionable conduct. The ASIC Act, is complemented by Code of Banking Practice (COBP), an industry code which legally binds its signatories. The COBP is a valuable piece of soft law and is relied on by most consumers in resolving disputes with banks. In addition to the COBP and the ASIC Act, it is mandatory for banks to adopt an external dispute resolution body[242] responsible for resolving any dispute between that bank and consumer. There are two external dispute resolution options for banks: the Credit Ombudsman Service Limited and the Financial Ombudsman Service (FOS). Most credit providers in Australia use the Financial Ombudsman Service to resolve disputes.

The ASIC Act and the COBP follow the same definition of small business ie both legal instruments are applicable to businesses which have fewer than 100 employees if it is a manufacturing business, and otherwise any business with fewer than 20 employees or no employees.[243] It is important to note that there is no monetary threshold regarding the turnover of the business, which makes these pieces of law applicable to small businesses.

VII. ASIC

a) Unfair Contract Terms

The ASIC Act renders a standard contract concluded with a small business void if the contract contains unfair contract terms and the contract was concluded for a financial product.[244] If the contract is ab le to prevail with the unfair terms being severed, the contract will not be rendered

[241] Australian Securities and Investments Act 2001 (Cth)
[242] S 47(1)(i) of the NCCCPA.
[243] S 12BC(1) of the ASIC Act.
[244] S12BF (1) of the ASIC Act.

void.[245] The contract is a small business contract if, at the time that the contract was entered into, the consumer was a business which employed fewer than 20 persons[246], and either the upfront price payable under the contract does not exceed A$300,000[247] or the contract has a duration of more than 12 months and the upfront price payable under the contract does not exceed A$1 million.[248]

A court will consider various factors, in determining whether a contract is a standard form contract.[249] These factors include:

- Whether one party has all or most of the bargaining power relating to the transaction[250];
- Whether the contract was prepared by one party before any discussion relating to the transaction occurred between the parties[251];
- Whether another party was, in effect, required either to accept or reject the terms of the contract[252];
- Whether another party was given an effective opportunity to negotiate the terms of the contract[253]; and
- Whether the terms of the contract take into account the specific characteristics of another party or the particular transaction.[254]

A term of a contract is unfair if it would cause a significant imbalance in the parties' rights and obligations under the contract [255] and such term is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term,[256] and it would cause detriment to a party if it were to be applied or relied on.[257] The ASIC Act provides a number of examples of terms that would be unfair.[258] When a credit provider has concluded several contracts identical to the contract in dispute the terms in all identical contracts will be declared unfair and

[245] S12BF (2) of the ASIC Act.
[246] 12BF (4)(a) of the ASIC Act.
[247] 12BF (4)(b)(i) of the ASIC Act.
[248] 12BF(4)(b)(ii) ASIC Act
[249] 12BK(2) ASIC Act
[250] 12BK(2)(a) ASIC Act
[251] 12BK(2)(b)ASIC Act
[252] 12BK(2)(C)ASIC Act
[253] 12BK(2)(d) ASIC Act
[254] 12BK (2)(e) ASIC Act
[255] 12BG(1)(a) of the ASIC
[256] 12BG(1)(b)of the ASIC
[257] 12BG(1)(c)of the ASIC
[258] 12BH of the ASIC.

void, even if the said identical contract was concluded with a small business that was not a party to the dispute.[259] However, there may be instances in which the customer's circumstances affect the finding of unfairness for that particular contract, even if the contract was identical to other standard contracts concluded with other consumers.[260] If small business consumers who were not party to the proceedings in which a term was found to be unfair, would suffer a loss or damage of some sort because of the unfair term being in their own contract, ASIC may seek an order to compensate non-parties in the same or later proceedings.[261]

The ASIC Act has incorporated the general law of contract into its provisions, by including unfair contract terms.[262] In addition, it has dealt with standard contracts which contain 'entire agreement' clauses and 'unilateral variation' clauses.[263] The former provides that the contract represents all the rights and obligations between the parties, with the effect that it may absolve the lender from any contractual responsibility for any conduct or representations made by the lender to a small business consumer regarding the operation of the contract.[264] The latter, are clauses which give lenders (but not borrowers) a broad discretion to unilaterally vary terms and conditions of the contract.[265] A unilateral variation clause, allows the lender to increase the cost of credit or terminate the contract at its discretion, forcing the small business consumer to exit the contract.[266] The ASIC Act recognises that lenders are entitled protect their commercial interests and therefore proposes that the lender gives substantial notice to borrowers if they are planning to unilaterally vary the contract terms.[267] More than that, the consumer should be given reasonable time to consider exiting the contract, without having to pay additional penalties if it does not want to accept the varied term.[268] However, everything owing prior the notice of variation should be paid

e) Unconscionable conduct

Suppliers of financial services are bound by the 'unconscionable conduct' provisions of the ASIC Act.[269] 'Put simply, unconscionable conduct is conduct against conscience by reference to the norms of society that are in question'.[270] In determining whether a particular pattern of behavior is unconscionable, there does not need to be a particular individual who is identified as being

[259] *Australian Competition and Consumer Commission v Chrisco Hampers Australia Ltd* (2015) 239 FCR 33
[260] Asic Report 564 ' Unfair Contract Terms and Small Business Loans' (2018).
[261] Ibid
[262] Ibid page 11.
[263] ibid
[264] S12BH of the ASIC
[265] S12BH of the ASIC
[266] *Australian Competition and Consumer Commission v JJ Richards & Sons Pty Ltd* [2017] FCA 1224
[267] Asic Report 564 'op cit note 260 at para 84.
[268] ASIC REPORT 564 ' Unfair Contract Terms and Small Business Loans' (March 2018).
[269] S12CB of the ASIC.
[270] *Australian Competition and Consumer Commission v Woolworths Limited* [2016] FCA 1472, [129]

disadvantaged by the behaviour of the finance provider.[271] In considering whether conduct to which a contract relates is unconscionable, a court may consider the terms of the contract[272] and the manner in which and the extent to which this contract is carried out.[273] The ASIC Act sets out various factors which the court will take into account in determining if the credit provider has contravened the unconscionable conduct provisions.[274] These factors include:

- The relative strengths of the bargaining positions of the credit provider and the smallbusiness consumer[275];
- Whether, as a result of conduct engaged in by the credit provider, the small business consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the credit provider[276];
- Whether the small business consumer was able to understand any documents relating to the supply or possible supply of the financial services[277];
- Whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the small business consumer or a person acting on behalf of the small business by the credit provider or a person acting on behalf of the credit provider in relation to the supply or possible supply of the financial services[278];
- The amount for which, and the circumstances under which, the small business consumer could have acquired identical or equivalent financial services from a person other than the credit provider[279];
- The extent to which the credit provider's conduct towards the small business consumer was consistent with the credit provider's conduct in similar transactions between the credit provider and other like small businesses[280];
- If the credit provider is a corporation − the requirements of any applicable industry code;[281]

[271] S12CB (4)(b) of the ASIC
[272] S12CB (4)(C)(i) of the ASIC
[273] S12CB (4)(C)(ii) of the ASIC
[274] S12CC (1) of the ASIC
[275] S12CC(1)(a) of the ASIC
[276] 12CC (1)(b) of the ASIC
[277] 12CC (1)(C) of the ASIC
[278] 12CC (1)(d) of the ASIC
[279] 12CC(1)(e) of the ASIC
[280] 12CC(1)(f)of the ASIC
[281] 12CC (1)(g)of the ASIC

- The extent to which the credit provider was willing to negotiate the terms and conditions of the contract with the small business consumer[282];
- The terms and conditions of the contract[283];
- The conduct of the credit provider and the small business consumer in complying with the terms and conditions of the contract[284];
- Any conduct that the credit provider or the small business consumer engaged in, in connection with their commercial relationship, after they entered into the contract[285]; and
- Whether the credit provider had a contractual right to vary unilaterally a term or condition of a contract between the credit provider and the small business consumer for the supply of the financial services[286]; and
- The extent to which the credit provider and the small business consumer acted in good faith.[287]

The case law suggests that mere inequality of bargaining power does not make the conduct of the credit provider unconscionable,[288] but it is more an indicator that the unconscionable conduct provisions could apply. Where the small business lacks an understanding and is in a more vulnerable position, and the credit provider takes advantage of this, it will be unconscionable conduct.[289] The standard that is looked at in determining when a small business is being exploited is what is acceptable in a commercial transaction.[290] Where one party exploits their position of superior bargaining power in a manner that goes beyond what is acceptable even in a commercial transaction, it will be unconscionable.[291]

VIII. CODE OF BANKING PRACTICE

Of all of the banks in Australia, 95 per cent of them subscribe to the Code of Banking Practice (COBP),[292] a voluntary code of conduct by which banks become bound upon becoming a

[282] 12CC (j)(i)of the ASIC
[283] 12CC(j)(ii)of the ASIC
[284] 12CC(j)(iii)of the ASIC
[285] 12CC (j)(iv)of the ASIC
[286] 12CC (k) of the ASIC
[287] 12CC (l)of the ASIC
[288] *Paciocco v Australia & New Zealand Banking Group Ltd* [2016] HCA 28
[289] *Australian Competition and Consumer Commission v Dukemaster Pty Ltd* [2009] FCA 682
[290] Ibid
[291] Godwin A et al op cite note 214
[292] Ibid.

signatory.[293] The provisions in the COBP are legally enforceable against the bank and must be incorporated in the contract entered into between the bank and the small business consumer.[294] In practice, consumers are more likely to enforce their rights under the COBP through alternative dispute resolution than to approach a court.[295] The COBP sets out extensive obligations for banks to observe in relation to their transactions with both ordinary consumers and small businesses.[296] Most notably for small businesses, the COBP includes a responsible lending and full disclosure regime for banks to observe, similar to that which is found in the NCCPA.[297] At the time of writing, the ASIC has approved an amended version of the COBP which will come into effect in April 2019.[298] As a result I have chosen to examine the current version of the COBP and then deal with the way in which it has been improved.

As set out earlier in the chapter, the Financial Ombudsman Service is the external dispute resolution system which is favoured by most Australian banks. The Service requires that all financial service providers comply with the COBP provisions, even if that financial service provider is not a signatory to the COBP.[299] From this, it can be noted that the COBP is a much respected piece of soft law in Australia and to a large extent is the primary source of protection which small businesses turn to with regard to credit transactions with banks.[300]

a) Responsible Lending

Clause 27 of the COBP provides that a credit provider must select and apply a credit assessment akin to a credit assessment being selected by a diligent and prudent banker who is acting with care and skill, before the bank can increase an existing credit facility of the consumer or advance a credit facility. The purpose of the assessment is to form an opinion about the ability of the consumer to repay the credit.[301] The Code Compliance Monitoring Committee (CCMC) has stated

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[293] ASIC, 'Approval of financial services sector codes of conduct' in Policy Statement 183, issued 23 February 2005, amended 4 March 2005, p 3, at <*http://www.asic.gov.au*>
[294] Godwin A et al op cite note 214
[295] Ibid
[296] COBP cl 42.
[297] COBP cl. 27.
[298] Australian Banking Association New Banking Code of Practice.
[299] Financial Ombudsman Service, *The FOS Approach Responsible Lending Series, 3 How we approach responsible lending disputes taking into consideration legal principles, industry codes and good industry practice* (Version 1, July 2014).
[300] Cl 8.2 (c) of Financial Ombudsman Service Terms of Reference (2018)
[301] CCMC *Guidance Note 9 (Provision of credit)*

that whether a credit assessment meets the standard of a diligent and prudent banker is something to be determined on a case-by-case basis.[302] The committee and financial ombudsman service will consider:

- If the bank has made reasonable inquiries into the small business's circumstances (the vulnerability and possible disadvantage of the consumer) as well as their objectives for obtaining the loan;
- Did the bank verify the financial position of the small business consumer? Did the bank assess the information it may have already held in respect of the small business consumer?[303]

In addition, the CCMC will take into account the NCCPA as well as the ASIC guidelines in determining whether credit has been extended responsibly.[304] This has the implication that the substantial hardship provisions of the NCCPA could apply to small businesses. Hence, a contract may be set aside if compliance by the small business depended on the sole proprietor or shareholder having to sell their principal place of residence. In the Victorian Supreme Court of Appeal decision of *Doggett v Commonwealth Bank of Australia*[305], the court held that it would not be responsible lending for the bank to advance a loan if, in its assessment, the only way that the small business could afford the credit was when the bank pooled together all resources available to the consumer from third parties.[306] In essence, the court was saying that the principal debtor should be able to repay the existing debt before a loan could be advanced; however a bank was not precluded from considering the finance available to the debtor through third parties in assessing the small business consumer.

The New Code has improved on clause 27 and has specifically set out in chapter 17:[307]

> If you are a small business, when assessing whether you can repay the loan we will do so by considering the appropriate circumstances reasonably known to us about:
> a) your financial position; or
> b) your account conduct.

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[302] Ibid
[303] Ibid
[304] Code Compliance Monitoring Committee Own motion inquiry: provision of credit (2017), p 9.
[305] *Doggett v Commonwealth Bank of Australia* [2015] VSCA 351.
[306] *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447
[307] Op cit note 93.

> Where reasonable to do so, we may rely on the resources of third parties available to you, provided that the third party has a connection to you. For example where the third party is a related entity of yours (including but not limited to your directors, shareholders, trustees, beneficiaries or related body corporates), or is a partner, joint venture, or guarantor of yours.

What is reasonable in terms of looking at third party resource availability will still follow the decision in *Doggett,* meaning that the bank will probably still be prohibited from pooling the borrower's and third parties' resources in assessing serviceability.[308] A borrower's capacity to pay from their own resources is a fundamental consideration. This supports the proposition that a bank may not conclude a loan with a small business consumer if the sale of the borrower's personal home was the inevitable consequence of default.

f) Financial Assistance

Clause 28 of the COBP requires a bank to assist a small business consumer when he/she falls into financial difficulty in repaying a loan or any other credit facility.[309] Banks are encouraged to help the consumer by forming a repayment plan.[310] Banks are prohibited from requiring consumers to apply for an early release of their superannuation fund (pension) in order to repay the debt.[311] In the case of businesses, this prohibition may apply to the release of any long-term investments that the owner of a small business may have used as collateral for the loan. Additional obligations on the banks include communicating effectively with consumers when they incur financial difficulty, even if the consumer has not made a specific request of assistance to the bank.[312] Banks must also provide the consumer with prompt written reasons for not assisting the consumer in financial difficulty.[313]

In enforcing the bank's obligations to provide financial assistance to small business consumers, the Code Compliance Monitoring Commission will consider the following[314]:

- Did the bank genuinely consider the consumer's request for assistance with their financial difficulty, having due regard of the consumer's circumstances?

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[308] Op cit note 35.
[309] Cl28.2 of the COBP
[310] Ibid.
[311] Cl 28.9 of the COBP.
[312] Cl 28.4 of the COBP.
[313] Cl 27. 28.8 of the COBP.
[314] Code Compliance Monitoring Committee op cit note 304

- Did the bank consider long-term solutions to assisting the consumer when it was clear that the short-term solution did not resolve the consumer's financial difficulty?
- The bank must provide evidence in writing that it considered the consumer's individual circumstances when it made its decision after assistance was requested?

IX. CREDIT GUARANTORS

Credit guarantors for small business loans are offered protection under the general law of contract as well as under the COBP but not under the NCCPA.[315] Equitable doctrines which apply to credit guarantors in some circumstances include the provision that 'it is unconscionable for a lender to enforce a guarantee against a guarantor who was at a "special disadvantage". [316] A guarantor is at a special disadvantage when the guarantor lacks an understanding of English, was not able to obtain independent legal advice and was not advised as to the extent of his liability under the guarantee. If the guarantor is disadvantaged in this way and as a result of this disadvantage is unable to make a judgment as to his own best interest, and the effect of this disadvantage is sufficiently evident to the credit provider, unconscionability will arise, where the creditor, being aware of the disadvantage, still enters into the transaction with the guarantor.

Clause 31 of COBP sets out guarantee-related obligations which the banks must abide by and incorporate into the guarantees entered into in respect of small business loans. The protections include but are not limited to the following:

- Liability under the guarantee must be limited to, or be in respect of, a specific amount plus other liabilities (such as interest and recovery costs)[317] or be limited to the value of a specified security at the time of recovery[318];
- The bank must give a prominent notice in relation to various matters before the guarantee is taken, including that the guarantor 'should seek independent legal and financial advice on the effect of the guarantee'[319];

[315] S8 of Schedule 1 of the National Credit Code (2012)
[316] *Commercial Bank of Australia Ltd* supra note 306
[317] Cl. 31.2 (a) of the COBP.
[318] Cl 31.2 (b) of the COBP.
[319] Cl 31. 4(a)(i) of the COBP

- The bank must tell the guarantor about any notice of demand made by it on the debtor, and any dishonour on any facility the debtor has (or has had) with it, which has occurred within two years before the bank tells the guarantor.[320]

In *National Australia Bank Ltd v Rose*[321], the court considered an earlier version of the COBP. It held that a failure of the bank to give prominent notice to the guarantor under the equivalent of clause 31.4(a)(i), had the result of a guarantee being set aside. The decision of *Doggett*, also extended clause 27 of the COBP to guarantors. The court held that the bank had an obligation to the guarantor to conduct a proper assessment of the small business's ability to repay the loan. If the bank did not fulfil this obligation, the guarantee might be set aside. This has now been incorporated into chapter 17 of the new COBP.

X. CONCLUSION

The Australian legal framework pertaining to loans is remarkable. First, Australia has managed to create a separate legal framework for natural persons whilst simultaneously creating a legal framework for small businesses. Secondly, due to the ASIC being applicable to all lending transactions by credit providers, it prevents credit providers encouraging natural persons to take out loans through juristic enterprises. This is because credit providers are consistently held to a single standard. Thirdly, instead of the law explicitly setting out rights for small businesses, the legislature and drafters of the COBP implicitly create rights for small businesses through setting out responsibilities for credit providers. This means that instead of the business owners needing to fully understand which set of rights and rules are available for their protection, they just need to understand what responsibility the credit provider was meant to undertake. Lastly, the fact that the COBP is enforceable only against its signatories, means that there is a gap, albeit a small gap, for credit providers to feel that the COBP asks too much of them in relation to the risk of the client. For all these reasons, it is my view that a similar system could be beneficial to South African SMME credit consumers.

[320] Cl 31.4 (b)(i) of the COBP.
[321] *National Australia Bank Ltd v Rose* [2016] VSCA 169

CHAPTER 4

I. INTRODUCTION

The issue which faces the sustainable growth that SMMEs need , go deeper than simply amending the NCA to include further protection for juristic persons. This is because, commercial loans and consumer loans are entirely different. Much like Australia, South Africa has the legal framework to support SMMEs. The framework which I speak of, consists not only of the NCA but also of the codes of conduct notified in terms of the Financial Advisory and Intermediary Service Act[322] (FAISA). This framework is further supplemented by the soft law, which is encompassed within the Banking Code of South Africa[323] (the Code). I do not purport to suggest that the FAISA or the Code be used to govern or to regulate lending to SMMEs in its totality. Rather, the suggestion that I make in this chapter, is that these pieces of law, subject to some amendment, be used by the courts in interpreting contractual terms in the loan agreements between SMMEs and credit providers. One of the key issues of the cases that I discussed in chapter 2, was that the courts were making conservative decisions for the sake of protecting commercial certainty. Therefore, the NCA was seen as unviable standard to which SMME contracts should be compared to. This then raised the question of what recourse SMMEs have other than the broad common law contractual rules. The approach which I advocate for, is one in which the courts can turn to the FAISA and the Code, to inform their interpretation of the loan contract. In this chapter, I have also considered the manner in which suretyship agreements should be governed, particularly when the surety is a natural person. Finally, I provide a brief conclusion to this dissertation.

II. IS THE FRAMEWORK OF THE NCA THE APPROPRIATE LEGISLATION TO GOVERN LOANS GRANTED TO SMEs?

In the preceding chapter, I highlighted why Australia had decided to regulate small business loans in a different way to personal loans. The overarching view of their legislature and most credit providers being that legislation drafted and adopted to the needs of natural persons cannot be equally malleable to suit all commercial realities. I find that a similar approach needs to be followed in South Africa because the NCA in its current wording and scope, is not suitable to juristic persons. The cases discussed above highlight this inefficiency. Firstly, when the NCA does

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[322] Act 37 2002

[323] Banking Association of South Africa 'The Code of Banking Practice' (2012)

apply to some SMMEs, there is cherry picking approach to which provisions apply. This means that many South African consumers are left with no certainty as to what protection is offered to any loan that they may take out. Imagine that you as a consumer take out a personal loan and it was granted recklessly by the credit provider, you would be deemed to know that you are protected under the NCA. Now imagine that you take out the same amount of loan as a business loan and it was granted recklessly, you would think that you have full recourse to the NCA since technically you constitute a juristic person consumer that falls under the NCA but in actual fact, you don't. The cases discussed throughout this dissertation, are indicative of the fact that even the courts sometimes get confused as to when the NCA applies to juristic persons. The legislature intended to create commercial freedom by loosely regulating SMME lending in the NCA but the irony is that it may just be resulting in commercial ,uncertainty.

It is just the reality that the NCA was drafted in a manner which is better suited to consumer credit rather than commercial credit. Take a moment to think about what would happen if the NCA had set out that before a loan can be granted to a juristic person for the development of the business, that the credit provider must be certain that the business would have a reasonable prospect of success? This is the standard applied to natural persons, before a loan can be granted the credit provider must be satisfied that the person is capable of repaying the debt and one of the things which determines this, is whether the person has a consistent income. The point of this mind exercise is to show that commercial needs and consumption needs are on opposite sides of the spectrum and legislating for all the commercial needs of an SMME, would result in the NCA becoming overly prescriptive.

III. IF NOT THE NCA, THEN WHAT?

The law of contract in South Africa is derived from the common law. In terms of the Constitution, the common law must be developed by the judiciary, whenever necessary, to promote the spirit, purport and objectives of the Constitution.[324] The result of this obligation imposed on the judiciary, has been that the Constitutional Court has made *obiter dicta* statements in contractual disputes, which have led to uncertainty as to whether or not constitutional standards of fairness, equality and good faith are a vital for a contract to be seen as enforceable.[325] Whilst, the case law would suggest that these are indeed prerequisites for a valid contract, some academics argue otherwise.

[324] S2 of the Constitution of South Africa, 1996
[325] Everfresh Market Virginia (Pty) Ltd v Shoprite Checkers Ltd 2012 (1) SA 256 (CC)

For example, Justice Malcom Wallis advocates for an approach whereby the right to freedom of contract should be respected by the court and that the contract in and of itself dictates the intentions of the parties and therefore the validity.[326] In this way, the Justice asserts, there will be commercial certainty. Again, I do not disagree that commercial certainty is important, however I do advocate for an approach whereby the courts consider the substantive factors in a particular commercial market and use those substantive factors to determine what would be commercially realistic in that market.[327] By looking at the substantive factors in the SMME market, the courts will be able to take into account the socio-economic reality of the participants of that market. However, this socio-economic reality should not be the overarching consideration in interpreting a loan agreement.

IV. HOW SHOULD THE COURTS DECIDE WHAT IS COMMERCIALLY ACCEPTED PRACTICE IN AN SMME LENDING MARKET?

The Code was developed by the Banking Association of South Africa, to serve as an industry code for banks.[328]The purpose of the industry code is to ensure fairness, transparency and accountability on the part of the banks. This code is however only applicable to small business consumers and natural persons.[329] From an enforcement perspective, the code is voluntarily adopted by the banks and can only be enforced against the signatories.[330] Furthermore, the code can only be enforced by the Ombudsman for Banking Services.[331] The Code is comparable to the COBP in Australia, except that as it currently exists, it has little recognition from the courts and the provisions as they are currently drafted, would not have much impact. However, given that the definition of small business within the Code is less restrictive than of that found in the NCA because the code applies to all small businesses with an annual turnover of R5 million or less, it can be used as a framework to determine how participants in the SMME credit market should conduct their commercial relationship with SMMEs.[332] Before it can be used as a guideline however, there are adaptations to be made, which we can take from Australian law.

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[326] Wallis M, 'commercial certainty and constitutionalism: are they compatible?', (2016) Vol 133 (3), *SALJ* 545
[327] Hutchison A, *Relational theory, context and commercial common sense: views on contract interpretation and adjudication* 2017 (2) SALJ 296 p 305.
[328] S1 of the Code of Banking Practice (2012).
[329] S1 of the Code of Banking Practice (2012).
[330] S1 of the Code of Banking Practice (2012).
[331] S1 of the Code of Banking Practice (2012)
[332] S12 of the Code of Banking Practice (2012)

S8 of the Code applies to all credit transactions. In terms of this section the credit provider undertakes the responsibility of ensuring that the SMME understands and appreciates the risk and the cost of the proposed credit.[333] Thereafter, the credit provider must make an assessment of willingness of the SMME to repay the loan, which will be determined through a number of factors, most notably the assets and liabilities of the SMME and the way in which the financial affairs of the SMME were handled in the past.[334] This section is comparable to clause 27 of the COBP in Australia. Whilst this is a step up from the NCA for juristic persons, the Code still does not create an opportunity for all credit providers to adopt a uniform approach in conducting credit assessments of SMMEs. Therefore, in my opinion, S8 should be amended to include the standard of the'diligent and prudent banker who is acting with care and skill' applied by the CCMC in Australia. A test such as this informs the adjudicative body of the commercial practice in the SMME lending market whilst simultaneously allowing the adjudicative body to consider more substantive realities, such as whether or not the credit provider made reasonable inquiries into the small business circumstances and objectives for obtaining the loan. Furthermore, S8 should be amended to prevent credit providers from granting loans based on the collateral that SMME can provide due to the reasons discussed in chapter 2 i.e. this collateral may be all that the business owner has. The alternative, is to adopt a provision akin to clause 28 of the COBP as this prevents the credit provider from forcing the business owner to cash in long term policies etc. in order to satisfy the debt of the business.

In order for the Code to be beneficial to SMMEs, two things need to happen. The first is that it needs to become enforceable as a general industry code for all SMME credit providers. After this is done, the courts can then use the Code to help them in determining the fairness of the loan contract. The standard of fairness, equality and good faith, are transposed through the Code, honing these values into something that is more tangible and industry specific.

A further tool that could be useful to the court in interpreting SMME loan contracts whilst simultaneously causing uniform market participation of credit providers, is the FAIS Act. The FAIS Act is comparable to the ASIC Act in Australia. At present the FAIS Act regulates the manner in which financial service providers give advice and sell financial products, through

[333] Cl8.1.3 of the Code.
[334] Cl 8.1.4 of the Code.

enforceable codes of conduct promulgated in terms thereof.[335] The scope of the General Code of Conduct for Authorised Financial Services Providers and Representatives, of 2003 (the Code of Conduct) is drafted in broad enough terms to include all industries within the financial services and could therefore be amended to include the SMME credit market as a separate industry to regulate in and of itself. At present the Code of Conduct regulates the manner in which financial products are marketed and sold, placing restrictions on the kind of marketing practices can be used and minimum requirements for products sold.[336] There is in my view, enough scope within this Code of Conduct, to include regulations against unconscionable conduct. I think what is necessary, is for there to be a similar list in the FAIS Act, to the list in the ASIC Act. This could be done either through the introduction of a new code of conduct or through the amendment of an existing code of conduct.

Unconscionable conduct is –largely- that which would be conduct that is contrary to societal norms or values, or more broadly, contrary to public policy. Important considerations to decide if the credit provider acted unconscionably, is whether the SMME could have obtained the financial service from another provider for much less. Additionally, whether the credit provider acts consistently when dealing with SMMEs. Because public policy is a broad concept and cannot be used as a justification to render all contracts null and void. The courts are not hastened to turn to public policy or societal norms to determine what constitutes unfair commercial practice, this we saw from the cases discussed in chapter 2. However, if the courts have a general list of what would be considered as unconscionable conduct in the SMME lending industry, they would be more likely to see the conduct of the credit provider, as being unduly beneficial to the credit provider.

South Africa seems to be moving toward an approach of having a more general regulation of all financial service providers. This can be seen from the Conduct of Financial Institutions Bill (the Bill) which was released for comment in December 2018. The first purpose stated on the Bill, is "*to provide for the establishment of a consolidated, comprehensive and consistent regulatory framework for the conduct of financial institutions that will, protect financial customers, promote the fair treatment and protection of financial customers by financial institutions*." Whilst the Bill does not set out the specific responsibilities which financial service providers must adhere to. It

[335] S15 of the FAIS
[336] Part 2 of the Code of Conduct

does authorize the designated Financial Sector Conduct Authority, to prescribe standards related to financial products and financial services.[337] The Bill sets out some of the standards which the Authority should address, including unfair contract terms and fair, just and reasonable terms of contracts.[338] If the Bill is assented to in the future, it will be a welcomed piece of law for the SMME credit market and would negate the need for the Code to amended or for the Code of Conduct to be inclusive of a separate category for SMME credit providers.

V. HOW SHOULD SURETYSHIP AGREEMENTS BE REGULATED?

Financial service providers and natural person sureties should be able to agree if they want that the suretyship agreement will be governed by the NCA provisions, even when the principle agreement concluded with the juristic entity falls out of the ambit of the NCA. This is possible under South African law for two reasons. The first is due to the principle of *pacta sunt servanda* or freedom of contract and the second reason is due to advancing the Constitutional principle of equality.[339] One of the legally accepted practices in contract law, is for parties to be bound by a set of principles or an agreement, which is separate to the document that is be signed or agreed on. Instead parties will make reference to the external document or statute, this is known as the doctrine of incorporation.[340] This principle was discussed in the High Court decision of *Clear Creek Trading.*[341]

In *Clear Creek Trading*[342], First Rank Bank had stipulated that the suretyship agreement as well as the principle mortgage agreement would be governed by the provisions of the NCA. However, when the case went before the High Court, First Rand had argued that it was a mistake and that because the principle agreement was concluded with a juristic person for a loan agreement which was considered to be large, the NCA could not govern the agreement.[343] However, despite this argument, First Rand had acted under the NCA before the case could be brought to court, by dispatching a letter under S129 of the NCA.[344] Clear Creek had on the other hand argued that the

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[337] S51 and S53 of the Bill.
[338] S51 of the Bill.
[339] S9 of the Constitution of South Africa, 1996.
[340] Renke S et al 'can the National Credit Act by agreement be made applicable to (excluded) juristic persons' (2014) 77 *THRHR* p567- 581
[341] *Firstrand Bank v Clear Creek Trading (1054/2013) [2015] SCA*
[342] *Ibid*
[343] *Firstrand Bank v Clear Creek Trading* supra note 339 para 8
[344] *Firstrand Bank v Clear Creek Trading* supra note 339 para *7*

provisions of the NCA governed the agreement and that meant that the plaintiff had breached S81(1) and (2) of the NCA because the plaintiff failed to ensure that the defendants had a full understanding of the loan being sought and all of the costs that were associated with it.[345] The High Court, set out principles relating to freedom of contract and the importance of allowing parties to be bound by their agreements where there are no weighty considerations which would militate against the agreement being applicable to them.[346] The court goes on to say that a relevant consideration would be whether the agreement infringes upon the legislative authority of parliament.[347] To determine whether there is such infringement, these are some of the factors to be considered:

- the nature, purpose and objectives of the Act in question that the parties seek to incorporate and make applicable to their agreement;
- the question whether the parties' agreement seeks to advance the objectives of such an Act or, conversely, detracts from or undermines such objectives;
- whether the agreement purports to create obligations for other entities who are not parties to the agreement, where such entities may have obligations provided for by the Act that the parties wish to make applicable to the agreement;
- whether the agreement offends the imperatives of public policy or whether the dictates of public policy require that the agreement be enforced;
- whether giving effect to the agreement is likely to be offensive to the principle of separation of powers and/or to undermine the legislative authority of parliament; and
- the facts and circumstances of the particular case.[348]

The court in essence, went on to make a finding that the agreement did not deter from the objectives of the NCA. In fact, the court found that the primary objective of the NCA was to ensure fairness and equality and freedom in the South African credit market.[349] The NCA in seeking to protect consumers, advances the constitutional imperative of equality. When the parties mutually

[345] *Firstrand Bank v Clear Creek Trading* supra note 339 para 11
[346] *Firstrand Bank v Clear Creek* supra note 339 para 21
[347] Ibid
[348] Ibid
[349] *Firstrand Bank v Clear Creek Trading* supra note 339 para 22.

agreed to extend this protection to the agreement, they were seeking to advance the constitutional imperative of equality, whether or not this was explicitly stated.[350] This the court stated, is conduct that should be encouraged, particularly when it is voluntary conduct by the parties. For that reason, it is difficult to see how such conduct can be contrary to public policy. Finally, the court expressed the view that such conduct does not impede on the doctrine of separation of powers because there is no explicit prohibition in the NCA which prevents parties agreeing that the NCA will be applicable to their agreement.[351]

In my opinion, the court erred in holding that the NCA should be applicable to the principal agreement, this is because the legislature had specifically excluded juristic persons from being protected by the provisions of the NCA, for large credit agreements. It is difficult to conclude as a result of this prohibition, that the separation of powers would not be infringed. If juristic persons and credit providers were to voluntarily be allowed to extend the NCA to their credit agreement, it may have arbitrary results.

A credit provider and the surety should be able to voluntarily extend the NCA to the suretyship agreement. As alluded to in chapter 2, when the legislature had taken the decision to exclude juristic persons from the full scope of the NCA, it was to prevent credit providers being discouraged to lend to juristic persons. This reasoning cannot be extended to a suretyship agreement concluded with a natural person for a juristic entity loan. This is because the risk of a credit provider agreeing to a natural person to stand as a surety, remains the same, regardless of whether the person is standing surety for a consumption loan or a commercial loan. Allowing for natural person sureties to do this, would also advance the Constitutional imperative of equality because all natural person sureties will be treated the same, even when the principle agreement does not fall within the scope of the NCA.

A further benefit of this, is that credit providers are then obliged to explain the full cost of credit to the sole owner who stands as surety. Furthermore, it indirectly obliges the credit provider to do a thorough assessment of the juristic persons affordability before granting the loan because the sole owner surety can challenge reckless lending under S80.[352] As discussed in the *Lowting*[353] above, substantive action from banks requires all natural person sureties to be treated the same,

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[350] Ibid.
[351] *Firstrand Bank v Clear Creek Trading* supra note 339 para 27.
[352] S80 of the NCA
[353] Absa Bank supra note 170

when it comes to pre-agreement notificaions and notifications to bring claims against the surety. However, I think that substantive equality and action is better served when sureties are given the option of falling into the reckless lending, overindebted and cost of credit protection. Practically, I think that this can only become a reality if credit providers make it clear to the sureties that they can voluntarily extend the NCA provisions to govern the suretyship agreement.

VI. CONCLUSION

This thesis has explored access to finance for SMMEs and all of the issues related to this access. To recap, the first major issues facing SMMEs is the lack of protection offered to owners of the SMMEs who offer surety for the loans of SMMEs and the second major issue, is the excessive cost of credit to SMMEs and the lack of recourse offered to them by the law. The lack of recourse offered by the NCA to SMMEs is detrimental to the sustainable growth of the economy because micro-enterprises and small enterprises require finance to grow their businesses in to larger enterprises. To achieve sustainable economic development of SMMEs, specific support needs to be given to micro-enterprises which are on the brink of becoming small enterprises. As is the reality in Australia, small businesses generate better outcomes for the economy because these businesses are capable of employing more people and overall contribute more to the GDP of the country. It is not enough for South Africa to continue to support SMME growth only at the initial level of entry as a micro-enterprise because opportunity entrepreneurship is what is needed for there to be sustainable growth of the South African economy. Sustainable growth for South Africa does not merely refer to SMEs contributing to the overall GDP but rather, to the ability of SMEs which are as a result of opportunistic entrepreneurship being able to absorb some of the unemployed people population and thereby contribute to the quality of life of the population.

The flaws of the legal framework for lending to SMEs have been pointed out in this dissertation, through the case law. The case law has illustrated the frustration of the judiciary to achieve substantive outcomes for SMES, whilst not impeding on the doctrine of freedom of contract and commercial certainty. The result of this has been to the detriment of the SME. The uncertainty of the NCA makes this a difficult task for the judiciary and even for the credit provider, as seen in *Credit Creek Trading*. Beyond this however, SMEs cannot grow sustainable if the terms of their credit agreement are subject to usurious costs of credit and other unfavorable contractual terms. A harsher criticism leveled against credit providers, is that the credit provider will act in its

best interests in dictating the terms of a loan, when there is no obligatory legal standard to which the credit provider must adhere to. The *Hunky Dory* case suggests that credit providers are easily satisfied by minimal collateral for the loan. I say minimal because it is often the case that the collateral offered for the loan, is the only personal asset which the owner of the SMME holds. However, this practice in and of itself it not viable for sustainable growth of the South Africa economy because, this practice has the potential to detract from the quality of life of the business owner.

An SMME credit market, being distinct from the personal credit market and to the credit market for large entities, allows for the development of a standard commercial practice within the market. The certainty that this creates for SMMEs and credit providers, will have long term effect on the sustainable growth of the South African economy SMMEs will be treated more equitably in entering into business loans and that the credit providers will be more wary of when their conduct could be problematic or one sided. The Conduct of Financial Institutions Bill, is indicative of the need for there to be minimum standards which should be adhered to by financial service provider. In my view, the Conduct of Financial Institutions Bill, should be given the force of law and should be amended to create a specific section of regulation, applicable to lenders within the SMME credit market, so that this long term effect can be realized. However, if this Bill is not assented to, in my view, the amendments to the Code and the Code of Conduct, would have the same effect for the SMME credit market. Finally, the scope of the NCA should be limited to natural persons, included in this, natural person sureties.

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