AN EXAMINATION OF THE LEGAL IMPLICATIONS OF MORTGAGES AS COLLATERAL IN NIGERIA

BY

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BEING A THESIS SUBMITTED TO THE POST GRADUATE SCHOOL, AHMADU BELLO UNIVERSITY, ZARIA IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE AWARD OF MASTER OF LAWS - LL.M DEGREE.

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DECLARATION

I hereby declare that this work is original and has been prepared by me. The information derived from the literature has been duly acknowledged in the thesis and a list of references provided. No part of this work was previously presented or published anywhere, at anytime by anybody for another degree at any university.

……..……..
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CERTIFACATION

This thesis entitled "An Examination of the Legal Implication of Collaterals in Financial Transactions" by Abubakar Mustapha meets the regulations governing the award of the degree of Master of Laws of Ahmadu Bello University, Zaria, and is approved for its contribution to knowledge and literary presentation.

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ABSTRACT

The challenge identified by this research was the manner of collaterisation of credits by financial institutions. It was discovered that due to the volume of funds available at the disposal of financial institutions as a result of the consolidation exercise and stiff competition towards making substantial margin of profits, some financial institutions often comprise or even ignore standard in giving out credit to their customers because of a combination of factors viz:

- Insider credits
- Desire to make huge profits
- Political reasons
- Ethnic considerations

Thus, as a result of the above factors, financial institutions often get saddled with lots of bad debts which usually militate against the growth of an organization with the likelihood of distress and corporate failure since the credits were not given based on business considerations. To arrest this situation, regulatory authorities like the Central Bank of Nigeria and the Nigeria Deposit Insurance Corporation should commence the enforcement of the provisions of the Banks and Other Financial Institutions Act which provides for various categories of offences and penalties relating to Bank officers who give credit facilities that were supposed to be backed by security, without such securities.

ILST OF ABBREVIATION

1. CAMA (Companies and Allied Matters Act) … 74
2. NLR (Nigerian Law Report) … 44
3. NWLR(Nigeria Weekly Law Reports) … 52
4. Chancery Division (CH. D) … 52
5. Appeal Cases (AC) … 9
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10. Adjei vs. Dabanka (1930) 1 WACA p.63 at pp. 66-67 51
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CHAPTER ONE

1.0 GENERAL INTRODUCTION

The 2005 consolidation exercise otherwise known as the recapitalization exercise embarked upon by the Central Bank of Nigeria (CBN), was meant to address the issue of inadequate share capital of banks in Nigeria by the introduction of N25Billion minimum share capital for all Banks in the country in order to make the banks stronger to be able to finance more businesses. *The concept of recapitalization refers to the policy that compelled all commercial banks to raise their capital base from N2billion to N25billion by the Central Bank of Nigeria on or before 31st December, 2005*[1]. The exercise brought about huge resources at the disposal of financial institutions which in turn enabled them to make credit available to a large number of individuals and corporate entities with the intention of making huge profits.

The desire to make huge profits consequently pushed the financial institutions into fierce competition as a result of which some of them started giving out loans without collaterals in a bid to lure customers with the ultimate aim of making huge profits. This culminated in billions of naira loans to the capital market which at the end of the day, got caught up in the financial meltdown (a situation were some financial institutions or assets suddenly lose a large part of their value especially in the stock market crashes). The melt down led to the near collapse of many banks/other financial Institutions as a result of bad debts which arose from credit facilities granted by financial institutions without adequate collateral.

Consequently, *some few Nigerian banks mainly due to the general weakness in their Risk Management and Corporate Governance framework, started displaying signs of failure as far as October 2008 due to huge concentrations of their exposure to certain*

[1] *Adam, J. A. (2005) "Banking Sector Reforms: The Policy Challenges of Bank Consolidation in Nigeria." A Paper Presented at the 46th Nigerian Economic Society (NES) Annual Conference, Lagos. 23rd – 25thAugust.*

sectors of the economy like the Capital Market and the Oil and Gas Industry. These banks started showing serious liquidity strain and had to be given financial support by the CBN in the form of an "Expanded Discount Window" (EDW)[2] when the CBN extended credit facilities to these banks on the basis of collateral in the form of Commercial Paper and Bankers Acceptance. This clearly indicated that recapitalization alone, was not the panacea to the problem of the banking industry in Nigeria as all the banks frequenting the EDW, had recapitalized and even raised additional capital thereafter.

1.1 STATEMENT OF RESEARCH PROBLEM:

The research identified a legal problem that arose after the 2005 Consolidation exercise of the Central Bank of Nigeria when some financial institutions started giving out loans without collaterals or adequate collaterals due to the volume of funds available at their disposal and stiff competition towards making substantial margin of profits as well as a combination of the following factors:

- Political reasons
- Ethnic considerations
- Insider related credits.

Thus, they capitalize on the silence of the Banks and Other Financial Institutions Act, 1990 as amended, because it did not state the sort of collateral that should back up each sort of credit being given by financial institution, rather it left the decision to the financial institutions with the consequence of lots of bad debts that militated against their growth and the likelihood of distress/corporate failure since the credits were not fully or adequately collaterised.

[2] *Afribank Plc, Finbank Plc, Intercontinental Bank Plc, Oceanic Bank Plc and Union Bank Plc.*

1.2 AIMS AND OBJECTIVES

The aims and objectives of the research is to establish that the problem of the Nigerian Banking system is not that of inadequate capital as portrayed by the consolidation policy of the Central Bank of Nigeria but that of bad loans occasioned by lax collateral. The research would also examine the implication of collaterals in financial transactions and elucidate the point that there is no alternative to taking collateral/security as well as adherence to Risk Management principles when extending credit facilities/loans in view of the recent near collapse of the financial industry as a result of the financial meltdown, when banks/financial institutions extended credit facilities/loans without adequate collaterals and adherence to Risk Management principles and ended up being caught in the financial meltdown web.

1.3 SCOPE OF THE RESEARCH

The scope of this research is limited by its objectives. In the light of the above, the work will mainly dwell on solutions and/or steps to be taken by financial institutions to avoid the problems of bad debts which usually arose as a result of bad credits, inadequate or zero collaterisation which would have served as a fall back to ensure recovery of funds in the event of default by ensuring that collaterals obtained for credit transactions are properly documented and perfected. So as to ensure that Financial Institutions would be able to have a fall back on collaterals obtained so as not to militate against the growth of financial institutions and bring about the likelihood of distress and corporate failure. Specific Statutes that makes explicit provisions on credit transactions such as the Banks and other Financial Institutions Act (BOFIA) would be considered.

1.4 RESEARCH METHODOLOGY

The doctrinal research method (i.e the library-oriented research) shall be adopted in the conduct of this research. Accordingly, Primary research materials will be analyzed from the Bank and Other Financial Institutions Act, 1990 (as amended), the Companies and Allied Matters Act, 1990 and Libraries in prosecution of the research. Secondary research materials such as textbooks and law journals containing articles by academic writers, Seminar/Workshop papers and Newspaper/Magazines will also be considered. Other sources of materials will include current practice and trends arising out of requisite credit transactions taking place in Nigeria, especially in the banking industry as well as the views of industry operators will be considered and examined to adumbrate the business trend.

1.5 LITERATURE REVIEW

In order to achieve the objective of this research, numerous literature were accessed, notable amongst them were standard textbooks on the law of credit transaction, Law reports, newspapers, magazines, seminar/workshop papers and policy statements made by constituted authorities. One of the leading works on the law of credit transactions in Nigeria is Smith, Imran Oluwole's Nigerian Law of Secured Credit[3], the work is actually more of practice and procedure without delving into academic exercise, as such, has little to offer the academic community. The Bank's and Other Financial Institutions Act, 1990 as amended, did not envisage the recent meltdown that affected the financial industry, thereby creating a gap as to its remedy. Therefore, this research will seek to fill the gap. Adeniji, A. Omolaji's Law and Practice of Banking in Nigeria, focused on general banking practice and highlighted

[3] *Nigerian Law of Secured Credit (2001) Ecowatch Publications (Nigeria) Limited, Lagos.*

governmental regulation/internal organization of commercial banks, organization, management and control of banking profession in Nigeria as well as the duties and responsibilities of banker and customer. The book did not address the issue of bad debts and how it contributes to corporate failure which this work intents to look at. Moses, Uzegwu's Credit Risk & Lender`s Desk Mate, would have been the near perfect book that would have done justice to the subject matter of this research except for the fact that it done did not envisage situations like the financial meltdown which this research will look into. Orojo, J. Olakunle's Company Law and Practice in Nigeria dwelt more on company law and procedure without touching the implication of collaterals in credit transactions vis-à-vis the capital market meltdown. Hence, this modest bid to fill the gap left by existing literatures.

1.6 JUSTIFICATION

In view of the successful consolidation exercise embarked upon by the Central Bank of Nigeria, which ultimately made credit available to a large number of individuals and corporate entities because of the resources at the disposal of macro and micro finance institutions, a research on the subject will definitely be a worthwhile endeavour. Beside the research would be an important and interesting reading material for Bankers, Consultants and Law Students as well as practitioners and the general public.

1.7 ORGANISATION LAYOUT

The research work is divided into six chapters. Chapter one deals with the General Introduction, it lays the foundation on which the work stands. The Chapter sets out the

objectives, scope and methodology of the research. Other segments of the chapter are the statement of the problem, literature review and organizational layout, which brings out the focus of the research.

Chapter Two dwells on the nature of lending relationships. A thorough examination of loans, debts and credits, their characteristics and types and why it is important to be able to distinguish loans and other forms of credit.

Chapter Three deals mainly with collaterals, their meaning, form, definition and purpose, how and which collateral takes priority over another.

Chapter Four centers on the nature of collateral interest, it also examines the interest of the lender as well as the customer arising as it relates to collaterals in credit transactions. The chapter also looked at Agreements and/or conditions for repayment and set off, and the stages at which collaterals becomes enforceable .

Chapter Five would examine the various forms of collateral with particular reference to consensus securities, fixed and floating collaterals, as well as pledge, mortgage and negative collaterals.

Chapter Six is the concluding chapter, which contains the summary, findings/ recommendations and conclusion that are aimed at enhancing and promoting effective credit transactions in Nigeria.

CHAPTER TWO

2.1 INTRODUCTION TO LOANS, DEBTS AND CREDITS

Lenders employ different strategies to control risk and build their business-lending portfolios. Factors in creating the strategy may include size of the institution, culture, expertise, and demographics of the markets they serve. Over the years, lenders have evolved the various means of lending relationship with their customers. However, Loans/Credits at times go bad when the Principles of Lending/Risk Management are not followed or when Debtors are faced with economic/business downturn. This chapter will in the light of the above, examine the implication of collaterals in financial transaction, the consequences of the failure to obtain adequate collateral as well as the effect of bad loans on financial institutions vis-a-vis the recent financial meltdown that affected the Nigerian Capital Market and the efforts of the Central Bank of Nigeria towards addressing the problem through its intervention policy.

2.1.1 Loans

Loan is a contractual promise of a debtor to repay a sum of money in exchange for the promise of a creditor to give another a sum of money.[1] It entails the redistribution of financial resources between the lender and The Borrower who initially receives an amount of money from the lender which he is suppose to pay back, usually but not always in regular installments.

2.1.2 Debt

Debt is something which is owed; usually referring to assets owed, but the term can cover other obligations. In the case of assets, debt is a means of using future purchasing power in the present. A debt is thus created when a creditor agrees to lend a sum of assets to a debtor. In modern society, debt is usually granted with expected

[1] *Wikipedia (online Encyclopedia)*

repayment; in many ways, plus interest. *Before a debt is made, both the debtor and the creditor must agree on the manner in which the debt will be repaid, known as the standard of deferred payment. This payment is usually denominated as a sum of money in units of currency, but can sometimes be denominated in terms of goods. Payment can be made in installments over a period of time, or all at once at the end of the tenure of the loan.*[42]

2.1.3 Credit

Credit on the other hand, is the provision of resources (such as granting a loan) by one party to another where that second party does not reimburse the first party immediately, thereby generating a debt, and instead arranging either to repay or return those resources (or materials of equal value) at a later date. The first party is called a creditor while the second party is called a debtor or borrower. Any movement of financial capital is normally quite dependant on credit which in turn is dependent on the reputation or credit worthiness of the entity which takes responsibility of the funds. The term credit is used in commercial trade as "trade credit" which refers to approval for delayed payments for purchased goods. Sometimes credit is not granted to a person who has financial infallibility or difficulty or Companies frequently offer credit to their customers as part of the terms of a purchase agreement.[3]

2.1.4 Distinction between Loan and Debts

The making of a loan necessarily involves the creation of a debt and, consequently, an extension of credit. But while it is correct to say that all loans give rise to indebtedness it is not in all situations that a debt or indebtedness will originate from loan transactions. Thus, a debt may be incurred by or in connection with the purchase of goods or services (though this may sometimes involve the granting or utilization of

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[2] Ibid

[3] *Wikipedia online Encyclopedia – accessed on 16/9/09*

loan facilities); or through the extension of some other forms of credit e.g. consumer credit. In economic terms, it will be correct to say that all transactions involving an extension of credit may be regarded as "lending" as such transactions result in an immediate transfer of purchasing power from one person to another, at least until the payment or the repayment of the loan. *However in legal terms, transactions acquire their characters by reference to their form. For instance, credit in the form of consumer credit differs from a loan since the primary objective of a consumer credit is the sale of the commodity in respect of which the credit is extended. This is however not necessarily soin the case of a loan .*[4]

2.2 THE IMPORTANCE OF DISTINCTION BETWEEN LOANS AND OTHER FORMS OF CREDIT TRANSACTIONS

Whether a particular transaction is or is not in law a loan is often of little significance per se, since the transaction will be contractual in nature and will therefore be construed in accordance with the intentions of the parties irrespective of the legal classification. But the distinction between a loan and other extensions of credit may become significant by reference to the circumstances and context in which the transaction is effected. Thus, where the party seeking to raise funds is a company, it is the nature of the transaction that would determine whether or not the company can lawfully enter into it. *In Chow Young Hong Vs. Choong Fah Rubber Manufactory*[5]*, Lord Devlin stated the position thus:*

> *"There are many ways of raising cash besides borrowing. One is by selling book debts and another by selling unmarked bills, in goods on credit or against a post dated cheque and immediately sell them in the market for cash ….. the task of the court in such cases is clear. It must*

[4] *Akanle, Prof. Oluwale, Security for Financial Transactions (2002), paper presented at the Workshop on Securities for financial Transactions, organized by the Centre for Law & Developing Studies, Lagos held on 5 – 8 November, 2002 at p.1*
[5] *(1962) AC 209 at 216-217*

> *first look at the nature of the transaction which the parties have agreed. If in form it is not a loan, it is not to the point to say that its object is to raise money for one of them or that the parties could have produced the same result more conveniently by borrowing and lending money"*[6]

Thus the documents evidencing the transaction between the parties is of great significance such that care must be exercised to think out how to structure and draft such documents.

2.3 CHARACTERISTICS OF A LOAN

In financial institutions perspective,a loan is the money given to a customer to be repaid Later with the following characteristics:

- *It is given on request, mostly in writing.*
- *It is given upon some agreement specifying the amount to be involved installment*
- *Repayment and duration over which it would be repaid are determined.*
- *It is given with some security (collateral) offered by the customer to serve as*
- *Safeguard against default.*
- *It is repaid with some interest.*[7]

There is however no authoritative judicial definition of a loan of money but a definition has been provided by the leading work on contact, i.e. Chitty on contract thus:

> *" a contract on loan is a contract whereby one person lends or agrees to lend a sum of money to another, in consideration of a promise express or implied to repay that sum on demand or at a fixed or determinable future*

[6] *Ibid at 216-217*

[7] The Chartered Institute of Bankers of Nigeria (CIBN), *Proceedings of the National Seminar on Banking and Allied Matters for Judges,* CIBN Press Limited, Yaba-Lagos (2002) p.51

time, or conditionally upon an event which is bound to happen, with or without interest."[8]

From the definition, four characteristics can also be identified for a contract to be classified as a loan contract viz:

- It has to qualify as an advance of money from one person to another.
- It has to have provision for repayments.
- It has to provide for the charging of interest and in the absence of some special provision requiring that the loan be used for a specified purpose, the borrower is free to use the proceeds from the loan as he deems fit.

2.4 TYPES OF LOANS

There are very many different ways of characterising loan transactions, which could be by reference to the duration such as short, medium and long-term loans or by reference to the method of interest calculation like fixed or floating interest rates. At some other time it could be with reference to the transaction for instance, sovereign, corporate or personal loans, etc. However, *whatever classification is adopted, it seems the following has been widely accepted especially in a domestic setting:*

- *Overdraft facility*
- *Revolving credit facility*
- *Term loan*
- *Debt securities*
- *Mezzanine debt.*[9]

[8] *Akanle, Prof. Oluwale, Security for Financial Transactions (2002), paper presented at the Workshop on Securities for financial Transactions, organized by the Centre for Law & Developing Studies, Lagos held on 5 – 8 November, 2002, at p.3*

[9] *Ibid*

2.4.1 Overdraft Facility

An overdraft facility is essentially a kind of credit made available by banks to their customers (usually current account holders) through the ordinary use of the customers' current account. Such facility may come into being as a result of an agreement expressly negotiated. *It may also arise by implication from the circumstance, like where a bank honours a cheque drawn on a customer's account where there is no sufficient funds to meet the face value of the cheque because once it is honoured, the account becomes overdrawn and that act will be treated as a loan transaction to the extent that the account is overdrawn.*[10]

2.4.2 Revolving Credit Facility

Revolving credit facility is where *a bank agrees to make loans available to a customer up to a specified maximum for a specified period for the borrower to in turn repays a portion of the loan, an amount equal to the repayment can be borrowed again under the terms of the agreement. In addition to interest payable on drawings, the bank charges a fee for the commitment to hold the funds available.*[11]

2.4.3 Term Loan

A term loan, as the name implies, is a loan for a specified period requiring payment at or by the end of the period; such repayment may be of the entire sum borrowed or, and more frequently in practice, according to an agreed repayment schedule. It is usually granted to enable the borrower acquire specific capital assets. A term loan may be short term (usually less than one year) medium term (not more than 5 years).

[10] *Ibid*
[11] *Ibid at p.4*

Depending on whether the market is domestic or international, this classification may vary.[12]

2.4.4 Debt Security

Debt Security is the financial instrument issued by companies or Governments and their agencies in connection with raising of loan finance by them or on their behalf. They are usually in the form of debentures, loan stock, bonds and notes. Some corporate debt securities may be issued on terms that permit their conversion into equity share capital.

2.4.5 Mezzanine Debt

The term "mezzanine debt" is commonly used in connection with take–over and leveraged buy-outs where companies are acquired with borrowed funds which result in the acquirer assuming a relatively high gearing ratio. It also refers to any form of subordinated debt claim or bank debt with equity warrants attached. Mezzanine debt packages can be structured so as to include layers of debt possessing different degrees of subordination.[13]

2.5 BAD DEBT/LOANS

Bad Debt/Loan is money owed to that cannot be collected back. It arises when the creditor has made all reasonable efforts to collect the debt but has been unable to do so. Bad debt also deprives institutions of requisite cash flow that is necessary to keep it in business.[14]

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[12] *Ibid*
[13] *Ibid*
[14] *Farlex Financial Dictionary, 2009 edition, retrieved on 11/2/11 from http://financial-dictionary.thefreedictionary.com/Bad+Debt*

In order to guard against bad loans and safeguard depositors' funds by ensuring that monies lent out are returned, lending is regulated by the Banks and Other Financial Institution Act, 1991, BOFIA (as amended). The Act provides thus: *"No Manager or any Officer of a bank shall grant any advance, loan or credit facility to any person, unless it is authorized in accordance with the rules and regulations of the bank, and where adequate security is required by such rules and regulations, such security shall, prior to the grant, be obtained for the advance, loan or credit facility and shall be deposited with the bank"*[15].

The Act also provides sanctions for failure to take adequate security in accordance with the rules and regulations of the bank thus:

> *"Any Manager or Officer who contravenes or fails to comply with any of the provisions of this section shall be liable on conviction to a fine of N100,00.00 or to imprisonment for a term of 3 years…* [16]".

2.6 EFFECTS OF BAD DEBT/LOANS

The effects of bad loans particularly the ones relating to the Capital Market within the last three (3) years, was very disturbing as disclosed by the Central Bank of Nigeria when it discovered that as at June 4, 2009*, " the total amount outstanding at the Expanded Discount Window was ₦256.571 billion most of which was owed by 5 banks*[17]. A review of the activity in the EDW showed that 4 banks had been almost permanently locked in as borrowers and were clearly unable to repay their obligations because their share capital had been eroded by bad loans. *A 5th bank had been a very frequent borrower when its profile ordinarily should have placed it among the net placers of funds in the market.*[18] Whereas the 5 banks were by no means the only ones

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[15] *Section 18(1) Banks and Other Financial Institution Act, 1991 (as amended).*
[16] *Section 18(2) Banks and Other Financial Institution Act, 1991 (as amended).*
[17] [20]*Press Statement by the Governor of the Central Bank of Nigeria on 14/8/09 @ www.cbn.gov.ng - accessed on 11/9/10*
[18] *Ibid*

that benefited from the EDW, the persistence and frequency of their demand pointed to a deeper problem and the CBN identified them as probable source of financial instability, most likely suffering from deeper problems due to non-performing loans. The CBN was able to detect this on time because the new CBN Governor is a risk management expert and saw the danger signals in the banks earlier mentioned.

All this analysis are being made in order to buttress the fact that huge sums of tax payers monies were being disbursed from the Federal purse as a result of bad loans given out by banks without adequate collaterals. Because the law regulating taking of collaterals (BOFIA) gave the banks the latitude to decide on what is adequate collateral and the banks used that latitude to comprise on taking tangible collaterals when they give out stock facilities loans.

The impact of the situation was being felt by the banking industry in different negative ways because the banks gave out huge loans for purchase of stocks and they took the same stocks as collaterals whose value got eroded as a result of the capital market meltdown. The following were some of the negative impact felt by the industry:

i. *Because of the strain in their balance sheets, the banks pushed up interest rate paid to private sector deposits and their competitors had to follow suit. There by making innocent customers pay higher interest rates as a result of misjudgment of granting loans without adequate collaterals*

ii. *The banks contributed to the destabilization of the inter-bank market as many of their competitors were unwilling to take an unsecured risk on them.*

iii. *It was primarily because of these banks, or at least some of them, that the CBN took the step of guaranteeing the inter-bank market when it stopped granting new lines under the EDW.*

Without guaranteeing the inter-bank market, four (4) banks would not have been able to borrow through the inter-bank market and they would probably have collapsed.[19]

The CBN in view of the aforementioned circumstances carried out a Special Examination of the 5 banks namely:

1. Afribank Plc
2. Finbank plc
3. Intercontinental bank plc
4. Oceanic bank plc and
5. Union bank plc.

The examination was conducted by a joint team of CBN and NDIC officials. *The major findings on the 5 banks included the following*:[20]

1. *Excessive high level of non-performing loans in the five banks which was attributed to poor Corporate Governance Practices, lax Credit Administration Processes and the absence or non-adherence to the bank's Credit Risk Management Policies. Thus the percentage of non-performing loans to the total loans ranged from 19% to 48%. The 5 banks will therefore need to make additional provision of ₦539.09 billion.*
2. *The total loan portfolio of these 5 banks was ₦2,801.92 billion.*

   Margin loans amounted to ₦456.28 billion and exposure to oil and gas was ₦487.02 billion. Aggregate non-performing loans stood at ₦1.143 billion representing 40.81%.
3. *From 1 and 2 above, it is evident that the (5) banks accounted for a disproportionate component of the total exposure to Capital Market and Oil*

[19] *op. cit p.2*
[20] *Press Statement by the Governor of the Central Bank of Nigeria on 14/8/09 @ www.cbn.gov.ng- accessed on 11/9/10*

and Gas, thus reflecting heavy concentration to high risk areas relative to other banks in the industry.

4. *The huge provisioning requirements led to significant capital Impairment in the banks. Consequently, they all became undercapitalized for their current levels of operations because they were required to increase their provisions for loan losses, which impacted negatively on their capital.*

5. *The 5 banks were either perennial net-takers of funds in the inter bank market or enjoyed liquidity support from the CBN for long periods of time, a clear evidence of illiquidity. In other words, these banks were unable to meet their maturing obligations as they fall due without resorting to the CBN or the inter-bank market. As a matter of fact, the outstanding balance on the EDW of the five banks amounted to ₦127.85 billion by the end of July 2009, representing 89.81% of the total industry exposure to the CBN on its expanded discount window while their net guaranteed inter-bank takings stood at ₦253.30 billion as at August 2009. Their liquidity ratios ranged from 17.65% to 24% as at May 31, 2009. (Regulatory minimum is 25%).*

It is important to note that at least *three of the banks are systematically important because they accounted for more than 5% of Assets and Deposits in the Banking system) and together the five banks accounted for 39.93% of loans, 29.99% of deposits, and 31.47% of total assets as at May 31, 2009*[21].

Given the extent of the asset quality problem leading to liquidity stresses, and the variety of stress points on the banks' balance sheets, failure to act to secure the financial health of these banks will clearly place the banking system at risk. The CBN had to then brace up to its responsibility of protecting all depositors and creditors to

[21] *ibid*

ensure that no one loses money due to bank failure. Since these 5 institutions were in grave financial situation and their Management had acted in a manner detrimental to the interest of their depositors/creditors. The CBN exercised the powers conferred on it by Section 33 and 35 of the Banks and other Financial Institutions Act 1991, as amended, and removed the Managing Directors and the Executive Directors of the 5 banks from office with effect from Friday, August 14, 2009, and injected a total sum of about ₦400 billion into the banks to be repaid from proceeds of capitalization in the near future.[22] This injection was sufficient to resolve and stabilize the 5 institutions to enable them continue normal business.

The scope of the Special Examination was later on widened to cover all the 24 banks in the country. Where 10 banks viz:

i. *Access Bank Plc*
ii. *Citibank Plc*
iii. *Ecobank Plc*
iv. *Fidelity Bank Plc*
v. *First City Monument Bank Plc*
vi. *Skye Bank Plc*
vii. *Stanbic IBTC Bank Plc*
viii. *Standard Chartered Bank Plc*
ix. *Zenith Bank Plc*
x. *UnityBank Plc*

were found to have adequate capital or liquidity to support the level of their Operations. While the 10th bank, UnityBank Plc was adjudged to have insufficient

[22] *ibid*

capital but with healthy liquidity position to support its level of operations[23]. The remaining banks; Bank PHB, Equitorial Trust Bank Plc, Spring Bank Plc and Wema Bank Plc were found to be in grave situation and punitive actions taken against them. And at the same time, the sum of about N200 billion was disbursed to them to normalize their operations save for Wema Bank Plc which had a relatively new Management Team.

Even though the 10th bank, UnityBank Plc was the only bank that did not raise additional capital out of the 24 banks in the country after the consolidation exercise, it survived the stress test of the CBN because of its strong Corporate Governance Culture and Risk Management Principles[24].

Globally also, institutions that upholds Risk Management Principles and good Corporate Governance Culture during the global credit crisis/financial melt down, were the ones that came out smiling while those that did not, burnt their fingers. Carol Sergeant, the Chief Risk Director of Lloyds TBS in the United Kingdom, attributed the good performance of their bank while their peers were declaring losses during the meltdown thus:

> "*we owe our strong performance to our well executed business strategy, which includes a mixture of business models, a strong risk policy and governance structure. I am very pleased indeed not only with the risk people in Lloyds TBS but equally and more importantly with the business people who made the hard decisions because they avoided deals that other institutions took, and they effectively executed our risk appetites and policies".*[25]

[23] *Press Statement by the Governor of the Central Bank of Nigeria on 14/8/09 @ www.cbn.gov.ng - accessed on 11/9/10*
[24] *Press Statement on the outcome of special examination of 14 banks by the CBN. @ www.cbn.gov.ng - accessed on 11/9/10*
[25] *July – August 1998 edition of the Risk Management Journal, pmartin@rmhq.org. - accessed on 16/9/09*

CHAPTER THREE

3.0 FORMS OF COLLATERAL

Form of Collateral is the layout of a secured credit transaction which symbolizes an express agreement between the debtor and the secured party. The agreement must be in writing, must be signed by both parties, must describe the collateral, and must contain language indicating a grant of a security interest to the creditor. Furthermore, something of value must be given by one party to the other party. This can be a binding commitment to extend credit or any other exchange of value sufficient to create a contract. Once these formalities have been completed, the security side of the agreement is complete and legally enforceable in such a form.[1]

To completely secure a secured transaction, or perfect the security, the secured party should file relevant documents to put the rest of the world on notice as to the creditor's rights in the collateral, and gives the creditor the right to take advantage of special remedies in the event the debtor does not repay the loan. However, since there are many forms of collateral for credits, the requisite collateral that would be required would depend on the nature and circumstances of the credit facility given as well as the customer. The list below though not exhaustive, represents the major collaterals usually taken by financial institutions:

- Legal Mortgage (Land and Landed Properties)
- Shares and Stocks
- Hypothecation
- Life Insurance Policy
- Debentures/Charges

[1] *Wikipedia online Encyclopedia – accessed on 16/9/09*

- Cash Collateral
- Guarantees
- Indemnities
- Bonds
- Domiciliation of Payment
- Negative Pledge
- Bill of Sale
- Lien
- Pledge.

3.1 COLLATERALS DEFINED

Collateral means a security or guarantee (usually an asset) pledged for the repayment of a loan if one cannot procure enough funds to repay[2] *Collateral is usually a comfort for guaranteeing the satisfaction of a debt. Thus, it is an auxiliary or supplementary guarantee.*[3] Collateral Is also looked up to if the cash flow of the client is insufficient to repay a debt. Key to understanding the role of collateral is its standby status as an alternative source of repayment when the borrower is unable or unwilling to repay from cash flow. Some collateral maintains better value in liquidation than other types. For example cash is better than inventory at holding its value. In fact the balance sheet arrays assets in order of their marketability viz;

- Cash
- Marketable Securities

[2] Wikipedia online Encyclopedia-accessed on 16/9/09

[3] The Chartered Institute of Bankers of Nigeria (CIBN), *Proceedings of the National Seminar on Banking and Allied Matters for Judges,* CIBN Press Limited, Yaba-Lagos (2002) p.79

- Receivables
- Inventory
- Fixed assets
- Investment
- Intangibles

Secondly, covenants and conditions can improve a lender's relative position in the liquidation of collateral assets. Examples of covenants and conditions that improve both unsecured and secured lender's position include[4]*:*

3.1.1 Negative pledge

This is where the borrower promises not to encumber his/company's assets as inducement for an unsecured accommodation.

3.1.2 Springing lien

This is where if the borrower fails to repay the lender has an option to collateralize the loan with the borrower's assets in its possession.

3.1.3 Blanket lien

This is where the collateral involves all the company's assets including assignment of leases, rents, or contracts. Thus, the lender has right to the cash generated by leases, rent, or contract. However, if no one rents, leases, or contracts, no cash flow will be generated, as such no protection would be available to the lender.

3.1.4 Pledge of specific Assets

Under Pledge of specific Assets, the lender is given security interest in specific assets as collateral, for example as opposed to a poll of assets where receivables and

[4] *Journal of Credit Risk and Lenders Deskmate Vol. 4 No.4 (2004) Published by Capital Vanguard Associates, 4B, Olutunda Street, Off Coker Road, Ilupeju-Lagos. P.27*

inventories are included as some percentage of the assets' value. *These legal devices improve the value of collateral and reduce the risk of unsecured lending*[5].

3.2 PURPOSE AND FEATURES OF COLLATERAL

The main purpose of taking collateral is for a creditor to have some form of back -up support or something to fall back upon in event of default which brings to fore the following features: [6]

i. *That collateral is fastened on the assets of the debtor so as to give the creditor some right over it.*
ii. *That collateral gives the creditor priority over the claims of other parties claiming rights over the same asset.*
iii. *That collateral minimizes the lender's perceived risk in extending credit by providing an alternative mode of getting paid in event of default.*
iv. *That collateral bestows priority on a creditor if the debtor becomes insolvent.*
v. *That collateral protects the secured creditor against other unsecured lenders.*
vi. *That collateral enables pari-passu treatment in consortium lending.*
vii. *That collateral insulates the secured assets.*
viii. *That collateral ensures control over the secured assets particularly in Project Finance.*

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[5] I*bid.*

[6] *Akanle, O. op. cit p.5*

3.3 THE MORTGAGE

A mortgage is a conveyance of land or assignment of chattels as a security for the payment of a debt or the discharge of some other obligation for which it is given. On repaying the debt however, the debtor is entitled to have back his security (that is to say, the debtor has equity of redemption)[7].

3.4 STEPS TO OBTAINING LEGAL MORTGAGE

i) Investigation of title to the land

Investigation of title is essentially a lawyer's job. It's object is to ensure that the customer is in fact the owner of the property or asset he is charging to the bank as security, that if the customer is in truth and in fact the owner of the land he has not already charge it in favour of another person or finance house and that no other encumbrances or encroachments exist with respect to the property or asset. Investigation requires a thorough scrutiny of the documents of title which may be a land certificate (in parts of Lagos, where the registration of title, as distinct from the registration of instruments applies), a certificate of occupancy (previously applicable in the northern states under the Land Tenure Law, 1962, but not throughout the country in view of the land use act), a conveyance or sale, a deed of lease, an assignment of a lease, etc as well as a physical inspection of the land, a search at the lands registry and in case of corporate customers, a search at the corporate affairs commission Abuja is necessary. The production of a document showing the customer as purchaser or lessee of a piece of land is not always conclusive evidence that he is the owner of the land or interest in question. The solicitor should trace the customer's

[7] *Akanle, O. "Security for Financial Transactions" being paper presented at the Workshop on Securities for financial Transactions, organized by the Centre for Law & Developing Studies, Lagos held on 5 – 8 November, 2002, p. 7*

title down to the root of title prescribed by law. The problem of proof of title is simplified in those parts of Lagos where the system of registered conveyance applies. The problem is also considerably simplified under the right of occupancy system in use in the northern states and now throughout the country by virtue of the operation of the land use act. As earlier stated, having obtained possession of the customers documents of title and being satisfied with the genuiness of the title to the property or asset, the lender must first get the customer or his duly authorized agent or guarantor to execute (i.e sign and where necessary, seal) the necessary forms of charge or deed. *If the customer is an illiterate, special care must be taken to comply with the provision of the illiterate protection law with regard to the execution of documents by illiterate person. Failure to comply may result in the security being either unenforceable or altogether void*[8].

ii) Obtaining the required Consent

The next step in the process of the perfection of the legal mortgage is obtaining the necessary and required consent as required by the Land Use Act. The statutes governing State lands, require the consent of the governor to any assignment, under-letting or parting with possession of state land. The acquisition of non-state land by an alien from a Nigerian citizen or its transfer by one alien to another also requires the approval of the governor. Failure to get the consent of the governor renders the disposition or transaction null and void. Most private leases also require the consent of the landlord to any disposition[9].

A remarkable feature of the Land Use Act is that a Right of Occupancy under the Act is inalienable without the consent of the Governor or a Local Government and alienation without necessary consent is illegal and void. This requirement of the law

[8] *Ibid p.6*
[9] *Id*

was given judicial recognition in the case of *Savannah Bank of Nigeria Limited vs. Ajilo & Another*[10]. *The issue that came up for determination in this case was whether a person who is deemed to be holder of a Right of Occupancy pursuant to Section 34 of the Land Use Act, 1978, requires solely by virtue of that fact, the Consent of the Military Governor before he can transfer, mortgage or otherwise dispose of his interest in the Right of Occupancy. The Supreme Court upheld the decisions of the two lower courts that the failure to obtain the requisite consent was vital to the transaction*[11].

However, this decision has been variously critised and in certain cases departed from, based on the equitable principle that a person should not use his own default or wrong doing to invalidate a transaction to which he was a party. The issue that also arises for determination is whether a party who is charged with the responsibility of obtaining Consent under the Land Use Act to a mortgage deed but failed to do so, can then turn around to challenge the validity of the deed, in order to evade his obligation there under, on the ground that the required consent of the governor was not obtained. *The court was emphatic in holding that a transaction will not be declared null and void for failure to obtain approval at the instance of the party, be he the plaintiff or defendant whose responsibility it is to seek and obtain the approval (as per Akpata J.C.A). Apart from the principle of law involved in this case, it is morally despicable for a person who has benefited from an agreement to turn round to say that the agreement is null and void. No one should be allowed to benefit from his own wrong".* The consent is not an element superimpose on the right, but rather an intrinsic component of it. It may therefore be concluded that a right of occupancy under the act in view of its alienability except with consent, is like a Right of

[10] *(1989) 1, N.W.L.R (pt. 97), 305*
[11] *Id*

Occupancy under Customary Law and unlike a lease. It is settled law that the rights of the customary tenant under native law and custom are limited to occupation during good behaviours and do not include the power to alienate without consent of the guarantor. Any alienation by the customary tenant of his interest without the consent of his guarantor is null and void. Likewise, stipulation in an instrument creating a lease may require the consent of the lessor for alienation[12].

iii) Stamping

A document required to be stamped but which does not bear the appropriate stamp would be inadmissible in evidence. Though it is not void, *stamping must be done within 30 days of the execution of the charge form, but it is inadvisable to stamp a security document before necessary consent is obtained*[13].

iii) Registration

Registration concerns Legal, Equitable Mortgages as well as Debentures because after stamping an requisite instrument, it is required that same should be registered if they are registrable instruments under the Instrument Registration Act and the various Instruments Registration Laws of the different States of the Federation. After due stamping, registration is expected to be effected within 30 days at the Lands Registry of the State where the Land Mortgaged is situated. Some part of Lagos came under the system of registration of title, while the rest of the country operates only a system of registration of instruments. *Registration at the Corporate Affairs Commission, Abuja in the case of Debentures or Charges which are forms of security relating to the assets of incorporated companies is also compulsory*[14].

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[12] *Id*

[13] *See s.*22 *Stamp Duties Act. Cap. 411 LFN 1990*

[14] *See s.*197*Companies and Allied Matters Act. Cap. 59 LFN 1990*

3.5 TYPES OF MORTGAGES

There are two types of Mortgages, Legal and Equitable Mortgage. The distinction between the two, has a practical significance as such, both the financial institution and the customer should be familiar with the nature of the distinction and the forms of and procedures appropriate to each of them viz:

i) Legal Mortgage

This involves executing a deed under seal/signature and the transfer of the legal title From the mortgagor to the mortgagee subject to the mortgagor's Right of Redemption which is a right to reconveyance and payment of the mortgage monies in accordance with the covenants bin the mortgages. Since the pre 1925 Real Property law applies in must part of Nigeria, the principal method of creating a legal mortgage of freehold is by conveyance of the fee simple interest in the property subject to a proviso for redemption.

A mortgage of leasehold will be by Assignment or Sub-demise for a lesser term than the original. The Nature and form of a legal mortgage depends on the conveyance system applicable in the area where the land is situated. There are two system in Nigeria viz:

(a) Registered Conveyance

(b) Unregistered Conveyance

The former is State operated system under the Registration of Title Laws while the latter is Private and Governed by the Registration of Instruments Law. Under registered conveyancing, the State arranged, as a sovereign entity to investigate and record by means of entries in a register maintained and warranted by the state, all the material particulars with regard to the ownership of a parcel of land to be fully

revealed to any interested person, and any alteration of those particulars could be validly affected only by altering the register[15].

Under Unregistered Conveyance however, the proof of title is by reference to a root of title based on private documents, traditional means or other acts. The problem of unregistered conveyancing in Nigeria is mitigated somewhat by the law requiring all instruments affecting land to be registered. Even though, registration of instruments affecting land falls far short of registration of titles. Registered Conveyancing under the Registration of Titles Law, applies in part of Lagos only, namely Yaba including Iwaya Onitiri village, Abule-Ijesha, Abule-Oja, Igbobi, Surulere, Iganmu, Victoria Island, Lagos Island, Ebute-Metta, etc. the list increases as more areas are brought under the system.

When a plot of land is brought under the registered conveyancing system, the registered proprietor, (whether his interest is freehold or leasehold) is given a land certificate, which is his documents of titles. A legal mortgage of land in any part of Lagos covered by the system must therefore be in the form prescribed by the governing statute which is the Registration of Titles Act of the 1958 Laws of the Federation of Nigeria i.e. it has to be by way of a charge drafted in a form of words prescribed by the law[16].

The rest of the country is covered by the registration of Titles Law. All the Northern and Eastern States belong to one category, here, subject to any local Statute, the Conveyancing and Law of Property Act, 1881(which is statute of general application in Nigeria having been enacted before 1st January, 1900). The main feature of this Act as it relates to mortgages is that it permits a mortgage to be by way of conveyance or assignment of the titled interest

[15] *Ibid p.9*
[16] *Ibid . p10*

which the land, subject to a condition for reconveyance or re-assignment upon the repayment of

the debt secured by the mortgage. Accordingly, if the mortgagor holds a freehold or leasehold

interest, the whole of that interest passes to the mortgagee subject to the right of redemption.

Under the Land Use Act which now governs land tenure throughout the country, a conveyance of freehold interest in land is no longer possible, the maximum interest permitted is a Right of Occupancy which could be (Statutory, Customary, or arising by operation of law).

The States comprised in the former Western Region of Nigeria namely Ogun, Ondo, Osun, Oyo, Edo, and Delta States belong to another category. The English Conveyancing and Law of Property Act, 1881 is no longer applicable there, having been repealed and replace by a local Statute called Property and Conveyancing Law 1959 (cap 100 of the laws of the former Western Region of Nigeria) which is itself based on the 1925 law of Property Reforms in England. The law does not permit the creation of mortgage of a freehold property by means of a conveyance or transfer of freehold title to the mortgagee subject to a condition for redemption.

A legal mortgage can only now be created in the case of leasehold property by a Sublease for a term of years less by at lease one day than the term vested in the mortgagor.[17] An alternative method is by way of a charge through a deed expressed to be by way of legal mortgage, which operates in the case of a freehold property as a

[17] *Id*

term for 3000 years before the land use act and in the case of leasehold property as a sub-term less by one day than the term vested in the mortgagor, in either case, the mortgage term is subject to a provision for redemption.

ii) Equitable Mortgage

A mortgage is equitable where the mortgagor has only an equitable interest in the land (e.g an equity of redemption) or where it is made by an informal document, that is document under hand, by means of deposit of title deeds usually referred to as simple deposit. Before the land use act of 1978 it was usual for a deposit of title document to be accompanied by a memorandum of deposit signed by the mortgagor which specified the terms upon which the deposit was made but a memorandum was not necessary if it can otherwise be proved that the deposit was made with intention that the title document should be held as security for a debt. This intention is presumed in the case of a deposit of title documents with a banker and it is for the depositor to prove the contrary. To be on the safe side, and to avoid any controversy, it was usual to obtain from the depositor some memorandum signed by him however informal, which evidence that the deposit was intended as security for a debt.

After the land use act 1978, equitable mortgage is now created by:

(i) A Memorandum of Deposit;

(ii) Power of Attorney, both duly executed by the mortgagor;

(iii) Obtaining Governor's consent,

(iv.) Stamping and Registration to be valid.

Although this is generally known, it is worthy of note to state that an equitable mortgage is not a desirable security. This is for the following reason;

(a) it cannot be enforced by sale except by an order of court;

(b) a subsequent purchaser or mortgagee of the legal title without notice of a prior equitable mortgage take free of the equitable interest[18].

By way of summary, it is clear that since the commencement of the land use act 1978 the right of occupancy, whether statutory, customary or arising by the Operations of the act, requires the consent of the governor to mortgage, otherwise the transaction is void and unenforceable. Also in case of customary right of occupancy where the property is to be sold or mortgage, consent of the governor is required, except that consent shall not be required in the creation of a legal mortgage over a statutory right of occupancy in favour of a person in whose favour an equitable mortgage over the right of occupancy has already been created with the consent of the governor. Also no Governor's consent is required in a case of release of mortgagor to a holder or occupier of a statutory right of occupancy, which the holder or occupier has mortgaged to a mortgagee with the consent of governor.[19]

3.6 RIGHT OF MORTGAGORS

The mortgagor has a right to redeem the mortgaged property on repayment of the debt (known as the right of redemption). The right of the mortgagor to redeem is no however perpetual. The right of redemption cannot be taken away or restricted by a provision in the mortgage. Any such provision is void and would be regarded as a clog on the equity of redemption. The mortgagor's right to redeem is, however subject to the mortgagee's power to sell the property or to foreclose the mortgage[20].

3.7 RIGHT OF THE MORTGAGEE

The mortgagee has the right of power of sale of the mortgaged property either granted by the mortgage deed or statute. This power could be exercised after it has

[18] *Id*
[19] *Id*
[20] *Id*

arisen; it would be deemed to have arisen after necessary notices have been given and the mortgage has been foreclosed. Even if the mortgage deed contains no power of sale, the mortgagee still has the power of sell conferred on him by statute to the same extent as if it has been conferred by the mortgage deed. So long as any part of the debt is outstanding and there is default in payment, the mortgagee could sell the property and the court will not interfere with the exercise of the power. The court will not enquire as to why or how the mortgagee exercised his power of sale[21].

Since the power of sale is given to the mortgagee for his own benefit, it follows that if he exercise it *bonafide* for that purpose without corruption or collision with the purchaser, or such willful or reckless impropriety as to be tantamount to fraud, the court will not interfere even though the sale was disadvantageous, unless indeed the price is so low as to in itself be evidence of fraud.

3.8 PERFECTION OF COLLATERAL

Perfection of collateral is the steps taken or arrangements made whereby a Financial Institution takes over title to a property which had hitherto been in the custody of a debtor when a request for a loan is received from the debtor in order for the debtor to charge his property to secure his debt. It is therefore important in such circumstance to ensure that the borrower has the necessary legal capacity to borrow, for example if the customer is a limited liability company, a careful study of its Memorandum and Articles of Association must be made to ensure that it has the requisite borrowing powers to borrow money from a financial institution. Information regarding the following should also be obtained so as to know the appropriate form of collateral to take:

i. The purpose of the advance;

[21] *Id*

ii. The amount involved;

iii. The duration of the advance;

iv. The source of repayment;

v. The profitability of the transaction;

vi. The collateral proposed.

Even though financial institutions lend money when they are satisfied with the Character of a customer, it is prudent to take some kind of collateral to act as fall back in the event of default so that if the debtor is unable to repay as is expected, the financial institution could dispose of the collateral and liquidate the debt from the proceeds of the sell.

3.8.1 Legal Mortgage

This is a charge created by a formal conveyance of a legal Estate by Deed from the mortgagor to the mortgagee for the purpose of securing the repayment of a debt, subject to the mortgagor's right of redemption upon the payment of the debt i.e on repaying the debt, the debtor is entitled to have back his collateral[22].

3.8.2 Perfection of Legal Mortgage

The process of perfecting a financial institutions interest on land/property in order to create a legal mortgage on the land/property offered as collateral for a loan, involves the following process:

i. Investigation of title to the land/property. This is essentially a legal practitioner's job. The purpose of which is to be convinced that the debtor is the owner of the property he is mortgaging to the Financial Institution as collateral and that even if he is in fact the owner, he has not mortgaged it to

[22] Ibid

another or there exist some encroachment or similar circumstances with respect to the property.

ii. Obtaining the necessary consent. This is a requirement under the Land Use Act.[23] Failure to get consent of the Governor renders any disposition whether by mortgage, lease, or transfer null and void.

iii. Stamping the requisite document. Any document that is required to be stamped but which does not bear the appropriate stamp is inadmissible in evidence although it might not be void.[24]

iv. Registering the Legal Mortgage at the requisite land registry office after stamping same in line with the Land Registration Act.[25]

3.8.3 Sale of Mortgaged Property

A mortgage instrument usually provides for the mortgagee's power of sale and stipulates conditions for the exercise of that power. *The power of sale under the deed of mortgage may be exercised by the mortgagee notwithstanding a debt recovery judgment in his favour and even where an appeal and a motion for a stay of execution are pending. As decided in the case of Union Bank of Nigeria Plc v. Olori Motors Co. Ltd*[26].

The right of sale is however dependent on two main conditions namely:

i That the power of sale must have arisen in the sense that the mortgage debt must have fallen due.

ii. The power of sale must have become exercisable.

The question of whether the mortgage debt has fallen due may be ascertained from the mortgage deed. If the money secured by the mortgage is payable by installments,

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[23] See s. 22 Land Use Act cap 203 LFN 1990

[24] *See s.*22 *Stamp Duties Act. Cap. 411 LFN 1990*

[25] *See s.2* Land Registration Act 1924

[26] *Union Bank of Nigeria Plc v. Olori Motors Co. Ltd. (1998)5 NLR (Pt. 554) p. 652*

the power of sale arises as soon as any installment is due and unpaid.[27] *Therefore, for the power of sale to be exercisable, at least one out of the following must have happened*[28]*:*

i) Notice requiring payment of the mortgage money had been served on the mortgagor and default had been made in payment of the money borrowed after such service.

ii) Some interest is in arrears and remains unpaid after becoming due notwithstanding the fact that even if the principal sum to be advanced instalmentally under the mortgage deed has not been advanced in full.

iii) There has been a breach of some provision contained in the mortgage deed/statute which imposes an obligation on the mortgagor and the obligation has not been fulfilled.

3.9 THE IMPLICATIONS OF CREATING OR TAKING COLLATERALS

The provision of credit facilities is an investment for financial institutions and a method of financial undertaking which propels economic growth. A borrower may however, seek a loan without offering collateral but in such an unsecured arrangement, the lender bears a risk such that if the debtor becomes insolvent or unable to pay, the unsecured lender's debt will only be satisfied after secured creditors (as the case may be) have been paid.[29]

Consequently, a lender has to decide on either of two options before providing credit facility i.e reliance might be placed on the borrower's covenant to repay having been satisfied of the viable purpose for which the credit facility is required or the certainty of the source of repayment. Since it has been said by the Business People that *"the*

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[27] *Okafor & Sons Ltd. v. Nigerian Housing Development Society Ltd. (1972) ECSLR (Pt. 1) p. 349*

[28] *S.125 of the Property and Conveyancing Law Cap 100 LWN (1959).*

[29] *The Chartered Institute of Bankers of Nigeria (CIBN),Proceedings of the National Seminar on Banking and Allied Matters for Judges, CIBN Press Limited, Yaba-Lagos* (2002) *p.35*.

most important factor to be taken when considering or assessing the safety of an advance, is the borrower's capacity to repay in accordance with his promise" but the fallacy of this proposition will be exposed upon the debtor's default because in the event of the debtor's bankruptcy or insolvency, the creditor may soon discover that he has no remedy. [30]

The CBN's Hair Cut Adjustment Policy for banks, re-emphasis the fact that the Apex Bank recognizes the importance of collaterals. The policy is meant to encourage banks to take collaterals by allowing provisioning level of 20% on any facility that is secured by a legal mortgage in the event of going bad as against the hitherto 100%[31]. This is to enable banks free up their provisioning levels for more funds to go to their profits and ultimately to the shareholders in form of dividends.

It is in the light of the above fact that taking collateral becomes imperative for financial institutions in order to maximize the lender's chances of recovering its funds in the event of the borrower's insolvency or bankruptcy.

Some of the implications of taking collaterals are listed below:

- *A lender who takes over specific assets of a debtor as collateral, takes exclusive control over the said assets. Therefore, the debtor's apprehension that failure to pay may result in the loss of such assets would make the debtor liquidate the secured debt.*
- *Collateral over secured specific assets will enable a lender sell off or take possession of such assets without having to seek judicial intervention.*
- *Taking collateral reduces the risk of non - payment thereby reducing the*

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[30] *The Chartered Institute of Bankers of Nigeria (CIBN), proceedings of the National Seminar on Banking and Allied Matters for Judges, CIBN Press Limited, Yaba-Lagos* (2002) *at p.35.*

[31] *Central Bank of Nigeria Prudential Guidelines as at 30/5/10 @ www.cbn.gov.ng - accessed on 31/5/10*

cost of credit since the cost of interest payable on a collateralized credit will be lower than that of a credit without collateral.

- *The debtor will be propelled to discharge his obligations due to the apprehension of the probability of enforcement of the collateral in the event of default.*
- *In the event of a downturn in the debtor's business and if the need for rescheduling the credit arises, the collateral will provide the creditor with a stronger negotiating hand.*[32]

On the other hand, an unsecured creditor in the event of default, usually has to resort to litigation in order to recover his funds and even where the creditor has obtained judgment and wants to levy execution, he might end up with nothing if there are no assets to levy the execution on. In some cases, the judgment might even be a barren one without any assets to attach ab initio.[33]

[32] *Smith, I. O. Nigerian Law of Secured Credit, (2001), Ecowatch Publications (Nig.) Limited, Lagos p.2*

[33] *Akanle, O. "Security for Financial Transactions" being paper presented at the Workshop on Securities for financial Transactions, organized by the Centre for Law & Developing Studies, Lagos held on 5 – 8 November, 2002, p. 5*

CHAPTER FOUR

4.0 THE NATURE OF COLLATERAL INTEREST

A security interest is a property interest created by agreement or by operation of law over assets to secure the performance of an obligation, usually the payment of a debt. It gives the beneficiary of the security interest certain preferential rights in the disposition of secured assets. Such rights vary according to the type of security interest, but in most cases, a holder of the security interest is entitled to seize, and usually sell, the property to discharge the debt that the security interest secures. A secured creditor takes a security interest to enforce its rights against collateral in case the debtor defaults on the obligation. If the debtor goes bankrupt, a secured creditor takes precedence over unsecured creditor in the distribution the assets[1].

4.1 COLLATERAL INTEREST ARISING FROM TRANSACTION INTENDED AS COLLATERAL TRANSACTION

This presupposes that it is only a transaction intended to create collateral transaction that would be treated as such by the courts. Therefore, any transaction not intended by the parties to create a collateral interest will not be treated as collateral even if it has affinity to same. Thus, a sale of goods contract which contains a lease back or a letting on hire purchase will not be taken by the courts as creating a collateral interest.[2]

4.2 A COLLATERAL INTEREST AS A RIGHT IN REM

What a collateral interest creates is a real right in an asset as opposed to personal rights to an asset. The secured creditor is thus entitled to remove the assets from the general body of creditors where the debtor becomes bankrupt. In the event of

[1] *Black's Law Dictionary (8th ed. 2004)*

[2] *Akanle, Prof. Oluwale, Introduction to Security for Financial Transactions (2002) paper presented at the Workshop organised by the Centre for Law & Development Studies, Lagos at page 7*

bankruptcy, a purely personal claim to delivery or transfer of an asset does not survive but becomes converted into a right to prove for a dividend in the debtor's estate in competition with other creditors.[3]

4.3 AGREEMENT TO GIVE COLLATERAL

Agreement to give collateral arises when customers are made to deposit their original title deed and execute a memorandum of deposit.[4]

There is an equitable maxim that says – equity treats as done that which ought to be done.

Thus most agreements to give collateral in an asset will be treated in equity as if they were real transfer, thus blurring the distinction between real and personal rights.

4.4 Contractual Set Off vis-à-vis Collateral

Though most financial institutions tend to regard right of set off as security, but is it really a security in law? A security interest creates a real right in the assets given as security while a right of set off on the other hand even if given by contract is a purely personal right to set one claim against another. It does not give a right in the other party's monetary claim at all but merely enables him to assert a countervailing claim which operates in pro tanto extinction of his monetary claim.[5]

4.5 Conditions for Repayment vis-à-vis Collateral

A condition for repayment differs from a security interest. Where for example company 'A' deposits money with a financial institution upon terms that the deposit is to be repayable only when company 'A' and company 'B' (which is typically a member of the same group) have discharged their indebtedness to the financial

[3] *Ibid*
[4] *Ibid*
[5] *Ibid*

institution on other accounts. Such an agreement does not constitute a security perse as the bank acquires no right of set off in that 'A's deposit is not extinguished, it remains intact as 'A's asset but can be withdrawn only on fulfillment of the condition.[6]

4.6 ENFORCEABILITY OF COLLATERAL – AT WHAT STAGE DOES THE COLLATERAL BECOMES ENFORCEABLE

The essence of taking mortgage collateral is to give the mortgagee an assurance of having property to fall back on upon failure of the mortgagor to meet his contractual obligations on the date fixed for payment of the mortgaged debt. The method of enforcement of the mortgage is legal or equitable. At least five methods of enforcement are recognized by law namely:

i) Enforcement of Covenant to repay

ii) Entering into possession

iii) Sale of mortgaged Property

iv) Appointment of Receiver

v) Foreclosure of the equity of redemption.

The foregoing methods of enforcement are cumulative not exclusive so that "the mortgagee is entitled to pursue any or all the remedies, subject as regards the powers of sale and appointing a receiver, to the restrictions imposed by agreement or by statute as the powers could be express or statutory. Also where one method did not satisfy he debt owing to the mortgagee, he can adopt another method. However once foreclosure proceedings are embarked upon by the mortgagee, he cannot afterwards fall back on any of the other remedies aforementioned.[7]

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[6] *Ibid*

[7] *Smith, I.O, Nigerian Law of Secured Credit (2001) Ecowatch Publications (Nigeria) Limited, Lagos at p.73*

4.7 Enforcement of the Covenant to Repay

A covenant to repay is a necessary covenant in a mortgage agreement but where it is omitted, it is implied since I n equity the receipt of money acrries with it the obligation to repay in the absence of a covenant to repay.[8] This covenant may be assigned in accordance with statutory provisions for a valid assignment of a chose in action or by joining the original mortgagee in the assignment. It is a pre-condition for an enforcement of this remedy that the mortgaged property is in existence and that the mortgagee is in position to re-convey same. Thus where the mortgagee has parted with the property or has encumbered same, he cannot enforce the covenant.[9]

Also the mortgagee cannot enforce this covenant after foreclosure except the property remains intact and he reopens the foreclosure proceedings thereby. A sale after foreclosure extinguishes the mortgagor's liability for the contract debt but any sale either with the express concurrence of the mortgagor or with express or implied power of sale in the mortgage deed does not extinguish the mortgagee's right to sue on the personal covenant to repay.[10]

A judicial sale does not bar the mortgagee from enforcing the personal covenant to repay even though he can no longer re-convey the mortgaged property.[11] A covenant to repay cannot be enforced by the mortgagee and the principal sum secured by the mortgage irrevocably after the expiration of twelve years from the date when the right to recover the money accrued.[12] But the right to recover money is deemed not to have

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[8] Ibid
[9] *Ibid*
[10] *Rudge v. Richens (1873) LR 8 CP p.358.*
[11] *Smith, I.O, Nigerian Law of Secured Credit (2001) Ecowatch Publications (Nigeria) Limited, Lagos at p.74*
[12] *Limitation Act. No. 88(1966) , s.28(1).*

accrued if the (property) subject of the mortgage or charge comprises any future interest which has not matured.[13]

4.8 ENTERING INTO POSSESSION

Typically, under a Legal mortgage, the mortgagee is entitled in law to enter into possession by virtue of his legal title. The legal right arises immediately after the execution of a mortgage deed except such right has been contracted out by himself under the mortgage agreement.

As *Hamman L.J*. pointed out in *Four Maids Ltd. Vs. Dudley Marshall (Properties) Ltd*:[14]

> " *The right of the mortgagee to possession in the absence of some contract has nothing to do with the default on the part of the mortgagor. The mortgagee may go into possession before the ink is dry on the mortgage unless there is something in the contract, express or by implication whereby he has contracted himself out of that right. He has the right because he has a legal term of years in the property".*

As a result of the mortgagee's right to possess the mortgaged property, neither the mortgagee nor his agent can commit trespass therein. Thus, in *Awojugbagbe Light Industries Ltd. Vs.Chinukwe*[15], the mortgagor's claim against the mortgagee for trespass on the grounds that he appointed a receiver who took possession of the mortgaged property with the aid of security men and Alsatian dogs, was dismissed by the court. It also follows that the mortgagee cannot be restrained by the court from taking possession except such has been contracted out by himself under the mortgage agreement. Where physical possession is not possible due to the existence of leases

[13] *Ibid. S.28(2).*
[14] *(1957) Ch. P. 317 at p. 320*
[15] *(1995) 4 NWLR (Pt. 390) p. 379*

binding on him, he can enter into receipt of rents and profits by notifying the lessees in possession to pay rent to him as opposed to he mortgagor[16].

Where a receiver has been appointed by the court, he may apply to court for removal of the receiver and when the exercise of the foregoing powers is impeded by the mortgagor; he may bring an action to eject the latter.[17]

4.9 Collateral Interest vis-a-vis Customer's Dominance over the Assets

A collateral interest implies a restriction on the debtor's dominance over the assets as such a creditor cannot have a fixed security interest in an asset and at the same time allow the debtor the right to continue to treat the asset as his own. Thus in a situation where the debtor is left free to sell items of stock charged to a creditor without having to obtain the creditor's approval, the creditor has no fixed security interest. At best what he has is a floating charge. i.e if 'A' wants to obtain from 'B' a fixed security debts due from it, it is not sufficient to prohibit 'B' from disposing of the debts so 'A' must control their collection. If 'A', not only leaves collection of the debts in 'B' hands but also allows 'B' to deal with sums collected as his own, A's security interest even if labeled as fixed by the terms of the security agreement will be characterized by the courts as a floating security.[18]

[16] *Horlock v. Smith (1895) 1 Ch. D. p. 516*
[17] *Doe D. Roby v. Maisey 108 ER p. 1228*
[18] *Akanle, Prof. Oluwale, Introduction to Security for Financial Transactions (2002) paper presented at the Workshop organised by the Centre for Law & Development Studies, Lagos at p.9*

CHAPTER FIVE

5.0 CONSENSUS SECURITIES

There are four forms of consensus securities viz:

i) Pledge

ii) Contractual Lien

iii) Mortgage

iv) Charge

5.1 The Pledge

This is the oldest form of security device and it entails the actual or constructive delivery of possession of the assets to the creditor as security. The pledgee enjoys very limited legal rights in the assets as ownership remains with the pledgor. The right of the pledgee is special in the sense that it encompasses:

i) The right to use the asset at his own risk as long as it will not be damaged.

ii) To sell his interest as pledge or assignit by way of gift.

iii) To deliver the assets to another for safe keeping.

iv) To sub-pledge the assets on the same condition as he hold it and a debt not greater than his own.

iv) To sell the assets in the event of default in payment by the pledgor.[1]

As a result of the nature of pledge, it is only assets that are reducible to possession that can be pledged. In reality, only goods and documentary intangibles can be pledged. These are documents that embody title to goods, money or securities such that the right to these assets is vested in the title holder of the document for the time being and can be transferred by delivery of the document with any necessary endorsement. It is therefore not possible to pledge ordinary written contract such as

[1] *Ibid at p.10*

building contract or hire purchase agreements, the production of which is not condition of the obligor's duty of payment or other performance.[2]

5.2 THE CHARGE

A Charge is an encumbrance on the asset of the charger. It is not dependent on delivery of possession or transfer of ownership but represents an agreement between a creditor and debtor by which a particular asset or group of assets is appropriated to the liquidation of a debt so that the creditor is entitled to look to the assets so charged and its proceeds to discharge the indebtedness, in priority to the claims of other unsecured creditors and subsequent encumbrances. It does not transfer ownership in an asset because it is a creature of equity. [3]

A charge does not in itself transfer ownership to the creditor. It is merely an encumbrance, and a weight hanging on an asset with which it travels into the hands of third parties other than a bona fide purchaser for value without notice.

5.3 CONTRACTUAL LIEN

It is only a purported contractual lien conferring a right of sale in event of default that can be called a pledge. Possessory lien being a right conferred by law to detain property until money owed is repaid does not confer a right of sale. The lien does not therefore constitute a transmissible interest and thus, cannot be pledged.[4]

5.4 FIXED AND FLOATING COLLATERAL

A fixed charge is created when a specific or determinable asset is appropriated to the payment of a debt or upon the acquisition of interest in title by the debtor. Under a floating charge however, the appropriation is differed to a future date upon the

[2] *Ibid at p.11*
[3] *Ibid*
[4] *Ibid*

happening of a specified event. The Chargee's rights attach on creation upon a shifting fund of assets and not to specific assets. The debtor is given a free hand to deal with the assets in its ordinary course of business. Often times, the charge crystallizes and attaches to the assets of the debtor comprised in the funds or subsequently acquired by the debtor when the debtor's management powers are brought to an end. [5]

5.5 PLEDGE COLLATERALS

The concept of pledge has always been associated with possessory right in the subject matter of security, be it land or chattels. With regards to land, the old method of creating mortgages in the earlier days of the common law was through pledge.[6] Land has always provided for the lender to posses and reap rents and profits there from and two types were common. There was the *vivum vadium* or living pledge which required that the lender entered into possession and take rents and profits in the discharge of both the principal and interest.[7] Where the lender was required to enter into possession of land and take rents and profits in the discharge of the interest only, it is called a *mortum vadium* or a dead pledge.[8]

The old English methods of creating mortgages on land was discarded by giving way to a transfer of proprietary interest in the land to lender as security to a condition that the borrower's title be annulled and be absolutely vested in the lender upon default to pay the loan. The era of equity of redemption evolved later to purify the mortgage transaction and cloth it with efficacy. [9]

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[5] *Ibid*
[6] *Hlodsworth, 'A History of English Law' vol. 3, p.128-132*
[7] *Ibid*
[8] Ibid
[9] *Smith, I.O, Nigerian Law of Secured Credit (2001) Ecowatch Publications (Nigeria) Limited, Lagos at p.107*

From the evolution of mortgage transaction, there is ample evidence that the old concept of mortgage as a pledge of land has changed especially with the emergence of chattels as security. The conception of a pledge as a way of taking physical control or custody of the subject matter of security made land unsuitable for that kind of arrangement since land is an immovable with physical existence that cannot be committed to the custody of anyone.

The movable nature of chattels has actually made it possible to create a pledge on it. Thus the position at common law is that chattels and not land may be pledged. The position is explained by *Sheridan* as follows; [10]

> *"the commonest pledges are of goods…land and incorporeal property cannot be pledged…deposit of title deeds to land to secure a loan operates as an equitable mortgage…"*

A deposit of title deeds to land as security for credit facility does not operate as a pledge of the documents but as an equitable mortgage.[11] It would be wrong therefore to refer to a pledge of land or title deeds thereto at common law or to create such security which has no place in modern English law.

Customary law unlike the common law has always recognized pledge of land as a security for advances. The evolution of customary pledge lies in remote antiquity and developed from a system known as pawn. In many parts of Africa, it was possible in early times for a man to pledge his own children to work for a number of days in the week on the lender's farm in return for the use of borrowed land.[12]

Although the practice of pledging human beings has long been made illegal in Nigeria and other African countries pursuant to global condemnation of same through laws

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[10] *Ibid*
[11] *Ogundare v. Araba (1978) 1 LRN p.280-288*
[12] *Smith, I.O, Nigerian Law of Secured Credit (2001) Ecowatch Publications (Nigeria) Limited, Lagos at p.108*

and conventions, the concept of security behind it survives with the use of agricultural land as the subject matter of a pledge on land. Customary pledge provides farmers with the means of realizing capital to the farm and boost productivity. It provides a convenient way of securing loans and advances in a traditional setting which hitherto made borrowing on the English type mortgage impossible due to the absence of title deeds in customary holdings.[13]

The pledge serves as "a safety valve against outright sale and being indigenous to the people, it is better understood by them than the received institution. Its simplicity and non complex nature and the ease with which it could be created, appeal more to the psyche of the people better than the technicalities and undue formalities associated with the English type mortgage.[14] The growth of grass root banking in Nigeria as evident in the springing up of community banks in modern times enhances the use of pledge of cash crops and other economic trees as security for bank loans and advances. The use of this customary institution however brought complications over the nature of pledges and the rights and duties of parties to the transaction which necessitated the articulation of certain rules and principles at customary law.

5.6 CUSTOMARY PLEDGE

A customary pledge is an arrangement at customary law whereby the owner -occupier of land known as the pledgor, in order to secure an advance of money or money's worth, it gives possession and use of the land to the creditor known as the pledge until the debt is fully discharged. From this description, two essential features of customary pledge are discernible thus:

[13] *Ibid*
[14] *Ibid*

i) That the pledge provides the pledgee–creditor with security for the performance of the pledgor's obligations of repaying the loan.

ii) That the security takesthe form of giving the pledge possession of the pledgor's property.

Sometimes the customary pledge is confused with the English mortgage[15] and the problem is further compounded by the practice of reducing transaction into writing and failing to use language precise enough to indicate the nature of the transaction. For example, the controversy the transaction in the case of loan between two parties whereby the plaintiff gave the defendant possession of his house with the right to collect rents and profits there from but a document was later executed describing the transaction as a mortgage.

The distinction between a customary pledge and the English Mortgage lies in the nature of the security granted to the creditor. If the agreement is intended to give the creditor some proprietary estate or interest in the property, then irrespective of the fact that the creditor takes possession of the property under an express stipulation or by operation of law, the transaction is a mortgage. On the other hand; where actual possession is to be given to the creditor under the agreement; the transaction is a pledge as opposed to a mortgage as *Michelin J. pointed out in Adjei v. Dabanka*[16] *that:*

> *"It is an essential of a native mortgage (pledge) that possession should be given at the time when the transaction takes place between the parties. It is out of the possession granted under the agreement that the pledgee's right spring"*

[15] *Ibid*
[16] *(1930) 1WACA p.63 at pp. 66-67.*

The usual understanding under customary pledge transactions is that the pledgee shall enter upon the pledgor's land and enjoy rents and profits from the land until the pledgor settles the debt owed.

5.7 CREATION OF CUSTOMARY PLEDGE

In its original form, a pledge could be created orally in which case witnesses were generally required to evidence the transaction. Through the flexibility of customary law and the recognition of the use of writing, the practice has been to document the transaction and provide for the terms and conditions binding between the parties to the transaction. The documentation in the simplest form shall identify the parties, the land and the understanding behind the transaction. it is not uncommon to find other terms and conditions stipulated. The use of witnesses is dispensed with by the parties simply executing the document.

It is advisable that all pledge transactions be recorded in writing to foreclose any claim that the land was sold to the person in possession. To create a valid pledge, the peculiarities of the Nigerian land tenure system must be borne in mind namely;

5.7.1 Ownership and consent requirement

Where the land is family land, the consent of the head of the family and the principal members must be sought and obtained. In the case of communal land, consent of head of the community must be obtained. The reason is that ownership of such land is vested in the corporate entity with the individual having only a right of user[17].

[17] *Amodu tijani v. secretary southern provinces (1921) AC .p.399.*

5.7.2 The Requirements of the land use Act.

With the advent of the Land Use Act, a prospective pledgor shall take note of the following instructions;

(a) Where the land is situated in an urban area but undeveloped, the borrower cannot pledge more than half hectare since that is the maximum quantum that he is entitled to by law[18].

(b) Where the land is situated in the federal capital territory, customary pledge can only be created over land the subject of a statutory right of occupancy mainly for, a customary right of occupancy does not exist there[19].

(c) Consent of the Local Government is required with regard to a customary right of occupancy and Governor's consent with regards to a statutory right of occupancy[20] since 'transfer' requiring such consent is expressly made to cover 'transfer of possession'[21].

(d) A holder of a customary right of occupancy granted by the Local Government is not entitled to more than 500 hectares in the case of Agriculture 5000 hectares in the case of land meant for grazing. Such holder cannot *ipso facto* create a pledge over land which exceed the maximum quantum prescribed by law[22].

The greatest impediment to the creation of a valid pledge is the provision of section 36(5) of the act which appears to prohibit any transfer of land in non urban areas deemed granted. The sub section provides;

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[18] *Land use act cap 202 LFN1990, s. 34(5)*
[19] *Ona and anor v. atenda (2000)5 NWLR(pt 656)p.244*
[20] *Land use act, ss. 21 and 22.*
[21] *Land use act , s.22(1).*
[22] *Ibid, s. 6(2)*

> *"No land to which this section applies i.e. land not in an urban area which was immediately before the commencement of the act held or occupied by any person shall be sub-divided or laid out in plots and no such land shall be transferred to any person by the person in whom the land was vested aforesaid"*

Whilst a literal interpretation of the provision suggest that there is a total bar on 'transfer of land' i.e. proprietary interest in such land, there is nothing to suggest same for 'transfer of possession. Except this interpretation is acceptable and applied by the courts, the bulk of agricultural land in Nigeria may be barred from being subject matter of customary

pledge[23].

5.8 NEGATIVE PLEDGE COLLATERAL

The following are the common forms of negative pledge:

5.8.1 Domestic Transactions

In domestic transactions a negative pledge clause is most commonly found in a floating charge. In a floating charge the burrower undertakes not to grant any subsequent security either ranking in priority to or parri passu with the floating charge without the prior consent of the debenture holder. When a negative pledge clause is inserted in a fixed charge it is usually more stringent. The burrower is prevented from creating subsequent interest without prior consent. It goes beyond the issue of priority, as a fixed charge no doubt has priority over a floating charge. Such a covenant goes beyond the mere preservation of the first lenders priority. The grant of a subsequent

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23 [14] *Smith, I.O, Nigerian Law of Secured Credit (2001) Ecowatch Publications (Nigeria) Limited, Lagos at p.112.*

security interest to another financier is a breach of the negative pledge clause and thus an event of default attracting various right and remedies[24].

5.8.2 International Transactions

In international loan financing, the negative pledge is commonly taken by an unsecured lender and is designed to secure equality not priority. The purpose of a negative pledge in international transactions is to ensure that the unsecured lender would have either equal and ratable security over the same asset or be given security over other assets of the debtor of at least to the same value if the burrower gives security to another financier.

The negative pledge clause comes in two forms in international transaction viz:

a) As a purely Negative Covenant

b) An Affirmative Covenant

In the negative form, the covenant is that the burrower will not grant security over assets without giving equal and ratable security over the assets or security over another asset of equal value to the earlier financier. The covenant in this form does not involve a promise by the borrower to give equal and ratable security. The provision of such security is simple a condition of the burrowers license to encumber the assets. In the affirmative covenant the borrower agrees that if it gives security over an asset it will give equal and ratable security over that asset to the same financier. The borrower is obliged in an affirmative covenant to give security to the first financier upon the happening of a stipulated contingency usually the grant of security to the second financier[25].

[24] *Ibid, p.13*
[25] *Id*

5.9 THE LEGAL NATURE OF THE NEGATIVE PLEDGE

i) Covenant not to encumber is not a Security Interest.

A negative pledge *per se* being a covenant not to encumber with no requirement to furnish security to the first financier if security is given to another financier cannot on its own amount to a security interest.[26] It does not purport to give the creditor any rights, not even a contingent one over the present or future assets of the debtor. This is irrespective of whether or not the creditor is secured or unsecured.

A negative pledge therefore does not create a security interest in itself because it merely constitutes an equity binding a third party with notice and thus builds up the security given by the floating charge.

ii) Provision for Matching Security Creates no Security Interest.

This is a situation where the negative pledge clause allows the debtor to give subsequent security provided that matching security is given to the creditor. If this covenant is given in a negative form the debtor does not undertake to furnish security to the first creditor on granting security to the second; the furnishing of security is merely a non promissory condition of the right of the debtor to encumber the assets. The first creditor is thus not entitled to security even if the covenant is broken since he did not bargain for it on the other hand if this provision is inserted in an affirmative covenant the debtor undertakes to give security in another asset of at least equal value to the first creditor if an asset is given by way of security to a subsequent creditor the debtor's promises to give security is called into play on the occurrences of a stipulated event[27].

[26] *Id*
[27] *Ibid*

5.10 TAKING SECURITY WITH NOTICE OF A NEGATIVE PLEDGE CLAUSE

Since a negative pledge does not on its own create a security interest in favour of an original creditor, can the original creditor invoke any equitable real right against a subsequent encumbrancer who takes his security with notice of the negative pledge? In the case of *Kelly v.Central Hanover Bank and Trust Co.11 f. supp.479 (1935) reverse 85 f. 2d 61 (1936).* A company issued unsecured debentures containing a negative pledge clause in negative form and subsequently gave some of its assets in security to the defendant. The plaintiff, a debenture holder, alleged that the grant of the security was a breach of the negative pledge clause and that the defendant had notice of the negative pledge.[28] His contention was based on the followings:

(1) That he had an equitable lien on all the assets of the debtor

(2) That the covenants created something in the nature of an equitable servitude.

(3) That the defendant having participated in the debtor's breach of trust or knowingly and unjustifiably interfered with the plaintiff's rights as debenture holder, held the security as constructive trustees or the plaintiff.

(4) That plaintiff had a right of equitable reparation against the defendant for knowingly invading the plaintiff's right to continue performance of its contract by the debtor.

The claim of the plaintiff was however dismissed on both facts and law. The fact that a party invoking the negative pledge cannot be put in a better position than he would have if the covenant had not been broken excludes the possibility of an equitable security in the debtor's assets whether directly or as beneficiary under a constructive

[28] *Ibid*

trust of the security taken by the subsequent creditor. It is only where plaintiff holds a floating charge and the negative pledge is used to secure priority for that charge over a subsequent encumbrance that a subsequent encumbrancer can be said to take subject to the negative pledge. The only remedy for a plaintiff in a negative pledge simplicita is to sue for an injunction to restrain the breach of the negative covenant or damages for inducing breach of contract[29].

5.11 CONTINGENT LIABILITIES

The term contingent is a liability which awaits or depends on the happening of an event. It could arise from Guarantees, Bonds and Letters of Credit opened by one bank and confirmed by another. These forms of documentation are taken as securities for advances or the discharge or some other obligations. It constitutes a form of insurance which the lending financier takes against the risk of non-payment in which event it could make a recourse to the security. The importance of Guarantees, Bonds and Letters of Credit as forms of securities will now be examined in details.

5.11.1 Guarantees

A guarantee is an undertaking given by one person called the guarantor to another called the creditor. The guarantor undertakes to be answerable to the creditor for the debt owed to the latter by a third person called the debtor if the debtor default. It is therefore, an accessory undertaking to the principal obligation between the debtor and the creditor. In *W. N. Finance Corporation Vs Aladesanmi, Agbaje j. explained the nature of a guarantee as follows:*

> *"It is the essence of a contact of guarantee… that the guarantor… shall make good the default of the principal debtor. so the fact that the principal debtor is no longer physically available to pay his debt does not in my view*

[29] *Ibid*

discharge the guarantor… from his obligation under a loan agreement[30]*"*

5.11.2 Indemnity

An indemnity is an undertaking to compensate someone else against loss or damage. An indemnity is therefore a principal obligation to compensate if loss or damage occurs, and the loss or damage need not be caused by default of a third party. It may result, for example, from a natural catastrophe – example insurance policies.

The essential distinction in law between guarantee and indemnity lies on the principle that a person who guarantees the other enters into secondary relationship with the beneficiary while a person who indemnifies the other enters into primary liability. A contract of guarantee involves the existence of another prior contract, one party being common to each contract, the principal debtor is liable on the first contract, the guarantor is only liable on the second contract, whereas the creditor is a party to both contracts. In an indemnity there are only two parties to the contract. The distinction between the two is best illustrated in the case of *Bentworth Finance (Nigeria) Limited v. Ibrahim*[31], *where it was held that guarantee requires the existence of three parties, while a contract of indemnity does not.* The distinction between an indemnity and guarantee is important because the contract of guarantee falls within section 4 of the statute of frauds 1677 and therefore unenforceable by action unless evidenced by a memorandum in writing signed by the guarantor. The statute of fraud 1677 is a statute of general application in Nigeria.

An indemnity on the other hand need not be in writing, in *Mounstephen vs. Lakeman*[32]*, the court held that an indemnity need not be in writing. Although, an indemnity need not be in writing it is not advisable for a bank to accept an oral*

[30] *(1970) NCLR 335*
[31] *(Unreported) High Court of Lagos, Rasim J. Suit No. LD/479/69 on 11/8/69. Case book p.205*
[32] *(1874) L.r. 7 II. 17*

indemnity unless it is in writing. Guarantees also feature prominently in both local and international transaction. It was a common practice for a Nigerian bank wishing to extend credit facilities to a customer to request for a foreign or local guarantee in order to protect its interest in the event of default by the customer.

As a matter of fact, few years ago guarantees, particularly foreign bank guarantees account for larger percentage of securities taken for loans. However, central bank Monetary Circular (amendment no. 3 of April, 1989) prohibits banks from granting naira dominated loans in the security of foreign guarantee and foreign deposits and/or in domiciliary accounts. The practice of accepting foreign guarantees by banks as security for loans has therefore been stopped since April 1989.

The difference between local and international guarantees lies in the fact that an international guarantee is subject to conflict of laws. It is therefore desirable to insert a clause in the guarantee that same be governed and construed in accordance with the laws of Nigeria. The advantage of such a clause is that it makes Nigerian law, the proper law of the contract. Furthermore, it avoids the hazards and expenses of instituting such proceedings in foreign courts.

5.12 FEATURES OF GUARANTEES:

First it is very essential that a financial institution should observe and act upon any preliminary conditions upon which the guarantee is given. Unless provided for in the guarantee or assented to by the guarantor any material alteration of the agreement between the banker and the customer releases the guarantor from all liability on the instrument. This point is best illustrated by the case of *Burton vs Gray*[33]; the plaintiff handed to his brother certain securities, which the brother took to the defendant bank

[33] *(1973) 8 Ch. App. 932*

for the purpose of obtaining a loan. He showed a letter purported to have been signed by the plaintiff, and giving a charge upon the securities..." in consideration of your lending. F. Burton the sum of $1,000 for seven days from this date". Instead of lending that sum to the brother, the defendant allowed him to overdraw his account by means of a number of cheques, the amount of the overdraft being rather less than $1,000. *It was held that the terms of the deposits required an immediate advance of $1,000 and had not been fulfilled,and that the defendant must give up the securities.*

Also in *Awolesi Vs National Bank of Nigeria Limited*[34]. The appellant guaranteed the account of a customer of the respondent bank up to a limit of $10,500. At the time the guarantee was signed the account was overdrawn by $3,500. The bank without notifying the guarantor subsequently opened another account in the name of the customer from where he withdrew money. The court held that an agreement altering a guaranteed contract without the consent of the surety, discharges the surely, unless, without inquiry, it is evident that the alteration is unsubstantial and one which cannot be prejudicial to the surety.

5.12.1 Writing

A guarantee can be enforced by legal action only if the guarantee itself is in writing and signed by the guarantor or the guarantor's authorised agent. This is a requirement under *S. 4 of the Statute of Frauds and S. 3 of the Contract Law, Cap 25 of the Laws of Western Nigeria which re-enacts the relevant section of the Statutes of Frauds. By S. 4 of the Statute of Frauds, no action shall be brought against the defendant for any special promise to answer for the debt default of another person unless the agreement upon which such action is brought or some memorandum or note thereof, is in writing*

[34] *(1973) 8*

and signed by the party to be charged therewith or some person lawfully authorized by him.

The importance of the guarantor's signature on the deed of guarantee was well emphasized in the case of *Arab Bank (Nigeria) Limited Vs Alhaji Dantala*[35]*, the Supreme Court held that a person or persons who had not signed on the deed of guarantee of loan is not bound by it.*

5.12.2 Consideration

If a guarantee is under seal, it is valid whether or not consideration is provided in return. Consideration is necessary in a simple guarantee. It is sufficient that the debtor should have the benefit of the consideration as the guarantor may well be a volunteer.

In practice, most guarantee forms designed by banks usually state the consideration, but a guarantee does not became invalid merely by reason that the consideration is not stated therein[36].

5.12.3 Capacity

Like in any other contract, it is necessary for the parties to a contract of guarantee to have the necessary capacity for it to be enforceable. This means, for example, that an infant is not bound by a guarantee entered by him. Likewise a partner has no implied authority to give a guarantee in the name of the firm without the express authority of his co-partners. In the case of a limited liability company the power to give a guarantee must be expressly provided for in its memorandum of association. It is therefore necessary for a financial organisation to inspect the memorandum of association in order to ascertain whether the company can give a guarantee or not and to what limit. The board of directors should pass a resolution authorizing the

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[35] *(1972) 1 Llyod's Report 546*

[36] *Akanle, Prof. Oluwale, Introduction to Security for Financial Transactions (2002) paper presented at the Workshop organised by the Centre for Law & Development Studies, Lagos at p.3*

guarantee and a certified true copy deposited with the bank, a copy of the company's certificate of incorporation should also be obtained. Capacity to contract is not limited to the surety. It must be considered from the point of view of the debtor as there must be a valid debt in respect of which legal proceedings can be brought against the principal debtor, before a contract of guarantee can be enforced against the guarantor[37]. However, an ultravires loan granted to a company, not being legal, although unenforceable against the company may be effectively guaranteed. For example, in *Yorkshire Railway Wagon Vs Maclure[38], where the directors had borrowed ultravires and given their personal guarantee, the directors contended that as the transaction was ultravires, there could be no surety. The court held that the directors could be liable on their guarantee.*

*5.12.4 D*isclosure

A financial institution is under no obligation to inform a prospective guarantor about the circumstances surrounding the account of the debtor because a contract of guarantee is not a contract of utmost good faith which requires disclosure of all material facts.

However, a financial institution must answer questions asked by the prospective guarantor. Thus In *Ikoni Vs. Bank of West Africa limited[39] the supreme court of Nigeria held that "a banker is not bound to volunteer to an intending guarantor information as to the state of the account or whether the customer was or was not in the habit of overdrawing. If asked by the intending guarantor, be must give the information, this sufficient reason for disclosing the customer's accounts.*

[37] *Courts & Co. Vs Browne Lecky & others (1947) RB 104*
[38] *(1882) 19 Ch. D 448*
[39] *(1965) AIR COMM. 25*

A banker has a duty not to mislead the surety. Questions asked by the surety must be answered accurately because if he signs the guarantee under a misapprehension of any serious kind, he may be able to avoid liability under the guarantee.

This being the case, the banker should take great care that the guarantor is treated fairly well before he signs. The presumption is that the account of the principal debtor is not already overdrawn above the limit of the guarantee. If it is, the banker must disclose to the surety before he signs otherwise liability under the guarantee may be avoided. In the case of the *Machezie Vs Royal Bank of Canada*[40]*, Lord Alkin said "a contract of guarantee, like any other contract, is liable to be avoided if induced by material misrepresentation of an existing fact, even if made innocently"* also in *A.C.B.Ltd Vs Wogu & or 11*[41]*,* two company sureties who had guaranteed the accounts of Wogu, the bank customer, up to the limit of $10,000 were held not liable to the plaintiff bank on the guarantee having regard to the fact that the sureties did not know and the bankers did not disclose to them at the time they signed the guarantee that Wogu's account was already overdrawn.

In the words of the trial judge:

> *There is no presumption that an account stands clear at the time of the guarantee… there would normally be a presumption that the account is not already overdrawn to extent greater than the limit of the guarantee… and that it was therefore a matter which ought to have been disclosed voluntarily by the creditor without enquiry being made. The guarantee is avoided.*

5.12.5. Guarantee by Two or More Parties

It is imperative for all parties who have agreed to sign a guarantee to do so. it is also desirable that where two or more persons undertake to sign a guarantee, a banker should not disbursed until all have signed. These points are best illustrated by the case

[40] *(1934) A.C 468*
[41] *(1965) ALL MIR 172*

of National Provincial Bank of England Vs Brackenbury[42], four parties agreed to sign a guarantee, three signed but the Bank advanced the credit in anticipation of execution by the fourth person, who subsequently died without signing. The court held that those who signed were discharge from the obligations under the guarantee. A similar decision was taken in the Nigerian case of *Arab Bank Vs Dantata*[43] the plaintiff was one of the four parties purporting to guarantee a bank loan given by the defendant. One of the four however did not sign the document of guarantee. *The Supreme Court held that where a co-surety signs a guarantee on the understanding that another is to join in signing and that other did not join, obligee cannot recover from the one who signed unless he waived his obligation and accordingly, that in this case the plaintiff could not be held liable.*

5.12.6 Determination of Guarantee

In some cases determination of guarantee is made clear by the terms of the contract itself if it states that the guarantee shall be terminated upon the happening of a certain event. *The principal ways in which a guarantee can be determined are as follows[44]:*

(a) By agreement i.e if the bank is no more relying upon the guarantee e.g. an overdraft that is paid off.

(b) By notice given by the guarantor.

(c) Notice of death- if the principal debtor dies, he clearly cannot incur any fresh liability, and the guarantee is determined in the sense that the surety's liability becomes crystallized.

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[42] *(1906) 22 T. L. R 797*
[43] *(1977) 7 S. C 33*
[44] *Akanle, Prof. Oluwale, Introduction to Security for Financial Transactions (2002) paper presented at the Workshop organised by the Centre for Law & Development Studies, Lagos at p.6*

(d) Notice of Mental Disorder - this operate in the same way as death, see Bradford Old Bank Vs Sutcliffe (1918) 2 K.B .833.

(e) Bankruptcy - guarantee would not be affected if the principal debtor becomes bankrupt, except that it provides the occasion for its enforcement.

(f) Variation of the Terms of the Principal Contract – alteration discharges the surety from a guarantee unless there is agreement to the contrary.

(g) Change in the constitution of the parties determines a guarantee as to future transactions. This is particularly important if the debtor is in a partnership where changes may take place by death or retirement. It is advisable to provide that the guarantee is to remain effective notwithstanding any change in the constitution of the debtor (if it is a partnership).

Finally, a guarantor may be limited to a given sum, in this type of arrangement the limitation is normally to the guaranteed sum and not an advanced amount. It is therefore advisable to insert a provision in the guarantee that the financial institution could determine or increase the facility without recourse to the guarantor otherwise he may deny liability for excess above the guaranteed amount. A guarantee may be limited in duration, so it is also necessary to clearly specify the time (tenor) for instance, it could be stated that the guarantee will ceased to have effect 12 months after the date of execution. A financial institution may also take a continuing guarantee as security for a debt owed or at any future time. This type of guarantee continues unless terminated by the guarantor as to future advances by notice to the creditor or by some legal event[45].

[45] *Id*

A surety that pays off the full debt is entitled to the right of the creditor by subrogation.

The creation of guarantee is advantageous because it is easy and cheap unlike other forms of security like mortgage or change on assets.

Furthermore, financial institutions often accept personal guarantee of directors as security for loans granted their companies. This practice encourages the director to ensure continued success of the company. Guarantees are also given by mother companies as securities for facilities granted to their subsidiaries. This encourages proper supervision of the subsidiary companies by the mother companies. Financial institution also accepts guarantees from government(s).

5.12.7 Demerits of Guarantee

The creation of guarantees also has its demerits such as[46]:

i) The ability to enforce a guarantee in a court of law could be barred by passage of time (limitation of time). As a matter of procedure, the guarantor could defeat the creditor's action by pleading the defense of limitation of time. Guarantees must therefore be drafted with utmost care in order to protect the interest of the financial institution.

ii) Misrepresentation and any significant alteration of agreement without the consent of the guarantor, enables the guarantor to avoid the contract.

iii) The ability to monitor the financial position of the guarantor could be a problem since the financial position of an otherwise sound guarantor when he executed the guarantee could change without the financial institution's knowledge.

[46] *Id*

However, it is worthy of note to state that although a guarantee may not be as reliable as other tangible securities, they are usually very effective if they are taken from men of sound financial position and integrity who are willing to honour their obligations.

5.13 Bonds as Security

A bond (also specie of guarantee) is a written instrument issued to a buyer or employer by an acceptable third party (a bank or insurance company) guaranteeing that the exporter or contractor will comply with its obligations under the contract. In the event that the contractor fails to comply, the employer will be indemnified with specific amount.

Today, bonds and guarantees are becoming increasingly important in both domestic and international commercial transactions. In fact, they are integral to modern international trade. Employer's demand for bonds in order to ensure that the contractor had the financial capacity to complete the work. They also give the employer certainly over receiving a pre-agreed payments if the contractor fails to meet his contractual obligations[47].

5.14 MAJOR TYPES OF BONDS

5.14.1 Tender or Bid Bond

Tender or Bid Bond as a form of security are mostly issued in circumstances where the employer is inviting tenders from different entitles. It is designed to ensure that the tenderer do not withdraw his bid, fail or refuse to accept the award of contract in his favor. Each tenderer has to submit such a bond as a condition to being permitted to bid for the contract. Such a bond gives the employer an assurance that all tenders are genuine, and in the event that the tender is successful and he fails to accept the

[47] *Id*

contract awarded, the issuer of the tender bond must compensate the employer with the stated amount of money in the bond. This will compensate the employer for his trouble and expenses towards conducting another tender. The employer is also protected from any damage as a result of his taking offers from others if the winning contractor does not keep his word this is because construction cost might increase as a result of the delay in obtaining fresh tenders[48].

5.14.2 Advance Payment Bond

Advance Payment Bonds as a form of security are mostly issued for major projects where the contractor may require an advance payment of the contract to finance operations, such as purchase of equipment, fund overhead and organization cost, hiring and housing of labour, transportation of materials and customs clearances. Such payments are covered by an advance payment in favour of the employer.

An Advances Payment Bond is therefore a comfort to the employer by the contractor's bank agreeing that the advance payments will be repaid in the event of the contractor defaulting on the contract. An Advance Payment Bond may be issued for the full amount of payment. The amount of the Bond usually reduces as the work progresses. This is usually backed by a certificate of completion indicating the amount of work reduced vis-a-vis the advance payment received. On production of the of the certificate, the issuer of the bond i.e. the bank is authorized to effect the requisite reduction. In exports sales, it would be possible to link reduction with the presentation of shipping documents. It is therefore advisable to provide that such bonds will not come into force until the advance payment has been received[49].

[48] *Id*
[49] *Id*

5.14.3 Retention Money Bond

The employer may require some assurance that the contractor will continue to provide service for a reasonable period after completion of the project. for instance, a customer-build power station may undergo acceptance trials satisfactorily, yet problems may occur subsequently. In order to obtain this assurance, the contractor may specify that part, say 5-10% of the payments will be retained until the project is completed and accepted.

The agreed time-lag is usually one year after completion of the project or delivery of the good. This gives the employer a strong position vis-à-vis the contractor, since the retained amount may represent a substantial percentage of the anticipated profit on the contract. This would create cash flow problems for the contractor. These can be overcome by providing a retention bond, which enables the contractor to receive the full payment while assuring the employer that funds will be call able if the contractor fails to meet his obligations[50].

5.14.4 **Performance Bond**

Performance Bonds are issued when a contract has been awarded. They are issued by banks to cover certain percentage of the contract value. A performance bond is a guarantee to the employer that the contractor will abide by the terms of the contract to complete the project correctly. Often, performance bonds are issued by the same bank that issued the bid bond. A major characteristics of a performance bond is that it is payable on demand irrespective of any objection raised by the contractor and without the need for any judicial proceedings or a resolution from an arbitrator. The reason is very clear. For example, in Nigeria cases abound of contractors leaving the country or abandoning the construction works after collecting mobilization fee. Every

[50] *Id*

government or any employer owes itself a duty to spent its money with the least possible risk. Such demand bonds enable the government or any beneficiary to obtain payments of a specified sum of money by calling the instruments. A performance bond may be conditional in nature. An undertaking is said to be conditional if the guarantor's liability is conditional on the employer (beneficiary) proving default by the contractor. The beneficiary has to establish an unremedied breach of the contract as well as loss caused by that breach. It is now judicially acknowledge that a breach will be conclusively proved if the beneficiary presents an arbitration award made in his favour to the guarantor.

It has been argued that the judicial approach has change the traditional nature of conditional bonds thus translating it into an unconditional or demand performance bond. The argument is based on the fact that the beneficiary can claim payment by mere presentation of the arbitration award. Although, there is some merit in this argument, I believe this approach does not alter the nature of the conditional performance bond. It only reduces the burden of proof of breach of the contract by the beneficiary. With unconditional (on –demand bonds) the legal relationship between the guarantor and beneficiary is wholly independent of the contract between the contractor and the beneficiary. The contractor can only restrain the bank (guarantor) from making payment to the beneficiary by applying for an *ex parte* injunction to prevent the guarantor from meeting its commitments. Except possibly in cases of fraud which the bank has notice, the injunction will not be granted by the court. The parties will thus be left to settle their dispute under the contracts by litigation or arbitration as available to them or stipulated in the contract. The danger inherent in agreeing to the issue of unconditional bond lies in the fact that the bond may be unjustifiably called by the beneficiary and there may be no adequate redress under the

contractual terms of the transaction which gave rise to the bond. In one case, *Edward Engineering v. Barclays Bank International Limited*[51] Owen engineering had entered into a contract to supply greenhouses to a Libyan buyer for over $500,000. At the seller's request, Barclays bank had its guarantee "payable on demand", to pay 10 percent of the contract price ($50,000) to the umma: bank in Libya, who in turn issued a performance bond or guarantee to the buyer. The seller alleged that the Libyan buyer did not comply with the terms of the contract as it failed to give a confirmed letter of credit, and therefore refuse to go on with the contract.

The Libyan buyer then demanded payment from Barclays under the terms of the guarantee. Lord Denning M.R ruled that "a bank which gives a performance guarantee must honour the guarantee according to its terms… the bank must pay according to its guarantee on demand if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice". A similar decision was reached in the case of *Hartbottle (Mercantile) limited* Vs. *National Westminister Bank Limited*[52]

In practice the risk incurred by sellers in providing unconditional bonds can be minimized by including provisions in the bonds aimed at preventing any claim being met by the guarantor in the absence of account or arbitration award in a party's favour and specifying the precise documentation required to accompany claims by the beneficiary. In Nigeria, performance guarantees feature prominently in areas of domestic and international construction contracts. A domestic construction contract is a contract between the employer (i.e. federal government or state governments as is often the case) and the contractor which is often a company incorporated in Nigeria to carry out works of civil engineering construction. A domestic construction contract

[51] *(1978) 1 Lloyds Re 161*
[52] *(1978) Q.B. 146*

has a tripartite structure whereby the employer is the beneficiary, the contractor is the principal and the guarantor is the contractor's bank. The contract is usually expressed to be governed by Nigeria law and payment there to be made in Nigeria currency.

It is advisable that financial institutions should be very cautious in giving performance bonds as instance abound in Nigeria where some contractors have collected some mobilization fee without performing the contract. Before issuing a bond a bank should satisfy itself that the contractor is unlikely to renege on its obligation to the employer. Furthermore, a bank should protect itself by obtaining adequate security.

As regards the employer, it is obviously in its interest that the provision of performance guarantee should be made mandatory in domestic construction contract contrary to the existing regulations which made the issue discretionary. Domestic contracts for works of civil engineering constructions are regulated by federal government of Nigeria. Clause 10 of the general conditions regulating the contract apart from making the provision of performance bond discretionary, states that the performance bond shall not exceed 10% of the tender sum[53] the percentage guarantee in the performance bond appeared to be too low and I would suggest that same should be increased to safeguard the employer's interest.

5.15. The Charge

A charge is a security for the repayment of money a financial institution lend to its customer. If the security is of adequate value it means the financial institution is protected if the customer becomes insolvent. *A charge is therefore the right to enforce claim to repayment against the security charged with debt, in effect the claim takes precedence over those of unsecured creditors*[54].

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[53] *Akanle, Prof. Oluwale, Introduction to Security for Financial Transactions (2002) paper presented at the Workshop organised by the Centre for Law & Development Studies, Lagos at p.10*

[54] *Id*

5.16. The Difference between a Mortgage and a Charge

A mortgage involves the actual transfer of title to landed property where the customer will convey his property to a financial institution with a provision that on the event of repayment of the debt, the financial institution is compelled to re-convey the property back to the customer. Landed property is therefore the essence of a mortgage but a charge however does not involve the actual transfer of title of a property and the customer could merely grant a financial institution the right to deal with certain part or the whole of its property in a particular fashion so that if the customer should default in repaying the debt or complying with the terms upon which the loan was granted, he could still retains the legal title to the property but the power to enforce certain rights against the property resides with the financial institution even though the legal title is retained by the customer which in essence constitutes the charge over the property[55].

An incorporated company is usually granted power under the companies and allied matters act to borrow money. *Where that borrowing is secured, it will likely be created by a debenture. A debenture is the "written acknowledgement of indebtedness, by a company"[56] usually made under seal and may create a charge over the whole or part of the company's property. Where the security for the borrowing is landed property, the document may be referred to as a mortgage debenture, similar to a mortgage created by an individual. Otherwise they would be Unsecured Debentures.*[57]

[55] *Id*
[56] *S.650 Companies and Allied Matters Act, 1990*
[57] *S. 173 (1) Companies and Allied Matters Act, 1990*

5.17 Types of Charges

A charge may be either fixed or floating. A fixed charge is one which is identified with a specific property, either landed property and buildings or plant and machinery which are identified at the commencement of the security, it is usually stated in the schedule to the Deed.

The types of charge are clearly stated in the *Companies and Allied Matters Act (CAMA) thus*[58]*:*

> *"Debentures may be secured by a fixed charge on certain of the company property or a floating charge over the whole or a specified part of the company's undertaking and assets or both by a fixed charge on certain property, and a floating charge on others"*

A floating charge is on the other hand defined thus[59]*.*

> *"……. an equitable charge over the whole or a specified part of the company's undertakings and "assets", including cash and uncalled capital of the company both present and feature. But so that the charge shall not preclude the company from dealing with such assets until…….*

(a) The security becomes enforceable and the holder thereof, pursuant to a power in that behalf in the debenture or the deed securing the same appoints a receiver or manager or enters into possession of such assets or;

(b) The court appoints a receiver or manager of such assets on the application of the holder or;

(c) The company goes into liquidation."

[58] *S.173 (2) Companies and Allied Matters Act, 1990*
[59] *S. 178 (1) Companies and Allied Matters Act, 1990*

5.17.1 Assets Charge

The court has consistently construed a clause charging "all the company's property, both present and future" as creating a floating charge. So also is a charge on "all the property hereafter to be acquired by the borrower ". *S. 178(1) of CAMA* specifically refers to cash and uncalled capital as part of the assets of a company subject to a floating charge. Also a floating charge may operate only on a class of assets, such as book debts, stock in trade and finished goods. It is possible to create a floating charge over landed property. As where the charge covers "all the undertakings and assets" of company. In such a situation the company could in the ordinary course of its business deal with the landed property by way of lease, such as exchange or specific mortgage as it deems fit[60].

5.17.2 Fixed Charges

From the definition of floating assets, it can be deduced that one cannot have a fixed charge on floating assets, since the idea of a fixed charge is that it is specifically related to a particular item. A specific charge cannot attach to assets which cannot be determined at the time the charge is created. As earlier stated, a fixed charge issued by a company is the corporate equivalent of a mortgage issued by an individual. It attaches to the generally immoveable property of the company such as land, plant and machinery or e.t.c. If the customer becomes insolvent a debenture holder secured by a specific charge is amongst the highest rank of creditors. He is a secured. Where the customer has issued several fixed charges on the same property as is possible, as between a first, second, third and subsequent fixed charge, the priority of financial institution to be satisfied first from the security is governed by the date of its creation, as priority will be based on that. In addition a company cannot dispose of a

[60] *Id*

property subject to a fixed charge without the consent of the lender(s). This is a major difference between a fixed and a floating charge. [61]

5.17.3 Floating Charge

One of the best descriptions of a floating charge is as stated by Lord Mac Naughten in *lllingsworth Vs. Houldworth (1904) A.C. 355 at 358*[62] *where he said:*

> ***"*** *I should have thought there was not much difficulty in defining what a floating charge is in contrast to what is called a specific charge. A specific charge, I think, is one that without more, fastens on a certain and definite property or property capable of being ascertained and defined, A floating charge on the other hand, is anticulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp."*

The statutory definition of floating charge is as contained in *S.178(1) of CAMA* and is no different from the above. The essence of a floating charge is that the company/borrower is not restricted from dealing with the assets upon which the floating charge is secured until some pre-agreed event occurs upon which the floating charge will be said to crystallize and attach itself to the assets, see *Intercontractors Nig. Ltd. v. UAC Nig. Ltd*[63].

As a result, unless otherwise agreed with the financial institution, a corporate borrower may create a specific charge in priority to any floating charge. If the intention is to prevent your customer from creating charges which can take priority over or rank *pari passu* with any floating charge which you may hold over its property, it must be clearly stated in the document securing the loan. In some

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[61] *Akanle, Prof. Oluwale, Introduction to Security for Financial Transactions (2002) paper presented at the Workshop organised by the Centre for Law & Development Studies, Lagos at p.3*

[62] *(1904) A.C. 355 at 358*

[63] *(1988)2 NWLR (pt 76) 303.*

instances however a borrower may be allowed to create a fixed charge over a specific portion of its property, since the floating charge may not cover all the company's property.

5.18 Crystallization of Floating Charge

The Company and Allied Matters Act states that a floating charge crystallizes and becomes a fixed equitable charge "on such of the company's assets as are subject to the charge" when the act upon which the parties have agreed, occurs to crystallized the floating charge. [64] In addition, a floating charge will crystallize when a receiver or manager is appointed over the assets of the company upon the application of the lender(s), or if the company goes into liquidation. Although a floating charge exist from the date of its creation, it does not affect the assets from that date, but from the date of its crystallization and attaches to those assets in existence at that date. See *Eze v. Express Steel Construction Ltd*[65]. It is therefore possible for a floating charge to crystallize and for there to be no asset available upon which it can attach, except perhaps for book debts and uncalled capital, if for instance the company has in the ordinary course of business sold all its stock in trade prior to crystallization. Below are some of the situation that could trigger crystallization of a charge:

(a) If the company makes default in the payment of principal or interest due.

(b) If a winding up order is made against the company and not withdrawn within a specified period.

(c) If a receiver is appointed over any part of the company's property.

(d) If the company ceases to carry on business.

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[64] *S. 178 (2) Company and Allied Matters Act, 1990*

[65] *(1980) NCLR 160 at 164.*

(e) If attachment is levied against the company's property and not discharged within a particular period.

(f) If the company fails to observe a specified obligation under the debenture.

In the event of crystallization, all assets secured by the charge and currently belonging to the company will be available to satisfy the holder of the now crystallized charge. This is however subject to the assets securing a fixed charge, which by *S. 179 CAMA,* takes priority over the floating charge. For a charge created by a company to be effective however, it must be registered with the Corporate Affairs Commission by virtue of *S179 of CAMA*.

By virtue of *S. 197 CAMA,* virtually all types of documents which create a charge on company's property irrespective of the nature of the security must be registered. For example a charge on goodwill or a patent as provided by *S. 197 (2) (1),* a charge on uncalled capital as provided by *S. 197 (2) (g)*, a charge securing a fluctuating amount as provided by *S. 202*. Even a charge on property situate outside Nigeria must be registered under *S. 197 (5)*.

Since a floating charge crystallizes upon the happening of a predetermined event, it is possible that if that event should disappear, the floating charge will decrystallise and detach itself from the asset already secured. This is envisaged by the wordings of *CAMA.*[66] The secured assets will be determined at the time of crystallization, when the rights of competing parties must be determined.

As earlier stated, a fixed charge takes priority over a floating charge unless the charge is taken with notice of any clause in the floating charge which prohibits the creation of a charge ranking in priority to it. All other assets not covered by the fixed charge can be attached by the holder of the floating charge. The main point where argument

[66] *S. 198 (2) Company and Allied Matters Act, 1990*

arises is the relationship between the holder of a floating charge and execution creditors.

Execution creditors may have obtained judgment in their favor but still remain unsecured creditors. If some assets of the company have been attached by virtue of the judgment debt but not yet sold, such creditor will definitely be unwilling to release them to a receiver appointed when a floating charge crystallizes. It should also be noted that attachment of assets is usually one of the crystallizing events. Since the assets have not been sold, they still belong to the company and therefore the charge crystallizes on them.

The lender secured by a floating charge therefore has priority over the judgment creditor see *Intercontractors Ltd. Vs . UAC*[67]. See also *M & K Vs. Anglo Canadian Cement Co*[68].

By law (S. 182 CAMA) a receiver appointed to represent the interest of a financial institution must pay out the receipts (money) that come into his hands in a specified fashion. In effect he must deal with the funds in his hands in the same fashion as if the company was being wound up and apply the money in the order specified in the law.

Finally and in summary, the main difference between a Fixed and a Floating Charge is in respect to the assets which are available as a security. Whereas a Fixed Charge "fixes" itself to the assets charged they are usually landed property or plant and machinery, while the Floating Charge "floats" over all the assets charged in their favour without disturbing the right of the borrower to deal with those assets, including selling them in the ordinary course of its business. A floating charge takes effect from the time it crystallizes and not before. If the security under a fixed charge is insufficient to satisfy the indebtedness which it secures, the holder of the fixed charge

[67] *(1988) 2 NWLR (pt 76) at 303.*
[68] *(1967) NCLR 42.*

becomes an unsecured creditor to the extent of his balance. He cannot enforce his security against other assets of the company not listed as part of his fixed charge[69]. Usually however a prudent lender will take a first or second fixed charge and a first floating charge. This ensures they are fully covered in event of default. When lending documents allow a floating charge to be created in priority to it (usually to secure working capital only) problems may sometimes occur in the event of default. The effect of such clause would be that a financial institution takes a first fixed charge over specific assets whilst the balance of its lending is subordinated to the loan taken for working capital purposes. The loan may however have been used to purchase tangible assets and finance work in production and stocks in trade. It is only after these have been used to satisfy the prior floating charge that the initial lenders will have recourse to the balance of the assets, which may then be only book debts and uncalled capital available to satisfy the balance of their lending.

[69] *Akanle, Prof. Oluwale, Introduction to Security for Financial Transactions (2002) paper presented at the Workshop organised by the Centre for Law & Development Studies, Lagos at p.6*

CHAPTER SIX

6.0 CONCLUSION

This chapter concludes the study with a view to providing summary, findings and recommendations to the problems identified.

6.1 SUMMARY

This thesis has highlighted the legal implications of taking collateral for loans and other financial indebtedness or obligations. In the course of doing this, detailed analyses of the different types of loans, their distinctions as well as characteristics were carried out. The effect of giving out uncollateralized loans on the economy especially the Banking sector, being the conventional lending institutions was also analyzed.

Collateral was described as a security deposited by a borrower to secure a loan made to him by a bank or any other lender. Such securities are deposited as a pledge or a guarantee that the loan will be repaid at maturity, if not paid the security may be sold to realize the loan. These collaterals come in different forms like title deeds, bonds, guarantees, cash deposits, shares etc. Other forms of collaterals are those where the objects themselves, instead of their papers, are put as collaterals. The well established fact that any lender – whether an individual or corporate body who wishes to be assured of repayment should take some form collateral, was highlighted consequently, financial institutions have a choice between relying on the borrower's promise to repay, or asking for collateral in addition to the bare promise.

Other elementary forms of collateral which are at times referred to as personal security and usually taken in the form of either a guarantee or an indemnity were also looked at. Good as this type of security may appear; it is not much different from a borrower's mere promise to repay because what the lender obtains is essentially one

or more additional bare promise. In this respect the thesis prefers security of a proprietary character, security that has property backing; which is called real security because it elevates the creditor to the status of a secured creditor, giving him something to hold unto until the debt is settled.

Prudent lenders realize the precariousness of a bare promise viz; the borrower may drop dead, he may become bankrupt, or he may simply refuse to pay back. Consequently, lenders insist on something to hold unto to assure them that the borrower would repay. This unfortunately was not fully adhered to by some Banks in Nigeria after the post 2005 Consolidation exercise of the Central Bank of Nigeria and the resultant effects were the distress and near collapse of some of the Banks which necessitated a bail exercise for them by the CBN via huge sums of tax payer's monies from the Federal purse.

6.2 FINDINGS

The following findings were made in the course of this research:

i) *That excessive high level of bad loans in Nigerian banks, were attributable to poor Corporate Governance Practices, lax Credit Administration Processes/Risk Management Policies and inadequate Collaterals because the percentage of bad loans to the total loans of just five (5) banks ranged from 19% to 48% totaling about ₦539.09 billion*[15].

ii) *The total loan portfolio of these 5 banks was ₦2,801.92 billion. Margin loans (stock facilities loans) amounted to ₦456.28 billion and their Aggregate non-performing loans stood at ₦1.143 billion representing 40.81%.*

[15] *Press Statement by the Governor of the Central Bank of Nigeria on 14/8/09 @ www.cbn.gov.ng- accessed on 11/9/10*

6.3 RECOMMENDATION

In the light of the fact that bad loans usually arise as a result of bad credits from inadequate or zero collateral which would have served as fall back for recovery of funds in the event of default as witnessed during the recent business collapses from the aftermath of the financial meltdown which was attributable to lax Risk Management Principles, inadequate collaterals and non adherence to Corporate Governance Principles, it is hereby recommended as follows:

i) The Banks and Other Financial Institution Act, 1991, BOFIA (as amended) which is the law requiring banks to take adequate collateral when lending, should be further amended to compel banks to take additional collaterals either in the form of a Legal Mortgage or a Fixed and Floating Debenture in addition to taking shares of quoted companies as collaterals whenever they give out stock facilities/loans (known as Margin Loans), so that the losses that would be incurred in the event of default, would not be as enormous as what was witnessed during the Capital Market Meltdown era since such collaterals could be realized without erosion of value even if the Capital Market collapses.

ii) The sanction provided by the Banks and Other Financial Institution Act, 1991, BOFIA viz; *"Any Manager or Officer who contravenes or fails to comply with any of the provisions of this section shall be liable on conviction to a fine of N100,00.00 or to imprisonment for a term of 3 years…",* should be amended to remove the option of fine or the fine should be increased to be commensurate to the amount lost by the bank whenever any Officer grants an advance, loan or credit facility without adequate security where the rules and regulations of the bank requires such an Officer to take security.

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