TRANSFER OF OBLIGATIONS

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CONTENTS

I INTRODUCTION

With every right or entitlement there must be a corresponding obligation. Apart from purely personal rights, there is no substantive technical impediment to the assignment or transfer of rights, whether these rights derive from contract or property. There is, however, a fundamental technical difficulty associated with transferring obligations. This commentary will consider the nature of that difficulty and how the various jurisdictions of Australia, Hong Kong, England and Singapore approach the issue. In the context of international law, the problem is particularly relevant with respect to how financiers can 'sell down' or transfer their rights and obligations by syndicating a loan. Consideration will also be given, though it is not intended to be exhaustive, to the various exceptions to the rule that obligations cannot be transferred.

II THE TECHNICAL IMPEDIMENT

What does it mean to say that obligations cannot be transferred? In this regard there are three relevant players. First, there is the obligor who owes the obligation; second, the obligee to whom the obligation is owed (and who therefore holds the benefit of the obligation); and third, the transferee, who assumes the obligation. Putting the legal position to one side for the moment, the transferee will need an inducement to assume the obligation, which may take the form of a payment from the obligee.

The expression 'defeasance' is frequently used in this context. An 'in-substance' or 'economic' defeasance is said to occur when the transferor obligor makes payment to the transferee obligor in consideration of the transferee

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obligor indemnifying the transferor obligor for the obligation. The defeasance is only in-substance because the transferor obligor remains bound in contract to the obligee. This in-substance defeasance is therefore distinct from a legal defeasance (or 'novation') where the transferor obligor is released from its obligations to the obligee, and the transferee obligor is bound in contract to the obligee.

What then are the technical impediments which restrict the ability to transfer obligations? The principal restriction on such a transfer is the doctrine of privity of contract, which coalesced in the middle of the 19th century.[1] According to that doctrine, 'only parties to a contract may sue for breaches of that contract, notwithstanding that some third party may be damnified by the breach and intentionally so damnified'.[2]

This proposition became so entrenched that at common law even the benefit of contractual rights was incapable of assignment. Absent the consent of the obligor in favour of a transferee (from an obligee) sufficient to constitute a new agreement between the obligor and the transferee (commonly referred to as a novation), the common law would not recognise an assignment. Equity, however, was more accommodating:

> At common law such a debt was looked upon as a strictly personal obligation, and an assignment of it was regarded as a mere assignment of a right to bring an action at law against the debtor … But the courts of equity took a different view … They admitted the title of an assignee of a debt, regarding it as a piece of property, an asset capable of being dealt with like any other asset, and treating the necessity of an action at law to get it in as a mere incident.[3]

Eventually the common law was induced by statute to permit the assignment of choses in action.[4] With respect to the assignment of obligations, however, neither equity nor the common law permitted a mere agreement between the obligor and a transferee which would cause the obligee to look to the obligor, unless the obligee consented to the agreement.

III THE SYNDICATION OF LOANS

Under a syndicated loan, existing financiers to a borrower can transfer their interest to other financiers.[5] Such liquidity enhances the attractiveness of the loan facility to financiers and thereby reduces the costs of funding to the borrower. Where the financiers have a continuing funding obligation to the borrower the problem arises of transferring that obligation to a future financier without having to revert to the borrower for further consent.

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1 See, eg, *Tweddle v Atkinson* (1861) 121 ER 762.

2 *Rookes v Barnard* [1964] AC 1129, 1187.

3 *Fitzroy v Cave* [1905] 2 KB 364, 372.

4 See, eg, *Conveyancing Act 1919* (NSW) s 12; *Property Law Act 1958* (Vic) s 134; *Law Amendment and Reform (Consolidation) Ordinance 1991* (Hong Kong) s 9.

5 Further explanation of syndicated loans is provided in Mallesons Stephen Jaques, *Australian Finance Law* (4th ed, 1999) 209–11; T M Lennox, 'Syndicated Loan Agreements' in T M Lennox (ed), *Australian Corporate Finance Law* (1994).

The *London Loan Market Association Multicurrency Term and Revolving Facilities Agreement* (‘*LMA Agreement*’) was intended to standardise the terms of syndicated loans, and takes an interesting approach to the question of syndication.[6] The procedure for transfer set out in clause 24.5 provides:

(a) Subject to the conditions set out in Clause 24.2 (*Conditions of assignment or transfer*) a transfer is effected in accordance with paragraph (b) below when the Agent executes an otherwise duly completed Transfer Certificate delivered to it by the Existing Lender and the New Lender …

(b) On the Transfer Date:

  (i) to the extent that in the Transfer Certificate the Existing Lender seeks to transfer by novation its rights, benefits and obligations under the Finance Documents each of the Obligors and the Existing Lender shall be released from further obligations towards one another under the Finance Documents and their respective rights and benefits against one another shall be cancelled (being the ‘Discharged Rights and Obligations’);

  (ii) each of the Obligors and the New Lender shall assume obligations towards one another and/or acquire rights against one another which differ from the Discharged Rights and Obligations only in so far as that the Obligor and the New Lender have assumed and/or acquired the same in place of that Obligor and the Existing Lender;

  (iii) the Agent, the Arranger, the New Lender and other Lenders shall acquire the same rights and assume the same obligations between themselves as they would have acquired and assumed had the New Lender been an Original Lender with the rights and/or obligations acquired or assumed by it as a result of the transfer and to that extent the Agent, the Arranger and the Existing Lender shall each be released from further obligations to each other under this Agreement; and

  (iv) the New Lender shall become a Party as a ‘Lender’.

A curious aspect of the *LMA Agreement* is that it provides no clear answer as to how the incoming financier assumes the obligation to fund the borrower without the borrower’s consent. This is so notwithstanding the use of the word ‘novation’. It is not contemplated that the borrower sign the LMA Form of Transfer Certificate (‘Transfer Certificate’). This problem is commonly solved by having the borrower appoint an agent under the syndicated loan for the purpose of approving the substitution of financiers. In this manner a new loan agreement is struck between the borrower, the continuing financiers, the agent and the incoming financier. Appointment of an agent by the borrower is seen as a critical element of the substitution provisions of a syndicated loan.

The *LMA Agreement* makes provision for an agent. However, the agent under the *LMA Agreement* acts only on behalf of the lenders, not the borrower. In light of the fact that the borrower does not sign the Transfer Certificate, the issue arises as to how the borrower will be bound in contract with an incoming lender. Consider a loan where the existing lender is obligated to provide further funds when called upon by the borrower and where a new lender signs the Transfer

[6] ‘Joint Statement’ to the *London Loan Market Association Multicurrency Term and Revolving Facilities Agreement* (copy on file with author).

Certificate. Is there a contract between the borrower and the incoming lender so that the borrower can require the new lender to fund a further request for funds? Arguably, there is no agreement between the borrower and the new lender, since the borrower does not sign the Transfer Certificate and the agent does not act on behalf of the borrower when the agent signs the Transfer Certificate. This is because the agent acts only on behalf of the lender, not the borrower.

IV *Contracts (Rights of Third Parties) Act 1999* (UK)

The *LMA Agreement* is governed by the law of the United Kingdom and the contractual principles described above would be equally applicable in Australia, Hong Kong and Singapore. An objection may be made on the basis that the *Contracts (Rights of Third Parties) Act 1999* (UK) ('*Contracts Act*') applies in the United Kingdom. The *Contracts Act* modifies the doctrine of privity of contract by providing that a third party may enforce a contract where that party is given the right to do so in the contract, or where the contract purports to confer a benefit on that party and the contract manifests no intention that the third party may not enforce it.[7] This could be achieved by excluding the application of the *Contracts Act*, for example.

The *Contracts Act* does not define the concept 'purporting to confer a benefit', and there would be an issue as to whether this extends to future financiers under a syndicated loan. The third party need not be an identified individual and could be a member of a group.[8] Most significantly, while the third party's rights are subject to the terms and conditions of the contract,[9] the *Contracts Act* does not seem to confer privity between a transferee obligor (the future financier) and the obligee (the borrower). The *Contracts Act* seems to provide a method for allowing third parties to receive benefits in the absence of privity between that third party and the existing contracting parties.

The *Contracts Act* operates to confer rights on third parties but does not clearly impose corresponding obligations. Thus, while an incoming lender may enjoy the benefits of a payment obligation owed by the borrower, the *Contracts Act* does not confer rights on the borrower against the new lender (here a third party). While the *Contracts Act* provides that the third party's rights to enforce the contract are subject to the terms of the contract, it is not a condition of the third party's enforcement of the contract that he or she have honoured any obligations under it. It would seem, therefore, that a new lender could enforce a borrower's payment obligation to the new lender, although the borrower could not require the new lender to fund a draw-down to the borrower.

V Exceptions to the Rule

While privity of contract is an important doctrine limiting the ability to transfer obligations, the doctrine does not cover the totality of rights and

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7 *Contracts Act* c 31, s 1.

8 *Contracts Act* c 31, s 1(3).

9 *Contracts Act* c 31, s 1(4).

obligations and their transfer. The following is a non-exhaustive overview of situations in which obligations are transferred without the consent of the obligee, in apparent violation of the privity of contract rule.

A *Land Covenants*

In certain circumstances involving interests in real property, a transferee of a proprietary interest takes subject to an obligation relating to the land. The precise rules vary from jurisdiction to jurisdiction, depending upon the local historical development of the rule and the degree of statutory modification. For example, with respect to leases, certain covenants will bind a transferee and will be said to 'run with the land'.

1 *Covenants Made by a Lessee*

(a) *Which run with the land*. Examples of this type of covenant made by a lessee include the covenant to pay rent, to repair, to use the leased premises in a particular way and not to assign the lease without the lessor's consent.[10]

(b) *Which do not run with the land*. Covenants by the lessee, which do not touch and concern the land, include covenants to pay an annual sum to a third party and to not employ persons living in other areas to work on the leased premises.[11]

2 *Covenants Made by a Lessor*

(a) *Which run with the land*. Case authority supports the proposition that this group would include covenants to renew the lease, to supply the leased premises with water and to give the lessee an option to purchase land adjoining the leased land.[12]

(b) *Which do not run with the land*. Examples of this type of covenant include covenants to pay on expiration of the lease for chattels.[13]

Hong Kong legislation provides a good example of the statutory support given to these principles. Section 41 of the *Law of Property (Enforcement of Covenant) Ordinance 1988* (Hong Kong) provides:

> This section applies to any covenant, whether positive or restrictive in effect
> (a) which relates to the land of the covenantor;
> (b) the burden of which is expressed or intended to run with the land of the covenantor; and
> (c) which is expressed and intended to benefit the land of the covenantee and his successors in title or persons deriving title to that land under or through him or them.

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[10] *Breams Property Investments Co Ltd v Stroulger* [1948] 2 KB 1.
[11] *Mayhov v Buckhurst* (1617) Cro Jac 438.
[12] *Collison v Lettsom* (1815) 6 Taunt 22.
[13] *Re Leeds and Batley Breweries Ltd & Bradburg's Lease* [1920] 2 Ch 548.

> Notwithstanding any rule of law or equity but subject to subsection (5), a covenant shall run with the land and, in addition to being enforceable between the parties, shall be enforceable against the occupiers of the land and the covenantor and his successors in title and persons deriving title under or through him or them.

These provisions modify and extend the general law position while respecting the general rule that certain obligations can be unilaterally transferred without the consent of the obligee.

B *Securities*

Certain securities will also operate in such a way that a transferee of the security will acquire that security and assume an obligation without establishing privity with the obligee. Farwell J offers a good definition of a share in *Borland's Trustee v Steel Brother & Co Limited*:

> A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se … The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money … but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.[14]

Jurisdictions which permit the incorporation of limited liability entities generally provide for a mutuality effect between shareholders. The Singaporean position is typical in providing that the memorandum and articles of association bind the company and its members upon registration, as if they had been signed and executed under seal.[15] The effect of this provision is to create a multiplicity of interlocking contracts between the company and each member, and between each member and each other member. Consequently, for example, if a member held a partly paid share which was the subject of a call for payment by the company and that member transferred the share, the transferee would take subject to that obligation to pay the call.

This position with respect to shares is well settled. Less certain, however, is whether this extends to 'securities'. The definition of securities exhibits an expansionist tendency in order to extend the regulatory reach.[16] However, a possibly unintended effect is also to modify the impact of the privity of contract doctrine. In the Australian context, s 1109D(1) of the *Corporations Law* provides:

> If a proper SCH transfer of quoted securities takes effect at a particular time:
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> (a) the transferee is taken to have agreed at that time to accept the securities subject to the terms and conditions on which the transferor held them immediately before that time, being the terms and conditions applicable as

[14] (1901) 1 Ch 279, 288

[15] *Companies Act* [Cap 50] (Singapore) s 39.

[16] *Corporations Law* s 92.

> between the issuing body in relation to, and the holder for the time being of, the securities; and
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> (b) if the securities are shares — the transferee is also taken to have agreed at that time to become a member of the issuing body and to be bound by the issuing body's constitution.

This provision operates as a kind of statutory novation so that a purchaser of the securities would assume any obligations of the transferor.

Under the heading 'Rights, Obligations, and Liabilities of Former Responsible Entity', the *Corporations Law* similarly provides:

> If the responsible entity of a registered scheme changes, the rights, obligations and liabilities of the former responsible entity in relation to the scheme become rights, obligations and liabilities of the new responsible entity.[17]

This provision has been used to support an argument that, upon the change of the responsible entity of a registered scheme, a form of statutory novation occurs such that the new responsible entity becomes subject to the same rights and obligations as the outgoing responsible entity.

VI CONCLUSION

The doctrine of privity of contract is a limitation on the transfer of obligations without the consent of the obligee, but it is a limitation which is not insurmountable. Significant exceptions to the rule exist. Caution must nonetheless be exercised for fear of falling foul of an insufficient attempted transfer of obligations.

The key question is whether the consent of the obligee is required. That is, where a party purports to assume an obligation, is it necessary for the obligee to consent to the assumption of the obligation by someone other than the original obligor? The doctrine of privity of contract expressly excludes the possibility of an assumption of obligations without the creation of a new relationship of privity between the transferee obligor and the obligee.

However, as has been shown, other legal mechanisms and systems permit the assumption of obligations without the obligee's consent. In the area of land covenants and securities, for example, there is significant scope for transferring obligations as a bilateral act between transferor and transferee, without any need to join or seek the consent of a third party.

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[17] *Corporations Law* s 601FS(1).