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Classification of Credit Security in Nigeria: Resolving the Perceived Dichotomy

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Abstract

This article is focused on the classification of credit security in Nigeria with a view to resolving the perceived dichotomy in the categorization. Credit security generally is within the ambit of property law which is circumstanced in secured credit. The work also attempts to determine the legal basis of this classification and the inherent utilities. We summarize that classification of security should be maintained for the purpose of distinction and clarity in aid of the unwary and non-legal minds.

Key Words: Credit Security, Security Interest, Property Law, Real Security, Legal and Equitable Security, Charge, Secured Credit.

Introduction

In General terms, security or security interest is that proprietary or personal assurance that is given and that helps secure the repayment of a debt or that which crystallizes into value for the benefit of the creditor in case of default by the debtor. It is based on this understanding of security that we will proceed to discuss the classification of security with the aim of resolving the perceived dichotomy in the categorization of security or security interest. The subject matter of this article is of importance to the law of secured credit as well as to the world of commerce generally. Due to the continued ingenuity of financiers and their legal advisers, the world of commerce has developed several forms of agreement which are intended to provide security but nevertheless do not in law create a security or security interest. Hence the aim of this paper is to explain the various classifications of security and the legal benefit derivable therefrom.

We also examined the concept of classification of security which is theoretical and is aimed at laying the conceptual foundation which underscores the various types of security. Furthermore, we identify and analyzed each of the various types of security. We have employed a method of juxtaposing each class of security against the other in order to bring to focus the succinct distinctions between them as well as appraise the legal right conferred by each.

Moreover, the four methods of creating real security were discussed. The focus here is a comparison each of mortgages, charge, pledge, and lien. An analysis of the watertight compartmentalization of security with the aim

of highlighting the overlapping areas that exist was effected. And a conclusion on responding to the question of the seeming dichotomy in the classification of security.

Property Law and The Concept of Classification of Security

The pattern of classification of security depends largely on the influence of property law which varies widely from jurisdiction to jurisdiction, particularly on the concept of ownership and possession. The owner of a property is the person who has the maximum legal rights over the property (including the right to possession). He may, however, part with possession without surrendering ownership. (Omotola, 2006, p. 27) Ownership is a legal concept which is an embodiment of various rights which an owner can exercise over his property, from the right of usage to pure possession, to the right to exclude others, and in the extreme case the right to destruct. What in common law is described as absolute interest/radical title. While possession is a state of fact, and involves actual control over property, for example where the owner of land lease same to a tenant, the tenant acquires legal possession and can assert his right of control against anyone (even against the owner, if the owner in breach of the lease attempts to regain possession) (Omotola, 2006).

Further to the above, According to Roy Goode, it appears to be recognized everywhere that a security interest involves the grant of a right in an asset which the grantor owns or in which he has an interest (Goode R. M., 2003, p. 3). However, the very concept of ownership and possession differs in the manner in which these concepts are understood for our purpose and as such the classification of security or what constitutes security interest depends on the polarized understanding of these two important concepts.

The most obvious divide is between the formal and the functional approach. The formal approach presupposes a surrender of a person's interest in his own property as security for a loan. The interest in question being proprietary in nature whether ownership or possession, while the functional approach envisages a conditional buyer, a lessee with an option to purchase and in many cases, a lessee under a finance lease as the owner and the interest of the conditional seller or lessor as limited to a security interest so that the reservation of title is equated with a purchase money chattel mortgage. However, under the functional approach where a person takes finance for a project and equally renders that project as security or creating security interest in the financed project in favour of the creditor, it is considered and assumed that the holder of the proprietary interest in the project is the creditor, while the lender merely reserve security interest in the project against the owner. This functional approach is popular across the united state as the basis for creating security, loan and project financing.

Contrary to the above, Roy Goode in explaining formal approach expressed and that the formal is one which sharply distinguishes the grant of security from the retention of title under conditional sale, hire purchase and leasing agreement, on the basis that the buyer or lessor has merely a possessory interest subject to which the seller, owner or lessor continues to enjoy absolute ownership by virtue of the agreement between the parties (Goode^{2003, p. 3-4}). The crucial difference between the functional and formal approach of the concept of classification of security is in the question, where does the proprietary interest in the subject matter security fall. In other words, who holds the proprietary interest subsequent to the transaction? We found that, in the case of the formal approach, it envisages a transfer or granting of rights or proprietary interest whether ownership or possession in the subject matter of security from the debtor/borrower to the creditor/lender, whereas in the case of the functional approach, ownership over the subject matter of security remains with or continues to be vested in the borrower, and the lender having enforceable interest in the property.

In Omotola's view (Omotola, 2006, p. 18) while reacting to the mid-way course of security that is underscored by the functional approach, opined that this mid-way course of security which while performing the functions of security do so with a prima fall under laying right of property. Such security which includes floating charge retention of title clause or Romalpa clause and another seemingly contractual device, do in fact possess attributes which could well qualify as property. Hence the concept of security or the place of security in loan transaction or secured credit transaction presupposes the grant transfer and attachment of proprietary interest or right to the creditor. This, however, is inadequate as a basis for classification, as it is submitted that all security presupposes some proprietary right though not necessarily ownership right in the holder of the security (Omotola, 2006, p. 7). In essence, this functional approach enables us to ascertain whether a transaction or relationship has created an

obligation for which an interest in apply may serve as protection, assurance or indemnification of the obligee in the event of default by the obligor. (Smith, 2001, p. 6) In the view of Allan, he concluded that that anything that performs the function of a security must be security(Allan, 1989, p. 345). The economic value of this statement is really exhaustive, and it is now apparent in modern time going by the continued creation of various forms of an arrangement of security or security interest in a secured credit transaction. (John, Vol. 5, p. 2470).

From the above discussed, we resolved that despite the divergent view that exists, i.e., the functional and formal approach, classification of security underscores determines enforcement and the extent of the right acquired by a creditor. While from this formal perspective proprietary assurance in term of ownership and possession render the fulfillment of the obligation more certain on the other hand, the functional school which postulate that anything which makes money more assured in repayment or more recoverable regardless of its proprietary value in term of legal ownership, in our opinion, render the acceptability and enforceability such security less certain, economically viable and legally secured.

Classification of Security

According to Goode, the form of consensual security known to the law are the mortgages, which is a sanity transfer of ownership; the pledge, which creates a limited legal interest by the delivery of possession, and the contractual lien. Where goods are deposited for repair, and the repairer then asserts a lien for unpaid repair charges as well as where a statute provides for charges by way of legal mortgage, all other charges are equitable (Goode²⁰⁰³, p. 5). While Omotola classified security into proprietary securities, personal securities, lien, and charges (Omotola, 2006, Chapter 2), Smith broadened his classification of security. The basis of classification by these legal scholars depends largely on what they considered as security or security interest. Whether the transfer of the entire proprietary interest over the property of the debtor or the creation of some form of encumbrance by way of a contractual device over the property.

Real Security

Real security confers an estate or interest in the property of the debtor or of a third party on the creditor by way of security. It takes the form of a right in rem over the specific property to the satisfaction of a particular debt so that the debt is a primary charge on the property. By the reality of real security, the property subject matter of the security is in principle, that of the creditor. Thus it is the asset of the debtor that forms the security.

Smith (Smith, 2001, p. 9-10) identified three methods of classifying real security as follows. Security by which the creditor obtains a proprietary right in the subject matter of the security such as a mortgage. In this circumstance, the debtor's title in the property whether legal or equitable is conveyed to the creditor by the debtor to be held by the former pending when his claim under the mortgage has been satisfied. Therefore what the debtor is left with at this point is a right called the equity of redemption (Rhodes, 1971).

Secondly, security which depends only on the creditor's actual possession of the subject matter of security the creditor continues to enjoy this form of security so far he remains in possession lien.

Thirdly, security which gives the creditor neither proprietary nor possessory right but a simple appropriation of specific property to the satisfaction of the debt. This is another instance of legal fiction where the creditor does not "own nor hold" the subject matter but acquires some form encumbrance over the property which right may be exercised through the judicial sale of the property.

There is no doubt that the proprietary right rendered through a mortgage in the first circumstances remain the best form in this regard conferring enforcement right which may be asserted against the debtor or even third party. This creditor is fully fortified as to property in any hand and the right to enjoy and exercise ownership over property.

Personal Security

This is where security is in the form of a personal undertaking which reinforces the debtor's primary undertaking to make payment or other performance in case of default by the debtor. We can, therefore, see personal security as the promise by a person to pay another's debt in the failure of the primary debtor to so pay. Personal security exists in two forms namely: by guarantee or indemnity. According to Smith contract of guarantee assures the creditor of the guarantor's secondary liability in the event of the inability of the principal debtor to meet his financial obligations even after adjudged liable by the court. (Smith, 2001, p. 12)

In this case, the creditor would have to proceed first against the principal debtor by the action in court, and it is only where the latter assets are insufficient to meet the financial obligation that the guarantor is proceeded against. However, in a contract of indemnity, the creditor is not obliged in law to proceed against the principal debtor first before suing the indemnifier. The obligation of a guarantor or surety is, therefore, collateral to that of the main debtor. The obligation created under a guarantee or indemnity may be a continuing type or a simple guarantee (Omotola, 2006, p. 20-21).

Legal and Equitable Security

The character legal security is such that the transferor's security or the debtor's title to the asset is in a legal form title and not merely an equitable interest. This subject matter of legal security involves the transfer of an existing asset to the creditor himself in conformity with any statutory formalities. By legal security, we should direct our minds to the creation of a legal mortgage on a particular property in compliance with statutory form and subsequent perfection of the creditor's title.

Accordingly, Goode identified equitable security as arising from six circumstances namely:

(1) the property relates to a future property; (2) there is no transfer or agreement for transfer at all, merely a charge (except for the form created by our law as a charge by deed expressed by way of legal mortgage); (3) there is no present transfer, merely an agreement for transfer or a declaration of trust by the debtor; (4) the transfer is not made in accordance with the formal requirement for the transfer of legal title; (Savannah Bank Plc. V. Ajilo¹⁹⁸⁹) (5) the transfer is made not to the creditor but to a third party as trustee for the creditor (for instance, a debenture trust deed); (6) the transferor's title to the asset is equitable not legal (Goode, 2003, p. 8).

The essential difference in effect between a legal mortgage and an equitable mortgage or charge is that a legal mortgage has priority over subsequent interest whereas equitable mortgage or charge may be overreached by a disposition to a bona fide purchaser for value of the legal title without notice of the equitable interest. Taking equitable interest as security constitute a weak and violate security for a creditor in a legal system where registration of interest (legal interest) determines priority. In fact, inchoate legal interest or security leaves loopholes for a defaulting debtor's advantages as in the case of non-compliance with statutory formalities

Tangible and Intangible Security

This is a further classification of real security. Real security may be over the tangible or intangible property. The distinction, in this case, relates to the mode of creation. Tangible security may be subject of possessory security by way of pledge and contractual lien. Whereas, intangible security like property may be created only by way of mortgage or equitable charge (Okuneye V. FBN¹⁹⁹⁶).

Possessory and Non- Possessory Security

In explaining this category of securities, Goode wrote that where security relates to tangible property, it may be either possessory or non-possessory. Possessory security may take the form of a pledge or contractual lien, the pledgee or lienee having limited legal interest in the asset. By contract, intangible property cannot be rendered into possession however where they are converted into documentary intangibles like title deeds or certificate of Occupancy; they nonetheless can be subject of a pledge, hence constituting an equitable charge.

Title Transfer and Charge

Transfer of title is a genre of mortgage whereby legal title or the full paraphernalia of proprietary title in property is conveyed or assigned or rendered to the benefit of the creditor as security. In essence, all of the debtor's interest in the property is staked against the loan, for example, mortgage. Whereas, in case of charges, an encumbrance is created over the debtor's property leaving the debtor as an owner but imposes a clog on his ownership in favor of the creditor. An instance of this is hypothecation or a charge by deed expressed to be by way of legal mortgage.

Fixed and Floating Security (Security In Specie & Security In Fund)

This classification is particularly important against the backdrop of corporate financing. Debenture and charge or attachment of corporate property to a loan transaction under the Companies and Allied Matters Act (Laws of the Federation of Nigeria, 1990). A debenture which is backed by a fixed charge supposes that the asset subject of security is already appropriated to the satisfaction of the debt immediately or upon the debtor acquiring an interest thereunder (Siebe Gorman and Co Ltd V. Barclays Bank Ltd., 1979). When a company gives a fixed charge, it can only deal with such assets subject to the charge (Omo-Bare V. New Nigerian Bank Ltd., 1978), whereas, under a floating charge appropriation differs. According to his Lordship Lord MacNaghten in the case of *Illingworth v. Houldsworth* a floating charge "is ambulatory and shifting in 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 creditor's right attaches in the first instance not to a specific asset but to a shifting fund of the asset. In a literal sense, we may say that fixed security is about attachment to a particular asset of the company while floating security attaches to the generality of the company's asset both present and those to be acquired in future.

While the classification of security particularly into "Real and Personal Security" remains watertight in the laws of secured credit, it does not, however, seem to be a rigid categorization in the practical sense, the transfer of title may seem opposite to a charge or a real security completely in contrast with a personal security; Activity in the commercial world which derives the law continue to evolve the third limb for each of these classifications. Hence, a creditor may take real security from a surety or guarantee beyond the superadded personal obligation to secure the loan and attach same in the event of default by the principal debtor.

Mortgage, Charge; Pledge and Lien; Compared

To further buttress the classification of security as discussed above, we consider it appropriate to highlight the distinction that exists between the aforementioned mode or the methods of creation of real security. English law recognizes four type of real security namely mortgage, pledge, charge, and lien (Goode, 2003, p. 5). These four types have since formed part of Nigerian law through the reception of English law in Nigeria. Smith commenting on the status of the four opined that use of these nomenclatures in recent times had betrayed their traditional associated meanings, definitions, and context in which they were used. (Smith, 2001, p. 12).

In the traditional sense, charges differ from a mortgage in that a charge was a mere appropriation of property or some form of interest or right or encumbrance on the debtor's title to the creditor existing only in the imagination of equity and transferring neither proprietary nor possessory security. Thus mortgage gives ownership and possession to the creditor, and charge merely reduces the potency of the debtor's legal right in his property without giving any proprietary interest to the creditor except some form of a right exercisable through the judicial sale of the property (Fasakin V. Fasakin, 1994). In both cases, the mortgagor, like the chargor, is still the real owner of the property until enforcement of the security, in the eye of equity, the real owner of the mortgaged property is the mortgagor despite the conveyance to the mortgagee. Thus, in essence, both the mortgagor and the chargor have lost nothing from the transaction. It should be noted that a charge will not secure the three most important rights for the Chargor, unlike a mortgage. These include the right priority over unsecured claims, the right of property and the trace, i.e., to follow up the property into the hands of third parties limited to a bone fide buyer without notice. However, by virtue of the property and conveyance law of the Old Western Nigeria which now applies in the various states, a legal charge may be created today with all the

ingredient of a mortgage. The law now recognizes a charge by deed expressed to be by way of legal mortgage as a proper form of a legal mortgage. The Companies and Allied Matters Act also defined a charge to include a mortgage.

Consequently, the real effect of a mortgage is much the same as that of a charge. Financiers and legal advisers have in recent times provided special power in charge instrument which practically makes available to the chargee the power of a mortgagee. Thus making the traditional difference mainly a formality and an academic exercise.

Pledge and Lien

A lien is a right over the property of another. This right is not proprietary in the real sense. Lien arises by operation of law independent of any agreement of the parties. A lienor has the following rights:

- (a) to retain the property until the owner has settled some debt owed to the lienor (common law or possessory lien), or
- (b) to sell the property in satisfaction of the debt (equitable lien). (Omotola, 2006, p. 21).

A pledge, on the other hand, is security derived from the express agreement. It is a voluntary deposit of chattel with a lender as security for a debt. There are two features of a pledge in that a pledge provides the creditor security for a loan made to the debtor and that security takes the form of giving the creditor possession of the debtor's property until the loan is repaid (James, 1974, p. 224). The true distinction between a mortgage and a pledge is that, in a mortgage, the legal and equitable title is transferred to the mortgagee until the loan is repaid, whereas in a pledge only possession and not title is transferred to the pledgee. Thus an English mortgage is proprietary security whereas a pledge is possessory security. The pledgee always takes possession though the mortgagee can also take possession for fear of account of rent and profit, this right is rarely exercised. The circumstance of redemption of the pledge is more open (Ikeanyi V. Adighohu, 1957). A pledge is perpetually redeemable, unlike mortgage where the mortgagor's right may be defeated or extinguished by a foreclosure order.

A Dichotomy of Classification; Resolved

Here, the poser of whether classifying security into the various classes as we embarked upon in earlier discussion is still and important in the light of the present market of secured credit and the law? We are of the opinion that so far the aim of secured credit transaction is to make the repayment of the loan more readily recoverable and thus lessen the risk involved in making advances to individuals and corporate entities. The commercial world must be made to understand that the long term held principle of freedom of contract may not be entirely convenient and assuring in relation to a secured credit transaction where the rules and principles of Property Law reign supreme. Each class of security as we have seen above comes with its own recognized and enforceable rights. Where it is a mortgage, the benefits accruing to the Mortgagee's advantage are well known, distinguished and certain except in rare circumstances where they can defect. A mortgage confers all of the advantages of the anatomy of secured credit.

Both charge and lien have their respective benefits as provided by both common law and the Nigerian statutes. The right to make claims against the property of the debtor and further to seek judicial sale where necessary, the right to retain the security until the debt or obligation against the lien exists is settled. However, as we have seen, the law in a bid to meet up with challenges of the forever evolving and ingenious world of financiers and their legal advisers has been watered down and resolved the concrete divide between the various classes of security. We have discussed above, the possibility of a charge conferring all of the benefits of a mortgage as provided by the Companies and Allied Act and The Property and Conveyance Law. Personal security which the 'real sense' does not confer the maximum security can be seen in today's world as ensuring what we can refer to as an 'all rounder form of security' combining the debtor's personal obligation with that of his surety, which can be enforced through an action on the loan; as well as attaching the surety's property as security for the transaction. Another instance is the reservation of title arrangement which is akin to a charge on the property.

Instances abound, both in law and in contractual instances that demonstrate that a dichotomy of classification of security into the watertight compartment is a theory that cannot be staunchly adhered to. More and more, the world of commerce has realized the direction of the present law and the old time saying that the law is an ass; however a note of caution must be sounded that prudence and ultimate sense of making security firmly secured and assured should be lighthouse for practitioners in this volatile area of secured credit law and practice.

Conclusion

In the paper, we have discussed the fundamental basis for the classification of security. We also embarked on a voyage of classification of security into the various heads, compared the four types of real security and found the melting point for classification of security. It is our considered view, therefore that classification of security should be maintained for the purpose of distinction and clarity in aid of the unwary and non legal minds, though the polarization intrinsically cannot be sustained due to the cited overlaps in law. Hence the dichotomy which exists in the classification of security should be seen as a means and not an end in itself.

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Note however that even now in English law, allodial, absolute interest, etc. are extinct, as a holder of land does so in possession for the Crown. A situation similar to the Land uses Act's leasehold interest, or estate that an individual enjoys.
- Omotola, *Op.cit* p. 1.
Goode R. M, *Legal Problems of Credit and security*, 3rd Ed. London, Sweet and Maxwell (2003) p. 3.
See Grant Gilmore, *Security Interest in Personal Property*, being classic text on the functional approach.
Goode R.M. *Op. cit* at Pp. 3-4.
Omotola *Op.cit*, p. 18.
S for illustration the case of *Aluminium Industries Vaasseen BV. V. Romalpa Aluminium Ltd.* (1976) NWLR 676
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Anything that makes money more assured in its payment or more readily recoverable is deemed security. See John S. James, *Stroud's Judicial Dictionary of Words and Phrases* 4th Ed, Vol 5, p. 2470.
Goode *supra* p. 5.
Omotola *supra* see chapter 2
Smith broadened into two heads and it is under these that he discussed all of the different shades of security interest.
Supra Pp. 9-10.
This equity of redemption is crucial in differentiating a sale from a mortgage. A right to redeem his tied down the title at any time. It goes side by side the mortgage from the time of creation. Thus goes the saying once a mortgage, always a mortgage until foreclosure. See *Rhodes V. Dalby* (1971) AER 1144.
Smith *supra* p. 12.
Omotola *Op. cit* Pp. 20-21.
See ss. 108(1), & 109(1) of the Property and Conveyance law, Cap 100, Laws of Western Region. This Law now applies in the various states that constitute the old western Region.
As in the case of *Savannah Bank Plc. V. Ajilo* (1989) SCNJ 159, where the formalities of Governor's consent was not first had and obtained.
Goode *supra* p. 8.
Whether by a proper over the property or by deposit of the title deeds over the property with the creditor. See the case of *Okuneye V. FBN* (1996) 6 NWLR (pt 457) p.749.
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Based on the understanding that pledges once a pledge forever a pledge particularly under Customary law, see

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