

SME cashflow threats: ensuring that your security offers a protection against payment default

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by *Brendan Olivier, Director*

It's becoming all-too-common: an SME that provides goods and services on credit to a major supplier or customer, is suddenly and unexpectedly on the receiving end of a payment default. Not being paid can break an SME. Those SMEs which take pre-emptive steps, can minimise the shockwave caused by a default.

Taking of security is common in commercial practice. It can include the cession of a debtors' book, a suretyship, a reservation of ownership, and a notarial bond. All too often, directors of an SME take fake comfort from a mistaken belief that they have done enough to have security in place. In reality, the attempt at taking security is usually contained in a single clause in the contract or terms and conditions, agreed to by an unknown representative, and with no proper assessment of the validity and effectiveness of the security. The security is then forgotten, never to be assessed or checked again, until a default occurs. This is usually when the dire realisation is made: the security is invalid, or practically worthless.

The real protection of security lies in regularly assessing whether the security taken by the SME is proper, valid and enforceable. The owners and managers of an SME need to ensure that the security in fact provides the SME with a shield against default, and will be valid and can be relied on to obtain payment, once a default strikes. These assessments need to be done as part of the SME's ongoing commercial operations, and before the default occurs.

Security needs to be properly put in place, needs to be enforceable, needs to provide a shield from the anticipated danger, and above all needs to be likely to result in payment. There are some common difficulties that arise once a default has occurred, and the SME seeks to rely on its security:

1. If the SME supplies to a customer on credit, the terms regularly provide that ownership in the product does not pass until full payment is received. But this is practically meaningless if the product has been on-sold, or if the product has been installed in such a way that it has become a part of a larger structure, or cannot be accessed physically by the SME. **Reservations of ownership** often provide the illusion of security, but in reality can be worthless, if there is no practical or realistic means of retrieving the goods in question.
2. Taking **cession of the supplier's or client's debtors' book** sounds like a certainty, but only if the cession is done effectively. There are fundamental differences between a security cession, and an out-and-out cession, with markedly different consequences. In any event, a debtors' book is only of value if it is accurate, kept up-to-date, and if the debts are in fact recoverable without significant effort or cost. A regular assessment and analysis of the debtors' book (ceded to the SME) is needed. A debtors' book of R1 million is worthless if it is comprised of a single debtor that has been liquidated. Likewise, it is of no practical value if it is comprised of 1 000 debts, each of R1 000 – the time and effort needed to recover such debts may render the security of little practical value. There is also the common problem of debtors' books (wrongfully) being ceded to multiple parties. This needs to be examined, which may include the need to insert warranties and undertakings into the agreement.
3. A **notarial bond over movables** gives the impression of semi-ownership. This is not always the case – often this security can put the SME creditor towards the bottom of the 'secured creditors' pile, only just above unsecured creditors. In addition, it is not always known that security over real assets can come with the need or responsibility to take possession of the secured asset, secure and protect them, insure them, and to transport and sell them – there are many hidden costs that are not taken into account when assessing the ultimate value that the security might provide. Legal proceedings may be needed to perfect the notarial bond, and take the security assets into the SME's legal possession.
4. A **suretyship** from the debtor's directors or shareholders sounds like it gives the SME a second bite at getting a debt settled, but this can be a mirage: multiple suretyships, to various parties, can be given by the same surety. This waters down the prospect of a meaningful recovery from the surety. In addition, a suretyship is only as valuable as the assets behind the surety – if there are no assets of value, or if the assets are bonded or leased, then the recoverability under the suretyship dwindles. A surety's financial position needs to be assessed at periodic intervals, and the mechanism to do so, and the protocol to have in place to properly assess the extent of the security, may need guidance from legal professionals.

An SME should not conduct its trading operations whilst labouring under a false belief that it has the protection of security in the event of a default. There is no point in taking half-hearted steps to obtain security, when those steps are later exposed as having been deficient.

If the protection of security is going to be sought (and it should), then it needs to be done properly: the SME needs to bring in legal expertise to assess the appropriateness and nature of the security, ensure that it is valid and enforceable, and suggest protocols that regularly assess the likelihood of actual payment, should the security ever be called up. Failure to do so might mean that an SME's security is nothing more than a fake comfort blanket, which offers no warmth when it is needed.



Brendan Olivier

Director

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