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# DISPUTE RESOLUTION ALERT

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### Are sureties still liable for a debt if the original causa is based on an invalid contract?

The Constitutional Court dealt with this question in *Shabangu v Land and Agricultural Development Bank of South Africa & Others* [2019] ZACC 42. The applicant and others stood as sureties for a loan agreement entered into between the Land and Agricultural Development Bank of South Africa (Land Bank) and Westside Trading 570 (Pty) Ltd (Westside) for the development of urban property.

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## Are sureties still liable for a debt if the original causa is based on an invalid contract?

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Subsequently it came to light that the loan agreement was invalid and therefore *void ab initio* as the transaction underlying the loan was beyond the scope of the Land Bank's statutory powers in terms of the Land and Agricultural Development Bank Act 15 of 2002.

By this time, however, funds had already been advanced by the Land Bank to Westside. Including interest, Westside was indebted to the Land Bank in the amount of R95 million. The financial director of Westside then signed an acknowledgement of debt in which Westside accepted liability to repay R82 million in full and final settlement of its indebtedness.

Westside then defaulted on its payments. The Land Bank then instituted proceedings against Westside and the sureties. Subsequent to the institution of proceedings, Westside was liquidated. The Land Bank therefore dropped its claim against Westside and pursued only the sureties.

It was common cause between the parties that the original loan agreement was invalid. The sureties had limited their liability specifically to Westside's obligations under the loan agreement. They argued that the liability in the acknowledgment of debt was based on the liability of Westside under the invalid

loan agreement. Consequently, the acknowledgment of debt was tainted by the self-same invalidity. Following this they argued that they could not be held liable when their accessory obligation related to an invalid contract.

After their application for leave to appeal to the Supreme Court of Appeal was unsuccessful, the Applicant sought and was granted leave to appeal to the Constitution Court.

In the court *a quo*, the Land Bank had been successful by relying on the judgment in *Panamo Properties 103 (Pty) Ltd v Land and Agricultural Development Bank of South Africa* [2015] ZASCA 70. *Panamo* held that it did not necessarily follow that because a principal agreement was invalid, that the ancillary agreement was also invalid. *Panamo* was, however, in the context of a mortgage bond as security and not suretyships. *In casu*, the court *a quo* held that the acknowledgment of debt was properly proved, and that the debt to which it referred was properly covered by the suretyships.

The Constitutional Court held that the *Shabangu* matter was distinguishable from *Panamo* on the basis that the mortgage bond in *Panamo* itself stipulated that a bond would be passed to cover "*in general ... any existing or future debt that Panamo owes or may owe to the [Land] Bank*". The bond was therefore wide enough to provide for any other liability which could or would be incurred by the debtors.

The Constitutional Court found that on the facts of *Shabangu* there was no scope for arguing that there was a transformation of the nature of the debt into something new and valid (for example an enrichment claim).

## Are sureties still liable for a debt if the original causa is based on an invalid contract?...continued

One should therefore be very careful to ensure that an acknowledgment of debt is not in itself tainted by invalidity, and be alive to the extent to which suretyships are limited.

The Constitutional Court therefore found that the acknowledgment of debt could not be premised on, or have as its *causa*, the invalid loan agreement. This would only perpetuate the invalidity of the indebtedness and tainted the acknowledgment of debt, making it too invalid. The court therefore found that the sureties could not be held liable where the debt underlying their accessory obligation was based on an invalid contract.

The Constitutional Court did find that it was possible that the subsequent agreement, that is, the acknowledgment of debt, could be valid if the original invalidity was overcome in one way or another. This was not done.

It was suggested that this original invalidity could have been overcome in the acknowledgement of debt by governing the recovery of what was transferred under an invalid agreement in terms of a claim for unjustified enrichment.

Unjustified enrichment occurs where a legal entity receives a benefit or value from another at the expense of the latter without any legal cause for such receipt or retention of the value or benefit by the former.

Therefore, if the acknowledgement of debt is based on a claim for unjustified enrichment then it would be valid, and the sureties, depending on the wording of the suretyship agreement, could be held liable.

In this matter, however, such alternative framing of the creditor's claim in the acknowledgement of debt would alone not have saved their claim in respect of the sureties. The wording of the surety agreements only bound the sureties for the "indebtedness" which flowed from the original (invalid) agreement, so a valid acknowledgement of debt based on enrichment alone would not have led to claims against the sureties either.

In summary, the outcome of this case would have been different if the acknowledgement of debt stated as the cause of the indebtedness the unjustified enrichment of Westside (and by means of ancillary liability – the sureties), and if the suretyship agreements signed were wide enough to incur liability for the sureties for any indebtedness by the principal debtor to the creditor as opposed to limiting the liability of the sureties to the indebtedness arising directly out of the loan agreement. One should therefore be very careful to ensure that an acknowledgment of debt is not in itself tainted by invalidity, and be alive to the extent to which suretyships are limited.

*Andrew MacPherson and  
Belinda Scriba*

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## OUR TEAM

For more information about our Dispute Resolution practice and services, please contact:



**Tim Fletcher**  
National Practice Head  
Director  
T +27 (0)11 562 1061  
E tim.fletcher@cdhlegal.com



**Thabile Fuhrmann**  
Chairperson  
Director  
T +27 (0)11 562 1331  
E thabile.fuhrmann@cdhlegal.com

**Timothy Baker**  
Director  
T +27 (0)21 481 6308  
E timothy.baker@cdhlegal.com

**Eugene Bester**  
Director  
T +27 (0)11 562 1173  
E eugene.bester@cdhlegal.com

**Lionel Egypt**  
Director  
T +27 (0)21 481 6400  
E lionel.egypt@cdhlegal.com

**Jackwell Feris**  
Director  
T +27 (0)11 562 1825  
E jackwell.feris@cdhlegal.com

**Anja Hofmeyr**  
Director  
T +27 (0)11 562 1129  
E anja.hofmeyr@cdhlegal.com

**Julian Jones**  
Director  
T +27 (0)11 562 1189  
E julian.jones@cdhlegal.com

**Tobie Jordaan**  
Director  
T +27 (0)11 562 1356  
E tobie.jordaan@cdhlegal.com

**Corné Lewis**  
Director  
T +27 (0)11 562 1042  
E corne.lewis@cdhlegal.com

**Richard Marcus**  
Director  
T +27 (0)21 481 6396  
E richard.marcus@cdhlegal.com

**Burton Meyer**  
Director  
T +27 (0)11 562 1056  
E burton.meyer@cdhlegal.com

**Zaakir Mohamed**  
Director  
T +27 (0)11 562 1094  
E zaakir.mohamed@cdhlegal.com

**Rishaban Moodley**  
Director  
T +27 (0)11 562 1666  
E rishaban.moodley@cdhlegal.com

**Mongezi Mpahlwa**  
Director  
T +27 (0)11 562 1476  
E mongezi.mpahlwa@cdhlegal.com

**Kgosi Nkaiseng**  
Director  
T +27 (0)11 562 1864  
E kgosi.nkaiseng@cdhlegal.com

**Byron O'Connor**  
Director  
T +27 (0)11 562 1140  
E byron.oconnor@cdhlegal.com

**Ashley Pillay**  
Director  
T +27 (0)21 481 6348  
E ashley.pillay@cdhlegal.com

**Lucinde Rhoodie**  
Director  
T +27 (0)21 405 6080  
E lucinde.rhodie@cdhlegal.com

**Belinda Scriba**  
Director  
T +27 (0)21 405 6139  
E belinda.scriba@cdhlegal.com

**Tim Smit**  
Director  
T +27 (0)11 562 1085  
E tim.smit@cdhlegal.com

**Willie van Wyk**  
Director  
T +27 (0)11 562 1057  
E willie.vanwyk@cdhlegal.com

**Joe Whittle**  
Director  
T +27 (0)11 562 1138  
E joe.whittle@cdhlegal.com

**Roy Barendse**  
Executive Consultant  
T +27 (0)21 405 6177  
E roy.barendse@cdhlegal.com

**Pieter Conradie**  
Executive Consultant  
T +27 (0)11 562 1071  
E pieter.conradie@cdhlegal.com

**Willem Janse van Rensburg**  
Executive Consultant  
T +27 (0)11 562 1110  
E willem.jansevanrensburg@cdhlegal.com

**Nick Muller**  
Executive Consultant  
T +27 (0)21 481 6385  
E nick.muller@cdhlegal.com

**Jonathan Witts-Hewinson**  
Executive Consultant  
T +27 (0)11 562 1146  
E witts@cdhlegal.com

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### JOHANNESBURG

1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa. Dx 154 Randburg and Dx 42 Johannesburg.  
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

### CAPE TOWN

11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.  
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

### STELLENBOSCH

14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.  
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com

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