

Dispute Resolution

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SOUTH AFRICA

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Collusion between debtor and creditor: Defence for a surety?

Although a person standing as a surety for a principal debtor might appreciate and understand what it means to be a surety, it is without doubt that many hope that the suretyship will never be implemented. Therefore, when the day comes when the suretyship is called upon, it comes as no surprise that the surety will try any defence, no matter how remote, to free themselves from liability.

One such defence was tried in the case of *Cohen v Absa Bank Limited* [2024] ZASCA, where the Supreme Court of Appeal (SCA) had to determine whether a surety was entitled to escape liability by relying on section 31(2) of the Insolvency Act 24 of 1946 (Insolvency Act).

Background

The appellant was the CEO of a company, A Million Up Investments 105 (Pty) Limited (AMU), which obtained a loan in excess of R300 million from Absa in order to build a hotel. The appellant bound himself as surety and co-principal debtor for the loan, as well as any future debts owed by AMU to Absa. He also bound himself to be liable for any claim by a trustee or liquidator in the case of AMU's insolvency.

Construction on the hotel was delayed and when the hotel finally opened, its financial performance was below expectations. As the financier of the hotel, Absa and AMU engaged in discussions for several months to come up with a mutually acceptable solution that would enable AMU to repay its debt to Absa. As a result, the credit facility with Absa was restructured and a turnaround plan was devised. The turnaround plan included AMU buying out one of its partners and selling of one of the hotel penthouses (the transaction). AMU and Absa then entered into an amended and restated loan agreement (ARLA).

Notwithstanding the turnaround plan, AMU failed to fulfil its payment obligations. Ultimately, AMU was wound up and the proceeds from the winding-up were not sufficient to cover what was owed to Absa. As such, Absa demanded payment from the appellant on the basis of the suretyship. The appellant attempted to escape liability by relying on section 31(2) of the Insolvency Act.

Section 31 of the Insolvency Act

Section 31 of the Insolvency Act, which governs collusive dealings provides that:

- After liquidation, the court may set aside any transaction where the debtor colluded with another party to dispose of their property where it had the effect of prejudicing creditors or of preferring one creditor over another.

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Band 2: Dispute Resolution.

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Jackwell Feris ranked by Chambers Global 2023–2024 as an **"Up & Coming"** dispute resolution lawyer.

Anja Hofmeyr ranked by Chambers Global 2024 as an **"Up & Coming"** dispute resolution lawyer.



- Any party to such collusive disposition shall be liable to make good any loss caused to the insolvent estate and shall pay a penalty, not exceeding the amount by which he would have benefitted by such dealing if it had not been set aside; and if the party is a creditor, they forfeit their claim against the estate.
- Such compensation and penalty may be recovered in any action to set aside the transaction in question.

Appellant's arguments

The appellant argued that he was not liable in terms of the suretyship because AMU and Absa colluded to dispose of certain assets in terms of the transaction in efforts to reduce the debt to Absa. The appellant contended that the transaction was prejudicial to creditors and had triggered section 31(2) of the Insolvency Act, and Absa should forfeit its claim against him.

Respondent's arguments

Absa argued that it was the only creditor that stood to be prejudiced by the disposition of the assets and that the purpose of the transaction was to allow AMU to trade itself into a better financial position. Further, Absa extended the credit facility to AMU in terms of the ARLA to allow it to pay its existing and continuing creditors.

The court's findings

Section 31 creates a process in terms of which the collusive dispositions are set aside once the requirements of section 31(1) have been satisfied, whereafter the loss suffered by the insolvent estate is made good by the

transgressor, upon whom a penalty is imposed, and finally that transgressor loses the right to enforce their claim on the insolvent estate if they are a creditor. The only entity that the section seeks to compensate is the insolvent estate which has suffered a loss.

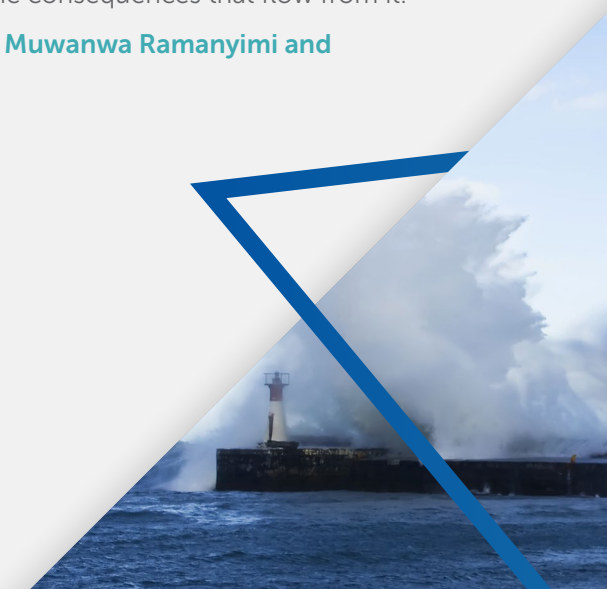
The SCA found that the purpose of section 31 was to empower a trustee or liquidator to institute proceedings against the offending parties to set aside the improper disposition and obtain a remedy.

Section 31(2) does not protect a surety who seeks to escape liability. The court stated that section 31(2) "serves as a sword" for the liquidator in winding up the insolvent estate, not as a shield for the third party, such as a surety.

The appeal was dismissed with costs.

The SCA made it clear that where a person has bound themselves as surety for a debt, an attempt to evade liability by claiming collusion and relying on section 31(2) of the Insolvency Act is unsustainable. Therefore, it is imperative that before signing a suretyship agreement one must be willing to accept the consequences that flow from it.

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