THE SUPREME COURT OF APPEAL
OF SOUTH AFRICA

Case no: 120/2001
REPORTABLE

In the matter between:

CAPE PRODUCE CO (PORT ELIZABETH) (PTY) LTD Appellant

and

DAL MASO, RM, NO First respondent

SCHOEMAN, PN, NO Second respondent

Before: Smalberger ADP, Harms, Cameron, Navsa and Mpati JJA
Appeal heard: 11 March 2002
Judgment: 27 March 2002

Subordination agreement – Effect on liability of surety – Available to surety even though neither a 'defence in rem*' nor a 'defence* in personam*' – Wording of suretyship however excluding reliance upon agreement – In addition, agreement inapplicable because no other creditors in favour of whose claims main creditor's claim could be subordinated*

JUDGMENT

CAMERON JA

[1] This appeal concerns, amongst other issues, the effect on a surety's liability of an agreement that subordinates a creditor's claims against a principal debtor to those of other creditors by postponing its enforceability. At issue is a debt of R15 million. It is owed to a company associated with the appellant, which took cession of its claim against two sureties (for brevity I refer to the appellant itself as 'CPC', and to the respondents in the appeal, the executors of the estates of the sureties, who both died after the action was instituted, as 'the sureties'). The suretyships at issue date from October 1988 and July 1996. In them, the sureties bound themselves jointly and individually as sureties and co-principal debtors in full for the debts of the principal debtor, a private company called Alberti Livestock ('Alberti'). In about October 1996 CPC became the sole shareholder in Alberti. At that stage Alberti was hugely indebted to CPC, which had over a period of years in effect been keeping it solvent. In December 1996 CPC and Alberti concluded an agreement in which CPC's claims against Alberti were subordinated to those of other creditors. The agreement starts by recording Alberti's substantial liability to CPC, and that CPC has 'agreed to assist' it by subordinating its claims in favour of Alberti's other creditors. Its further material terms are:

'2. In order to assist [Alberti], CPC, agrees, subject to the limitation imposed in 4, that -

2.1 It subordinates for the benefit of the other creditors of [Alberti], both present and future, so much of its claim(s) against [Alberti] as would enable the claims of such other creditors to be paid in full;

2.2 The claims of such other creditors of [Alberti], both present and future, will rank preferent to the subordinated claim of CPC against [Alberti].

2.3 . . .

3. It is the intention of the parties that this agreement constitutes a contract for the benefit of other creditors of [Alberti], both present and future, and that the benefit shall be capable of express or implied acceptance by any or all such creditors who may then enforce any term of this agreement.

4. The [subordination] referred to in 2 shall remain in force and effect for so long only as the liabilities of [Alberti] exceed its assets, fairly valued, and shall lapse immediately upon the date that the assets of [Alberti] exceed its liabilities and shall not, except by further agreement in writing, be reinstated if thereafter the liabilities of [Alberti] again exceed its assets, provided that the liabilities of [Alberti] shall be deemed to continue to exceed its assets unless and until the auditor of [Alberti] has certified in writing that he has been furnished with evidence which reasonably H satisfies him that the liabilities do not exceed the assets.

5. CPC hereby agrees that until such time as the assets of [Alberti] fairly valued exceed its liabilities, and the auditor's certificate referred to in 4 has been issued, it shall not be entitled to demand or sue [for] repayment of the whole or any part of the said amount owing to it by [Alberti] and set-off shall not operate in relation to the subordinated claim in respect of any debts owing by it now or in the future, provided that if the auditor of [Alberti] shall certify in writing that he has been furnished with evidence which reasonably satisfies him that the amount by which the liabilities of [Alberti] exceed its assets, such excess portion of the subordinated claim as is specified in the said certificate shall be released from the

operation of this agreement.'

[2] CPC instituted action against the sureties for payment of some R24 million. The first defendant opposed the action; the second abided the Court's decision. At the trial it was agreed that if the action succeeded judgment should be in the amount of R15 million. In the trial Court the action was dismissed; and an appeal to the Full Court was unsuccessful. The defence that succeeded at first instance before Joffe J as well as before the Full Court (Van Oosten J, Claassen and Mlambo JJ concurring)[1] was that the subordination agreement deferred CPC's right to claim against Alberti, with a corresponding benefit to the sureties. Hence CPC's claim against them was premature. CPC's argument that the subordination agreement was inapplicable because there were no liabilities to be subordinated - a fact the evidence clearly established - was rejected in both Courts. This Court granted CPC special leave for a further appeal in terms of s 20(4)(a) of the Supreme Court Act 59 of 1959.

Does a subordination agreement create either a defence in rem or a defence in personam?

[3] In both the trial Court and on appeal to the Full Court it was held, invoking the common-law distinction between defences relating to the principal debtor personally (defences in *rem*) and those relating to the nature, validity or existence of the debt itself (defences in rem), that the subordination agreement constituted a defence available to the sureties. This Court considered the distinction in *Ideal Finance Corporation v Coetzer*,[2] where it held that a surety was not entitled to the protection from certain types of execution orders that a statute extended to a 'buyer' under legislation regulating hire-purchase transactions because the protection the statute afforded the principal debtor was personal, and did not affect the nature, validity or existence of the creditor's claim or cause of action. [3] In *Standard Bank of SA Ltd v SA Fire Equipment (Pty) Ltd and Another*, [4] Rose Innes J analysed the distinction, in my view accurately, in a passage that has often

[1] Reported: 2001 (2) SA 182 (W)

[2] 1970 (3) SA 1 (A)

[3] 1970 (3) SA at 8H and 10F, per Rumpff JA; at 12D-E, per Holmes JA.

[4] 1984 (2) SA 693 (C) 696C-F

been cited and followed, thus:

> 'The contrast between defences *in rem* and *in personam* thus is that those *in rem* attach to the claim or cause of action or the obligation itself and arise from the invalidity, extinction or discharge of the obligation itself, whoever the debtor may be; those *in personam* arise from a personal immunity of the debtor from liability for an otherwise valid and existing civil or natural obligation. In the case of a defence *in personam* the obligation and debt remain in existence - the creditor may prove his claim in the insolvency or liquidation, the creditor may await the end of the moratorium, the minor's obligation remains a natural obligation, but in each case the debtor is personally immune from a claim. In the case of a defence *in rem* the law does not recognise the obligation or debt even as a natural obligation (illegality) or no obligation in fact came into existence or it was vitiated on a ground justifying its termination (mistake, misrepresentation, duress) or the obligation has ceased because it has been discharged or otherwise extinguished (payment, compromise, novation, judgment). It is in this sense that the defences *in rem* are said to adhere to or arise upon the obligation itself, regardless of the person of the debtor.'

[4] The distinction between defences in personam and in rem as received from our common law authorities and interpreted and applied in our case law does not, however, seem to me to be helpful in determining the respective positions of creditor, principal debtor and surety when a subordination agreement is at issue. The reason is that the dichotomy between the two types of defence does not seem readily applicable to the situation a subordination agreement creates, which is not to extinguish the creditor's claim, but to render it unenforceable during the subsistence of a condition. The present case illustrates the point. At the time the subordination agreement was concluded in December 1996, the debt was valid and enforceable against both Alberti and the sureties. What the subordination agreement did was to put the enforceability of the debt into abeyance subject to certain conditions. As Goldstone JA explained in *Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (in Liquidation)*,[5] the subordinated debt 'continues to exist', but 'its enforceability is made subject to the fulfilment of a condition'. He pointed out that the practical effect of such a condition depends on the terms of the specific agreement. But in creating a moratorium for the benefit of other creditors, such a creditor renders its own claim unenforceable unless other creditors receive payment in full, with the result that in the event of the principal debtor's insolvency 'the creditor has no claim'.[6]

[5] The inappropriateness of the received dichotomy to this situation is evident. On the one hand the subordinated debt is not unenforceable because

[5] 1993 (1) SA 493 (A) 504H-J.

[6] 1993 (1) SA 493 (A) 505E-H.

it is invalid[7] or because it has been extinguished or discharged. On the contrary, although its enforceability is made subject to a condition, until the occurrence of which the creditor cannot claim repayment at all, the debt remains in existence. On the other hand, it would be wrong to state that for this reason the unenforceability of the debt is purely 'personal' to the principal debtor, since it does not relate to any capacity or attribute attaching to the person of the principal debtor. (Examples from our case law include a statutory moratorium for soldiers serving abroad,[8] the fact that the debtor is a buyer protected under a statutorily regulated transaction of hire-purchase,[9] and the debtor's insolvency.[10])

[6] It seems an unnecessary and inappropriate pursuit of doctrinal uniformity to try to pare or push the case of a subordination agreement into either slot in the received dichotomy. The debt is unenforceable because, while the condition subsists, the creditor's cause of action itself is deficient. The creditor has no valid claim until the condition the subordination agreement spells out has been fulfilled. Until then the principal debtor has no need to invoke either a defence personal to him- or herself, or the extinction, discharge or invalidity of the debt: the principal debtor is immune from suit simply because the non-fulfilment of the condition, so long as it endures, renders the creditor's cause of action incomplete.

[7] This incompleteness affects proceedings against not only the principal debtor but also a surety, whose liability is accessory to that of the principal debtor.[11] The principle of the surety's accessory liability was correctly applied in *MAN Truck & Bus (SA) (Pty) Ltd v Singh and Another (2)*,[12] the criticism of which in the judgment of the Full Court misses the point that the received

[7] *Croxon'sGarage (Pty) Ltd v Olivier* 1971 (4) SA 85 (T) (hire purchase contract offending against s 7 of ct 36 of 1942 renders also suretyship concluded in respect of it invalid).

[8] *Worthington v Wilson* 1918 TPD 104 (Public Welfare and Moratoriums Acts 1 of 1914 and 37 of 1917 disabled suit against soldiers on active service abroad for duration of their service; defence personal to such soldiers and not available to sureties).

[9] *Ideal Finance Corporation v Coetzer* 1970 (3) SA 1 (A).

[10] Compare *Jayber (Pty) Ltd v Miller and Others* 1981 (2) SA 403 (W) (sureties liable for damages arising from principal debtor's inability to pay rental for full period of lease which arose because of principal debtor's liquidation); *Barclays National Bank Ltd v von Varendorff and Others* 1985 (2) SA 544 (D) 549 (surety not entitled to rely on limitation for purposes of proof of interest from date of sequestration on non-preferent claims against insolvent principal debtor in s 103 of Insolvency Act 24 of 1936 on rates of interest orally agreed to by principal debtor, since provision inserted for purposes of proof only and not invalidating underlying obligation to pay orally agreed interest)

[11] *Neon and Cold Cathode Illuminations (Pty) Ltd v Ephron* 1978 (1) SA 463 (A) 471C-472F.

[12] 1976 (4) SA 266 (N) 267H-268B.

dichotomy was not applied because it was not applicable.[13] In my view, therefore, the conclusion the courts below reached, that the sureties could invoke the subordination agreement, was correct, though not for the reasons given.

[8] The relevance of this analysis to the present case is that the Judges in the Courts below approached the problem as one primarily of categorisation: if the defence based on the suretyship agreement was in rem, it was available to the sureties and that disposed of the main burden of the case. The attempt to press the situation created by the subordination agreement into the slots provided by the received dichotomy, in my view, diverted attention from questions more pertinent to the resolution of the case. Those were (a) whether the fact that the subordination agreement rendered the debt conditionally unenforceable assisted the sureties in the light of the wording of the suretyship agreement; and (b) whether the subordination agreement was applicable at all, given the fact - which was common cause at the trial - that Alberti had no debts (other than that of CPC) to which that debt could be subordinated. I now consider these issues.

The terms of the suretyship agreement

[9] It is trite that a surety's liability depends on the terms of the suretyship.[14] In the present case, the suretyship concluded in July 1996, so far as is relevant, reads:

'It is further agreed and declared that . . . [CPC] shall be entitled without prejudice to its rights hereunder to give time, compound with, release from liability or make any other arrangements with [Alberti] . . . in respect of his indebtedness to [CPC]'.

In *MAN Truck & Bus (SA) (Pty) Ltd v Singh and Another (2)*[15] the suretyship provided merely that it was 'in the absolute discretion of the creditor' to 'grant time or other indulgences to the debtor' and 'to delay the date of repayment or to vary the terms of repayment'. The creditor was also empowered 'to release the whole or any portion of any security or to release any co-principal debtor or co-surety [and] to compound or make any arrangements with the debtor'. It was held that the creditor's giving of time to the principal debtor did not affect its claim against the surety, but that the claim could nevertheless be sued on only when the main debt was due, namely when the principal debtor had failed to pay the debt within the

[13] See 2001(2) SA 182 at 191G-H.

[14] *ABSA Bank v Davidson* 2000 (1) SA 1117 (SCA) para 19.

[15] 1976 (4) SA 266 (D)

additional time granted. In the present case the Full Court adopted this approach. It held that the wording of the suretyship 'merely ensures that the surety is precluded from contending that any of the creditor's acts referred to has prejudiced him thus entitling him to lawfully withdraw from the suretyship'.[16]

[10] I cannot agree. The suretyship at issue here differs in two signal respects from that in the *MAN Truck* case. First, the agreement in *MAN Truck* did not empower the creditor to release the principal debtor (in contrast to a co-principal debtor or another surety). More importantly, however, it did not expressly state what consequences it precluded from being attached to the granting of time or any other indulgence. It merely recorded that the creditor was empowered to grant time or indulgences, and to release a co-principal debtor or surety. The natural conclusion was that the agreement was intended only to preclude the release of the surety in the circumstances envisaged - a consequence that at common law would otherwise have followed.[17]

[11] The agreement here expressly empowers CPC not only to give time to Alberti, and to release it from liability, but stipulates that these powers may be exercised 'without prejudice to its rights A hereunder'. Those rights were expressed to include 'repayment on demand' of the sum owing by Alberti. The natural and obvious reading of these provisions is that CPC was entitled to subordinate in favour of other creditors the debt of Alberti without prejudicing its right to demand immediate repayment from the sureties. If CPC was empowered to release Alberti entirely without prejudice to its right to demand repayment, then it was similarly entitled to subordinate its debt in favour of Alberti's other creditors without affecting its entitlement against the sureties. The larger entitlement must include the lesser, and in this case that the natural reading of the suretyship agreement is that CPC acquired both, and that though the sureties were entitled to invoke the subordination of Alberti's debt, the terms of the agreement of suretyship precluded them from doing so effectually.

[12] It follows that on this ground alone the trial Court and the Full Court, in my view, erred in dismissing CPC's claim.

The interpretation of the subordination agreement

[13] The most signal reason for concluding that CPC's claim was erroneously dismissed lies in the evidence, which was not disputed at the trial, that, though the subordination agreement would have put in abeyance the

[16] 2001 (2) SA 193 (W) 192G-193C.

[17] Compare *French v Sterling Finance Corporation (Pty) Ltd* 1961 (4) SA 732 (A) 738 (novation of original agreement discharging surety); *ABSA Bank v Davidson* 2000 (1) SA 1117 (SCA) para 19 (prejudice to surety resulting from breach by creditor of legal or other obligation results in release of surety)

enforceability of CPC's claim in favour of Alberti's other creditors, there were at all relevant times no such creditors at all.

[14] At the trial before Joffe J, a chartered accountant was called whom the CPC group of companies had until November 1997 employed 'in-house'. Thereafter he became a partner in the firm of chartered accountants that prepared the audited statements relating to Alberti, which were submitted without contest as evidence during the trial. It will be recalled that in October 1996 CPC acquired all the shares in Alberti, which was itself thus part of the CPC group at the time the accountant in question was still employed by it. The accountant therefore had first-hand knowledge, which was not put in issue at the trial, not only of the group's dealings and specifically of the financial standing and liabilities of Alberti, but of its authenticated financial statements in regard to the position of Alberti.

[15] He testified without controversion that all Alberti's other creditors had been paid in full in December 1996. The sole outstanding debt was for the audit fee in the amount of R5 002 for the financial year ending 30 June 1997. That account was presented for payment in December 1997 when it became due (hence after summons was issued in March 1997). It was paid in full on presentation, as the auditor testified at the trial. It was therefore established that at the time the action was instituted there were no creditors of Alberti other than CPC itself, and the Full Court's suggestion to the contrary[18] is therefore erroneous.

[16] Despite this, both the trial Court and the Full Court rejected CPC's contention that the subordination agreement was inapplicable to the claim. Both Courts held that the subordination agreement itself deemed the excess of liabilities over assets to continue until the auditor certified otherwise in writing (clause 4), and that until the certificate in question had been issued, CPC was not entitled to demand or sue for repayment of the debt (clause 5).

[17] I am unable to agree with this approach to the interpretation of the agreement, which, in my view, flies in the face of the parties' intentions at the time the agreement was concluded, offends against elementary conceptions of commercial reality and disregards the purpose for which the contract was created.[19] The critical provision in the agreement is clause 2, and the Courts

[18] 2001 (2) SA 182 (W) at 189I.

[19] See *Venter and Others v Credit Guarantee Insurance Corporation of Africa Ltd and Another* 1996 (3) SA 966 (A)

below, in my respectful view, omitted to focus on its effect in contrast to that of clauses 4 and 5. It is clause 2 that creates the subordination. That subordination is stated to be 'for the benefit of the other creditors of the company [Alberti]'. Only so much of CPC's claim is subordinated 'as would enable the claims of such other creditors to be paid in full'. It is this subordination - that is, in favour of 'the other creditors' - to which clause 4 expressly refers back. It is in respect of this subordination that clause 4 deems an excess of liabilities over assets to exist until certification, and it is this subordination that clause 5 erects as an impediment to legal action in the absence of certification.

[18] How is clause 2 to be interpreted if it is established without dispute that there are no other creditors at all? In my view, quite clearly the subordination it effects is entirely inoperative, and the deeming provision of clause 4, and the impediment created by clause 5, do not come into operation at all. Clause 4 was plainly designed to create a mechanism of proof to avoid disputes about whether and in what measure Alberti's assets exceeded its liabilities. Clause 5 was designed to impede legal action by CPC in the absence of such proof. But where there are in fact no disputes at all, and where no disputes are indeed feasible, because of an absence of any question about the existence of other creditors, the certification requirement is wholly inapplicable.

[19] In these circumstances the decision by the Courts below that the absence of appropriate certification vitiated the creditor's claim against the sureties is erroneous.

1.1 The appeal succeeds with costs, including the costs of two counsel.

1.2 The decision of the Full Court is set aside.

1.3 In its place, the following order is substituted:

'1. The appeal succeeds with costs, including the costs of two counsel. I

2. The judgment of the trial court is set aside.

3. In its place there is substituted:

(i) Judgment is granted in favour of the plaintiff against the first and second defendants, jointly and severally, the one paying, the other to be absolved, in the amount of R15 million.

(ii) Interest on this amount at the prime rate of Nedbank Ltd from 1

973C-E; RH Christie *The Law of Contract* 4ed (2001) pages 243-244.

October 1996 to date of payment.

(iii) Costs of suit, including the costs of two counsel.'

E CAMERON

JUDGE OF APPEAL

Smalberger ADP, Harms JA, Navsa JA and Mpati JA concurred.