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ABSTRACT

Chapter 6 of the companies Act has attempted to resolve problems created by the ineffectiveness of judicial management which has failed to provide suitable alternative to the liquidation. The process of business rescue proceedings has made some impact on the liability of sureties in so far as it relates to creditors. Moratorium has been imposed once the business rescue proceedings commences and therefore the principal debtors are protected against any legal action unless the court or business rescue practitioner has consented thereto. The question is what is the impact of the business rescue proceedings on the rights of creditors against the sureties of the company under business rescue proceedings and what is the judicial position in so far as it relates to liabilities of sureties during business rescue proceedings, finally what is the position of comparative law in respect of other foreign Jurisprudence terms of business rescue proceedings and the liability of sureties.

The South African Companies Act does not regulate the situation of creditor's rights against sureties of a financially distressed Company. In terms of American law, the situation is different. Creditor's rights against non-debtors (including sureties) is regulated by Bankruptcy Codes. In terms of bankruptcy codes, the discharge of a debtor does not affect the liability of the non-debtors or other entities.

There are divergent views in terms of South African Court decisions in respect of liability of sureties. Some Judges believe that the commencement of business rescue proceedings does not affect the liability of sureties and others are of the view that the beginning of business rescue proceedings releases sureties from their obligations towards creditors unless business rescue plan or deed of suretyship provides otherwise.

It is therefore recommended that our legislature introduces some new sections into the companies act. One Section should be similar to section 524(e) of the bankruptcy codes which expressly states that a discharge granted to the principal debtor does not affect the liability of sureties towards creditors. Another section should be similar to section 105(a), which provide courts with powers to make any order to realize the objectives of the companies act. This to avoid conflicting courts decisions on this issue.

THE RELEASE OF LIABILITY OF A SURETY DURING BUSINESS RESCUE PROCEEDINGS

BY

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This Mini-Dissertation is submitted in Partial Fulfilment of the Requirements for the Degree of Master of Laws in Business Law

In the

College of Law and Management

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At the

UNIVERSITY OF KWAZULU- NATAL, DURBAN

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2019

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CHAPTER 1

GENERAL INTRODUCTION

1.1 Introduction

Prior to the enactment of the Companies Act 71 of 2008 (the Act), entities in financial distress were subjected to judicial management under the Companies Act 61 of 1973. Judicial management failed as an alternative to liquidation due to a lower number of actual rescues registered.[1] The business community never accepted judicial management as an effective corporate restructuring mechanism. Instead of making use of judicial management, the corporate world resorted to informal restructuring by approaching creditors directly and entering into informal agreement resulting in moratorium preventing or at least delaying creditors' claims.[2] The simplicity, costs effectiveness and speedy nature of these informal restructurings made them popular in the corporate world. However, the main challenge of informal restructuring was the resistance of greedy creditors.[3] The need for a formal and effective corporate restructuring process was felt resulting in the introduction of the business rescue proceedings into the Act.

The main aim of business rescue proceedings is to rehabilitate a company in financial distress and avoid the negative implications of liquidation. The process of business rescue entails three main steps, namely[4]:

- Placing the management of the company under the care of business rescue practitioner
- Placing a moratorium on the rights of all creditors
- Implementing a business rescue plan.

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[1] DA Burdette "Some initial thoughts on the development of a modern and effective business rescue model for South Africa" (2004) *SA Merc. LJ* (16) at 246; see also Loubser A "The business rescue proceedings in the Companies Act of 2008: concerns and questions (part 1) (2010) *TSAR* at 501.

[2] Ibid at 253-253. See also *Le Roux Hotel Management (Pty) Ltd and Another v E Rand (Pty) Ltd and another* 2001(2) SA 727 (C) at 223.

[3] H Rajak and J Henring "Business rescue for South Africa" (1999) *SALJ* at 265.

[4] Section 128(1)(b). See also FHI Cassim et al. "*Contemporary Company Law*" 2nd edition, Juta, 2013. 864.

These steps, though seemingly simple, cover a range of complex issues, not least of which is the interpretation or impact on the rights of creditors. In this regards this dissertation will focus on the specific impact of business rescue proceedings on the liability of sureties for a company placed under the business rescue.

1.2 Research problem

The Companies Act is silence on the issue of the rights of creditors against the liabilities sureties of an entity that is placed under business rescue. The problem arising thereof is whether creditors are or are not allowed to enforce their rights against sureties of such a company. This research aims at finding answers to this lacuna in the law by analysing the case and undertaking a comparative study.

1.3 Key questions

The introduction of business rescue in South African law did address some of the challenges encountered in the judicial review process. However, it did raise few problems of its own and one of them relates to the rights of creditors to pursue sureties during the business rescue proceedings. Legal proceedings against the company under business rescue can only be undertaken with the leave of the Court or authorization from the business rescue practitioner.[5] A moratorium is placed on all court processes commenced before and after the adoption of the business rescue plan.[6]

The questions that arise from the above discussion are:

- What is the impact of business rescue proceedings on the rights of creditors against the sureties of the company under business rescue proceedings?
- What is the judicial position with regard to the liabilities of sureties under business rescue proceedings?

This study analyses the impact of business rescue proceedings on the liabilities of sureties. Both concept of business rescue and suretyship will be discussed, approach

[5] Section 133(1)(a) and (b).
[6] Section 133(1) See also FHI Cassim *et al*. op cit note 4 above at 879.

adopted by foreign jurisdictions, relevant legislation, South African judicial approach will also be evaluated.

1.4 Methodology

This dissertation is a library based study. It is based on both primary and secondary sources. Information is gathered from national legislation, foreign legislation, case law and from analytical commentators. With regard to commentators, the dissertation uses publications from both local and international journals. This study adopts a comparative approach in that it analyses as well how the subject matter is dealt with in other jurisdictions, especially in the United Stated of America. The choice of the American model is justified by the fact that, our legislature relied heavily on the American law in enacting the South African law on business rescue and the two systems have a lot similarities in so far as business rescue proceedings are concerned.

1.5 Literature review

The introduction of Chapter 6 in the Companies Act has been subject of intense academic research with many researchers analysing critically different aspects of business rescue regime in general. The impact of business rescue on sureties has been also subject of robust academic debate as well.

Weyers[7] tried to answer the issue whether a creditor of a company in business rescue has the right to pursue a surety. The author states that the business rescue regime does not deal or address the position of a surety for a company placed under business rescue.[8] To solve the problem, Weyers turned to judicial review to analyse how Courts have deal with the subject matter. She analysed the legal position prior to the adoption of the business rescue plan and found that the moratorium on legal proceedings in respect of an entity in distress did not extend to its sureties.[9]

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[7] K Meyers "Securities and Business Rescue: Company Law" *Without Prejudice* (2016) 16(4) at 6-7.
[8] Ibid.
[9] Ibid. This was decided in the case of *Investec Bank v Andre Bruyns* (2012) (5) SA 430 (WCC) at 12.

After the adoption of the business plan, Weyers found that the situation of sureties was dependent on the provisions of the business rescue plan and clauses of the surety agreement.[10] Where both the documents are silent on the effect of business rescue on sureties, common law applies. In conclusion, the author recommends that creditors' rights need to be adequately protected in the suretyship agreement and this could be done either by incorporating a guarantee into the suretyship agreement or by expressly having a clause in the suretyship agreement preserving the rights of creditors to pursue sureties in case the principal debtor is placed under business rescue proceedings. Lombard and Swart[11] discuss the uncertainty about sureties in business rescue proceedings by analysing the case of Turning Fork (Pty) Ltd t/a. they conclude that provisions relating to business rescue should be approached differently from those relating to liquidation procedure.[12]

A creditor cannot pursue a surety after the adoption of the business rescue that makes provision for the full and final settlement of creditors' claims against a company.[13] Authors are of the view that the Tuning Fork decision can be an incentive for unscrupulous directors to initiate business rescue proceedings just escape liabilities as sureties.[14] On the other hand, creditors will be inclined to vote against the adoption of business rescue plan to avoid losing their rights against sureties who are usually directors of the company.[15]

They recommend that a deed of suretyship should contain clauses preserving the rights of creditors against sureties in a case of a principal debtor being placed under business rescue.[16] They also recommend that the Act be amended to provide clarity on the rights

[10] Ibid at 7. This was decided in the case of *Tuning Fork v Greeff* 2014 (4) SA 521 (WCC) at 512.
[11] M Lombard and WJC Swart "Case Note Business Rescue: the Uncertainty about sureties. *Tuning Fork (PTY) Ltd t/a Balanced Audio v Jonker* 2014 5 SA 521 (WCC)" *THRHR* 2015 (78) at 521-533.
[12] *Tuning Fork (PTY) Ltd* at 521.
[13] M Lombard and WJC Swart *op cit* note 11 above at 532.
[14] Ibid.
[15] Ibid.
[16] Ibid at 533.

of creditors against sureties in business rescue proceedings and on the recourse right of sureties.[17]

Given the fact that sureties are usually directors or owners of the company, it sounds absurd to grant a juristic person a moratorium but still allow creditors to pursue their claims against its directors as this defeat the purpose of the moratorium. It will be recommended that the legislature intervenes by expressly extending the moratorium granted to the entity under business rescue to its sureties if the distressed company will have any chance of being successfully rescued

1.6 Chapter overview

Chapter two discusses Chapter 6 of the Companies Act with special emphasis on the rights of creditors to hold sureties accountable. The effect of business rescue proceedings on these rights before and after the adoption of the business rescue plan is examined in chapter three. Chapter four deals with suretyship whereas chapters five and six analyse the American perspective of the subject matter and how American courts have deal with it. Chapter seven deals with findings of the study, and final recommendations and suggestions.

[17] M Lombard and WJC Swart *op cit* note 11 above at 533.

CHAPTER 2

BUSINESS RESCUE PROCEEDINGS

2.1 Introduction

Chapter 6 of the Act has introduced business or corporate rescue in South African law with the purposes of assisting financially distressed companies avoid demise and safeguarding the interests of all stakeholders, namely but not limited to employees, trade unions, creditors and shareholders. As already stated, business rescue replaces the old judicial management provisions contained in the old Companies Act.

For the business rescue proceedings to be considered, a company must fulfil two requirements, namely it must be financially distressed and there must be a reasonable prospect of rescue.[18] When a company is unable to pay its debts as they become due and payable within the next six months or if it appears that it will likely become insolvent within the next six months, business recue proceedings can be triggered.[19] The main implication of a business rescue proceedings is that it places a general moratorium on all legal proceedings and executions against the company itself or any assets belonging to the company.[20] Any creditor wishing to act against the company will require the leave of the High Court or permission from the business rescue practitioner.[21]

2.2 Resolution to start the business rescue proceedings

There are two ways provided by the law in which business rescue proceedings may be initiated, namely by a resolution passed by the board of the company[22] or by an application to Court by an affected person to place the distressed company under business rescue.[23] Whichever way is used, the ultimate aim is to rescue the company as a going concern or at least rearranged it in a manner that results in a better return for all

[18] Section 129(1)(a) and (b).
[19] Section 128(1)(f).
[20] Section 133.
[21] Section 133(1)(a) and (b).
[22] Section 129(1).
[23] Section 128(1)(a)(i) to (iii).

effected persons than the return that would have resulted from immediate liquidation of the company.[24] The two ways are discussed below.

2.2.1 Board of directors' resolution

The board of directors may initiate the business recue process by way of a resolution by stating that the company voluntarily begins business rescue proceedings and that it be placed under supervision.[25] It is worth mentioning that the Act has introduced a debtor friendly business rescue regime in contrast to our insolvency law which is considered creditor friendly.[26] For such a procedure to take place, the Board must be satisfied that:[27]

- the company is financially distressed
- There is a reasonable prospect of the company being rescued.

The business rescue proceedings formally commence on the day of filling of the Board resolution and once the business rescue has started the company cannot then adopt a resolution to start liquidation.[28] Liquidation may be considered only if the business rescue process has lapsed or has ended without turning the financial situation of the company around.[29]

Up until the adoption of the business rescue plan, an affected person may apply to the Court for the resolution adopted by the board of the company to commence the business rescue proceedings to be set aside on the following grounds:[30]

- That no reasonable basis exists that justifying the fact that the company is in financial distress;
- That there is no reasonable prospect of rescuing the company
- That the requirements prescribed in Section 129 were not complied with.

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[24] FHI Cassim *et al* "*Contemporary Company law*", 2nd ed.2012. Juta at 864.
[25] Section 129(1).
[26] FHI Cassim *et al* op cit note 18 above at 866.
[27] Section 129(1).
[28] Section 132(1).
[29] Section 129(6).
[30] Section 130(1)(a)(i)-(iii).

In considering such application, the court may set aside the resolution on any of the ground enumerated above or if it considers that it is just and equitable to do so.[31]

In other instances, the court may give the business rescue practitioner enough time to form an opinion on whether the company is in financial distress and whether there is reasonable prospect of rescuing it.[32] Based on such an opinion the court may or may not set aside the resolution of board to commence business rescue proceedings.

2.2.2 Commencement of business rescue by order of Court

The second manner in which a company may be placed under supervision and business rescue proceedings is by way of an application to court. A court may place a company under the rescue process on application by any affected person, at any time before the board adopts a resolution to commence the business rescue process.[33] This application may be brought by an affected person even if the company is under liquidation proceedings.[34] Of course this is in opposition to section 129(2) (a) which prohibits the board of directors from taking a resolution to commence business rescue proceedings if liquidation proceedings have already been initiated by or against the company. Therefore, while the board is unable to place the company under business rescue proceedings because of the start of liquidation proceedings, any affected person may apply to court under section 131(1) to place the company under business rescue. This is a useful mechanism for the conversion of liquidation proceedings into business rescue proceedings.

The application to Court to commence business rescue proceedings halts all other applications against the company.[35] The applicant must serve, in the prescribed manner, a copy of the application on the Commissioner of the Companies and Intellectual Property and the company, and must inform all affected persons of the existence of the court

[31] Section 130(1)(a)(i)-(iii).
[32] Section 135(b)(i)-(iii).
[33] Section 131(1).
[34] FHI Cassim *et al op cit* note 18 above 873.
[35] Section 131(6)(a) and (b).

application (in the prescribed manner as well).[36] Each affected person has the right to participate in the hearing of an application in terms of section 131 without the need to apply for leave of the court to intervene in the proceedings.[37]

A court may make an order placing a company under supervision and for business rescue proceedings to commence based on the following three reasons (which are much wider than the grounds on which the board of directors may adopt a resolution to commence business rescue):[38]

- The company must be financially distressed;
- The company must have failed to pay over any amount in terms of an obligation under a public regulation or contract in respect of employment related matters; or
- If it is just and equitable to place a company under business rescue for financial reasons.

Business rescue proceedings cannot be used as a strategic way of delaying payments of debts to the detriment of creditors. In the case of *Swart v Beagles Run Investments 25 (Pty)Ltd*[39] , the Applicant, a sole director and shareholder of the Respondent, sought an order placing the Respondent under supervision in terms of section 131(4)(a) of the Act claiming the company was in financial distress. All affected parties were informed in the prescribed manner as required by law. Creditors successfully opposed the application on the grounds that it was an abuse of the process and an attempt by the Applicant to postpone payments of the Respondent's debts. The following factors about the company were obvious from the evidence:[40]

- The company was hopelessly insolvent with the result that there was no real prospect of rescuing the company or reorganizing it to enable it to carry on business on a solvent basis

[36] Section 131(2)(a)-(b).
[37] Section 131(3).
[38] Section 131(4)(a).
[39] (2011) ZAGOOHC 103 (30 May 2011) (unreported) at 1 -9.
[40] *Swart v Beagles Run Investments* at 11.

- There was no basis for contending that creditors would be in better position than they would be in a liquidation of the company.

In dismissing the application, the court stated that where an application for business rescue proceedings entailed a weighing -up of the interests of creditors against those of the company, creditors interests should prevail.[41]

2.3 Duration of business rescue proceedings

Section 132 of the Act set out the start, duration and the termination of business rescue proceedings. The commencement date is of utmost importance because restrictions, moratoriums and other consequences of business rescue come into effect upon formal commencement of business rescue proceedings.[42] Section 132(1) provides instances in which business rescue proceedings are deemed to have commenced:

- When the business rescue proceedings, are initiated by a resolution of a board of directors of the company, they begin when the company files with the Commissioner the resolution to place itself under supervision.
- In the case of the initiation of business rescue proceedings by an order of Court, they commence when an affected person lodge an application in Court to place the distressed company under business rescue;
- When the Court, during the course of liquidation proceedings or proceedings to enforce a security interest, makes an order placing the company under supervision.

The underlying approach to the duration of the business rescue is that the appointed business rescue practitioner must perform his functions expeditiously, efficiently and cost effectively.[43] The business rescue process will benefit all affected persons only when it is quick. The Act, implicitly contemplates that the business rescue proceedings should end within 90 days subject to an extension of the time by the court.[44] If the business rescue

[41] *Swart v Beagles Run Investments* at 41.
[42] Section 133(1).
[43] Cassim *et al* op cit note 18 above 877.
[44] Ibid.

proceedings have not ended within 3 months or such longer time as the court permits, the business rescue practitioner must prepare a report on the progress of proceedings, and follow it up with updates at the end of each subsequent month until termination of the proceedings. These documents must be delivered to each affected person in the prescribed manner and to the court or the Commissioner depending on the process that commenced the business recue proceedings. 11

The business rescue proceedings end when:[45]

- The court sets aside the resolution or order that began those proceedings, or the court converts the business rescue proceedings to liquidation proceedings;
- The business rescue practitioner has filed with the Commission a notice of the termination of the business rescue proceedings;
- A business rescue plan has been proposed and rejected, but no affected person has sought to extend the proceedings as contemplated in section 153 of the Act or alternatively, a business rescue plan has been adopted and the practitioner has subsequently filed a notice of substantial implementation of the plan where the substantial purpose of the rescue process has been achieved.

2.4 Legal consequences of a business rescue order

The moratorium on all legal proceedings or executions against the company, its property, and its assets and on the exercise of the rights of creditors of the company, is the most crucial consequence of the commencement of business rescue proceedings. Stated otherwise, there is a general moratorium on the enforcement of remedies against a company that is under business rescue.[46] The moratorium is remains in place until the business rescue proceedings ends and the suspension of legal proceedings against the distressed company applies to all creditors, secured and general.[47] For a creditor to enforce their rights while the company is under the business rescue they need either the

[45] Section 132(2)(a)-(c).
[46] Section 133(1).
[47] Cassim *et al* op cit note 18 above 878.

consent of the business rescue practitioner or an order of Court.[48] The general rule is that during business rescue creditors' rights are simply frozen and not substantially altered.[49]

2.5 Business rescue plan

One of the most important duties of a business rescue practitioner is to prepare and implement an adopted business rescue plan. The main objective of the business rescue proceedings is to approve a business rescue plan.[50]

With this background in mind, the business rescue practitioner must start consultations first with all creditors of the company, followed by all other affected persons and lastly with the company management.[51] The practitioner must ensure that the business rescue plan is comprehensive and contains all the necessary information that will allow all affected persons to take a decision of whether accepting or rejecting the proposed business rescue plan.[52] Rights of employees, creditors and holders of company securities must be taken into account because they are affected the business rescue proceedings and are stakeholders in the business rescue proceedings. They are afforded general rights and specific rights. General rights belonging to all stakeholders are such as the right to apply for commencement of business rescue proceedings, right to lodge objections against such proceedings or against the appointment of a practitioner, right to receive notices of business rescue proceedings, right to participate in the business rescue proceedings and the right to receive updates on the progress of the rescue proceedings.[53] Specific rights of employees are set out in section 144 of the Act. They can be exercise though a trade union if employees are members of a union or through an employee representative.[54]

As a result of a moratorium freezing their rights, creditors of the company are given a *quid pro quo,* a right to influence the manner in which the affairs of the company are regulated

[48] Section 133(1)(a) and (b).
[49] Ibid at 879.
[50] Ibid at 897.
[51] Section 150(1).
[52] Section 150(2).
[53] Section 129 and 130.
[54] Section 144(1)(b).

and a right to vote on the approval of the business rescue plan.[55] Lastly, the rights of holders of the company's securities are set out in section 146, however their interests are regarded as being subordinate to the interests of creditors and employees.[56] Liquidation renders the value of the company shares worthless and a successful rescue or a return to profitability increases the value of the company shares.[57]

2.6 Adoption of a business rescue plan

As already stated, the responsibility to prepare a business rescue plan lies with the business rescue practitioner. He/she must consult with affected persons notably creditors, management of the company, employees' unions or representative and then prepare the business rescue plan for consideration by affected persons in terms of section 151.[58] The plan is to be published with 25 business days of practitioner's appointment unless leave of court or permission from holders of the majority of the creditors voting interests is obtained.[59] Ten days after the publication of the business plan, the business rescue practitioner must convene and preside over a meeting of affected persons including but not limited to creditors, shareholders, and any other holders of voting interest, called for the sole purpose of considering the proposed business rescue plan.[60]

The business rescue practitioner is required to present the proposed business rescue plan for consideration by the creditors and other affected persons.[61] His/her opinion on whether he/she believes that the company can still be rescued must be expressed at the meeting.[62] Employees' representative must also be given an opportunity to address the meeting and after that the business rescue practitioner must invite discussion, conduct a vote on any motions or call for a vote for preliminary approval of the proposed plan.[63] For it to be approved on a preliminary basis, the business rescue plan must receive the

[55] Cassim *et al* op cit note 18 above 902.
[56] Ibid at 904.
[57] Ibid.
[58] Section 150(1).
[59] Section 150(5).
[60] Section 151.
[61] Section 152(1).
[62] Cassim *et al* op cit note 18 above 905.
[63] Section 152.

support of at least 75 per cent of the creditor's voting interests and also by 50 per cent of independent creditors' voting interests.[64] If the business rescue plan is approved by the required number of voting interests of creditors, the plan is regarded as approved. If the business rescue plan is not approved on a preliminary basis, it is regarded as having been rejected and may be considered further only in terms of section 153.[65]

2.7 The effect of the adoption of the plan

An adopted business rescue plan is binding on all stakeholders whether they participated in the meeting or not, whether they voted for or against the plan or whether their claim was proved before the adoption of the plan or not.[66] This cramdown[67] is essential for the fruitful execution of the business rescue plan, however the business rescue practitioner is required to take all necessary measures to satisfy any condition on which the rescue is contingent and to implement the adopted plan.[68] The effect that the adoption of a business rescue plan has on the situation of sureties is indeterminate.

Section 154 deals with the discharge of debts and claims against the company under business rescue proceedings. A business rescue plan may provide that a company creditor who has agreed to the discharge of the whole or part of his/her claim against the company will lose the right to enforce the said debt or claim in its entirety or partially.[69] The effect of business rescue proceeding on creditors' claim are subject to the business rescue plan being approved and implemented in terms of the law.[70] Once adopted and implemented, creditors become unable to enforce their claims against the company owed before the beginning of the business rescue proceedings, save to the extent provided for

[64] Section 152(2).
[65] Cassim et al *op cit* note 18 above 906.
[66] Section 152(4). See also Loubser op cit note 1 at 693-694.
[67] Cramdown is a process by which creditors are forced to accept a reorganization or business rescue plan even if it is against their wishes.
[68] Section 140 (1).
[69] Section 154(1).
[70] Section 154(2).

in the business rescue plan.[71] The wording of section 154(1)[72] and mostly the use of the word 'acceded' create an impression that only creditors who have consented and voted in favour of the business rescue plan will be unable to enforce their claims against the company but dissenting creditors will still be able to enforce their claims in full despite provision to the contrary in the adopted business plan.

The court in the *Tuning Fork (Pty) Ltd T/A Balanced Audio v Greeff*[73] case criticised the legislature for the use of the word 'acceded' and stated that its use was inappropriate as it could not have been the intention of the legislature that the discharge as envisaged in section 154(1) would depend on a creditor assenting to it or not.[74]

The wording of section 154(2) suggests that, unless the business rescue plan provide otherwise, when a business rescue plan is adopted all creditors of the company lose their rights to put in force their claims against the company. The challenge raised by section 154 is whether if all or part of creditors' claims against the company become unenforceable as a result of the adoption of the business rescue plan, creditors would be able to go after sureties of the company for the payment of the unrecoverable portion of the debts owed by the company? The discussion in the following chapter deals with this challenge.

2.8 Summary

This chapter has discussed the notion of business rescue as set out by the legislature in Chapter 6 of the Act. The chapter has set out the circumstances under which a company can be placed under business rescue, the procedure to follow for the appointment of business rescue practitioner, the duties of the business rescue practitioner and the rights of affected persons.

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[71] Section 154 (2).

[72] Section 154(1) provides as follows "(1) A business rescue plan may provide that, if it is implemented in accordance with its terms and conditions, a creditor who has acceded to the discharge of the whole or part of a debt owing to that creditor will lose the right to enforce the relevant debt or part of it."

[73] 2014 (4) SA 521 (WCC).

[74] *Tuning Fork* at para 77.

CHAPTER 3

THE IMPACT OF BUSINESS RESCUE PROCEEDINGS ON THE LIABILITY OF SURETIES

3.1 Introduction

The position of sureties has remained uncertain and the subject of contentious debates since the coming into force of the Act and the introduction of business rescue proceedings in South African law. The first reason for this derives from the failure of the Act itself to address this issue. Secondly the use of an unclear and undefined word “acceded” in section 154(1) adds to uncertainty. Lastly conflicting Court judgments on this issue have failed to provide clarity.

The court judgments on the position of sureties under business rescue proceedings can be divided into two main groups, those that conclude that the liability of sureties remains unaffected by the adoption of the business rescue plan and those that have decided that the adoption of a business rescue plan fundamentally affects the liability of sureties towards creditors.

3.2 Legal position before a business rescue plan is adopted

This paragraph discusses the rights of creditors against sureties during business rescue proceedings but before a business rescue plan is adopted. The focus is on the implications of the section 133(1) legal moratorium.

In the case of *Nedbank Ltd v Zevoli 208 (Pty) Ltd*[75] the Plaintiff/Applicant (Nedbank) applied for a summary judgment against the principal debtor (Zevoli) as first respondent and the other respondents in their capacity as sureties.[76] Before the matter was set down for hearing, the first respondent decided to commence voluntary business rescue proceedings in terms of section 131(1) of the Act.[77]

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[75] 2017 (6) SA 318 (KZP).
[76] *Nedbank Ltd* at para 1.
[77] *Nedbank Ltd* at para 23.

The applicant/plaintiff had no choice but to adjourn the first defendant's/respondent's application *sine die* and proceed against the sureties only.

Counsel for the sureties raised several defences, but the one that is of interest to this discussion was that the sureties were also entitled to the benefit of the moratorium triggered by the business rescue in favour of the principal debtor.[78]

It was held by the court that the moratorium deriving from business rescue proceedings was a personal privilege, intended to benefit only the principal debtor that is placed under business rescue.[79] This benefit could not be claimed by sureties whose liabilities remained unaffected by the commencement of business rescue proceedings.[80] The court granted summary judgment in favour of Nedbank.

In the case of *Investec Bank Ltd v Bruyns*,[81] the plaintiff/applicant sued the defendant/despondent in his capacity as surety. The principal debtor was placed under business rescue but before the adoption of the business rescue the plaintiff decided to proceed against the surety. The surety then filed a notice to defend and the plaintiff/applicant applied for a summary judgment. In his opposing affidavit, the surety stated that the moratorium enjoyed by the principal debtor extended to him as well. One of the questions before court was whether a surety could raise as a defence a statutory moratorium which prohibits the creditor from claiming from the principal debtor. Differently stated, the court was asked to determine whether section 133(1) is a defence *in rem* or *in personam*.

The court ruled that the moratorium in favour of the principal debtor under business rescue in terms of section 133(1) is a defence *in personam.* It is a privilege or benefit enjoyed by the principal debtor only and is not available to sureties. This defence is personal immunity of the principal debtor in respect of an otherwise valid and existing claim.[82]

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[78] *Nedbank Ltd* at para 17.
[79] *Nedbank Ltd* at para 26.
[80] *Nedbank Ltd* at para 26.
[81] 2012(5) SA 430 (WCC).
[82] *Investec Bank Ltd* at para 18.

The creditor is entitled to sue the surety when the company (principal debtor) is placed under business rescue proceedings.

It can be deduced from the above cases that the liabilities of sureties for principal debtors' obligations remain unaffected, they remain liable.[83] The moratorium is a personal privilege enjoyed by the principal debtors alone.

3.3 Case law holding that sureties' liabilities are unaffected by the adoption of business rescue plan

In *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd*[84] the defendant/respondent (Kariba Furniture Manufacturers) was placed under business administration and a business plan was adopted. Directors of the company had signed deeds of suretyship for the benefits of the plaintiff/applicant (African Banking Corporation of Botswana). The suretyships expressly provided that the plaintiff/applicant's claim was not, in any way, going to be affected by, among others, business rescue.[85] The African Banking Corporation sought a declaratory order to the effect that the adoption of the plan was not going to affect its rights under the suretyship agreements, however, the directors of the company expressed an opposing view.[86] The rights of creditors were not preserved in the plan. The court concurred with the plaintiff/applicant and stated that there was no basis to suggest that a business rescue plan could contain a clause depriving creditors of their rights to sue sureties and the Companies Act did not make provision for such.[87] The court ruled that the adoption of a plan cannot affect the claim of a creditor against a surety.[88]

In the matter of *Blignaut v Stalcor (Pty) Ltd*[89] the Applicant brought an urgent application to stay a sale in execution of property that constituted his primary residence.

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[83] K Weyers "Sureties and business rescue" (2016) *Without prejudice* 6-7.
[84] 2013 (6) SA 471 (GNP).
[85] *African Banking Corporation of Botswana Ltd* at para 66.
[86] *African banking Corporation of Botswana Ltd* at para 67.
[87] *African Banking Corporation of Botswana Ltd* at para 69.
[88] *African Banking Corporation of Botswana Ltd* at para 71.
[89] 2014 (6) SA 398 (FB).

The applicant signed a suretyship agreement in favour of the respondent and when the principal debtor was placed under business rescue and a plan adopted, the respondent decided to go after the surety to recover the shortfall. The plan did not contain a clause preserving creditors' claims against sureties of the principal debtor.

The applicant argued that the acceptance of the business rescue plan amounted to a statutory compromise, therefore a defence *in rem* available to both the surety and the principal debtor. The respondent was late in filing an opposing affidavit and the court decided the matter based on the applicant's papers alone. The court concluded that the purpose of the whole business rescue regime is to enable a company in financial distress to get back to profitability. The business rescue is then a temporary measure which can achieve its objective only if it is afforded to the distressed company alone. The legislature did definitely intend for the process to benefit the principal debtor and co-debtors such sureties and dismissed the application with costs.[90]

In the case of *ABSA Bank Limited v Haremza*[91] the Respondent entered into a suretyship agreement binding herself as surety and co-principal debtor in favour of the applicant.[92] The company (principal debtor) was under financial distress and was placed under business recue in terms of section 129 of the Act.[93] A year later an amended business plan was presented and adopted by creditors. In terms of the amended plan, the company would be sold as a going concern and all secured creditors would be paid in full to the extent of the realisation of their securities. The applicant was a secured creditor and was to have been paid after the sale of its securities, which unfortunately would have left the applicant with a massive shortfall. Clause 6.5 of the business rescue plan provided that the settlement did not affect any rights that a creditor may have against anyone who bound themselves as surety.[94]

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[90] *Blignaut* at para 21.
[91] (12189/2014) [2015] ZAWCHC 73 (27 May 2015, unreported). This judgment relates to an application for summary judgment.
[92] *ABSA Bank Limited* at para 2.
[93] *ABSA Bank Limited* at para 2.
[94] *ABSA Bank Limited* at para 15.

The main defence raised by the defendant/despondent was that the deed of suretyship was an accessory contract in nature which follows the fate the principal contract.[95] As, in terms of the business rescue plan, the principal debt had been extinguished, by virtue of section 154 of the Act, the surety's obligation toward the creditor had, in the same way, been extinguished as well. The defence relied on the judgment by Rogers J in *Turning Fork (Pty) Ltd*[96] in support of her contention.[97]

In analysing the evidence presented by the defence, the court stated that Rogers J was of the view that a compromise or release of a principal debtor effected by a business rescue plan released the surety as well, unless the deed of suretyship provided otherwise or the business plan preserved the claim against the surety.[98] The court questioned the rationale in *Turning Fork* which was also questioned in *New Point Finance*[99] where the SCA had suggested that section 154 can be construed to be dealing only with the ability to sue the principal debtor and not with the existence of the debt itself.[100] The court faulted the reasoning of Rogers J and stated that it was incorrect.[101] In rejecting the defendant's/respondent's arguments, the court stated that the applicant's/plaintiff's right to pursue the defendant was preserved not only by the deed of suretyship but also by the adopted business rescue plan.[102] The court went on to say that the agreement between the applicant and principal debtor in the case under consideration was nothing more than a *pactum de non petendo.*[103] And the principal debtor acknowledges that should the creditor exercise his right of recourse against the surety, the principal debtor will be liable to the surety under the surety's right of recourse.[104] The court granted the application for summary judgment.

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[95] *ABSA Bank Limited* at para 15
[96] 2014(4) SA 521(WCC*).*
[97] *ABSA Bank Limited* at para 16
[98] *ABSA Bank Limited* at para 23.
[99] *Newpoint Finance Co (Pty) Ltd v Nedbank Ltd* [2014] ZASCA 210.
[100] *ABSA Bank Limited* at para 24.
[101] *ABSA Bank Limited* at para 24.
[102] *ABSA Bank Limited* at para 31.
[103] *Pactum de non petendo* refers to an agreement not to sue, it is an agreement in which a creditor promises not to enforce the debt.
[104] *ABSA Bank Limited* at para 30.

In the case of *Stan Rio Pipe and Steel (Pty) Limited v Esterhuizen*[105] the plaintiff instituted an action against the defendant for sum of monies due and payable by the defendant as a surety in terms of a deep of suretyship. The defendant resisted the summary judgment application stating that the suretyship agreement was invalid in that it did not comply with Section 6 of the general Laws Amendment Act 50 of 1956 in that it omitted to record the name of the principal debtor on it.[106] It was alleged further that the plaintiff's action was brought in bad faith and prematurely because the plaintiff had already subscribed to the business rescue plan which provided that the plaintiff was going to be paid in full over time. This entails that the plaintiff's claim is not due and payable in that it has not been determined that the principal debtor had failed to pay.[107] It is worth mentioning the adopted plan did not preserve creditors' rights against sureties.[108]

The plaintiff's representatives argued the deed of suretyship and the deed of sale which contained the terms and conditions of sale constituted one document and that, given that the principal debt is identifiable, there was compliance with Section 6 of the General Law Amendment. In respect of the second contention the plaintiff's representative argued that the liability of the surety is not affected by the adoption of the business rescue plan. They relied on the *New Port Finance Company (Pty) Ltd v Nedbank Limited* discussed above.[109]

The court rejected the defendant's arguments and accepted the plaintiff's submissions. The court concurred with the plaintiff and stated the right to pursue a surety remained unaffected by the adoption of a business rescue plan as stated in the case of *Port Finance*.[110] The court granted the summary judgment because it was of the view that the defendant had not raised a *bona fide defence*.

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[105] (64166/2015) [2016] ZAGPPHC 35 (29 January 2016, unreported). This is application for summary judgment.
[106] *Stan Rio Pipe and Steel (Pty) Limited* at para 4.
[107] *Stan Rio Pipe and Steel (Pty) Limited* at para 5.
[108] *Stan Rio Pipe and Steel (Pty) Limited* at para 9.
[109] *Stan Rio Pipe and Steel (Pty) Limited* at para 10.
[110] *Stan Rio Pipe and Steel (Pty) Limited* at para 11.

3.4 Cases holding that the adoption of business rescue plan affects the creditors' claims against sureties

The cases discussed below indicate that were the business rescue plan and the suretyship agreement are silent on the effect of a compromise or business rescue proceedings on the liability of sureties, the common law applies. For creditors to be able to claim from sureties, after the adoption of the business rescue plan, their claims must be preserved either by the plan or/and deed of suretyship

In the case of *New Port Finance Co (Pty) Ltd v Nedbank Ltd*[111] the respondent lend money to a company which loan was secured by a deed of suretyship. The company failed to repay the loan and the respondent obtained a judgment holding both the company and sureties jointly and severally liable. Subsequently, the company was placed under business rescue proceedings with the result that the business rescue plan restricted the amount of the judgment it had to pay. Nedbank then turned to the sureties and demanded the judgment amount from them, but they could not pay. Nedbank then applied for the liquidation and sequestration of the sureties who then applied for an interdict preventing the bank from enforcing the judgment pending the outcome of the business rescue. The application for an interdict was dismissed by the high court and the sureties appealed to the Supreme Court of Appeal.

The sureties' (appellants') argument was that the business rescue plan had altered the company's obligations towards the respondent, therefore, their own obligations as sureties were also altered. Stated otherwise, the sureties were entitled to the same benefits as the company under the business rescue plan. In this case as the company was given time to pay, so should the sureties and if the company's obligations are discharged at the end of the business rescue, so should the sureties' obligations be discharged. Unfortunately, the business rescue proceedings failed and were terminated.

However, the court noted the legal aspects raised by the sureties and provided the following reasons why they should fail:

[111] 2016 (5) SA 503 (SCA).

- The judgments obtained by the respondent fixed the liabilities of both the company and sureties, there was no grounds for rescission, nor had there been an attempt to rescind them.
- Further there was no authority extending the benefits of a company's liability to the sureties.
- Section 154 of the Act which regulates the enforcement of debts against entities under business rescue, did not affect the liabilities of sureties.
- The terms of the deed of suretyship itself provided for this eventuality, by entitling Nedbank to pursue action against the sureties irrespective of its dealings with the company.[112]

Any extension of time, compromise in relation to the extent of the amount owed made or granted to the company did not extend to the sureties. Even if the company was released completely from its obligations, this did not alter the right of the bank to pursue the sureties.[113] Notwithstanding the business rescue plan providing for the reduction of the amount of debts that the company was obliged to pay to the respondent, this benefit did not extend to the sureties. The respondent was entitled to pursue them in terms of the suretyship agreement.[114]

The representative of the appellant drew the court's attention, in support of their arguments, to the judgment by Rogers J in the *Turning Fork* case[115] where he commented *obiter dictum* that the common law principles of suretyship apply to business rescue because the Act itself is silent on this matter. This entails that a surety is released or discharge of his obligations toward a creditor to the extent of the compromise or discharge of the principal debt.[116] The court disagreed with this reasoning.

The court quoted section 154 of the Act which states in subsection 1, that in certain circumstances a creditor will not be able to enforce its debts against a company in business rescue and subsection 2 which states that a creditor may enforce its debt owed

[112] *New Port* at para 10.
[113] *New Port* at para 10.
[114] *New Port* at para 11.
[115] *Tuning Fork (Pty) Ltd t/a Balanced Audio v Greeff and Another* 2014 (4) SA 521.
[116] *New Port* para 13.

by the company under business rescue only to the extent provided for in the plan. If this is the case, then a surety does not benefit from a compromise or discharge accorded to the principal debtor under the business rescue plan. A surety's obligations toward the principal debtor's creditor remain unaffected by the business rescue, unless the plan itself provides otherwise.[117] The court concluded that section 154 deals only with the ability to sue the company or the principal debtor and not with the existence of the debt itself.[118]

In the case of *ABSA Bank Limited v TG du Toit*[119] defendants/respondents bound themselves as sureties and co-principal debtors for the indebtedness of the principal debtor (the company) for different loan amounts advanced by the applicant.[120] The principal debtor was placed under business rescue proceedings. Shortly thereafter, the Commissioner appointed a business rescue practitioner who prepared a business rescue plan for contemplation of creditors in terms of Section 50 of the Act.[121] ABSA Bank Limited was a principal and secured creditor of the company and after a meeting with all creditors an amended business rescue plan was adopted.[122] The plan provided that the amount paid to the applicant was agreed to be in full and final settlement of any claims that the applicant could have against the principal debtor.[123] The business rescue plan provided further that such settlement was not envisioned to affect any rights that applicant or any other creditors could have against any third party who had bound itself as surety.[124]

The applicant/plaintiff lodged an application for summary judgment against the sureties after they had filed a notice to defend the action and the defendants/respondents opposed the summary judgment on several grounds. The ones relevant to this discussion were as follows:[125]

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[117] *New Port* at para 14.
[118] *New port* at para 14.
[119] (7311/13) 2013 ZAWCHC 194. This is an application for summary judgment.
[120] *ABSA Bank Limited* at para 1.
[121] *ABSA Bank Limited* at para 2.
[122] *ABSA Bank Limited* at para 2.
[123] *ABSA Bank Limited* at para 10.
[124] *ABSA Bank Limited* at para 10.
[125] *ABSA Bank Limited* at paras 3 and 11.

- The amended business rescue plan would extinguish the applicant's claim against the principal debtor. Therefore, the sureties' liabilities being accessory in nature, would also be extinguished because of the extinction of the principal debt. Put differently, every suretyship agreement is conditional upon the existence of the principal obligation.
- Despite that fact that the business rescue plan expressly contained a clause retaining the rights of creditors to sue sureties, this clause in the plan was not enforceable against sureties because they were not part of the business rescue plan. Given that the surety could raise any defence that the principal debtor could raise, it followed that in the absence of a valid principal obligation the surety was not bound.

In response to the defendant's/respondent's arguments, the counsel for the applicant/plaintiff argued that if an estate of any principal debtor, to whom a bank had loaned money, is liquidated, surrendered or placed under administration or compromise either by way of statute or otherwise, a creditor that is not paid in full as result of the above mentioned situations, has always preserved the right to sue the sureties for the unpaid amounts.[126] Counsel for the applicant/plaintiff argued further that the deeds of suretyship provide that any arrangement, compromise or settlement or grant of extra time extended to the principal debtor, will not affect the creditor's right to sue the sureties.[127] Clause 6.5 of the business rescue plan provided expressly that the adoption and execution of the plan did not affect the claims of creditors against sureties.[128]

In support of these arguments, counsel for the applicant referred the court to the case of *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd*[129] in which the court states that there is no express provision in Chapter 6 of the Act which provides that the adoption of a business rescue plan will extinguish or deprive creditors of the principal debtor of their rights against sureties. The court went further to

[126] *ABSA Bank Limited* at para 14.
[127] *ABSA Bank Limited* at para 15.
[128] *ABSA Bank Limited* at para 16.
[129] 2013 (6) SA 471 (GNP).

state, *obiter dictum that* the consequences of such a provision, in its view, would be far-reaching as it would deprive a creditor of his rights to pursue sureties for a simple adoption of a plan, and if this was the intention of law makers, they ought to have expressly provided for such implication.[130]

The defendant's/respondent's representative argued in rebuttal that the *African Banking Corporation of Botswana Ltd* case did not deal with the provision of section 154 and did not therefore apply to the matter before court. The court concurred with the defendant's/respondent's argument that the business rescue plan had extinguished a portion of the applicant's/plaintiff's claim against the principal debtor and that the applicant/plaintiff could not sue the sureties for the extinguished amount. The court accordingly dismissed the application for summary judgment and granted the defendant leave to defend the matter.[131]

In the case of *Tuning Fork (Pty) Ltd t/a balanced Audio v Greeff*[132] the applicant/plaintiff (Tuning Fork) tendered goods on credit to the principal debtor (the company) with the defendants interposing themselves as sureties.[133] The company became financially distressed and was subsequently placed under business rescue. The business rescue practitioner prepared a business rescue plan and presented it at a meeting of all stakeholders where the plan was adopted.[134] The sureties had signed as surety and co-principal debtor with refutation of the common law benefits.

The suretyship agreement had a clause stating that any change in or temporary extinction of the principal debtor's obligations was not going to affect the deed of suretyship.[135]

The adopted business rescue plan provided that some creditors, including the plaintiff/applicant were to receive a dividend of 28.2% in full and final settlement of their claims.[136] The plaintiff/applicant then issued a summons suing the sureties for the balance

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[130] *ABSA Bank Limited* at para 17.
[131] *ABSA Bank Limited* at paras 18-21.
[132] 2014 (4) SA 521 (WCC). This is an application for summary judgment.
[133] *Tuning Fork* at para 3.
[134] *Tuning Fork* at para 5.
[135] *Tuning Fork* at para 4.
[136] *Tuning Fork* at para 6.

of the debt and then, subsequent to the sureties defending the matter, applied for summary judgment. In opposing the summary judgment application the defendant/respondents argued that the compromise with the company released the sureties from their liabilities.[137] The plaintiff/applicant argued that it could not have been the intention of the legislature, when drafting Chapter 6 of the Act, that a surety would be released from his obligations merely by virtue of the principal debtor being discharged from the claim by virtue of an adopted business rescue plan.[138]

The court concurred with the defendants'/respondents' arguments and refused the summary judgment application. The court held that because the law is silent on the impact of the adoption of a business plan on the liabilities of sureties, the common law applies. It is a well-established principle in our law that suretyship is an accessory contract, if the principal debtor is discharged of the debt though whatever means, the surety is discharged as well unless the suretyship agreement provides otherwise.[139] Stated differently, the extinction of the principal debt extinguishes the obligation of the sureties. Because the plaintiff's claim against the sureties was not preserved by the deeds of suretyship nor by the business rescue plan, it was fair and just to conclude that sureties have been released of their liabilities under the suretyship agreement.[140]

The court quoted several situations in which the legislature expressly provided for the discharge or extinction of the principal debt but preserved the claim of creditors against sureties.

The court analysed the comprise procedure in section 155 (9) of the Act which provides that "An arrangement or a compromise contemplated in this section does not affect the liability of any person who is a surety of the company".[141] The court stated further that the moratorium provided in section 133 is a defence *in personam*, available to the company only and not to sureties.[142] In terms sections 119 and 120 of the Insolvency Act 24 of

[137] *Tuning Fork* at para 12.
[138] *Tuning Fork* at para 34.
[139] *Tuning Fork* at para 42.
[140] *Tuning Fork* at para 72.
[141] *Tuning Fork* at para 21.
[142] *Tuning Fork* at para 26.

1936 an offer of compromise submitted by an insolvent to his trustee, if accepted by creditors, becomes binding on all creditors. However, section 120(3) of the same Act provides expressly that the compromise procedure does not affect the liabilities of sureties for the insolvent. However, when it comes to business rescue the law is silent and if it was the intention of the law makers that the liabilities of sureties should be preserved after the adoption of the business plan, they ought to have expressly stated so. As it stands the law is silent and the common law therefore applies.[143]

In the case of *DH Brothers Industries (Pty) Ltd v Gribnitz NO*[144] the applicant, who was one of the creditors, made an application to the court to set aside a board of directors' resolution to place their own company under business administration. The company had two directors and only one of them passed a resolution to place it under business administration.[145] A business rescue practitioner was appointed and his business rescue plan was not published within the time frame required by section 150(5) of the Act.[146] The plan had a provision stating that all creditors, including those who did vote against the plan, had to cede a portion of their claims to a third party. The applicant's motion intended not only to nullify the resolution placing the company under business rescue but also to declare unlawful the above-mentioned provision.

The court set aside the resolution commencing business rescue because it did not comply with the requirements of section 130(1)(a) read with section 130(5)(a) of the Act.

Turning to the question of a provision in the business rescue plan providing for compulsory session of all creditors rights to third party stated as follows:

> "it can be seen, therefore, that a plan may only provide that a creditor 'who has acceded to the discharge of the whole or part of the debt' may be deprived of the right to enforce its claims. Since section 152(4) makes an adopted plan binding on non-consenting creditors, and section 154(2) allows enforcement of pre-business rescue debts only to the extent allowed for in the plan, any provision in

[143] *Tuning Fork* at para 37.
[144] 2014(1) SA103 (KZP).
[145] Ibid at para 2.
[146] Ibid at para 3.

> a plan which goes beyond a voluntary discharge of a whole or part of a debt is not competent."[147]

So, a plan which deprives non-acceding creditors of the right to enforce a claim against a surety is unlawful, according to this judgment. Unfortunately, this point of law has not been taken on appeal. However, this interpretation can be problematic. It is the opinion of the author of this research that the amendment of section 154(1) is required to ensure that provisions of an approved plan are applicable to all creditors irrespective of the nature of their votes. This will eliminate objections from non-acceding creditors and ensure certainty in the implementation of an approved plan.

3.5 Summary

This chapter analysed the judicial approach to question of liability of sureties in business rescue proceedings, given that the legislature is silent on the matter. It has been found that there is no unanimity by the courts in dealing with this question as several conflicting judgments exist. The following chapter deals with the contract of suretyship.

It is unfortunate that there is no unanimity in our jurisprudence when dealing with the issue of the liability of sureties in business rescue proceedings. Given that the moratorium imposed on creditors of an entity in distress if of temporary nature and aimed at providing the financially distressed company with a breathing room to reorganise its operations and return to profitability, this can only happen if the moratorium is also extended to sureties. Sureties are for all intent and purpose directors of the company and primary source of the company's finance. It will be very difficult for a financial institution to extend fresh loans to a company under business rescue but directors can still be a reliable source of fresh capital needed to address the financial crunch at the entity. So allowing creditors to immediately recover their debts from sureties after the primary debtor is placed under business rescue can be self-defeating. The moratorium should be extended to sureties as well.

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[147] *DH Brothers Industries (Pty) Ltd* at para 67.

CHAPTER 4

SURETYSHIP

4.1 Introduction

This chapter deals with the concept of suretyship with special emphasis on the position of sureties during business rescue proceedings. Suretyship is said to be one form of intercession, which is a transaction in which a person undertakes liability for another's debt.[148] It is not always easy to determine whether a particular contract is a contract of suretyship or not, given the existence of many other similar agreements in which undertakings are made to indemnify another on the happening of a certain event.[149] To qualify as contract of suretyship, a particular contract must comply with requirements provided by the law, discussed later in this chapter.[150]

The law did not define the contract of suretyship but provided only requirements for its validity. Old authorities did not define the contract of suretyship either, however, they made it clear that suretyship is an accessory obligation that has no independent existence from a valid principal obligation.[151] The contract of suretyship is defined as

> "an accessory contract by which a person (the surety) undertakes to the creditor of another (the principal debtor), that the principal debtor, who remains bound, will perform his obligation to the creditor and that if and so far as the principal debtor fails to do so, the surety will perform it or, failing that indemnify the creditor."[152]

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[148] Forsyth CF and Pretorius JT; *Cany's the Law of Suretyship*. 6th ed. Juta 2010.

[149] Other contracts similar to suretyship are contracts of insurance and the contract of guarantee.

[150] Section 6 of the General Law Amendment Act 50 of 1956. This was confirmed by the court in *Fourlamel (Pty) Ltd v Maddison* 1977 (1) SA 333 (A) when it held that to be valid, a deed of suretyship must comply with requirement of section 6 of the Act 50 of 1956. See also *Nedbank Ltd v Wizard Holdings (Pty) Ltd* 2010 (5) SA 523 (GSJ) at 28-30 where the court held that only the non-compliance of an essential terms with Section 6 renders the deed of suretyship invalid, the non-compliance with non-essential terms does not affect the validity of the contract of suretyship.

[151] Forsyth CF and Pretorius JT.; *Cany's the Law of Suretyship*. 6th ed. Juta 2010.

[152] Ibid at 29.

This definition has been endorsed by Supreme Court of Appeal.[153]

4.2 The accessory nature of a contract of suretyship

The definition of the contract of suretyship clearly indicates that it is an accessory contract to a valid principal contract.[154] This means that for there to be a valid suretyship agreement there has to be a valid principal contract between a debtor and a creditor. Stated differently, every suretyship is dependent upon the existence of a principal or main obligation.[155] This position was confirmed by the court in *GA Odendal v Structured Mezzanine Investments* where it was held that the contract of suretyship is accessory in nature and that there must be valid contract principal contract between a creditor and a principal debtor for it to be valid.[156] The court stated that It follows that in the absence of a valid principal obligation the surety is not bound.[157] The surety is not bound to a person to whom the principal debtor is not liable, for there is no principal obligation between the principal debtor and the creditor to which the surety can accede.[158]

However, it was held in *Trust Bank of Africa Ltd v Frysch*[159] the contract of suretyship does not require the pre-existence of a principal obligation for it be valid, it can be entered into for a principal obligation that will come into existence in the future. However, should the principal obligation not come into existence in the future, for instance because of the illegality of the cause of action or any other reason, the surety will not be bound because of the absence of a valid principal obligation.[160]

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[153] *Trust Bank of Africa Ltd v Frysch* 1977 (3) SA 562 (A) 584F*; Sapirstein v Anglo African Shipping Co* (SA) Ltd 1978 4 SA 1 (A) 11H; *Nedbank Ltd v Van Zyl* 1990 (2) SA 469 (A) 473I.
[154] Ibid at 29. See also Du Bois et al *Wille's Principles of South African Law* 1018.
[155] Ibid at 30.
[156] (482/13) 2015 JOL 33675 (SCA) at para 9.
[157] *GA Odendal v Structured Mezzanine Investments* (482/13) [2014] ZASCA 89 (30 May 2014).
[158] Ibid at 30.
[159] 1977 (3) SA 562 (A) at 584G-H.
[160] Forsyth & Pretorius op cit note 134 above at 30 and 38-39. See also Sharrock *Business Transactions Law* 763; Du Bois et al *Wille's Principles of South African Law* 1018; Kopel *Business Law 253, 260;* Stoop & Kelly-Louw 2011 *PELJ* 73.

Nienaber JA in *African Life Property Holdings v Score Food Holdings*[161] confirmed this principal when the court compared guaranteeing a non-existent debt with the pointless act of multiplying any number by zero.

4.3 Accessory principle of suretyship and the business rescue proceedings

The application of the accessory principle to a relationship between a creditor and a surety is not automatic, parties to a contract must agree to its application. Should they refuse the application of the accessory principle to their contract, the assumption is that they intend their contract to be of guarantee rather than suretyship.[162] The application of this principle to business rescue proceedings has given rise to series of conflicting judgments.

The general rule is that the liability of surety is dependent upon the existence of a valid principal obligation and the extinction of the principal debt extinguishes also the obligation or liability of the surety.[163]

The first case contrasting the common law principle of suretyship with business rescue proceedings is the case of *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd*[164] in which the court decided that the institution of business rescue proceedings did not affect the liability of sureties towards the principal debtors' creditors, differently stated, sureties of a company remain liable to the creditors of the company even if the principal debt has been extinguished.[165] In the case of *Tuning Fork (Pty) Ltd T/A Balanced Audio v Greeff*[166] the court was called on to decide whether the accessory principle of suretyship applies to business rescue proceedings. The court made a distinction between the legal consequences dictated by statute, and those of the common law in response to a 'statutory event'.[167] The court stated that a statutory provisions supersede the common law principles and if a statute governs a position, it

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[161] 1995 (2) SA 230 (A) at 238F.
[162] WJC Swart & M Lombard *"Business Rescue: the Uncertainty about Sureties. Tuning Fork (Pty) Ltd t/a Balanced Audio v Jonker* 2014 4 SA 521 (2015) 78 *THRHR* at 530.
[163] *Tuning Fork* at para 53.
[164] 2013 (6) SA 471 (GNP).
[165] *African Banking Corporation of Botswana Ltd* at para 71.
[166] 2014 4 SA 521 (WCC).
[167] *Tuning Fork* at para 37.

must be applied irrespective of what the common-law provides.[168] However, if a situation is not governed by a statute then the answer must be found in the principles of the common law.

The court stated further that the liability of sureties in business rescue proceedings is not addressed in Chapter 6 of the Act, therefore the common law principles of suretyship apply unless the business rescue plan or the deed of suretyship provides otherwise.[169]

4.4 Obligations of the surety

The duty to make good the principle debt lies with the principal debtor. Should the principal debtor fail to honour his obligation then the creditor can pursue the surety for payment. Thereafter, the surety has the right of recourse against the principal debtor.

The surety's obligation is limited to the amount of his undertaking and becomes due and payable from the time the principal debtor defaults on his obligation.[170] In the *Trans-Drakensberg Bank Ltd v Guy*[171] case the court held that the liability of a surety is limited to an amount or cause as agreed to in the deed of suretyship. The surety's liability can only be equal to or less than the obligation of the principal debtor and never more than the latter's liability.[172] This common law principle was confirmed by the court *in Wessels v the Master of the High Court*[173] where it was held that a surety who purports to bind himself for more than the debtor's obligation is liable to the extent of the latter, no more and no less. To determine the amount of indebtedness, the surety may require that a certificate of indebtedness be produced and if the amount of the principal debt is undetermined, the surety's liability to pay will be established only once the principal debt amount has been determined through an order of court or has provided in the deed of suretyship.[174]

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[168] *Tuning Fork* at para 37.
[169] *Tuning Fork* at para 14 read with 37.
[170] Sharrock *Business Transactions Law* 766. See also Nagel et al *Commercial Law* 331.
[171] 1964 (1) SA 790 (D) at 795-796.
[172] Forsyth and Pretorius op cit note 134 at 64.
[173] (1891) 9 SC 18.
[174] Sharrock *Business Transactions Law* 766.

4.5 Defences available to a surety

This section examines circumstances under which a surety can be discharged from his obligations as surety or defences that he/she can raise in objection to creditors' actions. Since the surety's obligation is accessory to the principal debtor's, any defences available to the principal debtor can also be raised by the surety.

These defences are subdivided into two main categories depending on whether these defences relate to the principal obligation or whether they relate to the surety's own obligation under the deed of suretyship. The surety is discharged where the principal debtor is entitled to *restitutio in integrum* on any of the grounds on which a party to a contract is entitled to resile from it as being void or voidable.[175] When it comes to defences relating to the contract of suretyship, the surety will have the defences available to any contracting party under the general principles of the law of contract.[176]

4.5.1 Defences relating to the main obligation

The surety's obligation is extinguished when the principal debtor's is extinguished, and the surety can't be bound where the principal debtor is no longer obligated. This principle can be expended further.

4.5.1.1 Defences *in personam*

Not all defences available to the principal debtor are available to the surety. The only defences that the surety can raise are those that go to the root of the debt and not those that are personal to the debtor.[177] A typical example is a personal privilege granted to the principal debtor which is not available to the surety.[178] Courts have made a distinction between defences *in rem* and defences *in personam*. In the case of *Standard Bank of SA Ltd v SA Fire Equipment (Pty) Ltd*[179] the court explained the differences between the two

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[175] CF Forsyth and JT Pretorius "*Caney's the Law of Suretyship*" 6th ed. (2010) at 188. These grounds could be lack of consent, mistake, illegality, fraud, misrepresentation, intimidation, undue influence or forgery and they are related.
[176] Forsyth and Pretorius op cit note 161 at 188.
[177] Ibid.
[178] *Linden Duplex (Pty) Ltd v Harrowsmith* 1978(1) SA371 (W) at 373C.
[179] 1984 (2) SA 693 (C) at 696C.

defences. Defences *in rem* attach to the claim or cause of action or the obligation itself irrespective of who the debtor is and arise from the invalidity, extinction or discharge of the obligation itself. Defences *in personam* arise from a personal immunity of the debtor from liability for an otherwise valid and existing civil obligation.

The obligation and the debt remain in existence in the defences *in personam* but the debtor is personally immune from a claim. The following are examples of defences *in personam*: insolvency or liquidation of the principal debtor, statutory composition with creditors, exemption from execution, or legal moratorium.[180]

The general moratorium provided by section 133 of the Act in favour of a company under business rescue was classified as a defence *in personam* by the court in *Investec v Bruyns*.[181] It means a moratorium as a defence can only be raised by the company under business rescue proceedings and not by its sureties.

4.5.1.2 Defences *in rem*

Defences *in rem* are those that are available to the principal debtor and also to the surety. These defences include, but are not limited to misrepresentation, mistake, duress, payment, compromise, novation, judgment or set-off, non- performance by the creditor of his part of contract where that releases the principal debtor and, supervening impossibility of performance releasing the principal debtor.[182]

4.6 Surety's right of recourse

A surety has a right to reimbursement from the principal debtor once he/she has paid the debt. The surety's right of recourse may be enforced by *actio mandati* if the principal debtor has knowledge of the existence of the surety's obligation or by *actio negotiorum gestorum* if the suretyship agreement was entered into without the knowledge of the

[180] Forsyth and Pretorius op cit note 134 at 189.
[181] 2012(5) SA430 (WCC*).*
[182] Forsyth and Pretorius op cit note 134 at 189.

principal debtor.[183] A surety who is exercising his right of recourse is not subrogated to the rights of the creditor but he/he sues in his/her own right.[184]

Three conditions must be fulfilled before the surety can exercises his right to indemnification by the debtor.[185] First the surety must have made a valid payment and the debtor must have been discharged from his obligation towards the creditor. Secondly, the surety must not have failed to raise any defence of which he was aware, and which would have been available to the debtor had the creditor sued him/her. Lastly, the debtor must not have paid the creditor in ignorance of the fact that the surety had already done so. In other words, the surety must take care of informing the debtor of his/her payment to the creditor to avoid double payment. However, should the creditor receive double payment for one debt then the principal debtor must cede to the surety the right to recover one of the payments from the creditor.[186]

4.7 Summary

This chapter dealt with the suretyship agreement. It has been said that the purpose of the suretyship agreement is to protect a creditor against any loss caused by the failure of the principal debtor to fulfil his obligations under the principal contract. The accessory nature of the suretyship agreement was also discussed in light of business rescue proceedings. The failure of the legislature to regulate the liability of sureties towards creditors during business rescue proceedings has given rise to much speculations. It is now left to the business rescue plan or the deed of suretyship to provide for this situation failing which the common law applies.

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[183] Ibid at 159.
[184] *Turkstra v Massyn* 1959 (1) SA 40 (T) at 45, 47.
[185] Ibid at 164.
[186] Forsyth and Pretorius op cit note 134 at 165.

CHAPTER 5

REORGANISATION PROCEEDINGS UNDER THE UNITED STATES OF AMERICA (USA) LAW

5.1 Introduction

This chapter analyses the USA bankruptcy code[187]. While our own legislature was in the process of drafting provisions on the business rescue in the companies act, it analysed extensively and relied heavily on the provisions of Chapter 11 of the bankruptcy code.[188] It is against this back ground that a review of the American law and jurisprudence is undertaken to ascertain how the dilemma of creditors' rights against sureties is dealt with.

The Companies Act makes provision for our courts to consider foreign legislation when interpreting the law to take informed decisions.[189] However, caution should always be exercised given the differences of circumstances, business environment and local realities.

The bankruptcy statutory framework, the principles underlying reorganization process, the starting and termination of the bankruptcy proceedings are discussed below.

Bankruptcy codes are not reserved to reorganization proceedings alone, but they apply to all types of bankruptcy proceedings, such as liquidation. The codes comprise many chapters of which some are of general application and others specific to each bankruptcy procedure. Of importance to this study is chapter 11 of the codes which make provision for rules and principles applicable to reorganization proceedings of companies in financial distress.

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[187] In the United States, bankruptcy is governed by deferral law called "Bankruptcy Code". Reorganisation proceedings are for all intent and purpose business rescue proceedings in South African law.
[188] FHI Cassim *et al* op cit note 4 above at 861.
[189] Section 5(2) of the Companies Act.

It is worth mentioning that bankruptcy court are federal courts or every federal court has a bankruptcy jurisdiction, federal rules of bankruptcy procedure and the codes apply in these courts.[190]

5.2 The reorganisation process

As already stated, the reorganization process is regulated by chapter 11of the codes. The commencement of reorganization proceedings triggers an 'automatic stay'[191] which preclude all creditors from enforcing their rights while creating a breathing space for the debtor entity allowing it to reorganise itself financially. The automatic stay is discussed in detail below.

The reorganisation process aims further at achieving a rateable sharing of assets among creditors of a similar class. Differently stated, reorganisation seeks to achieve a methodical and just sharing of debtor's assets among creditors should the reorganization process fail to achieve its primary objective.[192] Should the reorganisation process result into liquidation, creditors should find themselves in the better position or receive a better return than in situation where no reorganisation is started.

The reorganisation provides the debtor an opportunity of a fresh start.[193] All debts contracted before the filing of reorganisation petition are frozen and the debtor is afforded an opportunity to focus on turning the business fortune around without worrying about creditors debts becoming due and payable. The discharge accorded to the debtor by this process is absolute unless the debtor has misrepresented creditors or concealed relevant information before the reorganization plan is confirmed by the court. In the later scenario, a creditor may apply to court declare the reorganization plan non-dischargeable.[194]

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[190] Steven H Rittmaster 'Bankruptcy 101' available at http://apps.americanbar.org/abastore/products/books/abstracts/5190454_chap1_abs.pdf, accessed on 27 December 2017 at 2.
[191] Automatic stay is equivalent to the moratorium in South African law.
[192] According to the Court in *Marrama v Citizens bank of Massachusetts*, 549 U.S. 365 (2007) at 367, the principal purpose of the bankruptcy code is to grant a fresh start to the honest but unfortunate debtor.
[193] Rittmaster op cit note 272 at 5.
[194] Ibid.

Further taxes and customs are non- dischargeable debts, they must be paid even if the debtor has filed a reorganization petition. [195]

5.3 Commencement and termination of reorganisation process

There are two forms of reorganisation, namely voluntary (initiated by the debtor) and involuntary reorganization (initiated by creditors). A debtor that is in financial distress, may file a reorganization petition with the bankruptcy court on a standard form.[196]

The filing of the reorganization petition is done together with a filing of a schedule of assets and liabilities, detailed statement of financial affairs and a current schedule of income and expenditure.[197] The initiation of the involuntary reorganisation follow exact the same process as the voluntary one, save to say that the accompanying documents are completed creditors initiating the process.[198] Where a debtor has less than twelve creditors, excluding any employee or an insider of such a debtor, by one or more of such holders that hold in the aggregate at least $ 10 000,00 of such claims.[199]

Upon filing of a petition, a bankruptcy estate is formed and it comprises of all the debtor's interests in property, or proceeds, products, rents of such property, irrespective of their location and of the person in charge.[200] As long as they belong to the debtor they form part of the bankruptcy estate.[201]

5.3.1 Management of the distressed entity (debtor)

Unlike under the business rescue regime, where the management and control of the entity under business rescue pass to the business rescue practitioner, under the bankruptcy code debtor remains in charge of its business even after the filing of the reorganization petition.[202] It exercises control and oversees day to day operations and financial

[195] Section 532(a)(1) of the code.
[196] Section 301 of the code.
[197] Section. 301 of the code
[198] Section 301.
[199] Section 303(b)(2).
[200] Section
[201] Section 541(a).
[202] Section 1107.

decisions.[203] In terms of section 1107 of the codes the debtor in possession is entrusted with the powers and rights of a chapter 11 trustee.

It is required to perform all investigative functions and duties of a trustee, which include but are not limited to accounting for property, examining and objecting to claims, filing reports required by the court, enlisting services of specialists such attorneys, accountants, appraisers and other professionals to assist during the bankruptcy process.[204] However, the debtor compliance with its responsibilities is monitored and supervised by the US trustee or bankruptcy administrator.[205] Further, the US trustee monitors payments made to professionals for their services to the debtor and conducts a meeting with creditors during which the debtor may be questioned under oath concerning its acts, conduct and the administration of the case in general.[206]

In terms of section 1102 of the codes, the US trustee can appoint 'creditors' committees' which generally consists of unsecured creditors who hold seven biggest unsecured claims against the entity under distress. The duties of the creditors' committees consist of consulting with the debtor on the administration of the bankruptcy case, participating in the formulation of the plan and investigating the operation of the business and the conduct of the debtor in possession.[207]

The termination of the reorganisation process can be initiated by the debtor or creditors depending on the party that filed the bankruptcy petition. In the case where is was started by the debtor, then it has a one-time absolute right to convert bankruptcy case into liquidation proceedings.[208] If the reorganisation started as an involuntary case under chapter 11, then a party in interest can file with the bankruptcy court a motion to convert chapter 11 proceedings to chapter 7 case (liquidation proceedings) or to dismiss the

[203] It is common knowledge that a company or juristic person exists separate and apart from its individual owners and shareholders. By 'debtor' reference is made to juristic person or corporation, whose management even after the filing of reorganisation petition, is allowed to remain in charge of the business and manage the all process of reorganisation.
[204] Section 1107.
[205] Section 1106.
[206] Ibid.
[207] Section 1103(c).
[208] Section 1112(a).

case.[209] The court decision on such a motion is guided by what is in the best interest of creditors and the estate.[210]

5.4 Automatic stay

In terms section 362(a) of the codes an 'automatic stay' of creditors' actions against debtor and the debtor's estate comes into effect upon filing of the bankruptcy petition.[211] During this period all judgments, foreclosures, collections, repossession of properties are suspended and may not be pursued. The automatic stay applies irrespective of the party that filed the bankruptcy petition.

5.5 The reorganisation plan

The law provides that the debtor as exclusive right to file a plan within 120 days from the date of the filing of the bankruptcy petition.[212] However, upon application to court and upon good cause shown, a court can extend this period but the extension may not exceed 18 months.[213] At the expiration of the exclusive period, a creditor may file a competing plan, the idea is to motivate the debtor to avoid delays and file a plan within the exclusive period.[214]

The reorganisation plan outlines how the debtor is going to repay creditors overtime. The plan must be not only accepted by creditors through ballots casting but also confirmed by the court. After confirmation, the debtor's dischargeable debts will be erased.[215] The plan must explain how the claim of each class of creditors will be handled. Different classes of creditors can be found, such as equity security holders or shareholders, general unsecured creditors, priority unsecured creditors and secured creditors.

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[209] Section 1112(b).
[210] Section 1112(b)(4) of the codes provides examples of factors that could be used in support of a dismissal or conversion, among others, establishing that there is a continuous loss to the estate and absence of rehabilitation possibility, massive mismanagement of the estate, failure to keep up with the payment of premiums of an insurance that protect creditors and financial misconduct.
[211] Automatic stay is the equivalent of the legal moratorium embedded in section 133(1) of the companies act in South Africa.
[212] Section 1121(b).
[213] Section 1121(d).
[214] Section 307. However, the US trustee is not allowed by law to file a plan.
[215] Section 1123(a).

Once a debtor has submitted a plan of reorganization, impaired creditors (those that won't be receiving the full value of their claims) will be allowed to vote on the plan by ballot. The court will confirm a plan if at least one class of impaired creditors has voted in favour of it. A 'yes' vote presumed for the class of creditors whose claims will be satisfied in full.[216]

In certain circumstances, the court will confirm the plan even though impaired class of creditors has voted against it as long as the plan is fair and equitable to each class of impaired creditors. This process is called 'cramdown'.

The debtor can make changes to the plan at any time before confirmation by the court. However, if changes are introduced after the ballot have been conducted, a hearing will be needed to ascertain whether any class of creditors is negatively affected by the proposed modifications. If the court finds that the proposed changes will have a negative effect on a class of creditors, then another round of vote by ballots is required to introduce the proposed changes.[217]

5.6 Summary

Chapter 11 of the codes regulates the reorganisation process which starts with a voluntary or involuntary filing of a petition in a bankruptcy court. Once the process has been started an automatic stay protects the debtor against all creditors' actions. The reorganisation plan is prepared by the debtor and confirm by the court. Once confirmed it has to be implemented by the debtor itself subject to supervision by State trustee and creditors.

[216] Section 1126.
[217] Section 1127.

CHAPTER 6

CREDITORS' RIGHTS AGAINST SURETIES AFTER FILING OF BANKRUPTCY PETITION

6.1 Introduction

Unlike the Companies Act that is silent the common law regulates the subject of rights of creditors against third parties in a situation where the principal debtor is placed under business administration. The subject matter is regulated by the bankruptcy codes in the United States. Of great interest in this is chapter are sections 524(e) and section 105(a) of the codes. The former provides as follows:

> "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." And the letter states that "The court may issue any order, process, or judgment that is necessary or appropriate tocarry out the provisions of this title. No provision of this title providing for the raising of anissue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process."

The application and interpretation of these two sections by courts will be examined below. This chapter starts by analysing whether the automatic stay enjoyed by the debtor extends to non-debtors[218] as well. This is followed by the examination of the implication of a court confirming a non-consensual reorganisation plan containing a release clause. As already stated above, under American law, a reorganisation plan can be confirmed by the court even if creditors have voted against it as long as the court is of the view that it is fair and equitable and comply with other requirements discused above as well. As it will be seen from the cases discussed below, courts opinion is divded on this matter, with come courts deciding that the confirmation of non-consensual plan releases non-debtors and others deciding otherwise.

[218] The term non-debtors refers to co-debtors or class of people who are liable together with the debtor or principle debtor for the benefit of a creditor such as sureties and guarantors.

6.2 Section 362(a) automatic stay and non-debtors

Unlike chapters 12 and 13 of the bankruptcy codes which extend the automatic stay to non-debtors, chapter 11 does not extend the same benefit to co-debtors in bankruptcy proceedings.[219] Let us analyse how courts have dealt with this issue.

In *In re: Gatehouse Commercial, LLC v Abeinsa Holding Inc., et al*.,[220] the issue before court for determination was whether the section 362(a) automatic stay could be extended to a surety. The facts of the case were briefly as follows. the creditors won a contract to construct a solar eletric generatiion facility and they subcontracted some of the work to the debtors and the creditors were protected a deed of suretyship signed in their favor.

A dispute arose among them as a result of which the debtors entered into a settlement agreement with the creditors (Gatehouse Commercial, LLC) for the payment of a specific some of money and on a specific date. The debtors defaulted on the agreement and the creditors approached the court to enforce the settlement agreement in the State Court action. Soon thereafter, the debtors filed a voluntary petition in the bankruptcy court and in the process requested the State Civil Court to stay the application pending the finalisation of the bankruptcy case. The filing of the bankruptcy case triggered the automatic stay under section 362(a) of the codes.[221]

The creditors then sought to proceed against sureties only, arguing that the automatic stay did not extend to them. The debtors did not fully develop their response, but they did list the surety bond among their assets. Issues before the court were whether a surety bond is an asset on the debtor's estate and whether the automatic stay extends to the surety bond.[222]

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[219] Chapter 12 deals with "adjustment of debts of a family farmer or fisherman with regular income" and its section 1201 extends the automatic stay to non-debtors. Chapter 13 provides for the "adjustment of debts of an individual with regular income" and section 1301 extends automatic stay to co-debtors.
[220] In the *United States bankruptcy Court for the District of Delaware*, case number 16-10790 (KJC).
[221] Section 362(a).
[222] Section 362.

After reviewing previous court decisions[223] on the subject matter, the court concluded that surety bond is not property of the bankruptcy estate. The court then turned its attention to analyse whether automatic stay extends to sureties.[224]

The court examined section 362(a) which states that the automatic stay prevents actions against the debtor, its property and the property of the bankruptcy estate. The court went on to say that although the non-debtor was going to step in to the shoes of the creditor after payment under the suretyship agreement because of the doctrine of equitable subordination,[225] this did not mean that the surety is protected by the automatic stay. Nor does it entitle the debtor to oppose the action against the surety unless exceptional circumstances exist that justify such a drastic decision. The cout went on to state that should it have been the intention of the legilsature to extend the automatic stay to sureties, it would have made it an exception to the co-debtors stay in section 1201(a) and section 1301(a) of chapters 12 and 13 of the codes respectively.[226]

The court further stated that where unusual circumstances exist and it is proved that the continuation of the action against the surety would adversaly affect the debtor, a request for a stay would have been made by the debtor under section 105 which allows the court to issue any order necessary to carry out tthe provisions of the bankruptcy codes. For the abovementioned reasons, the court concluded that the automatic stay does not appy to non-debtors and granted an order allowing the creditors to pursue sureties.[227]

6.3 Rights of creditors against sureties post reorganization plan

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[223] *In re Mansfield Tire & Rubber Co*., 660 F2d 1108 (6th Cir.1981); *In re Buna Painting & Drywall Co*., 503 F.2d 618 (9th Cir.1974); *In re Mclean Trucking Co*., 74 B.R.820,827 (Bankr.W.D.N.C.1987); *In re Apache Constr., Inc*., 34B.R.415 (bankr. D. Ore. 1983); *In re Jay Forni, Inc*., 33 B.R.538 (Bankr.N.D.Cal.1983).

[224] *In re Mansfield Tire & Rubber Co*., 660 F2d 1108 (6th Cir.1981).

[225] In *Acuity v Mckee Eng'g, Inc*., Slip op. at 3, 2008 WL5234743 (Tenn.Ct.App. 2008), the court summarised the principle of equitable subordination as follows: "A surety or guarantor, by payment of the debt of his principal when he is obliged to make that payment, acquires an immediate right to be subrogated to the extent necessary to obtain reimbursement or contribution to all remedies and securities which were available to the creditor to obtain payment from the person or property of any person who, as to the surety, is primarily liable for the debt.".

[226] As already stated, chapters 12 and 13 expressly state that the automatic stay does not extend to non-debtors and co-debtors such as sureties.

[227] In *Acuity v Mckee Eng'g, Inc*., Slip op. at 3, 2008 WL5234743 (Tenn.Ct.App. 2008).

The reorganisation plan after confirmation by the court amounts to a contract between debtor and its creditors.[228] The plan aims at resolving all the claims and issues affecting the debtor including claims from sureties or non-debtors who had settled claims brought against them by creditors for the benefit of the debtor.[229]

The purpose of including non-creditors claims in the plan is to provide the debtor with fresh-start and a real chance of turning around a bankrupt business. The implication of reorganisation plan is the discharge of the debtor, however, in terms of section 524(e) the discharge of the debor does not affects claims of creditors aganst non-debtors. Bankruptcy courts have broad and extensive powers to give effect to the provisions of the codes under of section 105(a). When creditors have voted and consented to the reorganisation plan, there is no problem. The challenge arose when a class or classes of creditors do vote against the reorganisation plan but despite their negative vote, the bankruptcy court confirms the non-consensual plan which contains a discharge clause of both the principal debtor and non-debtors (sureties). There are conflicting courts decisions in this regards, with some courts holding that non-debtors can not be discharged under a non-consentual plan because of the restrictive nature of the provisions of section 524(e), and others holding that courts have powers to discharge non-debtors in a non-consentual plan under section 105(a). Let us analyse some of the cases in detail below.

6.3.1 Decisions discharging non-debtors in a non-consensual reorganization plan

In the case of *Drexel Burnham Lambert Group*[230] the debtors' reorganisation plan was not approved by all classes of creditors but it included a non-debtors release clause. It was then presented to court as a non-consensual plan for confirmation.

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[228] Michael S Etkin and Nicole M Brown, 'Third-Party Releases?-Not So Fast! Changing Trends and Heightened Scrutiny' (2015) 29 *AIRA Journal* available at https://www.lowenstein.com/media/3182/third-partyreleases- not-so-fast.pdf, accessed on 27 December 207 at 22.

[229] Ibid.

[230] *Securities and exchange Commission v Drexel Burnham Lambert Group Inc (in re Drexel Burnham Lambert Group Inc* 960 F.2D285 (2dCir 1992).

The court was satisfied with the compensations to be paid to creditors and stated that taking an injuction prohibiting creditors from suing a third party in a reorganization plan should be allowed only where such injuction plays an crucial role in the debtor's reorganisation plan.[231] The court in *Monarch Life Ins. Co v Ropes & Gray*[232] took it further and stated

> " ...in extraordinary circumstances it has been held that a bankruptcy court can grant permanent injuctive relief essentional to enable the formulation and confirmation of a plan of reorganization if, for example non-debtors who would otherwise contribute to funding the plan will not settle their mutual claims adsent protection from potential post-confirmation lawsuits arising from their pre-petition relattionship with the chapter 11 debtor."[233]

In the case of *Munford Inc*.[234] the court provided circumstances under which non-debtors could be released from their obligations: when it is fair and equitable to do so and where non-debtors are an integral part to the success of the reorganisation plan. Therefore, the role played by non-debtors in the reorganisation plan such as monetary or/ material contributions, is taken into account into the court decision of whether to allow the release or not of non-debtors. *In re Transit Group Inc.*[235] the court aligned itself with previous decision recognizing the notion of substantial contribution by non-debtors when it held that "section 524(e) does not restrict the release of non-debtors where such debtors have made significiant contributions to the principal debtor's reorganization."

Despite refusing to grant the release of non-debtors in a non-consensual reorganisation plan in the matter of *In re Dow Corning Corp,*[236] the court, however, stated that an open mind needed to be kept in unusual circumstances which would justify such a release. The court went on to provide a list of elements that should be taken into account when exercising powers under section 105(a) with regard to the release of non-debtors:

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[231] *Drexel Burnham Lambert Group*.
[232] 65 F.3d 973 (1st Cir.1995).
[233] 65 F.3d 973 (1st Cir.1995) at 980-81.
[234] 97F .3d449 (11th Cir.1996).
[235] 286 BR 811(Bankr. M.D.Fla.2002).
[236] 287 B.R. 396 (E.D. Mich 2002).

- "the identity of interests between debtor and third party, such as an indemnity relationship, are such that a suit against the third party is in essence a suit against the debtor or will deplete the assets of the estate;
- the non-debtor has contributed substantial assets to the reorganization;
- the injunction is essential to reorganization to permit the debtor to be free from indirect suits that would cause indemnitor contribution claims against the debtor;
- the impacted creditors overwhelmingly voted to accept the plan;
- the plan provides a method to pay creditors affected by the injunction;
- the plan provides payment in full to those creditors who choose not to settle; and
- the bankruptcy court's records support the injunction or release."[237]

6.3.2 Restrictive approach to the discharge of non-debtors under a non-consensual plan

Some courts have adopted a restrictive interpretation of the codes with regards to the release of non-debtors when asked to confirm a non-consensual plan. These courts have relied on the provisions of section 524(e) to refuse the discharge. This is in opposition to the other view where courts relied on section 105(a) to confirm the discharge of non-debtors in a non-consensual plan. In the case of *Union Carbide Corp v Newboles*[238] a creditor extended a loan to the principal debtor or the debtor (company) and the owner of the company and his wife personally guaranteed the company's repayment of the loan. When the debtor defaulted on the payments, the creditor brought an action against both the debtor and guarantors. While this action was pending, the debtor petitioned for relief under the old Bankruptcy Act of 1898. Section 16 of chapter 9 of that Act had a clause similar to section 524(e) of the bankruptcy codes. It provided that the release of a debtor did not affect the liability of non-debtors toward creditors. Subsequent to the bankruptcy petition, the debtor prepared a reorganization plan which contained a clause providing for the release of non-debtors after its adoption by creditors and confirmation by the court.

[237] *In re Dow Corning Corp* at para 656-58.
[238] 686 F.2d 593 (7th Cir.1982).

All creditors including the respondent voted in favour of the plan which was then confirmed by the bankruptcy court.

After being paid under the plan, the creditor then sought to recover the balance of the unpaid loan amount from the non-debtors or guarantors.

The creditor obtained a summary judgment in its favour from the district court and the guarantors (appellants) then appealed the district court judgment. They argued on appeal that the reorganisation plan which was voted on by the creditor as well precluded the creditor from coming after them for unpaid loan amount owed by the debtor. In dismissing their case the court stated that the provisions of reorganisation plan were in violation of section 16 of the Act, and therefore unlawful. Private agreements cannot be used to circumvent legislative provisions, the law in this regard was clear, the release of a debtor in a bankruptcy court did not affect the liability of non-debtors toward creditors.[239]

In the *In re Lowenschuss*[240] case, the facts were briefly as follows; Lowenschuss (debtor company) file for a voluntary chapter 11 reorganisation in a bankruptcy court. All creditors' claims were put on hold pending the finalization of bankruptcy proceedings. The debtor prepared a reorganisation plan which included a global release clause from all claims including claims against non-debtors upon confirmation by the court. The plan was ultimately confirmed. The matter was then taken to the appeal court for determination. The one the issues before court for determination was whether a bankruptcy court can confirm a plan containing a global release clause. On this issue the court of appeal ruled that a bankruptcy court lacks the power to confirm a plan with a clause that releases non-debtors. As this did not comply with the provisions of chapter 11 of the codes in particular section 1129(a)(1) and section 524(a). The appeal court stated that section 524(a) provides for the release of the debtor from personal liability and does not provide for the release of third-parties or non-debtors. The appeal court stated further that section 524 (e) specifically stated the discharge of the debtor does not affect the liability of non-debtors. The court of appeal held further that section 524(e) precluded bankruptcy courts

[239] *Union Carbide Corp v Newboles.*
[240] 67 F. 3d 1394 (9th Cir. 1995).

from discharging the liabilities of non-debtors and a provision in the plan that enjoined creditors from proceeding against non-debtors or co-debtors violates the provisions of section 524(e).[241]

6.4 Summary

The analysis above indicates that courts decisions are divided when it comes to the release of non-debtors in a non-consensual reorganisation plan. Unlike under South African law where creditors' rights against non-debtors can be preserved either in the deed of suretyship or business rescue plan, in the American law these rights can't be preserved in the deed of suretyship but only in the business plan. Further, section 524(e) clearly states that the discharge of the debtor does not affect the liability of non-debtors. This create certainty for the business world and for creditors who know that their claims against non-debtors will not be extinguished by the discharge extended to the debtor. However, section 105(a) changes the completion of the rights of creditors against non-debtors in a non-consensual reorganization plan. Most courts are prepared to confirm non-consensual plan with a discharge of non-debtors clause as long as some requirements are met. In some cases, claim against non-debtors are tantamount to a claim against the debtor and allowing creditors to go after them might be self-defeating and implying undermining the reorganisation process.

[241] The court of appeal quoted a number of decisions in support of its decision, just to name a few, *American Hardwoods, Inc. v Deutshe Credit Corp. (in re American Hardwoods, Inc.)*, 885 F .2d 621, 626 (9th Cir.1989); *Underhill v Royal*, 769 F 2d 1426, 1432 (9th Cir.1985); *Commercial Wholesalers, Inc. v Investors Commercial Corp.*, 172 F 2d 800, 801 (9th Cir.1949); *Sun Valley Newspapers, Inc. v Sun World Corp. (In re Sun Valley Newspapers, Inc.)*, 171 B.R.71, 77(9th Cir. BAP 1994); *Seaport Automotive Warehouse, Inc. v Rohnert park Auto Parts, Inc. (In re Rohnert park Auto Parts, Inc.)* 113 B.R. 610, 614-17 (9th Cir. BAP 1990). These courts have found that reorganization plans which propose to release non-debtors violate section 524(e) and are unconfirmable.

CHAPTER 7

CONCLUDING REMARKS AND RECOMMENDATIONS

7.1 Comparative analysis and recommendations

From the analysis above, it is clear that the legislature sought to reproduce chapter 11 of the Bankruptcy Codes by drafting chapter 6 of the Companies' Act. Both the business rescue and reorganisation proceedings aim at avoiding liquidation where possible and provide a fresh-start to a business in financial distress. Or, should the rescue or reorganisation fail, creditors should find themselves in a better position than before. The creditors' role in the business world cannot be overemphasised. They provide the necessary funding to meet the operational requirements of entrepreneurs. To guaranty the repayment, creditors usually make recourse to suretyship agreement. The effectiveness of suretyship as security mechanism is called into question when entities are placed under business rescue. This problem is not unique to creditors with suretyship agreements, in fact it affects all creditors, secured and unsecured. Once a business plan is approved they can no longer enforce their rights against the bankrupt debtor.

In South Africa, courts are urged in terms of section 5(1) to interpret the Companies Act in a way that gives effect to its objectives. To achieve this, courts are encouraged to refer to foreign law where appropriate. The Act, under the influence of the Chapter 11 of Bankruptcy Code introduces a debtor-friendly business rescue process even though our insolvency law system is largely creditor friendly.[242] It is against this background that the analysis of the American law has been undertaken in order to determine how the issue of the rights of creditors against sureties is deal with and whether anything can be learned from them.

Under South African law, a business rescue practitioner is appointed and tasked with preparing the business rescue plan and present it at a meeting of creditors for them to vote on the plan. Once approved, the practitioner is tasked with implementing the approved plan. The business rescue practitioner literally substitutes the current board of

[242] FHI Cassim *et al* note 4 above at 866.

directors and the entire management of the distressed company and takes control of the business and its operations. In America, the debtor itself is tasked with the preparation of the reorganisation plan to be voted on by creditors.

The board and the management of the bankrupt company remain in control of the business and of its day to day operations.

The debtor is tasked as well with the implementation of a reorganisation plan that has been confirmed by a court. However, in the United States a state trustee and all creditors play a supervisory role in making sure the debtor implements the plan to its letter and steers the company out of bankruptcy.

The advantage of the South African position is that the management of the company is given to new person who might bring new perspectives and new ideas in the way the company is managed and who was not part of the managers who, because of their poor management caused the company to finds itself in a bankrupt situation. The disadvantage is that the business rescue practitioner might not be familiar with the company's operations and might not be able to familiarise him/herself with the company's way of operating and turn its financial affairs around in the three months allocated by the legislature. Most of those three months is spent trying to understand the company business and less time is allocated to the real work of rescuing the company. Even if the business practitioner manages to return the company to profitability, he/she has to handover the management to the old managers who were not active decision makers during the turnaround stage. The risk is that when the business practitioner leaves, the business might relapse into bankruptcy again.

The advantage of the American position is that the debtor itself is given the opportunity to prepare the plan with the assistance of experts such as accountants, lawyers, business consultants where necessary and it is given the opportunity to implement it. The debtor is still allowed to engage experts in the course of the reorganisation. It is therefore, recommended that, the legislature in South Africa should follow the American example by leaving the preparation and implementation of the plan to the hands of pre-existing management of the distressed company; subject to supervisory function exercised by a

designated person and creditors. The management and board of directors are familiar with the business of the financially distressed entity and should be in a better position to facilitate its rehabilitation.

7.2 Creditors' rights against sureties

The Companies Act does not regulate the situation of creditors' rights against sureties of a bankrupt company. In the American law, the situation is different. Creditors' rights against non-debtors (including sureties) are regulated by the bankruptcy codes. Section 524(e) of the codes states clearly that the discharge of a debtor does not affect the liability of non-debtors. However, section 105(a) has been interpreted by most courts as empowering them to grant the discharge of non-debtors when it is fair and equitable to do so. Often, sureties are the directors of a company and when it is under financial distress traditional lenders such as bank become cautious to extend fresh credit to a bankrupt company under business rescue. And if in the business rescue plan directors have undertaken to finance the plan from equity, it will mean that suing directors in their capacities as sureties will entails suing the company indirectly; and this might undermine the success of the reorganisation process. It is the view of the writer of this research paper that even in cases of a plan to which creditors have voted for but which contains a clause preserving their rights to sue sureties, courts should be allowed to decide on whether such preservation is fair and equitable or not and whether such preservation of rights will undermine the success of the reorganization plan or not.

At the meeting of creditors, they could make their support of the reorganisation plan conditional on the inclusion of a preservation clause of their rights against non-debtors. That is why it is preferable that in each case where the plan preserves such rights, a court enquiry should be needed to determine the fairness of such clause and its impact on the success of reorganisation plan. The American position is quite certain in the sense that the law expressly states that the release of the debtor does not affect the liability of sureties towards creditors. The law allows courts to prioritize the rehabilitation of the distressed company by confirming even a non-consensual plan that does not preserve the rights of creditors against non- debtors.

In American law, a business plan is prepared by the debtor and submitted to creditors for a vote by ballots and after the vote it is then submitted to court for confirmation.

Should the plan not get support among most creditors, it can still be submitted to court for confirmation.

The court has the power to confirm even a non-consensual plan if the court finds it fair and equitable. In South Africa, the plan has to be approved by all stakeholders mainly by creditors having the voting rights. There is no provision for court confirmation of a non-consensual plan. Making the court the final arbitrator of both consensual and non-consensual reorganisation plans is ideal so that creditors do not hold the reorganisation back or delay it unnecessarily with demands that might undermine the success of the rescue process.

The court is independent enough to decide on what is or is not fair and equitable to the reorganisation process and to stakeholders. It is also recommended that the business plan be prepared and implanted by the pre-existing management of the distressed company. The business rescue practitioner could play a supervisory role similar to that of the United State trustee.

It is therefore recommended that our legislature introduces some new sections into Companies Act. One section should be similar to section 524 (e) of the Bankruptcy Codes, expressly stating that a discharge granted to the principal debtor does not affect the liability of sureties towards creditors. Another section should be similar to section 105(a), which provide courts with powers to take any order to realize the objectives of the Companies Act. To avoid conflicting courts decisions in this matter, the former section should be subjected to the letter. Objective criteria should be created to guide the court decision on whether to extend or not a discharge of a debtor to sureties.

It is also recommended that preparation and the implementation of the business rescue should be allocated to principal debtor subject supervision. A business recue practitioner should play a role like a state trustee in America.

Further, two stage process should be introduced in the adoption of a business plan, namely, a vote by creditors and other stakeholders and a confirmation by a court of law. Courts should be empowered to confirm even a non-consensual plan whenever it is fair and equitable to do so.

7.3 Conclusion

This study dealt with the liability of sureties in relation to the business rescue proceedings. The situation of sureties before and after the adoption of the business rescue plan has been considered. It has been pointed out that the legislature did not make provision for the liability of sureties during business rescue proceedings and the courts' approach in this regard has been conflictual. Some judges believe that the adoption of a business rescue plan does not affect the liability of sureties towards creditors whereas others are of the view that the beginning of business rescue proceedings releases sureties from their obligations towards creditors, unless the business rescue plan or the deed of suretyship provides otherwise.

A comparative exercise to the American law has been undertaken. It has been found that the South African law maker relied heavily on the American law to draft chapter 6 of the Companies Act. It has been recommended that our legislature introduces new provisions in our company law to create commercial certainty. One section should be like section 524(e) which should provide that the release of debtor or the distressed company shall not be construed affecting the liability of third parties or any other person who has bound himself/herself as surety or in any other capacity in favour of the company. Further, the business rescue practitioner's duties should be limited to a supervisory role only, like that of a state trustee in the American law. The pre-existing management of the distressed company should be allowed to play an active role in the preparation and execution of the business rescue plan with the assistance of relevant experts where necessary. They should remain in charge of operations and financial decision of the company during the all rescue process.

Like in the American law, it has been recommended that the business rescue proceedings should be a two-step process, the first step should be the adoption or voting of the

business rescue plan by stakeholders and the second the confirmation of the plan by a court. Our courts should be empowered to confirm even a non-consensual plan subject to the development of an objective test or criteria that should be used by a court to reach its decision.

Lastly, the introduction of a section like section 105(a) of Bankruptcy Codes affording our courts the powers to take any order necessary and appropriate to give effect to the objectives of business rescue legislation, has been advocated as well.

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ACKNOWLEDGMENTS

- I would like to thank my wife Siyasanga Dubula for the support, motivation and allowing me to focus on my school work.
- I would also like to thank my supervisor Mr Adrian Bellengere for his patience, guidance and without him, this work would not be possible.
- Finally a special thanks to my dear friend, a colleague, Binene Bukasa, for providing his time and assist me with all information relating to this research.