To discharge or not to discharge a surety? The general prejudice rule

Abstract

South African law affords the surety a remarkable collection of grounds for discharge from liability under suretyship. This article discusses the so-called ‘general prejudice rule’ as one of the grounds on which the surety may be discharged from the obligations under suretyship. The basis of the rule in *Bock and Others v Duburoro Investments (Pty) Ltd*, which represents an instance where the rule was rejected, is considered. The author maintains that the courts should open the door to legal developments in this area.

1 Introduction

The South African economy is built on credit. Everyday, South Africans incur literally millions of rands in debt. Creditors want to be paid, but what happens when the debtor cannot repay the debt? It is to the benefit of the creditor if there is some form of security for repayment, because the creditor is then able to look to his or her security in order to obtain partial or total repayment.
There are various ways in which a creditor can secure a claim for debts against the debtor,\(^1\) one of which is suretyship.\(^2\) The nature of a suretyship contract is that one person (the surety) binds himself or herself as debtor to the creditor of another person (the principal debtor) to render the whole or part of the principal debt due to the creditor by the principal debtor if and to the extent that the principal debtor fails, without lawful excuse, to render such performance.\(^3\)

From the above explanation it is apparent that there are basically three obligations involved, two of which are auxiliary in nature. The first and foremost obligation is the obligation between the principal debtor and the creditor. This is the main obligation, because without it the other two obligations would not exist. The second obligation is between the surety and the creditor,\(^4\) and the last one is between the surety and the principal debtor.\(^5\)

However, creditors should not only be concerned about having securities for their claims or debts; it is also crucial to ensure that their securities are not diminished, for which reason they have to be definite, clear and reliable. For instance, even though a creditor might secure his or her claim or debt by way of suretyship, it is not unusual for sureties to resist making payments and to refuse to fulfil their obligations under the suretyship, relying on various defences that they believe discharge them from their obligations under the suretyship.\(^6\) In this way they diminish the creditor’s security. This is because the sureties’ point of view (like any other debtors’\(^7\)) is that the less they have to pay back, the better!

South African law affords the surety a remarkable collection of grounds for discharge from liability under suretyship.\(^7\) This article discusses the so-called general prejudice rule as one of the grounds discharging the surety from his or her obligations under suretyship.

### 2 The basis of the rule

There has been some controversy concerning the rule that the creditor’s dealings with the principal debtor and other sureties should not have the effect of prejudicing the surety, and that if they do so, the surety is discharged from his or her duties.

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1. Amongst other things, mortgage bonds, notarial bonds, pledges, liens and tacit hypothecs.
2. In Australia and other countries a suretyship contract is referred to as a contract of guarantee. A surety will then be referred to as a guarantor. See J O’Donovan and J Phillips *The Modern Contract of Guarantee* 2nd ed (1996). In South Africa, however, a contract of guarantee is totally different from a suretyship contract, in that a contract of guarantee exists where the guarantor undertakes a principal obligation to indemnify the promisee on the happening of certain events.
4. For instance, the surety has the obligation towards the creditor to perform in terms of the contract. See *LAWSA* (n 3) § 197.
5. For instance, the surety has the right of recourse against the principal debtor. See *LAWSA* (n 3) § 207.
6. For instance *Spur Steak Ranch Ltd v Mentz* 2000 (3) SA 755 (C); *Investec Bank Ltd v Lewis* 2002 (2) SA 111 (C); *Di Giulio v First National Bank of South Africa Ltd* 2002 (6) SA 281 (C); and as recently as 2004 in *Bock and others v Duburoro Investments (Pty) Ltd* 2004 (2) SA 242 (SCA).
The origin of this rule was considered in the case of Fry and Another v First National Bank of South Africa Ltd. The question put to the court was whether this rule was based on an entrenched legal principle or had to be regarded as the ‘exercise of a broad equitable power’. If the latter were applicable, there would (in the light of Bank of Lisbon and South Africa Ltd v De Ornelas and Another) be no reason for its continued existence and application. In other words, if the rule was based on a broad equitable power, it would be regarded as an element of the defence of exceptio doli generalis, which was rejected by the then Appellate Division in the case of De Ornelas.

The court decided, however, that this rule was based on an entrenched legal rule. The court’s reasoning was that although this rule was founded on the principles of equity, it had become firmly embedded and entrenched as part of South African law. Van der Westhuizen AJ therefore decided that the rule was not merely an exercise of a broad equitable power.

3 The rejection of the rule

The general duty not to prejudice is very wide, and therefore capable of radically extending the number of situations in which the creditor’s actions may discharge

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8 1996 (4) SA 925 (C). For a short discussion of this case, see H Schulze January (1997) De Rebus 42 43.
9 1988 (3) SA 580 (A). The court in this case held that the exceptio doli generalis (a defence in cases of breach of contract) has never formed part of Roman-Dutch law, and, despite the fact that in a number of judgments it was accepted that the exceptio was part of our law, the time had arrived, once and for all, to bury the exceptio as a superfluous, defunct anachronism. For criticisms of this judgment, see amongst others C Lewis ‘Demise of the exceptio doli: Is there another route to contractual equity?’ (1990) 107 SALJ 26; SWJ van der Merwe, GF Lubbe & LF van Huyssteen ‘The exceptio doli generalis requiescat in pace vivant aequitas’ (1989) 106 SALJ 235; JT Pretorius ‘Continuing suretyships’ (1988) 10 MB 85.
10 Van der Westhuizen AJ based his decision on the fusion of equity and common law, where all portions of the common law that conflicted with equity are eradicated.
the surety. This rule can be applied to practically any creditor’s action that might prejudicially affect the surety. For example, if a creditor who is justifiably trying to help the principal debtor overcome some temporary financial difficulties by supplying him with additional credit outside the limits of their original contract and the principal debtor’s financial position, in spite of this assistance, remains unimproved, the creditor may be faced with an argument from the surety that his subsequent assistance caused a worsening of the principal debtor’s financial status that prejudiced the surety. This would clearly be unfair towards creditors, but unfair as the argument was towards the creditors, it served as the rationale behind the Supreme Court of Appeal’s decision in *Bock and Others v Duburoro Investments (Pty) Ltd.*

The facts of the case were that the principal debtor borrowed money from three banks, and as security for the debts pledged shares to the banks and, in addition, a third person signed as surety. The principal debtor fell in arrears with regard to repayment and therefore, in terms of the deed of pledge, the banks took over the shares pledged at a price that was more or less equivalent to the closing price of those shares on the Stock Exchange. The price received for the shares was set off against the amount owed by the principal debtor, leaving a certain amount as the balance outstanding. The banks ceded their claim for the outstanding balance to a cessionary, who sought to recover, in terms of the contract of suretyship, the amounts owed from the sureties. One of the defences raised by the sureties was that they had been released from their suretyships because the banks had acted in a manner prejudicial to them as sureties. The sureties claimed they were prejudiced mainly with regard to the manner in which the three banks dealt with the pledged shares. The submission focused on the takeover of the shares, the date on which this occurred and the price at which the shares were taken over. In his judgment Harms JA decided that there is no general ‘prejudice principle’ in our law that, if the creditor does anything in his dealings with the principal debtor that has the effect of prejudicing surety, the latter will fully be released. The court held that, as a general proposition, prejudice caused to a surety will only release the surety if the prejudice is the result of breach of some or other legal duty or obligation, the prime sources of creditor’s rights, duties and obligations being the principal agreement and the deed of suretyship. Therefore, according to the court’s ruling, if the creditor breaches either the contract of suretyship or the principal contract, the surety will be released if such a breach prejudices the surety.

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11 2004 (2) SA 242 (SCA). This was an appeal from the Witwatersrand Local Division in *Duburoro Investments (Pty) Ltd v Bock and Others* 2003 (2) SA 76 (W).

12 *Duburoro* case supra (n 11) at 20 22.

13 This decision confirmed the dicta in *ABSA Bank v Davidson* 2000 (1) SA 1117 (A).
**4 Criticisms of the decision**

While I agree with the outcome of the court’s decision, I disagree with the reasons for the decision. The appellant’s case should have been dismissed, not because there is no general prejudice rule, but rather because the respondent’s actions were in accordance with the contract between the principal debtor and the creditors. I say this because, in terms of the contract, the creditors could, at their own discretion, decide how and when to realise the pledged articles. The creditors therefore only did what was allowed and provided for in terms of the contract. The question of prejudice should not have featured in the reasons for the judgment.

I am inclined to agree with Forsyth and Pretorius that the proposition by the court that the surety should only be discharged if the creditor prejudices the surety in breach of some or other legal duty does not hold water and is somewhat clichéd.

First, it is undisputed that the surety will only be released if the creditor breaches some or other legal duty. The fact of the matter is that the statement by the court that there must be a breach of some or other duty or obligation can be explained adequately on other well-established grounds of discharge. Undoubtedly a breach of contract (which the court refers to as a breach of some or other duty) is one of the grounds on which a surety can be released from his or her duties. For example, a surety for the due performance of a building contract will be discharged if the contractor pays the sums before they become due to the principal debtor under the principal contract. The prepayment will be a breach of contract, regardless of the fact that the surety can also claim discharge on the ground of being prejudiced, in that the prepayment might deter the principal debtor from rendering performance in terms of the contract in time (and so cause the surety to be liable).

It is clichéd for the court to reiterate this fact. This suggests the court avoided a precise formulation and application of this rule.

Second, the possibility of the surety being discharged for reasons other than the breach of some or other duty or obligation cannot be ignored. To employ the example used by Forsyth and Pretorius, if a creditor extends the time within which the principal debtor must make the repayment, this will not be a breach of some legal duty by the creditor, but the surety can still be discharged from his or her duties if these actions of the creditor are proved to have prejudiced him or her.

Third, the line of reasoning by the court that the court a quo’s dictum, which states that a value judgement should be considered in order to determine if the alleged prejudice constitutes real and substantial prejudice that has the effect of unduly increasing the contractual burden of the surety, is not necessary in cases of suretyship, is unwarranted. The court’s reasoning was based on the decision in *Brisley v Drotsky*.

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15 The authors in this instance were referring to the dicta in the case of *ABSA Bank Ltd v Davidson* supra (n 13).
16 Op cit (n 14) at 206.
17 2002 (4) SA 1 (SCA).
in which the court held that bona fides and value judgement in the law of contracts are merely an ethical value or controlling principle based on community standards of decency and fairness, but that it is not the only value or principle that underlies the law of contract, nor, perhaps, the most important one. However, I beg to differ from this statement as far as the suretyship contract is concerned. The fact that one person has agreed to assume responsibility for the debts of another person, albeit freely and voluntarily, confirms that value judgement and factual consideration should be taken into account. As long as the parameters within which this rule should be applied are clearly defined, there is no way in which value judgement or judicial discretion can violate the principle of legality, as the court maintains. 18

In order to formulate this rule accurately, one should take as a rule of thumb and a starting point that a surety should be discharged (partially or totally) if improper conduct (which is not the result of a breach of some or other legal duty) on the part of the creditor actually and materially increases the risk of the surety, taking into account value judgement and factual considerations.

4.1 Improper conduct

Because the general prejudice rule maintains that any dealings by a creditor with the principal debtor and other sureties may discharge the surety if the dealings prejudice the surety, the starting point in trying to identify the boundaries of this rule (therefore delimiting this rule) should have been to limit the application of the rule to certain conduct (including omissions) on the part of the creditor which will prejudice the surety.

Therefore, in order for a surety to claim a discharge there should be conduct on the part of the creditor that is considered improper and that the surety did not expressly agree to under the contract. Improper conduct in this instance may be any conduct that is not in the ordinary course of business. For example, if a branch manager of a bank approves an advance to the principal debtor without the required consent of all the sureties, this will be regarded as conduct not in the ordinary course of business. 19

Alternatively, improper conduct may be any conduct of the creditor that, to some extent, is indifferent to the surety’s position and is to some extent reckless in nature. For instance, the extension of time by the creditor to the principal debtor before the principal debtor is in mora may indicate some degree of indifference to the surety’s position and therefore become improper conduct on the part of the creditor.

4.2 The actual prejudice or increase in the risk

In the second place, the court should have determined whether the surety suffered actual material prejudice. The surety must show that his or her risk has been materially increased as a result of the improper conduct or that he or she has been

18 Duburoro case supra (n 11) at 20 22.
19 This was the decision in Fry and Another supra (n 8).
deprived of the opportunity of self-protection owing to the alleged conduct. In other words, the surety’s risk after the improper conduct should be much higher than his or her risk before the alleged conduct. Only material growth in risk should be taken into account. In determining the question of materiality, the quantum of the risk should be assessed.

4.3 Value judgement and factual considerations

After establishing the improper conduct as well as the actual material risk increase, there are certain factual considerations that cannot be ignored and should be taken into account when finally determining whether or not the surety should be discharged. The most important one is the assertion that the surety is, as a rule, well aware of the principal debtor’s financial position (his or her creditworthiness, liquidity and solvency). Furthermore, the surety is usually able to exercise a fair amount of control or influence over the principal debtor to ensure that the latter performs in terms of the principal contract. These factual considerations are especially true in cases where the principal debtor is a company and the sureties are the directors of that company. In such cases it can be averred that the surety, as a director of a company, in fact did not assume liability for an obligation which is not his or her own, as some benefit (directly or indirectly) can be derived from the whole transaction.

Therefore, in cases where it can be shown that the surety was aware of the principal debtor’s financial position and also able to control and influence the principal debtor to perform, these factors should be considered in deciding whether or not the surety should be discharged.

5 Conclusion

Because suretyship involves several parties, the law should endeavour to balance the rights and obligations of the different parties in a manner that is considered fair and just. The greatest difficulty in suretyship law lies in achieving a proper balance between the rights of the creditor and the rights of the surety. The question of whether it is the creditor or the surety who most deserves the law’s protection remains very controversial.

It would be wrong of the South African courts to shut the door to further development of the law in this field by rigidly confining the circumstances in which a surety may be discharged.20

While it is important for creditors that there should be a clear and precise formulation of the rules that govern the contract of suretyship, in particular the discharge of the surety by reason of the creditors’ dealings with the principal debtor

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20 As was acknowledged by Lord Justice Robert Goff in Bank of India v Trans Continental Commodity Merchants and Patel [1983] 2 Lloyd’s Rep 298 (CA) at 301 2.
and/or other sureties which prejudice the surety, a rigid limitation of the application of this rule is unfair towards sureties. There can be no doubt that public policy and well-established business morals require creditors to act bona fide in their dealings with sureties and that such considerations contribute to the development of the rule.