



Legal Alert | March 30, 2023

High Court Muddies the Waters on Enforcing Lending Securities

Background

A recent High Court rulingⁱ will have lenders scratching their heads on how to best secure facilities they issue and enforce full repayment. The High Court, in a decision we expect to be challenged, held a lender who had been allowed to purchase the property securing a facility could not pursue guarantors for any shortfall. The decision misapplies provisions of the 2015 Insolvency Act and misinterprets provisions of the 2012 Land Act, as analyzed below.

Brief Facts

The Bank had advanced KES 400 million to the borrower, secured by a charge over land and corporate guarantee. Upon the borrower's default, the Bank sought to sell the charged property but could not obtain its reserve price at auction. The Bank therefore successfully sought permission from the Court, to purchase the property at market value.

The Bank's position was the property had not been sold yet, and its forced sale value of USD 4 million was well below the outstanding debt of USD 7 million. It therefore had every right to demand the guarantors meet the shortfall.

Misapplication of Provisions of the Insolvency Act

The Bank issued statutory demands to the guarantors under the 2015 Insolvency Act. The guarantors challenged this and asked the Court to set aside the statutory demand.

The guarantors challenged the statutory demand on the basis of Section 17 (3) of the Insolvency Act and Regulation 17 of the 2016 Insolvency Regulations. Section 17 (3) of the Insolvency Act sets out when a natural person is deemed unable to pay debts. The Section contemplates a natural person can for good reason ask a Court to set aside a statutory demand. This position is supported by Regulation 15 of the Insolvency Regulations which is clear the provisions of Regulation 17 only apply to personal bankruptcies.

Section 17 of the Insolvency Act must be contrasted with Section 384 which sets out when a company is deemed unable to pay its debts. Section 384 does not contemplate a company applying to set aside a statutory demand. It would appear the Court did not distinguish between the bankruptcy process in respect of natural persons and insolvency process in respect of corporate entities set out in the Insolvency Act.

The bankruptcy process allows a natural person to challenge a statutory demand they received. However, there is no similar provision in respect of corporate insolvency. This misapplication of the law will create significant challenges to insolvency practice by opening a floodgate of baseless challenges to statutory demands.

Additionally, even assuming the provisions of the Insolvency Act and Regulations were correctly applied, the test for setting aside a statutory demand by a secured creditor was not satisfied in this case.

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The Court can only set aside a statutory demand by a secured creditor, if satisfied the value of the security equals or exceeds the full debt. In this case, the Bank was clear the outstanding debt significantly exceeded the security value. It is therefore clear there was a shortfall, which the Bank was right in asking the guarantors to remedy.

Misinterpretation of Provisions of the Land Act

The Court erroneously took the view the Bank wanted the guarantors to compensate it for its failure to properly exercise its statutory power of sale. This in our view is a misinterpretation of the provisions of the 2012 Land Act.

Section 97 (1) of the Land Act obligates a secured lender when realizing a security to obtain the best price reasonably possible. Breaching this obligation exposes the lender to liability. It is this liability that Section 97 (5) prevents the secured lender from shifting to a borrower or guarantor. Accordingly, the section is meant to ensure that a lender who breaches its duty of care when realizing a security, is personally responsible for any damages awarded for the breach.

The Court misinterpreted this provision to bar a secured lender from pursuing guarantors for any recovery shortfalls if it opted to purchase the security at market value as allowed by the Land Act. In effect, this decision will mean lenders cannot rely on guarantees to meet any shortfall arising after realizing a security.

Impact of the Decision

If allowed to stand, the decision will significantly affect lending practice. The most immediate impact is in regards to the value placed on guarantees as additional security. It may also lead to simple transactions being over-secured or only specific forms of collateral being accepted.

In the longer term, lenders are likely to be less accommodating to defaulters. This is because lenders will be weighing the value of the debt against the value of their primary security rather than the entire pool of securities available.

Way Forward

The High Court's position diverges from the Court of Appeal which found a creditor who holds various securities can choose which of them to enforce, how and when. The Court of Appeal was clear a guarantor's liability is generally co-extensive with that of the principal debtor but is not conditional on the security provided by the borrower.

Accordingly, we expect this decision will be challenged and is very likely to be set aside. However, until this happens, lenders must carefully consider and obtain professional advice on their lending and security arrangements.

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¹ Home Afrika Limited v Ecobank Kenya Limited (Insolvency Cause 010 of 2021) [2023]