PART 4C

THE INTRODUCTION OF A TRULY UNIFIED INSOLVENCY ACT: ANCILLARY MATTERS

In this part various ancillary matters relating to insolvency in general will be discussed with a view to determining whether or not they should be included in a unified Insolvency Act. These ancillary matters relate to debt relief measures, insolvent deceased estates, business rescue provisions, personal liability of directors and other officers and cross-border insolvencies. Each of these aspects will be briefly dealt with and recommendations made in regard to their inclusion or exclusion from a unified insolvency statute.

CHAPTER 10

THE INTRODUCTION OF A TRULY UNIFIED INSOLVENCY ACT: ANCILLARY MATTERS

SUMMARY

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1 INTRODUCTION

If a unified insolvency statute is to be introduced, then it cannot be said to be truly unified if substantially all aspects relating to insolvency are not included in such legislation. One of these aspects, namely the treatment of specialised institutions such as banks and insurance companies, has already been dealt with in chapter 7. However, there are a number of other issues that need to be addressed if this study is to claim that a framework has been created for a truly unified Insolvency Act.

Although the matters covered in this chapter are referred to as "ancillary", this has been done only for the purposes of this study. Due to the wide ambit of the issues covered in this chapter it is impossible to discuss them in any detail. For this reason the discussion of the ancillary matters will be limited to a discussion of where they should slot into the bigger insolvency picture. Consequently a discussion of the merits and / or principles of these ancillary matters will not be included here. Stated differently, should these issues be included in a unified insolvency statute or should they be contained in separate legislation? In answering this question it will be necessary to briefly determine the philosophy behind their inclusion in their current Acts, and to determine whether it is possible to include them in a unified insolvency statute.

2 ALTERNATIVES TO LIQUIDATION (SEQUESTRATION) FOR NATURAL PERSON DEBTORS[1]

2 1 Introduction

It has often been stated that the abuse of the current system of consumer insolvency in South Africa is due to the fact that there are insufficient alternatives available to a debtor experiencing

[1] To a large extent this discussion is based on a paper by Boraine and Roestoff entitled "Fresh Start Procedures for Consumer Debtors in South African Bankruptcy Law" presented at the Academics' Meeting of the INSOL Sixth World Congress held in London on 17 and 18 July 2001. This paper has since been published: Boraine and Roestoff "Fresh Start Procedures for Consumer Debtors in South African Bankruptcy Law" 2002 *International Insolvency Review* Vol 11 1 (hereinafter referred as Boraine and Roestoff "Fresh Start Procedures").

financial difficulties.[2] One of the only statutory alternatives,[3] namely administration orders,[4] are limited in their scope and are only available for use by debtors with liabilities totalling less than R50 000. The other alternative, namely a common-law composition offered by a debtor to his creditors, can be a dangerous option to be used by a debtor since the mere offer of composition amounts to an act of insolvency in terms of which the debtor may be sequestrated.[5] In addition, the offer of composition is ineffective unless it has been accepted by all the creditors of the debtor. If there are dissenting creditors, the composition cannot be forced on them and this leaves the agreement flawed in regard to the debtor.[6]

Statutory compositions, on the other hand, are of no real assistance to the struggling debtor as the procedure can only be invoked once the debtor has been sequestrated.[7] Although not the prime aim of South African insolvency law, the sequestration of an individual's estate does bring about

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2 See Boraine and Roestoff "Vriendskaplike Sekwestrasies - 'n Produk van Verouderde Beginsels" 1993 *DJ* 229; Roestoff and Jacobs "Statutêre Akkoord voor Likwidasie: 'n Toereikende Skuldenaar Remedie" 1997 *DJ* 189; Loubser "Ensuring Advantage to Everyone in a Modern South African Insolvency Law" 1997 *SA Merc LJ* 325; Boraine and Roestoff "Developments in American Consumer Bankruptcy Law: Lessons for South Africa" 2000 *Obiter* (Part1 Vol 1) 33 and (Part 2 Vol 2) 241; Evans "Friendly Sequestrations, the Abuse of the Process of Court, and Possible Solutions for Overburdened Debtors" 2001 *SA Merc LJ* 485 (hereinafter referred to as Evans).

3 For a discussion of the alternatives, see Boraine and Roestoff "Fresh Start Procedures" par 2.1. See also Evans 485.

4 Administration orders are regulated by s 74 of the Magistrates' Courts Act 32 of 1944 (hereinafter referred to as the Magistrates' Courts Act), falling under the jurisdiction of the magistrates' courts and conducted in terms of civil procedure.

5 See s 8(e) of the Insolvency Act 24 of 1936 (hereinafter referred to as the Insolvency Act). However, it must be pointed out that a notice by a debtor of his or her intention to apply for an administration order in terms of s 74 of the Magistrates' Courts Act can also constitute an act of insolvency under s 8(g) of the Insolvency Act - see *Barlow's (Eastern Province) Ltd v Bouwer* 1950 4 SA 385 (E); *Volkskas ('n Divisie van Absa Bank Bpk) v Pietersen* 1993 1 SA 312 (C) (Cf *Rodrew (Pty) Ltd v Rossouw* 1975 3 SA 137 (O)).

6 See SA Law Commission Project 63 Commission Paper 582 (11 Feb 2000) Vol 1 par 124.1 (hereinafter referred to as Commission Paper 582).

7 Statutory compositions are implemented in terms of s 119 of the Insolvency Act. See Boraine and Roestoff "Fresh Start Procedures" par 2.3.2 for a brief discussion of this procedure.

a discharge of the debt once the debtor has been rehabilitated,[8] and is for this reason that so many debtors make use of sequestration proceedings in practice.[9] In view of these shortcomings in the consumer laws of South Africa, the South African Law Commission has proposed a new form of composition in its review of the law of insolvency.[10] The proposal amounts to a common-law composition that has been given statutory recognition by the use of a clause providing for the binding of dissenting creditors. For the purposes of the discussion that follows, the new form of composition proposed by the Law Commission will be referred to as a "pre-liquidation composition", while the existing statutory composition in terms of section 119 of the Insolvency Act will be referred to as a "post-liquidation composition".

In the ensuing discussion the possible inclusion of administration orders in a unified insolvency statute will be discussed first, followed by a discussion of statutory compositions. The question that needs to be answered here is not whether the existing or proposed alternatives are workable, but whether or not they should be included in a unified insolvency statute.

2 2 Administration orders[11]

Administration orders are currently regulated by section 74 of the Magistrates' Courts Act. The procedure is quite obviously aimed at debtors in the lower income groups, since the procedure

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8 S 129(1)(b) of the Insolvency Act.

9 See also Evans 485.

10 Commission Paper 582 Vol 1 par 124.

11 For a general discussion of administration orders its procedure, see Harms *Civil Procedure in the Magistrates' Courts* (1997) paras 37.1-37.10. See also Boraine and Roestoff "Fresh Start Procedures" par 2.2. See also *Interim Research Report on the Review of Administration Orders in terms of Section 74 of the Magistrates' Courts Act 32 of 1944*, Centre for Advanced Corporate Insolvency Law, University of Pretoria, May 2002 par 1 (unpublished) for a brief history of administration orders (hereinafter referred to as Interim Research Report on Administration Orders); Shrand *The Law and Practice of Insolvency, Winding-up of Companies and Judicial Management* 3rd ed (1977) ch 16 (hereinafter referred to as Shrand).

cannot be used by a debtor whose liabilities exceed an amount of R50 000. The granting of an administration order in the magistrate's court does not amount to a discharge, and the debtor is required to repay all his or her debts in full. However, the granting of an administration order does bring about a stay for the debtor, in that the creditors that are affected by the order cannot take execution proceedings against such a debtor in respect of debts covered by the administration order. For this reason administration orders can be said to be a collective debt-collecting mechanism and forms part of South African debt relief measures.

However well this system of debt-collecting may appear to work in theory, it is fraught with problems in practice, a situation that has been exacerbated by the recent explosion of growth experienced in the micro-lending industry in South Africa. Research currently being carried out on this topic[12] shows that the following serious problems exist in regard to administration orders:[13]

(a) The payments made by debtors are in most cases too small to realistically pay off the debt within the required time frames;

(b) The procedures that need to be followed are onerous;

(c) The staff of the magistrates' courts that supervise this procedure are often ill-equipped to perform their tasks;

(d) The magistrates' courts are experiencing a massive work overload that leads to delays and eventual prejudice for both debtor and creditor;

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12 Interim Research Report on Administration Orders par 1.

13 For a detailed discussion of the problems relating to administration orders, see Interim Research Report on Administration Orders paras 3, 7.

(e) There are insufficient safeguards built into the procedure in that the administrators are not required to belong to any professional body. This leads to abuse by administrators by charging exorbitant fees and expenses;

(f) There is very little, if any, proper supervision over administrators which in turn leads to abuse.

These are but a few of the problems currently being experienced in this field of the law, and the question being addressed in the research currently underway is whether these provisions can be improved upon to make the system of administration orders more effective.[14] One of the questions that has been posed by the research team conducting the research on administration orders, is whether or not this procedure should not be included in a unified insolvency statute, enabling the procedure of administration orders to be linked to a possible pre-liquidation composition or, ultimately, a liquidation (sequestration) order.[15] In addition to this, one of the options being considered by the research team is the likelihood that administration orders will be more effectively administered if insolvency practitioners were to take responsibility for the general administration process.

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14 For a full discussion of how the current system of administration orders functions in practice, see Research Report on Administration Orders par 6.

15 It is interesting that in England the Cork Report (*Insolvency Law and Practice, Report of the Review Committee* (Cmnd 8558) 1982 (hereinafter referred to as the Cork Report)) ch 6 included a recommendation that administration orders be abolished and replaced with a Debts Arrangement Order as part of their insolvency law reform process. However, this recommendation was never implemented and currently the provisions relating to administration order are still contained in separate legislation. See also Fletcher *The Law of Insolvency* (1996) 60.

By increasing the threshold of those able to use administration orders, inserting the provisions into a unified insolvency statute and linking it to pre-liquidation compositions and insolvency, it is the view of the research committee that the administration order procedure will become more effectively regulated.[16]

2 3 Statutory pre-liquidation compositions[17]

As stated above, the South African Law Commission has proposed that common-law compositions be fortified by giving them statutory recognition in the form of a composition outside insolvency.[18] The Law Commission states that the statutory recognition of these types of compositions is necessary due to the requirement in the Draft Insolvency Bill that the liquidation of the estate of the debtor must be to the advantage of the creditors.[19] According to the Law Commission "provision must be made for debtors with little or no assets who through no fault of their own are unable to pay their debts".[20] In order to achieve this, the Law Commission proposes the insertion of a new sub-section into section 74 of the Magistrates' Courts Act, the provision dealing with administration orders. The new section provides for a composition between a debtor and his or her creditors *prior* to liquidation (sequestration) and which is binding on dissenting creditors. This procedure, too, is in essence a collective debt-collecting procedure aimed at alleviating the predicament of both debtor and creditor.

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16 For a discussion of the proposals being made in regard to administration orders and its role within the insolvency system, see Interim Research Report on Administration Orders par 10.

17 For a more detailed discussion of this new innovation, see Boraine and Roestoff "Fresh Start Procedures" par 3. See also Research Report on Administration Orders par 5.

18 As opposed to within the insolvency process, which is possible by means of the post-liquidation composition provided for in s 119 of the current Insolvency Act (cl 71 of the Draft Insolvency Bill and cl 119 of the unified Insolvency Act in ann E to this thesis).

19 Commission Paper 582 Vol 1 par 124.1.

20 Commission Paper 582 Vol 1 par 124.1.

For the purposes of this study it is not necessary to discuss the mechanics of the proposed new provision, but this does bring one to the point where the question needs to be posed as to where the provisions dealing with administration orders and pre-liquidation compositions should be included. It is submitted that both these procedures should be included in a unified insolvency statute. The reason for this statement can be found in the fact that the inability of a debtor to pay his or her debts resorts under the wide ambit of insolvency law. From a creditor's point of view South African insolvency law is a collective debt-collecting procedure,[21] while it is seen as a debt relief measure from a debtor's point of view. Consequently, any procedure aimed at alleviating a debtor's financial situation should, in my opinion, be included in insolvency legislation if it amounts to relief for both the debtor and the creditors in a collective fashion.

2 4 Conclusion

The information required to be placed before the magistrate's court in terms of the proposed new provision providing for pre-liquidation compositions, is very similar to the information required to be placed before the magistrate's court in the case of administration orders.[22] For this reason the two provisions should be linked in some way. In addition, the magistrate presiding over either of these procedures should have a discretion to decide which of them will be most suited to the prevailing circumstances in each case.

Although the conclusion has been reached that administration orders and pre-liquidation compositions should be included in a unified insolvency statute, for the purposes of the unified Insolvency Act included in this thesis, this has not in fact been done. The reason for this is that the decision to move administration orders out of the Magistrates' Courts Act and into a unified insolvency statute is one of policy that will have to be made by the relevant government

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21 As opposed to individual debt-collecting procedures initiated, eg, by the issuing of a summons for the recovery of debt.

22 Research Report on Administration Orders paras 5, 6.

authorities and the political powers that be. On the other hand, the proposed pre-liquidation composition provision has not yet been inserted into the Magistrates' Courts Act and can easily be slotted into a unified statute.[23]

The insertion of the provision dealing with pre-liquidation compositions is evident from clause 118 of the unified Insolvency Act that forms Annexure E to this thesis. However, some minor amendments have been made to this clause in consequence of what has been determined in this study. These amendments are the following:

(a) In terms of the proposals made by the South African Law Commission, pre-liquidation compositions have only been made applicable to individuals (natural persons). However, there is no reason why these same provisions cannot be made applicable also to the other debtors as defined[24] in the unified Insolvency Act.[25] For this reason the clause has been amended to make provision for all types of debtors.

(b) The second major amendment relates to the provision in the Law Commission's proposal that, in the event of the creditors rejecting the offer of composition, the presiding officer can request the debtor if he or she wishes for his or her assets to be divided in terms of the Insolvency Act. It is submitted that such a provision would lead to an abuse of this process by debtors, as they would be able to escape the rigorous test of advantage to creditors that is applied in applications for liquidation (sequestration). Consequently the

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23 If this cannot be achieved then pre-liquidation compositions should be inserted into the Magistrates' Courts Act, together with the provisions dealing with administration orders. However, such a step will lead to the further fragmentation of our insolvency law.

24 See ch 6 above in regard to the definition of "debtor" under a unified Insolvency Act.

25 Although there are other provisions that have been included in the unified Insolvency Act that have historically been used by companies, these provisions have also been made applicable to all types of debtors. See par 4 below and cl 120 and 120A in ch 23 of the unified Insolvency Act in ann E to this thesis.

clause has been amended to make provision for two possibilities. If the composition is rejected:

(i) The presiding magistrate can declare that the proceedings relating to a pre-liquidation composition have ceased and that the debtor is once again in the position he was prior to the offer of composition being made; or

(ii) The presiding magistrate can determine whether or not an administration order can be granted in terms of section 74 of the Magistrates' Courts Act[26] and, if so, grant the relevant order.[27]

By including administration orders and pre-liquidation compositions in a unified insolvency statute, South African insolvency legislation would be in line with the approach taken by many other countries.[28] For example, in Australia the Harmer Report[29] refers to a previous scheme, entitled the Regular Payment of Debt scheme, that was recommended by a previous commission of inquiry,[30] but was never tabled in Parliament. However, the Harmer Report recommended that a new scheme, entitled Debts Payment Plans, should be incorporated into the Australian Bankruptcy Act.[31] From the content of the recommendation it appears to be a hybrid between the South African administration order and the proposed pre-liquidation composition already referred to above.

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26 Ideally, s 74 of the Magistrates' Courts Act would be inserted into the unified Insolvency Act, in close proximity to cl 118, where reference would then be made to the relevant clause of the unified Act.

27 However, this will only apply to natural person debtors and not to other types of debtors who may also make use of the provisions.

28 Eg, in the United States of America compositions were held to fall under the bankruptcy laws as far back as 1874. See Tabb "The History of Bankruptcy Laws in the United States" 1995 3 *ABI Law Review* 5-51 at 21.

29 Australian Law Reform Commission Report No 45 *General Insolvency Inquiry* (hereinafter referred as the Harmer Report) Vol 1 paras 432-440.

30 Harmer Report par 433.

31 Harmer Report par 432.

Currently in Australia there are a number of options available to a debtor which serve as alternatives to formal bankruptcy.[32] In the first place it is possible for a debtor to enter into a private informal agreement with the individual creditors by restructuring loans or obtaining a moratorium for the payment of debt.[33] In the second place a debtor may enter into a private arrangement with his or her creditors under Part X of the Bankruptcy Act 1966 (Cth).[34] This arrangement has the avoidance of bankruptcy as a result.[35] In the third place a debtor may propose a debt agreement which is subject to Part IX of the Bankruptcy Act.[36] These provisions will not be discussed here, but it is important to point out that these debt relief measures are contained in the Australian Bankruptcy Act.

However, in England[37] there are both formal and informal procedures[38] that serve as alternatives to formal bankruptcy. The formal procedures consist of individual voluntary arrangements, deeds of arrangement[39] and administration orders,[40] although only individual voluntary arrangements are regulated by the Insolvency Act 1986.[41]

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32 See generally Duns and Mason "Consumer Insolvency in Australia: Current Regulation and Proposed Reforms" 7, a paper presented at the Academics' Meeting of the INSOL Sixth World Congress in London on 17 July 2001.

33 Keay *Insolvency* 18. For a discussion of this form of debt relief, see Keay and Kennedy "To Bankrupt, or Not to Bankrupt? The Question Faced by All Insolvency Advisers" 1993 *Insolvency Law Journal* 187.

34 Keay *Insolvency* 18.

35 Keay *Insolvency* 18; ch 3.

36 Keay *Insolvency* 18; ch 4.

37 See generally Fletcher ch 4; Cork Report ch 7.

38 For a discussion of the informal procedures, see Fletcher 66-67.

39 Deeds of Arrangement Act 1914. See also Fletcher 59-60.

40 For a discussion of administration order under English law, see Fletcher 60-66.

41 See part VIII, ss 252-263. See also Fletcher 41.

In Germany, Part Nine of the *Insolvenzordnung* (Insolvency Code) regulates consumer insolvency proceedings. Sections 305 to 310 of the Insolvency Code deal with a debt adjustment plan. In terms of these provisions a debtor may in the first place not commence an insolvency proceeding him- or herself unless it can be proved to the court that an extrajudicial agreement with creditors was attempted, but failed.[42] In addition, when filing the petition to commence an insolvency proceeding, the petition must be accompanied by a debt adjustment plan.[43] If the creditors accept the debt adjustment plan, the court makes an order to that effect and the insolvency petition is deemed to have been withdrawn.[44] If the debt adjustment plan is not accepted by all the creditors, the provisions make provision for a "cram-down" by the court, provided at least more than half the creditors of the estate have accepted it.[45] In the event the creditors do not accept the debt adjustment plan and the court has not substituted its consent for dissenting creditors, then the insolvency proceeding is reinstituted.[46] What is important about the German debt adjustment plan is not only that is forms part of the Insolvency Code, but also that it is a compulsory requirement before a debtor may approach the court for relief in the form of formal insolvency.

In the United States[47] the alternatives to bankruptcy are also contained in their bankruptcy legislation, namely the United States Bankruptcy Code.[48] In terms of the Code a debtor may file

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42 Insolvency Code s 305(1)1.

43 Insolvency Code s 305(1)4.

44 Insolvency Code s 308.

45 Insolvency Code s 309.

46 Insolvency Code s 311.

47 For a comprehensive discussion of alternatives to bankruptcy in the United States, see Research Project on Administration Orders par 9. See also Herbert *Understanding Bankruptcy* (1995) ch 18 (hereinafter referred to as Herbert).

48 11 USC.

for bankruptcy under Chapter 7, and a reorganisation process under either Chapters 13[49] or 11.[50] In terms of the Chapter 7 procedure the debtor's non-exempt property will be liquidated and distributed amongst the creditors.[51] The Chapter 11 procedure is complicated, and is generally only used by businesses, although nothing prevents an individual from making use of the process.[52] Chapter 13 procedures for reorganisation are usually utilised by individual or consumer debtors, and make provision for the debtor to remain in possession of his or her property by drawing up a plan to repay some or all of the debt out of future income. [53] What is important about alternatives to bankruptcy under the American system, is that the measures are contained in the same enactment, namely the United States Bankruptcy Code.

It is therefore important that South Africa takes note of international trends when considering a unified Insolvency Act, as it is evident that all debt relief measures should be included in the same legislation regulating insolvency.

3 INSOLVENT DECEASED ESTATES[54]

It is quite possible that the estate of a deceased person is found to be insolvent at the time of the deceased's death, or at a stage sometime thereafter. In terms of section 34 of the Administration

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49 For a discussion of this aspect that gave rise to the ch 13 procedure, see *Report of the Commission on the Bankruptcy Laws of the United States* (1973) ch 6.

50 For a discussion of this aspect that gave rise to the ch 11 procedure, see *Report of the Commission on the Bankruptcy Laws of the United States* (1973) ch 9.

51 11 USC s 726.

52 See Herbert 304.

53 11 USC s 1322.

54 Regarding the administration of insolvent deceased estates generally, see Burdette "Selected Aspects of the Administration of Insolvent Deceased Estates" 2001 2 *SA Merc LJ* 211-225 (hereinafter referred to as Burdette); Shrand ch 15.

of Estates Act[55] there are two possible manners in which these estates may be administered. In the first place it is possible that the estate may be administered in terms of a procedure set out in section 34 of the Administration of Estates Act. The second possibility is that the estate may be declared formally insolvent after an application to court,[56] and the estate is then administered in terms of the Insolvency Act.[57]

The choice as to which of these procedures will be implemented, is left to the creditors. This is done by way of a notice to creditors in terms of section 34(1) of the Administration of Estates Act, whereby they must make an election as to which procedure is favoured. Creditors are not actually given a choice as such - what happens is that the executor must inform the creditors and the Master that the estate in question is insolvent.[58] In the notice to creditors the executor must inform them that if the majority of creditors in number and value do not instruct him (the executor) to formally sequestrate the estate in terms of the Insolvency Act, he will proceed to administer the estate in terms of section 34 of the Administration of Estates Act. What this section does is to tell creditors that the estate will be wound up in terms of the Administration of Estates Act unless they instruct the executor to formally sequestrate the estate.[59] Obviously an executor should inform the creditors what the appropriate course of action should be considering the circumstances of each case.[60]

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55 Act 66 of 1965 (hereinafter referred to as the Administration of Estates Act).

56 It is interesting to note that s 3 of the current Insolvency Act states that "[a]n insolvent debtor or his agent or a person entrusted with the administration of the estate of a deceased insolvent debtor ... may petition the court for the acceptance of the surrender of the debtor's estate for the benefit of his creditors", this being an application for voluntary surrender. However, take note that a creditor of the deceased may still formally apply for the compulsory sequestration of the decedent's estate - s 34(13) of the Administration of Estates Act.

57 See s 34(1) of the Administration of Estates Act and Burdette 216-219.

58 S 34(1) of the Administration of Estates Act and Burdette 212-215.

59 S 34(1) of the Administration of Estates Act and Burdette 212-215.

60 S 34(1) of the Administration of Estates Act and Burdette 212-215.

For example,[61] it may be that the deceased donated most of his assets to his beneficiaries shortly before his death and as a result his estate is insolvent. The sections dealing with the setting aside of impeachable transaction in the Insolvency Act[62] cannot be implemented by an executor, only by a trustee of an insolvent estate. In circumstances such as these, the executor should inform the creditors that the appropriate course of action would be to formally sequestrate the estate in order that a trustee may be appointed. The trustee, once appointed, may then apply to court to have the transactions set aside.

In light of the proposals for the enactment of a unified insolvency statute in this study, the question has to be asked whether or not the provisions of section 34 of the Administration of Estates Act should also be included in such a unified statute. Considering the unique procedures that regulate the administration of deceased estates, it is submitted that the procedures regarding insolvent deceased estates should not be included under a unified statute. The reasons for reaching this conclusion are the following:

(a) Although the current procedure set out in section 34 of the Administration of Estates Act regulates the administration of insolvent deceased estates, the estate in question is still wound up as a deceased estate and not as an insolvent estate.[63] This is important in regard to a number of administrative measures:

    (i) In the first place, an insolvent deceased estate is administered by an executor and not a trustee. Moving the section 34 procedure will create unnecessary confusion as to whether the person appointed is an executor or a trustee.

    (ii) Secondly, insolvent deceased estates that are administered in terms of section 34 follow the same procedures as a normal deceased estate, for example the

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61 For more examples of where the deceased estate should be formally sequestrated, see Burdette 213-214.

62 Ss 26-34 of the Insolvency Act.

63 Burdette 211, 219-225.

appointment of an executor, the inspection periods, the considerations of objections by the Master, etcetera. Moving section 34 of the Administration of Estates Act will mean that the estate is subject to administration by a trustee, inspection periods differ and different rules regarding the consideration of objections by the Master will apply.

(iii) Thirdly, the fee structure[64] of an executor administering an insolvent deceased estate in terms of section 34 of the Administration of Estates Act differs from the fee structure of a trustee in an insolvent deceased estate being administered in terms of the Insolvency Act.

(b) An insolvent deceased estate that is administered in terms of section 34 of the Administration of Estates Act, is in any event wound up in accordance with the principles of insolvency law.[65] There is a curious hybrid of provisions that apply: the actual administration process takes place in accordance with the procedures set out in the Administration of Estates Act, while the division of assets among the creditors takes place in accordance with the principles of insolvency.[66]

(c) The consequences of a deceased estate being wound up in terms of section 34 are not the same as the consequences of a deceased estate being wound up in terms of the provisions of the Insolvency Act. An example would be where one of the spouses in a marriage in community of property passes away and the joint (deceased) estate is found to be insolvent. If the estate is administered in terms of section 34 of the Administration of Estates Act, the surviving spouse is not considered to be an insolvent and will

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64 Executors are generally entitled to 3,5% on the gross value of the assets in the estate, while the fees of a trustee are based on a percentage on the type of asset found in the estate.

65 S 34(7)(b) of the Administration of Estates Act and Burdette 211, 219-225.

66 However, not all the principles of insolvency apply. Eg, contribution will not be levied on the creditors where there is a shortfall - see Burdette 215 fn 8.

consequently not suffer any of the limitations on his or her capacity to act that are currently imposed by the Insolvency Act. On the other hand, the surviving spouse will also not enjoy any of the benefits of sequestration, such as the discharge of debts upon rehabilitation.[67] However, if the joint deceased estate is declared formally insolvent, this will have a completely different effect on the status of the surviving spouse.

For the above reasons it is important to maintain a distinction between an insolvent deceased estate that is being wound up in terms of section 34 of the Administration of Estates Act, and an insolvent deceased estate that is being formally wound up as an insolvent estate in terms of the Insolvency Act. An insolvent deceased estate is still a deceased estate that should, as far as possible, be administered together with other deceased estates. No prejudice is suffered by creditors by the use of section 34 of the Administration of Estates Act, as the principles of insolvency still apply to the actual distribution of the assets. By merging these very different provisions into the same Act, the advantage of having a simple and inexpensive procedure for the administration of insolvent deceased estates will be lost.

Part Ten of the German Insolvency Code provides for "Inheritance Insolvency Proceedings". These provisions are contained in sections 315 to 331, and allow various persons, including the executor, the heirs and creditors the right to approach the court in order to commence the insolvency proceeding.

Special rules pertaining to the administration of insolvent deceased estates also apply in England, although the insolvency provisions and rules are adapted to meet the needs of these special cases.[68] However, in Australia the situation is similar to the administration of insolvent deceased estates in South Africa, as the estate of the decedent may either be dealt with under the provisions

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67 There can be no rehabilitation in such a case, as there has been no formal sequestration.

68 See Fletcher 330-333.

of the Bankruptcy Act 1966 (Cth) or under the provisions of the State legislation governing the administration of deceased estates.[69] The reasons for making use of the Bankruptcy Act instead of the laws governing the administration of deceased estates seem to be the same as those relied upon in South Africa.[70]

Finally, it must be borne in mind that South Africa uses unique procedures when dealing with deceased estates. The Master of the High Court has a supervisory role in the administration of all estates, unlike the probate system that is used in countries such as England. Due to the uniqueness of the procedures used in both insolvency and deceased estates in South Africa, it is submitted that the administration of insolvent deceased estates should remain as it is.

4 BUSINESS RESCUE PROVISIONS[71]

4 1 Introduction and the legal nature and underlying philosophy of business rescue

Although South Africa currently lags behind the rest of the world when it comes to business rescue regimes, it is ironic that South Africa was one of the first countries to actually introduce a business rescue regime in the form of judicial management.[72] Unfortunately, since the

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69 Keay *Insolvency* 155. For a brief discussion of this aspect see also Rose *Lewis' Australian Bankruptcy Law* 11th ed (1999) 4.

70 Eg, to make use of the provisions dealing with impeachable transactions - see Keay *Insolvency* 155.

71 See generally: Hunter "The Nature and Functions of a Rescue Culture" 1999 *Journal of Business Law* 491 (hereinafter referred to as Hunter); Rochelle "Lowering the Penalties for Failure: Using the Insolvency Law as a Tool for Spurring Economic Growth; the American Experience, and Possible Uses for South Africa" 1996 2 *TSAR* 315 (hereinafter referred to as Rochelle); Harmer "Comparison of Trends in National Law: The Pacific Rim" 1997 13 *Brookings Journal of International Law* 139-165 (hereinafter referred to as Harmer); Goode *Principles of Corporate Insolvency Law* 2nd ed (1997) 267-270 (hereinafter referred to as Goode); Herbert ch 17. For a useful discussion of the underlying philosophy of reorganisations under United States law, see Jackson *The Logic and Limits of Bankruptcy Law* (1986) ch 9 209-224.

72 See Rajak and Henning "Business Rescue for South Africa" 1999 *SALJ* 262 (hereinafter referred to as Rajak and Henning).

introduction of judicial management in 1926, South Africa has not really developed its business rescue provisions any further and consequently finds itself out of step with the rest of the world regarding this important aspect of modern insolvency law.

While it is not the intention in this part of the chapter to discuss business rescue in any detail, a brief exposition of the current business rescue regimes will be given, and proposals made for their inclusion under a unified Insolvency Act.[73] It must also be borne in mind that the purpose of a business rescue regime is *not necessarily* to save the business and return it to its former profitable status. One of the spin-offs of a business rescue regime is that even if the business cannot be restored to a solvent and profitable status, the return to creditors in the long-run will be much higher.[74] It is stated thus by Smits:[75]

> "Modern 'corporate rescue' and reorganisation seeks to take advantage of the reality that in many cases an enterprise not only has substantial value as a going concern, but its going concern value exceeds its liquidation value. Through judicial bankruptcy procedures, reorganisation seeks to maximise, preserve and possibly even enhance the value of a debtor's business enterprise, in order to maximise payment to the creditors of the distressed debtor."

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73 It is interesting that Milman and Durrant *Corporate Insolvency Law and Practice* 3rd ed (1999) 1 (hereinafter referred to as Milman and Durrant) state that one of the aims of corporate insolvency is in fact to promote business rescue. See also Goode 267-270.

74 S 427(1) of the Companies Act requires that there must be a reasonable probability that the company will be able to pay its debts and meet its obligations if the judicial management order is granted. In *Noordkaap Lewende Hawe Ko-op Bpk v Schreuder* 1974 3 SA 102 (A) the court confirmed the requirement that there must be a reasonable probability and not merely a reasonable possibility. The court also stated that the intention of the legislature in using the term "probability" was to restrict as little as possible the rights of creditors. This requirement is stated as being unrealistic, and sometimes even against the wishes of creditors, by Rajak and Henning 268. Smits 86 is of the opinion that the success of judicial management should not be measured by this requirement, as this is not the only goal of a business rescue regime. See also Harmer 144 where he attempts to provide an internationally acceptable definition of the term "rescue".

75 Smits "Corporate Administration: A Proposed Model" 1999 32 *DJ* 80 at 83 (hereinafter referred to as Smits). See also Trebilcock and Katz "The Law and Economics of Corporate Insolvency: A North American Perspective" in Rickett (ed) *Essays on Corporate Restructuring and Insolvency* (1996), where the following is stated at 7:

> "The collective interest of all creditors requires the maximisation of the aggregate value of the assets of the debtor. In many cases, an insolvent firm is worth more as a going concern than the sum value of its discrete assets sold on a piecemeal basis. In these situations, it is in the collective interests of all creditors that the business be preserved as a going concern."

An important point made by Harmer,[76] is that a business rescue regime has a far better chance of succeeding if the insolvency system in which it is applied is debtor-friendly, as opposed to a creditor-friendly system of insolvency where business rescue regimes are not applied as successfully.[77] This is certainly true of South Africa. As has already been pointed out in this study South Africa has a creditor-friendly insolvency system, and it is submitted that the fact that the courts take a very conservative approach to insolvency and judicial management is a contributing factor in the failure of judicial management as a business rescue regime in South Africa. This aspect is discussed in more detail below.

While judicial management, as an example of a business rescue mechanism in South Africa, is seen to be an extraordinary measure, in other jurisdictions business rescue procedures are seen as a necessary and natural precursor to insolvency itself.[78] In this regard it is important to note the legal nature and philosophy behind a business rescue culture. In the Cork Report, the following two aims "of a good modern insolvency law" were identified in regard to English law:[79]

> "(i) to recognise that the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome, and to ensure that these public interests are recognised and safeguarded;
>
> (j) to provide means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country;"

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76 Harmer 147.

77 Harmer 147 refers to the United States as an example of a debtor-friendly insolvency system where business rescue has a very high success rate, as opposed to Australia with a low rate of success due to its creditor-friendly insolvency system.

78 See eg Herbert 303-314 who discusses the role of business rescue in the United States.

79 At par 198 of the Cork Report.

In addition to these statements on the general aims of English insolvency law, the Cork Report stated the following in regard to the appointment of administrators as a form of business rescue:[80]

> "498. Under our proposals, an Administrator may be appointed for all or any of the following reasons:
>
> (a) to consider the reorganisation of the company and its management with a view to restoring profitability or maintaining employment;
>
> (b) to ascertain whether a company of doubtful solvency can be restored to profitability;
>
> (c) to make proposals for the most profitable realisation of assets for the benefit of creditors and shareholders;
>
> (d) to carry on the business where this is in the public interest but is unlikely that the business can be continued under the existing management."

In determining what the actual meaning of a "rescue culture" is,[81] Hunter provides the following explanation:[82]

> "What then [is meant] by the term 'rescue culture'? It is a multi-aspect concept, having both a positive and protective role, and a corrective and a punitive role. On one level, it manifests itself by legislative and judicial policies, directed to the more benevolent treatment of insolvent persons, whether they be individuals or corporations, and at the same time to a more draconian treatment of true economic delinquents. On another level, it entails the adoption of a general rule for the construction of statutes, which is deliberately inclined towards the giving of a positive and socially profitable meaning (rather than a negative or socially destructive meaning), to statutes of socio-economic import. Of such statutes, insolvency legislation may justly be regarded as the paramount example."

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80 Cork Report par 498. See also Goode 267-323 for a useful discussion of administration orders under English law. The Harmer Report followed similar principles when recommending the introduction of voluntary administration as a form of business rescue in Australia - see the Harmer Report ch 3.

81 See also Harmer 143-148 where he gives an exposition of the general principles that a business rescue culture should ascribe to.

82 Hunter 498.

Having regard to what has been stated above, it is evident that business rescue procedures are closely linked to, or intertwined with, insolvency law.[83] This means that in order to be effective, the business rescue provisions must be contained in the same legislation as the insolvency laws so that the link between insolvency and business rescue can be maintained. In the United States,[84] Germany[85] and England,[86] their respective business rescue procedures are contained in their insolvency legislation. In Australia[87] the business rescue procedures (for companies) are contained in the Corporations Act, but that same Act also provides for the winding-up of insolvent companies, so the *nexus* between insolvency and business rescue is maintained there as well.

It is therefore submitted that in South Africa a unified Insolvency Act should also contain all provisions that relate to business rescue. Stated conversely, the machinery relating to business rescues should be included in the same legislation making provision for the liquidation of companies and close corporations. While acknowledging that a new business rescue culture needs to be developed for use in South Africa, it is submitted that any such new (or existing) scheme of business rescue must be included in a unified Insolvency Act. Since the development of a new business rescue regime seems to be some time away, the existing forms of business rescue, namely judicial management and the (current) section 311 compromises in terms of the Companies Act,

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83 See eg Harmer 143.

84 In the United States the business rescue provisions, also known as chapter 11 cases, are contained in the United States Bankruptcy Code (11 USC). See also the discussion of chapter 11 cases in Herbert ch 17. For a discussion of the rationale behind the advent of the ch 11 procedure, see *Report of the Commission on the Bankruptcy Laws of the United States* (1973) ch 9.

85 In Germany the rescue provisions are contained in parts six, seven and eight of the *Insolvenzordnung vom 5 Oktober 1994 (BGBI. I, S. 2866)* - hereinafter referred to as the Insolvency Code. This Code came into operation on 1 January 1999.

86 The English business rescue provisions are contained in the Insolvency Act 1986 (s 29 deals with administrative receivers, part I deals with voluntary arrangements and part II deals with company administration orders). For a useful discussion of business rescue in England, see Goode ch 10.

87 The Australian business rescue procedures are contained in the Corporations Act of 2001 (corporate receivership is dealt with in part 5.2, voluntary administration and deeds of company arrangement are dealt with in part 5.3A, and part 5.1 deals with formal schemes of arrangement). See also Harmer 148-155.

should be included until such time as a new system is installed. The two forms of business rescue that are discussed under this part of the chapter are judicial management and section 311 compromises.[88]

4 2 Judicial management[89]

4 2 1 Introduction

Judicial management is provided for in sections 427 to 440 of the Companies Act. It is a process that can be used by a company that is experiencing a temporary financial setback as a result of mismanagement or other special circumstances, and that will lead to it once again becoming a successful business concern.[90] This is achieved by replacing the existing management of the company with a judicial manager who takes over the company's business with the purpose of restoring it to profitability.[91]

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88 S 311 of the Companies Act 61 of 1973 (hereinafter referred to as the Companies Act).

89 See generally: Smits 80; Cilliers *et al Corporate Law* 3rd ed (2000) ch 26 (hereinafter referred to as Cilliers *ea Corporate Law*); Kunst (gen ed) *Henochsberg on the Companies Act* (1994) Vol 1 923-959 (hereinafter referred to as Henochsberg); Kloppers "Judicial Management Reform - Steps to Initiate a Business Rescue" 2001 13 *SA Merc LJ* 359 (hereinafter referred to as Kloppers "Judicial Management Reform");Kloppers "Judicial Management - A Corporate Rescue Mechanism in Need of Reform?" 1999 *Stell LR* 417 (hereinafter referred to as Kloppers "Judicial Management"); Rajak and Henning 262; Burdette "Unified Insolvency Legislation in South Africa: Obstacles in the Path of the Unification Process" 1999 *DJ* 44; Olver "Judicial Management: A Case for Law Reform" 1986 *THRHR* 84 (hereinafter referred to as Olver). For a useful discussion of the history of judicial management and its application by the courts, see Olver *Judicial Management in South Africa* (unpublished doctoral thesis 1980 UCT) (hereinafter referred to as Olver Thesis) and *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* 2001 2 SA 727 (C), [2001] 1 All SA 223 (C). For a useful summary of the *Le Roux Hotel Management* case, see O'Brien and Boraine "Review of Case Law and Publications" 2001 *SAILR* 25; Shrand ch 14.

90 S 427(1) of the Companies Act; Cilliers *ea Corporate Law* par 26.01 478; *Silverman v Doornhoek Mines Ltd* 1935 TPD 349.

91 Cilliers *ea Corporate Law* 478.

Judicial management was introduced into South African law by the Companies Act 46 of 1926, South Africa at the time being one of the first countries to introduce a business rescue regime.[92] Judicial management has not changed very much over the years, although a few amendments have been made as a result of a number of commissions of inquiry. The most important of these amendments was introduced in 1932,[93] and made provision for a moratorium on claims by creditors and introduced the principles of impeachable transactions to apply also to judicial management.[94] Further minor amendments were made in 1939, as a result of the report by the Lansdown Commission,[95] and 1952, following the report of the Millin Commission.[96] When the Van Wyk de Vries Commission[97] was deliberating the consolidation of the Companies Act in the early 1970s, the Masters of the Supreme Court called for the abolition of judicial management due to its low success rate.[98] However, the commission did not recommend the abolition of judicial management and retained it under the new Companies Act of 1973.

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92 Rajak and Henning 262. In the 1960s Australia imported judicial management into their legal system as a business rescue procedure, but used the term "official management" instead of "judicial management". However, as is the case currently in South Africa, official management in Australia was a "remarkable failure" - see Harmer 149. Harmer is of the opinion that the reason for official management's dismal failure as a business rescue regime, is that it requires all the debts of the ailing company to be repaid in full.

93 Companies Act Amendment Act 11 of 1932.

94 Rajak and Henning 265.

95 *Report of the Companies Act Commission* 1935-1936 (UG 45 of 1936) (hereinafter referred to as the Lansdown Commission).

96 *Verslag van die Kommissie van Ondersoek insake die wysiging van die Maatskappywet* (UG 69 of 1948) (hereinafter referred to as the Millin Commission).

97 *Kommissie van Ondersoek na die Maatskappywet* (there were two reports, the main report (*Hoofverslag* RP 45/1970) and a supplementary report with a draft Bill *(Aanvullende Verslag en Konsepwetsontwerp* RP 31/1972) (hereinafter referred to as the Van Wyk de Vries Commission).

98 Par 51.02 147 of the main report; Rajak and Henning 266.

The popularity of modern business rescue regimes worldwide,[99] and the fact that judicial management has not been very successful in South Africa, has of late resulted in a number of commentators calling for a review of South African business rescue procedures.[100] However, at a conference held on 6 October 1999 where three different models for a new business rescue regime were submitted for consideration, the delegates could not reach unanimity on the principles of such a new regime. The result was a rejection of all three models, with a call for proper research on the subject and proposals to be made sometime in the future.

4 2 2 The main problems experienced with judicial management

It is difficult to give a brief exposition of a subject-area as wide as judicial management. Consequently only the most problematic aspects of judicial management will be discussed here. The main problem, it is submitted, lies in the fact that the courts in South Africa see judicial management as an extraordinary procedure, and not as a viable alternative to liquidation.[101] Kloppers submits that this should not be the case and states that there is nothing in the provisions themselves that indicate that this should be so.[102]

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99 It is indisputable that business rescues have become the international buzzword. See Flessner "Philosophies of Business Bankruptcy Law: An International Overview" in Ziegel (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (1994) 20 where he states:

> "Over time, and in all developed economies, the view came to prevail that bankruptcy law should offer not only straight liquidation but also reorganization, including a restructuring of debt and equity, as a solution to insolvency. The American Bankruptcy Act of 1938, with its chapters X and XI, was the first piece of legislation in a capitalist and free-market economy fully to incorporate this idea. Since then it has become commonplace in modern business bankruptcy legislation to provide for alternatives to piecemeal liquidation of insolvent enterprises."

100 See Rajak and Henning 264-265, 287; Rochelle 328, 329; Smits 107; Kloppers "Judicial Management Reform" 371-379. While most authors call for a whole new system of business rescue to be developed, Kloppers in both his articles points out that there is nothing wrong with judicial management - he is of the opinion that the current shortcomings in the system can be rectified by means of a few legislative amendments.

101 Kloppers "Judicial Management Reform" 378; *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* 2001 2 SA 727 (C), [2001] 1 All SA 223 (C).

102 Kloppers "Judicial Management Reform" 378.

In terms of section 427(1) of the Companies Act the granting of a judicial management order by the court rests on various requirements. These requirements are:[103]

(a) If, by reason of mismanagement or any other cause
   (i) the company is unable to pay its debts or is probably unable to meet its commitments; and
   (ii) has not become, or is prevented from becoming, a successful business concern; and

(b) there is a reasonable probability that, if the company is placed under judicial management, it will be in a position to:
   (i) pay its debts or meet its obligations; and
   (ii) become a successful business concern,

then a court may, if it appears just and equitable, grant a judicial management order.

The first part of the requirements relate to the state that a company finds itself in, and must be proved before an applicant will have *locus standi* to obtain a judicial management order. The second part of the requirements relate to what can be achieved by obtaining a judicial management order, and what needs to be proved before the court will grant the order. Even if the above requirements have been met, the court will not grant an order for judicial management if it does not appear to the court that it is just and equitable[104] to do so.

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103 With acknowledgement to Cilliers *ea Corporate Law* 480.

104 According to *De Jager v Karoo Koeldranke & Roomys (Edms) Bpk* 1956 3 SA 594 (C), the court will consider the interests of both the creditors and the shareholders before deciding whether or not it is just and equitable to grant the judicial management order. See also Blackman *Lawsa* (1996) Vol 4.3 460-461 (hereinafter referred to as Blackman). It has been held by our courts on more than one occasion that it is not just and equitable to grant a judicial management order where the parties seek to use the remedy in order to settle internal disputes - see *Makhuva v Lukoto Bus Service (Pty) Ltd* 1987 3 SA 376 (V) and *Ben-Tovim v Ben-Tovim* 2000 3 SA 325 (C).

From our case law and the numerous articles that have been written on the subject of judicial management, it is submitted that the following main problems with judicial management as a viable business rescue regime can be identified:

(a) Judicial management is seen as an extraordinary measure. The courts[105] see judicial management as an extraordinary measure due to the fact that a creditor of a company that is unable to pay its debts is entitled to make use of liquidation in order to recover payment of his or her claims.[106]

(b) The requirement that there must be a "reasonable probability" that the company will become a successful concern.[107] There has been some debate as to whether this test is the same at the time the provisional and final orders are considered, or whether the test should be more stringent upon the return date of the order: in other words, should the test be more stringent once the provisional judicial manager has had time to investigate the affairs

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105 See eg *Silverman v Doornhoek Mines Ltd* 1935 TPD 349 at 353; *Sammel v President Brand Gold Mining Co Ltd* 1969 3 SA 629 (A) at 663 and *Tenowitz v Tenny Investments (Pty) Ltd* 1979 2 SA 680 (E) at 683. This conservative approach of the courts was recently criticised in *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* 2001 2 SA 727 (C), [2001] 1 All SA 223 (C). Before the introduction of voluntary administration, Australia too experienced a conservatism by the courts regarding business rescue. The Harmer Report Vol 1 stated it thus at par 52:

> "The Commission is also concerned that ... the legislative approach to corporate insolvency in Australia is most conservative. There is very little emphasis upon or encouragement of a constructive approach to corporate insolvency by ... focussing on the possibility of saving a business (as distinct from the company itself) and preserving employment prospects."

106 This right of creditors was described in *Tenowitz v Tenny Investments (Pty) Ltd* 1979 2 SA 680 (E) at 683 as a right *ex debito justitiae* to liquidate the company.

107 See Kloppers "Judicial Management Reform" 362-363. This requirement is in my opinion also one of the reasons why judicial management cannot be successfully implemented in South Africa, and has been criticised as being outdated and unrealistic (Rajak and Henning 267 and Smits 82-84). It is submitted that the burden of proof is too onerous, and that the test should rather be one of a "reasonable possibility". This aspect is discussed in par 4.2.3 below.

of the company and report back to the court.[108] In *Tenowitz v Tenny Investments (Pty) Ltd*[109] the court found that something more than a "reasonable probability" is required before the court can grant a final judicial management order. However, from cases such as *Ex parte Onus (Edms) Bpk: Du Plooy v Onus (Edms) Bpk*,[110] *Kotzé v Tulryk Bpk*[111] and *Ladybrand Hotel (Pty) Ltd v Segal*[112] it is evident that the courts felt that the test upon the granting of a final order should be the same as in the case of a provisional order. This latter view is supported by Kloppers[113] and Meskin,[114] although Olver[115] is of the opinion that a stricter test should be employed.[116]

(c) Reliance on court proceedings.[117] Kloppers is of the opinion that this is one of the most important drawbacks of the current judicial management system, stating that the costs of running a judicial management is hardly a financially sound one. The costs incurred in

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108 See *Tenowitz v Tenny Investments (Pty) Ltd* 1979 2 SA 680 (E) at 683; Henochsberg 926; Blackman 459; Cilliers *ea Corporate Law* 481where it is stated that upon the return day the court will be in a better position to assess whether or not the company has a chance of becoming a successful concern.

109 1979 2 SA 680 (E).

110 1980 4 SA 63 (O).

111 1977 3 SA 118 (T).

112 1975 2 SA 357 (O).

113 Kloppers "Judicial Management Reform" 363.

114 Henochsberg 926.

115 Olver Thesis, with reference to an unreported decision in ann IV, sc *In re Olver: Intafine Leasing & Finance (Pty) Ltd*, case no M1830/76 (C), judgment delivered on 16 Feb 1977.

116 Kloppers "Judicial Management Reform" 363 is of the opinion that since Cilliers *ea Corporate Law* do not refer to the *Ex parte Onus* decision, their view will not carry much weight in future. This statement by Kloppers is incorrect as Cillers *ea Corporate Law* does in fact refer to *Ex parte Onus* in fn 12 at 481. Kloppers also points out that Olver wrote his thesis before *Ex parte Onus*, and might have come to a different conclusion had he had the benefit of the decision. Although the court in *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* 2001 2 SA 727 (C), [2001] 1 All SA 223 (C) referred to this difference in opinion, it did not express its views thereon.

117 See Kloppers "Judicial Management Reform" 371.

running the process are so high that it does not make the process attractive for the creditors, as all the available funds are spent on the process itself.[118]

(d) The insolvency requirement.[119] Section 427(1)(a) of the Companies Act contains a strict requirement that the company must be unable to pay its debts before a judicial management order may be granted. Kloppers is of the opinion that insolvency or pending insolvency should not be a requirement as it not only acts as a bar for its more general use, but it also defeats the object of the exercise, namely staving off insolvency and making the company profitable again.[120] He submits further that the earlier a company enters judicial management for assistance, the better chance there is that it will be successful.[121]

(e) The use of liquidators as judicial managers.[122] Olver states that it is ludicrous to appoint liquidators as judicial managers, as they have been trained to liquidate companies and not save them.[123] Besides the conflict of interests that liquidators might often have in such a case, the structure of the fees is also seen by Olver as a problem.[124] Rajak and Henning[125]

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118 Rajak and Henning 268 are of the opinion that this factor makes judicial management unsuitable for small to medium business enterprises, as the process is unaffordable. See also Kloppers "Judicial Management Reform" 425.

119 See generally Kloppers "Judicial Management Reform" 375-377.

120 Kloppers "Judicial Management Reform" 375-377.

121 Kloppers "Judicial Management Reform" 375-377.

122 See generally Olver 84.

123 Olver 87.

124 Olver 84.

125 Rajak and Henning 282-285.

share the view that the wrong people are being used as judicial managers and suggest that a panel of retired or semi-retired businesspeople should be employed in order to oversee the rescue procedure, whatever form it takes.

(f) The fact that judicial management procedures only apply to companies. Currently the provisions relating to judicial management only apply to companies, and not to close corporations, partnerships or business trusts. Some doubt has been expressed by our courts as to whether or not the provisions relating to judicial management should be applied to small companies, for example private companies with only a few members.[126] However, in *Tobacco Auctions Ltd v AW Hamilton (Pvt) Ltd*[127] the court stated that there is no reason why the provisions cannot be held to apply also to small companies. The court further stated that one should not look at the size of the company, but rather at the extent and scope of its business activities, its assets and liabilities and the nature of its difficulties.[128]

While the above exposition does not cover all the aspects relating to judicial management, it does shed some light on the problems that make judicial management an unattractive option as an effective business rescue regime. These problems will serve as a point of departure for proposals that will be made in paragraph 4.4 for the retention of and inclusion under a unified Insolvency Act, of judicial management as an interim[129] business rescue mechanism.

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126 See eg *Rustomjee v Rustomjee (Pty) Ltd* 1960 2 SA 753 (D) at 758 where the court stated that it is doubtful whether judicial management proceedings are appropriate to small private companies.

127 1966 2 SA 451 (R) at 453.

128 At 453. It is submitted that what the court was saying, is that one should look to see whether it would be just and equitable to place the company under judicial management. This is a separate requirement under judicial management and has already been discussed above.

129 The word "interim" is used here because South Africa needs to address its lack of a proper business rescue regime. As stated above, delegates at a technical conference held on a unified Insolvency Act on 6 Oct 1999 rejected all three proposals for a new business rescue regime. No unanimity could be obtained even in regard to the principles that such a regime should subscribe to. For this reason it was decided that business rescue should be properly researched and a viable regime found for application in the South African context. Until such time as a proper regime can be formulated, it is submitted that judicial

4 2 3 Proposals regarding judicial management

The preceding discussion of the problems experienced with judicial management as a business rescue regime shows that South Africa is in dire need of a revised system that can effectively regulate this important aspect of insolvency law. The conservative approach of the courts and the unrealistic requirements that are laid down by especially section 427 of the Companies Act, have not allowed judicial management to develop as an effective means of saving financially distressed companies in South Africa.[130] Kloppers is of the opinion that judicial management does not need to be scrapped, but merely modernised by means of a few legislative amendments.[131] However, considering the considerable volume of case law restricting the use of judicial management in practice and the negative connotation[132] that can be attached to it, it may be more sensible to introduce an entirely revised form of business rescue into South Africa, a system that can be devised specifically with the South African economy and labour dispensation[133] in mind.

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management must be retained as the only viable alternative, together with s 311 compromises in terms of the Companies Act. One of the main purposes of including the judicial management provisions in a unified Insolvency Act, is to reserve a place for a new business rescue regime in such a unified statute. Once a new business rescue regime has been formulated and accepted, it can be imported into the unified Insolvency Act and the judicial management provisions can be repealed.

130 Harmer 149 is of the opinion that judicial management (or official management as it was known in Australia) does not work because it is used in a conservative creditor-friendly environment, and secondly because it requires the company's debts to be paid in full.

131 Kloppers "Judicial Management Reform" 378-379 actually makes proposals for the amendment of judicial management.

132 See Cilliers *ea Corporate Law* par 26.03 480 who state that the disadvantage of judicial management is that it affects the creditworthiness of the company, even if the order is later set aside. This negative connotation is not something that can be remedied by legislative amendments, but requires a change of attitude by all the stakeholders, a view shared by Kloppers "Judicial Management Reform" 377-378.

133 The impact of labour law on insolvency law cannot be underestimated. It is submitted that in light of s 197 of the Labour Relations Act 66 of 1995 (which makes provision of the employment contracts of employees to be taken over by the purchaser of a business, whether such business has been taken over as a going concern or sold piecemeal), and decisions such as *National Union of Leather Workers v Barnard and Perry* 2001 4 SA 1261 (LAC) , any new business rescue regime will have to be developed in conjunction and co-operation with the labour sector of the South African economy. For a discussion of the *National Union of Leather Workers* case, see ch 5 above and ch 11 below.

Consequently, judicial management has been included in the unified Insolvency Act, reflected in Annexure E to this thesis, in the form of Chapter 24, clauses 121 to 135. In addition to including these provisions in a unified Insolvency Act, it is submitted that two of the problems enumerated above regarding judicial management, can in fact be addressed even at this early stage. The two amendments relate to the strict test of "reasonable probability" and the entities to whom judicial management applies. Consequently, it is proposed that clause 121(1) - currently section 427(1) of the Companies Act - should be drafted to read as follows:

> "**121. Circumstances in which certain debtors may be placed under judicial management.** - (1) When a company debtor, close corporation debtor, trust debtor or association debtor by reason of mismanagement or for any other cause-
>
> (a) is unable to pay its debts or is probably unable to meet its obligations; and
>
> (b) has not become or is prevented from becoming a successful concern, and there is a reasonable possibility that, if it is placed under judicial management, it will be enabled to pay its debts or to meet its obligations and become a successful concern, the Court may, if it appears just and equitable, grant a judicial management order in respect of that debtor."

In terms of this revised clause judicial management will no longer only apply to companies, but also to close corporations, trusts and other associations that can be resurrected by the use of the relevant provisions. In paragraph (b) the current requirement of "reasonable probability" has been replaced by "reasonable possibility". It is submitted that these two minor changes will go a long way towards making judicial management a more attractive option for distressed businesses, and may even contribute towards removing the conservative approach taken by the courts up to now. However, these minor changes will not be sufficient to rectify the many problems associated with judicial management, and there is an urgent need for a complete overhaul of South African business rescue mechanisms.

4 3 Compromises in terms of section 311 of the Companies Act[134]

4 3 1 Introduction

A variety of circumstances may make it desirable for a company to reorganise its capital structure by, for example, reducing or increasing it according to its needs.[135] It is in meeting these needs that one speaks of the "reorganisation" of a company. According to Cilliers *et al*[136] the procedures that are provided for within the framework of the Companies Act in order to effect a reorganisation "range from resolutions for alteration of share capital, including increases, reductions and other changes of capital, and for variation of shareholder rights, to arrangements and compromises".

Since the purpose of this study is to propose a unified Insolvency Act that also contains mechanisms for the implementation of a successful business rescue plan, this part of the chapter will concentrate on compromises and arrangements in terms of section 311 of the Companies Act as a business rescue mechanism.

4 3 2 Proposals regarding compromises

It is submitted that the current provisions of section 311 of the Companies Act, in so far as they relate to a compromise between a company and its creditors, should be included as a separate provision under a unified Insolvency Act. The existing provisions of section 311 relating to an arrangement between a company and its members can then be retained in the Companies Act. This proposal would not appear to cause a great deal of confusion or difficulty, and even the large

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134 See generally Cilliers *ea Corporate Law* ch 25; Henochsberg 601-637.

135 Cilliers *ea Corporate Law* 449.

136 Cilliers *ea Corporate Law* 449.

body of case law regarding section 311 compromises and arrangements would not appear to be affected thereby as there is a clear distinction between a compromise and an arrangement.[137]

Considering that section 66 of the Close Corporations Act currently specifically excludes the possibility of section 311 compromises applying to close corporations,[138] the question that needs to be asked is whether or not this limitation is justified. In fact, the question can be asked as to whether there ought to be a limitation on its use in regard to any form of business enterprise. The mere fact that a close corporation, for example, has been incorporated under the provisions of the more informal provisions of the Close Corporations Act, does not necessarily mean that the business that is operated is not a complex or large undertaking. Conversely, just because a small private company has been incorporated under the more complex provisions of the Companies Act, does not mean that the undertaking is a large or complex one. In reality the question that needs to be asked is whether the provisions of section 311 of the Companies Act need to be reserved for use by companies only. Should other forms of business enterprise such as the close corporation, partnership, business trust and other associations of persons not also be in a position to use the mechanisms provided for by section 311 of the Companies Act?

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137 It is submitted that it would perhaps have been preferable to omit s 311 compromises from a unified Insolvency Act altogether, since there are other statutory forms of composition (see par 2 above) that could be utilised instead. In practice s 311 compromises are mainly used in order to obtain an assessed loss under s 20(1)(a)(i) of the Income Tax Act 58 of 1962, or where members of a company wish to retain ownership of the business, so the scope of application of these "rescue provisions" is very limited. However, considering the large volume of case law on the subject, and the fact that they are indeed used in practice, it has been decided to retain the provisions under a unified Insolvency Act. Although the mechanics and procedures of s 311 compromises will not be discussed here, see *Ex parte Kaplan: In re Robin Consolidated Industries Ltd* 1987 3 SA 413 (W) where these procedures are conveniently set out by the court.

138 Due to the uncertainty that prevailed in this regard (see De la Rey "Beslote Korporasies. Probleme in verband met Likwidasie en Akkoord" 1990 3 *Tran CBL* 107; Henning "Akkoord, Skikking en Reëling en die Beslote Korporasie in Likwidasie" 1987 2 *JJS* 218; Henning and Bonnet "Likwidasie van Beslote Korporasies en Reëlingskemas ingevolge Artikels 311 en 389 van die Maatskappywet" 1991 *THRHR* 274; Henning "Judicial Management and Corporate Rescues in South Africa" 1992 1 *JJS* 90), the Close Corporations Act was amended in 1997 to exclude the possibility of s 311 compromises and arrangements applying also to close corporations - see Cilliers *ea Corporate Law* 681. See also Fourie *'n Kritiese Evaluering van Enkele Probleme Rondom die Likwidasie van Beslote Korporasies* (unpublished LLM dissertation, University of Pretoria, 1991) 48-61.

In addition to this, the question that has already been asked, and addressed, in par 2 above, is why pre- and post-liquidation compositions cannot be utilised by companies as well. It is quite conceivable that a small private company may want to make use of the relatively simple and informal procedures relating to compositions. On the other hand, it is also conceivable that a close corporation with a large and complex business may wish to make use of the more complex and expensive procedure set out in section 311 of the Companies Act. Consequently it is proposed that:

(a) The provisions dealing with compromises in section 311 of the Companies Act be removed from that Act and inserted into a unified Insolvency Act;

(b) The provisions relating to an arrangement between a company and its members be retained in the Companies Act;

(c) The provisions dealing with compromises in a unified Insolvency Act be made applicable to all debtors.

To this end the provisions of sections 311, 312 and 313 have been reproduced and inserted into the unified Insolvency Act that appears in Annexure E to this thesis. These provisions have been included under clauses 120, 120A and 120B of the unified Insolvency Act, and read as follows:

> "**120. Compromise between a debtor and its creditors.** - (1) Where any compromise is proposed between a debtor, as defined in sub-section (8), and its creditors or any class of them, the court may, on the application of the debtor or any creditor or member of the debtor or, in the case of a debtor being liquidated, of the liquidator, or if the debtor is subject to a judicial management, of the judicial manager, order a meeting of the creditors or class of creditors, to be summoned in such manner as the court may direct.

(2) If the compromise is agreed to by a majority in number representing three-fourths in value of the creditors or class of creditors present and voting either in person or by proxy at the meeting, such compromise shall, if sanctioned by the court, be binding on all the creditors or the class of creditors, and also on the debtor or on the liquidator if the debtor is being liquidated or on the judicial manager if the debtor is subject to a judicial management order.

(3) No such compromise shall effect the liability of any person who is a surety for the debtor.

(4) If the compromise is in respect of a debtor being liquidated and provides for the discharge of the liquidation order or for the dissolution, where applicable, of the debtor without liquidation, the liquidator of the debtor shall lodge with the Master a report in terms of section 42[139] and a report as to whether or not any person who forms part of the management of the debtor is or appears to be personally liable for damages or compensation to the debtor or for any debts or liabilities of the debtor under any provision of this Act, and the Master shall report thereon to the Court.

(5) The Court, in determining whether the compromise should be sanctioned or not, shall have regard to the number of creditors or creditors of a class present or represented at the meeting referred to in subsection (2) voting in favour of the compromise and to the report of the Master referred to in subsection (4).

(6) (a) An order by the Court sanctioning a compromise shall have no effect until a certified copy thereof has been lodged with the Registrar under cover of the prescribed form and registered by him.

(b) A copy of such order of court shall be annexed to every copy of the memorandum or similar document, if applicable, of the debtor issued after the date of the order.

(7) If a debtor fails to comply with the provisions of subsection (6)(b), the debtor and every person who forms part of the management of such debtor who is a party to the failure, shall be guilty of an offence.

(8) For the purposes of this section, a "debtor" means an association of persons that has been accorded legal personality in terms of the common law or in terms of a statutory provision.

120A. Information as to compromises. - (1) Where a meeting of creditors or any class of creditors or of members or any class of members is summoned under section 120 for the purpose of agreeing to a compromise, there shall -

(a) with every notice summoning the meeting which is sent to a creditor or member, be sent also a statement -

(i) explaining the effect of and alternatives to the compromise; and

(ii) in particular stating any material interests of the management of the debtor, whether as directors or as members or as creditors of the debtor or otherwise, and the effect thereon of the compromise, in so far as it is different from the effect on the like interests of other persons; and

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139 This report is currently lodged with the Master in terms of s 400(2) of the Companies Act. Since a unified Insolvency Act makes provision for all debtors to be liquidated under the same Act, this report is now provided for in cl 42 of the unified Act (see ann E).

(b) in every notice summoning the meeting which is given by advertisement, be included either such a statement as aforesaid or a notification of the place at which and the manner in which creditors or members entitled to attend the meeting may obtain copies of such a statement.

(2) Where the compromise affects the rights of debenture-holders of a company, the said statement shall give the like explanation and statement as respects the trustee of any deed for securing the issue of the debentures as it is required to give as respects the company's directors.

(3) Where a notice given by advertisement includes a notification that copies of the said statement can be obtained by creditors or members entitled to attend the meeting, every such creditor or member shall, on making application in the manner indicated by the notice, be furnished by the debtor free of charge with a copy of the statement.

(4) Where a debtor makes default in complying with any requirement of this section, the debtor and every person who is part of the management of the debtor who is a party to the default, shall be guilty of an offence, and for the purpose of this subsection any liquidator of the debtor and any trustee of a deed for securing the issue of debentures of a company shall be deemed to be an officer of the debtor: Provided that a person shall not be liable under this subsection if he shows that the default was due to the refusal of any other person, being a director or trustee for debenture-holders, to supply the necessary particulars as to his interests and that fact has been stated in the statement.

(5) It shall be the duty of every person who forms part of the management of a debtor and of every trustee for debenture-holders, where applicable, to give notice to the debtor of such matters relating to himself as may be necessary for the purposes of this section, and if he makes default in complying with such duty, he shall be guilty of an offence.

120B. Provisions facilitating reconstruction or amalgamation. (1) If an application is made to the Court under this section for the sanctioning of a compromise proposed between a company and any such persons as are referred to in this section, and it is shown to the Court that the compromise or arrangement has been proposed for the purposes of or in connection with a scheme for the reconstruction of any company or companies or the amalgamation of any two or more companies, and that under the scheme the whole or any part of the undertaking or the property of any company concerned in the scheme (in this section referred to as the "transferor company") is to be transferred to another company (in this section referred to as the "transferee company") the Court may, either by the order sanctioning the compromise or by any subsequent order, make provision for all or any of the following matters:

(a) The transfer to the transferee company of the whole or any part of the undertaking and of the property or liabilities of any transferor company;

(b) the allotment or appropriation by the transferee company of any shares, debentures or other like interests in that company which under the compromise are to be allotted or appropriated by that company to or for any person;

(c) the continuation by or against the transferee company of any legal proceedings pending by or against any transferor company;

(d) the dissolution, without liquidation, of any transferor company;

(e) the provision to be made for any persons who, within such time and in such manner as the Court may direct, dissent from the compromise;

(f) such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation shall be fully and effectively carried out:

> Provided that no order for the dissolution, without liquidation, of any transferor company shall be made under this subsection prior to the transfer in due form of all the property and liabilities of the said company.
>
> (2) Where an order under this section provides for the transfer of property or liabilities, that property shall by virtue of the order vest in, subject to transfer in due form, and those liabilities shall become the liabilities of, the transferee company.
>
> (3) If an order is made under this section, every company in relation to which the order is made shall, within thirty days after the making of the order, cause a copy thereof to be lodged with the Registrar, under cover of the prescribed form, for registration, and if default is made in complying with this subsection, the company shall be guilty of an offence.
>
> (4) In this section the expression "property" includes property, rights and powers of every description, and the expression "liabilities" includes duties.
>
> (5) The expression "company" in this section does not include any company other than a company within the meaning of the Companies Act 61 of 1973."

The effect of these provisions, and the provisions of pre- and post-liquidation compositions that have been discussed in paragraph 2 above, is that a debtor now has a number of alternatives when considering the best manner in which to attempt a settlement of some kind with his, her or its creditors. Depending on what the person invoking the provisions wishes to achieve, a compromise or pre- or post-liquidation composition can be entered into with the creditors of the estate in question.

5 PERSONAL LIABILITY OF DIRECTORS OF COMPANIES AND MEMBERS OF CLOSE CORPORATIONS[140]

5 1 Introduction

While the use of a company or close corporation as a vehicle for conducting business has its attraction in the form of limited liability, this attractiveness is offset to an extent by the balance that the law attempts to strike between encouraging business operations and providing protection to creditors.[141] The attractiveness of the use of a company or close corporation for business operations lies in the fact that the company or corporation is a separate legal entity, with its own assets, liabilities, rights and duties. It acquires legal personality upon its incorporation and exists apart from its members.[142] Should the business fail, the individual estates of the members will not be affected thereby; the company or corporation will be liquidated and the losses incurred will be incurred by the company or corporation only.[143] While the principle of limited liability is necessary to encourage the spirit of entrepreneurship in business ventures, the other side of the coin is that

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140 The discussion of the personal liability of directors in terms of company law is largely based on a paper by Lombard entitled "Directors' Liability from a South African Perspective" presented at the Academics' Meeting of the INSOL Sixth World Congress held in London on 17 and 18 July 2001 (hereinafter referred to as Lombard). Generally, see also De Koker *Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappyereg* (LLD thesis 1996 UOFS) (hereinafetr referred to as De Koker Thesis); Cilliers *ea Corporate Law* 160-163; Henochsberg 911-920. See also Luiz and Van der Linde "Trading in Insolvent Circumstances - Its Relevance to Sections 311 and 424 of the Companies Act" 1993 *SA Merc LJ* 230.

141 Lombard 1.

142 This principle became entrenched in our law via the important English case of *Salomon v Salomon & Co Ltd* [1897] AC 22. That this principle has become entrenched in our law is evident from *Dadoo v Krugersdorp Municipal Council* 1920 AD 530; *Gumede v Bandhla Vukani Bakithi Ltd* 1950 4 SA 560 (N); *Lategan v Boyes* 1980 4 SA 191 (T) and *J Louw & Co (Pty) Ltd v Richter* 1987 2 SA 237 (N).

143 Of course the members of the company may also suffer loss in that the contributions they have made towards the business may be lost, but their personal estates will, eg, not be sequestrated because of the failure of the company or corporation (however, if the members have bound themselves as surety for the debts of the company or corporation, they may suffer further losses).

the principle of protecting creditors has also become entrenched in our law.[144] One of the provisions that was introduced into company law, and which is aimed at the protection of creditors, is the principle that the persons who conduct the business must do so in an honest and responsible manner, and not fraudulently or recklessly. This principle is entrenched in company law in the form of section 424 of the Companies Act. Similar principles have been designed to protect creditors who have dealings with close corporations.[145]

Ultimately this portion of the study is intended to determine whether a modified version of section 424 of the Companies Act should be included under a unified Insolvency Act, and also whether or not a provision relating to insolvent trading should be introduced.[146] In regard to close corporations the question is whether or not the current provisions contained in the Close Corporations Act should be included in a unified Insolvency Act, or whether they should remain where they are.

Another aspect that will affect the personal liability of directors and others, and which is not dealt with in detail here, is the possibility of making use of other remedies in order to bring delinquent businesspeople to book, the first traces of which have already made their presence felt. For example, in *McLelland v Hulett*[147] it was held that the shareholders may sue the directors, after

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144 See Lombard 1 for some examples of the protection that is afforded to creditors who conduct business with companies.

145 See eg ss 63, 64 and 65 of the Close Corporations Act.

146 In the *King Report on Corporate Governance for South Africa 2002* (King Committee on Corporate Governance, Main Report, March 2002) (hereinafter referred to as the King Report) s 424 of the Companies Act is cited in ch 2 par 2 143-144 as one of the examples of provisions contained in the Companies Act that seeks to hold directors accountable. However, with reference to the Nel Commission 127-131 (*The First Report of the Commission of Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa*) it is stated that "[u]nfortunately, [section 424] has been criticised for being both difficult and expensive to implement". In par 6 of the Executive Summary of the King Report it is stated that s 424 "is a very effective sanction for the punishment of delinquent directors and officers", but that "[c]onsideration should be given to the means by which section 424 can be more effectively implemented".

147 1992 1 SA 456 (D).

the dissolution of the company, for an omission that caused them pure economic loss.[148] The question as to whether the directors may be held personally liable in consequence of a class action by those that have suffered a loss, is a question that is about to become more pertinent in South African law. The King Report refers to this possibility as one which will make litigation against delinquent directors a financially viable one for litigants, and recommends that rules should be introduced to regulate this new form of civil litigation in South Africa.[149] The Constitution of the Republic of South Africa[150] makes provision for class actions,[151] although it would appear that at this time no rules have been formulated that regulate them.[152] The lack of properly formulated rules has not prevented class actions from being brought, however, as is evident from the decision in *Ngxuza v Permanent Secretary, Department of Welfare, Eastern Cape*.[153] In this decision the High Court allowed a class action to be instituted by a group of persons relating to the payment of pensions. Although the decision was appealed against, the Supreme Court of Appeal[154] confirmed the decision of the court *a quo*, allowing the class action to continue. It is quite conceivable that creditors may in future consider a class action against the directors and other officers of a company as a viable alternative to, or a remedy in addition to, liquidation.

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148 This decision was brought as a delictual action, and the decision was one based on policy considerations - see Cilliers *ea Corporate Law* 163 par 10.64.

149 King Report (Main Report) 145-146 par 5.

150 Act 108 of 1996 (hereinafter referred to as the Constitution).

151 See eg ss 38(c), 39(1)(a) and 39(2) of the Constitution.

152 In this regard see the recommendations in the King Report (Main Report) 146 par 5.4.

153 2001 2 SA 609 (E).

154 In *Permanent Secretary, Department of Welfare, Eastern Cape v Ngxuza* 2001 4 SA 1184 (SCA). *Inter alia* the decision was appealed against on the grounds of jurisdiction. The appellants contended that due to the fact that members of the class action fell outside the jurisdiction of the High Court in the Eastern Cape, the class action had to fail. The Supreme Court of Appeal rejected this contention and confirmed the decision of the court *a quo*.

5 2 Proposals for personal liability under a unified Insolvency Act

Although it is not the purpose of this chapter to discuss personal liability in any detail, it is necessary to arrive at some or other conclusion regarding the placement of the provisions relating to personal liability in so far as it plays a role in the liquidation of companies and close corporations in a unified Insolvency Act. For this reason the proposed clauses that deal with personal liability and which, it is submitted, should be inserted into a unified insolvency statute, are reflected below. Each insertion is accompanied by a brief explanation.

5 2 1 Fraudulent trading and insolvent trading provisions

At a symposium on corporate insolvency law reform held on 23 October 1998, De Koker[155] made various proposals in regard to the reform that should take place regarding personal liability. In sum his proposals amount to the following:

(a) The retention of a criminal fraudulent trading provision in the Companies Act,[156] without reference to personal liability for fraudulent trading, which he feels should be included in the unified Insolvency Act;

(b) The excision of reckless trading from the personal liability provisions. Instead of the reckless trading provision, De Koker would rather see the introduction of a new provision that provides for personal liability in respect of insolvent trading.

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155 De Koker "Personal Liability and Disqualification - Sanctioning Insolvent Trading by Companies" 2 (hereinafter referred to as De Koker "Personal Liability and Disqualification"). This unpublished paper was delivered at a symposium on corporate insolvency law reform held in Pretoria on 23 Oct 1998. De Koker points out in his paper that the amplification of the fraudulent trading provision was introduced as a result of a proposal made by the Jenkins Commission (*Report of the Company Law Committee* (Cmnd 1749 of 1962)), a proposal that was never introduced in England.

156 This is also the position in England where s 458 of the Companies Act 1985 embodies a provision of general application which is not confined to situations where the company concerned is in liquidation.. See also Fletcher 657.

In regard to an insolvent trading provision, De Koker states that "[i]nternationally it is a generally accepted principle that directors should have the permission of the creditors or of the court if they want to allow their company to continue incurring debts when the company is commercially insolvent and there is no reasonable prospect of the debts being repaid". In addition to giving a helpful rendition of insolvent trading provisions internationally, De Koker included proposals for new provisions relating to personal liability in his paper. To a large extent the proposals included here are based on the proposals made by De Koker.

Consequently it is proposed that the following two clauses should be included under a unified Insolvency Act (clause 114 deals with the fraudulent or reckless conduct of a business and clause 115 is the insolvency trading provision proposed by De Koker):

> "**114. Liability for fraudulent or reckless conduct of business.** (1) When a debtor[157] is liquidated in terms of the provisions of this Act, or is placed under judicial management in terms of Chapter 24 of this Act, and it appears that any business of the debtor was or is being carried on recklessly or with intent to defraud creditors of the debtor or creditors of any other person or for any fraudulent purpose, the court may, on the application of the Master, the liquidator, the judicial manager, any creditor or member or contributory of the debtor, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be responsible, without any limitation of liability, for all or any of the debts or other liabilities of the debtor as the court may direct.
>
> (2) The provisions of this section shall have effect notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is made.
>
> **115. Insolvent trading.** (1) If a debtor is liquidated in terms of the provisions of this Act, or is placed under judicial management in terms of the provisions of Chapter 24 of this Act, the court may, upon application, declare that any person responsible for the management of the debtor who caused or allowed the debtor to incur a debt at a time when he or she knew or had reasonable grounds to suspect that the debtor would not be able to pay such debt as well as its other debts as they fell due, shall be liable to pay such amount as awarded under this section.
>
> (a) For the purposes of this section the facts which a person referred to in subsection (1) ought to know or ascertain, the conclusions which he or she ought to reach and the steps which he or she ought to take

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157 "Debtor" will include, eg, a close corporation. The reckless and fraudulent trading provision contained in s 64 of the Close Corporations Act closely resembles s 424 of the Companies Act, and for this reason there should be no problem making the provision applicable also to close corporations. See eg Cilliers *ea Corporate Law* 641; De Koker Thesis 152-264; *TJ Jonck BK t/a Bothaville Vleismark v Du Plessis* 1998 1 SA 971 (O).

are those which would be known or ascertained or reached or taken by a reasonable diligent person having both-

(i) the general knowledge, skill and experience that may reasonably be expected of a person carrying out similar functions as are entrusted to and carried out by that person in relation to the debtor; and
(ii) the general knowledge, skill and experience that such person has.

(b) Proof that-
(i) the liabilities (including prospective and contingent liabilities) of the debtor exceeded its assets, fairly valued, when the debt was incurred; or
(ii) that the particular person committed an offence in respect of the accounting records of the debtor in respect of the period during which the debt was incurred; or
(iii) that the particular person failed to take all reasonable steps to ensure that the accounting records in respect of the period during which the debt was incurred are surrendered or transferred to the liquidator,

shall be prima facie evidence that the particular person, at the time the debt was incurred, had reasonable grounds to believe that the debtor would not be able to pay its debts as they fell due.

(2) Without prejudice to the defences which may be raised against an application under this section, a person, if he or she establishes one or more of the following defences, will not be held liable in terms of subsection (1) where, at the time the debt was incurred-

(a) he or she had no knowledge of the transaction and could not reasonably be expected to have had knowledge of such a transaction; or
(b) he or she believed that the debtor would be able to repay the debt because a competent and reliable person was responsible for monitoring the solvency of the debtor and for reporting to him or her and was fulfilling that responsibility satisfactorily; or
(c) he or she did not take part in the management of the debtor on account of illness or for some other good reason; or
(d) he or she took all reasonable steps to prevent the debtor from incurring such debt; or
(e) he or she took all reasonable steps to ensure that the creditor is informed that the debtor had reasonable grounds to believe that it would not be able to repay that debt when it fell due.

(3) The court shall determine the amount payable with reference to the loss that was or will be suffered by the creditors on account of the insolvent trading and-

(a) the amount so determined will be payable to the applicant or applicants for distribution among the creditors represented in the

application, or for distribution in such a way as the court may be requested to order, and the court may make any such order as it deems just and equitable in the circumstances;

(b) in determining the amount and its fair distribution among the creditors, the court shall have regard to the extent to which a particular creditor negligently or intentionally contributed to his or own loss.

(4) The provisions of this section shall apply notwithstanding that the person or persons concerned may be criminally liable in respect of the matters on which the declaration by the court is based."

5 2 2 Personal liability provisions relating to close corporations only

The liability of members and other persons for the debts of a close corporation are contained in various provisions of the Close Corporations Act. Some of these provisions, such as section 63, make the members liable for certain specific contraventions of the provisions of the Close Corporations Act, and will not be discussed here.[158]

Section 64 of the Close Corporations Act provides for the personal liability of the members in cases where there has been reckless or fraudulent trading. The provision is very similar to the personal liability of directors under section 424 of the Companies Act,[159] although section 64 of the Close Corporations Act provides for liability in the case of grossly negligent trading and not recklessness as in the case of section 424 of the Companies Act. Cilliers *et al*[160] correctly point out that the difference is not material, as the Supreme Court of Appeal[161] has already held that "recklessness" under section 424 amounts to gross negligence. Because the provisions of section 64 of the Close Corporations Act and section 424 of the Companies Act are so similar, it is submitted that separate provisions for reckless and fraudulent trading are not required for close

158 Although not dealt with here, it is worth mentioning that a contravention of these provisions also results in civil liability. In such a case the members are held jointly and severally liable with the corporation for specified debts - see Cilliers *ea Corporate Law* 638-641.

159 Cilliers *ea Corporate Law* 641.

160 Cilliers *ea Corporate Law* 641.

161 In *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* 1998 2 SA 138 (SCA) at 143C-F.

corporations under a unified Insolvency Act.[162] Consequently it has already been proposed that clause 114 of the proposed unified Insolvency Act should also be made applicable to close corporations.[163]

In addition to the provisions relating to personal liability by members as set out above, the Close Corporations Act also provides for repayments that may need to be made by the members of a close corporation within a specific period before liquidation.[164] These provisions are contained in sections 70 and 71 of the Close Corporations Act, and it is submitted that these two sections should be included in a unified Insolvency Act. This can be justified by the fact that the provisions are already contained in the winding-up provisions of the Close Corporations Act.

Consequently the following proposals are made regarding the personal liability of members of close corporations:

(a) In regard to reckless and fraudulent trading, it is proposed that clause 114 will also apply to close corporations.[165]

(b) As regards the personal liability of members currently regulated in terms of section 63 of the Close Corporations Act, it is proposed that these provisions remain in the Close Corporations Act.

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162 Cilliers *ea Corporate Law* 641 state: "[Section 424 of the Companies Act and section 64 of the Close Corporations Act] have the same ambit. Consequently the case law in respect of section 424 is instructive and can serve as authority in respect of the analysis of section 64." See also De Koker Thesis 152-264 and *TJ Jonck BK t/a Bothaville Vleismark v Du Plessis* 1998 1 SA 971 (O).

163 See par 5.2.1 above.

164 See Cilliers *ea Corporate Law* 679-681.

165 See par 5.2.1 above.

(c) As regards the provisions relating to repayments by members in specified circumstances, currently regulated by sections 70 and 71 of the Close Corporations Act, it is proposed that these provisions should be included under a unified Insolvency Act as clauses 116 and 117. For the sake of completeness the relevant clauses are reflected below:

"**116. Repayments by members of close corporations.** (1) Where a close corporation debtor is being liquidated in terms of this Act, any payment made to a member by reason only of his membership within a period of two years before the commencement of the liquidation of the corporation, shall be repaid to the corporation by the member, unless such member can prove that

(a) after such payment was made, the corporation's assets, fairly valued, exceeded all its liabilities; and

(b) such payment was made while the corporation was able to pay its debts as they became due in the ordinary course of its business; and

(c) such payment, in the particular circumstances, did not in fact render the corporation unable to pay its debts as they became due in the ordinary course of business.

(2) A person who has ceased to be a member of the corporation concerned within the said period of two years, shall also be liable for any repayment provided for in subsection (1) if, and to the extent that, repayments by present members, together with all other available assets, are insufficient for paying all the debts of the corporation.

(3) A certificate given by the Master as to the amount payable by any member or former member in terms of subsection (1) or (2) to the corporation, may be forwarded by the liquidator to the clerk of the magistrate's court in whose area of jurisdiction the registered office of the corporation is situated, who shall record it, and thereupon such notice shall have the effect of a civil judgment of that magistrate's court against the member or former member concerned.

(4) The court in question may, on application by a member or former member referred to in subsection (2), make any order that it deems fit in regard to any certificate referred to in subsection (3).

117. Repayment of salary or remuneration by members of a close corporation debtor. (1) If a close corporation debtor is being liquidated in terms of this Act, and-

(a) any direct or indirect payment of a salary or other remuneration was made by the corporation within a period of two years before the commencement of its liquidation to a member in his capacity as an officer or employee of the corporation; and

(b) such payment was, in the opinion of the Master, not *bona fide* or reasonable in the circumstances,

the Master shall direct that such payment, or such part thereof as he may determine, may be repaid by such member to the corporation.

(2) A person who has within a period of two years referred to in subsection (1)(a) ceased to be a member of a corporation referred to in that subsection may, under the circumstances referred to therein, be directed by the Master to make a repayment provided for in subsection (1), if, and to the extent that, any such repayments by present members are, together with all other available assets, insufficient for paying all the debts of the corporation.

(3) The provisions of subsections (3) and (4) of section 116 shall *mutatis mutandis* apply in respect of any repayment to a corporation in terms of subsection (1) or (2)."

5 3 Conclusion

While it is necessary to promote entrepreneurship in the South African economy, at the same time investors and creditors must be sufficiently and efficiently protected from delinquent directors and other officers of companies and close corporations. It is submitted that while most of the existing provisions regulating personal liability have been retained in the proposals under a unified Insolvency Act, they have been supplemented by a proper provision regulating insolvent trading. This provision should go a long way towards not only bringing delinquent directors and others to book, but also clearly demarcating the parameters within which such businesspeople may conduct their corporate affairs.

6 CROSS-BORDER INSOLVENCIES

Despite the promulgation[166] of the Cross-Border Insolvency Act[167] in South Africa, cross-border insolvencies are currently still dealt with in terms of South African private international law.[168] The

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166 Although promulgated by Parliament, the Act has not yet come into operation.

167 Act 42 of 2000 (hereinafter referred to as the Cross-Border Insolvency Act). For a detailed discussion of this new Act and the possible problems that may be encountered as a result of its promulgation, see Smith and Boraine "Crossing Borders Into South African Insolvency Law: From the Roman-Dutch Jurists to the Uncitral Model Law" 2002 10 *ABI Law Review* 135 (hereinafter referred to as Smith and Boraine).

168 See eg: *Viljoen v Venter* 1981 2 SA 152 (W) dealing with South African legislation and its extra-territorial operation (cf *Ex parte Steyn* 1979 2 SA 309 (O)); *Ex parte Palmer: In re Hahn* 1993 3 SA 359 (C) dealing with the "domicile" of corporations; *Deutsche Bank AG v Moser* 1999 4 SA 216 (C) dealing

Cross-Border Insolvency Act is based almost entirely[169] upon the UNCITRAL Model Law drafted by the United Nations Commission on International Trade Law, and South Africa is one of the first countries in the world that has elected to adopt the model law.

Considering the fact that cross-border insolvencies will for the first time be regulated by legislation, the obvious question that needs to be posed in the context of this study, is where such legislation should be incorporated. The Cross-Border Insolvency Act has been promulgated as an independent Act, and has not been incorporated, for example, into the Insolvency Act. However, it is submitted that it would make sense for cross-border issues to be incorporated into a unified insolvency statute should such a statute eventually be promulgated. There are various reasons for this:

(a) According to Smith and Boraine[170] a foreign representative may use either the cross-border insolvency rules, or make use of domestic (South African) insolvency rules, depending on the circumstances and whether or not the country from which the representative comes has been recognised as a designated country for the purposes of the

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with immovable property situated in South Africa; *Bekker v Kotzé* 1996 4 SA 1287 (Nm) dealing with the recognition of foreign judgments; *Ward v Smit: In re Gurr v Zambia Airways Corporation Ltd* 1998 3 SA 175 (SCA) dealing with movable property; *Ex parte Wessels & Venter: In re Pyke-Nott's Insolvent Estate* 1996 2 SA 677 (O) dealing with requests for assistance from overseas courts; *Nahrungsmittel Gmbh v Otto* 1991 4 SA 414 (C) and *Re Estate Morris* 1907 TS 657 dealing with jurisdictional matters; *Donaldson v British South African Asphalt and Manufacturing Co Ltd* 1905 TS 753 and *In re Leydsdorp & Pietersburg Estates Ltd (in liquidation)* 1903 TS 254 dealing with the refusal of a winding-up order where an order has already been granted in another jurisdiction; *Herman v Tebb* 1929 CPD 65 and *Chaplin v Gregory* 1950 3 SA 555 (C) dealing with the status of persons in South Africa where they have been sequestrated in a foreign jurisdiction; *Ex parte Robinson's Trustee* 1910 TPD 25 dealing with the qualifications of liquidators; *Moolman v Builders & Developers (Pty) Ltd (in provisional liquidation): Jooste Intervening* 1990 1 SA 954 (A) for an example of the type of order that the court may grant when a foreign representative applies for recognition; *Cape of Good Hope Bank (in liquidation) v Mellé* 10 SC (1893) 280 and *Dyer v Carlis* 4 Official Reports (1897) 67 dealing with the effect of rehabilitation; *North American Bank Ltd (in liquidation) v Grant* 1998 3 SA 557 (W) dealing with the discharge of foreign debt after rehabilitation in South Africa.

169 In addition to the few minor amendments that were made in order to make the statute applicable to South Africa, the Justice and Constitutional Development Portfolio Committee of Parliament decided to introduce the principle of reciprocity into the Cross-Border Insolvency Act.

170 Smith and Boraine par H.

Cross-Border Insolvency Act. It makes sense for all the legal principles applicable in both cases to be incorporated into one Act. This will avoid confusion for foreign representatives as they will not have to consult a multitude of Acts in order to determine the legal position that may or may not apply.

(b) The Cross-Border Insolvency Act contains a number of provisions that refer to the South African insolvency statutes. It will be far more convenient if the references were made to sections of the same Act.

(c) Considering the possible complications that can arise regarding jurisdiction,[171] it would be far more sensible to include the provisions relating to cross-border insolvency in a unified insolvency statute. This will alleviate the problems relating to jurisdiction in that the rules will be incorporated into one Act, and will not require cross-referencing to other pieces of legislation.

For this reason the provisions of the Cross-Border Insolvency Act have been incorporated into the unified Insolvency Act as a separate chapter dealing with cross-border issues. No amendments have been made to the Act, and it has merely been incorporated into the unified Act under Chapter 26, clauses 137 to 169.[172]

7 CONCLUSION

As explained above, the purpose of this chapter was not to discuss in any detail the ancillary matters that have been identified under this heading. This chapter was designed to provide a

171 Smith and Boraine paras I(8), K(1).

172 See ann E to this thesis.

holistic approach to the introduction of a unified insolvency statute. Many of the aspects dealt with under this chapter are policy issues that need to be decided by the powers that be, a task that will probably fall in the hands of the Justice and Constitutional Development Portfolio Committee, a committee falling under the auspices of Parliament.

However, the discussion of all these ancillary provisions and the inclusion of most of them in a unified insolvency statute has shown that it is indeed possible to include all insolvency related matters in one Act. To summarise:

(a) As regards alternatives to liquidation, it is submitted that the provisions relating to administration orders and pre- and post-liquidation compositions should be included in a unified insolvency statute. As far as pre- and post-liquidation compositions are concerned, these have been included in the proposals in this study for a unified Insolvency Act. However, the provisions relating to administration orders have been left out of the unified insolvency statute because they are currently included under the Magistrates' Courts Act.

(b) As regards insolvent deceased estates it is submitted that the procedures as they currently stand should remain in the Administration of Estates Act. These provisions contain special procedures, and there is no sound motivation for their removal from the current legislation. One of the most compelling reasons for leaving these provisions intact is the cost factor; the section 34 procedure under the Administration of Estates Act is a simple and inexpensive procedure that can be used by an executor. The inclusion of these provisions in a unified insolvency statute may lead to delays in the administration process, especially since it may lead to a liquidator having been appointed. Under the current provisions an executor that has been appointed under the Administration of Estates Act may administer the insolvent deceased estate.

(c) As regards business rescue provisions, it is submitted that South Africa needs to introduce a revised system of business rescue that can replace the current system of judicial management. However, in order to reserve a place in the unified Insolvency Act for a new business rescue procedure, and because judicial management is an existing form of business rescue with an accompanying body of case law, the provisions have been retained in the proposed unified insolvency statute. In addition to retaining the provisions relating to judicial management, two minor amendments have been made to the provisions in order to make it more accessible as a business rescue mechanism. The first of these two amendments relates to the burden of proof in order to obtain a judicial management order; instead of requiring proof that there is a "reasonable probability" that the business will be saved if placed under judicial management, the provision has been changed to require a "reasonable possibility". The second of the proposed amendments relates to whom the provisions may apply. Consequently the provisions will no longer apply only to companies, but have been extended to cover also close corporations and trusts. In addition to judicial management the provisions of section 311 of the Companies Act relating to compromises have been included in the proposed unified Insolvency Act. The provisions that are proposed to be included in the unified insolvency statute relate only to a compromise between a debtor and its creditors, the provisions relating to an arrangement having been removed. These provisions have also been made applicable to all types of debtors that have legal personality.

(d) As regards personal liability, it has been proposed in this chapter that all the provisions relating to personal liability be consolidated in order that they may apply to other juristic persons as well. In addition, an insolvent trading provision has been included under the proposed unified Insolvency Act. Special provisions relating to the personal liability of members of close corporations have also been included in the proposals for a unified Insolvency Act.

(e) As far as cross-border insolvencies are concerned, it has been proposed in this chapter that the Cross-Border Insolvency Act 42 of 2000 be inserted as a separate chapter in a unified insolvency statute.

In this way all the ancillary matters that have been discussed in this chapter, with the exclusion of insolvent deceased estates, will be dealt with and included in a the unified Insolvency Act that appears in annexure E to this thesis.