Re-evaluating Statutory Preferences in Insolvency Law

by

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Submitted in fulfilment of the requirements for the degree

LLM

In the Faculty of Law,

University of Pretoria

Date

26 November 2018

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Contents

CHAPTER 1 3

INTRODUCTION 3

1.1 BACKGROUND 3

1.2 RESEARCH STATEMENT 5

1.3 METHODOLOGY 6

1.4 ASSUMPTION AND CONCLUSION 6

CHAPTER 2 8

SOUTH AFRICAN INSOLVENCY LEGISLATION 8

2.1 OVERVIEW AND BRIEF HISTORY 8

2.2 THE AIM OF INSOLVENCY LAW AND THE *CONCURSUS CREDITORUM* 9

2.3 DISTRIBUTION OF ASSETS AND THE RANKING OF CREDITORS 11

2.4 DISTRIBUTION OF THE FREE RESIDUE 15

2.5 COLLECTION TOOLS AVAILABLE TO THE SOUTH AFRICAN REVENUE SERVICE 17

2.6 OVERVIEW OF BUSINESS RESCUE 19

2.7 CONCLUSION 26

CHAPTER 3 28

INTERNATIONAL CONTEXT AND COMPARITIVE OBSERVATIONS 28

3.1 CHANGES INTERNATIONALLY WITH REGARDS TO STATUTORY PREFERENCE 28

3.2 COMPARATIVE OBSERVATIONS: TAX PRIORITIES 29

3.3 CONCLUSION 34

CHAPTER 4 36

POLICY CONSIDERATIONS AND LAW REFORM 36

4.1 INTRODUCTION 36

4.2 ESSENTIAL PRINCIPLES OR FUNDAMENTALS OF AN INSOLVENCY SYSTEM 38

4.3 UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW: LEGISLATIVE GUIDE ON INSOLVENCY LAW 38

4.4 REFORM IN SOUTH AFRICA 41

4.5 CONCLUSION 46

5. CONCLUSION 48

5.1 GENERAL PRINCIPLES 48

5.2 SOUTH AFRICAN PERSPECTIVE 48

5.3 INTERNATIONAL PERSPECTIVES 49

5.4 POLICY CONSIDERATIONS AND REFORM 51

5.5 CONCLUSION 52

BIBLIOGRAPHY 54

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

Over the decades, insolvency law has developed to what we have come to understand and known as a collective debt collection mechanism. Long gone are the days when execution was directed at the debtor's person and not his estate, and perhaps even more so, the days in which creditors would either sell the debtor into slavery, imprison him or literally cut his body into pieces, whereby each creditor who was owed a sum of money received "something" from the debtor, albeit literally a "piece" of him.[1]

One of the purposes of modern day Insolvency law is to govern the orderly and equitable (fair) distribution of a debtors' assets amongst his creditors where the assets are insufficient to cover all his debts.[2] It differs substantially from individual collection action against a debtor, as it sets into motion a collective procedure, which is aimed at achieving a fair distribution amongst the group of creditors (the *concursus creditorum*).[3]

Individual collection action is thus stayed and Insolvency law provides the mechanism or procedure to achieve equality amongst creditors and secondly to maximise assets to be distributed amongst creditors. This collective, namely, the collective group of creditors is referred to as the *concursus creditorum* and forms the core of any further proceedings in terms of insolvency law. This is dealt with more fully below.

Wood[4] suggests that the aim or most fundamental principle of insolvency is in essence to provide for a *pari passu* distribution of a debtors' assets amongst his creditors, although he further states that this is an ideology "which is nowhere honoured" and bases his argument on the bankruptcy hierarchy – the ladder of payment or ladder of priorities. Creditors are paid, not each

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[1] Wood PR: *Principles of International Insolvency* at 1-027*:* at the time of the XII Tables Wood explains that the debtor who was unable to pay was either killed, enslaved, exiled or imprisoned.

[2] Bertelsmann E et al *Mars: The Law of Insolvency in South Africa* at §1.1 p2, also see Sharrock R, Van der Linde K and Smith A: *Hockly's Insolvency Law* at p4.

[3] Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* at 56 also see Sharrock R, Vander Linde K and Smith A: *Hockly's Insolvency Law* at p155 – the assets are distributed amongst the creditors in a pre-determined order of preference.

[4] Wood PR: *Principles of International Insolvency* at 1-002.

proportionately from the pool of the estate and *pro rata* according to their claims, but according to the ladder of priorities.[5]

At this early juncture one can thus already clearly see that priorities afforded by statute would have an impact on the position of creditors within the ladder of priorities.

What seems to be the aim of insolvency law is that equal creditors in the same class are to be treated equally. Upon a critical evaluation of the history of insolvency law it seems that the fundamental principle of insolvency law then rather seems to provide for an orderly and fair distribution of a debtors' assets amongst his creditors and a balancing of the rights of each party in liquidation proceedings (namely. the rights of the debtor and the rights of the group of creditors amongst themselves).[6]

Equality is achieved by maintaining the position that each creditor has in relation to the debtor as at the moment of liquidation and that position must be maintained. For instance, if a creditor had no security for his claim against the debt of his debtor as at date of liquidation, such creditor should remain a concurrent creditor and his position cannot be altered. Swart refers to this as the "voor-sekwestrasiebeginsel" – the pre-sequestration principle.[7]

One of the key features or principles of South African insolvency law is the concept of *concursus creditorum*[8], the interest of the group of creditors which becomes paramount from the moment it comes into effect. It forms the basis of the collectivity principle and the *concursus* is formed at the time of the granting of an order for liquidation or sequestration as the case may be.

The infamous judgment in the South African context is that of *Walker v Syfret, NO*[9] in which Lord De Villiers CJ said: *"The effect of a winding-up order is to establish a concursus creditorum, and nothing can thereafter be allowed to be done by any of the creditors to alter the rights of the other creditors".*

[5] Wood PR: *Principles of International Insolvency* 1-003.
[6] Swart B: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* at p94-97.
[7] *Ibid* at p100.
[8] Bertelsmann E et al *Mars: The Law of Insolvency in South Africa* §1.1 – *"The concursus creditorum is regarded as one of the key concepts of the South African law of insolvency."*
[9] *Walker v Syfret, NO,* 1911 AD 141. Also see Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* Chapter 11, p255-257.

In his judgment, Innes J stated as follows:

"The object of the Insolvent Ordinance is to ensure a due distribution of assets among creditors in the order of their preference …………. The sequestration order crystallises the insolvent's position; the hand of the law is laid upon the estate, and at once the rights of the general body of creditors have to be taken into consideration. No transaction can thereafter be entered into with regard to estate matters by a single creditor to the prejudice of the general body. The claim of each creditor must be dealt with as it existed at the issue of the order".[10]

This judgment laid down two important principles, namely the establishment of a *concursus creditorum* and the fact that the "claim of each creditor must be dealt with as it existed at the issue of the order". Thus, by introducing statutory preferences it has the effect of altering the position of such creditor on an *ex post facto* basis and one can no longer argue that the claim of such a creditor is being dealt with as it existed at the issue of the order. One can thus argue that a priority so afforded by statute has the effect of altering the position of these creditors. Furthermore, it is in stark contradiction with what was said by Lord De Villiers CJ in the *dictum* quoted above.

It is against this backdrop that this dissertation seeks to question the reasoning behind certain statutory preferences (specifically governmental tax priorities) in the current South African insolvency law.

1.2 RESEARCH STATEMENT

The introduction of statutory preferences in insolvency law alters the position of creditors and in principle goes against the grain and essence of the true meaning of *concursus creditorum*. It has the effect of altering the position of certain creditors as at date of liquidation or sequestration as the case may be in that these creditors, who holds no security and are therefore concurrent creditors, are suddenly, by virtue of statute, preferred and rank higher than other concurrent creditors, they are entitled by legislation to receive payment first and foremost before other concurrent creditors.

It is suggested that a statutory preference should only be afforded to creditors when it is justified based on sound policy considerations. Such priorities should be limited to the bare minimum as they have the effect of altering the relative position of creditors which they had prior to liquidation

[10] *Walker v Syfret, NO,* 1911 AD 141.at 166. *Also* refer to Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* at p302. On an interpretation of the judgments in *Walker v Syfret, Ward v Barrett* and *Porteus v Strydom* the court has found that the claim of each creditor should be dealt with as it existed at the date of liquidation (die "voor-sekwestrasie-beginsel"). Swart also refers to this as maintaining the relevant position of creditors as distribution norm.

(i.e. they are in a better position on an *ex post facto* basis). The aim of this dissertation is therefore to question critically whether there are any justification and sound policy considerations for affording these statutory preferences - and specifically those afforded to the South African Revenue Service (SARS) with regards to taxes. It seeks to question whether this special treatment of tax claims is just and equitable when measured against the nature and aim of insolvency law. The position relating natural person debts whose estates have been sequestrated in terms of the Insolvency Act and that of insolvency company debtors are largely the same as far as statutory preferences are concerned but differences will be indicated where applicable.

The dissertation will also briefly compare the position of creditors in business rescue in South African law with that of creditors in insolvency where the assets are liquidated and distributed.

1.3 METHODOLOGY

The methodology for this dissertation will be a literature study and limited comparative study of South African Insolvency law compared against, *inter alia* that of the United Kingdom and Australia.

It will also consider the difference in priority accorded to the Revenue Services with regards to tax within a business rescue process in terms of the Companies Act as compared to the priority granted within the ambit of insolvency law.

The study will mainly comprise a literature review. The following will be the outline for the various chapters:

Chapter 1: Introduction
Chapter 2: South African Context
Chapter 3: International Context and Comparative Observations
Chapter 4: Policy Considerations and law reform
Chapter 5: Conclusion

1.4 ASSUMPTION AND CONCLUSION

The current South African insolvency law is in serious need of revision and various working papers have been submitted by the Law Reform Commission in this regard. To date, however, there have

been no formal amendments. The socio-economic landscape has changed dramatically over the past 80 years and many countries have amended their insolvency legislation in order to keep it up to date and relevant to the social and political climate nationally and internationally.

This dissertation attempts to show that there is not a strong and justifiable case upon which statutory preferences in relation to government tax should be maintained in our insolvency law as they are against the principles of equality and the main aim of insolvency law, namely, the interests of the *concursus creditorum.* Preferences alter the position of certain creditors to the detriment of others and it is submitted that this is not justifiable in the current dispensation.

In stark contrast with insolvency law, the Companies Act of 2008 has not afforded any such preference to tax within the business rescue procedure. Although the policy considerations might differ, the question remains as to why such priority should be maintained within insolvency proceedings.

CHAPTER 2

SOUTH AFRICAN INSOLVENCY LEGISLATION

2.1 OVERVIEW AND BRIEF HISTORY

South African Insolvency law has its' roots in Roman Dutch Law, which forms the basis of our common law. Although the Ordinance of Amsterdam of 1777 is accepted to have formed the basis of South African insolvency law, it was also greatly influenced by English law.[11]

Furthermore, South African insolvency legislation is not contained in one single Act and in fact is fragmented and contained in various Acts. Although the Insolvency Act[12] forms the basis of our insolvency legislation in as far as it relates to procedural issues, such as the administration process of an insolvent estate, it mainly applies to individuals and partnerships in that "debtor" is defined in section 2 of the Insolvency Act as "…a person or a partnership or the estate of a person or partnership which is a debtor in the usual sense of the word, except a body corporate or a company or other association of persons which may be placed in liquidation under the law relating to Companies".[13]

To make things worse the Companies Act, 61 of 1973 was repealed and replaced by the Companies Act, 71 of 2008. Chapter 14 of the previous Act still applies (until the date determined by the Minister responsible for companies, with regards to the winding-up and liquidation of companies under the Companies Act of 2008, as if the previous Act had not been repealed. However sections 343, 344, 346 and 349 to 353 of the 1973 Act do not apply to the winding-up of a solvent company, except to the extent necessary to give full effect to the provisions of Part G of Chapter 2 of the Companies Act 2008.[14] Chapter 14 is thus still applied.

Besides the common law, the following Acts are applicable when dealing with insolvency in the South African context: Insolvency Act, Companies Act 1973, Companies Act 2008, Closed Corporations Act, Part VI of the Long-Term Insurance Act, Part VI of the Short-Term Insurance Act, section 29 of the Pension Funds Act, section 35 of the Friendly Societies Act, section 18(c) of the Medical Schemes Act, Sections 27, 28 and 39 of the Unit Trusts Control Act, chapter X of the

[11] Smith C: *The Law of Insolvency* at p6, also see Bertelsmann E et al *Mars: The Law of Insolvency* §1.3.
[12] Insolvency Act 24 of 1936 (hereinafter referred to as the Insolvency Act).
[13] See section 2, Insolvency Act.
[14] Item 9 of Schedule 5 Transitional Arrangement of the Companies Act 71 of 2008.

Co-Operatives Act, Section 33 of the Financial Markets Control Act, Section 68 of the Banks Act and chapter VIII of the Mutual Banks Act.[15]

In addition to the above, South Africa has a two-fold history in that we have a pre-Union history and legislation pertaining to the pre-Union state as well as the post Union state. However, for purposes of this dissertation it is not necessary to delve into the history and development of pre-and post-Union legislation, save for what is stated below. A uniform law of insolvency was enacted in 1916 under The Insolvency Act, No. 32 of 1916 and was structurally based on the Transvaal Law, No. 13 of 1895, which was in turn an adaption of the Cape Ordinance. The 1916 Act was amended by the Insolvency Amendment Act, No. 29 of 1926. There-after Act 58 of 1934 was introduced and finally, on 1 July 1936 the current Insolvency Act 24 of 1936 came into force.

2.2 THE AIM OF INSOLVENCY LAW AND THE *CONCURSUS CREDITORUM*

As set out in Chapter one the aim of insolvency law is to provide for a collective debt collecting process to achieve an orderly and fair distribution of a debtor's assets.[16] Once an order for liquidation or sequestration has been granted, it brings about a *concursus creditorum,* which is a key concept within the South African insolvency law landscape.[17]

According to Swart[18] the common-law development of *concursus creditorum* indicates that it was used to describe the collective execution procedure, which followed once a state of bankruptcy was established. It is thus safe to state that in its' infancy insolvency law was aimed at a collective collection or execution process. It is however more than simply a collective execution or collection process. Fletcher[19] states that insolvency law is occupied with the interests of the debtor and creditor, thus it must manage or rather protect the rights of the debtor, the rights of the creditors and manage the relationship between the creditors as a group. According to Wood[20] the "law has to choose who to pay".

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[15]Insolvency Act 24 of 1936, Companies Act 61 of 1973, Companies Act 71 of 2008, Closed Corporations Act, 69 of 1984, Long-Term Insurance Act, 52 of 1988, Short-Term Insurance Act, 53 of 1988, Pension Funds Act, 24 of 1956, Friendly Societies Act, 25 of 1056, Medical Schemes Act, 72 of 1967, Unit Trust Control Act, 54 of 1981, Co-Operatives Act 91 of 1981, Financial Markets Control Act, 55 of 1989, Banks Act, 94 of 1990, Mutual Banks Act, 124 of 1993.

[16] Bertelsmann E et al *Mars: The Law of Insolvency in South Africa* at §1.1.

[17] Bertelsmann E et al *Mars: The Law of Insolvency in South Africa* at §1.1 – *"The concursus creditorum is regarded as one of the key concepts of the South African law of insolvency."*

[18] Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* at p65. See Bertelsmann E et al *Mars: The Law of Insolvency in South Africa* at §1.1 – *"It is generally accepted that a concursus creditorum comes into being once a sequestration order is made".*

[19] Fletcher IF: *The Law of Insolvency* at p2.

[20] Wood PR: *Principles of International Insolvency* at 1-001.

The above clearly depicts the importance and relevance of the *concursus creditorum* within insolvency law. Further to this, if the law has to choose who to pay, the law should be clear, unbiased and based on sound policy considerations taking into account the rights of all the parties involved. Since insolvency law creates a mechanism for a collective collection or execution process, and since it governs the relationships between the debtor and his creditors, and the creditors as a group, it creates two questions according to Jackson[21] namely whether there are any limitations on what creditors are entitled to take from the debtor and how the rights of creditors are decided upon if there is not sufficient money or assets available.

I suggest that the second question is probably the most important one as these rights will eventually determine who is paid what and in which order. The decision of how the rights of creditors are decided upon is in direct contrast with the "voor-sekwestrasie beginsel" as set out by Swart,[22] this refers to the relative position of each creditor as it existed prior to sequestration.

At this juncture it must be re-emphasised that the *locus classicus* of the South African insolvency law with regards to *concursus creditorum* is the judgment of the Appeal Court in *Walker v Syfret.*[23] This judgment entrenched the general use of the term within the South African insolvency law, but even more important, if one follows the argument by Swart this judgment also "recognizes the principle of maintaining relative positions".

Swart argues that any improvement of a creditor's relative position as at date of sequestration is in conflict with insolvency principles.[24] He further states that this judgment clearly sets out the principles for distribution between creditors namely that: "……….. the claim of each creditor must be dealt with as it existed at the issue of the order", thus referring to the relative position of creditors prior to sequestration. The fact that Lord de Villiers' in his judgment held that "nothing can thereafter be allowed to be done by any of the creditors to alter the rights of other creditors" is according to Swart a further indication that this judgment sets out the correct principles for the distribution of the assets amongst creditors of an insolvent estate.

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[21] Jackson TH: *The Logic and Limits of Bankrtupcty Law* at p4.

[22] Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* at Chapter 8, p91-131.

[23] See *Walker v Syfret, NO, 1911 AD 141.* Also see Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* – at p255-257.

[24] Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* – 295 - 298, 524. Swart highlighted the judgment by Innes J as a significant judgment relating to the "voor-sekwestrasie beginsel".

In addition to *Walker v Syfret*[25] there is also the judgment in *Ward v Barrett*[26] in which Steyn J concluded that "the claim of each creditor had to be dealt with by the executrix as it existed at the date mentioned". In *Porteus v Strydom* [27] Galgut JA repeated what was stated in *Walker v Syfret*[28] and *Ward v Barrett.*[29] He concluded that "the claim of each creditor has to be dealt with as it existed at the date of the concursus, and that payment has to take place according to a recognized priority of claims established at that date".

It is thus clear that the courts' have interpreted the *concursus creditorum* as an important feature in our insolvency law and that the interest of the *concursus creditorum* is paramount when dealing with an insolvent estate.[30] The courts have also indicated in the judgments discussed *supra* that the claims of creditors must be dealt with as they existed at the time of the issuing of the order, thus the relative position that each creditor had at the time of insolvency as explained by Swart.[31]
Since the aim of this dissertation is to focus on the actual distribution and the priority afforded to statutory preferent creditors, I do not deal with the formalities in terms of the grating of the order for sequestration, the proving of claims and so forth. The focus is rather the distribution of assets amongst the creditors as provided for in legislation.

2.3 DISTRIBUTION OF ASSETS AND THE RANKING OF CREDITORS

In 2.2 *supra* it was concluded that there is sufficient authority that distribution of assets within an insolvent estate should be based on the relative position which creditors held at the time of insolvency. The Insolvency Act sets out the ranking (or classes of creditors) which is to be followed when distributing amongst the creditors.[32] The law distinguishes between three types of creditors for purposes of ranking, being secured, preferent and concurrent.[33] Both preferent and concurrent creditors are unsecured creditors and commonly referred to as concurrent creditors or unsecured as the case may be (they are thus regarded as one class of creditors, albeit it that the law created a further "sub-class" so to say. Preferent in this regard refers to statutory preferent creditors.

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[25] See 23 *supra.*
[26] *Ward v Barrett* 1963 2 SA 546 (A).
[27] *Porteus v Strydom* 1984 2 SA 489 (D).
[28] See 23 *supra.*
[29] *See* 26 s*upra.*
[30] See 23 *Supra* – more specifically the judgment by Innes J ".... *No transaction can thereafter be entered into with regard to estate matters by a single creditor to the prejudice of the general body*".
[31] Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* – Chapter 13.
[32] Sections 95-104 of the Insolvency Act, Act. Also see Boraine A and Van Wyk J – *Reconsidering the plight of the five foolish maidens: Should the unsecured creditor stake a claim in real security?* at par 2.
[33] Sharrock R, Van der Linde K and Smith A: *Hockly's: Insolvency Law* at p155, also see Meskin et al*: Insolvency Law and its operation in winding-up* at 12.3 Payment of Claims insolvent estate.

Secured creditors are also preferred in the sense that they are paid first and foremost from the proceeds of the security on which they rely. Reference to preferent creditors in this context however means statutory preferent creditors, those creditors who are preferred by operation of law.

As per Fourie J in his judgment in *The Commissioner for the South African Revenue Service v Beginsel and Others*,[34] the categorization of creditors into secured and unsecured "…is uncontentious and well-known in legal parlance. Secured creditors are those who hold security over the company's property, such as a lien or mortgage bond. Unsecured creditors are those whose claims are not secured, including concurrent creditors. The unsecured creditors are either preferent or concurrent creditors. The term "preferent creditor" used in the wide sense, refers to any creditor who has a right to receive payment before other creditors. To this extent, a secured creditor also qualifies as a preferent creditor. However, the term "preferent creditor" is normally reserved for a creditor whose claim is not secured, but who nevertheless ranks above other claims of concurrent creditors (whose claims are also not secured). Such preferent creditors are commonly referred to as "unsecured preferent creditors" and are mentioned in sections 96-102 of the Insolvency Act".

2.3.1 SECURED CREDITORS

The claims of secured creditors are paid in priority to any other claim and are paid from the proceeds of the realisation of the property (referred to also as encumbered assets) which constitutes these creditors' security, after the costs of sequestration (which includes the costs of maintaining, conserving and realising the asset(s)).[35]

Although secured creditors are not defined in the Act "security" has the following meaning as per the definitions in section 2 of the Act: "Security, in relation to the claim of a creditor of an insolvent estate, means property of that estate over which the creditor has a preferent right by virtue of any special mortgage, landlord's legal hypothec, pledge or right of retention".[36] As per the definition of security as quoted *supra* only the following types of security is recognised in our legislation: special mortgage, landlord's legal hypothec, pledge or right of retention. It is however worth noting that with regards to special mortgage bonds, the following does apply: Only a special mortgage bond, registered in the Deeds Office qualify as a secured claim on the bondholder. Special mortgage is defined as "a mortgage bond hypothecating any immovable property or a

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[34] *The Commissioner for the South African Revenue Service and Beginsel NO, 2013(1) SA 307(C).*
[35] Insolvency Act - Section 95(1) read with section 89(1).
[36] Insolvency Act – section 2.

notarial mortgage bond hypothecating specially described movable property in terms of section 1 of the Security by means of Movable Property Act, 1992 (Act 57 of 1993), or such a notarial mortgage bond registered before 7 May 1003 in terms of section 1 of the Notarial Bonds (Natal Act, 18 of 1932), but excludes any other mortgage bond hypothecating movable property".[37]

In as much as these secured creditors are paid from the proceeds of the realisation of their security (property), section 89 of the Insolvency Act stipulates that the cost of maintaining, conserving and realising property must be paid out of the proceeds of the property, if sufficient, and if insufficient and the property is subject to a special mortgage, landlord's legal hypothec, pledge or right of retention the deficiency must be paid by the proved secured creditors *pro rata* who would have been entitled in priority to other creditors to payment if the proceeds had been sufficient to pay the costs. The costs of maintaining conserving, and realizing property include costs such as auction costs, insurance, the trustees' remuneration, proportionate share of the Master's fee and so forth.[38]

In addition to the above, Section 89 further stipulates that amounts due for periodic taxes in respect of the immovable property are also to be paid from the proceeds of the realisation of the property. Tax is defined as "any amount payable periodically in respect of that property to the State or for the benefit of a provincial administration or to a body established by or under the authority of any law in discharge of a liability to make such periodical payments, if that liability is an incident of the ownership of that property".[39]

If a secured creditor, other that the secured creditor upon whose petition the estate was sequestrated, states in his affidavit submitted in support of his claim that he relies for the satisfaction of his claim solely on the proceeds of the property which constitutes his security, he will not be liable for any costs of the sequestration other than the costs specified in section 106(a) and (b).[40] Thereafter the proceeds are used to pay the funeral and deathbed expenses (applicable in

[37] Insolvency Act – section 2.

[38] Insolvency Act – section 89.

[39] See section 89(5) Insolvency Act 24 of 1936 – tax in this regard refer to *inter alia* property rates and taxes, limited to two years. Also see Section 118 of the Local Government: Municipal Systems Act. Prior to the transfer of immovable property, a clearance certificate e issued by the Municipality is required, which is to certify that all amounts for municipal service fees, surcharges on fees, property rates and other municipal taxes, levies and duties during two years preceding date of application for the certificate have been fully paid. Section 89(4) however does not limit other amounts (such as charges for basic fees, refuse removal etc. which must be paid prior to the property being transferred. Amounts owing in respect of levies due to a Home Owners Association is not regarded as a tax upon the property – therefore the two year limitation is not applicable, however must also be paid prior to the transfer of the property as it is regarded as costs of "maintaining, conserving and realising property" in terms of Section 89(1) of the Insolvency Act.

[40] See section 89(2) Insolvency Act 24 of 1936.

a natural persons' insolvent estate and not in liquidation) of the insolvent if the free residue is insufficient for that purpose.[41]

Any remaining proceeds must be applied in satisfying the claims of secured creditors in their order of preference, with interest in respect of any period not exceeding two years immediately preceding the date of sequestration.[42] The balance, if any, is paid into the free residue account.

2.3.2 UNSECURED CREDITORS: PREFERENT AND CONCURRENT

Preferent and concurrent creditors (both classes being unsecured creditors) have no form of real security and their respective claims are paid from the balance in the free residue. Free residue is defined as "in relation to an insolvent estate, means that portion of the estate which is not subject to any right of preference by reason of any special mortgage, legal hypothec, pledge or right of retention".[43] Free residue is simply speaking the surplus income derived from the proceeds of the realisation of real security (if any surplus), and the income from the realisation of unencumbered assets.[44] Unsecured creditors, thus statutory preferent and unsecured creditors are paid from the free residue with preferent creditors being paid first and foremost.

"Preference in relation to any claim against an insolvent estate, means the right to payment of that claim out of the assets of the estate in preference to other claims; and preferent has a corresponding meaning*"*[45] Preferent creditors (also referred to as statutory preferent), although also unsecured creditors, rank above concurrent creditors for the sake of distribution and are paid first and foremost from the free residue. Legislation has improved the ranking of these creditors' claims and, one can argue, preferred them above unsecured concurrent creditors.

The question that begs to be considered then is whether there are just and equitable reason for affording such preference, taking into account what has already been discussed as the "voor-sekwestrasie beginsel" as well as the fact that the Constitution of South Africa[46] provides for equality. The Bill of Rights as per chapter 2 of the Constitution enshrines "the rights of all people in our country and affirms the democratic values of human dignity, equality and freedom".[47]

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[41] See section 96(4) Insolvency Act.
[42] Sections 89(3) and 95(1) Insolvency Act.
[43] Insolvency Act – Section 2, definition of free residue.
[44] See Boraine & Van Wyk: *Reconsidering the plight of the five foolish maidens: Should the unsecured creditor stake a claim in real security?* at p4.
[45] Insolvency Act – Section 2.
[46] Constitution of the Republic of South Africa, Act 108 of 1996 (herein after referred to as "the Constitution".
[47] Section 7 of the Constitution.

Equality is therefore a fundamental right and the Constitution stipulates that "Everyone is equal before the law and has the right to equal protection and benefit of the law".[48]

One can thus argue that within insolvency all creditors have the right to be treated equal and the provisions in the insolvency act which prefer one creditor above another may be regarded as discrimination on the grounds of equality (i.e. discrimination against certain classes of creditors) and open for scrutiny on the basis that such preference may be unconstitutional.[49]

I submit that sufficient arguments can be made for the statutory preference with regards to the liquidation and administration costs of the estate (including the fees of the sheriff), the preference in terms of salaries and wages as salaries are the livelihood of employees. The same can however not be said for the affordance of the preferences in favour of the state. This will be more fully discussed and explored in chapters 3 and 4 below.

The affordance of a statutory preference is contrary to what was set out in 2.2 above in that affording such statutory preference has the effect of altering these creditors' relative position which existed at the time of the granting of the order of insolvency.

2.4 DISTRIBUTION OF THE FREE RESIDUE

Secured creditors are paid first and foremost in any liquidation from the proceeds of their security as discussed under 2.3. After payment of secured creditors, the free residue is distributed in the following order explained below (the following are to be paid prior to awarding any dividend to concurrent creditors):

Sections 96 to 103 of the Insolvency Act set out the order in which the free residue is to be distributed:[50]

1. Funeral and death-bed expenses;[51]
2. Cost of Sequestration;[52]
3. Costs of execution;[53]

[48] Section 9 of the Constitution.
[49] It must be noted that not all discrimination is immediately unconstitutional. Section 36 of the Constitution provides for the limitation of rights – rights may be limited in terms of law *"to the extent that the limitation is reasonable and justifiable to an open and democratic society based on human dignity, equality and freedom".*
[50] Sections 96- 102 Insolvency Act.
[51] Section 96 of the Insolvency Act.
[52] Section 97 of the Insolvency Act.

4. Amounts due to certain employees and funds – thus the “servant wages” preference was maintained since 1926)[54]
5. Preference with regard to certain Statutory Obligations:[55]
   i. Amounts due in terms of the Workmen’s Compensation Act;
   ii. Taxes deducted in terms of the Income Tax Act – this refers to PAYE (taxes deducted from employees but not paid over to SARS);
   iii. Customs, excise and sales duty in terms of the Customs and Excise Act;
   iv. VAT;
   v. Contributions to the Unemployment Insurance Fund;
   vi. Contributions in capacity as employer to funds (applicable only to estates prior 1 September 2000);
   vii. Salary and certain fees – applicable only to estates prior to 1 September 2000);
   viii. Income Tax;
   ix. General Bonds.

Section 103 then states that any balance in the free residue, after having paid the expenses in terms of Sections 96 to 102 shall then be applied to pay unsecured or non-preferent claims proved against the estate in proportion to the amount of each such claim; and there-after interest on such claims as from date of sequestration to date of payment and calculated in proportion to the amount of such claims.[56]

The question is whether affording such statutory preference in relation to tax can be justified and whether the statutory preference for tax is based on sound policies and principles. For this study this is a primary concern. Secondly, it should be asked whether such statutory priority is in conflict with the principles of *pari passu* distribution as well as the *concursus creditorum* and “voor-sekwestrasie-beginsel”.[57] Heath correctly stated that there should be a very good reason for departing from the *pari passu* rule.[58] Swart[59] justly points out that all of these statutory preferences have the result that the creditors’ relative position in the ranking order is improved as a result of insolvency.

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[53] Section 98 of the Insolvency Act.
[54]Section 98(A) of the Insolvency Act.
[55] Section 99-102 of the Insolvency Act.
[56] Section 103, 103(a) and 103(b) Insolvency Act 24 of 1936.
[57] Swart BH: *Die Rol van ‘n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* - at Chapter 8, p 91-131.
[58] See Heath P: *Preferential Payments on Bankruptcy and Liquidation in New Zealand* - 31.
[59] Swart BH: *Die Rol van ‘n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* – 361-363.

Prior to insolvency these statutory preferent creditors hold no security and as a result would have been entitled only together with other concurrent creditors, that portion of the estate which is not subject to security. After insolvency these creditors' positions are improved and they are first in line for payment of their respective claims from the free residue prior to other concurrent creditors. It therefore can be argued that as a result of the debtors' insolvency, these creditors are suddenly secured creditors in that they are entitled to payment before other concurrent creditors.

The question of statutory preferences has also been reviewed by the South African Law Reform Commission[60] in a number of discussion papers and draft Insolvency Bills, which are dealt with more fully in Chapter 4 below. The South African Law Reform Commission in their latest proposed draft Insolvency Bill[61] is of the view that all preferences, with the exception of cost of sequestration and administration cost, claims of former employees, arrear maintenance in terms of a court order and general bonds, should be abolished. As stated, this is dealt with more fully in Chapter 4. The question of statutory preferences has also come under scrutiny in a number of insolvency systems where legislative changes were made and with specific regards to statutory preference afforded to the "Crown" or fiscus. See further Chapter 3.

2.5 COLLECTION TOOLS AVAILABLE TO THE SOUTH AFRICAN REVENUE SERVICE

Finally, within the ambit of this debate one should not ignore the powers already afforded to the South African Revenue Service.[62] Below I will refer to "taxpayer" in relation to persons owing money to SARS and therefore "taxpayer" will have the same meaning as a debtor in insolvency.

SARS has extensive collection mechanisms afforded to them in terms of the Tax Administration Act.[63] As such, SARS, if effective in its' collection of debt and with the powers afforded to them by statute should be in a much better position than other creditors prior to any insolvency proceedings, since SARS would arguably be the first creditor to know of any financial difficulties experienced by a debtor. In terms of section 46 of the Tax Administration Act,[64] SARS may request

[60] 1996: *Review of the Law of Insolvency: Draft Insolvency Bill and Explanatory Memorandum* Working Paper 66, Project 63(1996) (hereinafter referred to as Discussion Paper 66) and *Review of the Law of Insolvency: Volume 2 Draft Insolvency Bill and Explanatory Memorandum,* Discussion Paper 86 vol 1 Project 63 (1999) – (hereinafter referred to as Discussion Paper 86). The South African Law Reform Commission was previously known as the South African Law Commission. For purposes of this dissertation reference will be made to the South African Law Reform Commission.

[61] Discussion Paper 86 Volume 2 Draft Insolvency Bill Project 63 ISBN 0-621-29377-6 – Clause 1.

[62] The South African Revenue Service (hereinafter referred to as SARS).

[63] Tax Administration Act, Act 28 of 2011.

[64] Section 46 of the Tax Administration Act.

for relevant material from any party, whom has or reasonably should have such material in relation to the taxpayer.

SARS therefore may on the first whim of any arrears amount owing in terms of taxes, request information from *inter alia* financial institutions, debtors of the taxpayer, and so forth. Such information should, if requested timeously enable SARS to decide upon an effective course of action for collecting arrear taxes. Section 179 of the Tax Administration Act[65] empowers SARS to appoint any third party "who holds or owes or will hold or owe any money, including a pension, salary, wage or other remuneration, for or to a taxpayer, require the person to pay the money to SARS in satisfaction of the taxpayer's tax debt." This section is indeed a very strong collection mechanism and any person so appointed who fails to comply with the notice issued by SARS may be held personally liable.[66] This collection mechanism is not available to any other creditor and SARS therefore is again in a better position than any other creditor prior to insolvency and in the normal course of business.

Section 172[67] allows SARS to file a certified statement with the relevant court, which statement has the same effect as a Civil Judgment. The only pre-requisite in this regard is that notice be given to the taxpayer ten days in advance. Yet again SARS cannot be regarded as an ordinary creditor in the sense that it does not have to issue summons for any debts due to it. SARS may simply file a statement and obtain a warrant of execution immediately as the statement in terms of Section 172 has the same effect as a Civil Judgment. All other creditors have to go through quite a tedious and sometimes lengthy process to collect outstanding debt and in many instances the issuing of a summons is met with a notice of intention to defend, which simply protracts the whole process. There is also a cost element involved in so far as it relates to those creditors who have to follow the collection process in terms of the civil law, whereas costs for SARS in terms of collection should be minimal.

In terms of Section 177[68] of the Tax Administration Act, SARS may institute proceedings for sequestration/liquidation of a taxpayer and may do so whether or not the taxpayer is present in the Republic or has assets in the Republic. Section 178[69] provides that a competent court may grant

[65] Section 179 of the Tax Administration Act.
[66] Section 179(3) of the Tax Administration Act.
[67] Section 172 of the Tax Administration Act.
[68] Section 177 of the Tax Administration Act.
[69] Section 178 of the Tax Administration Act.

such order whether or not the taxpayer is "registered, resident or domiciled, or has a place of effective management or a place of business, in the Republic".

In addition to the above SARS may also and in terms of section184 [70] hold a responsible third party as contemplated in sections 181 to 183 liable for the payment of tax debt and has the same powers of recovery against such responsible third party as it has against a taxpayer. The following persons may be held personally liable for the payment of tax debt:

- persons responsible for the financial management;[71]
- shareholders;[72]
- transferee; or[73]
- person assisting in dissipation of assets.[74]

From the above it is clear that SARS, even prior to any insolvency proceedings has extensive collection mechanisms available to it. If these collection tools are used at an early stage as and when debt becomes due, it should mitigate the risk of accumulating high values of debt within insolvency proceedings. It is therefore submitted that SARS already has an advantage in pre-liquidation phase, which other creditors does not have.

2.6 OVERVIEW OF BUSINESS RESCUE

For purposes of this study it is important to have regard to Business Rescue and the position of creditors, specifically SARS with regards to arrears taxes, since this is also broadly speaking an insolvency proceeding. The position of SARS with regards to taxes in arrears in Business Rescue proceedings will be discussed after a brief introduction of Business Rescue.

2.6.1 BACKGROUND AND PURPOSE

The new Companies Act 71 of 2008 introduced business rescue in Chapter 6.[75] Business Rescue replaced the previous Judicial Management in terms of Section 311 of the old Companies Act 61 of 1973 and is aimed at the rehabilitation of financially distressed companies by *inter alia* providing for: the temporary supervision of the company , a temporary moratorium on the rights of claimants

[70] Section 184 of the Tax Administration Act.
[71] Section 180 of the Tax Administration Act.
[72] Section 181 of the Tax Administration Act.
[73] Section 182 of the Tax Administration Act.
[74] Section 183 of the Tax Administration Act.
[75] Chapter 6 of the Companies Act 71 of 2008 (hereinafter referred to as the Companies Act) sections 128-155 read with s 7(k).

against the company or with regards to property in its possession, and the development and implementation, if approved, of a rescue plan to return the company to solvency alternatively to facilitate a better return for creditors or shareholders than immediate liquidation.

Section 7(k) of the Companies Act 2008 provides that one of the purposes of the Companies Act is to "provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interest of all relevant stakeholders." Section 5(1) then provides that "the Act must be interpreted and applied in a manner that gives effect to the purposes set out in section 7".[76] An important consequence of the commencement of business rescue proceedings is that it provides the company with extensive protection against legal action.[77] This is achieved by placing a general moratorium on legal proceedings and/or executions against the company, its property and assets, and the application of the rights of all its creditors.[78]

I will not deal with all the formalities in terms of the process and procedures to follow in terms of business rescue as it is not the aim of this dissertation. Instead, it is submitted that the distinction between secured and unsecured creditors and more specifically the preference in terms of payment in business rescue differs from the distribution rules and statutory preference in terms of the Insolvency Act.

2.6.2 CLAIMS AND RANKING OF CLAIMS

For purposes of this dissertation, the claims and ranking thereof are of high importance. Claims in business rescue are paid as provided for in terms of Section 135 of the companies act. Creditors are simply ranked as secured and unsecured.[79] In terms of Section 135(3) the following will be paid first, and as such enjoys preference:

1. Practitioner's remuneration and costs as per section 143;[80]
2. Post-commencement finance (which includes any remuneration and re-imbursement for expense or other amounts of money relating to employment which becomes due and

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[76] Section 7(k) Companies Act.
[77] Cassim et al *Business Structures* - 471. Also see Delport P et al: *Henochsberg on the Companies Act, 71 of 2008,* at 448: *"..it is temporary and not intended to be a long-term debt management plan".*
[78] Section 133(1)(a) and (b) Cassim et al *Contemporary Company Law* 793.
[79] Section 135 of the Companies Act 71 of 2008.
[80] Section 135(3) of the Companies Act 71 of 2008.

payable to an employee during the company's business rescue proceedings, but are not paid);[81]

3. Post-commencement finance further includes financing obtained by creditors/lenders and section 135((2)(b) specifically allows a company in business rescue to obtain financing and to secure it by utilising any asset of the company, which asset is not otherwise encumbered;[82]
4. All post-commencement finance as mentioned in 2 *supra* will be paid in the order in which they were incurred;[83]
5. Claims will be paid in the following order of preference:[84]
    a. Remuneration of practitioner and costs as per section 143;
    b. Remuneration/re-imbursement for expenses or other amounts owing relating to employment which becomes due and payable during the business rescue proceedings;
    c. Any finance obtained after commencement of business rescue, whether secured or unsecured;
    d. Only there-after will any unsecured claims against the company be paid.

The above order of preference will remain in force if business rescue proceedings are superseded by a liquidation order, except to the extent of any claims arising out of the costs of liquidation. As such, the remuneration for the practitioner, employee costs as well as post-commencement finance obtained will have preferred status even in liquidation.[85]

The publication of Stein[86] in October 2011 provided a first interpretation of the ranking of creditors' claims under business rescue, and as follows:

"Creditors' claims will therefore rank in the following order of preference –

1. The practitioner for remuneration and expenses and other persons (including legal and other professionals) for costs of the business rescue proceedings;
2. Employees for any remuneration which became due and payable after business rescue proceedings began;

[81] Section 135(1) -(3) of the Companies Act 71 of 2008.
[82] Section 135(2)(b) of the Companies Act.
[83] Section 135(3)(b) of the Companies Act.
[84] Section 135(3) of the Companies Act.
[85] Section 135 of the Companies Act.
[86] Stein & Everingham: *The New Companies Act Unlocked: A Practical Guide* – 420-421.

3. Secured lenders or other creditors for any loan or supply made after business rescue proceedings began (i.e. post-commencement finance);
4. Unsecured lenders or other creditors for any loan or supply made after business rescue proceedings began (i.e. post-commencement finance);
5. Secured lenders or other creditors for any loan or supply made before business rescue proceedings began;
6. Employees for any remuneration which became due and payable before business rescue proceedings began; and
7. Unsecured lenders or other creditors for any loan or supply made before business rescue proceedings began".

The above interpretation was confirmed in *Merchant West Working Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company*[87]. Kgomo J specifically referred to the publication by Stein and set out the ranking of claims as follows:

"[21] Claims rank in the following order of preference:

1. The practitioner, for remuneration and expenses, and other persons (including legal and other professionals) for costs of business rescue proceedings.
2. Employees for remuneration which became due and payable after business rescue proceedings began.
3. Secured lenders or other creditors for any loan or supply made after business rescue proceedings began, i.e. post-commencement finance.
4. Unsecured lenders or other creditors for any loan or supply made after business rescue proceedings began, i.e. post-commencement finance.
5. Secured lenders or other creditors for any loan or supply made before business rescue proceedings began.
6. Employees for remuneration which became due and payable before business rescue proceedings began.
7. Unsecured lenders or other creditors for any loan or supply made before business rescue proceedings began."

Delport however is not in agreement. He points out that the ranking seems not to be in accordance with the provisions of sub-section 3 in that the subsection does not refer to secured claims prior to

[87] *Merchant West Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company Ltd* (13/12406) 10 May 2013 (GS) – par 21.

business rescue proceedings and suggests that those are regulated by section 134(3). [88] The ranking as per the judgment in *Merchant West Capital*[89] was also followed in *Redpath Mining South Africa (Pty) Ltd v Marsden NO and Others*[90] although in this instance the court expressly referred to the rights of “secured” creditors as per section 134(3).

In addition, Section 144 of the 2008 Companies Act stipulates that in respect of any remuneration, reimbursement or any other amount of money relating to employment, which became due and payable to an employee prior the company commencing with business rescue proceedings, such employee will be treated as a preferred unsecured creditor.[91] It is submitted that the ranking provided for in section 135, in the event of the business rescue proceedings being superseded by a liquidation order, creates a super preference in terms of the remuneration of the business rescue practitioner, employee costs as well as post-commencement finance. It also creates a super preference to post-commencement creditors within the business rescue proceedings itself as post-commencement creditors are offered a priority (or “super priority”) over all pre-commencement unsecured claims against the company.[92]

2.6.3 STATUTORY PREFERENCE IN BUSINESS RESCUE

Delport[93] holds that Chapter 6 have created two categories of statutory preferences, namely “super preferences” and “preferred unsecured creditors”. “Super preferences” refer to claims that came into existence after the initiation of business rescue proceedings, yet are paid before the claims of creditors, which arose prior to the commencement of business rescue proceedings. These “super preferences” rank as follows and indicated in the order of payment:

1. The remuneration and expenses of the business rescue practitioner as well as other expenses arising out of the costs of the business rescue proceedings as per section 131;[94]
2. Claims by employees for remuneration including any re-imbursement for expenses or other amounts of money relating to employment), which became due and payable to an employee during the business rescue proceedings;

[88] Delport P et al: *Hdenochsberg on the Companies Act, 71 of 2008* at 482(47).
[89] *Merchant West Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company Ltd* (13/12406) 10 May 2013 (GS).
[90] *Redpath Mining South Africa (Pty) Ltd v Marsden NO and Others* 18486/2013 (GSJ).
[91] Section 144 of the Companies Act 71 of 2008.
[92] Bradstreet *The new business rescue: Will creditors sink or swim?* (2011) 128 S African L.J. 352 at 360. Also see *Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others, Farm Bothasfontein (Kyalami) (Pty) Ltd v Kyalami Events and Exhibitions (Pty) Ltd and Others [2012] - “Post commencement creditors are thus offered a super-priority as an incentive to assist the company financially”.*
[93] Delport P et al: *Henochsberg on the Companies Act 71 of 2008* – at 520 – 521.
[94] *Ibid* at 520(1), section 131, section 135 of the Companies Act.

3. Claims by creditors for post commencement finance – thus lenders who provided financing to the company after the commencement of business rescue proceedings. Claims are paid in the order that they were incurred.

"Preferred unsecured creditors" are statutory preferent claims which must be paid before claims of other unsecured creditors of the company. These claims rank equally and are as follows:

1. Claims by employees for remuneration of employment related amounts that became due prior to the commencement of business rescue proceedings;[95]
2. Amounts due or owing to medical, pension or provident schemes.[96]

Delport's[97] interpretation of the above is that the legislature intended to confer some form of preference for the payment of these amounts albeit that the relevant section refers to these amounts owing as "unsecured claims". He further reasons that any other interpretation would result in these amounts owing being treated as concurrent claims, "which would obviate the need to have specifically mentioned these claims in the first place. It is submitted that the intention is to treat these creditors as preferred unsecured creditors, as is the case with employee claims under s 144(2)".

It is submitted that the priority afforded to creditors for post commencement finance is based on the fact that post-commencement finance is undoubtedly crucial for successful business rescues and the aim is most probably based on some form of incentive for creditors. The incentive of course being the affordance of priority payment for these post-commencement finance. The concern however is that creditors might provide such finance on the condition that their pre-existing claims are secured, thus in effect obtaining a benefit of priority to payment of the full amount of their claim against the company.[98]

2.6.4 STATUTORY PREFERENCE WITH REGARDS TO TAX

Chapter 6 does not recognise or provide for the preference of Statutory Obligations contained in Sections 99 to 102 of the insolvency act. This raises the question why the legislature, when

[95] Section 144(2) of the Companies Act.
[96] Section 144(4)(a) and (b) of the Companies Act.
[97] Delport P et al: *Henochsberg on the Companies Act 71 of 2008* at 521.
[98] Cassim *et al: Contemporary Company Law* at 884 *"This is a form of what has been referred to as "que-jumping"*. Also see Davis *et al: Companies and other Business Structures in South Africa* at p249 where it is submitted that stronger rights might be created under business rescue proceedings for certain categories of creditors that might not have enjoyed such strong rights under liquidation proceedings.

introducing business rescue in 2011 has decided not to maintain statutory preference in favour of tax claims within a business rescue context.

It can be argued that the principles are not the same in that business rescue has as its' main aim to rescue a financially distressed entity, which, if successful will ensure the continuity of the entity and the retention of employees. As such this decision might have been based on sound socio-economic considerations given the unemployment rate in South Africa.

It might also be argued that a "rescued" entity will in essence continue to contribute to the fiscus and therefore the state should take a "back seat" in terms of ranking within business rescue proceedings as it will reap the benefits of future contributions by the company, which in turn will be to the benefit of the country at large. Further to the above section 145 of the Companies Act regulates the participation by creditors. Subsection 4(a) stipulates that secured or unsecured creditors have a voting interest equal to the value of the amounts owed to them. Subsection (b) refers to concurrent creditors as a class. However, it is specific in nature in that it stipulates that "a concurrent creditor who would be subordinated in a liquidation has a voting interest, as independently and expertly appraised and valued at the request of the practitioner, equal to the amount, if any, that the creditor could reasonably expect to receive in such a liquidation of the company".[99]

The issue of non-preference for debt preferred in terms of Section 96 to103 of the Insolvency Act came under scrutiny in *The Commissioner for the South African Revenue Service and Mark Bradley Beginsel N.O.*[100] SARS contended that its position in business rescue should be based on its position of preferent creditor as contemplated by sections 96 to 102 of the Insolvency Act.

In this case, the business rescue practitioner filed for business rescue, put the business rescue plan to the vote, but treated the claim of SARS as unsecured and afforded it a voting right as contemplated in section 145(b) of the Companies Act 2008. The business rescue practitioner maintained that the Companies Act did not confer upon SARS any preferential status in business rescue proceedings. SARS contended that they were to be treated as a preferent creditor in business rescue proceedings and thus would have a voting right as per section 145(a) of the Act and that all other concurrent creditors would be concurrent creditors as per section 145(b) of the Act.

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[99] Section 145(4) of the Companies Act 71 of 2008.
[100] *The Commissioner for the South African Revenue Service and Beginsel NO, 2013(1) SA 307(C).*

SARS further contended that the business rescue practitioner could have treated its claim as preferent in that section 150(2)(b)(v) of the Act permits a business rescue plan to specify the order of preference in which the proceeds of the property will be applied to pay creditors, subject to the preferences regarding different classes of post-commencement finance creditors as contemplated in section 135. Fourie J held that "SARS' construction of the provisions of section 145(4) of the Act, is not only contrary the ordinary grammatical meaning of the words used in the said section, but also leads to an illogical result that fails to balance the rights and interests of all relevant stakeholders, as envisaged in section 7(k) of the Act".[101] The court confirmed that the Companies Act provides for certain preferences namely, section 135 regarding post-commencement finance and section 144(2) in respect of the preference afforded to remuneration relating to employment which became due and payable prior to the commencement of the company's business rescue proceedings, in respect of which the employee is a preferred unsecured creditor of the company for purposes of Chapter 6.[102]

The court further held that it was not the intention of the legislature to create the statutory preferences as contained in sections 96 to 102 of the Insolvency Act and Fourie J specifically stated: "….. I should have expected that, if it were the intention of the legislature to confer a preference on SARS in business rescue proceedings, it would have made such intention clear. This could easily have been done, but no trace of such an intention on the part of the legislature is found in the Act".[103]

It remains to be seen whether the legislature will follow this approach when the Insolvency Act finally comes under review.

2.7 CONCLUSION

It is submitted that sufficient arguments can be advanced that statutory preferences created for the state (and by the state) and specifically those in sections 99 to 101 of the insolvency act are in conflict with the principle of the *concursus creditorum* as well as the *"voor-sekwestrasie beginsel"* as was set out in paragraph 2.2 above.

[101] 100 *supra* at [22].
[102] 100 *supra* at [23].
[103] 100 *supra* at [24].

There seem to be no fair and just arguments that can be advanced in favour of these preferences safe for some argument that the amounts due to the state is utilised for the benefit of the public.[104] The loss to concurrent creditors outweighs the purported loss to the fiscus. In addition, it is submitted that the current status quo might be open for constitutional scrutiny on the grounds of equality as was discussed above.

SARS has extensive collection tools to its disposal and are already in an advantageous position prior to liquidation, and if used effectively should be able to avoid a liquidation scenario where the debt due to the fiscus has accumulated. With regards to Business Rescue it is submitted that the legislature had no intention to maintain the statutory preferences contained in the Insolvency Act. The preference afforded to SARS in liquidation proceedings is not afforded to them within Business Rescue.

It is unclear as to why the legislature chose not to prefer the fiscus if the argument that money collected for the fiscus is utilised for the benefit of the public at large is followed. Clearly that cannot be a just and equitable reason advanced for maintaining the current preference within insolvency.

[104] See 1996: *Review of the Law of Insolvency: Draft Insolvency Bill and Explanatory Memorandum* Working Paper 66, Project 63(1996) (hereinafter referred to as Discussion Paper 66) and *Review of the Law of Insolvency: Volume 2 Draft Insolvency Bill and Explanatory Memorandum,* Discussion Paper 86 vol 1 Project 63 (1999) – hereinafter referred to as Discussion Paper 86).

CHAPTER 3

INTERNATIONAL CONTEXT AND COMPARITIVE OBSERVATIONS

3.1 CHANGES INTERNATIONALLY WITH REGARDS TO STATUTORY PREFERENCE

Since this dissertation aims to discuss the preference awarded by statute and more specifically those awarded to the taxes or the "crown" as it is referred to in other systems, I will henceforth deal with some of these changes and the rationale behind the abolition of or changes to these priorities.

A number of systems have abolished crown priorities *in toto*, while others have retained it, but to a lesser extent (limited it to a certain time-period) or certain tax type for instance Pay As You Earn/Value Added Tax. Most of these changes came about as a result of internal reviews and reports published for this specific reason. Major reports, which I submit have been recognised internationally and have led to significant changes in those countries' Insolvency Legislation include the Cork Report[105], the Harmer Report[106] and The Bankruptcy Commission Report (US).[107] Authors seem to share the same view, in that as more and more corporations are expanding their businesses and have multi-international foot-prints, the need for sound and effective insolvency systems has increased.[108] There is also an increased awareness on a global level that commerce is increasingly becoming global in nature and as such, countries should benchmark against global best practices.[109] The World Bank paper on Principles for Effective Insolvency and Creditor/Debtor Rights Systems[110] has exactly this in mind and was originally developed in 2001 on request by the international community.

The paper, which is discussed more fully below in this chapter sets out global international best practices as benchmark for other countries. The report further states that "countries must adapt and evolve to maximize their own advantages for commerce and to attract investment by adopting laws and systems that create strong and attractive investment climates." This in itself illustrates the

[105] *Report of the Review Committee, Insolvency law and Practice,* 1982 (hereinafter referred to as the Cork Report).
[106] *Report of the Commission on the Bankruptcy Laws of the United States,* H.R. DOC. NO. 93-137 (1ST SESS. 1973), reprinted B Collier on Bankruptcy (15th ed. Rev. 1999) (hereinafter referred to as the Bankruptcy Commission Report U.S.).
[107] Australian Law Reform Commission: Report No. 45, General insolvency Inquiry 734 (1988) (hereinafter referred to as the Harmer Report).
[108] Day BK: *Should the Sovereign be paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy* – [46] .
[109] See The World Bank Paper 101069: Principles for Effective Insolvency and Creditor/Debtor Rights Systems (Revised 2015).
[110] See The World Bank Paper 101069: Principles for Effective Insolvency and Creditor/Debtor Rights Systems (Revised 2015).

importance of insolvency law as it encompasses much more than just a collective collection process. As Wood stated insolvency law is "the root of commercial and financial law".[111]

The core principle of a *pari passu* distribution in insolvency seems to be the driving force in almost all the review papers, reports and guidelines published, which have led to significant changes in some major countries, such as the United Kingdom, the United States of America, Australia and Canada in so far as it relates to statutory preference afforded to the Crown. In addition to review papers in the countries listed above, a great deal of work has also been done by *inter alia* the World Bank[112] and UNCITRAL[113] and a number of reports and guidelines have been published emphasising amongst others, the principle of a *pari passu* distribution and the need to minimise statutory preferences.

Although a number of arguments have been made in favour of a statutory priority for tax preferences, a significant number of arguments were made against it. I deal with it in chapter 4, save to say that the fundamental principle of *pari passu* distribution and equality amongst classes of creditors are eroded by imposing statutory preferences (or priorities as they are referred to in many works).

3.2 COMPARATIVE OBSERVATIONS: TAX PRIORITIES

During 2000, Day published a report titled *Should the Sovereign be Paid First?*[114] The report focused on eight countries and how these countries, namely England, Australia, New Zealand, Canada, the United States, Germany, France and Mexico treated tax claims under their respective insolvency laws. It is worth noting that the countries included both civil and common law jurisdictions and with both pro-debtor and pro-creditor systems.

According to the report all the eight countries concerned had reformed their insolvency laws within the last twenty-five years and prior to the amendments of their insolvency laws, all these countries had in the past provided for priority in respect of government claims. This report led to another

[111] Wood PR: *Principles of International Insolvency* - 1-001.

[112] See The World Bank Paper 101069: *Principles for Effective Insolvency and Creditor/Debtor Rights Systems* (Revised 2015) – C12.3 at p25 – *"Following distributions to secured creditors from their collateral and the payment of claims related to the costs and expenses of administration, proceeds available for distribution should be distributed pari passu to the remaining general unsecured creditors, unless there are compelling reasons to justify giving priority status to a particular class of claims."*

[113] UNCITRAL *Legislative Guide on Insolvency law* 2005 – guiding principle 8 at 13 namely *"Recognition of existing creditor rights and establishment of clear rules for ranking of priority claims."*

[114] Day BK: *Should the Sovereign be paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy*, 74 AM. Bankr. L.J. 461 (2000).

report published by the International Insolvency Institute in March 2006[115] which focuses on and compares a total number of 35 countries. The 2000 report was a valuable resource in terms of arguments raised both in favour of tax priorities and against tax priorities.

It should be noted that all eight countries have laws that governs both the liquidation of corporate entities and individuals.[116] In the 2000 report liquidation is defined as a collective proceeding which aims to achieve equitable treatment among creditors and to maximize the assets which are to be distributed amongst creditors - a definition indeed shared by all authoritative writers' in the field.[117] The types of taxes in the eight countries reviewed included direct and indirect taxes (similar to those in South Africa), with direct taxes representing taxes payable by the taxpayer itself (such as Income Tax/Capital Gains Tax etc.) and indirect taxes representing taxes withheld from employee wages or salaries or what we refer to as PAYE as well as VAT. Similar to the South African context, all eight countries have administrative procedures for the raising of assessments (taxes) as well as the collection thereof. All eight countries have extensive collection powers, the right to charge interest and penalties when taxes are overdue and the authority to appoint a third party (referred to as "garnishment" in the report) for monies held or owed on behalf of or to the delinquent taxpayer.

For purposes of this dissertation, the focus is on England, whom have abandoned its' crown preference and Australia, whom have been selected due to interesting developments in their insolvency legislation. Below is a discussion of the current legislation and treatment of tax priorities as well as the arguments raised both in favour and against tax priorities, which ultimately led to the amendment of their insolvency legislation.

[115] International Insolvency Institute: *Governmental Tax Priorities in Bankruptcy Proceedings* – International Insolvency Institute Committee on Tax Priorities in Bankruptcy – Reporter Barbara K Day, International Insolvency Institute Toronto, Canada and Washington D.C. March 2006 (*www.iiglobal.org*).

[116] Quoted verbatim as per 114 *supra*: "ENGLAND: Insolvency Act, 1986, Enterprise Act 2002c, 45, Parts IV-VII (Company Winding Up), Parts IX-XI (individual bankruptcy); AUSTRALIA: Corporations Law, 1993, pt. 5.4 (Company winding up, Bankruptcy Act, 1966 (individual bankruptcy, NEW ZEALAND: Companies Act, 1993 (company winding-up), Insolvency Act, 2006 (individual bankruptcy), CANADA: Bankruptcy and Insolvency Act, R.S.C., ch. B-3 (1985), UNITED STATES – 11 U.S.C. 701-706 (1994), GERMANY: Insolvenzordnung, v. 5.10.1994(BGBI.I S. 2866), FRANCE: Law No. 85-89 of January 25, 1985, effective January 1, 1086, subject to Decree Nos. 85-1388 and 85-1389 of December 27, 1985; MEXICO – Ley de Concursos Mercantiles, D.O. (May 12, 2000)" .

[117] Wood PR: *Principles of International Insolvency* – 1-002 - Wood states *"Bankruptcy is a collective procedure for the recovery of debts by creditors".* Also see Bertelsmann E et al: *Mars: The Law of Insolvency in South Africa* - §1.1*: "The main aim of the sequestration process in terms of the Insolvency Act is to provide for a collective debt collecting process that will ensure an orderly and fair distribution of the debtor's assets……."* Also see the Cork Report – par 1396: *".... a fundamental objective of the law of insolvency to achieve a pari paasu distribution of the uncharged assets of the insolvent among the unsecured creditors.*

3.2.1 ENGLAND

According to Day Crown preference dates back to feudal times and it entitled the monarch "to and absolute priority for revenue-related debts upon the insolvency of an English subject".[118] Insolvency (both corporate and personal) is governed by the Insolvency Act 1986.

The legislative changes in England were mainly as a result of the work done by the Cork Committee in 1982.[119] The Cork Report which was prepared by a Committee under the Chairmanship of the late Sir Kenneth Cork has led to the passing of the Insolvency Act 1986. The passing of this was the first major change in insolvency law in England in 50 years. The Committee's recommendations regarding preferential debts were: "… we have adopted the approach that no debt should be accorded priority unless this can be justified by reference to principles of fairness and equity which would be likely to command general public acceptance".[120] The committee further pointed out that the evidence received in critique of the law at that time (1982) was *"deeply hostile to the retention of any system of preferential debt".*[121]
Prior to the amendment of the law in 1986 the government (or crown as it is referred to in England) enjoyed statutory preference in all insolvency proceedings. The 1986 Insolvency Act however, did not remove all statutory priorities – they were only finally removed by the enactment of the Enterprise Act 2002 (UK). The 1986 Insolvency Act did, however, abolish preference for taxes such as corporate income tax / personal income tax, capital gains tax and local rates.[122]

The 1986 Insolvency Act provided for the following statutory preferences:[123]

i. Income tax withheld from emoluments – 12 months as well as from amounts due to subcontractors in the construction industry – 12 months;
ii. Value Added Tax and insurance premium tax – 6 months;
iii. Vehicle tax and tax – 12 months;
iv. Tax on various activities and gaming licenses – 6-12 months;
v. Social security contributions – 12 months;
vi. Contributions to occupational pension schemes and state scheme premiums;

[118] See Day BK: *Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy* – [463] which further refers to *"Magna Carta (Confirmed version), 9 Henr. III, 1225, C. It is said that the Magna Carta determined that "The King's Debtor dying, the King shall be first paid".*
[119] See the Cork *Report.*
[120] See the Cork *Report* – at para 1398.
[121] See the Cork *Report* – para 1396 to 1450.
[122] Recommendation in the Cork *Report* 1982 (see note 6 1450 at 382-29 – recommendation to abolish priority for income tax, corporation tax and capital gains tax.
[123] See Day BK: *Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy* – p16.

vii. Sums due in respect of certain European Community levies on production of coal and steel and surcharges for delay in payments.

The above priority claims are paid *pari passu* with priority wage claims, after covering the costs of administration.

Arguments or rather justifications for tax claim preference per the Cork Report were as follows:

i. Tax claims are purported to be for the benefit of the community;[124]
ii. Tax authorities are involuntary creditors;[125]
iii. For VAT and PAYE (tax where the debtor acts as collector for the government) the argument were advanced that such monies, without preference to the government, will inflate the distribution to unsecured (concurrent) creditors, whom will be advantaged by such a windfall.[126]

Criticism regarding the affording and/or maintaining of preference to tax claims was mainly as follows:

i. The community argument was criticised and it was advanced that the debt owed to the government *vis a vi* the total government receipts would be insignificant where-as the loss to unsecured private creditors may cause real and severe financial hardship;[127]
ii. The Government is not the only involuntary creditor (and there is simply no general practice or rule that an involuntary creditor should receive some kind of preference.[128]

The Cork report recommended the abolition of certain tax priorities (Income and Corporate Tax, Capital Gains Tax) and a limitation to the period allowed for other tax types (such as VAT and

[124] See the Cork *Report* – at 320 *"it has been represented to us that sums due in respect of unpaid tax ought to have priority…. because they are owed to the community."*

[125] See the Cork *Report* – at 320 *"it has been represented to us that sums due in respect of unpaid tax ought to have priority…. because Revenue, unlike others who give credit, is an involuntary creditor."*

[126] See the Cork *Report* – at 321 *"Unless some measure of priority were accorded to the Crown for moneys collected on its behalf, or they were to be regarded as impressed with a trust, would go to swell the insolvent's estate to the advantage of the general body of creditors. We cannot think it right that statutory preference enacted for he more convenient collection of the revenue should enure to the benefit of private creditors."*

[127] See the Cork *Report* – at 320 *".....We unhesitatingly reject the argument that debts owed to the community ought to be paid in priority to debts owed to private creditors. A bad debt owed to the State is likely to be insignificant in terms of total Government receipts' loss of a similar sum by a private creditor may cause substantial hardship, and bring further insolvencies in its train."*

[128] See the Cork *Report supra* – at 320 *"The Crown is not alone in being an involuntary creditor. Many suppliers of goods and services are constrained to extend credit facilities in accordance with the custom of the trade, In a practical sense they have no real choice in the matter, and are sometimes unable to exercise credit control. Many other categories of involuntary creditor may readily be called to mind, litigants who obtain judgments for costs, for example, and the victims of breach of contract and tort do not normally extend credit voluntarily to their debtors."*.

PAYE).[129] The enactment of the Enterprise Act 2002 abolished priority treatment for PAYE, VAT and customs and excise duties. Section 251(1) removed these priorities from the list of preferential debts in Schedule 6.[130] The only remaining priority claims are:

i. Employer's Contributions to occupational pension schemes;

ii. A limited amount of employee remuneration claims for accrued holiday pay; and

iii. Levies on coal and steel production under the European Coal and Steel Community Treaty.

3.2.2 AUSTRALIA

Australian law has its' roots in English law.[131] The first federal bankruptcy legislation in Australia was enacted by the Commonwealth of Australia in 1924.

Insolvency in Australia has seen many amendments in recent years, the most substantial being the Bankruptcy Amendment Act 1991 (Cth) and according to Keay the most important being the Bankruptcy Legislation Amendment Act 1996 (Cth).[132] The Corporate Law Reform Act 1992 (Cth) further introduced amendments to corporate insolvency and was as a result of the Harmer Report, which report was handed down in 1988.[133]

The Australian Law Reform Commission was responsible for an enquiry into insolvency during 1987 to 1988 which resulted in the Harmer Report. What the Cork Report did for the review of insolvency legislation in the United Kingdom, the Harmer Report achieved for the overhaul of Insolvency legislation in Australia.

The Harmer report recommended the abolition of all tax priorities and raised the following arguments in substantiating the removal:

1. The Australian Tax Office ("ATO") might allow tax debt to accumulate which will be to the disadvantage of other unsecured creditors who would be ignorant of this fact. Such accumulation of tax debt would not prejudice the position of the ATO.
2. There is no incentive for the ATO to recover such debt within the normal commercial manner.

[129] See the Cork *Report* – at 328-329.
[130] Section 251(1), Enterprise Act 2002.
[131] See Keay A: *Insolvency Personal and Corporate Law and Practice* – Chapter 1.
[132] See Keay A: *Insolvency Personal and Corporate Law and Practice* – p3.
[133] See the Harmer *Report.*

3. The debt owed to the ATO is not significant *vis-á-vis* the total government receipts received, but it might be significant to other creditors.
4. Should tax priority be abolished it would not have a significant impact on the ATO in terms of its' total revenue.
5. The abolition cause a reduction in litigation.[134]

Priority afforded to tax debts was abolished in 1993 by the enactment of the Insolvency (Tax Priorities) Legislation Amendment Act 1993. To compensate the taxing authority, amendments were made to the Insolvency (Tax Priorities) Legislation Amendment Act and company directors are personally liable for unremitted tax. The Commissioner can also initiate winding-up proceedings at an earlier stage and for an uncertain amount.[135]

3.2.3 SOME OTHER COUNTRIES WITH NO PRIORITY FOR TAXES

For purposes of this study a few other countries with no preference for taxes will be mentioned without further discussion.
According to the International Insolvency Institute Report on Governmental Tax Priorities in Bankruptcy Proceedings,[136] Sweden and Turkey have abolished all general tax priorities (employee wage claims were retained as priority). Austria, Finland, Germany and Estonia afford no priority whatsoever to unsecured claims of any type arising prior to the opening of insolvency proceedings.

Indeed, Austria was the first country to have taken this approach and in 1982 abolished priority for all pre-bankruptcy claims *in toto* so as to provide for or rather enhance the universal principle of equal treatment amongst creditors. Finland abolished all priority claims in commercial insolvency cases for the same reason as Austria. Germany abolished all priorities during 1999 and Estonia implemented this model on 1 January 2004.[137] All these countries' taxing authorities have extensive collection or enforcement tools, provided for outside bankruptcy proceedings.

3.3 CONCLUSION

Over the past two decades, many countries have revised their insolvency laws in accordance with the principle of an equitable distribution between creditors. It is submitted that insolvency law is

[134] See the Harmer Report par 738-41. Also see Symes CF: *Reminiscing the Taxation Priorities in Insolvency* at III.
[135] Insolvency (Tax Priorities) Legislation Amendment Act, 1993 - 2.1.7.4.
[136] See 115 *supra.*
[137] See136 *supra*.

not only limited to insolvency *per se* but actually encompasses a number of other areas of the law such as contract law, labour law, commercial or corporate law and taxation law. Insolvency law should take into consideration all these aspects and provide for a smooth interplay amongst these various disciplines of law.

Furthermore, tax priorities afforded in liquidation (whether by means of provisions in insolvency legislation or by tax legislation), have received considerable negative commentary and the views in both the Harmer and Cork reports seem to be consistent in that they should either be limited, or abolished *in toto.*[138] Both reports, on good grounds recommended the total removal of any statutory priority.

Papers by UNCITRAL as well as the World Bank strongly suggest a movement towards insolvency systems with limited priorities especially not in favour of the fiscus as will be more fully discussed in chapter 4.[139] Even on the national level, the discussion papers and draft Insolvency Bill by the South African Law Reform Commission are suggesting the total abolition of tax priority.[140]

[138] See the Cork *Report* and the Harmer *Report:* Both the Harmer and Cork Reports contained similar commentary with specific regards to priority afforded to tax claims and both reports recommended the abolishment of such priority (statutory preference).

[139] See United Nations Commission on International Trade Law: *Legislative Guide on Insolvency law 2005* (ISBN 92-1-133736-4) (herein after referred to as "the guide") and The World Bank Paper 101069: *Principles for Effective Insolvency and Creditor/Debtor Rights Systems* (Revised 2015).

[140] 1996: Review of the Law of Insolvency: *Draft Insolvency Bill and Explanatory Memorandum Working Paper 66*, *Project 63* (1996) (hereinafter referred to as Discussion Paper 66) and *Review of the Law of Insolvency: Volume 2 Draft Insolvency Bill and Explanatory Memorandum, Discussion Paper 86 vol 1 Project 63* (1999) – (hereinafter referred to as Discussion Paper 86). The South African Law Reform Commission was previously known as the South African Law Commission. For purposes of this dissertation reference will be made to the South African Law Reform Commission.

CHAPTER 4

POLICY CONSIDERATIONS AND LAW REFORM

4.1 INTRODUCTION

It is accepted that the object of South African Insolvency law was stated by Innes J in *Walker v Syfret*[141] namely: "to ensure a due distribution of assets among creditors in the order of their preference… The sequestration order crystallises the insolvent's position; the hand of the law is laid upon the estate and at once, the rights of the general body of creditors have to be taken into consideration. No transaction can thereafter be entered into with regard to estate matters by a single creditor to the prejudice of the general body. The claim of each creditor must be dealt with as it existed at the issue of the order".

In the same case, Lord de Villiers CJ stated: "The effect of a winding-up order is to establish a concursus creditorum, and nothing can thereafter be allowed to be done by any of the creditors to alter the rights of the other creditors". In my view, two important principles or objects are pertinent from the above judgment, namely, the principle of an equal distribution of the assets of the estate amongst the creditors (in order of their preference), and secondly, the collective nature thereof – that is, the *concursus* creditorum, which is established once an order for liquidation is made. The fact that nothing can be done thereafter to prejudice the general body of creditors, also indicates the requirement to govern the relationship between creditors amongst each other as well as the relationship between the debtor and the body of creditors.

In this regard, Swart[142] has written substantially on the subject and concluded that the judgment in *Walker v Syfret*[143] had entrenched the principle of *concursus creditorum* in our insolvency system. This judgment further sets out how the division of the estate should take place.

Swart[144] maintains that it follows that the relative position of creditors as at date of insolvency should determine their ranking. In other words, a creditor who does not hold security prior to the date of insolvency should maintain his position as unsecured (therefore concurrent) creditor after

[141] Walker v Syfret, NO, 1911 AD 141.
[142] Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* – Chapter 11, p 255-257.
[143] See 141 *supra.*
[144] Swart BH: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* – Chapter 8, p 91-131.

insolvency. Therefore, any change in the position of a creditor on an *ex post facto* basis would result contrary to the decision in *Walker*.[145]

As discussed in chapter 2, our insolvency law sets out how the assets in an insolvent estate are to be divided after realisation. It distinguishes between two types of creditors, namely secured creditors and unsecured creditors, with unsecured creditors being further divided into two categories - those with a statutory preference (referred to as statutory preferent creditors) and concurrent creditors. Secured creditors (who holds a form of real security as recognised by the insolvency act) are paid from the proceeds of their security (after payment of certain costs) whilst statutory preferent and concurrent creditors are paid from the free residue with the provision that statutory preferent creditors are first in line.

Be that as it may, given what was discussed in previous chapters and given the *locus classicus* of *Walker v Syfret*[146] one would expect the relevant legislation to express or reflect these basic principles to ensure that insolvency law guards against any conduct which is in conflict with these principles. One would further expect that legislation to be kept up to date and be current in nature. It is safe to say that the South African insolvency legislation is not current in that our insolvency act dates back to 1936. It is further safe to say that the Act does not reflect international standards and principles simply because it has not been reviewed in 81 years. Commerce is taking place on a global scale and one would expect the legislature to take cognisance of this fact as businesses are expanding. Furthermore, the insolvency law, if reviewed should at least be benchmarked against global best practices.

The Legislative Guide on Insolvency law,[147] as published by UNCITRAL in 2005 states: "Because society is evolving, insolvency law cannot be static, but requires reappraisal at regular intervals to ensure that it meets current social needs. Responses to perceived social change involve an act of judgment that can be informed by international best practice. Such practice can then be transposed into national insolvency regimes, taking into account the realities of the system and available human and material resources". In addition, the law should also seek to balance the rights of the various parties in insolvency, namely the rights of the debtor, the rights of the creditors as well as the rights of the community at large.

[145]Walker v Syfret, NO, 1911 AD 141.
[146] Walker v Syfret, NO, 1911 AD 141.
[147] UNCITRAL *Legislative Guide on Insolvency law* 2005 – p16.

4.2 ESSENTIAL PRINCIPLES OR FUNDAMENTALS OF AN INSOLVENCY SYSTEM

As mentioned before Wood[148] describes Insolvency law as: "the root of commercial and financial law because it obliges the law to choose". In addition, Wood further argues that fundamental issues should be agreed upon on a global or international scale and therefore the issue of harmonisation comes to mind.

Fletcher[149] describes the foremost characteristic of developed insolvency law as the principle of collectivity. According to him a further feature is the ethical proprieties in the relationship between the creditors and the insolvent as well as the relationship between the creditors themselves. He refers to the general notion of "equality among creditors" and notes that this practice has been modified by judicial and legislative interventions which have "superimposed a system of stratification of liabilities, whereby certain groups of creditors are accorded preferential status or otherwise acquire some kind of privilege, and hence enjoy improved prospects of recovering full or partial payment of their debts". If one has regard to the general notion of equality or the *pari pasu* principle one has to agree with Fletcher with regards to preferential status.

It can further be argued that this affording of a statutory preference is in clear conflict with the principles laid down in *Walker v Syfret*[150] in that it does alter and, more so, improve the relative position of these preferred creditors.

4.3 UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW: LEGISLATIVE GUIDE ON INSOLVENCY LAW

UNCITRAL was requested during 1999 to undertake further work with specific regards to corporate insolvency and how to foster the adoption of effective insolvency regimes. What started in 1999 finally resulted in a comprehensive guide on Insolvency law, published in 2005, which contains key objectives and fundamental features for a strong insolvency system.[151]

I deal with the recommendations to establish and or develop an effective Insolvency law below as I believe that these recommendations should be considered in any attempt to review our current insolvency law as it has become crucial for countries to benchmark against best practices globally.

[148] Wood PR: *Principles of International Insolvency* – 1-002, 1-007.
[149] Fletcher I: *The Law of Insolvency* – p2.
[150] Walker v Syfret, NO, 1911 AD 141.
[151] UNCITRAL *Legislative Guide on Insolvency law* 2005.

According to the legislative guide, the following are regarded as the key objectives and structure of an effective insolvency law:

1. Insolvency law should provide certainty in the market place so as to promote economic growth and stability. More and more countries are moving towards a rescue culture, which are in most instances, incorporated in their Insolvency laws.
   UNCITRAL suggests that insolvency laws should promote the restructuring of viable businesses and the efficient closure and transfer of assets of those businesses that have failed. This should enable the assessment of credit risk, not only domestically, but internationally.[152] In the South African context the introduction of Business Rescue in the Companies Act of 2008[153] has been a step in the right direction with regards to a rescue culture.

   The Guide therefore suggests that the following key objectives be implemented with a view of enhancing certainty in markets and promoting economic stability and growth:
   a. Insolvency law should aim to maximise the value of the assets in an insolvent estate – (the aim is to facilitate maximum distribution to creditors). One way of doing this is to provide for incentives to achieve the maximum value for assets. Voidable dispositions (as they are known in our legislation) are one of the examples, which if provided for efficiently can achieve the goal of maximising the value of assets.[154]

   b. It should ensure equitable treatment of similarly situated or classes of creditors – it is based on the principle of collectivity. Creditors with similar legal rights should be treated equally and fairly, receiving a dividend in accordance with their ranking.[155]

   c. It should provide for the timeous, efficient and impartial finalisation of insolvency – this principle deals with the administration process. The liquidation process should be finalised timeously, efficiently and effectively in order to also

[152] See 151 *supra – p10 – 4.*
[153] See chapter 6 Companies Act ss 128 – 155 read with s7(k).
[154] See 151 *supra – p11 – 6.*
[155] See 151 *supra – p11 -7.*

reduce the costs, which will support the objective of maximising the asset value.[156]

The above can be achieved by an insolvency system that allows easy access to formal proceedings – clear and objective criteria to be set out. The Law should further provide for convenient means of identifying, collecting, preserving and recovering of assets belonging to the estate. There must be clear rules regarding payment of debts and liabilities, facilitating participation by both the debtor and the creditors alike, with little delay and in a cost effective way. The law should further provide for the administration proceedings (professionals and the institutions involved), in order to achieve effective resolution of the estate.

d. It should preserve the assets in the insolvent estate so as to ensure and allow an equitable distribution to creditors – collection action by individual creditors should be stayed in order to prevent premature dismemberment of a debtors' assets. A stay in collection action by individual creditors may allow some breathing space for the debtor involved, but also enable a proper examination into the debtors' financial position, thus facilitating the maximising of assets as well as and equitable distribution to creditors.[157]

e. The law should be transparent and predictable and contain provisions for the incentives of gathering and dispensing of information – an insolvency law which is transparent and predictable allows potential lenders and creditors to understand how the law functions and to assess their risks as creditors in the event of insolvency. An unpredictable law will undermine confidence in the system and cause unwillingness to make investment and/or credit decisions prior to insolvency.[158]

   It is further suggested that insolvency law should clearly indicate all the provisions of any other legislation that may affect the conduct of insolvency proceedings (i.e. labour law, taw laws, commercial and contract law etc.)

[156] See 151 *supra – p12 -8-9.*
[157] See 151 *supra – p12 -10.*
[158] See 151 *supra – p13 – 11-12.*

f. It should recognize existing creditors' rights and establish clear rules for the raking of priority claims – the legislative guide provides an important recommendation with regards to priority claims is provided for in the legislative guide, namely, that priority claims, namely, that priority claims that are not based on commercial bargains should be minimised. It is further noted that the recognition and the enforcement of differing rights of creditors, which they held *prior* to the commencement of insolvency, will create certainty.[159]

g. Establish a framework for cross-border insolvency – It is suggested that an Insolvency law should adopt the UNCITRAL Model Law on Cross-Border Insolvency.[160]

4.4 REFORM IN SOUTH AFRICA

The fact of the matter is that South African Insolvency Legislation is 81 years old. It is safe to say that it has not kept up with changes and has been "static". The South African Law Reform Commission has been busy with efforts to reform the current insolvency law since 1980 and since 1996 has published two Draft Bills.[161]

This is in addition to six interim reports and seven working papers up to 1999, which were published for comments. The current act has been in operation since 1936, and amended more than 20 times, but never reviewed in totality.[162] In addition to these working papers, and specifically those relating to the winding-up of companies and closed corporations, and in conjunction with the South African Law Reform Commission, proposals for a unified Insolvency Act were also made by the University of Pretoria, Centre for Advance Corporate and Insolvency law.[163]

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[159] See 151 *supra – p13 – 13.*
[160] See 151 *supra* – p14. It needs to be noted that South Africa has indeed adopted the UNCITRAL Model Law on Cross-Border Insolvency as adopted in Vienna on 30 May 1997. The Act (Act 42 of 2000) was assented to in December 2000 (on 8 December 2000) and came into effect on 28 November 2003. However, the Cross Border Insolvency Act has not come into full effect as the Minister of Justice has to designate foreign states in respect of which the Act will apply. Also see MARS: The Law of Insolvency in South Africa at 30.1. This designation requirement is a deviation from the UNCITRAL Model Law in the sense that it requires reciprocity.
[161] See 60 *supra*.
[162] See *Review of the Law of Insolvency*: *Volume 2 Draft Insolvency Bill and Explanatory Memorandum,* Discussion Paper 86 vol 1 Project 63 (1999) – at 1.1.
[163] University of Pretoria, Faculty of Law, Centre for Advanced Corporate and Insolvency law – *Final Report containing Proposals on a Unified Insolvency Act – Final Report and Explanatory Memorandum,* January 2000.

The Final Report together with Explanatory Memorandum was prepared for the Standing Advisory Committee on Company Law and the Insolvency Project Committee of the South African Law Reform Commission, its specific purpose was to make proposals regarding the merging of the liquidation provisions in the Companies Act 61 of 1973 and the Closed Corporations Act 69 of 1984 into the Draft Insolvency Bill as drafted the by the South African Law Reform Commission at the time (Discussion Paper 86, Project 63). The above report clearly was not considered favourably as the new Companies Act still provides for the winding up of companies (albeit only applicable to "solvent" companies).[164] Since this dissertation aims to focus on statutory preference, I shall discuss the submissions made by the Law Commission in this regard. The guidelines used as basis for the proposed amendments contained in Discussion Paper 86 are briefly as follows:

i. A number of legal systems were considered – reform proposals were considered with a view of finding innovative solutions to the problems experienced with the insolvency law.[165]

It was noted by the Commission that a number of similarities between the general principals of Insolvency law were found in various systems and it found that similar solutions are used for similar problems. A general need exists for efficient procedures to deal with the assets of an insolvent estate.

ii. The Discussion Paper further points out that its aim to "balance and satisfy the needs of the different stakeholders", namely the commercial community in general and more specifically the creditors, insolvent debtors, insolvency practitioners and the government.

The basis for the review was the need of all stakeholders for effective, speedy and fair procedures.[166]

iii. Practical and technical solutions to problems should not be underestimated. Problems in an insolvency system should be solved fairly and efficiently as it is to the benefit of the economy as well as society as a whole. An example of obtaining the directions of creditors at an early stage of insolvency was used and it was submitted that such directions at an early stage can ensure the finalisation of the estate and limiting the period that funds are caught up or kept in the insolvent estate.[167]

[164] Item 9 of Schedule 5 Transitional Arrangement of the Companies Act 71 of 2008.
[165] Discussion Paper 86 – p1 at 2.1.
[166] Discussion Paper 86 – p 2 at 2.2.
[167] Discussion Paper 86 – p 2 at 2.3.

iv. The constitutionality of the recommendations or provisions contained in the proposed Bill was considered.

4.4.1 SOUTH AFRICAN LAW REFORM COMMISSION: STATUTORY PRIORITIES – COMMENTARY RECEIVED ON DISCUSSION PAPER 86

Comments received with regards to statutory priorities that all creditors, including the Land Bank, should be treated equally and bound by the Insolvency Act. In addition, it was submitted that preferences for institutions such as the State (tax) and Workmen's Compensation Commissioner be limited to the absolute minimum.[168]

Discussion Paper 66 also contained similar comments to the effect that statutory provisions which prefer certain creditors are unwanted and cannot be justified on the basis that they are in the public interest (that is to say funds are utilised for the community at large).[169] It was further submitted that one of the reasons why concurrent creditors are seldom awarded any dividend is that of the preferences to the State and other creditors are paid from the free residue; there are also the special rights of the State and other creditors. It therefore is not surprising that the only preference contained in the proposed Bill are those in favour of employees, contributions to employee funds and claims for arrear maintenance payable in terms of a court order.[170]

Those Creditors enjoying preference in terms of legislation other than the Insolvency Act were dealt with in Working Paper 61, published for comment in 1995. However, aspects relating to preference created by the Insolvency Act as per the commentary received on Working Paper 61 are dealt with in the proposed Bill and relevant Working Paper 86.[171] It is re-iterated in Discussion Paper 86 that statutory provisions which prefer creditors are "undesirable and cannot be justified merely because revenue is utilised for the public or because the State or State assisted bodies are involved".[172] The Discussion Paper and Proposed Bill also contain recommendations for the removal of the special protection of the Land and Agricultural Bank.

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[168] Discussion Paper 86 – p 5 at 3 (b) and (c).
[169] Discussion Paper 86 – p 5 at 3.10.
[170] Discussion Paper 86 – p 8 at 4.4.6. Also see Clause 80 of the Proposed Bill.
[171] Statutory Provisions that Benefit Creditors, Working Paper 61. Also see Discussion Paper 86 – p 15-16 at 7.1 – 7.2.
[172] Discussion Paper 86 – p 16 at 7.3 – 7.4.

It was also recommended that the preference for monies due to a body corporate in terms of section 15B(3)(a) of the Sectional Titles Act[173] should fall away. It was submitted that there is no reason why the Body Corporate should enjoy a preference and special protection.[174]

The lien in terms of section 114 of the Customs and Excise Act[175] should be limited to property so attached prior to insolvency in terms of section 114(2) of the said Act. It was further submitted in Discussion Paper 86 that the lien should be limited to property of a person liable for duty or a levy or persons who are guilty or partaking in tax evasion. It was further submitted that a lien in favour of the State be treated or limited to enjoy the same rights as that of an ordinary lienholder in insolvency.[176]

4.4.2 SOUTH AFRICAN LAW REFORM COMMISSION: DISCUSSION PAPER 86: DRAFT INSOLVENCY BILL

A number of new definitions contained in Discussion Paper 86 as they may be included should the Insolvency Act be reviewed:[177]

"concurrent creditor" means a creditor who has a claim other than as a secured creditor or preferent creditor"

"preferent creditor" means a creditor whose claim enjoys preference in terms of section 80(2) or (3) or a similar preference in terms of any other Act"

"secured creditor" means a creditor on an insolvent estate who holds security for his or her claim against the estate"

"security" in relation to the claim of a creditor of an insolvent estate, means property of the insolvent estate over which the creditor has a preferent right by virtue of any special bond, landlord's legal hypothec, pledge, including a cession of rights to secure a debt, right of retention, reservation of ownership, financial lease, or a preferent right over property in terms of any other Act"

"special bond" means a mortgage bond hypothecating any immovable property or a notarial bond hypothecating specially described moveable property in terms of section 1 of the Security by Means of Moveable Property Act, 1993 (Act 57 of 1993), or such notarial bond registered before 7 May 1993 in terms of section 1 of the Notarial Bonds (Natal) Act, 1932 (Act No. 18 of 1932)".

[173] Sectional Titles Act, Act 95 of 1986.
[174] Discussion Paper 86 – P 18 AT 7.10.
[175] Customs and Excise Act, Act 91 of 1964.
[176] Discussion Paper 86 – p23 AT 7.20.5.
[177] Discussion Paper 86 Volume 2 Draft Insolvency Bill Project 63 ISBN 0-621-29377-6 – Clause 1.

Since this dissertation focuses on statutory preference and more specifically those afforded to taxes, I shall now deal with the suggested amendments of same, which are contained in section 80 of the Draft Insolvency Bill under the heading "Application of the free residue".

Section 80 first provides for the payment of the costs of liquidation.[178] There-after the balance of the free residue shall be applied to pay:

1. Salaries to employees employed by the insolvent – for a period not exceeding three months;[179]
2. payment in respect of leave or holiday due to the employee during the year of liquidation or the previous year;[180]
3. any other payment in respect of any other form of paid absence for a period not exceeding three months;[181]
4. any severance or retrenchment pay due to the employee immediately prior to liquidation in terms of any law, agreement, contract or wage regulating measure;[182]
5. any contributions which the insolvent owes in his capacity as employer to any pension, provident, medical aid, sick pay, holiday, unemployment or training scheme or fund, or any similar scheme or fund;[183]
6. payment of the above are not to exceed the smaller of R7 500 or six month's salary with regards to a single employee;[184]
7. The above amounts may be amended by the Minister by notice in the Gazette.[185]

Reference to an unemployment fund does not include the Unemployment Insurance Fund[186] as referred to in section 6 of the Unemployment Insurance Act.[187] Section 80(3) further allows for preference to payment of maintenance in terms of a court order that are in arrears as at the date of liquidation of the estate, limited to a period of three months and subject to the maximum amount fixed for payments in terms of clause 2(a)(i).[188]

[178] Clause 80(1) of the Draft Insolvency Bill as per Discussion Paper 86.
[179] Clause 80(2)(a)(i) of the Draft Insolvency Bill as per Discussion Paper 86.
[180] Clause 80(2)(a)(ii) of the Draft Insolvency Bill as per Discussion Paper 86.
[181] Clause 80(2)(a)(ii) of the Draft Insolvency Bill as per Discussion Paper 86.
[182] Clause 80(2)(a)(iv) of the Draft Insolvency Bill as per Discussion Paper 86.
[183] Clause 80(2)(b) of the Draft Insolvency Bill as per Discussion Paper 86.
[184] Clause 80(2A(a) of the Draft Insolvency Bill as per Discussion Paper 86.
[185] Clause 80(2A(b) of the Draft Insolvency Bill as per Discussion Paper 86.
[186] Clause 80(2)C(b) of the Draft Insolvency Bill as per Discussion Paper 86.
[187] Unemployment Insurance Act, Act 30 of 1966.
[188] Clause 80(3) of the Draft Insolvency Bill as per Discussion Paper 86.

There-after the free residue shall be applied in payment of holders of general bonds over movables or special bonds over movables with a general clause, registered in the deeds registry.[189] Provision is made for the payment of simple interest from the date of liquidation to date of payment at the rate of interest prescribed in terms of the Prescribed Rate of Interest Act.[190] There-after the free residue shall be applied to pay the claims of concurrent creditors in proportion to the amount of their claims.[191]

4.5 CONCLUSION

It is clear that our insolvency law is in dire need of review with specific regards to the number and nature of statutory priorities. As discussed in chapter 3 many countries have already revised their insolvency laws and are no longer providing for any priority with specific regard to taxes.

Sufficient arguments on both international level and national level have been made by means of *inter alia* the Cork Report, the Harmer Report and the South African Law Reform Commission[192] for the total abolishment of priorities afforded to taxes alternatively at least for consideration to minimise same.

Goode[193] states that "the most fundamental principle of insolvency law is that of *pari passu* distribution, all creditors participating in the common pool in proportion to the size of their admitted claims". He further states that such rateable distribution, despite it being fundamental and all pervasive, is hardly ever achieved and cites as one of the reasons for this the fact that "huge chunks of what remains" must be applied to pay claims which ranks in priority to those of unsecured creditors. Heath[194] correctly states that increasing preferential "debts" simply results in unsecured creditors receiving less. According to Heath, questions on policy and principles arise when one considers who should bear the loss in insolvency. For example, Heath states that the "over-riding requirement of insolvency law is to determine which of two or more innocent parties will, ultimately, bear a loss". The only question that remains then is whom should bear the loss. Unless there is justification based on social, economic or political reasons to prefer one creditor above another, Heath suggests that such preference should not be afforded. He further added that

[189] Clause 80 3A of the Draft Insolvency Bill as per Discussion Paper 86.
[190] Prescribed Rate of Interest Act, Act 55 of 1975.
[191] Clause 80(4) of the Draft Insolvency Bill as per Discussion Paper 86.
[192] See 60, 105 and 107 *supra.*
[193] Goode RM *Principles of Corporate Insolvency law* (1997) – 59-60.
[194] See Heath P – *Preferential Payments on Bankruptcy and Liquidation in New Zealand* – 30-31. Also see Heath *"How Can Creditors Achieve Certainty? A Commentary"* (1993) *NZ Law Conference, Conference Papers,* Vol 2 p 187 at 189 par 5.2.

good reason should exist to depart from the *pari passu* principle. Heath is in favour of the abolition of priorities afforded to the "Crown" (tax debt). It is submitted that the current statutory priorities afforded to taxes seems not to be justified on any social or economic reasons and the legislature will have to show just cause should it decide to maintain these priorities in future.

It remains to be seen whether the legislature will indeed formally review the Insolvency Act, and to what extent the proposals made in Discussion Paper 86, the proposed Insolvency Bill as well as international papers/guidelines as discussed in chapters 3 and 4 above will be taken into account.

5. CONCLUSION

5.1 GENERAL PRINCIPLES

As discussed in chapter 1 the universal principle of insolvency is to provide for a *pari passu* distribution of a debtors' asset amongst his creditors.[195] As such, any provisions in legislation with regards to statutory preference in insolvency are thus in conflict with this principle. Claims of unsecured creditors are therefore eroded by what Wood refers to as the "ladder of priorities".

As fully set out in Chapter 1, in terms of South African insolvency law the fundamental principle is that of the *concursus creditorum*. This principle was explored by Swart,[196] the "voor-sekwestrasiebeginsel" correctly suggests that all creditors' claims must be dealt with as it existed at the time of liquidation, thus implying that a statutory preferent creditor will be treated as a "normal" unsecured creditor seeing that as at date of liquidation such creditor(s) did not hold any form of security to afford them any priority. This was fully explored in chapter 1 and I conclude that this position is indeed what the courts intended in various judgments.[197]

5.2 SOUTH AFRICAN PERSPECTIVE

The current statutory priorities provided for in the insolvency law were discussed in Chapter 2. I discussed the recommendations made, not only in the international arena but also in the recommendations made by the South African Law Reform Commissions' Review and the proposed draft Insolvency Bill.

I submit that, as regards priorities currently afforded to the state in terms of Tax, there can be no justification on social grounds for maintaining same should the law be amended.

I submit that those priorities contained in section 96 – 98(A), namely, Funeral and death-bed expenses; cost of sequestration, cost of execution and amounts due to certain employees and funds could probably be justified in terms of the public interest and sound socio-economic considerations. However, as regards to priorities currently in favour of taxes namely PAYE, customs, excise and sale duty in terms of the Customs and Excise Act and VAT, it is my submission that there can be

[195] See chapter 1: General Background.
[196] Swart B: *Die Rol van 'n Concursus Creditorum in die Suid-Afrikaanse Insolvensiereg* as discussed in 1.1 as well as 2.2.
[197] See chapter 2.2: *Walker v Syfret, NO,* 1911 AD 141, also see *Ward v Barrett* 1963 2 SA 546 (A) and *Porteus v Strydom* 1984 2 SA 489 (D) as discussed in chapter 2.2.

no justification in terms of the public interest to maintain such priorities should the law be amended.

Even the proposed Draft Bill does not contain any priority in terms of these taxes. There is much substance in the submissions in the UNCITRAL guide namely that these priorities not only shrink or reduce the available funds available for distribution to the unsecured creditors, but that they also infringe on the fundamental principle of a *pari passu* distribution. They therefore should be either abolished as happened in many countries, or the legislature should consider limiting the time-period allowed for these claims.

Both the Cork and Harmer report contained a number of arguments in favour of abolition of priorities afforded to tax.[198] Both reports indicated that the amount so lost by the government would be insignificant if weighed against the total receipts of the government although they can be significant to unsecured creditors in an insolvency. It is further submitted that if South Africa wishes to remain in line with current international trends in terms of insolvency law and systems, serious consideration should be given to these priorities. The fact that the UNCITRAL Model Law on Cross Border Insolvencies[199] was adopted gives some indication that it might be the vision of the legislature to remain in line with current international trends and legislation.

5.3 INTERNATIONAL PERSPECTIVES

Taking into account what has been set out in the chapter 3, international developments and the fact that the economic landscape of today is not that of 1936, it is clear that the current insolvency law does not represent modern times and is in serious need of a full and comprehensive review.

Current international writers have criticised the existence of statutory preference and in almost all instances argues for the abolition specifically of preferences afforded to the State in terms of tax. In the international landscape, the fundamental principle of liquidation is the *pari passu* distribution of the assets in an insolvent estate amongst the creditors.
The Cork report[200] stated that "It is a fundamental objective of the law of insolvency to achieve a rateable, that is to say pari passu, distribution of the uncharged assets of the insolvent among the unsecured creditors". The view of the Cork Report in relation to the United Kingdom was shared in

[198] Refer to chapter 3 for discussion on the Cork Report and the Harmer report respectively.
[199] Refer to chapter 4.3.
[200] Refer to chapter 3.2.1 for a discussion on the findings of the Cork *Report*.

the Australian Law Reform Commission's report, General Insolvency Inquiry (the Harmer Report),[201] which regards "equal sharing" as the fundamental principle of insolvency law. The commission's review was based on this fundamental principle and it was recommended that priority afforded to the Commissioner of Taxation should be abolished as "it provides a substantial advantage to the Commissioner over other creditors…".

The Harmer Report also stated: "Despite this principle, the objective of equal distribution is rarely, if ever, achieved because of the extensive range of creditors upon whom statutory priority is conferred. It is the view of the Commission that, to the maximum extent possible, the principle of equality should be maintained by insolvency law subject to these qualifications:

- It should not intrude unnecessarily upon the law as it otherwise affects property rights and securities; and
- It should encourage the effective administration of insolvent estates.

Any departure from this approach should only be countenanced by reference to clearly defined principles or policies which enjoy general community support".[202]

International writers share the same view regarding the fundamental principle of insolvency law being a *pari passu* distribution and the abolition, alternatively limitation of statutory preference. Further to the above reviews and international writers, a number of international organisations, such as UNCITRAL, the World Bank and the International Monetary Fund have done a number of researches and published various guidelines and reports containing some fundamental key issues. A key feature in these papers is the common principle of equality amongst creditors and the maximising of the distribution of assets to the creditors in the estate.

In the Legislative Guide on Insolvency law published by UNCITRAL[203] it is submitted that there are many diverse creditors in insolvency proceedings, with different and competing rights. Most of these creditors' rights stems from having entered into a legal or contractual relationship with the insolvent and all have competing rights. However, taxing authorities *inter alia* as well as claimants in tort (as it is referred to in the international context) have no contractual relationship with the insolvent. Claims by these creditors not having a contractual relationship with the insolvent are dealt with in terms of different laws. In South Africa this is provided for in the insolvency act and enjoys statutory preference.

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[201] Refer to chapter 3.2.2 for a discussion on the findings of the Harmer *Reports*.
[202] Refer to chapter 3.2.2 for a discussion on the Harmer *Report* and its' recommendations
[203] Refer to chapter 4.3 for a discussion on the UNCITRAL Legislative Guide.

As a result, creditors may have the same rights based on their contractual or legal relationship with the insolvent, whilst others might enjoy superior rights or claims. Therefore, insolvency law ranks creditors in accordance with their claims for purposes of distribution of the proceeds of the assets in an insolvent estate. This ranking of creditors based on the different contracts that creditors have entered into with their debtor is accordingly viewed as justifiable as the insolvency law recognises and uphold the different contracts or as it is referred to in the Guide "bargains" which creditors have struck with the insolvent debtor.[204]

Insolvency law further affords certain priorities (statutory priorities) to unsecured claims, which rank higher or rather will be paid in priority to others. It is argued that these priority claims which are normally based on social and in some instances political considerations is in conflict with the principle of *pari passu* distribution and in general affects or are detrimental to ordinary unsecured creditors as they decrease the value of the assets available for distribution amongst them as a class.[205]

Some of the priority claims are indeed in line with the public interest (such as the priority afforded to the costs of the proceedings including the costs of the administrator, the administration of the estate) and it is recommended that the reasons for affording and establishing these priorities be clearly stated in the insolvency law so as to provide for and ensure transparency and predictability.[206] The Guide suggests that priorities afforded in terms of insolvency law be kept to a minimum as the higher the number of creditors being afforded priority treatment, the less beneficial that treatment becomes and it can also lead to inequities.[207]

5.4 POLICY CONSIDERATIONS AND REFORM

As fully discussed in chapter 4 above it is submitted that the aim of insolvency law is to provide for an equal distribution amongst creditors within an insolvent estate, and secondly the collective nature thereof, or otherwise stated, the *concursus creditorum* which is established once and order for liquidation is made.[208]

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[204] Refer to chapter 4.3 for a discussion on the UNCITRAL Legislative Guide
[205] Refer to chapter 4.3.
[206] Refer to chapter 4.3.
[207] Refer to chapter 4.3.
[208] Refer to chapter 3.1.

A number of important guidelines and reports have been published in this regard by *inter alia* the United Nationals Commission of International Trade Law[209] and the World Bank.[210] On national level the Discussion Papers and Draft Insolvency Bill published by the South African Law Reform Commission has made some significant proposals, all in favour of the total abolishment of the current statutory priorities afforded to taxes in specific.[211]

5.5 CONCLUSION

I submit that statutory preference in relation to taxes should be abolished for the following reasons:

1. It is against the principles of *pari passu* distribution amongst creditors.[212]

2. Statutory preference has the effect of altering the rights of these creditors so preferred and has a detrimental effect on concurrent creditors to the extent that it erodes the available pool for distribution.[213]

3. It is in conflict with the decision in *Walker v Syfret*[214] in that the claims of statutory preferent creditors are not being dealt with as it existed at the date of granting the order. Thus, and as Swart[215] has explained, it alters the relative position of these creditors and they are in a better position after liquidation than they were prior to liquidation.

4. It is against international best practices as discussed in chapters 3 and 4 respectively.

5. The legislature has failed to provide any acceptable policy considerations for such priority in relation to taxes and the current *status quo* might be open for challenges in terms of the constitutionality thereof.[216] There is sufficient justification for all other existing preferences but not for that of SARS.

[209] Refer to chapter 3.1, 4.1 and 4.3 specifically for a discussion on the United Nationals Commission on International Trade Law.
[210] Refer to chapter 3.1.
[211] Refer to chapter 4,4, 4.4.1 and 4.4.2.
[212] Refer to chapter 1.1.
[213] Refer to chapter 3.2.1 and 3.2.2 for a discussion on recommendations by the Cork Report and Harmer report respectively.
[214] Refer to chapter 1.1 and 2.2.
[215] Refer to chapter 1.1 and 2,2.
[216] Refer to chapter 2.3.2 for a discussion on the constitution and unfair discrimination.

6. In accordance with the Cork and Harmer reports[217] the abolition of the preference will be minimal in terms of total receipts or revenue for SARS, although the amount might be significant for other creditors, especially in difficult economic times.

7. The abolishment of priority for taxes does not mean that SARS will not receive any dividend in insolvency. SARS will still be treated as concurrent creditor and will thus share whatever is available in the free residue with other concurrent creditors on a *pro rata* basis.

8. SARS has to its' avail significant collection methods during the ordinary course of business, which other creditors do not have. As such SARS is already "preferred" in a pre-liquidation phase.[218]

9. It is submitted that priorities afforded to specifically SARS within insolvency proceedings should be brought on par with that in Business Rescue.[219]

[217] Refer to chapter 3.2.1 and 3.2.2 for a discussion on the Cork *Report* and the Harmer *Report*.
[218] Refer to chapter 2.5 for a discussion on the collection tools available to SARS.
[219] Refer to chapter 2.6.2, 2.6.3 and 2.6.4 for a discussion on the ranking of creditors and priorities within Business Rescue.

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