SOUTH AFRICAN LAW COMMISSION

PROJECT 37

REVIEW OF PREFERENT CLAIMS IN INSOLVENCY

REPORT

July 1984

To The Honourable H J Coetsee, MP, Minister of Justice.

I am pleased to submit to you in terms of section 7(1) of the South African Law Commission Act, 1973 (Act 19 of 1973), for consideration the Commission's report on the review of preferent claims in insolvency.

G VILJOEN
CHAIRMAN
27 July 1984

INTRODUCTION

The South African Law Commission was established by the South African Law Commission Act, 1973 (Act 19 of 1973).

The members of the Commission are -

The Honourable Mr Justice G Viljoen (Chairman)
The Honourable Mr Justice H J O van Heerden (Vice-Chairman)
Prof J T Delport
Mr J E Knoll
Mr P A J Kotzé
Mr P J J Olivier SC
Mr G G Smit
Prof C H Smith (Additional member for the purposes of the project)

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British Columbia Report	Law Reform Commission of British Columbia Report on the Crown as creditor: Priorities and privileges LRC 57 Victoria: Queens Printer for British Columbia 1983 99p
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1. INTRODUCTION

1.1 Origin of the project

In May 1979 in a memorandum to one of your predecessors the Secretary for Justice wrote as follows:

> Masters of the Supreme Court have in the past warned against the creation of new preferent claims. It stands to reason that the creation of more preferent claims or the increase of the amounts claimable under existing preferent claims would further erode the free residue available for distribution among concurrent creditors. Although convincing reasons for the creation of new categories of preferent claims or the increase of maximum amounts under existing preferent claims might exist, it becomes more and more difficult to decide where the line must be drawn. It appears necessary that a thorough investigation into the law relating to preference in insolvency ought to be carried out with a view to reforming this branch of the law. It is suggested that the matter, including the requests for the inclusion of particular categories of preferent claims referred to above, be referred to the South African Law Commission for investigation.

Your predecessor granted his approval for the Commission to undertake such an investigation, and the project was included in the Commission's programme.

1.2 Scope of the project

There are two classes of creditors who enjoy preference over the other creditors in general. The first class is known as secured creditors. They are creditors who hold certain assets or rights over them as security for the payment of their claims. Section 2 of the Insolvency Act[1] defines security as property of the insolvent estate over which the creditor has a preferent right by virtue of any special mortgage, landlord's legal hypothec, pledge or right of retention. Apart from these four types of secured creditors, section 84(1) of the Insolvency Act accords a seller in terms of an instalment sale transaction[2] a hypothec over the property sold whereby the amount still due under the sale transaction is secured. There are also other Acts which create preferences similar to a pledge or right of retention.[3] All these secured creditors are

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1 Act 24 of 1936. Hereinafter the "Insolvency Act".
2 Credit Agreements Act 75 of 1980.
3 Cf eg sec 114 of the Customs and Excise Act 91 of 1964; sec 33 of the Land Bank Act 13 of 1944; sec 173 of the Co-operatives Act 91 of 1981.

paid out of the proceeds of the particular assets comprising their security. Whatever remains of the insolvent estate[4] after payment of the claims of secured creditors constitutes the free residue of the insolvent estate. Creditors falling into the second class enjoying preference are those who are in terms of sections 96 to 102 of the Insolvency Act entitled to payment of their claims out of the free residue of the insolvent estate, before the claims of the remaining creditors (concurrent creditors) are taken into account. These creditors are hereinafter referred to as preferent creditors.

It is inferred from the memorandum referred to in paragraph 1.1 above and the representations made to the Department of Justice for the extension of existing preferences and the creation of new preferences that the investigation must be confined to preferences payable out of the free residue. The Commission has, however, included a separate project on the giving of security by means of movable property in its programme.

1.3 Historical survey

Several hypothecs existed under the common law which conferred a preference on some creditors over others:[5]

> Tacit hypothecs, which might be both special and general, are a legacy from the Roman law. In addition to the reception of numerous tacit hypothecs from the Roman law dozens of new tacit hypothecs were created by legislation in the Roman-Dutch law.
>
> The common law tacit hypothecs hampered the commercial intercourse of the time. Since these hypothecs came into being by operation of law without registration, it was impossible for a grantor of credit to ascertain whether the assets of the prospective borrower were already subject to a tacit hypothec. This was probably the reason why most of the common law hypothecs were already abolished by pre-Union legislation in three of the provinces - the exception being the Orange Free State.

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4 Cf the definition of "property" in sec 2 of the Insolvency Act. There are also statutory provisions in terms of which property does not vest in an insolvent estate. Cf sec 23 and 82(6) of the Insolvency Act; sec 5A of the National Supplies Procurement Act 89 of 1970 discussed in par 3.6.8 below; sec 4(7) of the Financial Institutions (Investment of Funds) Act 56 of 1964; sec 78 and 79 of the Attorneys Act 53 of 1979.

5 Van der Merwe 441 and 493 (our translation). Cf Wille 235.

This clearing-up process was followed by section 85 of the Insolvency Act, which provided that no tacit hypothec other than a landlord's legal hypothec or the hypothec of the hire-purchase seller, specially created by section 84 of the same act, conferred any preferent right against an insolvent estate.

The old Insolvency Act,[6] which abolished certain common law hypothecs, itself again introduced preferences in their present form.[7] Other preferences followed shortly afterwards[8] and preferences increased through the years until the present position was reached.

The preferences contained in sections 96 to 102 of the present Insolvency Act differ from the common law hypothecs in that they confer no real rights over the property of a debtor, but on insolvency their effect on concurrent creditors is the same. As is the case with common law hypothecs there is no way in which a person who extends credit can determine how much will be due to preferent creditors. Apart from the advantage that they are the first to receive payment, preferent creditors are liable to pay a contribution only in exceptional circumstances if the proceeds of the assets do not cover the administration costs.[9]

1.4 Short survey of the existing legal position

Sections 96 to 102 of the Insolvency Act provide for the order of priority of claims on the free residue of an insolvent estate. The order of priority is briefly as follows:

(a) Funeral expenses not exceeding R300.

(b) Death-bed expenses not exceeding R300.

(c) Costs of sequestration and costs of administration of the insolvent estate.

(d) Costs of execution before sequestration.

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6 Sec 86 of the Insolvency Act 32 of 1916.
7 Funeral and death-bed expenses sec 82; costs of administration sec 83; costs of execution before sequestration sec 84; salaries sec 85.
8 Sec 93 of the Income Tax (Consolidation) Act 41 of 1917; sec 18 of the Miners' Phthisis Act 40 of 1919.
9 Sec 106 of the Insolvency Act; Mars 394.

(e) The following, which rank pari passu:

(i) Amounts due in terms of the Workmen's Compensation Act in respect of a workman.

(ii) Amounts which in terms of the Income Tax Act were deducted or withheld by the insolvent in respect of another person's obligation to pay tax but were not paid to the Commissioner for Inland Revenue.

(iii) Amounts due, in terms of the Occupational Diseases in Mines and Works Act, to the Compensation Fund for Mines and Works.

(iv) Amounts due in terms of the Customs and Excise Act.

(v) Amounts provided by the State from the National Supplies Procurement Fund.

(vi) Sales tax.

(vii) Appreciation contributions in terms of the Community Development Act.

(viii) Amounts due by an employer to the Unemployment Insurance Fund.

(ix) Contributions payable under any law to any pension, sick, medical, unemployment, holiday, provident or other insurance fund.

(f) Salary or wages (including a commercial traveller's commission) due to an employee for two months or certain fees due to an accountant, auditor or a nurse not exceeding R2 000 for each employee, accountant, auditor or nurse and an employee's leave or bonus in respect of leave for 21 days and not exceeding R1 000.

(g) Income tax.

(h) Claims secured by bonds on movables.

(i) Concurrent creditors.

(j) Ex lege claims for maintenance after sequestration and the claim by an investor if a partnership is involved.

Section 342(1) of the Companies Act,[10] provides as follows:

> In every winding-up of a company the assets shall be applied in payment of the costs, charges and expenses incurred in the winding-up and ... the claims of creditors as nearly as possible as they would be applied in payment of the costs of sequestration and the claims of creditors under the law relating to insolvency ...

Section 219 of the Co-operatives Act[11] contains provisions similar to those in sections 97 and 99 to 101 of the Insolvency Act relating to the insolvency of a co-operative.

1.5 Publication of the working paper

At the July 1982 meeting of the Commission a working paper on preferences on insolvency[12] was approved for publication. The working paper was reproduced by the secretariat of the Commission and on 17 January 1983 it was forwarded to 50 persons or bodies from whom correspondence had earlier been received in connection with the project or who, in view of the secretariat, have interest in the project or can make a contribution in this regard. A list of the persons and bodies to whom the working paper was forwarded mero motu appears as Annexure A to this report. When the Government Printer had reproduced the English working paper in March 1983, 45 copies were dispatched to contacts abroad and 64 copies were sent to law libraries, law journals, the judges president, the law societies, universities and other interested parties. During March 1983 the working paper was also announced in a press statement and a notice in the Government Gazette. Reports in newspapers, in professional journals and over the radio announced the availability of the working paper. In response to telephonic and written requests for the working paper approximately 160 copies were forwarded to interested parties. The vast majority of persons and bodies who asked for the working paper did so in response to the notice in the Government Gazette. During the Commission's meeting in Cape Town in April 1983 the working paper was discussed with the local representatives of the law society,

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10 Act 61 of 1973.
11 Act 91 of 1981.
12 Hereinafter the "working paper".

auditors, the Master of the Supreme Court and trust companies. References in this report to pages of the working paper are references to the English reproduction by the Government Printer.

In the working paper[13] the following general premise was provisionally accepted and the following tentative proposals were made:

> It should be accepted as a general premise that the unsecured creditors should be dealt with on an equal footing except for justified preferences. Justified preferences must be based on considerations of fairness, not only to the preferent creditor concerned but also to the general body of creditors. The interest of the community as a whole and any hardship which a creditor would suffer in the absence of a preference should also be taken into account.
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> It is recommended that in applying these criteria only the following preferences on the free residue of an insolvent estate are justified:
>
> (a) sequestration costs and costs of administration pari passu;
>
> (b) claims by a former employee of the insolvent in respect of salary or wages, limited to two months' salary or wages and claims in respect of bonus or leave, subject to a maximum amount of R1 500 (or an amount fixed by the minister from time to time) per employee, provided that commission due to someone in full-time employment of an employer is for the purposes of this preference reckoned as salary or wages;
>
> (c) claims in respect of a mortgage over movables to the extent that the free residue was subject to the mortgage.
>
> It is proposed that all other preferences at present provided for should be abolished.

Written comment on the working paper came from the 23 persons or bodies mentioned in Annexure B. The Commission expresses its gratitude to the persons and bodies who commented on the working paper and in so doing made their specialised knowledge on the subject available to the Commission. Considering that the subject of the working paper does not receive much prominence or elicit much interest in the legal literature, the reaction to the publication of the working paper may be regarded as satisfactory. The comments received were in general favourable and eight of the commentators supported the recommendations in the working paper wholly or substantially. One commentator rejected the recommendations without giving reasons and pleaded for the retention of the

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13 Par 19 at 104.

existing position. The rest of the commentators mostly limited themselves to the recommendations which effect them and pleaded for the retention of existing preferences in their favour. One commentator recommended a new preference and requested that the payment of certain claims should be deferred until other creditors have been paid.[14] Another commentator also requested that a new preference should be recognised.[15]

2. ARGUMENTS AGAINST PREFERENCES IN GENERAL

2.1 Preferences cause dissatisfaction of other creditors

The Cork Committee[16], which investigated the insolvency law in England, came to the following conclusion:[17]

> We have received a considerable volume of evidence on this subject, most of it critical of the present law, and much of it deeply hostile to the retention of any system of preferential debts. We are left in no doubt that the elaborate system of priorities accorded by the present law is the cause of much public dissatisfaction, and that there is a widespread demand for a significant reduction, and even a complete elimination, of the categories of debts which are accorded priority in an insolvency.

A similar line of thought is apparent from the preface to a textbook on the English law of insolvency.[18] The granting of preferences frequently results in hardship to other creditors.[19] It appears from the comments on the working paper and discussions with interested parties that in South Africa, too, there is dissatisfaction with the existing preferences and strong support for steps to eliminate or drastically reduce the preferences.

2.2 The precedents created by existing preferences lead to requests for further preferences

It is possible to advance reasons for the existence of all the preferences allowed at present. If these reasons are examined it generally emerges that

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14 Par 4.1 below.
15 Par 4.2 below.
16 Cork Committee Report par 1397 at 317.
17 Quotations to the same effect appear in par 143 at 42 and par 233 at 61 of this report.
18 Williams and Muir Hunter vii quoted in par 1.2 at 2 of the working paper.
19 Scotland Report par 15.4(3) at 220; British Columbia Report 37.

other creditors can advance the same or some of the reasons why they should also be entitled to a preference.[20] It is undesirable to allow one creditor a preference while other creditors who are entitled to a preference for similar reasons are allowed no preference. Nor, since the equal treatment of creditors is the fundamental purpose of the insolvency law, would it do to expand the preferences to such an extent that concurrent creditors receive virtually nothing. The appropriate solution is to limit preferences to cases which are clearly entitled to special treatment and which cannot be adequately met in another way than the granting of a preference.

2.3 Exceptions to the rule of equal distribution should be allowed only if cogent reasons exist

The line of approach of the Cork Committee Report appears from the following:[21]

> Since the existence of any preferential debt militates against the principle of pari passu distribution and operates to the detriment of ordinary unsecured creditors, 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.

The Scotland Report[22] and the British Columbia Report[23] also emphasise that preferences should be limited to cases where cogent reasons for an exception exist. In the working paper[24] the Commission also provisionally accepted this view and no commentator doubted the correctness of this approach.

2.4 Preferences lead to creditor apathy

The Chief Master of the Supreme Court commented as follows:

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20 Cf the Cork Committee Report par 241(3)(b) at 64 under "Evidence received by the Committee".
21 Par 1398 at 317. Cf par 1072 at 245.
22 Par 2.20 at 10.
23 At 1.
24 Par 19 at 104, see par 1.5 above.

> Criticism is often levelled at non-preferent creditors for not actively involving themselves in the administration of an insolvent estate by appearing at meetings, giving the trustee instructions and so on. Their apathy can to a certain extent be ascribed to the fact that they are not in many cases, because of all the preferent claims, hopeful of receiving a dividend.

The Ontario Law Reform Commission[25] draws attention to the ability of the State to "snatch" the fruits of the enforcement efforts of other creditors. This state of affairs evokes a great deal of criticism. The British Columbia Report[26], the Cork Committee Report[27] and the Scotland Report[28] point out that the existence of preferences may result in ordinary creditors not being interested in the administration of insolvent estates because the fruits of any endeavours to recover more for insolvent estates will in the first place accrue to preferent creditors. If the preferences were abolished this might encourage ordinary creditors to protect their interests more diligently. This would be a healthy development and might have the effect that companies and their officials would observe the law with greater care knowing that creditors would closely examine the dealings of the company if a creditor were not paid in full as a result of insolvency.

The granting of preferences may result not only in the indifference of ordinary creditors, but also in preference creditors' not being so prompt to recover their claims.[29] The British Columbia Report[30] observes the following in this regard:

> Sometimes when a debt due to the Crown is not paid, the Crown extends a period of grace to the debtor to overcome a temporary financial difficulty before taking any action to recover. The Crown can give time without serious risk because of its priority. This practice, while commendable, clothes the debtor with an appearance of liquidity which is not supported in fact. Thus, third parties subordinate to the Crown's priority may be misled as to the extent of their risk and extend credit where they would not otherwise have done so.

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25 Ontario Report 28.
26 At 36 et seq.
27 Par 914 at 214.
28 Par 15.4(2) at 219.
29 Par 1.7 of the working paper at 5.
30 At 38.

Allegations that the preferences in favour of the State result in the State's failing to take suitable action to enforce its claims are dealt with in the course of the discussion of the State's preferences below.[31]

2.5 Preferences hamper the administration of insolvent estates

In their comments on the working paper the Southern African Institute of Charte red Secretaries and Administrators and the Law Society of the Cape of Good Hope argued that the abolition of preferences would facilitate the administration of insolvent estates. Although the preferences probably do not entail much extra work for administrators of insolvent estates[32] the removal of preferences would nevertheless simplify the work in the majority of cases.

3. EVALUATION OF EXISTING PREFERENCES

3.1 Introduction

The working paper gives a detailed exposition of the origin, nature and merits of each of the existing preferences and a short exposition of the preferences in related legal systems. An evaluation of each of the existing preferences will now be made in the light of the comments received on the working paper and developments in related legal systems. The detailed exposition in the working paper will not be repeated and this report concentrates on the evaluation of the reasons which can be advanced for each of the preferences.

3.2 Funeral expenses

Section 96 of the Insolvency Act[33] provides that the free residue shall be applied in the first place in defraying the expenses of the funeral of the insolvent, if he died before the submission of the trustee's first distribution account, and in defraying the expenses of the funeral of the insolvent's wife or minor child if those expenses were incurred within the three months preceding the sequestration of the insolvent's estate. The preference is limited to a

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31 Par 3.6.2 (c).
32 If one preferent creditor is entitled to the whole balance for distribution this might facilitate the distribution of the estate.
33 Quoted in full in par 3.1 at 11 of the working paper.

maximum amount of R300.[34] If the free residue is insufficient the funeral expenses are paid out of the proceeds of the other assets of the insolvent estate (assets subject to secured claims) in proportion to their value.

In earlier times the reason advanced for the preference was that for sanitary reasons it was to the benefit of the community that corpses should be buried.[35] Our present law provides that the local authorities or the institutions where the deceased died are responsible for the funeral of destitute persons or the funeral of the deceased where no person undertakes to bury and does bury the deceased.[36]

The Scotland Report[37] accepts the justification that funeral expenses are a "debt of humanity" and recommends that the highest preference for funeral expenses should be retained. The Cork Committee Report[38] recommended that the preference for funeral expenses should be retained in England.

The National Funeral Directors' Association of Southern Africa advances the following reasons for the retention of the preference:

- The solvency of an estate cannot be predetermined and funeral services must be performed in good faith.
- There are many persons who as a result of bad health do not have any insurance for funeral expenses.
- The onus for the burial of the remains is placed involuntarily upon the funeral undertakers where other preservation facilities are not available.
- Increased prices to compensate for losses as a result of the abolition of the preference will place an unfair burden on the public and contribute to inflation.

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34 Sec 12(a) of the Insolvency Amendment Act 101 of 1983 increased the maximum amount from R100 to R300.
35 Van Zyl 547; Voet 11.7.7; Faber's commentary on D 11.7.14 discussed in Stewart v Insolvent Estate Hyland (1907) 17 CTR 343 at 344.
36 Sec 48(2) of the Health Act 63 of 1977.
37 Par 15.24 at 229.
38 Par 1400 at 317.

- A considerable increase in pauper funerals will increase State expenditure.

- If estates are no longer so readily accepted as debtors great inconvenience will be caused to the relatives of the deceased. (The Law Society of Transvaal also submits that the unenviable position of the family justifies the retention of the preference.)

- Fewer than 20 % of funerals are cash transactions and for the balance payment has to be awaited until the favourable finalisation of the estates.

- The general impression that the funeral directors' trade is extremely healthy and profitable and is therefore able to absorb bad debt, is contradicted by the fact that the net return of one of the largest funeral directors amounts to only 2,4 % on a turnover of R15 000 000.

One of the commentators[39] supports the tentative recommendation in the working paper that this preference should be abolished, for the following reasons. He is of opinion that it is the right (if not the obligation) of the survivors, as a matter of dignity and self-respect, to bury their dead in accordance with their means and according to the tenets of the deceased's religious community. If for any reason the individual basically responsible for seeing to the burial is unable to do so, the community concerned should as a matter of social conscience bury the deceased. This commentator is also of opinion that undertakers (who according to him often supply services which are more sumptuous than necessary) have no right to call on anybody else to render them assistance if they cannot recover their costs. The other commentators who commented on the tentative proposals in the working paper in general support the recommendation that this preference should be abolished.

The funeral of a loved one is an emotional event. It would be undesirable to add to the stress accompanying the death of a loved one by the problem of the financial burden of funeral expenses and arrangements to determine who will be liable for the funeral expenses and the time of payment. Although there is at

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39 M J Ensor, a trust company official.

present a preference for funeral expenses this does not result in financial arrangements for the funeral being delayed until after the funeral. The effect of further arrangements which may perhaps have to be finalised before the funeral if the preference is abolished, should not be considerable.

Voet[40] mentioned the following reason for the preference:

> The principle which operates in favour of religious duty appeared to be the highest of all principles.

The next of kin of the deceased undoubtedly feel morally obliged today to give him a proper funeral. They are the ones who wish to pay the last respects to the deceased by way of a fitting and dignified funeral. The question may well be posed why this should take place at the expense of the deceased's creditors. One would expect that the "religious duty" which Voet mentions should rest on the next of kin or possibly on the community as a whole rather than on the deceased's creditors. If the abolition of the preference resulted in more persons having to be buried by local authorities as paupers, the funeral expenses would have to be borne by the general public. It appears more reasonable that the general public rather than the deceased's creditors should carry this burden. It is the view of the Commission that it is in any case unacceptable that funeral expenses should enjoy a higher preference than costs of sequestration and that in certain cases the expenses should even be borne by secured creditors. Judging by the guide-lines as set out above, the Commission is not convinced that any person will suffer hardship as a result of the absence of the preference, indeed the Commission believes that the abolition of the preference will best serve the interests of creditors in general and the community. Accordingly it is recommended that the preference in respect of funeral expenses be abolished.

3.3 Death-bed expenses

Section 96 of the Insolvency Act[41] provides that the free residue, after payment of the preference for funeral expenses, shall be applied in defraying the death-bed expenses of the insolvent if they were incurred before the submission

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40 11.7.9 Gane's translation Vol 2 at 738.
41 Quoted in full in par 3.1 of the working paper at 11.

of the first distribution account and the death-bed expenses of the insolvent's wife or minor child if they were incurred within the three months preceding the sequestration of the insolvent's estate. The preference is limited to R300.[42] If the free residue is insufficient the death-bed expenses are paid out of the proceeds of the other assets of the insolvent estate (assets subject to secured claims) in proportion to their value.

Voet[43] believes that this preference gained recognition in the common law as a result of an oversight. He also points out that the preference is limited to the expenses of an illness which results in the death of the patient. The preference therefore favours the doctor whose treatment was unsuccessful above the doctor who succeeded in saving the patient's life.

Van Zyl[44] advances the following as a reason for the preference:

> A person should not be deserted in the hour of death, and, therefore, death-bed expenses should be preferent.

Although a medical practitioner may normally refuse to treat a patient if he thinks that the patient might not pay him,[45] he is obliged in terms of a guideline of the Medical Council to render assistance in an emergency.[46] Medical schemes, which guarantee payment, alleviate the problem. Although the number of persons who enjoy coverage under medical schemes is increasing rapidly[47] it is clear that there will be no question of medical cover for virtually the whole population in the near future. However, there are measures for providing health services for the needy.[48]

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42 Sec 12(b) of the Insolvency Amendment Act 101 of 1983 increased the maximum amount from R100 to R300.
43 11.7.15.
44 At 547. Cf McNally v Wiggett's Trustees (1905) 22 SC 686.
45 Strauss 31.
46 Ibid 12.
47 Van Assche "Ziekteverzekering in Zuid Afrika" 1978 De Jure 9 indicated that 3 728 637 persons enjoyed coverage. According to particulars for December 1982 obtained from the Registrar of Medical Schemes the number was then 4 667 966 which amounted to about 18 % of the population.
48 Sec 12(b)(iv) of the Health Act 63 of 1977.

The Scotland Report[49] describes the claim for funeral expenses as "a debt of humanity" which for this reason deserves the highest priority. The working paper which tentatively proposed that the preference be abolished was forwarded to the Medical Association of South Africa but the Association did not offer any comments. The commentators who commented on the tentative proposals in the working paper, in general, or on the proposed abolition of this preference, in particular, support the proposal that this preference should be abolished.

The medical practitioner is in the exceptional position that he is obliged to render his services in an emergency without regard to any risk that he will not be paid. Private medical and nursing services are expensive, and the preference for R300 which exists is so limited as to be of little value. The preference is furthermore limited to accounts of patients who did not survive the treatment. Should the preference be extended to cover actual expenses of all emergency treatment, the creditors of the insolvent estate would be seriously prejudiced. Medical practitioners usually have a great number of patients and a big turnover. Losses in connection with the few patients who do not pay for emergency treatment which was followed by the death of the patient should not make a big difference to the total earnings of a medical practitioner. It was noted above that medical cover, which alleviates the problem, is expanding rapidly and that measures exist to provide health services for the needy. As indicated with regard to funeral expenses in paragraph 3.2 above, the Commission is of opinion with regard to death-bed expenses that it is unacceptable that these costs enjoy a higher preference than costs of sequestration and that in certain cases the expenses should even be borne by secured creditors. The Commission finds that the preference for death-bed expenses is not justified and recommends that it be abolished.

3.4 Costs of sequestration and administration

Section 97 of the Insolvency Act[50] provides that after payment of the preferent claims for funeral and death-bed expenses the free residue shall be applied in

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49 Par 15.24 at 229.
50 Quoted in full in par 4.1 at 23 of the working paper.

defraying the costs of sequestration with the exception of the costs of maintaining, conserving and realising assets subject to secured claims such as assets subject to a special mortgage, pledge or right of retention. The last-mentioned costs are not paid out of the free residue but out of the proceeds of the assets subject to the secured claims.

It is obvious that sequestration costs should enjoy the highest preference. Before an insolvent estate can be distributed the estate must be sequestrated, a trustee must be appointed and the trustee must comply with the statutory requirements and liquidate the estate. Voet[51] correctly states the position as follows:

> It is clear that necessary expenses come before all claims however privileged in such wise that there is not even understood to be an estate except after deduction of what has been spent in order to adjust sales or in some other necessary way.

If the persons who have to render services in connection with the sequestration and administration of the estate are not assured of payment the administration of insolvent estates will be seriously impaired.[52] This is why sections 89(1) and 106 of the Insolvency Act provide that in cases where there are no or insufficient assets to pay these costs, they must be paid by specified creditors. No commentator objected to this preference or the high priority which it enjoys.

Section 97(2) in its present form sets out an order of priority applying inter se for administration costs. The working paper[53] suggested that it is not clear why there should be differentiation between the different administration costs and proposed tentatively that all administration costs should enjoy the same preference.

The South African Association of Deputy Sheriffs submitted that its members were entitled to better treatment. According to the Association the sheriff is at present obliged, like anyone with a claim against the estate, to see to it that

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51 11.7.9 Gane's translation Vol 2 at 739. Cf Van Zyl 547.
52 American Jurisprudence Vol 9A par 693 at 443.
53 Par 4.4.4 at 27.

his claim is reflected in the liquidation account. Should the account not make provision for the costs and the account is confirmed, the sheriff, according to the Association, loses his claims. The sheriff is obliged by law to render certain services and the Association thinks it is unfair to treat the sheriff like an ordinary creditor. The Association proposes that a trustee who accepts an appointment should be personally liable for the payment of the deputy sheriff's account or that an applicant for sequestration should deposit an amount with the Master of the Supreme Court to make provision for these costs. This will ensure that the deputy sheriff is always paid and that he will not like other creditors have to wait long for payment.

Although the Insolvency Act compels the deputy sheriff to do the work, this is part of the conditions which a person accepts when he undertakes this type of work. Of course, these persons also have the benefit that the same Act creates a market where they can do work at the prescribed remuneration. It cannot be denied that these persons occasionally have problems in obtaining payment from insolvent estates. It is clear, however, that attachments in insolvent estates do not form a large part of the deputy sheriff's work. The Association itself indicated in its comments that the amounts involved are not substantial. The contention that the sheriff loses his money if the claim is not reflected in the trustee's account cannot be accepted unreservedly. It is possible that a trustee who is aware of certain administration costs but omits them from his account without reason will be personally liable for any loss suffered by a deputy sheriff as a result of his actions. The Commission is of opinion that the deputy sheriffs did not make out a case which entitles them to a special preference. The high priority granted for these costs by section 97 of the Insolvency Act and the provision in section 106 that other creditors shall pay these costs in the event of a shortfall provide sufficient protection.

One commentator[54] agrees that there should be no priority inter se for certain costs but points out that for practical reasons certain costs do not abate. These are costs for which the trustee accepts personal liability or for which the trustee pays cash. Examples are costs of advertising meetings and security

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54 M J Ensor.

bond premiums. If there is a shortfall it is impractical and perhaps impossible to recover a portion of these costs from the persons who rendered the service. It appears to be undesirable however to make special provision for these cases. Firstly, it would be difficult to define the costs in such a way that the definition does not become too complicated or again lead to anomalies. Secondly, abatement of administration costs rarely occurs because these costs enjoy the highest preference and section 106 of the Insolvency Act provides for a contribution by other creditors in the event of a shortfall. Like any other businessman a trustee must accept any loss which he suffers in this respect as bad debt which occurs generally in commerce.

The working paper[55] criticised section 97(2)(c) of the Insolvency Act because it is too complicated. Section 111(2) of the Insolvency Act authorises the Master of the Supreme Court to disallow any costs which are incorrect or improper or which were incurred mala fide, negligently or unreasonably. It is therefore unnecessary to provide in section 97 that certain costs "as the Master considers reasonable" should be allowed.

The Commission recommends that the highest preference should be retained for costs of sequestration and administration. The Commission also recommends that there should be no priority applying inter se for different administration costs and that the wording of section 97 of the Insolvency Act should be simplified. The draft legislation set out in Annexure C to this report contains the Commission's proposed wording of section 97.

3.5 Costs of execution before sequestration

Section 98 of the Insolvency Act[56] allows a preference for the taxed fees of the sheriff or messenger and other taxed costs, the last-mentioned limited to R50,[57] in connection with an execution before sequestration, limited to the proceeds of the property under attachment, if the property or its proceeds were still in the hands of the sheriff or messenger at the time of the sequestration. These costs are paid out of the free residue after funeral and death-bed expenses and costs of sequestration and administration of the estate.

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55 Par 4.2 at 25.
56 Quoted in full in par 5.1 at 28 of the working paper.
57 Sec 13 of the Insolvency Amendment Act 101 of 1983 increased the maximum amount from R10 to R50.

The rights of an execution creditor of a company which is subsequently liquidated are apparently limited to this preference allowed at the sequestration of an insolvent estate.[58]

The preference is a relic of the more comprehensive pignus praetorium or judiciale of the common law which conferred a preference on the execution creditor for his claim and costs.[59] Although the preference is paid out of the free residue the award is limited, as in the case of a hypothec, to the proceeds of the goods under attachment.

The preference in its original form was unacceptable because it defeated the whole purpose of the insolvency procedure. The purpose of the insolvency procedure is to bring about a concursus creditorum whereupon the creditors, apart from acknowledged preferences, share on an equal footing. If an ordinary creditor could obtain payment of his concurrent claim in full after insolvency by attaching the debtor's assets before insolvency this purpose would be defeated. Even the limited preference for costs contained in section 98 of the Insolvency Act cannot be justified. If a person is not a preferent creditor for some other reason, there is no justification for his enjoying a preference for his costs just because he attached property before sequestration. However, if the attached property is handed over to the trustee after sequestration, the insolvent estate is saved the costs of attachment. It would then not be necessary to attach the property in terms of section 19 of the Insolvency Act. The attachment by the creditor before sequestration would be to the benefit of the insolvent estate and it would be unfair if only one creditor were to bear the costs.

The Commission recommends that the sheriff's or messenger's costs of execution before sequestration be included in the costs of sequestration in terms of section 97 of the Insolvency Act, if the property was under attachment at the date of sequestration. The wording of section 97 proposed in the draft bill[60] implements this recommendation. The Commission recommends that the preference at present provided for in section 98 of the Insolvency Act be abolished.

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58 Strydom v M G N Construction Limited: In re Haljen 1983 1 SA 799 (D) 808; cf contra Ex parte Vermaak: In re Klopper v Lavdas 1980 2 SA 696 (T).
59 Stewart v Insolvent Estate Hyland (1907) 17 CTR 343 at 345.
60 Annexure C below.

3.6 Preferences in favour of the State

3.6.1 Introduction

Sections 99 and 101 of the Insolvency Act confer preferences in favour of the State in respect of taxes deducted or withheld in respect of the tax liability of other persons, but not paid over before sequestration, customs, excise and sales duty, amounts provided from the National Supplies Procurement Fund, sales tax, appreciation contribution due to the Community Development Board and income tax. Before each of these preferences and particular reasons for the preferences are discussed individually, the advisability of preferences in favour of the State in general is discussed.

3.6.2 Arguments in support of preferences in favour of the State

(a) Public interest

An English decision explains this reason for the preferences as follows:[61]

> Except so far as the Legislature has thought fit to interfere, the rule is one of universal application, and perhaps not unreasonable, when it is considered that, after all, it only means that the interests of individuals are to be postponed to the interests of the community.

In his comments on the working paper the Commissioner for Inland Revenue submits that this argument is even more convincing when regard is had to the fact that the essential and costly services rendered by the State require considerable resources and that it is also in the interests of concurrent creditors that these services be maintained. Another commentator[62] also submits that the preferences should be retained because they are in the interests of society as a whole. With reference to the preferences in section 99 of the Insolvency Act (which include several preferences in favour of the State) the Appeal Court noted[63] that "these preferences are obviously for the public benefit." The working paper[64] questioned the argument that these preferences

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61 Commissioners of Taxation for the State of New South Wales v Palmer 1907 AC 179 at 182.
62 M J Ensor.
63 Cohen v Verwoerdburg Town Council 1983 1 SA 334 (A) 346H.
64 Par 6.4 at 33.

are justified as being for the public benefit and submitted that the following criticism of this point of view is justified:[65]

> In the case of Palmer Lord Macnaghten justifies the doctrine on the ground that its assertion results in the benefit of the general community (that is, the general body of taxpayers) although at the expense of the individual. I should have thought this was a reason for condemning the principle. Why should individuals be made to suffer for the general good, especially in a case like the present, where the general benefit is infinitesimal but the individual loss substantial? In the second place, this alleged prerogative is hostile to the general policy of the Bankruptcy Acts, which aim at equal treatment of all creditors in the matter of the distribution of the estates of a bankrupt.

With the exception of the two commentators referred to above, the commentators did not find fault with the view expressed in the working paper that the justification of the preferences on the ground of public benefit is unconvincing. The Cork Committee Report[66], the Scotland Report,[67] the British Columbia Report[68] and the Senate Standing Committee on Constitutional and Legal Affairs of the Parliament of the Commonwealth of Australia[69] all rejected the argument that the preferences of the State are justified because they are for the benefit of the public.

The premise that the State applies its income for the benefit of the public is not challenged. However, a logical corollary to this premise is that the public as a whole should contribute to the revenue. There is no logical reason why other creditors of the insolvent estate should as a result of the operation of the preferences in favour of the State be compelled to bear the losses in State revenue in the first place. The State can divide the burden of unpaid taxes among taxpayers in general. On the grounds of fairness and logic it would be better if the State levied its losses on taxpayers in general and if the State were not paid first at the expense of other creditors who have al-

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65 Admiralty v Blair's Trustee 1916 SC 247 at 248 quoted in the Scotland Report 217.
66 Par 1410 and 1411 at 320.
67 Par 15.3(1) at 217.
68 At 36.
69 Report on the priority of Crown debts Parliamentary Paper No 169/1978 quoted in the British Columbia Report at 36.

ready suffered losses as a result of the sequestration.

(b) The State is an involuntary creditor

It is argued that the State cannot choose its debtors. An ordinary creditor can investigate a debtor's financial position before granting credit. He can refuse further credit until an arrear debt has been paid if doubt arises about the creditworthiness of a debtor. The State is obliged to levy taxes on all persons liable to pay taxes and it cannot choose its clients or refuse credit.[70]

However, the State is not the only creditor who cannot choose its debtors or refuse credit. A creditor who institutes a claim for damages as a result of a delict cannot choose his debtor or call for security before the liability arises. It is unacceptable for this reason alone to confer a preference on these creditors and all other creditors who are in a similar position.[71] Even the ordinary businessman's ability to choose his debtors and refuse credit is limited in the modern business world. He is practically compelled to give credit to the same extent as do his closest competitors.[72] A businessman who for the sake of a bigger turnover follows a policy of giving credit easily, should not complain if he suffers losses as a result of bad debts. In the same way the State who has provided for the sake of a broad tax base that almost every person is liable for taxes, should not complain if it suffers losses as a result of bad debts.

(c) The preferences avoid unacceptable loss of State revenue

In his comment, on the working paper, the Commissioner for Inland Revenue points out that, notwithstanding the granting of the preferences, the State still suffers losses as a result of taxes being written off after the sequestration of taxpayers. For the 1982/83 financial year 5½ million rand in respect of income tax was written off in this way. It is clear that loss suffered by the State as a result of sequestrations will at first sight seem to increase if the preferences are abolished. No statistics could be obtained to indicate what the

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70 American Jurisprudence Vol 9A par 716 at 459.
71 Cf par 2.2 above.
72 Scotland Report par 15.3(2) at 217; Cork Committee Report par 1412 at 320 and 1414 at 321; British Columbia Report 35 et seq.

direct loss would be if the State did not have the preferences. It is clear, however, that the preferences are not necessary to safeguard the financial stability of the State. Owing to its strong financial position the State is in a better position than ordinary creditors to bear any loss.[73] The following factors will contribute towards limiting the loss of State revenue.[74] A substantial portion of the loss of revenue will be recouped because commercial creditors will, as a result of bigger dividends, write off fewer bad debts against their trading profits.[75] Greater involvement of ordinary creditors[76] may lead to the recovery of bigger amounts for insolvent estates. Abolition of the preferences will probably result in the improvement of the methods used for the recovery of taxes.[77] In his comments on the working paper the Commissioner for Inland Revenue refers to the "impossible task for Inland Revenue to investigate the financial affairs of a taxpayer in order to ensure that the taxpayer concerned was not approaching a state of insolvency before granting ... extensions of time". The Commissioner continues with the following observation:

> Should Inland Revenue lose its preferent status it would be necessary to reconsider its policy in regard to the granting of such extensions. The greater risk to which the fisc would be exposed may compel the Commissioner to curtail the periods of the extensions - a step that would inconvenience many taxpayers and could well cause a measure of dislocation in our economy.

In his commentary the Commissioner for Customs and Excise points out that the reduction of surety bonds was based inter alia on the preference conferred on the free residue. If this preference is abolished the whole question of the safeguarding of State revenue will again have to receive urgent attention. The Commissioner will be obliged to insist on more security. This may lead to an outflow of currency and problems for businesses.

The following comment on the working paper is relevant here:[78]

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73 This statement is confirmed by the comments received from the Chief Master of the Supreme Court and the Law Society of the Cape of Good Hope. Cf British Columbia Report 35.
74 Ontario Report 62.
75 Cork Committee Report par 1416 at 321.
76 Par 2.4 above.
77 British Columbia Report 43.
78 M J Ensor.

> One often gains the impression, rightly or wrongly, that the philosophy of the persons charged with the collection of the taxes and contributions dealt with in this Section is "There is no urgent need for me to bestir myself in identifying taxpayers or of collecting monies timeously because inevitably every one will either go insolvent or he will die and it will be time enough then to consider the question as to whether he is liable for any amount, and in any case we will be at the head of the queue both in respect of any amounts which might be owing and penalties to boot!" Such an attitude, if it in fact exists, is clearly contrary to the public interest and should be discouraged.

Another commentator[79] is of opinion that "the present system leads to complete laxity on the part of State Departments in enforcing recovery in the normal fashion and such laxity would cease if the State were not in a position to claim preference where at least it did not act with reasonable despatch in a similar manner to other creditors protecting their interests".

(The view of the British Columbia Report on this matter appears from the quotation from this report[80] in paragraph 2.4 above.)

It is not necessary to make a finding on the allegation that the State is lax about recovering its debts. The Commission is satisfied that the abolition of the preferences will in any case have a beneficial effect on procedures to safeguard and recover State revenue. The Commission is not indifferent to the loss of State revenue that may result from the abolition of the preferences. It would be undesirable however if the abolition of the preference were to lead to merciless clamping down by the tax collectors on anyone who does not conscientiously render unto Caesar what is due to him, when it is due to him. The Commission is nevertheless of opinion that loss of State revenue will be limited to an acceptable level by the factors mentioned above. The limitation which the practical problems of debt collection will place on tax collectors will serve to ensure that steps for the safeguarding and collection of State revenue will be taken only when they are necessary and desirable. The possible loss of State revenue does not outweigh the unfair effect which the existing preferences have on ordinary creditors.

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79 The Transvaal Creditors' Protection Association Limited.
80 At 38.

3.6.3 Arguments against preferences in favour of the State

In paragraph 2 above the following arguments against preferences in general were dealt with in detail. Preferences lead to creditor apathy and dissatisfaction on the part of concurrent creditors. The precedents created by existing preferences lead to requests for further preferences and preferences hamper the administration of insolvent estates. Exceptions to the rule of equal distribution should be allowed only if cogent reasons exist. All these arguments against preferences also apply to preferences in favour of the State.

In his comments on the working paper the Commissioner for Inland Revenue points out that all the related legal systems dealt with in the working paper (England, Australia, Canada, Germany and France)[81] make provision for preferences in favour of the State. However, in at least three of these legal systems (Canada, England and Australia) commissions of inquiry criticised the preferences in favour of the State and recommended that the preferences should be abolished or curtailed.[82] In addition to these three legal systems it was also recommended in Scotland[83] and Ireland[84] that the preferences should be abolished and in America, too, the preferences in favour of the State were severely criticised.[85] The working paper[86] points out that there is a strong tendency today to treat the State as an ordinary creditor.

The Cork Committee Report[87] arrived at the following conclusion:

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81 Annexure at 106 of the working paper.
82 British Columbia Report 42; Ontario Report 63; Cork Committee Report par 1417 at 321; Senate Standing Committee of Australia referred to in footnote 69; Report of the Study Committee on Bankruptcy and Insolvency Legislation in Canada Government of Canada Publication (1970) at 122 quoted in the British Columbia Report at 35.
83 Scotland Report Chapter 15.
84 Budd Report referred to in par 15.4(4) at 220 of the Scotland Report.
85 Cf the reference to the Report of the Commission on the Bankruptcy Laws of the United States in the Ontario Report at 59.
86 Par 6.4 at 33.
87. Par 1417 at 321.

> In our view, the ancient prerogative of the Crown to priority for unpaid tax cannot be supported by principle or expediency, and cannot stand against the powerful tide calling for fairness and reform.

The British Columbia Report[88] also submits that the State's preference cannot be justified today:

> A final argument in support of the abolition of Crown priority is simply that it is an anachronism. The legal theory of Crown priority arose in an age which also gave rise to ideas such as "the divine right of Kings" and the notion that "the King can do no wrong" and is closely associated with them. Today, no one seriously regards these as operative principles in the conduct of government and it would seem to follow that, in the absence of special factors, the prerogative of the Crown to prior payment should be viewed in the same way and abandoned.

In the case of a claim for restitution there is a rule that the State is placed in the same favourable position as a minor.[89] Voet[90] indicates as a reason for this rule that as is in case of a minor, the State's affairs are administered by others on its behalf. If this argument is taken to its logical conclusion it might be argued that any legal person in modern society should be entitled to the same special treatment. This indicates that the reason for this rule is not valid in modern circumstances.

Except the government departments concerned only one commentator[91] differed from the tentative proposal in the working paper that the State's preferences should be abolished. The Commission is convinced that the mere fact that the State is a creditor does not justify a preference. When the specific claims of the State which at present enjoy a preference are considered below, circumstances which may justify a preference in a particular case will be examine

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88 At 39.
89 Commissioner for Inland Revenue v The Master 1957 3 SA 693 (K) 701 et seq
90 4.4.55.
91 M J Ensor. Cf par 3.6.2(a) above.

3.6.4 Income tax

Section 101 of the Insolvency Act[92] provides that any claim for tax on persons or the incomes or profits of persons for which the insolvent was liable under any Act shall enjoy a preference on the free residue. The priority of the preference ranks relatively low.[93]

The problems experienced by a tax collector are set out as follows in an English decision:[94]

> Matters like wages, and such like, accrue regularly and probably at a regular rate. Taxes, as we know, are different. They are the subject of assessments which may be postponed by argument and other events for years and years, so that at any particular date it may be a wholly uncertain matter what will be the debts due when the taxes have been finally assessed ... It is common knowledge that, as a trader ... approaches his financial doom, he becomes less likely than ever to pay taxes, and, indeed, less likely than ever to get his taxes assessed.

An ordinary trade creditor can at the outset establish what is due to him and take steps to recover the debt if payment is not received according to the agreement. In contrast it may happen that the Commissioner for Inland Revenue discovers that he has a claim against a taxpayer only long after the liability to pay tax had arisen.[95] An American textbook[96] indicates as one of the reasons for the preference that tax collectors "require time to locate and pursue delinquent tax debtors".

In his comments on the working paper the Commissioner for Inland Revenue points out that his only contact with a taxpayer is when the taxpayer is required to render a return and when the tax is assessed. Other creditors who are in closer and more regular contact with the debtor and who may be expected to have a better knowledge of the debtor's current financial standing are in a better position to take timeous action for the recovery of debts owing to them. There is merit in these arguments. It is also to be expected that a debtor who is unable to pay all his debts will first pay creditors who regularly insist on

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92 Quoted in full in par 17.1 at 95 of the working paper.
93 Item (g) in par 1.4 above.
94 Re Pratt 1950 2 AE 994 at 1002.
95 Scotland Report par 15.3(3) at 218.
96 American Jurisprudence Vol 9 A par 716 at 459.

payment and that he will not be inclined to make the same provision for the payment of income tax.

The working paper[97] refers to the following provisions in the Income Tax Act[98] which are designed to ensure that taxes are collected:

(a) The disadvantage that tax is payable only after the assessment is considerably alleviated by the system of provisional tax and employees' tax. The taxpayer pays instalments on tax long before it is assessed. There is special provision in regard to persons not ordinarily resident in the Republic for the imposition of tax immediately on income derived from goods such as patents, dividends on shares, and interest on investments.

(b) Tax is payable immediately notwithstanding an appeal against an assessment.

(c) Failure to render a return is an offence and the taxpayer can be required to pay three times the amount of the tax in the event of such failure. In the event of failure the Commissioner for Inland Revenue may appoint another person to furnish the return. The Commissioner may obtain information from other sources regarding a taxpayer's salary, profits derived from any business, investments, interest or rent, interest on debentures, debenture stock, etc, dividends on shares and interest on bearer warrants. If a person fails to render a satisfactory return or information, the Commissioner may issue an estimated assessment.

In this regard the Commissioner commented as follows on the working paper:

> Prima facie, those powers appear to be comprehensive, but it must be borne in mind that details of a taxpayer's income are peculiarly within his own knowledge, and where he has failed to keep proper records the Commissioner will find it practi-

97 Par 6.8 at 37.
98 Act 58 of 1962.

cally impossible to obtain that information "from other sources" particularly where he may have no knowledge as to the names of any persons with whom the taxpayer had any dealings during any relevant tax year. In practice the risk to the fisc of losses on insolvency is greatest in the area of commercial and industrial undertakings, and it is here that the remedy in question is particularly ineffectual. In estimating the income of any taxpayer, particularly where the taxpayer has been declared to be insolvent, the Commissioner must at all events act judiciously, otherwise in the event of an overestimate he could truly be accused of acting to the prejudice of the other creditors in the insolvent estate.

(d) The Commissioner has at his disposal an exceptional civil remedy. He may file with the clerk or registrar of a competent court a statement setting out what tax or interest is owing by a person and that statement will then have all the effects of a judgment by default. The correctness of an assessment on which such a statement is based may not be questioned in any proceedings in connection with the statement.

In his comments on the working paper the Commissioner points out that this remedy is of little avail when other creditors have already issued summons and obtained execution.

(e) The Commissioner may, if he deems it necessary, declare a person to be the agent of another person and require the agent to pay any tax due out of moneys, including pension, salary, wages or other remuneration, which may be held by him for, or due by him to, the other person.

(f) There is provision for interest on unpaid tax.

These measures will not ensure that income tax is always recovered in full, but they are nevertheless an aid to the Commissioner in collecting tax, an aid which is not available to ordinary creditors.

The Commissioner is in the unfortunate position of having to deal with involuntary debtors. Those who do not recognise that the imposition of tax is to the

public benefit and indirectly to the benefit of each taxpayer, or who are not concerned about the fact that tax not paid by them will have to be borne by others, will always endeavour to reduce the payment of tax as much as possible and to delay payment as long as possible. More money can be spent to create a better structure to ensure that tax is paid and tax evasion is limited. It may be inadvisable to do so for economic, practical and other reasons. A preference for tax is an inexpensive way of limiting loss in the collection of tax. However, the preferences have adverse side-effects and are unfair to other creditors.

Should the preference for income tax be retained, a limitation on the period and amount for which the claims are preferent should be considered. No preference should be conferred for penalties which are not aimed at the recovery of actual pecuniary loss. The creditors of the insolvent should not be penalised for transgressions by the insolvent. The American law recognises a rule that penalties which are not aimed at the recovery of actual loss should be paid only after all other claims have been paid in full.[99] This rule is logical and fair.

In the light of the Commission's general premise[1] and the discussion in paragraphs 2, 3.6.2 and 3.6.3 above, the Commission is of opinion that this preference is not justified. The Commission recommends that the preference for income tax be abolished.

3.6.5 Amounts deducted or withheld in terms of the Income Tax Act

Section 99(1)(b) of the Insolvency Act[2] makes provision for a preference for amounts in respect of the tax liability of other persons which have been deducted by the insolvent from the following moneys and have not yet been paid:

* Income from patents, trade marks, copyright, films, videotapes or payment for scientific, technical, industrial or commercial knowledge and income from investments which accrue to persons and companies outside the Republic.

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99 American Jurisprudence Vol 9A par 756 at 488.
1 Par 1.5 above.
2 Quoted in full in par 8.1 at 48 of the working paper.

- Moneys received by agents of the Commissioner for Inland Revenue.
- Salary (employees' tax).
- Insurance benefits.

The type of claim in point here is analogous to the type of claim which the State, according to the common law had against a tax collector for taxes which he collected. This preference (together with several other classes of creditors) ranks in priority immediately after funeral and death-bed expenses, sequestration costs and costs of administration, and costs of execution before sequestration. The legislature has, in the present Insolvency Act, given the State a stronger preference for these claims than the preference for income tax. According to French common law only the claim against the tax collector was preferent and not an ordinary claim for income tax.[3] In Australia[4] and Canada[5] the legislature also favours this type of claim above the ordinary claim for income tax.

A higher priority is probably allocated because this is money already collected from the taxpayer but still in the possession of a third person at the time of the sequestration of the latter's estate. It seems fair that the person for whom the money was collected should have a stronger claim than the possessor's creditors in general. However, this is not the case in law. The owner of movable property which is in the possession or custody of another person whose estate has been sequestrated may demand the return of that property.[6] However, money received and merged with the receiver's assets becomes his property:[7]

> Under common law money in the possession of an attorney enjoys no special protection in the event of the death or insolvency of the attorney, because an obligation to pay money gives rise to a personal right and not a real right and such personal right gives no preference over other creditors.

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3 Exchange Bank of Canada v The Queen 1886 AC 157.
4 Annexures 2.2 and 2.8 to the working paper at 110 and 111.
5 Annexures 3.7 and 3.9 to the working paper at 114.
6 Sec 36(5) of the Insolvency Act.
7 Incorporated Law Society Transvaal v Visse 1958 4 SA 115 (T) 131G.

This appears unfair, but the matter must also be regarded from the point of view of the other creditors. As soon as the money has merged with that of the debtor, the creditors have no reason to suspect and no way of finding out that the money belongs to someone else. Although it is sometimes an offence to do so, it is possible for the debtor to use the money as his own. It is acceptable that assets should not be available to all creditors only in those cases where specific measures are taken to keep the assets separate.[8]

The Scotland Report[9] recommended that Inland Revenue's claim for employees' tax which has not been paid over should be treated in the same way as any other claim by a principal against the insolvent estate of his agent. The British Columbia Report[10] also recommended that the State's right to amounts collected should be determined according to the ordinary rules. The Cork Committee Report[11] made the following finding regarding claims of this nature:

> 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, they would go to swell the insolvent's estate to the advantage of the general body of creditors. We cannot think it right that statutory provisions enacted for the more convenient collection of the revenue should enure to the benefit of private creditors. It would be commercially impractical to treat moneys collected for the Crown as impressed with a trust, and in these special circumstances we have formed the view that the retention of a measure of Crown preference is justified.

In paragraph 3.6.3 above it was pointed out that the Commission is convinced that the mere fact that the State is a creditor does not justify a preference. A preference in favour of the State for moneys collected on its behalf can be justified only if all other creditors on whose behalf moneys have been collected receive a similar preference.[12] If stress is laid on the fact that it is unfair that money which is specifically due to someone should be distributed to all the creditors there would, in addition to principals on whose behalf money has been collected, be other creditors too who could claim that they are en-

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8 Cf sec 78 and 79 of the Attorneys Act 53 of 1979.
9 Par 15.7 at 222 quoted in full in par 8.4.7 of the working paper at 55.
10 At 54.
11 Par 1418 at 321.
12 Par 2.2 above.

titled to a preference. Examples are creditors who had paid a deposit or entered into a lay-by transaction but who did not receive the goods or services.[13] The American law[14] recognises a preference for "consumer deposits on orders". This includes claims by creditors in terms of a "layaway plan", service contracts or a deposit on goods or services.[15] The Commission is of opinion that such an extension of preferent creditors would be undesirable. This would encroach too much on the dominant principle of the equal treatment of creditors on insolvency.

In the discussion of the claim for income tax above,[16] the problems experienced by the tax collector because he has little contact with the taxpayer were mentioned. In the case of employees' tax this consideration should not play such a major role because payment is usually made monthly. Statistics obtained from the Commissioner for Inland Revenue support this statement. During the 1981/82 financial year more than R3 600 000 was written off in respect of taxes assessed on individuals, whereas only R423 052 in employees' tax was written off.

The working paper[17] mentions that as soon as employees' tax has been deducted the taxpayer receives credit therefor. In his comments on the working paper the Commissioner for Inland Revenue has pointed out that an employee may experience difficulties in cases where an employees' tax certificate was not handed to the employee and the employer did not pay over the tax deducted to Inland Revenue. The burden of proof that an amount of employees' tax has been deducted by the employer is then on the taxpayer.[18] The trustee can issue an employees' tax certificate but where the employer failed to maintain proper records of the salary due or paid by him the employee may be prejudiced. From enquiries made of practising trustees of insolvent estates it appears that cases where employees are prejudiced in this regard do not occur often.

Should this preference be retained, a limitation on the period and amount for which the claims are preferent should be considered. As indicated in paragraph 3.6.4 above, no preference should be conferred for penalties which are not aimed

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13 Par 8.4.3 at 53 of the working paper.
14 American Jurisprudence Vol 9A par 712 at 457.
15 Ibid par 713.
16 Par 3.6.4
17 Par 8.4.4 at 54.
18 Par 28(2) of the Fourth Schedule to the Income Tax Act 58 of 1962.

at the recovery of actual pecuniary loss. Paragraph 8.4.6 of the working paper[19] suggested that deductions in terms of the Black Taxation Act[20] should be dealt with in the same way as employees' tax in terms of the Income Tax Act. After the publication of the working paper the Income Tax Amendment Act[21] repealed the Black Taxation Act and all the taxes concerned are now dealt with in terms of the Income Tax Act.

The Commission is of opinion that the preference provided for in section 99(1)(b) is not justified and recommends that it be abolished.

3.6.6 Customs, excise or sales duty

Section 99(1)(cA) of the Insolvency Act makes provision for a preference for the amount of customs, excise or sales duty or interest, fine or penalty which in terms of the Customs and Excise Act[22] was, immediately prior to the sequestration of the estate, due by the insolvent. This preference (together with several other classes of creditors) ranks in priority immediately after funeral and death-bed expenses, sequestration costs and costs of administration, and costs of execution before sequestration.

In this case the State already has a hypothec which gives it a considerable advantage. The present provision in connection with the hypothec appears in section 114(1)(a) of the Customs and Excise Act 91 of 1964 and elicited the following comment:[23]

> The lien envisaged by sec 114(1)(a) is far more extensive than the legal hypothec enjoyed by the State at common law in respect of taxes due to it, for, whereas the latter extended over the property of the debtor only, the former extends also over property belonging to third persons...

There must however be an attachment of the property before sequestration in order to perfect the hypothec.[24] The State is also entitled to call for security before a customs and excise warehouse, container depot, or clearing agent is

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19 At 55.
20 Act 92 of 1969.
21 Act 30 of 1984.
22 Act 91 of 1964.
23 Secretary for Customs and Excise v Millman 1975 3 SA 544(A) 551A.
24 Ibid 551F and 552D.

licensed.[25] As a general rule the Customs and Excise Act contains provisions which can ensure that duties are paid before any risk of loss to the State worth mentioning arises.[26] However, there are provisions for the deferment of payment of duty.[27]

The working paper[28] mentions the following reasons for the preference on the free residue which were advanced before this preference was inserted in the Insolvency Act during 1973. The giving of security causes problems. With big firms like petroleum and tobacco companies the deed of security amounts to millions of rands and the firms encounter great difficulty in obtaining the necessary cover here or overseas. Some of the smaller firms leading a precarious existence would have to discontinue their activities should the Department of Customs and Excise insist on security. Because the lien may be exercised only before liquidation the Department must constantly be on its guard lest it be caught unawares by liquidation. The exercise and discharge of the lien demand many man-hours which could fruitfully be devoted to sales duty inspections.

In his comments on the working paper the Commissioner for Customs and Excise made a plea for the retention of the preference on the free residue. Firstly the Commissioner points out that the taxpayers are effectively granted extension for the payment of duty in order to enable them first to recover the duty from the purchaser or consumer. On the insolvency of the taxpayer, therefore, a component of excise duty is included in any cash asset or collectable debts of the insolvent estate. In paragraph 3.6.5 above the argument that a preference in favour of the State is justified if a specific sum in the insolvent estate is due to the State was considered and rejected. Secondly the Commissioner points out again the disruption and dissatisfaction which may follow if he should insist on sufficient security to cover all amounts which might possibly become outstanding. The Commissioner quotes examples to indicate that he at present relies on security which covers 10 % or less of the actual payments. He also quotes figures to illustrate that the lien over plant and stills accor-

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25 Sec 61(1), 64A and 64B of the Customs and Excise Act 91 of 1964.
26 Ibid sec 20, 27(3), 37(1), 37(8) and 39(1)(b).
27 Ibid sec 105; par 4.04.09 of R1770 Regulation Gazette 1846 of 5 October 1973.
28 Par 10.3 at 64.

ded by section 114(1)(aA) of the Customs and Excise Act does not nearly cover possible losses. The Commissioner mentions that if the protection afforded by the preference on the free residue in terms of section 99(1)(cA) of the Insolvency Act should disappear, the Commissioner would be obliged to insist on more security.

In paragraph 3.6.3 above it was pointed out that the Commission is convinced that the mere fact that the State is a creditor does not justify a preference. In the case of customs, excise and sales duty the State already has a hypothec which to a certain extent secures its claims. In several cases the State may insist on security and may control imports and manufacture in order to limit losses to the State. Because of the high costs to and disruption of commerce that might be entailed, the Commissioner for Customs and Excise is not inclined to insist in all cases on sufficient security to ensure that there will not be any losses. He prefers to recover losses which occur from the free residue of insolvent estates. The Commissioner's view that measures to collect taxes should not cause undue disruption is justified. However, his solution that shortfalls which occur should be recovered to the detriment of other creditors of the insolvent must be questioned. If the State holds the view that it is in the public interest that commerce should not be disrupted, the community as a whole should bear any losses suffered as a result of such a view. There is no justification for recovering losses from a small group of creditors who are already suffering a loss as a result of the sequestration of a debtor.

According to the 1984/85 estimates of revenue,[29] customs and excise account for about 8 % of State revenue.[30] Excise duty represents about 60 % of this contribution of 8 %. Excise duty is levied on liquor, tobacco and fuel. As a rule companies with strong funds are involved. It was not possible to obtain statistics on the losses the State would suffer if this preference is abolished.

The Commission recommends that the preference on the free residue for customs, excise and sales duty be abolished.[31]

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29 RP 3/1984.

30 Approximately 1 636 million rand out of a total of 20 761 million rand.

31 As indicated in paragraph 3.6.4 above, a limitation on the period and amount for which the claims are preferent should be considered if this preference is retained. No preference should be conferred for penalties which are not aimed at the recovery of actual pecuniary loss.

3.6.7 Sales tax

Section 99(1)(cC) of the Insolvency Act provides for a preference for sales tax, interest, fine or penalty which in terms of the Sales Tax Act[32] was, immediately prior to the sequestration of the estate, due by the insolvent. This preference (together with several other classes of creditors) ranks in priority immediately after funeral and death-bed expenses, sequestration costs and costs of administration, and costs of execution before sequestration.

The working paper[33] refers to provisions of the Sales Tax Act which are aimed at ensuring that this tax is collected. The tax is usually payable monthly in the case of businesses. If the taxpayers do not lodge returns the Commissioner for Inland Revenue may estimate the tax. An appeal against an assessment does not suspend the obligation to pay tax. There are provisions for penalties and interest. The Commissioner can take judgment by means of a simple procedure.[34] The Commissioner may recover the tax by means of agents and persons acting in a representative capacity. The Commissioner may demand security for the tax and on default cancel the registration certificate. In respect of aircraft, boats, vehicles, etc, registration shall not be effected until sales tax has been paid.

According to the 1984/85 estimates of revenue[35], general sales tax contributed about 24 % to the State revenue. According to statistics supplied by the Commissioner for Inland Revenue approximately 0.014 % of the sales tax due was written off as bad debt during the last two fiscal years.

Like the employee in the case of employees' tax, the supplier in the case of sales tax is an involuntary agent of the Commissioner for Inland Revenue.[36] For the same reasons as those submitted in paragraph 3.6.5 above in the case of the similar claim in favour of the State the Commission recommends that the preferences on the free residue for sales tax be abolished.[37]

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32 Act 103 of 1978.
33 Par 12.2 at 67.
34 Cf par 3.6.4 (d) above.
35 RP 3/1984.
36 Cf Scotland Report par 15.8 at 223.
37 As indicated in paragraph 3.6.4 above, a limitation on the period and amount for which the claims are preferent should be considered if this preference is retained. No preference should be conferred for penalties which are not aimed at the recovery of actual pecuniary loss.

3.6.8 Amounts provided from the National Supplies Procurement Fund

Section 99(1)(cB) of the Insolvency Act provides for a preference on the free residue for amounts provided to the insolvent by the State from the National Supplies Procurement Fund. This preference (together with several other classes of creditors) ranks in priority immediately after funeral and death-bed expenses, sequestration costs and costs of administration, and costs of execution before sequestration.

The National Supplies Procurement Fund was established by section 12 of the National Supplies Procurement Act.[38] The object of the Act is to enable the State to acquire and exercise control over goods and services in the interests of the security of the Republic. The Fund provides money to stockpilers to maintain strategic materials as reserve stock. The loans are interest free and are repayable when the State has indicated that stockpiling is no longer necessary. The Fund also provides subsidies for the storage and handling of the reserve stocks. Such subsidies are not repayable when the stocks are liquidated.

The working paper[39] called attention to the provisions of section 5A of the National Supplies Procurement Act. Goods which pursuant to an arrangement in terms of this Act are stored or have been acquired or are to be supplied or delivered or sold and facilities or property at the disposal of any person for supplying a service which he is required to supply in terms of the Act are not subject to seizure under any judgment of a court and are not deemed to form part of that person's insolvent estate.

In its comments on the working paper the Department of Industries, Commerce and Tourism pointed out that reserve stock usually has a limited shelf life and can therefore not be stored physically separate from the normal stockholding because the reserve stock must be regularly replaced by fresh stock. The State has to rely on quarterly certificates by the stockpiler and annual certificates by auditors and inspectors as proof that the stock is still on hand and usable. A stockpiler who develops financial problems can without the State's knowledge

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38 Act 89 of 1970.
39 Par 11.3 at 65.

sell the reserve stock or a substantial part of it. By the time that an insolvent estate's stock has been sorted out to identify the reserve stock, the stock may be useless because it was not rotated in time. The Department therefore submits that section 5A of the Act does not afford sufficient protection. Although as a general rule the Department selects the stockpilers and determines their creditworthiness beforehand, there is sometimes only one supplier of strategic materials with whom the State must perforce negotiate an agreement. Since the amounts of the loans are usually large the cost of providing other securities to the State would be excessive. Since the State acts in the interests of the country and unlike other creditors does not contract with the stockpiler for gain, the Department submits that the preference is absolutely justified.

This type of claim has characteristics which distinguish it from the claims of ordinary creditors. However, suppliers in the commercial world in general are also in the position that stock or funds which they have provided are at sequestration applied for the benefit of creditors in general while the suppliers or financiers are not in the ordinary course of bussiness entitled to preferent payment. Since the money is advanced to safeguard the Republic and the advances are therefore made for the benefit of the population in general, it is unfair to allow a preference to the prejudice of a small group of creditors. It is more equitable for contributors to the exchequer in general to bear the losses. In the 1984/85 fiscal year R3 300 000 was budgeted for financial assistance to the National Supplies Procurement Fund.[40]

The Commission recommends that the preference on the free residue for amounts provided from the National Supplies Procurement Fund be abolished.

3.6.9 Appreciation contribution due to the Community Development Board

Section 99(1)(d) of the Insolvency Act provides for a preference on the free residue for the amount of any appreciation contribution which in terms of the Community Development Act[41] was due to the Community Development Board by the insolvent.

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40 Estimates of the expenditure to be defrayed from State Revenue Account during the financial year ending 31 March 1985 RP 2/1984 Vote 18-25.

41 Act 3 of 1966.

Both sections of the Community Development Act[42] which made provision for an appreciation contribution were repealed by later legislation.[43]

The Commission recommends that section 99(1)(d) of the Insolvency Act be deleted.

3.7 Compensation due to a workman in terms of the Workmen's Compensation Act

Section 99(1)(a) of the Insolvency Act[44] provides for a preference on the free residue for compensation which in terms of the Workmen's Compensation Act,[45] was, immediately prior to the sequestration of the estate, due by an employer in respect of a workman. This preference (together with various other classes of creditors) ranks in priority immediately after funeral and death-bed expenses, sequestration costs and costs of administration, and costs of execution before sequestration.

The Workmen's Compensation Act distinguishes between two types of employers, namely ordinary employers and employers who are individually liable. The ordinary employers are liable only for contributions to the Accident Fund and penalties. In their case the employee or defendant must recover compensation from the Accident Fund.[46] The employers who are individually liable in terms of section 70 of the Workmen's Compensation Act are the State, certain local authorities who have obtained a certificate of exemption and other employers who have, with the approval of the Workmen's Compensation Commissioner, obtained a policy of insurance for the full extent of their potential liability under the Workmen's Compensation Act to all workmen employed by them.

The working paper[47] suggested tentatively that the workmen would be adequately protected if a provision were enacted to the effect that, in cases where a policy of insurance for the employer's liability had been obtained, amounts payable by the insurance company would be excluded from the employer's insolvent estate. It appears from the comments of the Workmen's Compensation Com-

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42 Sec 34(4)(a) and 35(1)(a)(i).
43 Community Development Amendment Act 19 of 1978.
44 Quoted in full in par 7.1 of the working paper at 39.
45 Act 30 of 1941.
46 Sec 7 and 37 of the Workmen's Compensation Act 30 of 1941.
47 Par 7.4.2 at 45.

missioner and further discussions with his staff that the recovery of compensation does not present problems. The Commissioner is also of opinion that the Accident Fund is liable for compensation in cases where the compensation cannot be recovered from employers who are individually liable. Nevertheless, he has no objection to the further protection of workmen as recommended in paragraph 7.4.2 of the working paper.[48] Since the Workmen's Compensation Act contains sufficient provisions to protect the employees against loss of compensation as a result of the sequestration of their employer, the Commission does not recommend further legislation to cover a few cases which might arise in future.

It might be argued that claims for compensation against insolvent estates practically never occur and that the preference for compensation can do no harm. However, there is no justification in principle for the preference and the Commission recommends that the preference for compensation be abolished.

3.8 Contributions to benefit funds for employees

3.8.1 Introduction

Section 99 of the Insolvency Act provides for a preference on the free residue for contributions to various benefit funds. They are the Accident Fund,[49] the Compensation Fund for Mines and Works,[50] the Unemployment Insurance Fund[51] and various funds administered by industrial councils.[52] This preference (together with several other classes of creditors) ranks in priority immediately after funeral and death-bed expenses, sequestration costs and costs of administration, and costs of execution before sequestration.

Although the funds and the way in which they levy contributions are not identical, they have the same broad purpose. The purpose of these funds is to provide for the welfare of employees and their dependants when certain circumstances occur. The discussion of contributions to the Accident Fund[53] deals with the general considerations which apply to all these funds and this discussion

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48 At 45.
49 Sec 99(1)(a).
50 Sec 99(1)(c).
51 Sec 99(1)(e).
52 Sec 99 (1)(f).
53 Par 3.8.2 below.

is not repeated when the other funds are dealt with. The discussion of the other funds is limited to matters which are peculiar to the particular fund and which have not already been discussed.

3.8.2 Contributions to the Accident Fund

The Workmen's Compensation Commissioner assesses every ordinary employer[54] on such percentage of the annual wages of his workmen as he deems necessary for the Accident Fund. There is provision for several penalties.[55] In the event of the disablement or death of an employee as a result of an accident in the course of his employment the Accident Fund pays certain amounts to the employee or his dependants.[56] These amounts include medical expenses and certain other expenses as a result of the accident.[57]

The Workmen's Compensation Commissioner may transmit a statement indicating outstanding moneys to the clerk of a magistrate's court and this has the effect of a civil judgment.[58] An employer who does not pay the assessment or penalty is guilty of an offence.[59] These provisions will not ensure that contributions are recovered in each case but they are aids for the collection of debts which are not available to ordinary creditors. The preference is aimed at safeguarding the fund from loss as a result of the insolvency of employers. A workman is or his dependants are prejudiced if he dies or becomes disabled as a result of an accident in the course of employment. There is this same prejudice, however, if he dies or becomes disabled in other circumstances. He can take precautions against such an eventuality but the contributions for insurance are not accorded a preference on insolvency at the expense of his or someone else's creditors. If the Accident Fund suffers loss as a result of an employer's insolvency, contributions to the Fund may be increased in general. The preference has the result that loss to the Fund is avoided at the expense of the insolvent employer's creditors. It seems fairer that the loss should fall on employers in general rather than on the creditors of one insolvent employer in particular.

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54 Cf par 3.7 above.
55 Cf par 7.3.1 of the working paper at 43 for details.
56 Sec 38 to 40 of the Workmen's Compensation Act 30 of 1941.
57 Cf par 7.3.2 of the working paper at 44 for further details.
58 Sec 73(4) of the Workmen's Compensation Act 30 of 1941.
59 Ibid sec 73(3).

The British Columbia Report[60] mentions two reasons for a preference in favour of a similar fund:

- If contributions are not collected this would place an unfair burden on employers who have paid their assessments promptly.

  Superficially this result appears to be unfair but is not so unusual. In the case of almost any business, clients who pay their debts regularly are obliged through a built-in price mechanism to bear the cost of uncollected debts.

- The fund is obliged to accept all employers and cannot select its clients.

  It was noted in paragraph 3.6.2(b) above that too much weight should not be attached to the argument that certain persons are involuntary creditors.

The report[61] concludes that this type of claim is of a different character than the State's claim for taxes and that the special character of these claims justifies a preference, provided that other creditors should be able to ascertain the amount of the fund's preferent claim.

In his comments on the working paper the Workmen's Compensation Commissioner argued for the retention of this preference. He stresses that the Fund is a non-profit-making body and that the Fund suffers losses notwithstanding the existing preference. Other employers who are the only contributors to the Fund will protest if contributions are increased. If the preference is abolished the expected loss in contributions would have to be taken into account when the contributions are calculated.

There are three alternatives which merit consideration:

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60 At 60 et seq.
61 Ibid at 61.

(a) The present position could be maintained. The Fund is paid at the expense of the other concurrent creditors of the insolvent employer.

(b) The preference could be abolished and any shortfall could be recovered from other contributors to the Fund, namely the other employers.

(c) The State may decide to bear the shortfalls as a social service.

Alternatives (a) (b) and (c) pass the shortfall on to different groups of persons which are small for alternative (a), viz the employer's other concurrent creditors, larger for alternative (b), viz all employers who contribute to the fund, and larger still for alternative (c), viz all contributors to the Exchequer. The larger the group of persons who bear the shortfall the less disruption is caused because the amount which each contributor must bear is pro rata smaller. There appears to be no justification for the employer's other concurrent creditors having to bear the shortfall, each moreover bearing a large portion. There appears to be a sufficient connection with other contributors to the Fund to justify the levying of a further contribution from them to make good a shortfall. This is a large group and each one's contribution will be relatively small. The taxpayers in general are an even larger group but it may be argued that these are not costs that should be borne by the community as a whole. It is not part of this investigation to determine whether the State should bear such costs. In the case of the Compensation Fund for Mines and Works the State does bear the shortfall which cannot be recovered with the aid of the preference.[62] In the case of the Unemployment Insurance Fund the State makes a contribution which at present amounts to 7 million rand per year.[63] In the absence of a contribution by the State the recommendation in the working paper that this preference should be abolished appears to be justified. This recommendation received considerable support from commentators on the working paper.

The Commission recommends that the preference on the free residue for contributions to the Workmen's Compensation Fund be abolished.[64]

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62 Sec 74 of the Occupational Diseases in Mines and Works Act 78 of 1973.
63 Sec 29 of the Unemployment Insurance Act 30 of 1966.
64 As indicated in paragraph 3.6.4 above, a limitation on the period and amount for which claims are preferent should be considered if this preference is retained. No preference should be conferred for penalties which are not aimed at the recovery of actual pecuniary loss.

3.8.3 Contributions to the Compensation Fund for Mines and Works

Section 99(1)(c) of the Insolvency Act refers to any amount due to the General Council for Pneumoconiosis Compensation in terms of the Pneumoconiosis Compensation Act.[65] In terms of the provisions of section 12(1) of the Interpretation Act[66] this reference must be construed as a reference to an amount due to the Compensation Fund for Mines and Works in terms of the Occupational Diseases in Mines and Works Act.[67]

The Compensation Commissioner for Occupational Diseases determines in respect of each controlled mine or controlled works in such manner as he deems fit and with due regard to the risk of the mine or works in question an amount payable by the owner to the Fund, in respect of each shift worked by a person at the mine during which such person performed risk work. The owner of the mine pays to the Fund in respect of each such shift an amount determined by the Minister of Mines for the purposes of research on the health of persons working in mines or works and for research on medical treatment for compensatable diseases. The owner pays interest at a rate determined by the Compensation Commissioner and approved by the Minister. A penalty not exceeding R10 per shift may be imposed if the owner fails to pay an amount due. The Minister pays out of public funds any amount irrecoverable from the owner of the mine or works. Compensation is paid out of this Fund to persons who contract certain diseases in the mines or works or to their dependants. (The works are works which are connected with diggings and the mining industry.) No person is entitled to benefits under this Act and under the Workmen's Compensation Act or any other law.

The preference is very similar to the preference for contributions to the Accident Fund which was dealt with in paragraph 3.8.2 above. An important difference is that the State and not the Fund carries the shortfall in an insolvent estate. In his comments on the working paper the Compensation Commissioner for Occupational Diseases indicated that he had no objection to the abolition of the preference.

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65 Act 64 of 1962.
66 Act 33 of 1957.
67 Act 78 of 1973.

The Commission recommends that the preference on the free residue for contributions to the Compensation Fund for Mines and Works be abolished.[68]

3.8.4 Contributions to the Unemployment Insurance Fund

The Unemployment Insurance Act[69] applies to persons whose annual income does not exceed R12 000. It does not apply to persons whose earnings consist only of a share in takings or are calculated purely on a commission basis. Each employer and contributor has to contribute to the Fund 0,3 % of the salary of the employee, in the case of the employer, and 0, 5 % in the case of the contributor. The employer may deduct the contributor's share from his salary. The State contributes 25 % of this amount, with a maximum of R7 million per financial year, to the Fund. When a contributor is unemployed, he or she is entitled to unemployment, sick or maternity benefits. On the death of a contributor his dependants are entitled to a benefit. If the Fund is strong, the rate of benefits may be increased. If the Fund becomes weak the rate of contributions may be increased or the rate of benefits may be reduced within certain limits. Parliament must consent to any alterations.

There are special provisions to enforce payment of amounts by an employer. It is an offence if an employer does not pay the amounts due to the Fund.[70] On conviction the court must determine the amount unpaid and order the employer to pay the amount within a period fixed by the court. Such an order has all the effects of a civil judgment.[71]

The preference corresponds largely with those discussed in paragraphs 3.8.2 and 3.8.3 above. The preference benefits contributors to the Fund and their employers at the expense of the creditors of the individual employer. In conformity with the conclusion in regard to similar preferences above, it seems fairer that contributors and their employers in general should bear the loss.

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68 As indicated in paragraph 3.6.4 above, a limitation on the period and amount for which claims are preferent should be considered if this preference is retained. No preference should be conferred for penalties which are not aimed at the recovery of actual pecuniary loss.

69 Act 30 of 1966.

70 Ibid sec 61(1)(j)(i).

71 Ibid sec 31.

As far as the employees' contributions are concerned it is arguable that the money has been deducted by the employer and merely has to be paid over so that the Fund has a stronger claim to the money than the employers' creditors. This argument has already been dealt with and rejected in paragraph 3.6.5 above.

The Commission recommends that the preference on the free residue for contributions to the Unemployment Insurance Fund be abolished.[72]

3.8.5 Contributions to benefit funds administered by industrial councils

Section 99(1)(f) of the Insolvency Act provides for a preference on the free residue for -

> any other contributions payable by the insolvent (including any such contributions payable in respect of any of his employees) under the provisions of any law, which, immediately prior to the sequestration of the estate, were due by the insolvent, in his capacity as an employer, to any pension, sick, medical, unemployment, holiday, provident or other insurance fund.

A prerequisite of this preference is that the contributions are payable by the insolvent in terms of a statutory provision.[73] The preference is aimed at compulsory contributions to funds which were established under the Labour Relations Act.[74] Employers and groups of employers may form an industrial council. The councils my conclude agreements to regulate conditions of service of the employees concerned, which may include-[75]

> the establishment of pension, sick, medical, unemployment, holiday, provident and other insurance funds, and the levying upon employers and employees of contributions towards such fund...

The Minister of Manpower may, by notice in the Government Gazette, declare the agreements binding on the parties to the agreement or on other employers and

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72 As indicated in paragraph 3.6.4 above, a limitation on the period and amount for which claims are preferent should be considered if this preference is retained. No preference should be conferred for penalties which are not aimed at the recovery of actual pecuniary loss.
73 Millman v African Eagle Life Assurance Society 1981 4 SA 630(K).
74 Act 28 of 1956.
75 Ibid sec 24(1)(r).

employees in the same occupation. Numerous agreements have from time to time been made binding in Regulation Gazettes. The agreement of the Building Industry in the Transvaal is cited as an example.[76] It makes provision for the following funds, inter alia: A vacation fund which provides annual leave pay. A benefit fund which compensates employees when they are unable to work because of bad weather, sickness or permanent disability. A pension fund, military service fund and a medical fund. There is also a stabilisation fund which compensates for time lost because of change of employment or unemployment. The contributions are payable by employers but they may recover certain amounts from the employees' remuneration.

It is an offence if an employer fails to pay over amounts in terms of an agreement. On conviction the court must determine the amount underpaid by the employer and order him to pay that amount within such period as the court may fix. Such an order has the same effect as a civil judgment. It is not a defence to the charge that the employer's failure was due to a lack of means.[77]

Although the general purpose of these funds corresponds with the purpose of the other funds discussed in paragraphs 3.8.2, 3.8.3 and 3.8.4 above, these funds have certain characteristics which distinguish them from the other funds. The provisions for these funds which are established under industrial agreements are not laid down by statute but are the result of negotiations between employers' and employees' organisations. Although these agreements receive official recognition by publication in the Government Gazette and are binding on employers and employees covered by them, they remain the outcome of negotiations between employers and employees. In their comments on the working paper the industrial councils submitted rightly that the benefits conferred on employees by the funds should be regarded as part of the employees' salary package.[78] Since there are more than 100 industrial councils who all negotiate their own agreements, the funds which are established as a result of the agreements differ according to circumstances in the particular industry. The methods used to levy contributions also differ among the funds. The consequence of the abolition of the preference would not be the same for each of the

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76 Regulation Gazette 2894 of 26 October 1979.
77 Sec 53 and 54 of the Labour Relations Act 28 of 1956.
78 In NIC of Leather Industry v Parshotam & Sons 1984 1 SA 277(D) 279F it was pointed out that the benefit funds are for the benefit of employees.

funds and it would in any case be an impossible task to determine the effect of the abolition of the preference for each of the funds. A number of these agreements were, however, examined and from these agreements and discussions with officials of the Department of Manpower it would appear that these funds differ from the statutory funds in that employees and not the fund bear the loss if contributions to the industrial funds are not paid over. In the case of certain holiday funds what it boils down to is that a portion of the employee's remuneration is set aside weekly or monthly and paid to him at the beginning of the annual holiday period. The Commission is of opinion that a preference for the salary of an employee is justified.[79] Since the contributions to these funds can be regarded as part of the salary package, consideration is given later in this report[80] to the question whether these contributions should enjoy a preference, as part of the salary.

A proposal by one of the industrial councils[81] that amounts deducted by employers from employees' salaries should not vest in the employers' insolvent estate is unacceptable. Such an arrangement can be justified only if this money is kept separate from the employers' other assets.[82]

In the light of the preference for the protection of employees recommended later in this report,[83] the Commission recommends that the preference provided for in section 99(1)(f) of the Insolvency Act be abolished.[84]

3.9 Salary and wages

3.9.1 Introduction

Section 100 of the Insolvency Act[85] provides for a preference on the free residue for payment of the salary or wages of an employee, including the commission of a commercial traveller, for a period prior to sequestration, not exceeding

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79 Par 3.9.2 below.
80 Par 3.9.4 below.
81 National Industrial Council for the Iron, Steel, Engineering and Metallurgical Industry.
82 Cf par 3.6.5 above.
83 Par 3.9.4 below.
84 As indicated in paragraph 3.6.4 above, a limitation on the period and amount for which claims are preferent should be considered if this preference is retained. No preference should be conferred for penalties which are not aimed at the recovery of actual pecuniary loss.
85 Quoted in full in par 16.1 of the working paper at 75.

two months. There is also provision for certain fees due to a nurse, an accountant or an auditor. The preference is limited to R2 000 per person.[86] There is also provision for leave or holiday bonus not exceeding 21 days limited to R1 000.[87] The present priority for this preference ranks relatively low.[88]

3.9.2 Merits of the preference

The working paper[89] points out that in certain judgments the reason given for the preference was that the employees had helped to create or keep together the estate which is available to creditors and are for this reason entitled to preferent treatment. A text book on American law[90] submits that the purpose of the preference is "to insure that employees would not abandon a failing business for fear of not being paid". This argument is not altogether satisfactory. There are numerous other creditors who may have contributed to the preservation of the insolvent estate but who receive no legal preference. Examples are a banker who advances money or a merchant who supplies provisions to a concern on credit. As the preference is at present worded in the Act, it is not confined to persons who have contributed to the preservation of the estate. An employee whose wrong policy or decisions led to the failure of a concern or an employee employed unnecessarily is nevertheless entitled to the preference.

A more acceptable argument for the preference is that it is essential to protect the employees of the insolvent.[91] An employee has no choice but to render his services on a credit basis.[92] Employees usually have little knowledge of their employers' financial affairs and in order to retain their employment they are often prepared to continue to render their services in the hope that the employer will overcome his financial difficulties in circumstances where other creditors would no longer be prepared to do so.[93] Lastly, an employees' salary is, in most cases, his only livelihood. Should he be deprived of his salary cheque for one month, he would in most cases be plunged into financial difficul-

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86 This amount was increased from R400 to R2 000 by sec 14(a) of the Insolvency Amendment Act 101 of 1983.
87 This amount was increased from R200 to R1 000 by sec 14(b) of the Insolvency Amendment Act 101 of 1983.
88 Item (f) in par 1.4 above.
89 Par 16.4.2 at 81.
90 American Jurisprudence Vol 9A par 703 at 449.
91 Ibid; par 16.4.3 of the working paper at 82; Cork Committee Report par 1428 at 324.
92 British Columbia Report par 2.1.03 of the quotation at 58.
93 Ibid par 2.1.04 of the quotation.

ties. Other creditors are better able to absorb losses because they usually have more than one source of income and can be expected to make provision for a certain percentage of bad debt.[94]

There was strong support from the commentators on the working paper for the tentative proposal that the preference for salary claims should be retained and improved. No commentator objected to this tentative proposal. In other jurisdictions the necessity for this preference is also accepted without serious opposition.[95]

Notwithstanding the arguments against preferences in general[96] the Commission is of opinion that this preference is justified. The preference adversely affects other creditors but at present there is no existing structure to protect employees by recovering the shortfall on salary claims from a larger section of the community. The Commission recommends that the preference for salaries should be paid immediately after costs of sequestration and administration of the estate. If any other preference is retained it should not be paid before salary claims.

3.9.3 Limitations on the preference

The protection which employees deserve must be weighed up against the interests of concurrent creditors. There is no justification for the view that any salary claim should take preference over other claims. The justification for the preference is that employees should be protected against the hardship they will suffer if their salaries are not paid. The protection given by the preference must be limited to the prevention of hardship so that other creditors are not prejudiced more than is justified to prevent hardship to employees.

The first limitation which is considered is the period for which a preference for salary should be granted. It is not desirable that employees should be encouraged by the protection of a preference to remain in employment with a concern which clearly cannot make the grade. A limitation must be placed on the

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94 Ibid par 2.1.01 and 2.1.06 of the quotation; Ontario Report 56.
95 British Columbia Report 58; Ontario Report 56; Scotland Report par 15.18 at 227; Cork Committee Report par 1429 at 324.
96 Par 2 above.

period for which the preference is valid. The present limitation of two months applies to any two months before sequestration. The justification for the preference for salary is that hardship to employees must be prevented. However, the burden which the preference for salary places on other creditors must always be kept in mind. If the salary was not paid for a period long before sequestration the employee's hardship can no longer justify the preference. In such circumstances a preferent award would to a certain extent be a windfall for the employee at the expense of other creditors. It appears to be reasonable that the preference should be limited to the period immediately before sequestration. However, if only the period immediately before sequestration is taken into account, the period of two months is too short. The Commission recommends that the preference should be limited to the period of three months immediately prior to the sequestration of the estate.

The second limitation of the preference which is considered is a maximum amount per employee. If at all possible, the determination of the maximum preference by reference to an amount of money should be avoided. Such an amount is soon outdated and the problem arises that the legislature does not adjust the amount regularly. Certain other legal systems which were examined (England, Australia, Canada and America)[97] have a maximum amount. The working paper argued[98] that a limitation on the amount appears to be the only practical limitation which may be imposed on a preference based on an exorbitantly high salary. The purpose of the preference is furthermore not so much to pay the full salary but rather to assist the employee to meet his reasonable obligations. In its comments on the working paper one of the industrial councils[99] submitted that a maximum amount is unnecessary and that preferent claims for exorbitantly high salaries can be excluded by taking the average salary for the last year. This solution would complicate the calculation of the preferent claims and would not ensure that an employee does not receive more than is fair to other creditors.[1] The Commission is of opinion that a maximum amount should be fixed in the Insolvency Act. In order to expedite adjustment of the amount when necessary the working paper[2] suggested that the Minister of Justice should be authorised to increase the amount by proclamation after the consumers' price index has shown a

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97 Par 16.4.8 of the working paper at 84; American Jurisprudence Vol 9A par 702 at 448.
98 Par 16.4.8 at 84.
99 National Industrial Council for the Iron, Steel, Engineering and Metallurgical Industry.
1 Cf Cork Committee Report par 1430 at 325.
2 Par 16.4.8 at 84.

certain rise. The Insolvency Act empowers the State President to promulgate proclamations and make regulations under this Act. Since any amendment to the Insolvency Act should fit in with the existing provisions of this Act the Commission recommends that the State President should be granted powers to adjust the amounts. It appears too complicated to link the adjustments to the consumers' price index. The State President can make the necessary adjustments after consideration of all the circumstances. The working paper suggested tentatively[3] that R1 500 would be a reasonable amount. Since the publication of the working paper, section 14 of the Insolvency Amendment Act[4] has increased the maximum amount for salary from R400 to R2 000 and the maximum amount for leave and bonus from R200 to R1 000. The industrial councils and the Law Society of the Transvaal submitted in their comments on the working paper that R1 500 is insufficient. The Commission recommends that the maximum preference for salary, leave and bonus should for the present be fixed at R3 000.

The working paper[5] pointed out that creditors may be protected by the exclusion of certain persons from the preference. The Canadians deny a preference to certain relatives of the insolvent or an official or director of a company in liquidation. Only one commentator[6] was of opinion that such a limitation is desirable. Such a provision would in the nature of things be arbitrary and would not operate fairly in all cases. The Commission does not recommend that such a limitation should be placed on the preference of employees.

3.9.4 Fringe benefits

The working paper[7] pointed out that leave benefits and bonuses are an integral part of an employee's salary package today. In their comments on the working paper the industrial councils submitted that other benefits also form part of the salary package. During negotiations on conditions of service of employees, it is sometimes agreed that an improvement in conditions of service is justified but for various reasons, for instance to combat inflation, the improvement

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3 Ibid.
4 Act 101 of 1983.
5 Par 16.4.7 at 84.
6 The Association of Trust Companies in South Africa.
7 Par 16.4.11 at 86.

of the conditions of service is not effected by an increase in salaries but by an increase in the contributions by employers to funds administered by the industrial councils. These funds generally provide for pension, leave benefits, medical cover and the training of employees. There is usually also a benefit fund which provides cover in the case of permanent disability and provides for compensation for loss of income as a result of illness, accidents or other circumstances. The contributions to the funds are paid over by employers. A portion of the contributions may generally be recovered by the employers by a deduction from the employees' salaries. The contributions are compulsory for employers and employees covered by the industrial agreements.

In its comments on the working paper the Southern African Institute of Chartered Secretaries and Administrators suggested that the proposed preference for salary should be so worded that it will also cover deductions made for transfer to these funds. In American law a preference for unpaid contributions to employees' benefit funds was recognised fairly recently:[8]

> Hence, the 1978 Bankruptcy Reform Act recognized the realities of labour contract negotiations, under which wage demands are often reduced if adequate fringe benefits are substituted.

The American law limits the preference for contributions to benefit funds to the unused portion of the employees' preference for salary claims.[9]

If it is accepted that an employee must be protected up to a certain amount it is logical to argue that this protection should apply to the whole salary package. Bonuses, leave benefits or contributions to benefit funds are not the only fringe benefits which occur. The fringe benefits may for example take the form of the provision of motor cars or housing, loans at low interest rates and entertainment or other allowances. However, the purpose of the preference is not to pay an employee his full salary package in each case. The purpose of the preference is to assist the employee who has not received his salary as a result of the sequestration of his employer to meet his reasonable needs. Unlike leave pay and bonus the employer's and employees' contributions to the

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8 American Jurisprudence Vol 9A par 710 at 456.
9 Ibid par 711 at 457.

other funds would never have been paid to him. If he had lived within his means an employee would therefore not have needed these contributions to meet his reasonable obligations. The Commission has weighed up the protection to which an employee is entitled against the disadvantage which any preference imposes on other creditors and the arguments against preferences in general. The Commission is of opinion that a preference for the contributions to these funds is not justified.[10] In order not to make the calculation of the amount of the preference too complicated it is necessary to limit fringe benefits which are for purposes of the preference regarded as part of salary to those which are easy to calculate and which occur regularly in the case of employees in the lower wage categories. It is these employees in particular who need the protection of the preference. The Commission recommends that the following items should for purposes of the preference be regarded as part of the employee's salary:

- Leave pay due for a period not exceeding 21 days.
- Bonus due.

(Commission due to an employee is discussed in paragraph 3.9.6 below.)

3.9.5 Payment of salary after sequestration

An employee's salary is, in most cases, his only source of income. If his salary is not paid disruption and financial difficulties frequently result for the employee. It is desirable that an employee should receive the salary due to him from the insolvent estate as soon as possible. Section 100(3) of the Insolvency Act provides that a preferent claim for salary may be paid even though the claim has not been formally proved. This may help to speed up matters and the employee can avoid the danger of paying a contribution by not formally proving his claim and relying on his preferent claim.[11] However, a trustee or any other person or body who pays the salary claim before confirmation of the account does so at his own risk.[12] Should it appear after payment of the salary claim that insufficient funds are available in the free residue

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10 As indicated in paragraph 3.6.4 above, a limitation on the period and amount for which claims are preferent should be considered if this preference is retained. No preference should be conferred for penalties which are not aimed at the recovery of actual pecuniary loss.
11 Sec 106 of the Insolvency Act.
12 Mars 387.

to pay these claims the trustee or other person or body will be liable to make good the shortfall. One commentator with a great deal of practical experience of the administration of insolvent estates[13] outlines the dilemma in which a trustee occasionally finds himself as follows:

> Try telling a gang of a hundred unskilled or semi-skilled construction workers that you wish them to continue working and complete the contract, that you have noted their claims for unpaid wages and that in due course and provided no claims are proved which rank in priority to their own they will receive payment of what is due to them and you would be lucky if you did not have a riot on your hands. Invariably trustees ... make immediate arrangements for the payment of unpaid wages with the fervent hope that no claims ranking in priority to such wages are submitted against the estate.

It would alleviate the problem if the Commission's recommendations were accepted because no claims except costs of sequestration and administration would then have a higher priority than salary claims. As another commentator[14] pointed out, the increase of the maximum preferent claim for salary from R400 to R3 000 will again aggravate the problem.

A provision that other creditors should bear any shortfall on preferent salary claims[15] would impose too much of a burden on other creditors. A provision that salary claims should, in the event of a deficit in the free residue, be paid from assets subject to secured claims[16] would be of assistance only if there were such assets and this would seriously prejudice the position of secured creditors.[17]

The Association of Trust Companies in South Africa had the following comments:

> All concerned will agree that a salaried person should be paid as soon as possible but the necessary authority and indemnity will be difficult to implement in practice. The Committee wonders if it would be possible to provide that any Industrial Council concerned or, failing one, the Unemployment Insurance Fund, should on application by the employee (if necessary supported by a certificate

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13 M J Ensor.
14 Association of Trust Companies in South Africa.
15 There used to be such a provision in respect of a shortfall on funeral and death-bed expenses but this was deleted in 1965. Cf par 3.3 of the working paper at 14.
16 Such a provision applies to a shortfall on funeral and death-bed expenses at present. Cf par 3.3 of the working paper at 13.
17 The British Columbia Report 57 criticises such a provision which applies there.

from the liquidator as to the preferent amounts due) be authorised and instructed to immediately pay such preferent amounts and be allowed to prove the preferent claim in its own name in place of the employee.

It will obviously not be possible for the trustee to certify that sufficient funds will be available to pay such claims in full but on the grounds of the extreme hardship suffered by employees in these circumstances, it would surely not be too much to expect that the Unemployment Insurance Fund or the relevant Industrial Council, which are strong funds and have very many members, should bear any shortfall.

Some industrial councils already help to alleviate the problem by insisting in terms of industrial agreements on security by employers for the salary of employees and contributions to the funds, which will be due for a certain period. (Naturally this requirement means an extra financial burden on employers planning to enter the industry.) After sequestration industrial councils occasionally pay a part or the whole of salaries due to employees and recover the amounts from the insolvent estate or security which the industrial councils hold. The practice of persons and bodies of paying salary claims immediately is encouraged if someone who has paid a salary claim after sequestration is entitled to the preference which the employee would have had. The Commission is of opinion that the claim of a person who has after sequestration paid a preferent claim is without doubt preferent as well. However, it does not appear to be advisable to compel industrial councils to pay salary claims immediately in cases where the industrial agreements do not provide therefor. The Unemployment Insurance Fund does assist employees who contributed to the Fund if they become unemployed as a result of the sequestration of their employers. It is not advisable to apply this Fund in favour of employees who did not contribute to the Fund or in cases where there is no question of unemployment. In some other legal systems State-administered funds do provide for the immediate payment of salaries at the sequestration of the employer.[18] Such funds, which are apparently maintained by contributions by all employees, would undoubtedly alleviate the problem but it is not part of this investigation to examine the advisability of such a fund. The only relief which the Commission can offer for this problem is a recommendation that no other creditor should enjoy a higher preference than salary creditors.

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18 Cork Committee Report par 1432 at 325; Scotland Report par 15.19 at 227. Cf British Columbia Report 59.

There was a proposal that industrial councils should be authorised to prove claims on behalf of employees in all cases and that awards from insolvent estates should be paid to the industrial councils who would then pay them over to the employees. Industrial councils are frequently in a better position than employees to lodge the claims and make the distribution. They have a thorough knowledge of the relevant industrial agreements and also sometimes hold security which has been lodged for salaries. In practice the industrial councils sometimes lodge the salary claims after they have paid the salaries and have obtained cession of the claims. There seems to be nothing to prevent the industrial councils from contracting for such a procedure in the industrial agreement or in a particular case. It does not, however, appear to be advisable to provide by legislation that industrial councils should always act on behalf of employees.

3.9.6 Commission

Section 100(1)(b) of the Insolvency Act provides that the commission of a commercial traveller shall, like the salary of an employee, be paid as preferent.

This preference applies only to a commercial traveller and not to any other earnings on a commission basis. The English, Australians, Canadians and Germans expressly include a claim for commission in the preferent claim for salary or wages, without limiting commission to that of commercial travellers.[19] The Estate Agents' Board has made representations for their members to be protected as well. Most estate agents work on a commission basis exclusively. Commission is usually payable only after the property transaction is registered in the deeds office. Whereas an ordinary employee can look for other work if his employer does not pay him, the estate agent must necessarily wait for months for his commission and he is powerless if his principal's financial position deteriorates. There are numerous salesmen in business who work, for the most part, on a commission basis and it seems unfair that only commercial travellers should have a preference in respect of commission. If salaried persons qualify for a preference, persons in a similar position who earn commission should be entitled to the same preference.

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19 Par 16.4.14.1 of the working paper at 94.

Making all claims for commission preferent could open the door to abuse. A person could couch a contract in terms entitling him to commission on sales rather than as a partnership agreement. He would then enjoy some of the advantages of a partner and at the same time acquire a preference on insolvency, while a partner may not claim in competition with any other creditors. A housewife who works as an estate agent in her spare time does not arouse the same sympathy as an employee who earns a commission or salary as his chief source of livelihood. The same applies to persons who earn commission on a casual basis or incidental to their main business on investments put through or new business introduced to some enterprise or other. The only feasible limitation would appear to be that persons who render services full-time to an employer or other person and are reimbursed either in whole or in part by way of commission should be dealt with on the same basis as a salaried person in respect of commission claimable for work done within the three months immediately before sequestration. The Southern Africa Commercial Traveller's Association did not offer any comment on this view which was also expressed in the working paper.

The Commission recommends that a full-time employee should be entitled to a preference for commission as if it were part of his salary.

3.9.7 Fees due to accountants or auditors

Section 100(1)(a) of the Insolvency Act confers a preference on accountants or auditors, limited to R2 000 per accountant or auditor, for fees due for the keeping, writing up or auditing of books relating to the insolvent's affairs.

Section 31 of the Insolvency Amendment Act[20] introduced this preference. The reason advanced at the time to justify this preference was that the accountant is frequently called upon to do work for a person whose financial position is precarious and that it is in the interests of creditors that an insolvent's books should be up to date. The working paper[21] pointed out that there are numerous other persons who render services in similar circumstances but who enjoy no preference. If the trustee deems it necessary after sequestration, he can have the books relating to the insolvent estate written up at the expense

20 Act 99 of 1965.
21 Par 16.4.13 at 88 et seq.

of the estate. Accountants are in a good position to protect their interests because they are aware of the financial position of their clients. They are apparently not obliged to render their services on credit. There no longer appears to be any reason why an auditor cannot resign during a financial year.

The South African Institute of Chartered Accountants offered no comments on the working paper. One commentator[22] submitted that the legislature in publishing the Close Corporations Bill apparently accepted the principle that audits in respect of small private companies are unproductive and inflationary. He agrees that this preference should be abolished.

The Commission recommends that the preference for the fees of auditors and accountants be abolished.

3.9.8 Fees due to nurses

Section 100(1)(a) of the Insolvency Act grants a preference to a nurse, limited to R2 000 per nurse, for any fee due for nursing the insolvent, his wife or minor child.

The nurses referred to here are nurses who render services to their patients in their private capacity. They have a contractual relationship with their patients. They offer their services for a set fee per hour or per day or for any other period. Medical funds make provision for such fees in certain cases. Not all patients however, enjoy the benefits of a medical fund. Unlike a medical doctor who has a great number of patients and whose losses in respect of some of them do not make an appreciable difference to his total income, a private nurse usually has one or a few patients at a time. Her income is analogous to a salary which she receives for her services. In regard to salary and commission[23] it is suggested that only persons who render services full-time to one employer should be entitled to a preference. If a preference is conferred on a nurse who is not in full-time employment of one person, this will constitute a departure from this principle. The fact that nurses may render services only to a few persons does not distinguish them from persons who work for a couple of employers on a commission basis or a merchant who renders ser-

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22 M J Ensor. Cf now the Close Corporations Act 69 of 1984.
23 Par 3.9.6 above.

vices to a number of customers. It appears that for the sake of uniformity the preference conferred on a nurse should be limited to cases where the nurse is in the full-time employment of one person. The South African Nursing Council and the South African Nursing Association offered no comments on the tentative recommendation in the working paper that this preference should be abolished.[24]

The Commission recommends that the preference for fees due to a nurse should be abolished. A nurse who qualifies therefor would continue to enjoy the preference for a salary claim.

3.10 Bonds over movables

Section 102 of the Insolvency Act provides for a preference on the free residue for claims "secured by a general mortgage bond". According to the wording of this section read with other provisions of the Insolvency Act[25] the preference covers only a general bond over movables. It has, however, been decided that the common law preference of a special mortgage over movables has not been excluded by the Insolvency Act.[26]

Like any legal notion which has, so to speak, fallen between two stools in the process of legal development, this preference must be regarded as sui generis. The intention of the parties as is evident from the document is to provide for a secured claim. If the property which is the subject matter of the mortgage is not in the possession of the mortgagee, the law does not however confer a real right and the creditor is accordingly not a secured creditor. As far as a special mortgage under the common law and a general mortgage under section 102 of the Insolvency Act are concerned the law confers a preferent claim on insolvency over the free residue before payment of concurrent creditors. This obviously applies only to those movables in the free residue over which the mortgage was registered. Unlike other preferent claims payable out of the free residue, the creditor, like a secured creditor, receives interest on his claim from date of sequestration to date of payment if there are sufficient funds.[27]

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24 Par 16.4.12 at 87.
25 Sec 86. Cf par 18.3 of the working paper at 97.
26 Vrede Koöp Landboumaatskappy Bpk v Uys 1964 2 SA 283 (O).
27 Sec 102 of the Insolvency Act.

There can be little doubt that this preference is an anomaly and that it can lead to abuse and unsatisfactory consequences. Divergent comments were received on the discussion of this preference in the working paper. One commentator submitted that these mortgagees should be fully protected as secured creditors while other commentators proposed that this preference on the free residue should be abolished. In the course of its investigation of The giving of security by means of movable property[28] the Commission will deal with bonds over movables. After the completion of that investigation the existing preference on the free residue will be adapted to fit in logically with bonds over movables as a security device. It is possible that the preference on the free residue will then be abolished. It appears to be advisable that the status quo should be maintained until that investigation has been finalised.

The Commission recomends that the preference for general bonds over movables in section 102 of the Insolvency Act should be retained in its present form until the Commission's investigation of The giving of security by means of movable property has been finalised.

4. REPRESENTATIONS FOR NEW PREFERENCES

4.1 Trade creditors

The Transvaal Creditors' Protection Association Limited submitted that the present system of preferent claims is out of touch with present commercial realities and lends itself to abuse to the detriment of trade creditors in particular. The Association recommends that three classes of creditors should be distinguished:

- x Trade creditors - Creditors who supply commodities in the ordinary course of business.
- x Loan creditors - Creditors who advance funds in financing a business.
- x Personal creditors - Creditors who are relatives or friends of the debtor and have assisted him with financing from time to time.

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28 Project 46. Cf par 1.2 above.

These terms are hereinafter used in the sense set out above.

The Association recommends that, after other preferent creditors, payment should first be made to trade creditors, thereafter to other creditors who are not loan or personal creditors, thereafter to loan creditors and lastly to personal creditors. The Association advances the following reasons for this proposed order of priority. Many insolvents build up stocks in hand obtained from trade creditors and transfer such stocks secretly to others before they flee the country or are sequestrated. They then leave behind not only a large number of trade creditors but also personal creditors whose claims cannot be tested adequately. Trade creditors are not really in a position to monitor the financial position of debtors. Unusual increases in stocks purchased are often seasonal and can be obscured by spreading them amongst different suppliers. Balance sheets are usually out of date. A loan creditor can make a careful investigation and can insist on security or obtain sureties. It is inequitable that a creditor who can also sue a surety can claim from the insolvent estate on an equal footing with other creditors. Personal creditors who have a better knowledge of the debtor's position advance money on a different risk basis and should not be treated the same as trade creditors. As a matter of practical fact it is very difficult to test the claims of personal creditors and avoid abuse. Because of their relationship with the insolvent personal creditors are often paid in full privately, when the crisis has passed.

In respect of loan creditors certain legal systems[29] provide that a loan to someone who carries on business or who wishes to commence a business in exchange for part of the profits, is repaid only after all other claims have been paid in full. The wording of the rule is sometimes to the effect, that a person who provides capital cannot compete with other creditors. Apparently the South African law excludes such a creditor from competition with other creditors only if a partnership is involved.[30]

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29 England: Working paper Annexure 1.3.2 at 109; Cork Committee Report par 1141 at 260 and par 1960 et seq at 441; Canada: Working paper Annexure 3.12 at 115; Scotland: Scotland Report par 15.28 at 231; America: American Jurisprudence Vol 9A par 597 at 275 and par 749 at 482.

30 Mars 470 and the cases cited there.

There does not appear to be sufficient justification for the Association's proposal that a distinction should be made between loan creditors as such and trade creditors. If loan creditors select their clients more carefully than trade creditors and do more to ensure that their claims are repaid, they can surely not be blamed or penalised for this. If trade creditors, as a matter of normal business practice, grant credit more readily than loan creditors, they must accept the consequences of their business practice. As indicated in the Association's supplementary comments, there are persons who supply goods and advance funds as part of the same transaction. A rule providing that the claim of one creditor in connection with one transaction should be split into one part as a trade creditor and one part as a personal creditor and that the two parts should be treated differently, would be difficult to justify. Nor would it be fair to distinguish between loan creditors who are also trade creditors and loan creditors who are not trade creditors.

There is merit in the view that a person who makes an investment for profit should be distinguished from the ordinary creditor. It would be difficult to define this class of creditors in such a way that the provision does not cover cases that are not intended but is at the same time not too easy to evade. Unlike the English law, our law does not have a flexible rule[31] which can be applied. In order to keep the distribution of insolvent estates simple and in order to depart from the principle of equal treatment of the creditors of an insolvent estate only in exceptional cases, the Commission does not recommend that a distinction should now be made between creditors who have always been treated the same in our law.

In respect of personal creditors certain legal systems[32] have rules which exclude a spouse from competition with other creditors in certain circumstances. Under South African law the sequestration of the separate estate of one spouse (including a de facto spouse) has the effect that the estate of the other spouse also vests in the trustee of the insolvent spouse's estate. The assets can be reclaimed only if they fall under specified exceptions.[33] Assets given to one spouse by the other can be reclaimed only in exceptional circumstances.[34]

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31 Tyson v Rodger and Nicol (1907) 10 HCG 139 at 155.

32 England: Working paper Annexure 1.3.1 at 109; Cork Committee Report par 1140 at 260; Australia: Working paper Annexure 2.10 at 112; Canada: Working paper Annexure 3.10 at 114; Scotland: Scotland Report par 15.29 at 231.

33 Sec 21 of the Insolvency Act.

34 Ibid sec 21(2); Kilburn v Estate Kilburn 1931 AD 501 at 507.

There is not sufficient justification to subordinate all creditors who are relatives or friends of the insolvent. At most the setting up of a procedure for the careful examination of suspect claims might be considered. The American law grants the court authority to subordinate certain claims on equitable grounds.[35] South African decisions already indicate that suspect claims should be examined carefully before they are admitted against an insolvent estate. Relationship between the creditor and the insolvent or a case where the interests of the creditor coincide with the interests of the insolvent gives rise to suspicion which justifies a careful examination of the claims.[36] It appears to be undesirable in this instance, also, to depart from the principle of equal treatment of creditors.

The Commission does not recommend any differentiation between trade creditors, loan creditors and personal creditors.

4.2 Arrear maintenance in terms of a court order

In its comments on the working paper the Law Society of the Cape of Good Hope recommended that provision should be made, immediately before concurrent creditors, for the claims of an ex-wife and children of the insolvent for maintenance in terms of a court order which was in arrear at the date of sequestration.

Maintenance claims which become payable after sequestration cannot be recovered from the insolvent estate but must be recovered from the insolvent personally.[37] The claims can apparently be paid from the insolvent estate if other creditors have been paid in full.[38] The reason for the rule that maintenance claims cannot compete with other creditors, given by the Scotland Report[39], is that a maintenance claim can be enforced only if the person against whom it is claimed has more money than is necessary to meet his own requirements.

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35 American Jurisprudence Vol 9A par 745 et seq at 478.
36 Aspeling v Hoffman's Trustee 1917 TPD 305 at 309; Chappel v The Master 1928 CPD 289 at 291; Marendaz v Smuts 1966 4 SA 66(T) 73D.
37 Mars par 16.1 at 310.
38 Par 2.4.1 of the working paper at 10.
39 Par 16.34 at 246.

Should this person be insolvent there can therefore be no question of such a claim against his insolvent estate. Although the position of maintenance claims which become due after sequestration is not crystal clear, the Commission is of opinion that it is not advisable to make proposals to amend the position of these claims or to regulate them by statute as part of this investigation.

Regarding maintenance in terms of a court order which became due before sequestration, the insolvent estate is liable and arrear maintenance cannot be recovered from the insolvent personally. In respect of these claims the persons who did not receive maintenance are in a position similar to that of an employee who did not receive his salary. The maintenance creditor is dependent on the creditworthiness of the debtor for the payment of the claim. The divorced spouse and children usually have little knowledge of the financial affairs of the other spouse or parent. The maintenance creditors are usually dependent on maintenance payments to meet their reasonable requirements.[40] A limit should, however, be placed on the amount of the preferent claim and the period for which a preference may be claimed, as is the case with salary claims. Since a maintenance creditor has considerably more problems than an employee in tracing his debtor and enforcing his claim, the period of three months should not be limited to the three months immediately before sequestration. In this case the Commission regards a maximum amount of R1 500 as fair.

If both salary and maintenance claims are entitled to a preference the question arises whether one of these preferences should enjoy priority over the other. The Ontario Report[41] decided that maintenance claims should enjoy a higher preference than salary claims because creditors for salary can obtain another source of income with greater ease than maintenance creditors. It should, however, be borne in mind that the insolvent remains personally liable for future maintenance and that the duty to maintain passes to other persons if the person who is liable in the first place cannot afford it. This applies also to a maintenance claim by a married child of age.[42]

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40 Par 3.9.2 above. Ontario Report 51 et seq.
41 At 58.
42 Ex parte Jacobs 1982 2 SA 276 (O) 279 C.

The Commission recommends that claims for maintenance in terms of a court order in arrear at the date of sequestration should have a preference on the free residue after payment of the preferent salary claims of employees. The Commission also recommends that the preference should be limited to R1 500 per insolvent estate and to a claim for arrear maintenance for three months. The Commission recommends that the State President should have the power to amend the amount of R1 500 by regulation, as in the case of salary claims.

5. SUMMARY OF RECOMMENDATIONS

5.1 The Commission recommends that the following claims should be paid out of the free residue with preference over other creditors:

- Firstly, the costs of sequestration and administration of the estate.
- Secondly, claims by employees, limited to R3 000 per employee, for salary and commission for a period of three months immediately before sequestration, leave pay for a period of 21 days and bonus.
- Thirdly, claims for arrear maintenance in terms of a court order, limited to three months and R1 500 per insolvent estate.

5.2 The Commission recommends that the preference for holders of a general mortgage bond provided for in section 102 of the Insolvency Act should be retained in its present form until the investigation of The giving of security by means of movable property has been finalised.

5.3 The Commission recommends that all the other preferences at present provided for in sections 96, 98, 99 and 101 of the Insolvency Act be abolished.

6. DRAFT LEGISLATION

Section 5(5) of the South African Law Commission Act[43] provides that if after investigating any matter the Commission is of the opinion that legislation ought to be enacted with regard to that matter, the Commission shall prepare draft legislation for that purpose. A Bill to give effect to the Commission's recommendations is attached as Annexure C.

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43 Act 19 of 1973.

ANNEXURE A

PERSONS AND BODIES TO WHOM THE WORKING PAPER WAS FORWARDED OF THE COMMISSION'S OWN ACCORD

Afrikaanse Handelsinstituut

Association of Chambers of Commerce of South Africa
Association of General Banks and Finance Houses
Association of Law Societies of the Republic of South Africa
Association of Trust Companies in South Africa

Clearing Bankers Association of South Africa

Departments of: Co-operation and Development,
Industries, Commerce and Tourism,
Manpower

Estate Agents' Board

General Council of the Bar of South Africa

Justice Training

Masters of the Supreme Court

Medical Association of South Africa

Merchant Bankers' Association of South Africa

Motor Industries' Federation

National Funeral Directors' Association of Southern Africa

National Industrial Council for the Iron, Steel, Engineering and Metallurgical Industry

Public Accountants' and Auditors' Board

Secretary to the Treasury

South African Federated Chamber of Industries
South African Institute of Chartered Accountants
South African Nursing Association
South African Nursing Council

Southern Africa Commercial Travellers' Association

Southern Africa Institute of Chartered Secretaries and Administrators

Standard Trust Limited

Trade Union Council of South Africa

Universities (17)

ANNEXURE B

PERSONS AND BODIES WHO COMMENTED ON THE WORKING PAPER

Association of Trust Companies in South Africa

Chief Master of the Supreme Court

Clearing Bankers Association of South Africa

Commissioner Carletonville

Compensation Commissioner for Occupational Diseases

Departments of: Finance (Directorates of Customs and Excise and Inland Revenue)
Industries, Commerce and Tourism
Manpower

M J Ensor Metboard (Natal) Limited

Hill Samuel Merchant Bank (SA) Limited

Industrial Councils for the Building Industry (Natal, Port Elizabeth, Transvaal and Western Province)

Law Society of the Cape of Good Hope
Law Society of the Transvaal

Master of the Supreme Court Grahamstown

Motor Industries' Federation

National Funeral Directors' Association of Southern Africa

National Industrial Council for the Iron, Steel, Engineering and Metallurgical Industry

South African Association of Deputy Sheriffs

Southern Africa Institute of Chartered Secretaries and Administrators

Transvaal Creditors' Protection Association Limited

University of Durban-Westville

ANNEXURE C DRAFT LEGISLATION

BILL

To regulate further the preference in respect of costs of sequestration and the salary, leave and bonus of an em= ployee after sequestration; to make provision for a preference in respect of arrear maintenance due by an insolvent; to repeal certain provisions of the Insol= vency Act, 1936, and the Co-operatives Act, 1981, which confer a preference in respect of certain classes of claims; and to provide for matters incidental thereto.

Introduced by the Minister of Justice

BE IT ENACTED by the State President and the House of Assembly of the Republic of South Africa, as follows:-

Amendment of section 95 of Act 24 of 1936.

1. Section 95 of the Insolvency Act, 1936 (Act No. 24 of 1936, hereinafter referred to as the princi= pal Act), is hereby amended by the deletion of the proviso to subsection (1).

Substitution of section 97 of Act 24 of 1936.

2. The following section is hereby substituted for section 97 of the principal Act:

"Costs of se- questration

97.(1) Any free residue of an insolvent estate shall be applied in

the first place in defraying the costs of sequestration of the estate with the exception of the costs mentioned in section 89(1).

(2) The costs of sequestration shall include -

(a) the sheriff's charges incurred since the sequestration;

(b) fees payable to the Master in connection with the sequestration;

(c) the costs (as taxed by the registrar of the court) incurred in connection with the application of the debtor for acceptance of the surrender of his estate or of a creditor for the sequestration of a debtor's estate, but not including the costs of opposition to such an application unless the court directs that they shall be included;

(d) the amount determined by the Master in terms of section 16(5) for the preparation of the statement of affairs required by section 16(2)(b);

(e) the remuneration of the curator bonis and of the trustee and all other costs of administration and liquidation of the estate, including such costs incurred by the trustee in giving security for his proper administration of the estate;

(f) the expenses incurred by the Master or by a presiding officer in terms of section 153(2); and

(g) the salary, wages or fee of any person who was engaged or appointed by the curator bonis in connection with the administration of the estate.

(3) The taxed fees of the sheriff or messenger in connection with any execution upon property in proceedings stayed in terms of section 20 shall be regarded as costs of sequestration of the estate.

(4) The costs of sequestration referred to in subsections (2) and (3) shall rank pari passu and abate in equal proportion, if necessary.".

Substitution of section 100 of Act 24 of 1936.

3. The following section is hereby substituted for section 100 of the principal Act:

"Preference in respect of salary, wages, leave and bonus due to employees.

100.(1) Thereafter any balance of the free residue shall be applied in paying -

(a) the salary or wages due to an employee of the insolvent for any period during the three months immediately prior to the sequestration of the estate;

(b) salary or wages in respect of the period of leave due to the employee, not exceeding 21 days; and

(c) any bonus due to the employee whether or not payment thereof is due at the date of sequestration of the estate,

subject to a maximum amount of R3 000 in total per employee in respect of the said salary, wages, leave or bonus, or the maximum amount fixed in terms of section 158.

(2) For the purposes of subsection 1(a) the commission due to any person who is or was a full-time employee of the insolvent shall be deemed to be salary or wages.

(3) An employee shall be entitled to salary or wages, leave and bonus in terms of subsection (1) even though he has not proved his claim therefor in terms of section 44, but the trustee may require the employee to submit an affidavit in support of the claim.".

Insertion of section 100bis in Act 24 of 1936.

4. The following section is hereby inserted in the principal Act after section 100:

"Preference in respect of arrear maintenance.

100bis Thereafter any balance of the free residue shall be applied in paying maintenance due by the insolvent in terms of a court order and in arrear at the date of sequestration of the estate, for a period not exceeding three months subject to a maximum amount of R1 500 or the maximum amount fixed in terms of section 158.".

Amendment of section 158 of Act 24 of 1936.

5. Section 158 of the principal Act is hereby amended by the addition of the following paragraph:

"(d) the maximum amounts in respect whereof a preference is granted in terms of section 100 and 100bis.".

Repeal of sections 96, 98, 99 and 101 of Act 24 of 1936.

6. Sections 96, 98, 99 and 101 of the principal Act are hereby repealed.

Amendment of section 219 of Act 91 of 1981.

7. Section 219 of the Co-operatives Act, 1981 (Act No. 91 of 1981), is hereby amended by the deletion of paragraphs (b) and (d).

Saving.

8. The provisions of this Act shall not apply to an insolvent estate, company or co-operative in respect whereof the sequestration or liquidation commenced before the commencement of this Act.

Short title.

9. This Act shall be called the Insolvency Amendment Act, 19__.