SEQUESTRATION OF THE INSOLVENT ESTATE: THE 'ADVANTAGE TO CREDITORS' REQUIREMENT

*by Cherrie Olivier**

1 Introduction

This essay deals with the 'advantage to creditors' requirement imposed by the Insolvency Act,[1] in South African law. This essay is divided into four parts. Firstly, the requirement will be examined in order to establish the objective it aims to achieve. It will then go on to describe the various ways in which the requirement is implemented during the sequestration process in order to achieve this objective. The second part will discuss how courts interpret the relevant provisions with reference to case law. In the third part, South African insolvency law will briefly be compared to foreign insolvency law in order to raise some potential concerns about the emphasis on the 'advantage to creditors' requirement in our law. Finally, with due regard to the current legal institutions and proposals for legal reform in South Africa, conclusions will be drawn as to the necessity of revisiting the scope and implementation of this requirement.

2 The meaning and implementation of the 'advantage to creditors'

The common law principle *concursus creditorum* is described as being 'fundamental' to insolvency law.[2] The Insolvency Act is argued to give effect to this principle by creating procedures for the division of the insolvent's estate and the distribution of dividends to the group of creditors.[3] The main objective of the Act is to provide for the fair distribution for the insolvent's assets in the event where the assets are insufficient to satisfy all of the creditors' claims.[4] Each creditor

* Third year LLB Law, Tutor in the Department of Private Law, University of Pretoria.

1 Act 24 of 1936.

2 CH Smith 'The recurrent motif of the Insolvency Act — advantage of creditors' (1985) 7 *Modern Business Law* 27.

3 As above.

4 M Roestoff & H Coetzee 'Consumer debt relief in South Africa; lessons from America and England; and suggestions for the way forward' (2012) *South African Mercantile Law Journal* 53 55.

will then receive a dividend which is calculated on a basis of 'orderly sharing' of all the assets in the insolvent's estate.[5] While the insolvent's estate is being sequestrated, the estate is deemed to be 'frozen' and no creditor can act to alter or prejudice the rights of the other creditors.[6] The 'advantage to creditors' requirement therefore functions not to serve the benefit of an individual creditor but rather the entire group of creditors as an entity.[7]

Sequestration can be effected through the Act either by way of the debtor applying for voluntary sequestration of her (or his) estate or the creditor(s) can apply to have the estate sequestrated.[8] The Act provides that in the instance of applying to a court for the voluntary surrender of the debtor's estate, advantage to creditors must be proven.[9] Voluntary surrender is a procedure that is designed for the benefit of the creditors.[10] This can be justified with reference to the cumbersome venture the creditor has to pursue in order to obtain her (or his) assets[11] as well as the possibility that the creditor could be liable to contribute to a shortfall.[12] In the compulsory sequestration procedure, the Act provides that a provisional sequestration order will only be granted with the court is *prima facie* of the opinion that there is reason to be believe that there will be advantage to the creditors.[13] It will thus follow that the Act provides that a final order of sequestration will only be ordered if the court finds that there is reason to believe that there will be advantage to the creditors.[14]

The above provisions expressly states that it is operating to the 'advantage of creditors'. However, there are other sections which, albeit do not make use of the term, are designed for the same purpose.[15] For example, when a partnership is sequestrated the Act provides that all partners' estates must simultaneously be sequestrated.[16] This is done for the benefit of the creditors: the partnership may be insolvent, but the partners could potentially have private assets which can assist in satisfying the creditors' claims.[17]

Another instance of provisions in Act working toward the benefit of the creditor is the various provisions which enable the trustee (or the creditor in the name of the trustee) to apply to a court for an order setting aside agreements made by the insolvent prior to the

5 Smith (n 2 above) 27.
6 As above.
7 Smith (n 2 above) 27.
8 Roestoff & Coetzee (n 4 above) 55.
9 Insolvency Act 24 of 1936 secs 3(1) & 6.
10 As above.
11 As above.
12 Smith (n 2 above) 27.
13 Insolvency Act (n 9 above) sec 10(c).
14 Insolvency Act (n 9 above) sec 12(1)(c).
15 Smith (n 2 above) 29.
16 Insolvency Act (n 9 above) sec 13(1).
17 Smith (n 2 above) 29.

sequestration process.[18] The Act provides for the setting aside of 'dispositions without value'; 'voidable preferences'; 'undue preferences' and 'collusive dealings'.[19] These provisions clearly give effect to the principle of *concursus creditorium*. Creditors who are prejudiced in that assets ordinarily available for distribution are no longer available, can apply to have those assets made available via a court order that retrospectively sets the prejudicial agreement aside.[20] Consequently the advantage to a group of creditors, as opposed to only a few creditors or single creditor, is protected.[21]

There are also measures in place to prevent undue benefit to a creditor after the sequestration process has begun. It is explicitly provided for in the Act that no composition offer may be accepted if it contains a condition whereby any creditor would obtain as against another creditor any benefit to which (s)he would not be ordinarily entitled to upon the distribution of the estate.[22]

Mention must also be made to the provision in the Act allowing for the interrogation of the insolvent and other witnesses during a meeting with the creditors.[23] The scope of the interrogation is wide: Enquiry can be made to all matters of the insolvent, her (or his) property and business affairs or the affairs of her (or his) spouse.[24] The purpose of this interrogation is to the advantage of creditors in that it assists them in recovering assets which would otherwise be concealed, improperly disposed of or unfairly dealt with.[25]

The indirect advantages the Act provides for in isolation cannot truly be advantageous if not accompanied or linked to a potential financial gain to the creditors.[26] The 'advantage to creditors' requirement is then only fulfilled if there is potential of some 'pecuniary benefit' to the group of creditors.[27]

3 The courts' interpretation of the 'advantage to creditors'

In *Ex parte Arntzen,*[28] the applicant requested the court for a voluntary sequestration order in terms of the Act. The court held that the requirements for a voluntary sequestration order are set out in

18 Smith (n 2 above) 30.
19 Insolvency Act (n 9 above) secs 26, 29, 30 & 31.
20 Smith (n 2 above) 30.
21 As above.
22 Insolvency Act (n 9 above) sec 119(7).
23 Insolvency Act (n 9 above) sec 65(1).
24 Smith (n 2 above) 30.
25 Smith (n 2 above) 31.
26 Smith (n 2 above) 32.
27 *Ex parte Bouwer* 2009 6 SA 382 (GNP) para 13.
28 2013 1 SA 49 (KZP) para 1.

section 6(1) of the Act.[29] These requirements are *inter alia* that the debtor has sufficient assets to cover the sequestration costs (that is to be paid from the free residue) and that the sequestration of the estate will be to the advantage of the creditors.[30] The court emphasised the need for full and comprehensive disclosure from the side of the debtor in an application for voluntary surrender.[31] Gorven J went on to explain that the 'advantage to creditors' requirement is more strictly dealt with by the court in these applications compared to applications for forced sequestration.[32] This approach is justified due to the fact that there is a greater risk of abuse and the potential of undermining the creditors' rights in a voluntary surrender of the insolvent's estate.[33] Therefore there is an onus upon the applicant to relay detailed evidence, which includes the disclosure of all available documentation, to the court in order to prove that all the necessary requirements are complied with.[34] The applicant in this particular case failed to fully disclose all the information required and hence failed to convince the court that his assets will cover the sequestration costs and that there will be an advantage to his creditors.[35] The voluntary sequestration was therefore not granted.[36]

In *Ex parte Bouwer*[37] the court also dealt with applications for voluntary sequestration. Firstly, the court dealt with the statement of affairs the debtor needs submit to the Master as required by section4 of the Act.[38] The statement of affairs needs to consist of *inter alia* the debtor's property (inclusive of both movable and immovable property) and a detailed record of the cause of the debtors insolvency.[39] Makgoka J had contentions regarding information disclosed by the applicants on basis that it failed to provide adequate facts to prove the state of insolvency.[40] Sufficient detail regarding their movable assets and their income and expenditure was also not relayed in the statement of affairs.[41] In turning to the substantive requirements provided for in section 6(1) of the Act, the court found that the valuator of the insolvents' estates failed to lay a basis for her valuation.[42] Makgoka J termed the valuation to be a 'bald assertion of values' which rendered the dividends allegedly accruing to the

29 *Arntzen* (n 28 above) para 2.
30 As above.
31 *Arntzen* (n 28 above) para 5.
32 *Arntzen* (n 28 above) para 4.
33 *Arntzen* (n 28 above) para 12.
34 As above.
35 *Arntzen* (n 28 above) para 22.
36 *Arntzen* (n 28 above) para 23.
37 *Bouwer* (n 27 above) para 2.
38 *Bouwer* (n 27 above) para 3.
39 As above.
40 *Bouwer* (n 27 above) para 11.
41 As above.
42 *Bouwer* (n 27 above) para 18.

creditors equally 'unreliable'.[43] The information given by the applicants did not successfully assist the court in establishing an advantage to creditors and the applications were thus dismissed.[44]

The advantage to creditors requirement was again emphasised by Satchwell J, in *Ex parte Shmukler-Tshiko*,[45] in dealing with an application for voluntary sequestration. The learned judge found that in most instances the applications displayed that the shortfall between the assets and liabilities of the debtor were exceeded by the sequestration costs.[46] Not only would granting the sequestration order place the applicants further in debt, but it would also reduce the amount available for the distribution among the creditors.[47] Being mindful of this fact, Satchwell J also commented on the provisions in the Act which offer advantage to creditors such as the right to investigate the insolvent's estate.[48] However, there was no indication in any of the applications that exercising this right would hold any benefit to the creditors in question.[49] Satchwell J reasoned that in voluntary sequestration the investigation is not likely to be to the advantage of creditors as an applicant debtor is unlikely to argue that further enquiry into her (or his) affairs would result into disclosure of concealed assets.[50] The majority of the applications were dismissed due to the lack of indication of advantage to the creditors.[51]

In determining whether an advantage to creditors exists, the ırt has the discretion to consider whether there are other appropriate procedures available from legislation such as the National Credit Act.[52] In *Ex parte Ford*, the debtors applied for the voluntary sequestration order, but upon considering their applications the court found that the source of their indebtedness resulted from credit agreements as defined in the National Credit Act.[53] The applicants held that the National Credit Act did not provide a solution to the debt problems they were encountering.[54] The applicants also contended that they have a constitutional right to bring forth an application for voluntary surrender in terms of the Insolvency Act.[55] Binns-Ward AJ, held that the primary objective of voluntary surrender is not to grant relief to 'harassed' debtors.[56] The court further argued that the purpose of both the Insolvency Act as well as the National Credit Act

43 *Bouwer* (n 27 above) paras 18 & 19.
44 *Bouwer* (n 27 above) para 34.
45 [2013] JOL 299999 (GSJ) para 7.
46 *Shmukler-Tshiko* (n 45 above) para 30.
47 *Shmukler-Tshiko* (n 45 above) paras 30 & 31.
48 *Shmukler-Tshiko* (n 45 above) para 59.
49 As above.
50 As above.
51 *Shmukler-Tshiko* (n 45 above) paras 68, 69, 77, 78, 88, 89, 92, 93, 97 & 98.
52 Act 34 of 2005; *Ex parte Ford* 2009 3 SA 376 (WCC) para 1.
53 *Ford* (n 53 above) para 2.
54 *Ford* (n 53 above) para 15.
55 *Ford* (n 53 above) para 21.
56 As above.

is to manage the way in which creditors are paid, not to deprive them of their claims.[57] The applications were dismissed due to the fact the court considered the debt review process in the National Credit Act to be the most appropriate procedure for debt relief in this instance.[58]

It is evident from the judgments discussed above that the court places great emphasis on the advantage to creditors in the granting of voluntary sequestration orders.

4 Foreign insolvency law

There is an emerging international trend to adapt insolvency law to assist over-indebted debtors.[59] However, South African insolvency law has not been affected by this trend and remains largely centred around the interests of the creditor.[60] Most of the debt relief procedures in our system are also court driven which makes them an expensive option.[61] Below two countries with aims to protect both the interest of the creditors as well as the debtors are explored.

In American insolvency law, equal treatment of the creditors is also of the essence, but it differs from South African law in that the effective rehabilitation of the debtor is also deemed to be a main objective.[62] As opposed to South African insolvency law, that has debt relief procedures originating from various statutes, American debtors rely on one act, the Bankruptcy Reform Act of 1978.[63] The American legal system allows debtors who are honest in their dealings but unfortunate due to their circumstances to obtain a fresh start.[64] Chapter 7 of the Bankruptcy Code provides for petitions to be filed voluntarily or involuntarily to effect the liquidation of the debtor's estate and discharge of the claims of the unsecured creditors.[65] An aspect that is distinctly different from the South African system is that the advantage to creditors is not a requirement for the granting of the discharge order.[66]

In the English and Welsh system, debtors who have no income and no assets (referred to as the 'NINA debtors') are especially provided for.[67] A debt relief order may be granted to a debtor with liabilities less than £15 000 and a minimum monthly surplus (after normal household expenses are paid) of £50. In addition the debtor's assets

57 As above.
58 *Ford* (n 53 above) para 22.
59 Roestoff & Coetzee (n 4 above) 75.
60 As above.
61 As above.
62 Roestoff & Coetzee (n 4 above) 71.
63 Generally referred to as the Bankrupcy Code.
64 Roestoff & Coetzee (n 4 above) 71.
65 Roestoff & Coetzee (n 4 above) 72.
66 As above.
67 Roestoff & Coetzee (n 4 above) 73.

should not exceed £300.[68] This order is granted with no court involvement. the official receiver makes the order which places a moratorium on the enforcement procedures.[69] No creditor can apply for bankruptcy procedures during this period (usually 1 year) and after the completion of the period all qualifying debts will be discharged.[70]

The interests of the creditors are also taken into consideration in the English and Welsh system, as it is only permissible for debtors to apply for a debt relief order once every six years.[71] Creditors can also object to the granting of the debt relief order or to the inclusion of debts on the list of debts to be discharged.[72] If the debtor should experience an increase in her (or his) monthly salary, notice should be given to the official receiver.[73] During the subsistence of the period the debtor cannot receive credit exceeding £500 without disclosing to the creditor that (s)he is subject to a debt relief order.[74]

The South African insolvency law may stand to improve if certain aspects of the above mentioned foreign legal systems are incorporated into our law. A single source of legislation dealing with insolvency, as is in this case in America, will eliminate duplication of debt relief procedures and eliminate ambiguities as to the most appropriate procedure to follow.[75] Granting special debt relief to NINA debtors, as provided in the English and Welsh legal system, poses a two-fold benefit to the South African legal system. Firstly, the cumbersome venture of initiating a costly court procedure with little chance of success will be avoided and secondly, it will be a step towards a more debtor orientated approach and thus in line with international trends in this regard. that the South African legal system should take.[76]

5 Revisiting the scope and implementation of 'advantage to creditors'

There are currently proposals for the reform of the South African insolvency law system. The South African Law Reform Commission, recommends these changes in the 2010 Insolvency Bill.[77] In view of the fact that some debtors become insolvent due to circumstances for which they are not to blame and that some creditors exploit their

68 Roestoff & Coetzee (n 4 above) 74.
69 As above.
70 As above.
71 As above.
72 As above.
73 As above.
74 As above.
75 Roestoff & Coetzee (n 4 above) 75.
76 Roestoff & Coetzee (n 4 above) 76.
77 Roestoff & Coetzee (n 4 above) 59.

debtors, the Bill proposes procedures with the aim to achieve a balance between the interests of the creditors and the interests of the debtor in our insolvency law.[78]

Roestoff and Coetzee suggest that in order to achieve an advantage for the creditors, distribution of the insolvent's estate should not result in the payment of 'negligible dividends' to the creditors.[79] Currently, the statistical prevalence of creditors who receive dividends is strongly outweighed by creditors who are required to pay a contribution.[80] Thus, despite the clear requirements laid down by the Act preventing sequestration without potential advantage to creditors, an advantage to creditors is meagrely achieved.[81]

In order to circumvent this, the Commission has proposed to amend the Act by including a provision which allows for a provisional order of voluntary sequestration.[82] The Commission further suggests that a meeting with all the creditors should be held prior to the return date and after the appointment of the liquidator.[83] This meeting will then allow the creditors to establish whether sequestration would be to the advantage of the creditors if the final voluntary sequestration order would be granted.[84]

The Commission also suggests that the applicant debtor should offer security for the payment of the administration costs in the instance where the costs cannot be recovered from the free residue, and that less expensive remedies should be made available to the debtor if sequestration proves to be financially impossible.[85] The fact that concurrent creditors fail to receive sufficient dividends can also be attributed to the extensive list of secured creditors (who have preferential claims against the estate).[86] The Commission thus recommends that the preferential claims be limited to claims for maintenance, salaries in arrears and the claims of bondholders.[87]

Although the advantage to creditors requirement needs to be more effectively enforced, due regard also needs to be given to the plight of the debtors. Court orders do not provide sufficient relief to debtors as 'poor' debtors who cannot prove the advantage to creditors are excluded from using the relief procedure in the Act.[88]

78 Roestoff & Coetzee (n 4 above) 76.
79 As above.
80 As above.
81 As above.
82 Roestoff & Coetzee (n 4 above) 59.
83 Roestoff & Coetzee (n 4 above) 59 and 60.
84 Roestoff & Coetzee (n 4 above) 60.
85 Roestoff & Coetzee (n 4 above) 60.
86 As above.
87 As above.
88 Roestoff & Coetzee (n 4 above) 75.

Court decisions such as the decision in *Ford*[89] show that our courts do not consider the best possible solution for the debtor's financial dilemma.[90] The only focus seems to be whether the 'advantage to creditors' requirement is achieved and debtors' interests are disregarded.[91]

The court in *Ford* has now created a precedent, which may result in debtors in future not being able to rely on the debt relief procedures provided for the Insolvency Act. Instead they would be forced to use the procedures in terms of the National Credit Act which provides considerably less relief.[92] The debt review procedure in terms of the National Credit Act does not allow for the court to force the discharge of a portion of the creditor's claims against the debtor.[93] Thus, a debtor who does not have sufficient income would not be able to relieve herself (or himself) from her (or his) debts.[94]

A potential solution for this dilemma would be for the court to take a more balanced approach to exercising its discretion when considering the granting of a sequestration order.[95] This approach would then entail having regard for the interests of the debtor.[96] For such an approach to be effectively realised, Parliament may need to amend the Act to include an advantage to the debtor as a requirement for the voluntary sequestration process to take place.[97]

The Commission has also proposed that a pre-liquidation composition be made available in insolvency law for the benefit of debtors.[98] Debtors, who are excluded from using the debt relief procedure in the Act due to the fact that advantage to creditors cannot be proven, will be able to enter into a composition with creditors in order to find alternative debt relief.[99] The debtor and creditors will be able to enter into a composition if two-thirds of the concurrent creditors are in favour of the agreement.[100] In order to initiate such a process the debtor will be able to lodge a signed composition and a sworn affidavit with the magistrate's court. The composition will be supervised by the court and an investigation will be conducted into the financial affairs of the debtor.[101] In the period between the lodging of the application and the judgment order on the composition, no creditor will be able to apply for an order to

89 *Ford* (n 53 above).
90 Roestoff & Coetzee (n 4 above) 63.
91 As above.
92 Roestoff & Coetzee (n 4 above) 63.
93 Roestoff & Coetzee (n 4 above) 75.
94 As above.
95 As above.
96 As above.
97 Roestoff & Coetzee (n 4 above) 63.
98 Roestoff & Coetzee (n 4 above) 70.
99 As above.
100 Roestoff & Coetzee (n 4 above) 70
101 As above.

sequestrate the debtor's estate.[102] The preferential claims against the estate will only form part of the composition if the secured creditors gave written consent to that effect.[103] If the court grants the composition it will be binding on all creditors who attended or were aware of the hearing.[104] If the composition is unsuccessful, the debtor will be in the position (s)he was in prior to the initiation of the proceedings.[105] However, it may be even more beneficial to the debtor if there are compulsory out-of-court negotiations to this effect, as opposed to a composition order that requires court involvement and can hence prove to be costly.[106]

6 Conclusion

In South African insolvency law, the interests of debtors are currently almost entirely outweighed by the need to satisfy the interests of creditors. Both the legislature and the judiciary have failed to accommodate debtor interests and a cost effective debt relief procedure that results in successfully relieving the debtor of her (or his) debt should be introduced. However, as explained above, the procedure used to secure the claims of creditors also falls short of fulfilling its purpose. There is a clear need to address these concerns and effective insolvency law reform is thus vital. However, whether the proposals of the Commission will effect the necessary reform is yet to be seen.

102 Roestoff & Coetzee (n 4 above) 71.
103 As above.
104 As above.
105 As above.
106 Roestoff & Coetzee (n 4 above) 76.