TOO POOR TO BE BROKE

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1 Introduction

The 'advantage to creditors' requirement has far-reaching adverse consequences and implications for debtors in South African insolvency law. Despite the negative implications, as will be explained below, this requirement has been part of our insolvency law since 1936 and has remained untouched. One of the major impacts of this requirement may be summarised as follows:

> Since the mainstream bankruptcy procedures are out of reach for many debtors ... many debtors are without proper discharge measure in South African law. This is especially evident amongst the previously disadvantaged people who are now fast becoming part of the credit industry. Some may therefore view our system as being discriminatory, since, due to its stringent requirements for sequestration on the one hand, and due to the limited alternatives to sequestration available on the other hand, the formal discharge is only available to an exclusive few.[1]

This paper will focus on the meaning of 'advantage to creditors' in the context of both voluntary and compulsory sequestration. The consequences of this requirement and the efficacy of the alternative debt relief measures to the Insolvency Act[2] (the Act) will also be discussed. Recommendations to remedy the situation as it stands in South Africa will be submitted, taking into account all the proposed changes to South African insolvency law.

2 Background

Insolvency law is a collective debt collecting procedure which provides for fairer distribution of the proceeds of a debtor's estate amongst the creditors where the debtor does not have sufficient assets to settle all his debts in full.[3] The law of insolvency is mainly

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1 'Review of administration orders in terms of section 74 of the Magistrates' Courts Act 32 of 1944' Interim research report 83.

2 Act 24 of 1936.

3 C Nagel *et al Commercial Law* (2006) 422.

regulated by the Act and is based on two principles, namely the right which creditors have to satisfy their claims and the concurrency of creditors who do not have a secured or preferent claim.[4] This causes a *concursus creditorum*, as general interests of the creditors as a group have a higher priority than the interests of individual creditors. In *Ex parte Pillay*,[5] Judge Holmes stated that 'the procedure of voluntary surrender was primarily designed for the benefit of creditors, and not for the relief of harassed debtors'. Therefore, even though one of the inevitable consequences of sequestration is the discharge of debts after rehabilitation,[6] discharge is not the main aim of sequestration.

A debtor's estate may be sequestrated by way of voluntary surrender[7] of his or her estate, or by way of compulsory sequestration.[8] Only a high court can make sequestration and rehabilitation orders as these affect a person's status.[9] This results in relatively high costs of proceedings since high court litigation is required.[10]

In terms of section 6 of the Act, the debtor in a case of voluntary surrender must prove the following requirements:

> (a) that he has complied with all the statutory formalities in terms of section 4 of the Act;
> (b) that he is factually insolvent;
> (c) that the sequestration will be to the advantage of creditors; and
> (d) that the free residue will be sufficient to cover the costs of sequestration.

In the case of compulsory sequestration the applicant creditor must provide *prima facie* evidence that:

> (a) he or she has established a claim which entitles him, in terms of section 9(1), to apply for sequestration of the debtor's estate;
> (b) he or she has a liquidated claim of at least R100 and, where more creditors with separate claims apply jointly, that the total of their claims in aggregate is not less than R200;
> (c) the debtor is actually insolvent or has committed an act of insolvency; and
> (d) there is reason to believe that sequestration would be to the advantage of creditors.[11]

From the above it should be clear that the requirements for voluntary sequestration are more stringent than those for compulsory

4 Nagel (n 3 above) 423.
5 1955 2 SA 309 (N) 311.
6 The Act (n 2 above) sec 129.
7 The Act (n 2 above) secs 3-7.
8 The Act (n 2 above) secs 9-12.
9 Nagel (n 3 above) 427.
10 n 1 above.
11 The Act (n 2 above) secs 10(c), 12(1). These sections provide for provisional and final sequestration orders respectively.

sequestration.[12] The degree of proof required in relation to the advantage to creditors principle is lighter in the case of compulsory sequestration due to the wording of section 6(1) compared to the peculiar wording of sections 10(c) and 12(c). Unlike voluntary surrender, which requires positive proof of advantage to creditors, compulsory sequestration requires only a reasonable prospect that it will be to the advantage of creditors. Therefore, it is not necessary for the applicant to prove that it will be to the advantage of creditors, but only that there is reason to believe that it will be so.[13] The reason for the difference in the burden of proof is that a debtor knows his own business and can adduce facts to show advantage to creditors. On the other hand, a creditor is not in the position of being in possession of sufficient facts relating to the debtor's assets as to be able to furnish details to the court.[14]

Furthermore, the standard of proof differs in respect of provisional and final sequestration orders.[15] In both cases the facts must show that there is a reasonable prospect, not necessarily likelihood but a prospect which is not too remote, that some pecuniary benefit will accrue to the creditors. In the case of a provisional order there need only be *prima facie* proof of the facts. In the case of a final sequestration order the court must be satisfied that those facts exist on a balance of probabilities.[16]

The question which then follows is what exactly is the meaning of the term 'advantage to creditors'?

3 Advantage to creditors

3.1 Definition

The Act does not define the 'advantage to creditors' requirement and it has therefore been subjected to several judicial interpretations. In the case of voluntary surrender the estate must provide something substantial for the distribution amongst creditors after costs of realisation have been borne and after costs of sequestration have been paid.[17] In compulsory sequestration the general consensus is that a reasonable prospect of some pecuniary benefit must accrue to the general body of creditors.[18] It is not necessary to prove that the

12 R Sharrock *et al Hockly's insolvency law* (2006) 17.
13 *Amod v Khan* 1947 2 SA 432 (N) 435; *Meskin & Co v Friedman* 1948 2 SA 555 (W) 558; *Arbor Trading Co v Pillay* 1949 4 SA 982; *Sacks Morris (Pty) Ltd v Smith* 1951 3 SA 167 (O) 168.
14 *Hillhouse v Stott; Freban Investments v Itzkin; Botha v Botha* 1990 4 SA 580 (W) 584.
15 *Walker v Walker* 1998 2 All SA 382 (W) 383.
16 As above.
17 *Ex parte Van Den Berg* 1950 1 SA 816 (W) 817.
18 *Meskin & Co* (n 13 above) 59.

insolvent has any assets. Even if there are no assets at all, but there is reason to believe that as a result of an investigation in terms of the Act some assets may be revealed to the advantage of creditors, it is sufficient.[19] Creditors must therefore at least receive a not negligible dividend, and the amount of this dividend depends on the fact of each particular case.[20]

In *Hillhouse v Stott*[21] the question under consideration was whether the requirement of section 10(c) of the Act is satisfied merely by proof that the value of the debtor's assets exceeds the minimum of R5 000 (then considered to be the minimum to cover costs of sequestration) as governed by Rule J5 of the Practice Manual applicable in the Transvaal. The Court held that the Practice Manual does not have the force of law and when determining whether advantage to creditors has been shown the court must have regard only to such considerations as were contemplated by the legislature. This case illustrates that there is no set monetary figure which proves advantage to creditors. The test according to *Epstein v Epstein*[22] remains whether the facts placed before the court show that there is a reasonable prospect – not necessarily a likelihood, but a prospect which is not too remote – that some not negligible pecuniary benefit will result to creditors.

Direct financial advantage is by no means the only benefit to be gained by creditors from the sequestration of the debtor's estate.[23] There are other advantages and factors which the courts will take into consideration besides direct financial advantages, such as the superior legal machinery which creditors acquire after sequestration, the rights of control by the trustee, and an investigation of the estate of the debtor.[24] The examination of the insolvent estate might reveal assets which were not declared by the insolvent and are therefore not within the knowledge of the creditors. Conversely, in *Walker v Walker*[25] it was held that the mere fact that sequestration enables investigation of an insolvent's affairs is not sufficient. There must be additional facts which are not too remote; a possibility that the investigation of an insolvent's affairs might reveal assets. The courts have also considered section 23(5) of the Act in determining advantage to creditors.[26] If income earned by the insolvent could be

19 As above.
20 *Trust Wholesalers and Woollens (Pty) Ltd v Macan* 1954 2 SA 109 (N) 111; *Fesi v Absa Bank Ltd* 2000 1 SA 499 (C) 501.
21 *Hillhouse* (n 14 above) 584.
22 1987 4 SA 606 (C) 609.
23 *Wilkins v Pieterse* 1937 SA 164 (CPD) 196.
24 *Stainer v Estate Bulkes* 1933 SA 86 (OPD) 90; *Awerbuch, Brown & Co. (Pty) Ltd v le Grange* 1939 SA 20 (OPD) 23, 25.
25 *Hillhouse* (n 14 above) 584.
26 *Ressel v Levin* 1964 1 SA 28 (C); *Ex parte Veitch* 1965 1 SA 667 (W).

used to settle the debt in full over time, the courts may refuse sequestration.

Another factor which has been considered by our courts is that in the sequestration of a partnership there is a further advantage to creditors in that, if the sequestration is ordered, it will be a sequestration not merely of the partnership estate but of the private estates of the partners.[27] The partners may have in their private estates considerable assets which will be available for distribution if sequestration is granted. In a case where the partners are married, there is also a possible benefit in the fact that the spouses' assets will also fall in the hands of the trustee.[28]

From the above discussion it should be clear that advantage to creditors is best reached by striking a balance between direct financial advantage and other indirect advantages mentioned. Swart[29] summarises the approaches adopted by the courts to determine whether the advantage to creditors requirement has been met as follows: In the first category, sequestration must be to the advantage of all creditors. Unless the court is satisfied that the sequestration will not be to the advantage of all creditors, it should not dismiss the application for sequestration.[30] The second category takes a general approach by treating the creditors as a general body. This body consists of the majority of creditors, and numbers are important in some cases while other cases emphasise the value of the claim.[31] In the third category, courts treat the creditors as a group. The test is that the group must benefit and not the individual creditor.[32]

3.2 Consequences

According to the Report on Administration Orders[33] the advantage of creditors principle can be seen as the gateway to the bankruptcy regime. If a debtor is insolvent but cannot produce the funds to apply for the proper relief in terms of the Act, or cannot prove advantage to creditors, a sequestration order that would eventually lead to a discharge of the debt would not be an option to such a debtor. Due to the formal requirement to prove advantage to creditors, many creditors are left without a formal discharge remedy.

27 *Behrman v Sideris and Another* 1950 2 SA 366 (T) 372.
28 n 1 above.
29 Unpublished: Swart 'Die rol van 'n *concursus creditorum* in die Suid-Afrikaanse insolvensiereg' unpublished PhD dissertation, University of Pretoria, 1990 279-286.
30 *Provincial Trading Co* 1921 CPD 781; Swart (n 29 above) 279.
31 *Paul v Estate Wakeford* 1926 GWLD 13; Swart (n 29 above) 281.
32 *Stainer v Estate Bukes* 1933 OPD 86; Swart (n 29 above) 283.
33 n 1 above.

It should therefore be accepted that the Act offers no relief to debtors who have no assets or no income. A person who is unemployed and without regular income will have no proper relief due to the advantage to creditors requirement.[34] Most debtors have been categorically excluded from the discharge offered by the sequestration and rehabilitation procedures because of this requirement.

Since this requirement is so paramount in accessing sequestration, every sequestration order granted by our courts should in theory benefit the creditors. However in practice this is not so and many creditors have to contribute to costs of sequestration. According to the Report on Administration Orders[35] a survey conducted in the office of the Master of the High Court (Pretoria) showed that concurrent creditors received dividends in only 28.6% of sequestration cases, while creditors were required to contribute in 40% of the cases included in the survey.[36] Taking these statistics into account the entire existence of this advantage to creditors requirement may be questioned.

3.3 Alternatives to the Insolvency Act

The next question that needs to be answered is what happens if no advantage to creditors is proven? Given the stringent requirements of the Act, one would wonder whether there are appropriate alternatives to sequestration. The alternatives include an administration order in terms of section 74 of the Magistrates' Courts Act,[37] provided the debt does not exceed R50 000. Secondly, should a debtor not qualify for the formal administration order, the creditors may be approached to obtain a release or novation. The third option is debt re-arrangement in terms of section 86 of the National Credit Act.[38] I will now consider these options in turn and test whether they can be considered appropriate alternative debt relief measures to sequestration.

3.3.1 Section 74 of Magistrates' Courts Act

Where an application for an administration order is granted, the debtor must make periodic payments to an administrator who in turn pays the amount to a list of creditors. The administration procedure in terms of the Magistrate's Courts Act is of limited scope since it is

34 As above.
35 As above.
36 'Review of the law of insolvency: Prerequisites for and alternatives to sequestration' Working Paper 29 Project 63 (1989) Schedule 3.
37 Act 32 of 1944.
38 Act 34 of 2005.

only available where the debtor's debt amounts to R50 000 or less. An administration order only lapses when all listed creditors have been paid in full.[39] Therefore it does not provide for a discharge of the debt. Because there is no fixed time within which debts must be paid, many debtors fall into a debt-trap.[40] The result is that the poorest sections of our communities who cannot afford sequestration end up paying for their debts for the duration of their entire lives.

3.3.2 Release or novation

The debtor may enter into an agreement with the creditors to reschedule the debt by, for example, paying it off in monthly instalments. It is up to the creditors to accept the offer or reject it since the agreements are based on the principles of contract. This may result in a discharge of debt, but the problem is that it is at the discretion of creditors to either grant the debtor an extension, to discharge the debt, or to accept partial payment as full and final payment. Furthermore in practice it is often difficult for all creditors to reach consensus on such an agreement.[41]

3.3.3 Debt re-arrangement in terms of the National Credit Act

The National Credit Act applies to agreements which qualify as credit agreements as defined in the National Credit Act itself.[42] The application procedure for debt review is provided in section 86 of the National Credit Act. The debt counselor must determine whether the consumer appears to be over-indebted. If it is concluded that the consumer is over-indebted, the debt counselor may recommend that the Magistrate's Court make an order that one or more of the consumer's credit agreements be declared to be reckless credit and/or that one or more of the consumer's obligations be re-arranged.[43] Roestoff and Renke point out that the provisions dealing with reckless credit may provide for indirect debt relief for consumers.[44] The credit provider has to take reasonable steps to assess a proposed consumer's general understanding of the risks and costs, debt re-payment history and the existing financial means, prospects and obligations.[45]

The effects of debt review or debt re-arrangement are far reaching because they apply to all credit agreements whether small or large, irrespective of their form, the type of goods or amount of

39 Magistrates' Courts Act 32 of 1944 sec 74U.
40 n 1 above.
41 As above.
42 M Roestoff & S Renke 'Debt relief for consumers — the interaction between insolvency and consumer protection legislation (part 1)' (2005) *Obiter* 564.
43 National Credit Act sec 86(7)(c).
44 Swart (n 29 above) 572.
45 National Credit Act secs 80-84.

money involved.[46] However, the limitation is the fact that the National Credit Act only applies to credit agreements as defined in the National Credit Act itself.[47] This, among others, excludes for example delictual debts or where the consumer is a juristic person.[48] The debt re-arrangement procedure also does not provide for discharge.

Having looked at the possible alternatives to sequestration and the disadvantages they pose, it is fair to say that South Africa offers no appropriate solution to debtors who cannot prove the advantage to creditors requirement. What then can be done to resolve this dire economic set back?

4 Possible solutions and recommendations

A good starting point would be to look at foreign jurisdictions for guidance. The United States of America has a pro-debtor system not strictly based on advantage for creditors, but one of its main aims is to grant a fresh start (discharge) to debtors.[49] Advantage to creditors is not a formal requirement, and a natural person may be granted a discharge in terms of chapter 7 of the Code which is a process similar to sequestration in South Africa, but without the requirement of advantage to creditors. A natural person may also be discharged in terms of chapter 13 which is a rescheduling of payments such as a section 74 administration order, but the difference is that the debtor actually receives a discharge of his debts.[50]

However, because of abuse by debtors of the chapter 7 procedure, the USA has introduced the Bankruptcy Abuse Prevention and Consumer Protection Act, 2005 (BAPCPA) in an attempt to make the system more pro-creditor. The main characteristics of a pro-creditor system are that the advantage to creditors principle and the debtor will remain liable until all his debts are paid. The BAPCPA creates a new system that increases the proof necessary to qualify for the filing of bankruptcy. Proponents of the BAPCPA assert that its intent is to increase fiscal responsibility in respect of individuals and business entities.[51] Detractors believe the BAPCPA will have an adverse financial effect on individuals who seek relief from debts

46 Roestoff & Renke (n 42 above) 569.
47 In terms of the National Credit Act sec 8(2), agreements that do not constitute credit agreements are an insurance policy, a lease of immovable property and a transaction between a *stokvel* and a member of that *stokvel*.
48 Other exclusions to the National Credit Act are where the consumer is the state, or organ of state, or the credit provider is the Reserve Bank of South Africa.
49 Bankruptcy Reform Act, 1978 (the Code).
50 As above.
51 http://www.ll.georgetown.edu/guides/bankruptcy_act_2005.cfm (accessed 13 June 2008).

caused by extenuating circumstances such as illness, divorce, or long-term unemployment.[52]

The United Kingdom, in an independent research commissioned by the Department of Constitutional Affairs, identified three types of debtors: the so-called 'could pays', 'can't pays' and 'won't pays'.[53] The 'can't pays' are those who are unable to pay their debts because they have limited or no surplus income, which is similar to the position of most South African debtors. The Department of Trade and Industry proposed a new scheme called the NINA — 'no income, no assets' — debt relief scheme aimed at the 'can't pay' debtors.[54] In essence the scheme would entail an administrative debt relief order that would result in the discharge of the debtor after one year without court intervention which would make it more cost-effective.

After considering the international position it is submitted that the problem with South African insolvency law is not the Insolvency Act or the advantage to creditors requirement. The Act has a pro-creditor purpose which is to make sure that creditors' claims are satisfied and it is not aimed at discharging debtors of their obligations. As far as its purpose is concerned, the Act has not failed; in fact the advantage to creditors requirement is essential to meet this purpose. To remove the advantage to creditors requirement would subject the sequestration procedure to abuse by debtors. It is for this very reason that the United States of America is making amendments to their law to make their system more pro-creditor. The problem with South African insolvency law is in fact the lack of appropriate alternatives to sequestration. It is suggested that the focus should therefore be on reforming and improving the existing inadequate alternatives to sequestration. In this regard I recommend the following:

> As far as section 74 administration orders are concerned, the R50 000 limitation should be adjusted to perhaps R100 000 or R150 000. The administration procedure should be strictly regulated starting with proper supervision of administrators. Only attorneys should be allowed to serve as administrators. The order should provide for a discharge or a time period for repayment to avoid debtors who are bound to their debts for life.[55]
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> Regarding release or novation, the pre-sequestration composition proposed by the Law Reform Commission[56] is a possible solution to the contractual discretion which creditors enjoy and enables them to refuse offers by the debtors. With the insertion of the proposed section 74X in

52 As above.
53 M Roestoff & S Renke 'Debt relief for consumers — the interaction between insolvency and consumer protection legislation (part 2)' (2006) *Obiter* 107.
54 Roestoff & Renke (n 53 above) 108.
55 n 1 above.
56 'Review of the law of insolvency' South African Law Commission Report Project 63 Draft Bill (2000).

the Magistrates' Courts Act, composition between a debtor and his creditors before liquidation would be possible. The composition would be binding on all creditors if accepted by the required majority. The composition is also supervised by a magistrate and takes place after an investigation of the affairs of the debtors. A composition supervised by a mediator or arbitrator governed by the rules of alternative dispute resolution is also a cheaper and viable solution compared to court supervision.

The duty of credit grantors to investigate the affairs of a possible credit receiver before granting credit in terms of sections 80 to 84 of the National Credit Act should be extended to all credit transactions, even those which do not comply with definition of credit agreement in terms of the National Credit Act.

5 Conclusion

It is clear that South African insolvency law is creditor-driven. Although this reasoning is justified, something more needs to be done to resolve the problem of over-indebtedness in the country. South Africa does not necessarily have to abandon its pro-creditor philosophy but simply implement some pro-debtor measures as recommended above to strike a balance between the impoverished debtor class and the ever developing creditor group. If the situation remains as it is, the poor will become poorer which in turn over-burdens the growing economy. The proposed Insolvency Bill is a good start, but as already stated the focus should be turned to the alternatives to sequestration.