

The ranking of creditors' claims – now settled law!

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Since the introduction of the Companies Act 71 of 2008 ("the Companies Act"), and particularly Chapter 6 of the Companies Act dealing with business rescue proceedings, there has been much legal debate on various issues that have arisen as a result of the business rescue provisions introduced by the Companies Act. These issues either stem from ambiguous provisions in the Companies Act or the fact that the Companies Act does not cater for every eventuality that may arise in practice.

One of these issues, which has received much attention, is the ranking of creditors' claims or the so called "payment waterfall" in business rescue proceedings.

The judgment by the High Court of the Gauteng Division, Pretoria in the case of *The South African Property Owners Association v Minister of Trade and Industry and Others* 2018 (2) SA 523 (GP) (29 November 2016) ("**SAPOA Judgment**") has settled the ranking of creditors who provide goods and/or services post the commencement of business rescue proceedings under an agreement that was concluded prior to the commencement of these proceedings.

In addition, the Supreme Court of Appeal, in *Diener N.O. v Minister of Justice and Others* 2018 (2) SA 399 (SCA), and the Constitutional Court thereafter, in the case of *Diener N.O. v Minister of Justice and Correctional Services and Others* 2019 (2) BCLR 214 (CC) ("**Diener Judgments**"), had regard to the ranking of business rescue practitioners' fees in an instance where business rescue proceedings had been converted into liquidation proceedings. By extrapolation, this judgment is equally important on the ranking of creditors' claims in instances where business rescue proceedings fail and where the liquidators may be faced with a significant bill from the business rescue practitioner(s) for their fees.

These judgments, and the effect they have had on the ranking of creditors' claims or the payment waterfall, is discussed herein for the purposes of providing a definitive opinion on this issue.

The SAPOA Judgment

During November 2016, the Honourable Justice van der Westhuizen AJ of the High Court, Gauteng Division, Pretoria handed down the SAPOA Judgment, wherein the applicant, the South African Property Owners Association, sought a declaratory order that the rights of a landlord in respect of rental and other services (such as electricity, water, sanitation and sewerage charges and payments to other service providers disbursed by the landlord) in respect of a property leased by a company in business rescue, fell within the ambit of either post-commencement financing in terms of section 135(2) of the Companies Act or as costs arising out of the costs of business rescue proceedings in terms of section 135(3) of the Companies Act.

The relevant provisions of sections 135(2) and (3) of the Companies Act provides that:

"135(2) During its business rescue proceedings, the company may obtain financing other than as contemplated is subsection (1), and any such financing:

...

(b) will be paid in the order of preference set out in subsection (3)(b).

135(3) After payment of the practitioner's remuneration and expenses referred to in section 143, and other claims arising out of the costs of the business rescue proceedings, all claims contemplated:

...

(b) in subsection (2) will have preference in the order in which they were incurred over all unsecured claims against the company"

Van der Westhuizen AJ essentially held that: *"In my opinion, and applying the principles of interpretation, the financing intended in subsection (2) of section 135 of the Act relates to the obtaining of financing in order to assist in managing the company out of its financial distress, hence the provision that any asset of the company may be utilised to secure that financing to the extent that the asset is not otherwise encumbered. It does not lean to an interpretation that encompasses existing obligations, other than to company employees, of the company that are utilised to assist in managing the company during the business rescue proceedings. Further in this regard, sections 133 and 136(2) of the Act militate against such interpretation."* (own emphasis added)

Van der Westhuizen AJ further held that the costs relating to the lease agreement are a direct result of the terms of the lease agreement and that those costs cannot constitute post-commencement financing or costs classified as costs occasioned by the business rescue proceedings. If that were the case, a lessor would enjoy a preference over other creditors which would defeat the purpose or aim of the business rescue proceedings.

Accordingly, any costs or liability that arise out of an agreement that was concluded prior to business rescue proceedings, and which costs were incurred during business rescue proceedings, will not constitute *"post-commencement financing"* or *"costs arising out of the costs of business rescue proceedings"*.

Such costs and/or liabilities, unless already secured, will merely form the subject of an unsecured (concurrent) claim against the company in business rescue and will not enjoy any preference above other creditors.

The Diener Judgments

In this case, shortly after the applicant, Ludwig Wilhelm Diener ("**Diener**"), was appointed as the business rescue practitioner of JD Bester Labour Brokers CC ("**the Company**"), Diener instructed certain attorneys to institute an application in terms of section 141(2)(a) of the Companies Act to convert the business rescue proceedings into liquidation proceedings on the basis that Diener was of the view that the Company could not be rescued.

An order for liquidation of the Company was granted and Diener sought a preference for payment of his fees and submitted a claim to the joint liquidators of the Company. Diener argued that the claim for remuneration by a practitioner was not a concurrent claim but a special class of claim created by section 135 of the Act, that it enjoyed *"a special and novel preference"* and that it granted the practitioner *"security over all assets, even above securities existing when the practitioner takes office"*.

Section 135(4) of the Companies Act provides that *"[i]f business rescue proceedings are superseded by a liquidation order, the preference conferred in terms of this section will remain in force, except to the extent of any claims arising out of the costs of liquidation"*. (own emphasis)

The SCA held at:

"...[45] This leads me to the place of the preference created by s 135(4) in the broader scheme of the [Insolvency Act](#). Section 135(4) contains a strong indication when it provides that the claims that it deals with rank after the costs of sequestration.

[46] Section 96 of the [Insolvency Act](#) provides that the first call on the free residue of an insolvent estate – that 'portion of the estate which is not subject to any right of preference by reason of any special mortgage, legal hypothec, pledge or right of retention' – is in respect of funeral expenses and death bed expenses of the insolvent and his or her family. This is followed, in [s 97](#), by the costs of sequestration.

...

[49] For these reasons, I conclude that s 135(4) and s 143(5), whether taken individually or in tandem, do not create the 'super-preference' contended for on behalf of Diener. Section 135(4) provides to the BRP, after the conversion of business rescue

*proceedings into liquidation proceedings, no more than a preference in respect of his or her remuneration to claim against the free residue after the costs of liquidation but before claims of employees for post-commencement wages, of those who have provided other post-commencement finance, whether those claims were secured or not, and of **any other** unsecured creditors."*

The Constitutional Court concluded at paragraph 71 thereof that there is no *"...basis on which to interfere with the order of the Supreme Court of Appeal"*.

As a consequence, in a liquidation, the following ranking should be applied:

1. Proceeds from the sale of the **Encumbered Assets**:

1. Section 89 of Insolvency Act 24 of 1936 ("**Insolvency Act**") – Payment of the cost of maintaining, conserving, and realising any property. In this regard, the realisation costs include, in terms of this section, *"the trustee's remuneration in respect of any such property and a proportionate share of the costs incurred by the trustee in giving security for his proper administration of the estate, calculated on the proceeds of the sale of the property, a proportionate share of the Master's fees, and if the property is immovable, any [property] tax [and penalties thereon]"*
2. Section 95(1) of Insolvency Act – Payment of secured creditors.

2. Proceeds from the sale of the **Unencumbered Assets**:

1. Section 97 of Insolvency Act read with section 135(4) of Companies Act – Payment of the costs of liquidation;
2. Section 135(3) and (4) of Companies Act, read with the Diener Judgments:
 1. Payment of the business rescue practitioner's remuneration and expenses, and other claims arising out of the costs of the business rescue;
 2. Payment of any remuneration, reimbursement for expenses or other amount of money relating to employment that becomes due and payable by a company to an employee during the company's business rescue proceedings (section 135(1)); and
 3. Payment of unsecured post-commencement financiers (section 135(2));
3. Section 98 of the Insolvency Act – Payment of the costs of execution;
4. Section 98A of the Insolvency Act – Payment of salaries or wages of former employees of the company, subject to the limits described in this section. It is worth pointing out that this section would only become applicable if salaries and wages became payable prior to the commencement of business rescue proceedings, failing which it will fall under section 135(3), as described aforesaid;
5. Section 99 of Insolvency Act – Payment of statutory obligations, e.g. Workmen's Compensation, Taxes, UIF, etc.;
6. Section 101 of Insolvency Act – Payment of taxes on persons or the incomes or profits of persons per any Act of Parliament;
7. Section 102 of Insolvency Act – Payment of unperfected General Notarial Bonds; and
8. Section 103 of Insolvency Act, read with *South African Property Owners Association v Minister of Trade and Industry and Others* 2018 (2) SA 523 (GP) – Payment of concurrent creditors, including those concurrent creditors who provide services and supply goods after the commencement of business rescue proceedings under an agreement that was concluded prior to the commencement of business rescue proceedings and from whom the company did not "obtain financing" in terms of section 135(2) of the Companies Act.

Conclusion

The SAPOA and Diener Judgments clarifies the following:

1. any costs and/or liability incurred by a creditor during business rescue pursuant to an agreement concluded prior to business rescue will simply be a concurrent claim during business rescue. Such creditor will not enjoy any preference as set out in section 135 of the Companies Act, unless the creditor concludes a new agreement (makes application) or concludes an addendum to its current agreement, which provides that any services provided during business rescue will

enjoy a preference during business rescue. Business rescue practitioners will only enter into such arrangements if they are of the view that the contract and the service provided by the creditor is essential to the successful rescue of the company; and

2. claims under section 135 of the Companies Act, will have to be proved like any other claim in terms of section 44 of the Insolvency Act, and will not enjoy any preference over secured claims in liquidation. However, such claims will rank after the costs of liquidation, but before other preferent creditors and concurrent creditors.



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