

Effects on the employment relationship of the insolvency of the employer: A worker perspective

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SUMMARY

The article looks critically at the Insolvency Act prior to the amendments of 2002 and the limited protection it gave workers on the insolvency of their employer. The effect of the Act was that workers' contracts of employment were automatically terminated by their employer's insolvency, leaving them with a limited preferent claim against the employer's insolvent estate. Since certain other creditors (such as the Revenue Service) ranked higher than employees, there was often little left for workers to recover.

Another problem was that workers often had no warning of their employer's insolvency, giving them no opportunity to make representations to save the company – and their jobs.

Under pressure from organised labour, the 2002 amendments to the Insolvency Act and the LRA addressed these problems by:

- requiring an employer that is facing financial difficulties to advise its employees or their representatives of possible liquidation;
- providing that a provisional sequestration or liquidation suspends contracts of employment for a period before they are terminated, rather than terminating them immediately; and
- providing for a process of consultation between employees facing dismissal as a result of an insolvency and relevant stakeholders to attempt to reach consensus on appropriate measures to save part or the whole of the business.

The above are important gains for shop stewards and trade unions, placing them in a strong position to respond to the threat of job losses as a result of an employer's insolvency. In addition, the article points out the right of workers as creditors to appoint their own liquidator to supervise the process.

But, as the article notes, there are still some remaining problems – for example, the fact that it is relatively easy to have a business declared insolvent on technical grounds (or for a company to go into voluntary liquidation and relocate elsewhere); the possibility of 'restructuring' a group of companies in such a way that a company going insolvent has no assets because all its plants and equipment are owned by other companies; and the fact that workers employed by labour brokers have no claim if the company they actually work for goes insolvent. On the positive side, the Labour Appeal Court has ruled that workers whose employment terminates because their employer goes into voluntary liquidation are 'dismissed' and can therefore claim unfair dismissal.

The article concludes with a detailed examination of challenges faced by trade unions on issues arising from the insolvency of employers.

1 INTRODUCTION

One of the main features of the contract of employment in a capitalist economy is the inequality between the economic and social position of employees and that of employers.

Workers are more likely to be vulnerable in the employment relationship because, as wages earners, they are dependant on the availability of jobs in the company. It is not an exaggeration to say that the financial security of employees is sometimes so closely related to the stability of a company that the insolvency of the latter means financial disaster for its labour force.

Before the recent amendment of section 38 of the Insolvency Act¹ the employee's position in the case of insolvency of the employer was not an enviable one. The law did not afford workers many rights in the event of insolvency. The insolvent employer did not have any particular obligation towards its employees and existing contracts of employment were simply terminated. Employees were left with nothing but often futile claims affording little consideration to their plight. One of the main objectives of labour law is to strike a balance in order to reach an equilibrium between labour and management in the employment relationship, hence the necessity for the amendment of section 38. This amendment in fact attempted to give more consideration to workers' rights and the reciprocal duties of the employer in the event of insolvency.

In this paper we analyse the contribution of the amendments of the Insolvency Act and what effect these amendments had in terms of workers interests and rights. This will lead to a discussion from the workers' perspective, not only of the gains but also of the setbacks implicit in the amended section 38. It is,

1 24 of 1936, as amended by Insolvency Amendment Act 33 of 2002 with effect from 1 January 2003

however, necessary to sum up the legal framework and the courts' interpretation of the legislation applicable in case of the insolvency of the employer. It is equally important to look at the implementation of the law.

2 LIQUIDATIONS AND INSOLVENCY IN THE LEGAL FRAMEWORK

2.1 The applicable law

The Insolvency Act was passed in 1936 and has been amended many times. It is significant to note that when dealing with the law applicable to insolvency one is confronted by a host of statutes that could be applicable. Liquidations are currently regulated through a combination of laws. These include the Insolvency Act, the Companies Act,² the Close Corporations Act³ and, under particular circumstances, the Labour Relations Act⁴ and the Basic Conditions of Employment Act.⁵

Does this abundance of statutes imply a stricter and more defined regulation of the employer's rights and obligation in the case of insolvency? Does it effectively provide for the prevention and sanction of any unfair labour practice that is a consequence of acts or omissions by the employer?

2.2 Definition of insolvency

Hockly's Insolvency Law gives a comprehensive definition of the notion of insolvency:

'In common parlance, a person may be said to be insolvent when he is unable to pay his debts. But the legal test of insolvency is whether the debtor's liabilities, fairly estimated, exceed his assets, fairly valued (*Venter v Volkskas Ltd* 1973 (3) SA 175 (T) 179). Inability to pay debts is, at most, merely evidence of insolvency. A person who has insufficient assets to discharge his liabilities, although satisfying the test of insolvency, is not treated as insolvent for legal purposes, and does not suffer the legal consequences of insolvency until his estate has been sequestrated by an order of the court'.⁶

The sequestration order is then considered to be the formal declaration of a debtor's insolvency. Sharrock *et al*, however, point out the necessity to distinguish between a person and his or her estate and of the appropriate terms to use:

"The terms "sequestration" and "sequestration order"⁷ should strictly be used only with reference to a person's estate. A debtor's estate is sequestrated, not the debtor himself. However, both a debtor's estate and the debtor himself may appropriately be described as "insolvent". When the word 'insolvent' is used to describe a debtor, it carries two possible meanings: either that the debtor's estate has been sequestrated, or that his liabilities exceed his assets.⁸ The notion of "becoming insolvent", thus, has a wider meaning than

2 Company Act No 61 of 1973

3 Close Corporation Act No 69 of 1984

4 Labour Relations Act No 66 of 1995

5 Basic Conditions of Employment Act No 75 of 1997

6 Van der Linde S & Smith *Hockly's Insolvency Law* 7ed Juta: Cape Town (2002) 3

7 Insolvency Act 24 of 1936, s 2: 'sequestration order means any order of court whereby an estate is sequestrated and includes a provisional order when it has not been set aside'.

8 See (fn 7 above), s 2: 'insolvent when used as a noun, means a debtor whose estate is under sequestration and includes such a debtor before the sequestration of his estate, according to the context'.

that of “being sequestered” (*Land- en Landboubank van Suid-Afrika v Joubert NO 1982 (3) SA 643 (C) 648*).⁹

2.3 Background to the amendment of the Insolvency Act

Before 1 January 2003 the Insolvency Act provided for the immediate termination of contracts of employment on the employer's insolvency. The effectiveness of the constitutional right to fair labour practice in the field of insolvency was therefore questionable. Firstly, in the event of insolvency vulnerable workers paid the price through job losses. Secondly, more consideration was given to creditors as to how the distribution of liquidated assets would take effect, with preference being given to secured creditors. Van Eck *et al* explain:

‘Before 1 January 2003, the effect of section 38 of the [Insolvency Act] was that all contracts of employment between an insolvent employer and its employees automatically terminated on the date of sequestration or liquidation, subject to the right of the employees to claim damages available at common law, for losses sustained as a result of such termination. Section 38 was never challenged on the grounds of common law principles, that is on the grounds that the insolvency of the employer (and the subsequent sequestration or liquidation) did not necessarily constitute the supervening impossibility of performance (in that insolvency might have been attributable to fault on the part of the employer or that there existed merely relative or subjective inability on the part of the employer to fulfill its obligations). However section 38 was challenged against the background of the right to fair labour practice’.¹⁰

Labour's argument around the Insolvency Act is to promote the constitutional right to fair labour practices. This was the basis for the 2002 amendments:

‘COSATU demanded that workers be notified of potential and actual liquidation, to afford them the opportunity to make representations to save the company from liquidation. In the past there was no requirement for a notice to be served on workers in the event of liquidation.

Furthermore COSATU raised a concern about the automatic termination of workers' employment contracts in terms of the Insolvency Act. The proposed amendment will address this problem by making it compulsory for a notice to be served on workers in the event of liquidation.

Upon sequestration, workers' contracts will be suspended rather than terminated. Workers will then negotiate with the trustees on the appropriate way forward. During suspension workers can claim their UIF unemployment benefits’.¹¹

As alluded to by Van Eck *et al*, it was organised labour that drove the reform of the Insolvency Act. The previous legal framework did not represent the interests of workers. This conservative legislation meant that workers often got the bare minimum or even nothing out of the process. Liquidation orders were granted without difficulty and courts were insensitive to the devastating impact on workers without considering the possibility of salvaging the business. Often the actions of the role players in the liquidation process did not benefit workers. Secured creditors, mostly banks, held security over debts while continuously increasing credit to the business in trouble, thus triggering

⁹ See (fn 7 above).

¹⁰ Van Eck B & Steyn ‘Fair labour practices in South Africa insolvency law’ (2004) 121 *SALJ* 902

¹¹ *The Shopsteward* No. 3 (September 2000) 9 at www.cosatu.org.za/shop

liquidations. Secured creditors would then vigorously pursue liquidation rather than attempt to save these businesses.

Trade unions, faced with the complexities of the laws and processes, have only recently begun engaging actively in the liquidation process. Previously disempowered by the liquidation process, they saw the need to pursue an amendment to the Insolvency Act in order to give a new dimension to the role of workers in the liquidation processes. The amendment of section 38 was intended to address the issue of the right to fair labour practices and to protect workers' rights in the event of insolvency:

'The Department of Labour together with the Department of Justice is proposing amendments, which seek to align the Insolvency Act and Labour Relations Act and will:

- Ensure that the workers are informed timeously of possible liquidations.
- Provide that a provisional sequestration or liquidation suspend contracts of employment (rather than terminates which is currently the position) and regulates the rights of employees during this period.
- Provides for a process of consultation between employees facing dismissal as a result of an insolvency and relevant stakeholders to attempt to reach consensus on appropriate measures that could be taken to save part of the whole of the business'.¹²

3 Impact of the amended Insolvency Act

3.1 Gains for workers

It is difficult to identify clear gains that the unions and employees have secured from the amendment to the Insolvency Act. However, it is important to note at least some of what can be considered minimal gains:

- Trade unions and workers are now required to be notified of BOTH the application for, as well as the granting of a liquidation order. This provision, if effectively enforced, will allow quicker engagement by unions with members affected by the liquidation in appointing their own liquidators or in opposing liquidation. It should be pointed out that, although this amendment took effect in 2003, courts are still granting liquidation orders even if notification requirements have not been complied with.
- Another innovation is the fact that not only claims for salary/wage or leave pay but also for severance pay due as a result of the employer's insolvency are now classified as preferent claims.¹³
- One of the most favourable impacts of the new section 38 is the fact that it now provides for the suspension of all employment contracts upon insolvency until the end of a 45-day period after a provisional liquidator

¹² Summary of issues and amendments to the Labour Relations Act, Basic Conditions of Employment Act and Insolvency Act at www.polity.org.za.

¹³ The Insolvency Act creates preferences in regard to the following claims: Funeral and death-bed expenses (s 96), costs of sequestration (s 97), costs of execution (s 98), salary or remuneration of employees (s 98A), statutory obligations (s 99), income tax (s 101). See also Van der Linde S (fn 6 above) at 161–162.

has been appointed, whereafter employment contracts terminate by law. Previously the Act had provided only for the immediate termination of all contracts of employment upon granting a liquidation order.¹⁴

Labour believed that the amendment to the act did not sufficiently address the appointment of liquidators. In practice, it was argued,

'the rights of workers are consistently violated with impunity by liquidators, larger secured creditors (in most instances financial institutions) and Masters alike, in direct contradiction of both insolvency and labour law provisions. In particular, there is no uniformity in the approach adopted by different Masters to the appointment of liquidators, often leading to the arbitrary rejection of liquidators requisitioned/nominated by unions on false grounds. Masters and liquidators in general display bias towards secured creditors, thereby prejudicing other creditors. Liquidators, especially those that are long established, depend on secured creditors for regular requisitions. Therefore, they rarely challenge them especially where this would impact on the possibility of receiving further nominations'.¹⁵

Against this background, an important gain of the amendments to the Insolvency Act was in making workers more aware of their rights, specifically the right of workers as creditors to nominate their own liquidator. This is normally done by trade unions. However, it is important in the interest of workers that clear instructions are given to liquidators. The appointment of a liquidator should not be seen as the sole leg of labour strategy in respect of liquidations.

3.2 Problems

- The first problem is that it is still too easy to obtain liquidation. The decision is normally based on whether there has been an act of insolvency, such as failure to satisfy a judgment, and not necessarily whether the employer is proved to be insolvent. So it is technically possible to get a liquidation order granted against a person who is in fact solvent.
- There is also an increased risk of abuse of corporate and insolvency legislation – for example, employers voluntarily liquidating their businesses to avoid debts and then opening similar businesses in a different location or under a different name.
- This is also the case when considering different options for reorganisation or restructuring of a corporation. For example, workers are often employed by single entity that is part of a group of companies owned by the same person while all assets are owned by another company in the group, against which workers have no legal claim. The liquidation of a single franchise raises similar problems because ownership of the assets is retained by the main company.
- The Insolvency Act, to be more effective in its intention to protect workers' interests, should specifically address the issue of preventing unfair practices, such as company assets being bought piecemeal from the estate after

¹⁴ Van der Linde S (fn 6 above) at 77–78

¹⁵ Labour's submission on the Draft Insolvency and Business Recovery Bill submitted to the NEDLAC Labour Market Chamber, 11 May 2004, accessed at <http://www.cosatu.org.za/docs/2004/insolvency.pdf>.

the liquidation order has been granted to avoid the application of section 197 of the LRA (providing for transfer of employment contracts when a business is transferred as a going concern).

- Friendly and convenient liquidations can be orchestrated by friends, family members and fellow directors, characterised by little consideration given to the potential of saving the business.
- Private companies may be liquidated while the assets of directors and other individuals responsible for the management of the failing company are protected even if they have been involved in reckless or fraudulent dealings.
- Applications for liquidations can be deliberately timed to sideline unions and workers – for example, in late December during factory and union shutdown, or on Thursdays to avoid having to pay salaries on Friday.
- Workers contracted to labour brokers do not have any claim against companies contracted to the labour broker, even in cases where they were working primarily or exclusively for that company.
- Black Economic Empowerment (BEE) companies sometimes exploit the liquidation process and BEE policy, approaching union nominated liquidators to buy the liquidated company at a discounted rate as a “business rescue” and undertaking to save jobs. However, trends reflect that they often sell within a year.
- In practice, the correct procedures are not always adhered to in the courts and Master’s Office, which may lead to certain irregularities being overlooked. For example, some officials refuse to recognise severance pay as a claim for this purpose if employment contracts are suspended and not yet terminated.¹⁶

3.3 A critical analysis of the amendments

Section 38 of the Insolvency Act¹⁷ was amended to afford workers some form of protection. These amendments came as a result of intended protest action by Cosatu.¹⁸ Major reforms to insolvency law and labour law were instituted in 2002 and 2003 with a package of amendments to the Insolvency Act, the LRA and the BCEA.¹⁹ From a worker perspective the question arises: To what extent have workers benefited? To answer this question it is necessary to explore a number of issues relevant to the plight of workers who find themselves in this position. Firstly, are their jobs protected? Secondly, why in the event of insolvency, are workers not deemed to be dismissed? And, thirdly, what has been the role of the courts in assisting workers?

¹⁶ See also the submission by labour referred to in fn 15 above.

¹⁷ 24 of 1936

¹⁸ The notice of intended protest action was served on NEDLAC on 2 August 1999 in terms of s77 (1) (b) of the LRA.

¹⁹ See Van Eck B (fn 10 above) at 906.

3.3.1 *Are workers' jobs protected?*

A contract of employment is suspended from the date of an employer's sequestration order. This form of suspension is not the same as being suspended in a normal employment relationship, when a worker may still receive salary and benefits.²⁰ In the event of sequestration, suspension of the employment contract does not allow for payment of salaries and benefits to workers. Workers are only entitled to claim unemployment benefits.²¹ This provides little relief.

A trustee may terminate the suspended contracts of employment provided that the trustee has consulted with the relevant trade union or other employee representatives.²² The protection afforded to workers only means that, once suspended, they witness the countdown of what can be referred to as industrial euthanasia unless the trustee manages to revive the insolvent undertaking or sell it as a going concern.

3.3.2 *Can sequestration be deemed to be dismissal?*

Section 185 of the LRA confers a right on every employee not to be unfairly dismissed. The meaning of dismissal includes an employer terminating a contract of employment with or without notice.²³ Section 210 of the LRA clearly spells out that, when other laws are in conflict with the LRA, the LRA must prevail. Despite this, in *SAAPAWU v HL Hall & Sons*²⁴ the Labour Court held that it lacked jurisdiction under these circumstances as the employees were not dismissed and that the employees should seek relief in the civil courts.

The Labour Appeal Court in *Nulaw v Barnard NO & Another*²⁵ came to a different conclusion by distinguishing between voluntary and compulsory winding up of a company. Davis AJA concluded that there was a clear difference between a procedure leading to compulsory winding up of a company, in which a court has a discretion as to whether to grant such an order, and a voluntary winding up where the court cannot interfere with the right which the Companies Act gives to the requisite majority to so effect a winding up once proper procedures have been followed.²⁶ In the case of a voluntary winding up the termination of the employees' contracts is a result of a decision taken by the shareholders whereas in a compulsory winding up such decision is taken by the courts. The LAC held that the termination of the contracts of employment in the case of voluntary winding up was deemed to be a dismissal.

Employees who have been deemed to be dismissed as a result of a voluntary winding liquidation are entitled to be consulted in terms of section 189 of the LRA and to claim compensation for unfair dismissal from the liquidators of the company if they have been unfairly dismissed.²⁷

20 A collective agreement will often set out the terms in relation to periods of suspension with regard to salaries and benefits.

21 S 35 of the Unemployment Insurance Act 30 of 1996.

22 See s 38(5) of the Insolvency Act. The consultation referred to is much the same as that required in terms of s 189 of the LRA in the event of operational requirement dismissals.

23 See s 186 of the LRA.

24 [1999] 2 BLLR (LC)

25 [2001] 9 BLLR 1002 (LAC)

26 At para 18

27 *Grogan Dismissal, discrimination and unfair labour practices*Juta: Cape Town 443.

3.3.3 *What happens to workers who are dismissed and then reinstated by virtue of a Court order?*

In *CWIU & Others v Master of the Supreme Court, Grahamstown & Another*²⁸ a number of workers were dismissed by the company Plaschem and subsequently reinstated by the Industrial Court. Upon tendering their services the company turned them away. The company continuously refused to give effect to the Industrial Court's order on the basis that it intended to appeal the decision although no application was ever lodged. During this time the company was placed under liquidation.

The appointed judicial manager also refused to accept the tender of service by the workers, treating them as if they had been dismissed. Even the Master refused to entertain the workers' claims that wages due to them should be treated as preferential.

In review proceedings to have the Master's decision set aside the Court held that, if creditors passed a resolution attaching preference to judicial management, liabilities remained in force on the winding up. Wages due to employees fell into the category of liabilities and the obligation to pay wages was an obligation which arose out of a contractual obligation (in this case employment contracts) to pay.

3.3.4 *So what are workers entitled to?*

Once dismissed, workers are entitled to claim from the insolvent estate of the employer. Workers become preferred claimants. But, while workers enjoy the status of preferred claimants, they are still not regarded as the number one priority. It also does not mean that workers will receive their entire earnings: they are entitled to payment from what is left of the employer's estate after secured debts and certain other expenses have been paid, and the liquidators have paid themselves the costs of winding up the insolvent business.

The employee is further entitled to claim severance benefits.²⁹ However, the law also places a limitation on the amount of salaries and wages to be claimed by workers.³⁰

4 NEW CHALLENGES FACED BY THE UNIONS

The primary challenge faced by the unions is that insolvency law benefits employers and disadvantages employees. Another challenge is the lack of effective implementation and the difficult enforcement of the principles developed by the amendment. This means that there are significant organisational and political challenges faced by trade unions in ensuring the development of the law to their advantage. Law changes as society and its political and economic terrain changes. It is therefore important for the labour movement to respond effectively to these changes in the interests of their members.

²⁸ [1996] 9 BLLR 1067 (E)

²⁹ See s 41 of the BCEA.

³⁰ ss 98A(1)(a) of Insolvency Act

- In that it does not build a comprehensive set of measures that will effectively implement the right to fair labour practice in case of insolvency of the employer, the Insolvency Act should be further amended to protect employees more effectively. In fact, workers and unions expect profound modification in the insolvency legislation framework.
- Disclosure of information to workers and unions regarding company's status and ownership of assets should be made compulsory. Failure to do so should be made a criminal offence.
- Directors should be made criminally as well as civilly liable for reckless and fraudulent dealings, especially when insolvency is the consequence of such mismanagement.
- It is also important for worker's financial security that claims for wages, bonus and severance pay and others are treated as secured claims, as they are explicitly recognised by labour legislation and collective agreements.
- The South African Revenue Service (SARS) should be treated as a concurrent creditor to ensure the effectiveness of a payout to employees, which is quite difficult when the liquidator has first to pay SARS and various banks which are not always innocent in the insolvent status of the company. In fact, banks' securities should be forfeited if they continue to lend money to already insolvent companies.
- Retirement fund legislation needs to be amended to secure payment of contributions, including provisions for enforcement through bargaining councils.
- A further consideration is the transparency of actions against insolvent employers. First of all, there is the need of a more stringent regulation of when liquidation applications should be granted. For example, during the December shutdown there should be a seven-day notification before applications can be heard. Nominations for liquidators should be allowed also if based on claims for severance pay and employment contracts have only been suspended.
- Workers employed by labour brokers should be able to lodge claims against liquidated client companies.

Finally, it will be worth considering some changes to laws not directly related to insolvency but with considerable impact on the financial situation of the worker affected by the liquidation of his or her employer. The major issues to be addressed here are, on the one hand, banks that blacklist workers on the basis that their employers are liquidated and, on the other hand, creditors which persecute workers despite the fact that non-payment of debts is the result of the employment situation. That is, for example, the case with municipalities in respect of utility bills and schools in respect of fees.

5 CONCLUSION: HOW CAN UNIONS TAKE THESE ISSUES FORWARD?

Unions have felt that there is limited range of actions they could take owing to the nature of the liquidation process. Let us consider that the primary strategy has been the tool of ensuring the effectiveness of a union nominated liquidator who is, ideally, given various instructions and timeframes.

However, there are also important actions unions should implement before the insolvency of the company as well as after the granting of the liquidation order. In fact, there is an important need for a checklist of early warning signals of potential liquidation so that unions are able to act more proactively. Unions and workers should then regularly scrutinise company annual reports as well as audited reports, if accessible, to look for warning signals of impending liquidation.

It will also be meaningful for that purpose to organise capacity-building workshops for organisers on strategies for engaging with liquidations, as well as a programme of campaigns and organising, not only around legal reform, but to increase union capacity and target the roles played by other institutions in increasing workers' hardship – for example, banks, SARS, municipalities, etc.

Finally, a panel of liquidators from which to select nominees for union-appointed liquidators can be envisaged. This is, however, not a universally-accepted practice owing to varying experiences amongst unions. Accountability of liquidators to all stakeholders is important, given the ethos of the South African labour movement.

During the liquidation period, besides appointing a liquidator and following the liquidation procedure step by step, unions need to engage with workers with the aim of providing assistance with matters outside the liquidation process – for example, claiming UIF or making arrangements with their own creditors. This is quite an important activity for unions because, owing to the nature of liquidation process – which involves less physical interaction between unions and workers – there is an increasing risk of demoralisation if workers cannot handle all the consequence of the situation on their own.

Unions should urgently address the issue of corruption implicating both union officials/office bearers and union-nominated liquidators as well as laying criminal charges against employers/directors who have fraudulently withheld contributions in respect of pensions or UIF.

Lastly, there is also the option for workers to take control of the company with the purpose of running it under workers control.

In moving towards labour law reform

- The definition of 'employee' should be extended to include employees of labour brokers in the event of the labour broker not paying workers on account of non-payment by the liquidator of the insolvent business.
- The issue of disclosure of ownership relating to all assets should be incorporated into section 197B of the LRA.



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- The position of the SARS as a preferred creditor over workers is questionable in this option because SARS claims may drastically reduce the amount eventually paid out to workers.
- Amendments to the UIF legal framework should allow claims from workers in respect of suspended contracts and provide for shorter timeframes for payment.
- Termination of contracts of employment in the case of insolvencies should be included in Section 186 of the LRA.

For unions the best strategy to ensure that workers are not unfairly disadvantaged by company insolvencies is to see it as an essential part of their organising strategies to ensure that workers' interests are not compromised in the event of an employer's insolvency.

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