

Reconsidering the plight of the five foolish maidens: Should the unsecured creditor stake a claim in real security?

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OPSOMMING

'n Heroorweging van die lot van die vyf dwase maagde: Behoort die onversekerde skuldeiser 'n aanspraak op die opbrengs van saaklike sekerheid te geniet?

In hierdie artikel ondersoek die outeurs geselekteerde aspekte wat betrekking het op die posisie van onversekerde skuldeisers wat eise teen 'n insolvente boedel instel. Dit word oor die algemeen aanvaar dat sodanige klas van skuldeisers normaalweg min, indien enigsins, betaling by wyse van 'n dividend ontvang. Daarteenoor staan die versekerde skuldeiser en die statutêre voorkeurskuldeiser in 'n veel gunstiger posisie. Dit is vir die ekonomie en die gemeenskap in die algemeen van uiterste belang dat skuldeisers se regte gerespekteer word, maar die vraag het tog al ontstaan of sekere onversekerde skuldeisers onder bepaalde omstandighede 'n aanspraak op minstens 'n deel van die opbrengs van sekuriteite behoort te hê. Daar word spesifiek verwys na dié skuldeisers wat onvrywilliglik skuldeisers word en dus nie oor dieselfde gunstige onderhandelingsmoontlikhede beskik as 'n skuldeiser wat doelbewus kontrakteer en dus meer voordelige terme en sekuriteit kan beding nie. Die aspek is as 'n beleidsoorweging in ander regstelsels ondersoek en ook al in beperkte gevalle geïmplementeer. In Suid-Afrika het artikel 135 van die Maatskappywet van 2008 ook 'n super-voorkeur op die sogenaamde na-aanvang finansiering ten gunste van, onder andere, sekere werknemerseise geskep – 'n voorkeur wat selfs bo gespesifiseerde versekerde skuld sal rangeer. Die artikel is nietemin bloot verkennend van aard maar die outeurs meen dat die debat as sulks nie nutteloos is nie en straks verder ondersoek behoort te word.

1 INTRODUCTION

It is trite law that, within the context of debtor-creditor law, the status of the creditor is always of paramount importance. Secured creditors whose claims are secured by way of an acknowledged form of real security, are to a large extent guaranteed of settlement of their debts – either in full or at least in part.¹ The value of the real security for the claim will thus protect such a creditor in the case where the debtor defaults and this is followed by either an individual debt enforcement remedy or insolvency/bankruptcy, that is, a collective debt enforcement procedure.

¹ See in general Schwartz "Security interests and bankruptcy priorities: A review of current theories" 1981 *J of Legal Studies* 1 2 4.

First, the article focuses on the function and role of real security within bankruptcy by taking the South African distribution rules in insolvency as the point of departure to examine some aspects of the functioning of secured claims in a bankruptcy system. The purpose of the first part of the article is to provide a background against which the practical effect of the relative rankings of creditors as secured, unsecured priority and concurrent creditors respectively may be dealt with.

The explorative research question is whether the secured creditor should under all circumstances enjoy extensive coverage of his or her claim and, more importantly, whether and under what circumstances an argument can be put forward for unsecured creditors to share in at least a percentage of the proceeds of a security. It is also a point of departure that there are existing exceptions where some creditors do receive special treatment despite the fact that they do not have a right of real security in their favour.

A pertinent aspect to consider is that many ordinary unsecured creditors hardly receive any dividends in bankruptcy – in many instances they do not receive any return on their claims,² whilst some of them become creditors on an involuntary basis, for example the victims of a delict. Questions that arise are therefore whether a policy should be developed that in certain estates, especially those where the ordinary unsecured creditors receive no payment at all, these creditors should have a claim in at least a fixed portion of those assets serving as real security. Also, in view of existing exceptions – born out of public or socio-economic considerations – the question is whether there is room for extending existing categories of unsecured creditors who share in the proceeds of securities. At the same time it is also conceded that secured credit plays an extremely important role in a modern credit-driven economy and that great care must be taken when a so-called carving out of secured assets is proposed. However, this fact does not mean that the issue should not be explored.³

The discussion focuses on some of the arguments for and against granting the right to share in the proceeds of securities to other classes of creditors, especially to certain categories of concurrent creditors such as involuntary creditors, for instance delict or tort creditors.⁴ Currently the voluntary secured creditor's claim

2 See eg the South African Law Commission's *Working paper 29 of Project 63* "Review of the law of insolvency" (1989) Schedule 3, where the data of a statistical survey in the offices of the then Master of the Supreme Court indicated that only in 28,6% of the cases included in the survey concurrent creditors received a dividend whilst in 40,6% of the cases they had to make a contribution towards the costs. Note that the name of the South African Law Commission was changed to the South African Law Reform Commission by the substitution of various sections in the South African Law Commission Act 19 of 1973, now known as the South African Law Reform Commission Act, by the Judicial Matters Amendment Act 55 of 2002.

3 See in general Wood *Principles of international insolvency* (2007) 356ff.

4 The point of departure of this article is the differential treatment of creditors when it comes to the distribution hierarchy and consequential payment of dividends, thus the advantages that accrue to secured and statutory preferential creditors. It must, however, be kept in mind that alternative motives for taking security may exist *inter alia* that "[a] secured creditor's very reason for relying on security is to distance himself or herself from the free residue and its application in defraying the cost of liquidation" – see The South African Law Commission, *Project 63 Report on insolvency/Review of the law of insolvency (vol 1)* (February 2000) 230 para 94.3. See further <http://bit.ly/kzWEQ1> and <http://bit.ly/kNXjDA>

must be satisfied first and foremost from the proceeds generated by the security on which he or she relies.⁵ The remaining creditors' claims will then be satisfied if and to the extent that further funds are available in the insolvent estate. The possibility remains that no funds will be available for further distribution, leaving the claims of unsecured creditors unsatisfied. The main focus is on bankruptcy proceedings in the form of liquidation. Relevant aspects in business rescue will only be referred to with this in mind.

2 DISTRIBUTION RULES IN SOUTH AFRICAN INSOLVENCY LAW

2.1 Classes of creditors

Creditors may generally be divided into secured and unsecured creditors.⁶ To rank as a secured creditor, a creditor's real security right must already have vested at the commencement of bankruptcy. Secured creditors are those creditors who enjoy a form of real security over the property of the insolvent, which right of security is recognised by the Insolvency Act⁷ as indicated below, whilst unsecured creditors have no such security.

Unsecured creditors may be divided further into statutory preferent creditors (referred to as priority creditors in some systems) and concurrent creditors respectively. For purposes of the distribution of a dividend as well as for the identification of contributories where such a system is adhered to, such as in South Africa, it is of the utmost importance to ascertain to which category a creditor belongs. These differences are important, as secured creditors are paid out of the income derived from the realisation of their securities, while (statutory) preferent creditors and concurrent creditors are paid out of the free residue.

In order to distinguish between the various classes of creditors, the definitions of "preference", "security" and "special bond" as defined in section 2 of the Insolvency Act are relevant.⁸ It must be noted that, in terms of the definition of "preference" as defined in section 2, a secured creditor and an unsecured creditor who enjoy a statutory preference are referred to as preferent creditors. For the sake of clarity the first category is referred to as secured creditors and the second as statutory preferent or priority creditors.

2.2 Real security

The Insolvency Act recognises special mortgage bonds, that is, a mortgage bond over immovable property, special notarial bonds over movable property specifically describing the hypothecated property and which were registered after 7 May 1993, as well as special notarial bonds over movable property in the Natal province registered in terms of section 1 of the Notarial Bonds Act (Natal) of

(accessed on 16 November 2010). Reference will be made to the South African Law Commission as this was the name of the Commission at the time of the report of February 2000, Project 63.

5 See below.

6 See Kunst *et al* *Meskin insolvency law* (2010 update) para 12.4; Bertelsmann *et al* *Mars The law of insolvency* (2008) ch 20–22.

7 Act 24 of 1936 (the Insolvency Act or the Insolvency Act of 1936).

8 See in general Stander "Secured claims in insolvency and the order of preference among creditors secured by the same property" 2000 *TSAR* 542.

1932,⁹ the lessor's tacit hypothec over the *invecta et illata* of the lessee,¹⁰ and the hypothec of a credit grantor in terms of an instalment sale transaction,¹¹ a pledge and a lien as forms of real security for the purposes of the Insolvency Act.

It must also be noted that, despite the general distribution framework providing for the various classes of creditors in insolvency that affects their ranking in insolvency in terms of the Insolvency Act, other pieces of legislation also bestow special rights or privileges in some instances on certain types of creditors – especially where the state is the creditor – which may form exceptions to the rules discussed in this section. These special provisions may confer ownership, rights of retention, liens, pledges or other special rights such as sale and transfer embargoes and charges on property in favour of certain creditors.¹²

Important to this discussion is that some of these special rights will amount to a charge on the proceeds of the property that serves as security and will thus have to be paid first as a cost of realising such property in terms of section 89(1) of the Insolvency Act. It is therefore important to note the impact of such provisions on the general administration of the estate and the distribution of the proceeds.

A few examples illustrating these special rights will suffice:

Municipalities enjoy special statutory priorities regarding amounts due in relation to immovable property.¹³ A purchaser of residential land on instalments enjoys a special statutory preference with regard to the proceeds of the sale of land on the insolvency of the owner of the land.¹⁴

The costs of the maintenance and realisation of assets serving as security must be paid out of the proceeds of such security,¹⁵ whereafter these secured claims are paid out in order of preference. Where the proceeds are sufficient to cover all these claims and a balance remains, the residue will form part of the free residue and will be distributed amongst the unsecured creditors. Where all secured claims are not paid or only settled in part, secured creditors will have to claim as concurrent creditors from the free residue.¹⁶

2.3 Application of free residue towards payment of unsecured claims

The free residue, being the surplus income derived from an asset serving as real security and the income from unsecured assets, is used to pay those creditors with (statutory) preferent claims, and thereafter to pay concurrent creditors. Preferent claims are those that are preferred by operation of law and are paid first

9 See the definition of "security" and "special mortgage" in s 2 of the Insolvency Act as amended by s 4 of the Security by Means of Movable Property Act of 1993.

10 S 85 of the Insolvency Act.

11 S 84(1) of the Insolvency Act.

12 See below.

13 See *The City of Johannesburg v Kaplan NO* 2006 5 SA 10 (SCA). For a comprehensive discussion of s 89 of the Insolvency Act read with s 118 of the Local Government: Municipal Systems Act 32 of 2000, see Kelly-Louw "The Land Bank's decision whether or not to join in the insolvency proceedings" 2004 *Speculum Juris* 168.

14 See ss 18–22 of the Alienation of Land Act 68 of 1981.

15 See s 89 of the Insolvency Act.

16 Ss 89, 95 and 103(2) of the Insolvency Act.

within the prescribed ranking order. The order of preference provided for in the Insolvency Act is as follows:

- (a) The first two preferential claims in favour of a natural person debtor are funeral costs of the insolvent, his or her spouse or children up to a maximum of R300 and anything above R300 is a concurrent claim;¹⁷ and
- (b) death-bed expenses to a maximum of R300;¹⁸ then
- (c) general sequestration and administration costs;¹⁹
- (d) certain sheriff charges incurred for legal proceedings before sequestration;²⁰
- (e) salary or wages and related claims in arrears of former employees of an insolvent employer in terms of section 98A of the Insolvency Act. The benefits included under this heading are limited to maximum amounts due and confined to a prescribed time period;
- (f) certain statutory obligations of an insolvent rank and abate in equal proportion if necessary in terms of section 99 of the Insolvency Act;
- (g) income tax due by the insolvent;²¹
- (h) claims secured by a general bond and certain special notarial bonds registered before 7 May 1993 outside the province of Natal.²²
- (i) If any balance remains, it is used to pay the concurrent creditors in proportion to their claims. Thereafter interest on such claims, if such claims are settled in full, from the date of sequestration to the date of payment, is also used to pay the creditors in proportion to the amount of each such claim.²³

2.4 Indemnified third party

In terms of section 156 of the Insolvency Act, whenever an insurer is obliged to indemnify another, that is, the insured in respect of any liability incurred by the insured towards a third party, the latter shall on sequestration or liquidation of the estate of the insured be entitled to recover the insured amount directly from the insurer.²⁴ Although this section does not deal with the distribution of the proceeds of a secured asset it does establish a deviation from the collectivity

17 S 96(1) of the Insolvency Act.

18 S 96(2) of the Insolvency Act.

19 S 97(2) and (3) of the Insolvency Act.

20 S 98(1) and (2) of the Insolvency Act.

21 S 101 of the Insolvency Act.

22 S 102 of the Insolvency Act and ss 1(2) and (4) of the Security by Means of Movable Property Act 57 of 1993.

23 S 103 of the Insolvency Act.

24 In the matter of *Venfin Investments (Pty) Ltd v KZN Resins (Pty) Ltd t/a KZN Resins* [2010] JOL 25688 2 the court had to decide whether the contents of clause 12.5 of the contract between the parties amounted to cover as purported by s 156 of the Insolvency Act of 1936. Of relevance hereto and for further discussion hereafter, are the contemplation of policy that the court referred to at 72 para 11 and the comment of the court at 73 para 11.5: "If the ambit of section 156 were to be beyond the realm of insurance, to cover ancillary and accessory contractual obligations, it would allow ordinary trade creditors of an insolvent, such as the present defendant, to leap-frog the *concursum* and obtain an unfair preference over other concurrent creditors in respect of their contractual claims. The unbridled scope for the unfair preferment of creditors is obvious." See also Van Niekerk "The liability of insurer, the insolvent insured and section 156 of the Insolvency Act" 1999 *SA Merc LJ* 59 and para 3 1 2 *infra*.

nature of the *concursum creditorum* in the sense that the indemnified third party will escape the statutory order of payment in terms of the Insolvency Act.

2 5 Statutory preferential claims

Some similar considerations apply to unsecured creditors who enjoy preferential treatment by virtue of statutory provisions and are noted briefly.²⁵ The abolition of some statutory preferential claims of unsecured creditors has been suggested based on the point of view that all unsecured creditors should be treated equally.²⁶ Du Plessis states further considerations for deviation in this regard, namely, that fairness between the preferent creditor and other unsecured creditors should generally be borne in mind as well as the public interest and the deliberation of any impairment suffered by a creditor due to the preferential treatment of some.²⁷ Preferences cause discontent among creditors as well as demands by other unsecured creditors for the same treatment.²⁸

2 6 Companies Act of 2008

2 6 1 Section 135 of the Companies Act

Section 135 deals with post-commencement financing within the ambit of business rescue and provides as follows:

“Post-commencement finance

135(1) To the extent that any remuneration, reimbursement for expenses or other amount of money relating to employment becomes due and payable by a company to an employee during the company’s business rescue proceedings, but is not paid to the employee—

- (a) the money is regarded to be post-commencement financing; and
 - (b) will be paid in the order of preference set out in subsection (3)(a).
- (2) During its business rescue proceedings, the company may obtain financing other than as contemplated in subsection (1), and any such financing—
- (a) may be secured to the lender by utilising any asset of the company to the extent that it is not otherwise encumbered; and
 - (b) will be paid in the order of preference set out in subsection (3)(b).
- (3) After payment of the practitioner’s remuneration and costs referred to in section 143, and other claims arising out of the costs of the business rescue proceedings, all claims contemplated—
- (a) in subsection (1) will be treated equally, but will have preference over—
 - (i) all claims contemplated in subsection (2), irrespective whether or not they are secured; and
 - (ii) all unsecured claims against the company; or

25 See paras 1, 2 1 and 2 3 *supra*. In line with the research question, it must also be noted that reference is made in The South African Law Commission, Project 63 (fn 4 above) 205 paras 80.18 and 80.19 to the suggestions of commentators on Discussion Paper 86, as referred to in the abovementioned Report, “that in respect of wages and other benefits workers should be ranked above all secured creditors. Another commentator on Discussion Paper 86 says a super preference cannot be supported since claims for salary, etc, can be of such a magnitude that it will simply wipe out the securities; this would work against the whole scheme of credit supply and have a devastating effect on the economy; the introduction of a guarantee fund as well as a preference based on section 98A of the Insolvency Act is an option”.

26 Du Plessis “Voorgestelde hersiening van voorkeureise by insolvensie” 1985 *De Jure* 161 162.

27 *Idem* 161.

28 *Idem* 162.

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

(4) If 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.”²⁹

This is a prime example of an alteration of the hierarchy of payment of secured and unsecured creditors in insolvency proceedings, although this payment rule will first and foremost apply within company rescue proceedings in terms of the 2008 Companies Act. However, this preference will also apply in the subsequent liquidation of the same company as prescribed by section 135(4). Section 135(1)(b) refers to the priority of creditors (specifically relating to employment) who have claims deemed to be post-commencement financing as purported by this section. In terms of the aforementioned, specifically subsection (3)(a), certain claims will enjoy priority status over other claims “irrespective of whether or not they are secured”.

2.6.2 Section 143(5) of the Companies Act

Section 135(3) of the Companies Act refers to the priority of the business rescue practitioner’s compensation and states that this claim, along with the expenditures of the proceedings, enjoys preference above some secured and unsecured claims relating to business rescue. Section 143(5) deals with the compensation due to a business rescue practitioner and reads as follows:

“Remuneration of practitioner

143. (5) To the extent that the practitioner’s remuneration and expenses are not fully paid, the practitioner’s claim for those amounts will rank in priority before the claims of *all other secured and unsecured creditors*” (own emphasis).

In this regard it must be noted that the hierarchal status of claims for unpaid compensation and disbursements is higher than that of secured and unsecured creditors as referred to in the aforementioned subsection.

2.7 Observations

It is submitted that distributional rules in collective debt enforcement acknowledge in principle the payment structure, namely, that secured debt is first and foremost paid from the security on which the secured creditor relies, but that such a security is subject to charges such as the cost of realising it, and depending on the nature of the security object, other charges such as property taxes in arrear in the case of immovable property. These statutory charges are usually mandated by legislation.³⁰

It is clear that unsecured creditors must also be paid out of a fund and such fund, termed the free residue in South African insolvency law, is usually made up of the income derived from assets not forming the object of real security, or in some instances the surplus income derived from the realisation of real securities. In one way or another, various systems make provision for statutory preferences or priorities, that is, claims that will first be paid out before the pro-rata distribution will take place with regard to the unsecured and unprioritised claims.³¹

²⁹ Take note that s 135 is in the process of being amended by the Companies Amendment Bill B40 of 2010 but the essence of this section will apparently remain.

³⁰ See paras 2.2 and 2.6.

³¹ See paras 2.3 and 3.1.3 and see Scwartz 1981 *J of Legal Studies* 1.2.

The legislature sometimes prefers certain unsecured creditors in other ways than statutory priorities by, for instance, allowing an insurer to pay amounts that serve to indemnify third parties in case of certain losses against the insolvent insured party.³² Such indemnified third party, albeit unsecured, therefore escapes queuing in bankruptcy distribution.³³

Section 135 of the Companies Act creates a most definite statutory preferential claim for wages in arrears in favour of employees.³⁴ This grants them a priority standing even over some secured creditors.³⁵ This super-priority as it is termed in other systems, also applies if such a company is liquidated subsequent to the rescue attempt.³⁶

Taken from the South African distribution rules, these serve as mere examples of exceptions made by the legislature whereby certain otherwise unsecured claims enjoy priority of payment, even against certain rights of real security. The statutory priorities that grant a priority ranking in favour of some unsecured creditors over others with regard to the free residue is also an example of legislative preference. Lastly, the indemnified third party who is also an unsecured creditor of the insolvent can claim directly from the insurer, thereby avoiding many pitfalls by claiming from the estate, and he or she is clearly also in a superior position *vis-à-vis* other creditors.

By looking at this state of affairs regarding distribution, it becomes clear that the *pari passu* notion that calls for a pro-rata collective enforcement and payment device afforded by bankruptcy only exists on paper and that there are many exceptions to this rule. On the one hand, apart from many arguments that can be raised in this context it must be taken as a point of departure that, although real security is undoubtedly essential in a modern credit-driven economy, it does not warrant full payment to the creditor who relies thereon, especially since it is also subject to certain charges that must usually first be paid from its proceeds. On the other hand, the legislature also grants other forms of preferential treatment to creditors. The pertinent question in each instance is what the policy consideration is for granting such exceptions. The further question will thus be, in particular for the purposes of this article, if and on what grounds (some) unsecured creditors should be allowed to share in the proceeds coming from a real security object.

3 COMPARATIVE NOTES

3.1 Arguments in favour of a reconsideration of the position of unsecured creditors

3.1.1 General

Although secured debt is a distinct feature of commercial trade,³⁷ international legal scholars and practitioners have long debated the fairness and functionality

³² See para 2.4.

³³ *Ibid.*

³⁴ See para 2.6.

³⁵ *Ibid.*

³⁶ See para 2.6.

³⁷ McCormack "The priority of secured credit: An Anglo-American perspective" 2003 *JBL* 389 401. See also Scott "The truth about secured financing" 1996/1997 82 *Cornell LR* 1436 1441.

of the supreme priority afforded to creditors holding a form of secured debt during insolvency proceedings.³⁸

In order to challenge the priority afforded to some creditors through secured property, it is also important to investigate the rationale behind the existence of the hierarchy of creditors.³⁹ The theories on the use and significance of secured debt may not necessarily pertain only to insolvency proceedings (or bankruptcy proceedings, depending on the relevant jurisdiction) and the legal consideration of priority distribution.⁴⁰

The priority afforded to the secured creditor is weighed against the interests of the unsecured creditor and, for purposes of this article, the suggestion of an alternative method of priority distribution will be considered with the current position of the involuntary unsecured creditor, specifically the mass-tort creditor, in mind.

The delictual or tort claimant in insolvency proceedings would typically be an involuntary unsecured creditor as the debt came into existence without the consent of the parties.⁴¹ There is usually no secured property as collateral for a debt thus incurred.⁴²

Alheit forwards a practical example of delictual liability that may form a *causa* for mass-tort litigation,⁴³ and subsequently the claim of an involuntary unsecured creditor in insolvency proceedings.⁴⁴ He refers to the widespread use

38 See Ashwin "Tortious liability of company in winding-up: An analysis" 2005 26(6) *Comp L* 163; Baird "The importance of priority" 1996/1997 82 *Cornell LR* 1420; Bebhuk & Fried "The uneasy case for the priority of secured claims in bankruptcy" 1995/1996 105 *Yale LJ* 857; Listokin "Is secured debt used to redistribute value from tort claimants in bankruptcy? An empirical analysis" 2007/2008 57 *Duke LJ* 1037; McCormack 2003 *JBL* 389; Mokal "The search for someone to save: A defensive case for the priority of secured credit" 2002 *Oxford J Legal Studies* 687; Perkin "Case comment: Corporate insolvency: administration – construction of Insolvency Act 1986, s. 176A – entitlement of floating charge holder to participate in a fund set up in pursuance of the legislation for the benefit of unsecured creditors" 2008 *Cov LJ* 19; Scott "The truth about secured financing" 1996/1997 82 *Cornell LR* 1436; Scott "A relational theory of secured financing" 1986 *Colum LR* 901; White "Case comment: Corporate insolvency: Distribution to unsecured creditors" 2009 *JIBLR* N25.

39 Johnson "Adding another piece to the financing puzzle: The role of real property secured debt" 1991 24 *LYLALR* 335 336. Baird 1996/1997 *Cornell LR* 1420 1422. See Scott 1996/1997 *Cornell LR* 1436 1443.

40 Bebhuk & Fried 1995/1996 *Yale LJ* 857 872. See also Johnson 1991 *LYLALR* 335ff and Listokin 2007/2008 *Duke LJ* 1037 1050.

41 Ashwin 2005 *Comp L* 163 168.

42 *Ibid.*

43 Alheit "Delictual liability arising from the use of defective software: comparative notes on the position of parties in English law and South African law." 2006 *CILSA* 265 specifically 266 fn 5.

44 Mokal 2002 *Oxford J Legal Studies* 687 691. There are, of course, other (mass)-tort claimants, such as those listed by Mokal *ibid.*: "[P]roduct liability claimants, victims of business torts (ranging from negligence to intentional interference with contractual relations'), victims of anti-trust violations, unfair competition, patent, trademark and copyright infringement, environmental agencies which perform clean-ups, and creditors who acquire that status because of the debtor's fraud." For purposes of this discussion it will be assumed that all mass-tort creditors' claims are liquidated amounts as several jurisdictions do not recognise tort claimants with unliquidated claims as creditors for purposes of insolvency proceedings: In this regard see Ashwin 2005 *Comp L* 163 esp 163

continued on next page

of modern technology in the form of software that may give rise to delictual claims should the software be defective and cause general and/or special damages.⁴⁵

A creditor does not have to request security before extending credit and no legal obligation rests on a debtor to offer or provide security.⁴⁶ In essence, the providing and taking of security is an agreement between creditor and debtor⁴⁷ and parties can exercise a variety of options regarding the provision of security for a debt, or none at all.⁴⁸ The delictual nature of the mass-tort creditor's claim against the debtor lacks exactly that, namely, contractual consensus and the ability to negotiate the terms of their legal relationship with one another.⁴⁹

The prime difference between creditors in general and delictual claimants is that the credit providing creditor has various options in demanding security for financing or not,⁵⁰ whereas the tort victim is an involuntary casualty of events.⁵¹

For the purposes of this article, the key effect of the creditor hierarchy in the jurisdictions referred to in this article is that, when realising the secured property, the income will first be used to satisfy the debt of the voluntary secured creditor in whose favour the property was secured and the remaining proceeds are only available to benefit other creditors thereafter.⁵² Unsecured creditors also involuntarily forfeit the right to institute individual debt collection procedures and have to participate in the collective collection proceedings should they wish to recover some of the debts due to them.⁵³ McCormack argues the effect thereof by stating that the "[r]ecognition of security interests appear[s] to clash with a basic fairness principle namely equality of treatment of creditors in the debtor's insolvency".⁵⁴

3 1 2 *Redistribution of the proceeds of the assets*

Bebchuk and Fried discuss the provision found in American bankruptcy law that disallows a debtor to rearrange the hierarchy of creditors without the consent of

where he refers to the United Kingdom, the United States and New Zealand as recognising the unliquidated claims of tort creditors in insolvency proceedings, but lists Australia, Canada and Malaysia as jurisdictions that do not recognise the standing of these tort claimants as insolvency creditors as they "do not allow proof of unliquidated tort claims in bankruptcy".

45 Alheit 2006 *CILSA* 265 306.

46 McCormack 2003 *JBL* 392 392.

47 Bebhuk & Fried 1995/1996 *Yale LJ* 857 932 933. In this regard, also take note of the following policy consideration of Wood *Principles of international insolvency* (2007) "General introduction" 6 para 1-007: "The law should be reasonably predictable, not arbitrary, capricious or discretionary. Parties should be able to evaluate legal risks in advance and either price those risks or adjust their transactions to reflect those legal risks, so far as they can."

48 Johnson 1991 *LYLALR* 335 340.

49 Mokal 2002 *Oxford J Legal Studies* 687 691 692. See also Bebhuk & Fried 1995/1996 *Yale LJ* 857 869 and Ashwin 2005 *Comp L* 163.

50 Johnson 1991 *LYLALR* 335 340. McCormack 2003 *JBL* 389 392; Ashwin 2005 *Comp L* 163 168.

51 Ashwin 2005 *Comp L* 163. See Ashwin 2005 *Comp L* 163 168 169.

52 Johnson 1991 *LYLALR* 335.

53 Mokal 2002 *Oxford J Legal Studies* 687 688.

54 McCormack 2003 *JBL* 389 398.

those who would end up with a lower priority stand than before the rearrangement.⁵⁵ The ideal starting point in a non-priority system is that all creditors ought to be treated equally, thus receiving an allocation from the total proceeds of the estate pro rata to their respective claims.⁵⁶ When providing security the practical implications of priority distribution clash with the abovementioned principle because some creditors are automatically subordinated as the estate gains secured creditors.⁵⁷ The debtor manages to treat the secured creditor to the proceeds of his estate before other creditors.⁵⁸ In so doing the debtor intentionally rearranges the repayment order of his estate's creditors.⁵⁹

The counter-argument is that unsecured creditors who have knowledge of the option of secured property when deciding not to take security are consenting to their lower rank in the hierarchy of creditors.⁶⁰ This contention is then challenged by considering the involuntary and non-adjusting nature of the delictual claimant who does not voluntarily and with the knowledge of the wrongdoer's financial state become a creditor.⁶¹

These creditors can be distinguished from ordinary creditors as they do not wish to provide financing to the debtor through a credit agreement and do not voluntarily create the legal bond between the parties.⁶² Ashwin elaborates by pointing out that the law of insolvency aims to dispense risk among creditors and take full advantage of the assets available for distribution.⁶³ On the other hand, the law of delict seeks to avoid tort-related losses by creating a sanction through accountability for certain behaviour and reducing the economic impact of tortious accidents.⁶⁴ The aims, obligations and outcomes generated by the toils of these two legal domains differ and can be at odds with one another when both are applicable to a specific set of facts.⁶⁵

In reality, the distribution of proceeds to secured creditors can be done either in terms of legislative measures and principles, as mentioned above, or through the intentional behaviour of individual debtors, as shown hereafter.

55 Bebchuk & Fried 1995/1996 *Yale LJ* 857 868–870. They refer (*ibid*) to the abovementioned provision as “the general prohibition against nonconsensual subordination”.

56 Johnson 1991 *LYLALR* 335; Bebchuk & Fried 1995/1996 *Yale LJ* 857 868. See also Ashwin 2005 *Comp L* 163 168: “The bankruptcy system thereby ensures that, should the worst occur, the position of any creditor will generally be no worse than that of similarly situated creditors.”

57 Bebchuk & Fried 1995/1996 *Yale LJ* 857 869 870.

58 *Ibid*.

59 *Idem* 867 869 870. See McCormack 2003 *JBL* 389 400.

60 Bebchuk & Fried 1995/1996 *Yale LJ* 857 869.

61 *Idem* 869 870. According to Bebchuk & Fried 1995/1996 *Yale LJ* 857 864 865, a non-adjusting creditor cannot amend his or her agreement with the debtor in accordance with the [potential] impact of secured debts on the debtor's estate during insolvency, eg by increasing the contractual interest rate payable by the debtor. See McCormack 2003 *JBL* 389 400 401.

62 Mokal 2002 *Oxford J Legal Studies* 687 691.

63 Ashwin 2005 *Comp L* 163.

64 *Idem* 163 169. Ashwin 2005 *Comp L* 163 168 elaborates by stating that the rationale for a delict is founded in social aversion to involuntary uncompensated harm whilst the law of insolvency is based on voluntary contractual dealings. The effect, Ashwin 2005 *Comp L* 163 169 notes, “reflects a sanctioned oppression of the relatively weak and uninformed”.

65 Ashwin 2005 *Comp L* 163 172.

In 2008 Listokin published the findings of an empirical study regarding the theory that the taking of secured debt may be implemented to distribute available funds in a bankrupt estate from involuntary delictual claimants towards voluntary creditors.⁶⁶

This may be a factor to take into consideration as an inefficient result of the supreme priority of secured creditors.⁶⁷ It is of special relevance when considering the fairness of their supreme priority and arguing for the alteration of the *status quo*.⁶⁸ There are other foundations for an argument supporting an alternative system of priority that do not centre on inequalities among creditors or the misuse of the hierarchy but on the inefficient usage of secured debt.⁶⁹

Furthermore, the principles underlying the existence of the two distinct fields of law are challenged by the operation of priority distribution.⁷⁰ As Ashwin puts it: “Bankruptcy fosters externalisation of tort liability.”⁷¹ By this he means that the debtor is able to burden delictual claimants with the expenditures of the tort.⁷²

The principles of the law of insolvency undercut the preventative function of liability.⁷³ Priority distribution confers upon debtors the luxury to defer from safeguarding themselves against tortious claims as they will not have to compensate delictual claimants in the event of insolvency.⁷⁴ In the race for “maximi[sing] wealth”, it seems that the law of insolvency does not provide for adequate protection of the interests of delictual creditors in line with the law of torts.⁷⁵ It must be noted that section 523(a)(6) of the US Bankruptcy Code of 1978 determines that debt arising from wilful and malicious injury by a debtor is not dischargeable in bankruptcy. However, this provision is clearly only effective against natural person debtors, namely individuals, since a corporation does

66 Listokin 2007/2008 *Duke LJ* 1037ff. The author notes at 1078 that “[t]he empirical results presented in this Article strongly suggest that companies do not use secured debt to expropriate value from tort claimants. Indeed, firms facing mass tort bankruptcy have less debt than otherwise comparable firms without high tort liabilities”.

67 *Idem* 1040. See Mokal 2002 *Oxford J Legal Studies* 687 689. Listokin 2007/2008 *Duke LJ* 1037 1078 states that “[m]any commentators, fearing that firms would use secured debt for redistribution, have advocated super priority for tort claimants. The fears upon which these proposals are based are unfounded, however. Corporations do not use secured debt with priority to diminish the bankruptcy realizations of their tort claimants”.

68 Mokal 2002 *Oxford J Legal Studies* 687 689.

69 *Ibid.*

70 Ashwin 2005 *Comp L* 163.

71 *Ibid.*

72 *Idem* 172. Baird 1996/1997 *Cornell LR* 1420 1429 further states that “firms can shift the risk of insolvency onto tort victims and other involuntary creditors by granting their creditors security interests”.

73 Ashwin 2005 *Comp L* 163 169. He refers 169 170 to another aim of tort law, namely, to transfer the loss of one party to the party that is not only responsible for the damages but may also be in a better position to shoulder the financial losses.

74 Ashwin 2005 *Comp L* 163 170.

75 *Idem* 163. In this regard, Ashwin (*ibid*) refers specifically to the legal position under the Indian bankruptcy law in as much as the tort creditor is, hypothetically speaking, an involuntary creditor: The reason why the tort creditor’s position is hypothetical is because, under Indian bankruptcy law, an unliquidated tort claimant is not regarded as a creditor at all for purposes of insolvency. It is shown earlier and later on that the position is the same in various other jurisdictions.

not have an existence after final liquidation; furthermore, even after discharge the individual may not be in a position to repay either. The empirical study, however, showed that intentional redistribution is an uncommon occurrence⁷⁶ even though scholars argue that such behaviour is a practical possibility.⁷⁷

Another example that can lead to the redistribution of funds to secured creditors is the granting of secured debt to “new” creditors.⁷⁸ Listokin mentions the occurrence of “leapfrogging” by new (in the sense of later in time) creditors that acquire secured debt in property of an estate that already has unsecured creditors.⁷⁹ Should the estate become insolvent, the newcomers will receive priority repayment to the disadvantage of the “older” unsecured creditors.⁸⁰ It must be noted that the dire consequences of this scenario can in some instances be tempered by remedies provided for in insolvency/bankruptcy law, for instance by way of voidable dispositions, but by the same token it is not always a simple exercise or cost-effective to attack such transactions.⁸¹

3 1 3 Legislative examples favouring unsecured creditors

3 1 3 1 General

Redistribution among creditors, however, does not always favour the secured creditor. The allocation of funds in contrast with the trite ranking of creditors in insolvency proceedings is legally sanctioned in the form of various legislative provisions.⁸²

Bebchuk and Fried point out that US bankruptcy legislation, *inter alia* in the form of sanctions incorporated into Chapter 11 which is the main rescue provision, undermines the functioning of the traditional hierarchy of creditors in bankruptcy proceedings.⁸³

76 Listokin 2007/2008 *Duke LJ* 1037 1078.

77 Bebhuk & Fried 1995/1996 *Yale LJ* 857 866 882. Also see Mokal 2002 *Oxford J Legal Studies* 687 689 692.

78 Listokin 2007/2008 *Duke LJ* 1037 1039.

79 *Ibid.*

80 *Ibid.*

81 See in general ss 26 to 31 and 88 of the Insolvency Act of 1936 and cf Moo “Security interests in bankruptcy” 1973 *American Bankruptcy LJ* 23 27 and LoPucki “Should the secured credit carve out apply only in bankruptcy? A systems/strategic analysis” 1997 *Cornell LR* 29 34.

82 Bebhuk & Fried 1995/1996 *Yale LJ* 857 911 912. “Commentators generally believe that the cumulative effect of these rules and practices is to divert value from secured creditors to both unsecured creditors and equityholders” (*idem* 912).

83 *Ibid.* See also McCormack 2003 *JBL* 389 413 who refers to the US Bankruptcy Code that contains sections that factually provide for partial priority when it comes to secured credit, eg Ch 11, that may disallow the realisation of some security interests. Unsecured creditors are also not considered alike when distributing the remaining funds of the bankrupt/insolvent estate *pro rata* and there are distinct exceptions in foreign jurisdictions and the South African Insolvency Law: In this regard see Bebhuk & Fried 1995/1996 *Yale LJ* 857 861 862 905 and paras 2 1 and 2 3 *supra*. Tolmie *Corporate and personal insolvency law* (2003) 320 states that s 39 of the Sale of Goods Act of 1979 is an example where property stays linked to the specific creditor even though property rights have passed to the debtor: A seller of property that has not yet received payment for the goods sold may, subject to statutory conditions, reclaim the property even though “title to the goods has passed” to the buyer. The South African Insolvency Act of 1936 confers a limited preferential payment status on employees as well as the South African Revenue

Ashwin refers to Section 529A of the Companies Act of 1956 (India) in terms of which workers enjoy similar priority to secured creditors, even though they hold no security for debts such as unpaid wages and salaries.⁸⁴ There are similar provisions in a number of other jurisdictions.⁸⁵

3 1 3 2 The floating charge/Enterprise Act of 2002

“A floating charge floats over the whole or a part of the company’s assets, which may fluctuate as disposals and acquisitions are made free of the charge. ... The charge crystallises on the occurrence of a specified event (automatically on a winding-up), in which case it becomes a fixed charge over the assets then in the company’s possession. Its value as security then depends, of course, on the assets remaining in the company’s possession.”⁸⁶

The English Enterprise Act of 2002 that, amongst others, amended the Insolvency Act of 1986 (England and Wales) also empowers the administrator of an insolvent estate to utilise a part of a realised floating charge to supplement the payment of unsecured creditors.⁸⁷ Section 252 of the Enterprise Act of 2002 provides for the incorporation of Section 176A into the Insolvency Act of 1986. Section 176A is headed “Share of assets for unsecured creditors”. Section 176A(2) reads as follows: “The liquidator, administrator or receiver (a) shall make a prescribed part of the company’s net property available for the satisfaction of unsecured debts, and (b) shall not distribute that part to the proprietor of a floating charge except in so far as it exceeds the amount required for the satisfaction of unsecured debts.” Perkin mentions that it has been ruled that secured

Service above other general unsecured creditors as dealt with above in para 2 3. S 135(3) of the South African Companies Act of 2008 provides priority payment to employees for remuneration during a rescue operation – even above secured claims securing post-commencement finance – see para 2 6 *supra* in this regard.

84 Ashwin 2005 *Comp L* 163 177.

85 See Sarra *Employee and pension claims during insolvency* (2008) Part IV 15 where the author refers to countries such as Brazil, Chile, Columbia, Mexico, Indonesia and Malaysia where employees enjoy priority even above secured creditors. Sometimes the priority limit is capped and in other instances unlimited. With regard to the position under the Enterprise Act of 2002, McCormack 2003 *JBL* 389 393 notes that the Insolvency Act of 1986 Schedule 6 still provides for a priority standing of creditors’ claims such employees’ unpaid salaries and payments for vacation leave, even though certain payments to the Crown have lost priority standing. Even though a full discussion of preferential treatment of some unsecured creditors is beyond the scope of this article, also see in this regard the Enterprise Act 2002 – Corporate Insolvency Provisions: Evaluation Report January 2008 10: “In order to promote a more equitable distribution of assets within all insolvencies, the EA abolished the Crown’s preferential status as a creditor. One of the policy intentions behind this amendment was that the benefit should flow to unsecured creditors.”

86 Rose *Nutshells company law* (2009) 30.

87 McCormack 2003 *JBL* 389. See also White 2009 *JIBLR* N25. In this regard, see the Enterprise Act 2002 – Corporate Insolvency Provisions: Evaluation Report January 2008 by The Insolvency Service (www.insolvency.gov.uk) 10: “In cases where assets are not subject to a floating charge, the reduced categories of preferential debt should allow funds, where available, to flow directly to ordinary unsecured creditors. To address the situation where assets are subject to a floating charge, a new section 176A was inserted into the Insolvency Act 1986 which requires that a prescribed part of the funds available to floating charge holders be set aside for the benefit of unsecured creditors. However, this requirement does not apply in insolvencies where a floating charge was created prior to 15 September 2003.” Refer to aforesaid report in general for an evaluation of the success of the Enterprise Act.

creditors claiming the “unsecured balance of the debts”, are not entitled to the funds set aside by section 176A.⁸⁸ This percentage to be set aside was proposed in relation to the 1982 Cork Committee suggestion that a set figure should be deposited in a fund for the benefit of unsecured creditors.⁸⁹

3 1 3 3 Further remarks

In terms of South African insolvency legislation, the costs of realising, maintaining and storing secured property will be deducted from the proceeds generated by the sale of the property and paid over to the relevant creditors before the claim of the secured creditor is satisfied.⁹⁰ Certain charges in favour of local authorities will also enjoy preferential payment.

It seems that some secured creditors will therefore ordinarily have no recourse to the funds that may in terms of legislation be subtracted from the proceeds of the secured assets to benefit other creditors.⁹¹ Sometimes they are restricted to claim only from the proceeds of the security and in some systems they may run the risk of becoming a contributory to the deficit in the free residue if they decide to rely on both the security and the free residue for payment purposes.⁹²

3 1 4 Efficiency

A concern of scholars opting for an alteration to the current priority of secured creditors is the matter of efficiency.⁹³ Bebchuk and Fried argue that “full priority gives rise to priority-dependent efficiency costs that increase the total costs associated with the use of security interests, and it causes borrowers and their sophisticated creditors to increase their use of inefficient security interests”.⁹⁴ In a nutshell, the inefficiencies generated by secured interests include keeping debtors in business when they ought to be shut down,⁹⁵ contracting for secured finance even though the agreement would encourage over-investment and unwanted operations,⁹⁶ and decreasing the usable and distributable value available to debtor and creditors alike.⁹⁷

88 Perkin 2008 *Cov LJ* 19 20 21. See Walters “Statutory redistribution of floating charge assets: Victory (again) to Revenue and Customs” 2008 29(5) *Comp L* 129 specifically where the author notes that “the *pari passu* rule had therefore been modified by the provision to differentiate between unsecured creditors with no form of security and the unsecured claims of secured creditors”.

89 McCormack 2003 *JBL* 389. See Bebchuk & Fried 1995/1996 *Yale LJ* 857 910 and Perkin 2008 *Cov LJ* 19 21.

90 S 89 of the Insolvency Act of 1936 and see para 2 2 *supra*.

91 A foreign example in this regard would be the ruling by Patten J mentioned by Perkin 2008 *Cov LJ* 19 20 21 with reference to s 176A of the Insolvency Act of 1986.

92 In South African insolvency law, creditors, especially unsecured concurrent creditors, become liable to pay the shortfall regarding the costs of bankruptcy if there is not sufficient funds in the estate to meet those – see s 106 of the Insolvency Act of 1936.

93 Scott 1996/1997 *Cornell LR* 1436 1438. In this regard, also take note of the following policy consideration of Wood *Principles of international insolvency* (2007) “General introduction” 6 para 1-007: “The law should aim to reduce credit risks in the interests of economic efficiency and cost reduction.”

94 Bebchuk & Fried 1995/1996 *Yale LJ* 857 904.

95 *Idem* 865.

96 *Ibid.*

97 *Idem* 870.

Ideally, any amendment of the current priority distribution system will encourage social changes to benefit both the community and economy as a modification of the law may alter the behaviour of individuals.⁹⁸ Creditors, other than delictual claimants, may change a debtor's precaution and prevention policies and behaviour where tort liability can be foreseen as a result of the activities of the debtor, specifically where the creditors run the risk of sharing the hazard of insolvency equally with the tort victims.⁹⁹ The obvious example would be that creditors, when negotiating the terms for the extension of credit, demands that the debtor procure sufficient personal indemnity insurance and maintain the premiums.¹⁰⁰

Furthermore, companies that face insolvency due to mass-tort litigation are more likely to be thriving business enterprises.¹⁰¹ These businesses differ from other companies in financial distress because their financial difficulties are not caused by management or production problems.¹⁰² Listokin notes that secured creditors would initiate insolvency proceedings in favour of opting for reorganisation to rescue the company.¹⁰³ This behaviour does not correlate with other legislative provisions in some jurisdictions that attempt to rescue companies¹⁰⁴ and the South African Companies Act of 2008.¹⁰⁵

On a slightly different note, LoPucki notes that a carving out of securities, if introduced, should also apply in the individual debt enforcement procedure outside bankruptcy.¹⁰⁶ Otherwise, secured creditors will for instance be tempted to effect the liquidation outside bankruptcy, leaving the unsecured creditors out

98 Baird 1996/1997 *Cornell LR* 1420 1426 1428 1429. Ashwin 2005 *Comp L* 163 169 170 171.

99 *Idem* 1429 1430. Ashwin 2005 *Comp L* 163 170 176 177.

100 Listokin 2007/2008 *Duke LJ* 1037 1053–1055. See also Baird 1996/1997 *Cornell LR* 1420 1429. Ashwin 2005 *Comp L* 163 170 171 mentions that procuring insurance may have very different social effects than intended: To prevent or reduce behaviour that will lead to delictual claims. The author notes (170 171) that the insurer or creditor will not necessarily be able to induce the insured debtor to take measures to safeguard against tortious claims and a firm would not be troubled to take care to avoid wrongful acts or properly insure itself against possible claims as it would not personally compensate tort claimants partly or in full during bankruptcy.

101 Listokin 2007/2008 *Duke LJ* 1037 1045.

102 *Ibid.*

103 *Ibid.* In contrast with the author's point of view, see Mokal 2002 *Oxford J Legal Studies* 687 specifically 720. He mentions that secured creditors would "encourage (or force) distressed firms to undergo restructuring . . . They are also significantly (and positively) related to the probability of a successful rescue. All the concerned parties, including trade creditors, are much better off if their debtor recovers than if it is liquidated."

104 Simmons "Some reflections on administrations, crown preference and ring-fenced sums in the Enterprise Act" 2004 *JBL* 423 425 426. See also ch 6 of the South African Companies Act of 2008 that regulates business rescue in the South African company law.

105 Ch 6 of the Companies Act of 2008 specifically regulates the position of employees and contracts of employment during business rescue. Having regard to the social and economic welfare of the community, it should be noted that s 7(b) states that one of the purposes of this Act is to "promote development of the South African economy"; s 7(d) states that "the company concept [should be a] means of achieving economic and social benefits" and s 7(k) states as a further purpose "[the] efficient rescue and recovery of financially distressed companies in a manner that balances the rights and interests of all relevant stakeholders".

106 1997 *Cornell LR* 29 37 42.

of the picture in any event.¹⁰⁷ The other side of the coin is that a bankruptcy carve out-rule would serve as an incentive for the unsecured creditors to file for bankruptcy.¹⁰⁸

3.2 Arguments supporting the retention of the full priority rule in favour of secured creditors

Johnson summarises some of the theories that may validate the trend of secured debt and the rationale for the benefits that accrue to one or both of the parties in order to explain the occurrence of secured debt in society.¹⁰⁹ He notes, however, that these theories tend to avoid focusing on securing real property as the object of security.¹¹⁰

The conventional theory assumes that security is about satisfying the needs of the debtor, that is, to receive adequate financing without drowning in risk-reducing interest rates.¹¹¹ In order to persuade creditors to take financial risks against non-payment, taking security is perceived as an acceptable and protective measure.¹¹²

The following example of unequal treatment of creditors given by McCormack illustrates one of the main reasons why creditors are willing to bargain for secured debt: He argues that debtors who provide security to creditors lower the risk that the creditor has to take in financing the debtor and by doing so avoid harsh terms of repayment.¹¹³ The unsecured creditor is then faced with high interest rates in order to make the increased risk worthwhile for the creditor.¹¹⁴

Security has a further advantage that benefits both creditor and debtor when assets are involved: A floating lien may very well motivate both the creditor and debtor to participate in the debtor's asset-related business as, according to the relationist theory, asset growth will be beneficial to both parties.¹¹⁵ The advantages flowing from the credit agreement for all parties go further than the mere transfer of monies at a particular interest rate, but are reliant on the future success of the debtor's business venture.¹¹⁶

Another outcome based on the interrelationship between secured and unsecured creditors is explained by way of the "zero-sum game analysis".¹¹⁷ This theory holds that the unsecured creditors of an estate will make up for the advantages that the secured creditors enjoy by being subjected to harsher repayment terms such as increased interest rates.¹¹⁸ Even though the analysis shows a need

107 *Ibid.*

108 *Ibid.*

109 See Johnson 1991 *LYLALR* 335 336–340.

110 *Idem* 338.

111 *Idem* 336.

112 Scott 1986 *Colum LR* 901. See also Johnson 1991 *LYLALR* 335 336.

113 McCormack 2003 *JBL* 389 410.

114 *Ibid.*

115 Johnson 1991 *LYLALR* 335 338.

116 *Ibid.*

117 *Idem* 337. See also Scott 1986 *Colum LR* 901 902.

118 Johnson 1991 *LYLALR* 335 337. See also Scott 1986 *Colum LR* 901 902: "The benefits to secured creditors from taking security are offset by the increased costs to unsecured creditors who face a corresponding reduction in the pool of assets available to them upon default. Alan Schwartz has shown that, given certain assumptions, secured credit is a zero

for the unsecured creditor in the credit relationship, it is still a prime example of an advantage held by the secured creditor that is generated by and reliant on the unequal treatment of creditors: the creditor can afford to grant certain privileges to the secured debtor because negative repercussions will be counterbalanced by the proceeds from the unsecured debtor.¹¹⁹

Johnson further evaluates the theoretical and practical considerations that may shed a favourable light on real-property secured debt, even though it is not necessarily applicable to insolvency/bankruptcy law:¹²⁰

The value of the extended credit can be balanced against the creditor's capacity to keep an eye out for misconduct on the debtor's part.¹²¹ Real property facilitates management as the object of the security is immobile.¹²² This is referred to as "the monitoring advantages of real property secured debt".¹²³

Real-property security is the first choice among creditors and the absence of real property, either because the debtor does not have any property available or because the existing real property is already the object of security, forcing the creditor to turn to other forms of security.¹²⁴

It serves as an effective indication of a client's merit as a debtor, the so-called "signalling function".¹²⁵ The existing real property security may further impart on the financial backer the risk of the venture.¹²⁶

If the full priority that secured debtors enjoy during insolvency proceedings is tainted, financing institutions will tend to only extend credit to clients that present lower risks and/or can afford stricter terms of credit, for example, pay higher interest rates.¹²⁷ The other benefits that exist as a result of security remote of the insolvency scenario will also be influenced.¹²⁸

Those in favour of retaining the rule of full priority of secured creditors argue that creditors and debtors enjoy freedom of contract¹²⁹ as the parties negotiate terms that are acceptable to both the borrower and the financier.¹³⁰ An important aspect of the relationship between the parties is that the unsecured creditor agreed to finance the debtor without demanding security.¹³¹

sum game in which gains to some creditors are achievable only by inflicting losses on others."

119 Johnson 1991 *LYLALR* 335 337; Scott 1986 *Colum LR* 901 902.

120 *Idem* 340–351.

121 *Idem* 340.

122 *Idem* 340 341.

123 *Idem* 340. Johnson 1991 *LYLALR* 335 337 states that in terms of the monitoring theory creditors utilise secured debt as a balancing mechanism where the creditor cannot supervise the behaviour of the debtor and check for misconduct.

124 Johnson 1991 *LYLALR* 335 343.

125 *Idem* 356 and discussed further 357ff.

126 *Ibid.*

127 McCormack 2003 *JBL* 389 419. See also Perkin 2008 *Cov LJ* 19 21. McCormack 2003 *JBL* 389 further suggests that "[this] measure would hurt businesses by freeing up credit lines and especially 'marginal' and minority-owned businesses".

128 See Listokin 2007/2008 *Duke LJ* 1037 1050; Johnson 1991 *LYLALR* 335 336.

129 McCormack 2003 *JBL* 389 419.

130 *Idem* 398.

131 *Ibid.*

Bebchuk and Fried explain that the argument cannot stand as the hierarchy of creditors is not based on freedom of contract.¹³² The secured creditor's agreement with the debtor essentially means that the creditor's claim will be satisfied before other unsecured creditors' claims are enforced and the secured creditor enjoys full and superior priority over the unsecured creditor.¹³³ The agreement between the debtor and the unsecured creditor, that the unsecured creditor will enjoy priority over other creditors, which is as legal and binding as the contract between the secured creditor and debtor, will not be enforced.¹³⁴

As shown above, the unsecured creditor's claims are satisfied after the claim of the secured creditor and only if and to the extent that funds are available in the insolvent estate. Furthermore, all unsecured creditors will receive their pro-rata share as the insolvent estate will not be able to fully satisfy all unsecured claims.¹³⁵ This is a legislative measure and not based on considerations of freedom of contract.¹³⁶

The response to legislative measures that allocate a percentage of the secured debt to satisfy the claims of unsecured debtors was that it would contravene the European Convention on Human Rights and the Human Rights Act.¹³⁷ The argument is that such measures would infringe the secured creditor's rights towards the secured property.¹³⁸ In order to evaluate whether section 25 of the South African Bill of Rights regulating constitutional property rights are similarly infringed, one would first have to decide whether the constitutional right is harmed by these specific measures and, if so, whether the impairment can be justified in terms of section 36.¹³⁹ McCormack notes the argument that the breach of such basic rights cannot be justified, but this assumption is obviously made with reference to foreign jurisdictions.¹⁴⁰

3 3 Proposed measures to limit the full priority status of secured creditors

As mentioned above, the proposed solutions to the dilemma of the unfair treatment of involuntary creditors will focus on alternatives to the current priority system. There are other means available to compensate these creditors for financial losses suffered and some of these will be mentioned briefly.

3 3 1 Insurance

The South African Insolvency Act contains a provision that confers a special preference on a third party who has in fact been indemnified by an insolvent and where the insolvent has insurance to cover such a risk.¹⁴¹ In foreign jurisdictions, the functionality of liability insurance in compensating tort claimants and promoting the goals of tort law is debatable: the question is whether liability

132 Bebhuk & Fried 1995/1996 *Yale LJ* 857 933 934.

133 *Idem* 933 934. Johnson 1991 *LYLALR* 335.

134 Bebhuk & Fried 1995/1996 *Yale LJ* 857 933 934.

135 *Idem* 933.

136 *Idem* 933 934. See *idem* 932–934 for the full extension of this argument.

137 McCormack 2003 *JBL* 389.

138 *Ibid.* In this regard, also take note of the following policy consideration of Wood (fn 93 *supra*): "So far as consistent with the reality of insolvency, the law should seek to preserve contract and property rights and not be an instrument of destruction."

139 Currie & De Waal *The Bill of Rights handbook* (2005) 26.

140 McCormack 2003 *JBL* 389 398–401.

141 S 156 of the Insolvency Act of 1936 as discussed in para 2 4 *supra*.

insurance will further tortious activities by alleviating the burden on companies to compensate tort claimants.¹⁴² As the debtor will not repay the successful mass-tort litigant (the insurance company will) and in all probability will not make any or very little payment in the event of insolvency, there is no motivation to thoroughly insure against tort claims or to abstain from tortious acts.¹⁴³ The effect would be that tort victims could still not be adequately compensated for the harm suffered by them.¹⁴⁴

3 3 2 *The “superfund”*

A similar external pooling concept, dubbed the “superfund”, can be created for the sole purpose of looking after the interests of tort victims.¹⁴⁵ Debtors functioning within a specific work sphere where their ventures may involve tortious activities would contribute to a fund with the sole purpose of compensating tort victims, whether the debtor becomes insolvent or not.¹⁴⁶ For instance, in many countries there are mandatory public or private insurance systems regarding personal injuries flowing from road accidents.¹⁴⁷

3 3 3 *Individual liability*

A further suggestion would be to enable tort creditors to institute action against the directors of a juristic person and recover their damages from the director’s personal estate.¹⁴⁸ The main arguments against this proposal are that the director’s estate will rarely be big enough to compensate mass-tort creditors in a meaningful way and would scare off potential directors.¹⁴⁹

3 3 4 *Alternative systems for priority distribution*

Adjustments to the existing rules of priority have been proposed: Listokin, for example, notes that “super priority of tort claimants” has been suggested by scholars that accept that secured debt is an efficient means of satisfying secured creditors over other ordinary and delictual creditors.¹⁵⁰ The rationale for adopting this departure from the trite rules of the creditor hierarchy is that affording the debtor the ability to interfere with the quantum awarded to legitimate tort creditors is unjust.¹⁵¹

Ashwin goes further and states that the calculated redistribution of funds towards secured creditors amounts to “a sanctioned oppression of the relatively weak and uninformed”.¹⁵² In his opinion, an obligation to compensate victims of wrongful acts should rest on the tort debtor and should also include those creditors that cause the full financial burden to rest on the tort creditor due to the

142 Ashwin 2005 *Comp L* 163 170.

143 *Idem* 170 171.

144 *Ibid.*

145 *Idem* 177.

146 *Ibid.* Ashwin 2005 *Comp L* 163 177 proceeds to list various features and probable problems with this fund, eg the impact, if any, on the delictual conduct of a company, which are similar to the payable premiums and the administration of an insurance policy/company.

147 See eg the Road Accident Fund Act of 1996 (South Africa).

148 Ashwin 2005 *Comp L* 163 173.

149 *Ibid.*

150 Listokin 2007/2008 *Duke LJ* 1037 1041 1042.

151 *Idem* 1042.

152 Ashwin 2005 *Comp L* 163 169.

advantages they enjoy through secured financing.¹⁵³ Although, practically speaking, a secured creditor impairs the prospects of an unsecured creditor in insolvency proceedings; it is doubtful whether the law makes provision for an alternative claim against secured creditors for financial loss incurred as a result of the hierarchy of creditors.¹⁵⁴

Bebchuk and Fried state that “when two parties are able to create a contractual agreement that transfers value from a non-consenting third party, they will have an incentive to create such an arrangement even if value is lost as a result”.¹⁵⁵ In the search for a remedy to reduce the unfair treatment of unsecured tort creditors, a legal amendment of the priority system should be introduced¹⁵⁶ – not a system of “private ordering” between creditors.¹⁵⁷

The debtor would be expected to take extra caution when dealing with possible delictual claimants where tort creditors enjoy priority over secured and all other creditors.¹⁵⁸ Creditors need to ensure that the debtor behaves in an acceptable manner as they carry the risk of insolvency along with the other general creditors and in doing so will indirectly further the aspirations of tort law.¹⁵⁹

On the other hand, secured creditors who have negotiated for the advantage of priority over general creditors and extended credit in return for that privilege will now be penalised for the behaviour of the debtor.¹⁶⁰ The counter-argument is that unsecured creditors are already burdened with the repercussions of a debtor’s behaviour by partaking in the remains of the insolvent estate along with delictual creditors.¹⁶¹ There is no reason why the secured creditor has to be treated differently as he or she can still negotiate the terms of credit and balance the risk of tortious claims,¹⁶² even though it may increase the expenditure of financing.¹⁶³

The interpretation of the provisions of section 176A of the Insolvency Act of 1986 (England and Wales) goes even further in applying the principle of *pari passu* to unsecured creditors that are entitled to compensation from the funds generated by the abovementioned section.¹⁶⁴ The judiciary refused to distribute the funds via a court order and in terms of section 176A(5) in favour of some unsecured creditors and to the detriment of others, depending on the amount of debt owed to them.¹⁶⁵

153 *Ibid.*

154 *Ibid.*

155 Bebhuk & Fried 1995/1996 *Yale LJ* 857 870.

156 *Idem* 934. See also Ashwin 2005 *Comp L* 163 177 who states that “it is doubtful whether, in a system of company law so heavily tilted in favour of securing credit at cheaper rates, the legislature would agree to frame rules giving super priority to tort creditors”.

157 Bebhuk & Fried 1995/1996 *Yale LJ* 857 934.

158 Ashwin 2005 *Comp L* 163 176.

159 *Ibid.*

160 *Ibid.*

161 *Ibid.*

162 *Ibid.*

163 *Idem* 177.

164 White 2009 *JIBLR* N25.

165 *Ibid.*; see also the author’s statement that: “Section 176A(2) provides for a liquidator, administrator or receiver making a prescribed part of the company’s net property available for the satisfaction of unsecured debts in priority to any floating charge holder . . . Blackburne J.’s view was therefore that the cost/benefit balance was to be approached by treating creditors as a body and that any disapplication order, if made, would only operate to disapply subs. (2) in its entirety.”

Further to the above, it has been shown that scholars hold different opinions regarding the introduction of an alternative order of priority among certain creditors. The ideal solution would be to advance the interests of involuntary creditors without limiting the advantages of secured debt unnecessarily, specifically with regard to aspects unrelated to collective debt collection proceedings.¹⁶⁶ The alternative measures proposed by Bebchuk and Fried aim to eradicate some unwanted aspects of the priority system and secured debt but strive to maintain the economic efficiency of secured debt and not be unjust to secured and unsecured creditors alike.¹⁶⁷

In 1995/6 Bebchuk and Fried suggested two ways to grant “partial priority to secured claims”.¹⁶⁸ These proposals are put forward as the “fixed-fraction partial-priority rule” and the “adjustable-priority rule”.¹⁶⁹

The “fixed-fraction partial-priority rule”: A set part of the secured debt and the debtor’s resulting priority ranking with regard to this part of the debt is forfeited and ranks equal to an unsecured debt.¹⁷⁰

The “adjustable priority rule”: Secured debtors will not enjoy a higher ranking than that of the non-adjusting creditors.¹⁷¹

The abovementioned writers seem to have proposed these alternatives specifically with the problematic inefficiencies generated by security interests in mind,¹⁷² as well as trying to lessen debtors’ capacity to reallocate funds to and for the benefit of secured creditors.¹⁷³

In 1982 the Cork Commission suggested that 10% of floating charges should be renounced in favour of unsecured creditors, but the specific percentage was not incorporated into legislation *per se*.¹⁷⁴ At a later stage, section 252 of the Enterprise Act of 2002 introduced section 176A into the Insolvency Act of 1986 (England and Wales) with effects as discussed at various stages in this article.¹⁷⁵

The second option covers the crux of the debate on the unjust treatment of unsecured creditors through the priority afforded to secured creditors during insolvency proceedings. Under the second rule mentioned above, tort creditors would fall in the category of non-adjusting [unsecured] creditors¹⁷⁶ and, for purposes of this proposed scheme, the portions of the secured debts that lose the

166 Bebchuk & Fried 1995/1996 *Yale LJ* 857 904 932 934. Mokal 2002 *Oxford J Legal Studies* 687 691 lists various involuntary creditors and apart from different types of delictual claimants, the author also lists creditors that have claims due to legislative provisions: “[T]ax authorities and certain other government agencies, and utility companies.”

167 Bebchuk & Fried 1995/1996 *Yale LJ* 857 904 932 934.

168 *Idem* 904ff. See Bebchuk & Fried 1995/1996 *Yale LJ* 857 904 where it is shown that the writers proposed these alternatives specifically with the problematic inefficiencies generated by security interests in mind.

169 Bebchuk & Fried 1995/1996 *Yale LJ* 857 904 934.

170 *Idem* 904.

171 *Ibid.*

172 *Idem* 904 908 910.

173 *Idem* 910.

174 *Ibid.* See also Perkin 2008 *Cov LJ* 19 21 where he refers to the specific wording of the Cork Committee.

175 In this regard see also McCormack 2003 *JBL* 389.

176 Bebchuk & Fried 1995/1996 *Yale LJ* 857 908.

priority ranking would be available for distribution to supplement the non-adjusting creditors' claims.¹⁷⁷

The argument that the principles of insolvency are unfairly biased towards the tort victim can be circumvented by the prioritising of involuntary unsecured creditors above secured creditors.¹⁷⁸ The goal is ultimately to burden the wrongdoer, capable of shouldering the loss, with the financial loss suffered by the victim.¹⁷⁹ Ideally, all creditors, secured and tort, should be treated alike¹⁸⁰ but the tort victim will still carry the risk of non-payment by the tort debtor.¹⁸¹ In either circumstance, tort creditors would not necessarily receive full compensation for damages suffered and still carry some of the risk of insolvency, but the chances of allocating a large part of the risk to the responsible debtor would improve.¹⁸²

It is pointless to discuss the possibility of granting tort creditors priority over general unsecured creditors but still a lower ranking than secured creditors.¹⁸³ The option is available but the same arguments opting for a change in creditors' priority status would apply: tort creditors would still be relying on any funds left in the estate after the secured creditors' claims had been satisfied and lack the opportunity to negotiate the best terms of agreement that general creditors have.¹⁸⁴

4 CONCLUSION

Against the backdrop of the functioning of the distributional rules in insolvency in South African insolvency law, and while recognising the importance of secured credit in a modern economy, this article explored the question whether a case can be argued for allowing unsecured creditors the opportunity to stake a claim in the proceeds of real security.

It is clear that exceptions exist in some systems¹⁸⁵ and it is also a fact that in many instances the unsecured creditor receives little, if any, payment. The question thus is under what circumstances exceptions could or rather should be made. For instance, only where a particular case can be argued as in the instance

177 *Idem* 905. See further 905: "Under the adjustable-priority rule, claims of non-adjusting creditors would not be subordinated to secured claims with respect to which they were non-adjusting. The adjustable-priority rule would require that, when applying the rule of full priority, a non-adjusting creditor's share of bankruptcy value be calculated by treating as unsecured the secured claims with respect to which the creditor was non-adjusting."

178 Ashwin 2005 *Comp L* 163 176.

179 *Ibid.*

180 Scott 1986 *Colum LR* 901. Ashwin 2005 *Comp L* 163 176 also suggests "parity with secured creditors".

181 Ashwin 2005 *Comp L* 163 176.

182 *Ibid.* Ashwin 2005 *Comp L* 176 discusses the operation of the first-in-time rule and notes that creditors with perfected claims will still enjoy a further priority status above tort claimants even if these claims enjoyed equal ranking. The author states one of the shortcomings of this proposal as follows: "Parity with secured creditors produces the anomalous result of allowing earlier creditors who funded the injurious activity, and who arguably should be held responsible for its effects, to escape liability because of the first-in-time rule, while later creditors who were not responsible for the victims' injuries are shouldered with the burden of accidents."

183 See Ashwin 2005 *Comp L* 163 175 176.

184 *Ibid.*

185 See *inter alia* paras 2 2, 2 6 and 3 3 1.

of the involuntary victim of a delict, or a more general exception such as by granting a fixed percentage of the proceeds of securities to unsecured creditors who enjoy no form of priority otherwise.¹⁸⁶

It is clear that many examples exist where especially legislation grants priority treatment in favour of certain creditors – even above secured creditors.¹⁸⁷ Some are uncontroversial, such as the cost of maintaining and realising a real security object that is an essential expense,¹⁸⁸ others may be subject to legal scrutiny and debate such as those jurisdictions that allow employees to claim wages in arrears from the proceeds of secured assets.¹⁸⁹

This happens at all levels in that there already are instances where some unsecured creditors are allowed to claim from the proceeds of real security – sometimes such a claim enjoys higher priority than the secured creditor him- or herself.¹⁹⁰ Some unsecured creditors are preferred in that their claims enjoy priority payment against other unsecured creditors; and in some instances where certain third parties are indemnified they may escape the collectivity of the bankruptcy proceeding in that they may claim directly from the insurer.¹⁹¹

A few systems grant super priority to claims of employees for wages in arrears, *etcetera*.¹⁹² England and Wales serve as examples where a portion of the income derived from some securities are provided to unsecured creditors.¹⁹³

The article has also indicated that otherwise unsecured creditors may also enjoy preferential payments as a result of other options, such as private or public insurance funds, particularly in the case of certain tort victims, wage guarantee funds in favour of employees in some systems, and the notion that certain claims such as tort claims will not be discharged in bankruptcy with the result that the debtor, if an individual, will remain liable to pay same after bankruptcy has been dispensed with.¹⁹⁴

Various arguments in favour of and against the use of the proceeds of real securities to pay (some) of the unsecured claims have been considered – especially in those instances where the unsecured creditors who enjoy no priority may end up without receiving any dividend at all.¹⁹⁵

It was shown that existing policy considerations may favour the plight of the unsecured creditor by advocating for measures to increase funds available for distribution to unsecured creditors.¹⁹⁶ In some instances such considerations have led to the removal of the preferential status of some unsecured creditors and in others the denial of unsecured claims of creditors that have received payment of a part of the claim by virtue of a form of security.

186 See *inter alia* para 3 3 4.

187 See *inter alia* paras 2 2, 2 6 and 3 3 1.

188 See para 2 2.

189 See paras 2 6 and 3 3 1.

190 See *inter alia* paras 2 6 and 3 3 1.

191 See paras 2 4 and 3 3 1.

192 See para 3 1 3 1.

193 See para 3 1 3 2.

194 See paras 2 4, 3 1 2 and 3 3 2.

195 See paras 3 1 and 3 2.

196 See paras 2 4; 3 1 3 1 and 3 1 3 2.

It can be accepted that many will resist a general rule that allows all unsecured creditors to share in the proceeds of those assets serving as real security in an estate. As well, if allowed in too liberal a way it may bring irreparable harm to the economy.¹⁹⁷ But meritorious instances have been highlighted, such as the position of involuntary creditors who become creditors as a result of a delict committed by a debtor, because such a creditor will not usually have the opportunity to negotiate real security with the debtor for repayment.¹⁹⁸ In the case of a mass delict committed by, for example, a corporate debtor and in the absence of insurance or adequate insurance, such victims may end up with no dividend at all.¹⁹⁹ It is also generally accepted that unsecured creditors will hardly ever receive a dividend at all. All these factors, read against exceptions that already exist, can possibly be used to raise an argument in favour of a policy-based approach to allow some unsecured creditors under prescribed circumstances to share in at least a portion of the proceeds of secured assets.

197 See *inter alia* para 3.

198 See para 3 1 1.

199 See para 3 1 2.