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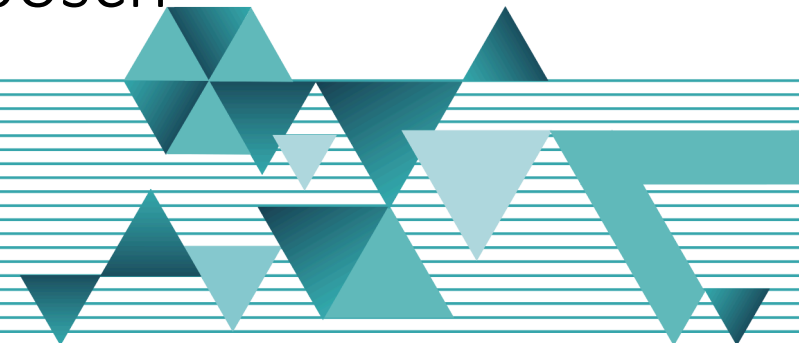
Secured Creditors, Free Residue, Contribution and the Liquidation and Distribution Account

PowerPoint Slides

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Secured creditors, free residue,
contribution, L&D account
Chapters 21 to 23 and Appendix A

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Background

- Purpose of insolvency = collect & realise assets, and distribute funds to creditors = thus, “liquidation and distribution” account
- **Different types of creditors:**
 1. Secured creditors
 2. Statutory preferent creditors
 3. Concurrent creditors
 4. Also: certain costs
- Types of assets (distinguished in liquidation account):
 1. Encumbered assets = Encumbered asset account (for each asset)
 2. Unencumbered assets = Free residue account (for all assets)

Assets

ENCUMBERED ASSET ACCOUNT

- Realization value of encumbered asset
- Plus: fruits of asset
- Less: costs
- Less: debt owed to secured creditor(s) plus interest
- Surplus = free residue (unsecured creditors)
- Shortfall = becomes unsecured claim (unless rely on security)

FREE RESIDUE

- Realization value of all unencumbered assets + surplus from encumbered assets
- Plus: fruits of asset
- Less: costs
- Statutory preferent creditors
- Concurrent creditors (dividend)
- Shortfall = discharged
- Surplus = to debtor / shareholders

Secured creditor

- Definition of “**security**” in s 2 of Insolvency Act:
- Re the claim of a creditor = property over which the creditor has a preferent right by virtue of:
 1. **Special mortgage**
 2. **Landlord’s legal hypothec**
 3. **Pledge**
 4. **Right of retention**
- Also: s 84 of Insolvency Act
 5. **Instalment agreement hypothec**
- I.e. security = collateral = property in which a creditor has a **security right** = preference to proceeds of that property
- Encumbered asset = dealt with in **encumbered asset account**

Special mortgage

- Definition of “**special mortgage**” in s 2 of Insolvency Act:
 - 1. Mortgage bond** hypothecating any **immovable** property
 - I.e. a bond over **land** or anything else classified as immovable property
 - 2. Notarial (mortgage) bond** hypothecating specially described **movable** property i.t.o. s 1 of the Security by Means of Movable Property Act 1993
 - I.e. a bond over movable objects (not land)
- Registered in the Deeds Office i.t.o. Deeds Registries Act 1937

Examples

ASSETS

- Erf 123 Bellville (House) valued at R1 000 000
- Farm 23 Paxton valued at R500 000
- Unit 5, Sunnyside Sectional Title Scheme valued at R700 000

CREDITORS

- ABC Bank: R800 000, secured by mortgage bond over Erf 123 Bellville
- ZZZ Bank: R100 000, secured by mortgage bond over Farm 23 Paxton
- XXX Bank: R75 000 credit card

Mortgage of movables (notarial bonds)

- Two types of notarial bonds:

1. General notarial bonds

- Over all movables of debtor in general
- Registration alone = not secured creditor
- Additional step = **perfection** of security = take possession (attach)
 - a) Upon perfection = secured creditor (pledge)
 - b) Before perfection = statutory preferent (over concurrent)

2. Special notarial bonds

- If complies with Security Act 1993 (tangible; specified & described so that readily recognizable) = “special mortgage” = secured creditor
- If not = unsecured; requires “perfection” (like general bond)

Pledge

- **Movable** property

1. **Tangible** objects = deliver to creditor (including perfected general notarial bond)

- Different forms of delivery (transfer of possession)

2. **Intangible** assets (personal rights) = cede to creditor (cession *in securitatem debiti*)

- E.g. shares, book debts, insurance policies

- **Two theories**

- i. **Fiduciary transfer of personal right** (out-and-out cession = transfer ownership of asset to creditor until debt paid)

- ii. **Pledge of claim** (limited transfer = keep ownership, but create security right for creditor)

Examples

ASSETS

- John Dore tractor, registration number 12345A, valued at R100 000
- 500 sheep, worth R90 000
- Golden neckless, worth R55 000
- 1000 shares in AngloGold Ltd, worth R500 000
- Equipment worth R120 000
- Cash in bank: R15 000

CREDITORS

- XYZ Financiers: R80 000 secured by notarial bond registered over John Dore tractor, reg nr 12345A
- Trick Lenders: R50 000, has golden neckless in their possession as pledge
- Grow Suppliers: R1 000 000, secured by cession of 500 AngloGold shares
- AKA Bank: R85 000, secured by notarial bond over sheep and all other movables

Landlord's legal hypothec

- **Movable** property on leased premises
- Outstanding rental: Landlord has hypothec over movables
 1. **Belonging to tenant (in insolvency = only this)**
 2. Belonging to subtenant
 3. Belonging to third parties (requirements; exclusions)
- Perfection of hypothec = interdict, attachment or sequestration
- **Limit on secured claim:**
 - a) Rent payable monthly or shorter = 3 months' rent
 - b) Rent payable between 1 and 3 month intervals = 6 months' rent
 - c) Rent payable between 3 and 6 month intervals = 9 months' rent
 - d) All other intervals = 15 months' rent
- NB: rent after sequestration = cost of sequestration

Example

- John lives in house rented from Mary. He must pay R10 00 per month. John is sequestration on 1 July. On this day, he owes Mary R5 000 in outstanding rent. He has furniture in the house. His car worth R15000 is parked there. John owes R10 000 on the car to Eastbank i.t.o. an instalment agreement. The lease is terminated on 1 August and John must also still pay Mary for the month of July. John furniture is sold at auction for R6 000 and commission of R600 is paid to the auctioneer
- Encumbered asset account:
 - Furniture sold for R6 000 (car excluded by Security Act 1993)
 - Less: costs of R600 = R5 400
 - Less: debt owed to landlord = R5 000 (but limited to 3 months: R3000)
 - Surplus = R2 400
- R1 000 for July = post-sequestration rent = cost (free residue)

Right of retention (lien)

- **Movable** or **immovable** property
- In possession of someone (creditor): did work / incurred expenses
- Can retain property until paid
- Two types:
 - 1. Debtor-creditor lien (contractual)**
 - Work done i.t.o. a contract
 - Secured debt = amount of contract
 - 2. Enrichment lien (Salvage / improvement)**
 - No contract; owner enriched at expense of creditor
 - Work/expenses = prevents market value from falling (salvage)
 - Work/expenses = increases market value (improvement)
 - Secured debt = smallest of: amount expended / increase in market value

Right of retention (lien) (continued)

- **Ranking** (claims by more than one secured creditor)
- General rule: time sequence of creation
- **Exception** in case of liens:
 1. Costs
 2. Enrichment lien (always first creditor)
 3. Mortgagee / pledgee
 4. Debtor-creditor lien

Examples

ASSETS

- BMW worth R130 000
- 100 sheep worth R50 000
- Farm worth R2 000 000

CREDITORS

- JJ Mechanics has BMW with them: claims R50 000 for repair works i.t.o. contract
- Peter claims R500 for feeding 50 of your sheep. You were on holiday and your sheep were starving, so Peter (your neighbour) took them to his farm and fed them.
- Bob Builder: R100 000 for a store built on farm. Bob already handed over the store and left your farm.

Instalment agreement hypothec

- **S 84 of Insolvency Act**
- Purchased and took delivery of movable i.t.o. **instalment agreement**
 - as defined in paras (a), (b) & (c)(i) of def in National Credit Act 2005
 - Periodic payments; interest payable
- I.e. creditor is owner until debt paid (**retention of title**)
- Upon sequestration: asset vests in estate
- In exchange: creditor has **hypothec** (security right) as security for balance of purchase price

Examples

ASSETS

- BMW worth R130 000
- Toyota worth R55 000
- Machinery worth R20 000

CREDITORS

- ABC Bank has claim for R80 000 i.t.o. instalment agreement i.t.o. NCA w.r.t. the BMW
- JJ Mechanics has BMW with them: claims R50 000 for repair works i.t.o. contract
- Mary claims R55 000, purchase price of Toyota. She retained ownership until payment in one lumpsum at future date
- Peter claims R500 for storing the Toyota to prevent hail damage while you were on holiday

Special statutory security rights

1. Alienation of Land Act
2. Agricultural pledges and charges
3. Customs and excise lien
4. Municipal charge and embargo power

Municipal charge and embargo power

- S 118 of Local Government: Municipal Systems Act
- Secures **taxes** and other **charges for services** re land, owed to local authority (municipality) – in two ways:
 - 1. Embargo power (s 118(1)) (rates clearance certificate)**
 - For previous two years
 - Municipality can veto transfer of property until payment
 - Thus, trustee must pay this debt **as part of costs of realizing** the property
 - 2. Charge (s 118(3))**
 - Hypothec / security right = all debt (not limited to 2 years)
 - Preference over mortgage bonds
- S 89 of Insolvency Act: **tax** portion of claim = **limited to two years** (rest will be unsecured claim)

Example

- House sold for R1 000 000 at auction; paid R10 000 to auctioneer
- ABBA Bank claims R800 000 for mortgage loan
- City of Cape Town claims R50 000 in outstanding amounts:
 - a) **Tax** for previous **two** years: R5 000
 - b) Charges for **services** for previous **two** years: R5 000
 - c) Older **tax**: R10 000
 - d) Older **service** charges: R30 000
- Proceeds: R1 000 000
- Less: costs (auctioneer): R10 000 = R990 000
- Less: costs (embargo: services & tax): R10 000 = R980 000
- Less: charge (only services): R30 000 = R950 000
- ABBA Bank: R800 000 = R150 000 (surplus: to free residue)

Section 89(1) costs

- Costs of: **maintaining, conserving** and **realizing** the property
 - E.g. security guard, repairs, storage, etc.
- Paid from proceeds (before anyone else is paid)
- If proceeds not enough = secured creditors must pay
- Cost of realizing the property includes:
 1. Trustee's **remuneration**
 2. Trustee's **bond of security** (proportional share)
 3. **Master's fee** (proportional share)
 4. Property tax (and service charges) for previous two years (embargo)
 5. Levies to body corporate or homeowners' association
 6. Other: estate agent, auctioneer, etc. (anything necessary to sell)

Free residue: statutory preferent & concurrent

- **What is in free residue:** proceeds of unencumbered assets plus surplus from encumbered asset accounts
- **How distributed:** s 96 to s 103 of Insolvency Act
 1. **S 96: Funeral and death-bed expenses (max R300)**
 2. **S 97: Costs of sequestration**
 - i. **Sheriff's** charges
 - ii. **Master's** fees
 - iii. Other (rank equally)
 - a) Cost of application
 - b) Cost for completion of statement of affairs
 - c) **Remuneration of trustee**
 - d) Cost of administration and liquidation: e.g. **trustee's bond of security**, postages and petties, completion of contracts, convene meetings, legal work, etc.

Free residue: statutory preferent & concurrent

3. S 98: Costs of execution

4. S 98A: Certain employees

- Employees (excluding director/member of company / close corp.)
 - a) Salary/wages – not more than 3 months (max R12 000)
 - b) Leave (max R4 000)
 - c) Other paid absence – not more than 3 months (max R4 000)
 - d) Severance/retrenchment (max R12 000)

Free residue: statutory preferent & concurrent

5. **S 99: Certain statutory obligations**

- a) Compensation for Occupational Injuries and Diseases Act
- b) Income taxes deducted from salary but not yet paid to SARS (PAYE)
- c) Customs and Excise Act (if SARS does not have a lien)
- d) VAT
- e) Contributions to UIF

6. **S 101: Income tax**

7. **S 102: General notarial bonds**

- If not perfected
- Only preference to proceeds of movable property

8. **S 103: Concurrent claims**

Value added tax (VAT) = 15%

- If trustee is VAT vendor
 - 1) Must **charge VAT on certain receipts** (pay over to SARS) **OUTPUT**
 - E.g. proceeds of property sold; estate income
 - 2) Will **pay VAT on certain expenses** (claim back from SARS) **INPUT**
- Calculation
 - If VAT included: $15/115 \times \text{amount} = \text{VAT}$
 - If VAT excluded: $15/100 \times \text{amount} = \text{VAT}$
- For each account: must calculate how much payable to or claimable from SARS
 - Add: all VAT amounts you can claim back from SARS (**INPUT**)
 - Minus: all VAT amounts you have to pay over to SARS (**OUTPUT**)
 - If positive = claim from SARS; if negative = pay to SARS

Certain important costs

- a) Trustee's remuneration
- b) Master's fee
- c) Trustee's bond of security premium

❖ Each: divided across assets:

- **Trustee's remuneration:** percentage of each asset realized
- **Master's fee and bond of security premium:**
 - One amount for entire estate: must be proportioned to each asset account:
 - Encumbered asset account(s) and Free residue account
- Certain other expenses might also have to be divided proportionally
 - E.g. auctioneer gives you one bill for selling several assets

Master's fee (no VAT)

- Since 2018:
 - a) Gross value of estate: less than R5 000 = 0
 - b) R5000 or more, but less than R50 000 = R250
 - c) R50000 or more, but less than R150 000 = R1 000
 - d) R150 000 or more = **R1 000** on first **R150 000**;
plus: **R275** for each completed **R5 000** thereafter
- a) Max = R275 000

- Example

- Estate = R1 000 000
- R1 000 000 – **R150 000** = R850 000
- R850 000 / R5 000 = 170 x **R275** =

R1 000
R46 750
R47 750

Trustee's remuneration

- Movable property, amounts collected i.t.o. promissory notes, book debts, rent, interest = **10%**
- Immovable property, shares, securities = **3%**
- Money, bank accounts, deposits, cheques = **1%**
- Sales in business of insolvent = **6%**
- Amount distributed in composition = **2%**
- Movable property taken over by secured creditor = **5%**
- Minimum = R2 500

- NB: remuneration on VAT (next slide)

VAT on remuneration

- *Spendiff* case: can charge remuneration on VAT charged on purchase price of property
- But must be reduced
- **Example:**

| | | |
|--|-----------------|------------------|
| Proceeds of movable property (without VAT) | | 100 000.00 |
| VAT 15% | | <u>15 000.00</u> |
| Gross proceeds (including VAT) | | 115 000.00 |
| Fee 10% | 11 500.00 | |
| Less: 15% x R 15 000 x 10% | <u>-225.00</u> | |
| Fee | 11 275.00 | |
| VAT 15% | <u>1 691.25</u> | |
| Total fee (including VAT) | 12 966.25 | |

Proportioning of Master's fee and bond of security

- Master's fee = R20 000 (no VAT)
- Bond of security = R10 000 (VAT inclusive)
- Two encumbered assets plus free residue

| Account | Proceeds | Master | Bond |
|----------------|----------------------|---------------------|---------------------|
| Enc-1 | 50 000 | 10 000 | 5 000 |
| Enc-2 | 35 000 | 7 000 | 3 500 |
| Free-R | <u>15 000</u> | <u>3 000</u> | <u>1 500</u> |
| Total | 100 000 | 20 000 | 10 000 |

Contribution by creditors: Ch 23

- **When relevant?** No free residue / free residue not enough to cover expenses in s 97 (i.e. costs of sequestration)
- What must happen? Certain creditors must pay for shortfall (i.e. contribute)
- Only creditors who proved claims (and creditor who applied for order)
 1. **Concurrent creditors** (& concurrent portion of secured claims)
 2. **Secured creditors**
 - Costs of maintaining, conserving, realizing the security (if proceeds not enough)
 - If all creditors are secured without concurrent claims: contribute to Free Residue
 3. **Preferent creditors** (if no concurrent / withdrawn / not enough)
 4. **Creditor who applied for order** (even if no proved claim)

Basic structure of an asset account

| | VAT | DEBIT | CREDIT |
|---|----------------|------------------------|------------------------|
| <u>Receipts:</u> | | | |
| Proceeds of property | R15 000 | | R115 000 |
| <u>Payments:</u> | | | |
| Trustee remuneration | (R450) | R3 450 | |
| Master's fee | 0 | R500 | |
| Auctioneer fee | (R750) | R5 750 | |
| VAT payable to SARS (R15 000-R450-R750) | | <u>R13 800</u> | |
| Total payments: | | R23 500 | |
| <u>Balance awarded as follows:</u> | | | |
| Creditor 1 | | R90 000 | |
| Interest | | R10 000 | |
| Balance to Free Residue | | <u>R1 500</u> | |
| | | <u>R115 000</u> | <u>R115 000</u> |

Basic structure of an distribution account

| Creditor name | Total claim | Secured claim | Preferent claim | Concurrent claim | Secured/preferent award | Concurrent award |
|---------------|-------------|---------------|-----------------|------------------|-------------------------|------------------|
| Creditor 1 | R1 000 | R0 | R0 | R1 000 | R0 | R100 |
| Creditor 2 | R3 000 | R3 000 | R0 | R0 | R3 000 | R0 |