



**INSOL**  
INTERNATIONAL



# Secured creditors; encumbered asset accounts; free residue account

Dr David Burdette (INSOL International, UK)

# Overview

Proceeds of asset



Payment of costs



Payment of  
creditors

# Distinction between categories of creditors in Insolvency Law

<h2>Secured</h2> <ul style="list-style-type: none"><li>• special mortgage</li><li>• pledge</li><li>• landlord's hypothec</li><li>• right of retention</li><li>• instalment sale agreement hypothec (s 84)</li></ul>	<h2>Unsecured</h2> <p>statutory preferent / concurrent</p>
<h2>Encumbered</h2> <p>= securities (creditors have recognized security right) - preference regarding payment</p> <p>* s 2 of Insolvency Act defines "security" and "preference"</p>	<h2>Unencumbered</h2> <p>Free residue</p>

# Creditor hierarchy (free residue)

## Administrative Expenses (s 97 - s 98)

Master's Fee - Trustee's Fee - Bond of Security - Advertising Costs - Bill of Costs



## Unsecured Creditors

- Preferent Statutory ie Employees - SARS (s 98A - s 102)
- Concurrent (creditors that are neither secured not preferent) (s 103)



# Creditor hierarchy (encumbered asset)

## Administrative Expenses (s 89(1))

Master's Fee - Trustee's Fee - Bond of Security - Cost of maintaining conserving and selling the property



## Secured Creditors (s 95(1))

Special mortgage - pledge - landlord's hypothec - right of retention - instalment sale agreement



## Balance to Free Residue (if any)

# Special / general mortgage bonds

Immovable property	Movable property	
<p><i>Mortgage bond</i></p> <ul style="list-style-type: none"> <li>• Must be registered in Deeds Office – grants bondholder full security right in the property</li> <li>• Purpose to secure the repayment of a debt</li> <li>• eg mortgage bond registered to secure a home loan</li> <li>• The registration of the bond creates a limited real right (security) in favour of the creditor</li> <li>• Entails land and everything attached to land</li> <li>• More than one mortgage can be registered over same property</li> <li>• Priority of a mortgage that secures payment of a future debt depends on the date of registration of the bond</li> </ul>	<p><i>General notarial bond</i></p> <ul style="list-style-type: none"> <li>• Must be registered in Deeds Office –does not grant bondholder full security right in the property</li> <li>• All debtor’s movable property (nothing excluded)</li> <li>• Includes tangible and intangible movable property</li> <li>• Will have a preference to the free residue and is preferred over concurrent creditors</li> <li>• Movable property remains with the debtor</li> <li>• Bondholder can strengthen its rights by taking possession– perfecting of the security (after registration of the bond but <u>before sequestration</u>)</li> <li>• Converted into a pledge – bondholder fully secured</li> </ul>	<p><i>Special notarial bond</i></p> <ul style="list-style-type: none"> <li>• Must comply with requirements set out in Security by Means of Movable Property Act</li> <li>• Creates security right in specifically identified movable object(s)</li> <li>• Three requirements to be met: <ul style="list-style-type: none"> <li>• Bond must be registered in terms of Deeds Registries Act</li> <li>• Movable property must be corporeal (tangible)</li> <li>• Movable property must be specified and described in the bond in a manner that renders it easily recognisable</li> </ul> </li> <li>• Need not be delivered to bondholder</li> <li>• Be deemed to have been pledged to bondholder as if it had expressly been pledged and delivered to bondholder</li> </ul>

# Pledge


## Corporeal movable property

- Pledge does not require registration
- Delivery of movable property to creditor required to make creditor a secured creditor
- Creditor must remain in possession of property
- Property can be delivered to creditor by:
  - physically handing over
  - pointing out to creditor
  - removal from premises
  - agreement that creditor will hold in pledge
  - delivery of a symbol ie key to warehouse

## Incorporeal movable property

- A personal right (right of action) can be pledged by ceding (transferring) rights as security for a claim
- Referred to as cession *in securitatem debiti*
- Can include:
  - cession of debts
  - shares in a company
  - rights under instalment sale transactions
  - rights under insurance policies
  - a future debt
  - a contingent claim

# Legal nature of cession *in securitatem debiti*

"out-and-out" (outright) cession theory	pledge theory
<ul style="list-style-type: none"><li>• Cession fully transfers the personal right to the creditor (cessionary)</li><li>• <i>Dominium</i> (ownership) of asset passes to the creditor and the personal right must then be re-transferred to the debtor once the secured debt has been discharged</li><li>• Effect of theory – should cedent / debtor be sequestrated, ceded claim will form part of the cessionary / creditor's estate (ownership had been transferred to such creditor)</li></ul>	<ul style="list-style-type: none"><li>• After the cession <i>in securitatem debiti</i>, the bare <i>dominium</i> (ownership) of the right ("reversionary interest") remains vested in the cedent / debtor</li><li>• The cession has effect of creating a limited security right (like a pledge) in favour of the cessionary / creditor</li><li>• No re-transfer of right once secured debt discharged - right of pledge falls away automatically</li><li>• Ceded personal right will form part of insolvent estate – cessionary / creditor will have a preference</li></ul> <p> Unless parties expressly structure their cession according to the out-and out theory, the default position will be the pledge theory</p>



# Landlord's legal hypothec

## Common law

- lessor of immovable property has a security right – tacit hypothec
- over movables brought onto the leased property (extends to subtenant and third parties)
- comes into existence when tenant falls behind with rent
- needs to be perfected

## Insolvency

- only secures outstanding rent – s 85 of the Insolvency Act
- hypothec covers movables only belonging to the tenant (insolvent debtor)
- automatic right of preference afforded to the landlord over all movables of insolvent debtor
- s 85 limits secured claim (see notes for limitations)
- rental after sequestration is cost of administration

# Right of retention

- Types of liens (rights of retention)
  - A debtor-creditor lien (*real right*)
  - Enrichment lien (salvage or storage and improvement liens) (*personal right*)
- Physical possession a prerequisite
- Ranking of rights of retention (where other security right)
  - Enrichment lean must be paid first
  - Debtor-creditor lien must be paid after holder of security

# Instalment agreement hypothec (s 84)

- Not listed in definition of "security" in s 2 of Insolvency Act but recognised separately in s 84(1) of Act
- Instalment agreement means a sale of movable property where:
  - all / part of purchase price deferred - paid periodically
  - possession / use transferred to consumer
  - ownership of property passes to consumer when agreement fully complied / passes to consumer immediately subject to right of credit provider to re-possess property if instalments not paid
  - interest, fees or other charges payable to credit provider
- Effect of s 84(1) upon sequestration:
  - Ownership of property will pass from seller (creditor) to debtor's insolvent estate
  - Seller endowed with hypothec - serves as security = secured creditor

# Special statutory rights

- These are created in other pieces of legislation and include:
  - Alienation of Land Act
  - Agricultural pledges and charges
  - Customs and excise lien
  - Municipal charges and embargo power

# Distribution of proceeds of security

## Encumbered asset account (separate account for each asset)

- Section 89(1) costs – cost of maintaining, conserving and realising property ie auction costs – insurance – security guards – amount payable for lease (if lease continued to store property in question)
- Claims treated as cost of realization:
  - Trustee's remuneration
  - Pro rata share of bond of security premium
  - Tax defined in s 89(5) – municipal property taxes (2 year period prior to sequestration)
  - Levies
  - Arrear interest to date of sequestration / interest on secured claim after sequestration
- If proceeds insufficient to cover costs, deficiency paid by proved secured creditors who would have been entitled (in priority to other person) to payment if the proceeds had been sufficient to pay the costs

# Example: proportionate share of cost of realization (Master's fee)

Gross value of assets in Account 1 = a

Gross value of assets in Account 2 = b

Gross value of assets in Account 3 = c

Total gross value = a + b + c = t

Total costs of Master's fee = m

	<b>Value of asset</b>	<b>Master's Fee</b>	<b>Formula</b>
Account 1	100,000.00 (a)	4,885.59 (m1)	$m \div t \times a = m1$
Account 2	220,000.00 (b)	10,748.31 (m2)	$m \div t \times a = m2$
Account 3	860,000.00 (c)	42,016.10 (m3)	$m \div t \times a = m3$
Total	1,180,000.00 (t)	57,650.00 (m)	Check $m1 + m2 + m3 = t$

# Application and distribution of the free residue

- Free residue – not subject to security right (includes balance of proceeds of security after payment of secured claim)
- s 96 – 103 of Insolvency Act provides for order of priority claim paid from free residue
  - s 96 – funeral and death bed expenses
  - s 97 – costs of sequestration
  - sheriff's charges (tariff A – second schedule to Act)
  - master's fees (third schedule to Act)
  - s 97 – cost of the application (taxed by Registrar)
  - remuneration of trustee
  - costs of administration and liquidation
  - costs to convene meetings
  - postages and petties (Chief Master's Directive 4 of 2016)
  - attorneys or counsel to perform legal work
  - taxation of legal costs

# Application and distribution of the free residue continued

- s 89 - costs of execution
- s 98A - amounts due to certain employees and funds
- s 98(A)(1)(a) - amounts due to employees
- s 98(A)(1)(b) - contribution to funds
- s 99 - certain statutory obligations
  - workmen's compensation
  - income tax
  - customs and excise tax
  - VAT
  - UIF
  - PAYE
- s 102 - general mortgage bonds
- s 103 - concurrent creditors



# Master's Fee - position from 1 January 2018

- No fee payable if gross value of asset is less than R5,000.
- If value is R5,000 or more but less than R50,000 - Master's fee = R250
- If gross value of estate is R50,000 or more but less than R150,000 - Master's fee = R1,000
- If gross value of estate is R150,000 or more, R1,000 is payable on first R150,000 - thereafter for each completed R5,000 further R275 is payable
- Maximum Master's fee - R275,000.

<b>Gross value of estate:</b>	<b>285,000.00</b>
Less:	1,000.00
	284,000.00
Divide by ZAR R5,000 (rounded down)	56
Therefore, 56 x R275 + R1,000	<b>R16,400.00</b>

# Remuneration of trustee – (s 63 of the Insolvency Act - according to Tariff B in the Second Schedule of the Act

Gross proceeds of movable property, book debts, rent, interest	10%
Gross proceeds of immovable property, shares or similar securities, life insurance policies, immovable property sold prior to sequestration	3%
<ul style="list-style-type: none"><li>• Money found in estate</li><li>• Gross proceeds of amounts standing to credit of insolvent in current savings and fixed deposits</li></ul>	1%
On sales by trustee in carrying on the business of the insolvent	6%
On amount distributed into composition	2%
On value at which movable property in respect of creditor with preferent right has taken over such creditor	5%
Minimum trustee's fee in terms of the tariff	R2,500

# Remuneration on valued added tax

## *Graham and Spendiff v The Master of the Supreme Court*

<b>Method 1</b>		
Selling price of movables		100,000.00
Vat at 15% on 100,000		15,000.00
10% trustee's fee on 100,000	10,000.00	
10% fee on VAT of 15,000.00	1,500.00	
	11,500.00	
Less reduction of 15% on 1,500	225.00	
	11,275.00	
Plus 15% input VAT on fee of 11,275	-1,691.25	
Total fee	12,966.25	

## Employee claims (s 98A)

• Any salary or wages, for a period not exceeding 3 months	R12,000
• Any payment in respect of any period of leave or holiday due to the employee in the year of insolvency or the previous year	R4,000
• Any payment due in respect of any other form of paid absence for a period not exceeding 3 months prior to the date of sequestration	R4,000
• Any severance or retrenchment pay due to the employee in terms of any law, agreement contract or wage-regulating measure	R12,000

# Remuneration on valued added tax (continued)

## *Graham and Spendiff v The Master of the Supreme Court*

<b>Method 2</b>		
Selling price of movables		100,000.00
Vat at 15% on 100,000		15,000.00
		115,000.00
Fee at 10%	11,500.00	
Less 15% (15,000)(10%)	-225.00	
Fee	11,275.00	
Vat thereon (@ 15%)	1,691.25	

# Contribution by creditors

- Where there is no free residue or free residue is insufficient to meet all expenses, certain creditors liable for contribution
- Proved creditors liable for contribution
- Applicant creditor, even if no claim proved, liable to contribute (s 14(3))
- Concurrent creditors are liable in proportion to the amount of proved claim
- Secured creditor liable in proportion to amount for which creditor would have ranked upon the surplus of the free residue (if there had been any) – only liable on concurrent portion – creditor did not rely on its security when proving claim