



USAID | **SOUTHERN AFRICA**
FROM THE AMERICAN PEOPLE

INSOLVENCY SYSTEMS IN SOUTH AFRICA

COMPARATIVE REVIEW OF EMPLOYEE CLAIMS TREATMENT

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FINANCIAL SECTOR PROGRAM

**INSOLVENCY SYSTEMS IN SOUTH AFRICA – COMPARATIVE
TREATMENT OF EMPLOYEE CLAIMS**

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ACRONYMS

ACTP	Association of Certified Turnaround Professionals
AIPSA	Association for Insolvency Practitioners in South Africa
Bill	Insolvency and Business Recovery Bill
BRP	Business Rescue Practitioner
CA	Companies Act
CAD	Canadian Dollar
CCA	Close Corporations Act
CCIL	Committee on Consumer Insolvency Law
CCRD	Consumer & Corporate Regulation Division
DDG	Deputy Director General
DOJ	Department of Justice and Constitutional Affairs
DTI	Department of Trade and Industry
EU	European Union
FSP	Financial Sector Program (USAID)
GSA	Government of South Africa
IA	Insolvency Act
IBRD	International Bank for Reconstruction and Development (World Bank)
ILO	International Labor Organization
IMF	International Monetary Fund
IP	Insolvency Practitioner
MJCD	[Minister] for Justice and Constitutional Development
NEDLAC	National Economic Development and Labor Council
OCM	Office of the Chief Master
ROSC	Regulatory Observance of Standards and Codes
SA	South Africa
SADC	Southern African Development Community
SALRC	South African Law Reform Commission
SME	Small and Medium Enterprise
UNCITRAL	United Nations Commission for International Trade Law
USAID	United States Agency for International Development
USD	United States Dollar

EXECUTIVE SUMMARY

The most valuable assets of a country are its employees. Economic progress and development often hinge upon the degree to which the citizens of a country can be gainfully employed on a sustainable basis. In an increasingly global economy, businesses face enormous competitive pressures to minimize costs and maximize returns often at the expense of domestic labor. And in times of economic crisis or decline, businesses frequently encounter financial distress or may become insolvent, raising issues about the treatment of employee claims in the insolvency of the employer.

In connection with a review of the insolvency law by the Government of South Africa, the issue has arisen as to what level of preference should be accorded worker claims in the context of an employer's insolvency, and how should such preference be treated relative to other secured or unsecured creditors. The question is multifaceted, as there are many types of claims that affect employees pertaining to outstanding wages, health and disability benefits, and longer term pension commitments. Decisions on these issues can be compounded where the pension fund has been either underfunded or inappropriately dissipated to keep the business operating, or in some cases where the value of the pension fund is predicated on stock contributions to the fund of the company's own stock, which has now become seriously devalued or worthless.

Employees and pensioners are placed in a unique category of creditors in the context of an employer's insolvency. They are not treated as arms-length creditors with whom the company has negotiated, nor are they equity holders with a vested interest in the company who have taken an inordinate risk in the operation of the business. Rather they are providing a service and have an interest in maintaining their job. As such, workers are particularly vulnerable when an enterprise fails, facing the prospects of job loss, loss of unpaid wages or benefits and future income, and in some cases loss or decline in value of their pension rights. Loss of benefits may also include health and disability benefits.

The International Labor Organization and the European Union have adopted conventions and passed legislation strongly supporting the payment of worker claims in the event of an employer's insolvency. International insolvency standards promulgated by the World Bank and others likewise acknowledge the vulnerable position held by employees and the need for careful consideration in balancing treatment of employee rights against the interests of other creditors.¹

At the same time, such policies must be balanced in a manner that maintains confidence in the commercial sector through greater enforceability of bargained for contractual and collateral rights so as to support access to finance. Accordingly, the vast majority of countries typically recognize and give effect to secured rights in an insolvency proceeding and relegate employee claims to a preferential position below secured and administrative claims. Some grant a preference over other general unsecured claims or particular classes of unsecured claims. A growing trend among countries, and the common approach adopted in the European Union, is to establish wage payment guarantee institutions to pay statutorily allowed wage claims of employees in the event of an employer's insolvency. These

¹ See Principle C12.4 of the World Bank, *Principles for Effective Insolvency and Creditor Rights Systems* (Rev'd 2005) [hereinafter "World Bank Principles"].

institutions assure a rapid payout to employees, rather than force them to wait until final administration of the case before receiving a distribution in respect of wage claims. South Africa's current treatment of employee claims relative to other creditors is largely consistent with international best practice, ranking employee claims after secured claims and administrative costs. The preference of such claims was elevated in recent amendments. What is lacking in the system, however, is a mechanism to a more immediate and more complete satisfaction of employee wage claims, such as through a wage guarantee or insurance fund.

SECTION 1: INTRODUCTION

The Financial Sector Program (FSP) supports the accomplishment of the U.S. Government's Economic Growth Objective in South Africa, as one of three main vehicles to promote vibrant growth of historically disadvantaged small and medium enterprises (SMEs) and reduce unemployment and poverty. The objectives of this program are to expand access to financial services and lower financing costs for SMEs by reforming the legal and regulatory framework affecting the financial sector and business environment and improving the commercial viability of lending to historically disadvantaged SMEs in South Africa with the goal of expanding SME access to a range of high quality and affordable financial services.

Government tabled the Insolvency and Business Recovery Bill (Bill) at National Economic Development and Labour Council (NEDLAC) in 2003, which was held back pending the development of modern business rescue provisions under a new companies act. The Department of Justice and Constitutional Development gave presentations on the Bill to the Labour Market Chamber on 28 July 2003 and 23 November 2006. NEDLAC raised questions concerning a number of issues in the draft Bill, including among others the priority in distributions to be accorded to employee claims relative to other creditors in an employer's insolvency. From 2007-2010, an inter-agency task team addressed issues and worked on a NEDLAC report and proposed recommendations for a new draft insolvency bill. A new draft bill is expected to be resubmitted to Cabinet in late 2011 or early 2012, which if approved will be tabled at NEDLAC for consideration.

In an effort to contribute to the ongoing dialogue on insolvency law reform, this paper examines some of the approaches currently adopted by different legal systems in order to protect employee entitlements in the event of an employer's insolvency. Section II addresses policy considerations related to the treatment and balancing of employee claims relative to the claims of other creditors and parties. Section III outlines the international position on employee claims treatment as addressed by the International Labor Organization, the European Union and international insolvency standards, while Section IV provides an overview of comparative experience among countries in treating employee claims, reflected in four primary models currently in use.² Section V identifies the current position in South Africa on treatment of worker claims. While not endorsing a particular model or approach on legal treatment of employee preferences in the context of insolvency, it offers some observations and strategies to balance policy interests while protecting worker claims in Section VI and provides some policy recommendations in Section VII on addressing these issues in the context of South Africa.

² Annex 1 contains a more detailed treatment of employee claims in bankruptcy on a country-by-country basis.

SECTION 2: POLICY CONSIDERATIONS

Employee entitlements clearly deserve special attention and raise numerous policy questions with regard to the treatment and balancing of creditor rights.³ The threshold questions addressed in this paper are how to ensure protection of employee claims in the context of an employer's insolvency and whether to grant employee claims preference over other administrative, secured or unsecured creditors. If policy makers grant a preference in favor of employees, what will be the impact on business environment where the increase in risk to trade creditors is passed on to the businesses in the form of higher priced goods and services, putting labor intensive businesses at risk and inadvertently hindering job creation? If the decision is not to grant a preference, what other options are there to protect what is perhaps the most vulnerable of stakeholders in the insolvency proceeding?

The answer to the question seems straight forward, but the approach chosen may have broader policy implications on lending incentives and disincentives, affecting general credit behavior of stakeholders whose claims are to be subordinated in an insolvency proceeding. This in turn will have repercussions on access to finance and the cost of credit for all businesses, not merely the statistically insignificant percentage (relative to the entire market) that file for bankruptcy.

Employees typically possess a contractual right to entitlements accrued under their work contracts, which as creditors places them in a category similar to other unsecured creditors who had bargained for rights that were unsatisfied. In legal terms of relative priority, worker entitlements and rights are contractually no different than those of other unsecured creditors holding contractual rights and claims to payment. Both groups of creditors are on an even legal footing to be paid from the general assets of the company, as distinct from the rights of secured creditors whose *in rem* rights entitle them to satisfaction from specific assets in the event of a default.

The difference for employees is that, unlike creditors, they have little bargaining power and probably less flexibility in the available options for compensation for their services. Employees generally begin and maintain their course of employment without information as to the precise economic condition of their employer.⁴ Even if such economic information was available or able to be understood by the staff member, under a standardized contract, there is little an employee can do to factor in the risk of insolvency. In the event that an employee does learn of the financial ill-being of his/her employer before a formal declaration of bankruptcy, that individual may still remain powerless, as job prospects and mobility tend to be limited. And in the event of the employer's insolvency, employees are generally the silent or lost voice, having little influence or bargaining power (outside the collective bargaining process) over the decisions made in a case. Yet, they stand to lose the most. Wages generally constitute a significant portion of employees' wealth, leaving them with few options to fall back on in the event of their employer's default.⁵ Moreover, the overwhelming majority of employees have not intentionally assumed the risk that their employer might fail to pay them.

³ The World Bank Principles support enforcement of the general preferences of creditors obtained prior to commencement of the proceeding, but add a principle calling for special recognition and treatment of labor claims. Principle C.12.4 provides: "Workers are a vital part of an enterprise and careful consideration should be given to balancing the rights of employees with those of other creditors."

⁴ Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 Am. Bankr. Inst. L. Rev. 5, 6 (1996).

⁵ *Id.*

By contrast, creditors can transfer or mitigate risk of non-payment in multiple ways, such as by factoring such defaults into their pricing or lending rates, require and obtain insurance for losses, and include other protective provisions in their contracts. Regular trade creditors also have access to financial and economic data on the debtor and can theoretically, if not realistically, set their terms of trade to reflect their assumed risk. So too, trade creditors will often have a variety of sources of income, whereas employees usually only work for a single organization.

The financial security of employees in the event of employer insolvency is an issue capable of having a far-reaching societal affect. Depending on training and location, employees may have limited job mobility and prospects. For employees whose pension benefits derive from the ongoing operations of the business or who are vested in the stock of the company (now worthless), there are valid concerns of practical security, especially for employees facing their retirement years. The insolvency of a company may cause workers to lose their retirement benefits, as frequently happens in the case of a liquidation of major companies (e.g. Enron), placing the employees at the mercy of taxpayer-sponsored state support and forcing them to extend their employment well into the retirement years.⁶

These broader issues, affecting employment rights and benefits, must be taken into consideration. Unemployment and insolvency are an even worse combination in the context of troubled economies or economies with high unemployment rates, such as South Africa. Developing and transition economies typically have weak social protection systems for unemployed workers, whose numbers spiral when companies in financial distress downsize their workforce to rationalize their costs. In systemically affected countries, there is a greater potential for social unrest.

Even if one concludes that employees are a vulnerable class of creditors deserving of protection and preferential treatment in an employer's insolvency, this does not suggest that workers' pre-commencement claims should be accorded a preference above all other claims, such as those of secured creditors or administrative (post-commencement) claims. To the contrary, international standards also underscore the fundamental importance of promoting greater certainty for financial claims that are secured so as to promote access to affordable credit for a wider segment of the business community. On this point, international standards support recognizing and enforcing priorities for secured creditors in their collateral, and ensuring that reasonable and necessary costs to administer the insolvency proceeding are paid ahead of general unsecured creditors (See discussion in section 3.3 below). As countries grapple to find a proper balance between protecting workers and promoting access to credit through a more predictable and enforceable set of contractual and collateral rights, policy makers and legislators have found innovative ways to balance the interests of both groups of creditors in a manner that is outcome positive. This is typically done through a combination of protective measures that may include a limited preference, employee guarantee payment funds, and protections pertaining to pensions and retirement funds.

⁶ Enron's collapse, the largest corporate insolvency in the United States until the insolvency of Lehman Brothers, put the spotlight again on employee entitlements in the event of corporate bankruptcy. The insolvency left over 4,500 staff unemployed globally with uncertain ability to access entitlements owed to them under their work contracts. Worse, employees and other investors who had invested their life's savings in Enron's stock and pension fund were left with nothing, while many of Enron's management and upper echelon walked away with large bonuses, severance packages or managed to sell their own Enron stock before the real collapse. A tragedy of epic proportion, it led to a number of regulatory reforms in the areas of corporate governance and accounting and auditing practices. See Sheila McNulty, *Enron Employees form Coalition*, Financial Times, January 20, 2002.

SECTION 3: INTERNATIONAL CONVENTIONS AND STANDARDS

3.1 International Labor Organization

As early as 1949, the International Labor Organization (“ILO”), whose members include all the countries discussed in this paper, produced a Protection of Wages Convention in which it addressed the effect of insolvency on workers’ wages.⁷ Article 11.1 states:

In the event of the bankruptcy or judicial liquidation of an undertaking, the workers employed therein shall be treated as privileged creditors either as regards wages due to them for service rendered during such a period prior to the bankruptcy or judicial liquidation as may be prescribed by national laws or regulations, or as regards wages up to a prescribed amount as may be determined by national laws or regulations.⁸

Nevertheless, Article 11.3 acknowledges that national laws and regulations are to determine *the relative priority of such debts*. If the workers’ claims are protected by a guarantee institution, however, they may be relegated to a lower privileged status. By giving individual nations the right to limit the privileged nature of employee claims to a certain extent, the ILO may have surrendered a degree of its leverage regarding the rights of workers.

In 1982, the ILO issued a Convention regarding the termination of employment.⁹ Part II, Article 11, requires that employers provide employees on the verge of unemployment with either reasonable notice of such termination or compensation for the lack of reasonable notice. The ILO also seeks strong and direct participation by the workers’ representatives in employment termination, particularly in light of major restructuring, downsizing or terminations due to employer insolvency.

3.2 European Union

In contrast to the ILO requirements, the European Union (“EU”) Directives are binding on members. In 1980, the Council of the European Communities issued a Directive regarding the protection of employees in the event of their employer’s insolvency.¹⁰ It was updated by the European Parliament in 2002¹¹ and again on 22 October 2008.¹² A main purpose of the Directive is to protect employees who have a claim for unpaid remuneration against an employer where formal insolvency proceedings have been opened or where the employer’s undertaking or business has been closed and its assets are insufficient to satisfy the claims. The Directive establishes a minimum degree of protection for employees and gives guidance on determining the liability of guarantee institutions.¹³ The 2008 Directive also clarifies

⁷ International Labor Organization, *C95 Protection of Wages Convention* (1949).

⁸ *Id.*

⁹ International Labor Organization, *C158 Termination of Employment Convention* (1982).

¹⁰ The Council of the European Communities, *Council Directive 80/987/EEC on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer* (1980).

¹¹ *Social Policy: European Parliament Backs New Insolvency Directive*, European Report (May 15, 2002).

¹² The Council of the European Communities, *Council Directive 2008/94/EC of the European Parliament and of the Council on the protection of employees in the event of the insolvency of their employer* (2008).

¹³ *Id.* at paras. (3) and (4) of preamble.

guarantee payment responsibilities when employees are located in several member states of the European Union.¹⁴

Chapter II, Article 3.1, of the EU Directive requires that guarantee institutions secure employees' outstanding pay claims relating to their employment or employment relationship, including severance pay or termination rights. Article 4.2 requires the minimum period of remuneration by the guarantee institution is calculated on the basis of either (i) payment of claims for at least three months during a minimum reference period of six months or (ii) payment of claims for at least eight weeks if the reference period is at least eighteen months. The Directive prefers those periods that are most favorable to the employee for the calculation. Member States may exercise an option to limit liability of and set ceilings on payments made by the guarantee institution, provided they inform the Commission of methods used to set the ceilings. EU states have adopted a variety of approaches, a number of which do not give the 18 month protection.¹⁵ Notably "assets of the institutions must be independent of the employers' operating capital and be inaccessible to proceedings for insolvency" and "employers must contribute to financing [these institutions], unless it is fully covered by the public authorities".¹⁶ The guarantee institutions' obligations to pay must not depend on whether employer contribution requirements have been satisfied.¹⁷

Council Directive 98/59/EC requires that any employer considering collective dismissals consult with workers' representatives first, with a goal of reaching an agreement and thereby curtailing the need for such measures.¹⁸

3.3 International Standards

International insolvency standards have been developed and endorsed through the efforts of the international community, primarily through the efforts of the World Bank in its broad-based but flexible Principles for Effective Insolvency and Creditor Rights Systems¹⁹ and the United Nations Commission for International Trade Law (UNCITRAL) in its Legislative Guide on Insolvency Law, which serves as a model law containing more detailed recommendations for insolvency laws.²⁰ The World Bank and UNCITRAL, in consultation with the International Monetary Fund, prepared a joint Insolvency and Creditor Rights Standard that combines both the Principles and the Recommendations in one document.²¹

World Bank Principles

¹⁴ Article 9 provides that where the insolvent employer operated in the territories of at least two Member States, the authority responsible for meeting claims is the one in the country where the employee habitually worked.

¹⁵ See Annex A containing a summary of comparative experience among countries.

¹⁶ Council Directive 2008/94/EC, Article 5.

¹⁷ *Id.*

¹⁸ Centre for Environmental Informatics, *Employment Protection* (1998).

¹⁹ After the Asian Financial Crisis, the World Bank led an initiative to develop global standards of best practice to benchmark the effectiveness of insolvency and creditor rights systems, considered fundamentally important in sustaining a country's financial sector, promoting reliable credit markets, and supporting attractive investment climates. The standards are contained in the World Bank's Principles for Effective Insolvency and Creditor Rights Systems (2005), which have been approved by the Bank's Board representing member countries, endorsed by the G-20, and included in the compendium of standards accepted by the Financial Stability Forum. The text of the World Bank Principles is available on the World Bank's website: <http://web.worldbank.org/gild>.

²⁰ The UNCITRAL Legislative Guide was completed in 2004 with the goal of encouraging the adoption of effective national corporate insolvency regimes. The Legislative Guide presents a detailed series of Legislative Recommendations ("Recommendations") combined with a discussion of various options and approaches for an insolvency law. The text of the Legislative Guide is available at <http://www.uncitral.org>.

²¹ The joint ICR Standard is available on the World Bank's website (see above).

The core principles addressing preferences among creditors and treatment of employee claims are located in Principle C.12 of the World Bank Principles dealing with Treatment of Stakeholder Rights and Priorities,²² as follows:

C12.1 The rights of creditors and the priorities of claims established prior to insolvency under commercial or other applicable laws should be upheld in an insolvency proceeding to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships. Deviations from this general rule should occur only where necessary to promote other compelling policies, such as the policy supporting reorganization or to maximize the insolvency estate's value. Rules of priority should enable creditors to manage credit efficiently, consistent with the following additional principles:

C12.2 The priority of secured creditors in their collateral should be upheld and, absent the secured creditor's consent, its interest in the collateral should not be subordinated to other priorities granted in the course of the insolvency proceeding. Distributions to secured creditors should be made as promptly as possible.

C12.3 Following distributions to secured creditors from their collateral and payment of claims related to costs and expenses of administration, proceeds available for distribution should be distributed *pari passu* to the remaining general unsecured creditors,⁷ unless there are compelling reasons to justify giving priority status to a particular class of claims. Public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum.

fn 7. Subject to any intercreditor agreements and contractual subordination provisions or where equitable subordination of a creditors claim may be appropriate.

C12.4 Workers are a vital part of an enterprise, and careful consideration should be given to balancing the rights of employees with those of other creditors.

World Bank commentary justifies the above priority (preference) scheme in favor of secured creditors by emphasizing the broader impact on public policies supporting access to credit and the need for certainty in secured transactions:

Secured transactions play an enormously important role in a well functioning market economy. Laws on secured credit mitigate lenders' risks of default and thereby increase the flow of capital and facilitate low cost financing. Discrepancies and uncertainties in the legal framework governing security interests are the main reasons for high costs and unavailability of credit, especially in developing countries.²³

Admittedly, in some countries unpaid wages, taxes and many other debts come ahead of a security interest in the distribution of the sale proceeds of assets subject to a security interest, with the result that the benefits of secured credit are unavailable. Comparative experience supports the view that any preference placed ahead of the secured party represents a substantial cost, which is generally transferred back to borrowers in the form of higher interest rates and transaction costs. Often the public policy represented by the preference (e.g.

²² The use of the term "priorities" should be read as interchangeable with the term "preferences" as used in South Africa.

²³ World Bank Principles, Executive Summary.

benefiting workers) receives a minor and occasional benefit at a substantial cost to the entire commercial system. Accordingly, the World Bank position supports the view that such preferences should be eliminated, reduced, and, where public policy concerns are compelling, addressed by other legal reforms that do not compromise the system for secured lending.

Following the enforcement of contractual rights in collateral, however, the World Bank acknowledges that there can be some room for adjusting preferences among unsecured claims, and that workers deserve special attention as “*a vital part of an enterprise, and careful consideration should be given to balancing the rights of employees with those of other creditors*” (emphasis added). In doing so, several important policies are worth underscoring. In liquidation, where the fate of the enterprise is terminal, a case for preserving jobs at the expense of a defunct enterprise cannot reasonably be made. The insolvency proceeding is generally viewed as a process of financial adjustment in the relationships among lenders and borrowers or creditors and debtors—a view that could be interpreted to overlook or marginalize the significance of employees and their rights.

As a class, workers fall between the extremes of shareholders or managers and lenders or creditors. There is typically an implicit commitment between workers and the firm. If the worker continues to work effectively, the firm will continue employment and pay wages commensurate with the employee’s abilities and efforts. This commitment is necessarily qualified: if the firm’s financial fortunes decline precipitously, the worker – as well as the firm’s shareholders – bear some of the risk. The commitment is typically not explicit, simply because it is impossible to write down all the relevant conditions. Many legal systems recognize these implicit commitments. Thus in insolvency proceedings a payment due to workers for work already performed is given preference over other unsecured creditors holding a priority or preference in payment.

UNCITRAL Legislative Guide

The Legislative Guide is less emphatic in respect of the priority for secured creditors, stating as follows:

[Recommendation 188] The insolvency law should specify that a secured claim should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor’s claim, the secured creditor may participate as an ordinary unsecured creditor.

[Recommendation 189] The insolvency law should specify that claims other than secured claims, are ranked in the following order:⁶⁵

- (a) Administrative costs and expenses;
- (b) Claims with priority;
- (c) Ordinary unsecured claims;
- (d) Deferred claims or claims subordinated under the law.

⁶⁵. The insolvency law may provide for further ranking of claims within each of the ranks set forth in paras. (a), (b) and (d). Where all creditors within a rank cannot be paid in full, the order of payment should reflect any further ranking specified in the insolvency law for claims of the same rank.

Unlike the World Bank Principles, the Legislative Guide does not take a specific position on the ranking or preference of worker claims. Acknowledging that some countries do not allow secured claims a first priority, and that in some cases they may be subordinated to other claims (including those for wages), or the law may provide for a carve-out from the secured creditor's collateral proceeds to ensure that other unsecured creditors receive some distribution on some notion of equity, the Guide's Commentary notes that:

The adoption of these types of exception to the rule of first priority of secured creditors has the potential to create uncertainty with respect to the recovery of secured credit, thus

discouraging the provision of secured credit and raising the associated costs. It is highly desirable that the use of such exceptions in an insolvency law be limited.²⁴

²⁴ UNCITRAL Legislative Guide, part two, chap. V, para. 64, pp. 269-70.

SECTION 4: COMPARATIVE EXPERIENCE

4 MODELS ON TREATMENT OF EMPLOYEE CLAIMS

Countries have adopted a variety of approaches in their efforts to protect employees in an employer’s insolvency. Most countries fit into one of four categories in terms of approaches, which can be summarized as follows: (1) Pro-employee Super-preference approach; (2) Bankruptcy Preference Approach; (3) Guarantee Fund Approach; and (4) Hybrid Approach: Bankruptcy Preference and Guarantee Fund. In fact, the first two categories can be said to be part of the same approach, except that the first grants preference even over secured and administrative claims, while the second affords a preference only over other types of unsecured claims. Even so, within the four categories there is wide variance in the amounts and types of claims allowable in the employee claims or that are given priority, with countries placing limits on maximum amounts, reference period for which claims are reimbursable, types of claims allowed, caps on the preference claims, ranking of preference claims, and the way in which claims are paid by guarantee funds or insurance schemes.

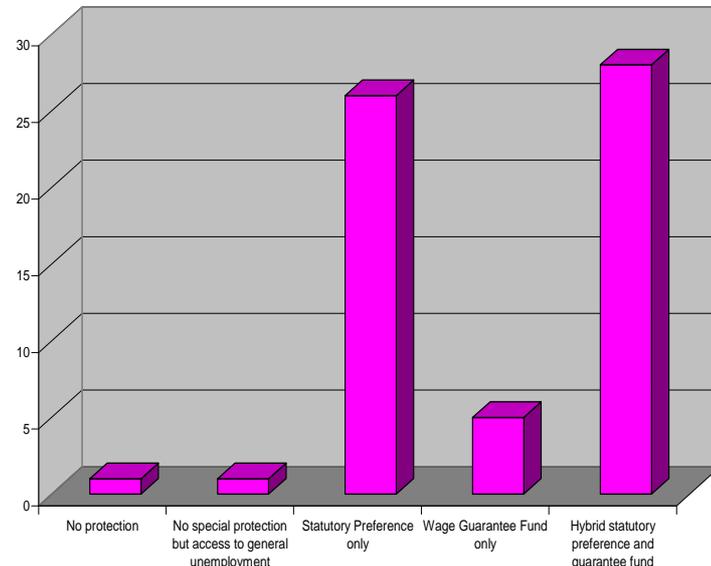
In one of the more comprehensive comparative studies conducted to date, Dr. Janis Sarra, University of Vancouver Faculty of Law, compares the treatment of employee and pension claims in an employer’s insolvency in 62 jurisdictions.²⁵ Dr. Sarra identifies three primary models, plus a hybrid model, which include granting a preference, super-preference, paying wage claim through a guarantee fund or hybrid systems that protect wage claims by combining more than one of these approaches. Graph 1 below depicts the breakdown in the protection types afforded

employee wage claims among the 62 countries in the study. As illustrated, 29 jurisdictions (47% of those surveyed) adopt a hybrid approach protecting employee wages and related claims through a combined statutory claim preference and utilizing a wage guarantee fund.²⁶ Of the total, 26 countries (42%) adopt a preference only regime, whereas five (8%) of reporting countries use only a wage guarantee fund. Notably, 89% of all jurisdictions provide some form of preferential

treatment for employee wage claims, while 55% of the 62 jurisdictions studied have a wage guarantee fund. Only two jurisdictions in the study, Estonia and the United Arab Emirates,

Graph 1

Treatment of Wage Claims in Insolvency



Source: Sarra Study, University of British Columbia Faculty of Law

²⁵ Sarra, J., *Treatment of Employee and Pension Claims during Company Insolvency (A Comparative Study of 62 Jurisdictions)*, presented at the Eighth Annual International Insolvency Conference, Humboldt University, Berlin, Germany, June 9-10, 2008 [hereinafter, “Sarra Study”].

²⁶ This should not be entirely surprising given the requirements under the EU Directive for establishing guarantee funds, although it is clearly not a pre-requisite to also extend a preference.

provide no special protection for employee wage and related claims during insolvency, although Estonia has a general unemployment insurance scheme that also addresses job loss on insolvency.²⁷ The United Arab Emirates, recorded here as no protection, does offer nationals some limited insurance as well.

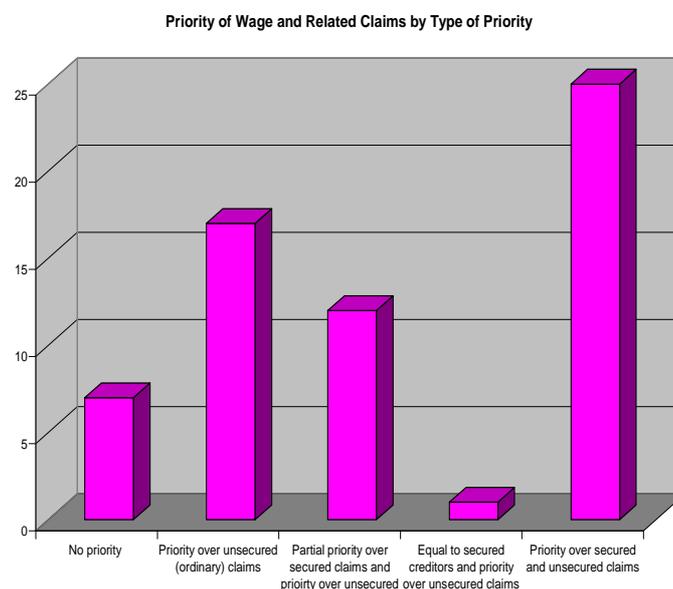
4.1 Model One: Pro-employee Super-preference Approach

A number of jurisdictions grant a super-preference in favor of wages and related claims over both secured and unsecured creditors' claims. This approach places strong public policy importance on employee protection, even at the risk of creating higher costs across the system for finance. Such a preference may create stronger incentives on senior secured lenders to more closely monitor the financial health of the company to ensure repayment of their claims.

In this category, countries such as Brazil, Chile, Colombia, Mexico, Indonesia and Malaysia grant employee claims an absolute priority, including over secured creditors, for a capped amount. In some cases, this amounts to a partial priority over secured claims, as in the case of Brazil, which changed from a full priority to a partial priority in adopting its new bankruptcy law in 2005. Under pressure from the credit markets and financial community, Brazil adopted a split priority, granting an absolute priority over all claims (including secured) for up to 150 minimum wages, equivalent to approximately USD 30,000, while relegating other portions of the employee claims to a lower priority below secured claims.²⁸

In the Sarra Study, an astonishing 25 (40%) of the 62 countries grant a super-priority for wage and related claims over both secured and unsecured assets, with most jurisdictions in this group reporting the policy rationale to be based on the unique vulnerability of employees at the point of enterprise insolvency. As Graph 2 reflects, the priority of wage preferences by type of priority for the 62 countries, an additional 12 countries (19%) grant a “partial priority” over secured claims, typically over floating charges, but not over mortgages or other security on real property. One country creates an equitable preference equal to secured claims. Thus, in total, 61% of the jurisdictions grant a full, partial or equal preference with respect to secured claims for employee wage and related compensation claims.

Graph 2



Source: Sarra Study, University of British Columbia Faculty of Law

²⁷ See Sarra Study, Estonian contribution by Andres Vinkel and Kuldar Kirt (2008).

²⁸ Federal Law 11101/05, Law of Restructuring and Insolvency; see also Dr. Sidnei Beniti, Brazil country contributor (2008) in Sarra Study.

Jurisdictions that provide for an absolute or split (restricted) priority typically place a higher value on satisfying employee claims on a preferential basis, while trying to cap or limit the claims in ways that are more predictable for the credit markets, enabling lenders to more precisely assess their risks based on the potential subordination of their claims.

One noteworthy example on a dramatic shift in policy is that of China, which maintained a cradle to grave rice bowl policy for employees, protecting their claims and rights above all other interests. Prior to 2006, under the bankruptcy law governing state-owned enterprises, employees enjoyed an absolute priority over secured creditors with a very pro-employee approach to staff redundancies, encompassing a compulsory unemployment insurance that went well beyond mere monetary compensation for entitlements owed, though not all workers were covered by it.²⁹ The cost burden for the insurance was carried by both employers and employees, providing for a priority in insolvency to cover outstanding entitlements, for employees to be paid up to 80 percent of the national minimum wage for up to two years. It also aimed to enhance the competitiveness and employability of the unemployed through training and job referrals in an attempt to speed their rejoining the workforce. These strong pro-employee protection measures were amended under the new 2006 bankruptcy law governing private commercial bankruptcy cases (although state-owned enterprises were to be subject to the law also after a phase in period). Under the new law, the super-preference for employees over secured creditors was reversed in deference to modern trends favoring certainty in secured transactions to promote greater access to finance, and hence economic growth.

Mexico is another example of a country that relies solely on a super-preference to protect employees, having no insurance scheme to cover unpaid wages in the bankruptcy.³⁰ Like a number of civil law systems, it awards first priority in bankruptcy to certain worker entitlements, such as payments of up to three months' wages in lieu of severance pay. The law has come under considerable criticism for furthering the old law's practice of favoring employees in a biased manner.³¹ There is a view that the preference over secured creditors' rights increases the risk in commercial relationships and cost of credit, without significantly enhancing the protection of workers' entitlements.

4.2 Model Two: Bankruptcy Preference Approach

In the second group are countries that have adopted a general preference for employee wages and related compensation, but which have no insurance or guarantee fund or other form of social safety net to compensate employees. These preferences rank below secured claims and administrative costs. Examples of countries in this category are Gibraltar, Chile, Jersey Channel Islands, China, Cayman Islands, Guatemala, Singapore, Nepal, Nigeria, and South Africa. As with the super-preference, the underlying rationale is to protect employees that are considered particularly vulnerable in an employer's insolvency.³²

²⁹ Vicky Lee, Research and Library Services Division, Legislative Council Secretariat, *Unemployment Insurance and Assistance Systems in Mainland China* 5 (2000). Austria also has adopted a sector specific training program financed by unemployment insurance, which has improved considerably the employment prospects for its participants. Rudolf Winter-Ebmer, the World Bank Group, *Long term Consequences of an Innovative Redundancy-Retraining Project: the Austrian Steel Foundation*, Social Protection Discussion Paper No. 0103, 01/2001.

³⁰ Dario U. Ocosco Coria & Ocosco Abogados, *The New Mexican Law on Commercial Insolvency* 4 (2001), available at http://www.iiiglobal.org/country/mexico/mex_insolv.pdf.

³¹ See Sheppard at 72 citing Ignacio Herrera et al., *Excelsior* (Mex.), December 11, 1999, available at <http://www.excelsior.com.mx/9912/991211/nac13.html>.

³² See Sarra Study at 9.

As noted above, even among countries granting a preference for employee claims, there is a wide range of treatment based generally on the *scope* (type of compensation), *amount* (based on monetary and time limitations) and *ranking* of the employee preference relative to other unsecured claims. Scope has to do with the type of claim, whether wages, vacation pay, severance, termination pay, accident compensation or other. Not all employee claims are

accorded priority. Those that are not, may be delegated to a lower ranking preference, or treated as general unsecured. In Brazil, for example, only wage claims are given preference, while unpaid leave/holiday, severance and termination have no preference.³³ In Greece, however, vacation, severance, termination and travelling/other expenses are included in the preference, because such amounts are included in the definition of “wages”.³⁴

Similarly, the amount of the wage preference claim is often limited in the amount given a preference, capped either by the monetary allowance or by the reference period of time for which an employee can claim unpaid wages and related claims. Amounts vary considerably from country to country. In the United States, an employee is entitled to a preference for wage claims up to approximately USD 10,950³⁵ and for employment benefits up to the same amount.³⁶ Wage and benefit claims arising post-commencement are treated as administrative claims with priority over pre-commencement claims.³⁷ The US has no guarantee fund or insurance scheme to protect wages. The US approach has been criticized as faring poorly on workers entitlement protection by international comparisons, due to its pro debtor stance and relegation of certain worker entitlements to third priority status within the unsecured creditor class.³⁸ In the US, however, these priorities must be counterbalanced by special provisions for the treatment of collective bargaining agreements and handling of insurance benefits for retired employees.³⁹

In Canada, by comparison, the allowed wage preference is capped at CAD 2,000, with another CAD 1,000 being allowed for expenses of travelling salespeople, relating to the six months immediately preceding the bankruptcy.⁴⁰ An example of a system that clouds predictability by the retention of complicated priority structures is Australia’s, which delineates no less than fourteen claims that have priority over regular creditors in the unsecured creditors class.⁴¹

And as with scope and amounts, countries vary considerable in their ranking of preferences. In addition to the broad categories illustrated in Graph 2 above, the Sarra Study identified at least 7 categories of variations in the treatment of preference rankings among the 62 countries in the study, as follows:

- **Absolute priority** - including over secured creditors, for a capped amount (e.g. Brazil, Chile, Colombia, Malaysia);

³³ See Sarra Study, Brazil country report by Dr. Sidnei Beniti (2008).

³⁴ See Sarra Study, Greece country report by Georgios B. Bazinas (2008).

³⁵ 11 U.S.C. section 507(a)(4).

³⁶ 11 U.S.C. section 507(a)(5).

³⁷ 11 U.S.C. section 507(a)(2).

³⁸ Richard A. Posthuma et al., *Labor and Employment Laws in Mexico and the United States: An International Comparison*, Labor Law Journal 20 (2000).

³⁹ See US Bankruptcy Code sections 1113 and 1114.

⁴⁰ Section 136, *Bankruptcy and Insolvency Act (BIA)*. Note that the status of the claims of employees will change when the statutes amending the *Bankruptcy and Insolvency Act* are proclaimed in force, likely in 2008.

⁴¹ Australian Commonwealth Corporations Act 2001.

- **Restricted absolute priority** - secured creditors and employees paid preferentially only for a percentage of assets (e.g. Czech Republic);
- **Split priority** - distinguishing types of employees in ranking (e.g. India);
- **Priority as a cost of bankruptcy** - with first priority as part of costs of administration (e.g. Slovenia);
- **Priority after secured creditors but prior to floating security creditors** (e.g. Australia, Ghana, Israel, Slovakia);
- **Priority by time frame** (e.g. France, with different priorities for different time frames);
- **Priority over unsecured creditors** – (e.g. Austria, Hungary, Japan, Norway, Thailand, and Switzerland).

4.3 Model Three: Guarantee Fund Approach

The guarantee fund approach is one of the most commonly adopted solutions to protect employee wage or compensation claims, generally in combination with a preference, but in some cases with no preference. Those that rely solely on the guarantee do not adopt a preference scheme (e.g. Germany and Finland). The primary rationale behind the guarantee fund is that it provides for prompt payment to workers at a point when they are most vulnerable and in need of the funds, and allocate the risk of insolvency for such claims on the business sector or state or a combination of both. This is a much more effective solution for employees that requiring them to wait to the end of the liquidation proceeding, which can take years.

The German model treats all unsecured creditors, including employees, the same and accordingly allows all of them equal access to the remaining available assets of an insolvent enterprise. Worker entitlements not satisfied through bankruptcy are paid out of a national insolvency fund.⁴² The only exception to this flat priority structure is the creation of a social welfare plan for those who face severe disadvantages due to their employer's insolvency. Employees under the welfare plan are then awarded first priority in insolvency, albeit with a limitation to one third of all assets, thereby ensuring greater clarity and, consequently, greater creditor confidence in the process.

4.4 Model Four: Hybrid Bankruptcy Preference and Guarantee Fund Approach

Most developed countries use a hybrid system that gives workers' predetermined entitlements some priority in bankruptcy, but also provides unemployment insurance in acknowledgement that often the remaining assets will be insufficient to cover outstanding entitlements. Examples of hybrid systems can be found in Italy, Japan, France, Korea, Cyprus, Thailand, Spain, and Denmark. As with the other models, the policy rationale to provide maximum protection for employees and create incentives for director and officer conduct in the period leading up to the business enterprise entering insolvency proceedings.⁴³ By way of example, the Danish system gives the highest priority among unsecured creditors to claims for salaries, wages and other employee benefits (behind administrative costs), with a Guarantee Fund as a safety net, should the assets prove to be insufficient.⁴⁴

⁴² German Federal Parliament, *Insolvenzordnung (InsO)* (1999).

⁴³ Sarra Study at 10.

⁴⁴ EMIRE, *Denmark: Employees' Pay Guarantee Fund*, at <http://www.eurofound.ie/emire/DENMARK/EMPLOYEESPAYGUARANTEEFUNDDN.html>.

SECTION 5: SOUTH AFRICAN TREATMENT OF EMPLOYEE CLAIMS

A main objective of the Southern African Development Community's (SADC) Treaty is "to promote sustainable and equitable economic growth and socio-economic development through deeper cooperation and integration", including promoting social security, freedom of collective bargaining and gender equality, and the promotion of workplace democracy.⁴⁵

A cornerstone of South Africa's economic policy focuses on employment for previously disenfranchised persons and job creation for the unemployed, estimated at around 24%. The Government hopes to reduce unemployment figures to 15% by 2020, creating jobs for an additional 5 million workers. While much focus is given to creating jobs, one cannot lose sight of the need to preserve existing jobs through business rescue and to adequately protect the claims of workers for insolvent companies. This chapter summarizes the current treatment of employee claims in the context of an employer's insolvency.

5.1 General Treatment of Claims

South African law contains reasonably clear and comprehensive provisions on preferences and distributions, which for the most part comply with international good practices, with some deviations. Pre-commencement rights of creditors are generally enforced in an insolvency proceeding, contributing to greater certainty and predictability in the enforcement of such rights.⁴⁶

Treatment of Secured Creditors

As with most laws, rules governing the treatment of secured rights can be complex and multifaceted depending on the nature of the secured rights, and whether the creditor is claiming under a true security interest, installment agreement,⁴⁷ retention of title,⁴⁸ right of reclamation,⁴⁹ or other form, and depending on whether the assets involved are movable or immovable. Most such rights will be subject to different rules of perfection.

Although a secured creditor is generally protected and given a first priority in its collateral, its rights are subordinate to satisfying administrative costs pertaining to the sale and the creditor

⁴⁵ SADC Treaty, Article 5. The treaty was signed on 17 August 1992 in Windhoek, Namibia, and amended on 14 August 2001.

⁴⁶ The Companies Act of 1973 and the new business rescue procedure contained in the Companies Act of 2008 also contain provisions that must be consulted to determine treatment of claims under the specific type of proceeding. For example, in a business rescue procedure, secured creditors are precluded from enforcing their rights due to a general moratorium on legal proceedings against the company, absent written consent of the business rescue practitioner, leave of court and subject to any terms the court deems suitable. See Companies Act 2008, section 133; see also section 150(2)(b)(i) requiring the plan to specify the duration of the moratorium.

⁴⁷ Sequestration of a debtor's estate automatically creates a statutory hypothec in favour of a creditor that sold goods under an instalment agreement, notwithstanding a pre-commencement contractual ownership interest in the goods. Insolvency Act 24 of 1936 (hereinafter, "IA"), section 84(1).

⁴⁸ Reservation of title clauses are treated as giving rise to security interests in favour of a creditor, rather than treating the assets as being excluded from estate.

⁴⁹ Such as where the debtor contracted to purchase "movable" property, but failed to pay the credit at the time of the commencement of the insolvency proceeding. In such case, the creditor is entitled to reclaim the property within ten days of delivery. IA section 36(1). In other words, the property is temporarily excluded from the estate.

has a limited period of time following the commencement of a proceeding in which to exercise its enforcement rights; failure to do so results in the collateral becoming part of the estate for administration and disposition by the liquidator.⁵⁰ Other secured assets can be taken over by the liquidator at an agreed value within seven days, absent which the secured may realize such collateral directly.⁵¹ Marketable securities in the secured creditor's possession can also be realized directly following the requisite notice.⁵² In addition to an unduly short period of time to realize collateral, the law also deviates from best practice by requiring the secured creditor to turnover sales proceeds from collateral sold to the liquidator or Master, with its claim to be satisfied only after confirmation of the liquidation account, although in practice the liquidator generally makes an advance distribution toward satisfaction of the claim.⁵³ When secured assets are sold by the liquidator, the secured creditor is paid from the net sales proceeds (after deducting disposition costs and applicable taxes).⁵⁴ The secured creditor may participate as an unsecured creditor for any deficiency amount in the satisfaction of its claim, unless the claim is a non-recourse claim to be satisfied only from the collateral.⁵⁵

Distribution of the estate

The free residue of the estate from which claims are satisfied is constituted from any surplus proceeds after paying secured creditors and funds derived from the realization of the unencumbered assets.⁵⁶ Following preparation and confirmation of the liquidation account, detailing all receipts and payments and establishing a plan for the distribution of the estate,⁵⁷ distributions are made in the following order:

- Liquidation costs;⁵⁸
- Execution costs against the estate;⁵⁹
- Employee entitlements;⁶⁰
- Certain statutory obligations;⁶¹
- Government tax claims;⁶²
- Preferences under a general mortgage bond; and
- Concurrent or general unsecured creditors.⁶³

Where the free residue is insufficient to satisfy all claims, distributions are made in the order of priority on a *pari passu* basis amongst creditors in a particular class, with each preferential

⁵⁰ IA section 83(6).

⁵¹ IA section 83(3).

⁵² IA section 83(2).

⁵³ IA section 83(10).

⁵⁴ IA sections 89 and 95.

⁵⁵ IA section 83(12).

⁵⁶ Stander, L., "Secured claims in insolvency and the order of preference among creditors secured by the same property" 2000 TSAR 542.

⁵⁷ CA73 section 408. In the case of an insolvent individual, and where applicable, it may be necessary to pay first the funeral expenses of the debtor.

⁵⁸ IA section 97.

⁵⁹ IA section 98

⁶⁰ IA section 98A, as inserted by the Judicial Matters Second Amendment Act 122 of 1998, section 2. The priority of workers' wages is limited to three months' salary.

⁶¹ IA section 99.

⁶² IA section 101.

⁶³ IA section 102.

class of creditors being satisfied in full before moving to the next. Where assets are insufficient to pay all claims in a given class, the funds are distributed on a *pro rata* basis.⁶⁴

5.2 Treatment of Employee Claims

Pre-liquidation claims of employees include claims for unpaid wages, bonuses and other benefits. The law establishes a statutory preference for such claims (relative to other unsecured claims) up to a statutorily allowed amount equivalent to three months' salary.⁶⁵ Amounts over and above the prescribed limit are accorded the same preference and participate in distributions as a general unsecured claim. Other types of claims typically included in the preference, include payments due in respect of: (i) accrued leave or holiday in the year of or prior to date of sequestration; (ii) paid absence of not more than 3 months prior to the date of sequestration; (iii) severance or retrenchment pay; and (iv) contributions to any pension, provident, medical aid, sick pay, holiday, unemployment or training scheme or fund, or to any similar scheme or fund.

Employees also receive preferential treatment under the new business rescue procedure (Ch. 6, Companies Act of 2008), for post-commencement unpaid wages over all claims in the event of a liquidation. Thus, if the business rescue fails and the company ends up in liquidation, the new procedure entitles employees to be paid before all other claims for post-commencement unpaid wages. This particular treatment has come under criticism by some stakeholders in the area as creating a disincentive to the lending of new money to financially troubled businesses, making the demise of the business all the more likely. The new business rescue process also extends stronger rights to employees with respect to treatment of employee contracts and in connection with employee representation in the proceeding, where employees are regarded as a special class of stakeholder who may form a special committee.⁶⁶

Reform issues: One of the topics debated by labor and business constituencies in connection with an updating of the insolvency laws is whether to grant workers a higher preference in the context of an insolvency proceeding, including preference over the rights of secured creditors. Such a policy could undermine other equally important policies of the government to support economic growth and jobs creation by promoting greater access to credit at affordable rates for a larger segment of the business community. Such access to finance and growth would in turn fuel the creation of new jobs. Accordingly, policies should be balanced in a manner that achieves both objectives of creating jobs through access to finance and protecting worker rights. The examples cited in this paper suggest that both are possible and have been achieved in other jurisdictions.

⁶⁴ IA section 103.

⁶⁵ IA section 98A.

⁶⁶ Companies Act 71 of 2008, sections 135, 136 and 144.

SECTION 6: STRATEGIES TO PROTECT EMPLOYEE CLAIMS

The concept of an entitlement insurance protection scheme has been widely adopted throughout the developed world, and would appear to offer the most protection for worker entitlements while not interfering with the efficient distribution of credit in the market. What follows is a discussion of some elements to be considered in the construction of an insolvency social protection system.

6.1 Bankruptcy Preference for Workers

The approach adopted should properly balance policies that promote commercial confidence with those that support social protection measures. As discussed in section 3.3 of the paper, Principle C.12 of the World Bank's Principles addresses claims resolution in terms of the treatment of stakeholder rights and priorities.⁶⁷ It states that insolvency and creditor rights systems, through commercial laws, should both preserve the legitimate expectations of creditors and, most importantly, encourage greater predictability in commercial relationships by upholding, to the maximum extent possible, the relative priorities of creditors established prior to insolvency.⁶⁸ The easiest way to ensure this is to have a "flat" hierarchy of priorities, which only consists of two levels: first, secured creditors maintain recognized priority in their collateral; second, following satisfaction of administration costs, the remaining proceeds are to be distributed equally among the remaining creditors.⁶⁹ The World Bank Principle states that there should be few if any deviations from this general rule, and these rules of priority should encourage creditors to manage credit effectively.

While the global standards aim for a proper balance among claimants to promote certainty in commercial relationships, even the World Bank recognizes that compelling circumstances can exist for treating employee claims differently. In emerging markets and developing countries, where private sector growth is imperative to ensure economic and social prosperity, ready access of private enterprises to credit at reasonable terms is paramount. The more predictable and transparent the insolvency process, and the greater the chance of retrieving collateral effectively in the event of bankruptcy, the more willing lenders typically will be to lend at rates that reflect lower risk premiums. This is not to diminish the importance of employee entitlements, but rather to reorient solutions for satisfying such claims to more efficient methods while preserving a strong, predictable financing market.⁷⁰ Thus, as a general rule, any preference for employee claims should be subject in the first instance to satisfying secured claims, and covering the costs of administration. Thereafter, workers may be granted a preference relative to other general or preferential unsecured claimants, which is the current treatment under South African law.

⁶⁷ See World Bank Principle C12.

⁶⁸ *Id.*

⁶⁹ The priority of administration costs over general unsecured creditors reflects the view that the administrator's efforts in selling assets inures mainly to the benefit of this class, and consequently should be borne evenly by allowing these expenses to be paid first. This general rule recognizes exceptions where secured creditors gain a benefit from having the administrator maintain and dispose of secured assets, which might be surcharged for the activities associated with the effort to sale such assets. Other rules may also come into play, such as whether the administrator's fees are actual, reasonable and resulted in a benefit to the estate.

⁷⁰ It goes without saying that the same logic applies to preference for public debt, which can also distort expectations in commercial relationships by allocating a firm's insolvency risks to the general creditors. Notably, in its 2002 reforms to the insolvency law, the United Kingdom reclassified outstanding payments to the Inland Revenue Service as general "unsecured" debts. See section 251 of United Kingdom Enterprise Act 2002.

6.2 Insurance Funds

One way to ensure the payment of employee entitlements, while maintaining market confidence, is through an insurance fund. Insurance funds can reduce the burden of the unemployed on the state for interim social protection, although they would not entirely displace the necessity of providing protection for purposes of unemployment, retraining and other needs. On an economic level, an insurance fund may provide a higher degree of reliability to the markets, while at the same time affording stronger protection to employees to fulfill social objectives. Of the four models examined above, clearly the most effective are those that establish a guarantee fund as a backstop to the payment of employee claims in bankruptcy. Notably, the SA Law Reform Commission has recommended this solution as one way to enhance protection of employee claims

The guarantee fund models typically rely on a “bankruptcy payment first” concept that requires employees to wait for a period of time (in some cases, months or even years) before they can top up the shortfall in their recovery from the guarantee fund. Many employees and their families can be left destitute while they await the accrued entitlements they are owed. This hardship can be magnified if there is a lengthy delay for payment on back wages and claims. Rather than forcing employees to linger during a potentially drawn out liquidation process, where assets have to be identified, realized and distributed, consideration should be given to establishing an immediate right of payment from the insurance or guarantee fund to settle worker claims up front.⁷¹ Upon satisfaction of the claims, the guarantee fund would be subrogated to the employee’s claims against the debtor to recoup any distributions to which the workers would be entitled. For example, if an employer in Belgium is unable to pay entitlements within fifteen days of the close of the business, the ‘Fund for Closures’ immediately commences payment on its behalf.⁷²

Critics of insurance funds claim that they are expensive to run, punish successful companies, and benefit only certain employees.⁷³ All of these accusations are difficult to substantiate empirically, however, as a pure entitlement insurance fund system does not appear to have been comprehensively tested as yet. Although there may be greater cost burdens for business, the burden of the risk of insolvency would appear to be better carried through an insurance fund system prior to insolvency rather than the employees (or the general creditors) afterwards. Shifting the risk to the business and taxpayers in protecting employees is more consistent with the responsibilities and obligations assumed by the debtor and the state.

There are a number of ways in which a country considering such a system can attempt to reduce the cost burden to business. The existing forms of insurance already used widely throughout the developed world, albeit usually in a hybrid system that requires some alteration to be made to the order of priority in bankruptcy, is a good example of this. Some countries may require compulsory insurance through a government-run commission, while other countries require companies to have private insurance to cover worker entitlements in the case of bankruptcy. Still others require contributions by employees, although some question remains as to whether the workers themselves are best placed to bear these costs.

⁷¹ This assumes a claims resolution process either in bankruptcy or through another administrative procedure that would be dispositive of employee claims.

⁷² EMIRE, *Belgium: Notice*, at <http://www.eurofound.ie/emire/BELGIUM/NOTICE-BE.html>.

⁷³ See, e.g., New Zealand Ministry of Economic Development, *Employee-Related Claims*, 2002, <http://www.med.govt.nz/ri/insolvency/tierone/priority/priority-06.html>.

Another alternative used by many countries to minimize the cost of such a scheme to business, and particularly to small business, is by limiting compulsory insurance to only those companies with a predetermined minimum number of employees, e.g., businesses larger than 20 employees. Another option still is to limit the size of the payout either to a predetermined amount or to a percentage of entitlements owed. In Italy, for instance, an employee can only recover up to 80 percent of entitlements owing.⁷⁴ Belgium restricts compulsory insurance to the for-profit sector. However, this creates uncertainty as to the security of entitlement payouts for employees in the non-profit sector.

Another option assumed by states attempting to reduce the cost burden of entitlement payouts is by limiting the types of entitlements that employees can claim. Some states expressly exclude outstanding holiday pay from priority payments, while others use a combination of included/excluded entitlements, such as commissions, outstanding sick leave, and maternity leave. The availability and level of severance pay also varies widely.

Employees should be able to expect a base level of entitlements in the advent of an employer's insolvency. In Part II, Article 12, the ILO clarifies what entitlements workers should expect upon termination of employment.⁷⁵ They include a *severance allowance or separation benefits based upon length of service and amount of wages to be paid by the employer directly or by an employer contribution fund*, as well as *unemployment insurance or social security*. Part II, Article 6, stipulates that the privilege protection shall include:

- workers' claims for wages for a *period of three months or more* prior to the insolvency or termination of employment,
- workers' claims for *holiday pay* due as a result of work performed that year and the year before,
- workers' claims for amounts due for other types of *paid absences dating three months or more* before the insolvency or termination, and
- *severance pay* due to workers upon the termination of their employment.

Some countries do not have worker entitlement insurance that covers some or all of an employee's unpaid wages or retirement claims. In times of crisis, the absence of such "safety nets" may create additional hurdles to recovery and may need to be supplemented with an economic stimulus package as opposed to immediate satisfaction of back claims. The absence of social safety nets or adequate programs where claims are not likely to be covered in a bankruptcy by the available assets makes for a high wire act of rectifying the past or building for the future. Countries with more scarce resources would no doubt find little justification to follow the path to the past.

Notwithstanding the above, an ideal employee entitlement insurance system would allow for the prompt repayment of 100% of worker entitlements owing. But in the initial stages of building this fund from scratch to a point where it could withstand a major insolvency may take considerable time. To overcome this problem, one solution may be the Australian model, which consists of a temporary government fund designed to cover entitlement payouts until

⁷⁴ EMIRE, *Italy: Wages Guarantee Fund (CIG)*, at <http://www.eurofound.eu.int/emire/ITALY/WAGESGUARANTEEFUNDICIG-IT.html>.

⁷⁵ International Labor Organization, *C173 Protection of Workers Claims (Employer's Insolvency) Convention* (1992), at <http://ilolex.ilo.ch:1567/cgi-lex/convde.pl?C173>.

the newly implemented insurance system has built sufficient capital to operate in its own right.⁷⁶

A major consideration of any insurance system is what form of corporate governance it will possess. Ideally, it would be administered entirely by the private sector, but this may be unrealistic in countries with undeveloped financial markets. If it were to be controlled by a state – and indeed in many countries, the social security administration may be best placed to operate such a fund – there would nonetheless need to be very tight controls in place to ensure that such a fund was free from corruption and accounted for individually, so profits did not simply become consolidated government revenue. The box below illustrates how the French have approached the worker guarantee payment fund.

FRANCE WORKER GUARANTEE PAYMENT SYSTEM⁷⁷

Workers' claims are granted by a super-priority and a general privilege.

- The super-priority for workers' claims is allowed in an amount covering up to 2 months of unpaid wages prior to opening of insolvency proceedings, while the maximum privilege allows unpaid wages up to 6 months during the same period.
- The sums due for salaries have to be paid from the first incomes received by the company if it continues to operate during proceedings. If not, all unpaid wages in the above amounts (2 and 6 months, respectively) are paid by a mutual fund, the "*Association pour la gestion du régime d'assurance des créances des salariés*" ("**AGS**"), which is funded by all "in bonis" companies and traders: their contribution (of 0.35 % in 2003) is determined on the basis of all salaries of the company.
- All workers and all claims in relation to labor contracts are covered by the insurance body, even if the employer does not pay its debts to this regime in due time.

Workers have not to lodge their claims with the liquidator.

- Prior to filing with the AGS, wage claims are first checked by the insolvency practitioner ("*représentant des créanciers*" or liquidator) and by the judge, who may deny its obligations as to the requested sums.
- AGS also pays amounts due in cases where the liquidator is dismissed (liquidator fees?).
- In case of a reorganisation plan, workers' claims are not submitted to the postponements and are to be paid without delay.

For funds provided to workers, AGS is granted by the above mentioned super-priority, but not by the general privilege, for which its claims are submitted to any moratorium included in a plan.

- If the company owns assets subject to sale, debts of workers and AGS are paid from the proceeds before secured claims of banks and suppliers.
- Other general privileges also enjoy a higher priority (e.g. taxes and administration costs).
- "Fresh money" and the sums incurred or due in relation to pending contracts are also afforded a legal priority over secured and unsecured pre-petition debts.
- In liquidation proceedings, which constitute 90% of cases, secured claims are paid ahead of general privilege claims, except for taxes and administration costs.
- AGS is partially reimbursed about 1/3 of the funds paid to employees in respect of salaries. This entails modifications of contributions decided every year.
- Recent amendments to the reorganization act did not materially impact these provisions.

⁷⁶ Australian Workplace, *General Employee Entitlements and Redundancy Scheme (GEERS)*, at http://www.workplace.gov.au/Workplace/WPDisplay/0,1251_a3%253D3649%2526a0%253D0%2526a1%253D517%2526a2%253D623,00.html.

⁷⁷ Texts are available on the official website of www.legifrance.fr, under "Codes", in an English version. Texts addressing these issues are mentioned under "Code de commerce", art. L 621-125 to art. L 621-32 and "Code du travail", art. L 143-10 to L 143-13-11.

6.3 Other considerations

In addition to the foregoing considerations, the role of outstanding contributions to pension/superannuation schemes is one that raises a number of issues affecting employees. This raises issues for employees who are left with a savings portfolio that consists either of currently worthless stock in their former employer, or an employer-administered pension plan which is now subject to liquidation. Consequently, a country looking to implement an insurance scheme would need to consider whether such a scheme should be obliged to cover outstanding payments to pension funds, or whether this would be considered too great a cost burden.

In addition, while not addressed in detail above, many countries also provide a substantial role for worker unions in determining the most appropriate way to deal with mass redundancies and ensuing worker entitlements. There remains room for further discussion as to how a collective bargaining insolvency agreement would affect the order of creditor priority and, indeed, whether they would be necessary under an insurance scheme such as the one proposed above.

Other specific issues worthy of consideration in a law relating to employee entitlements is the place of victims of work-related injuries who perhaps stand to lose the most in countries without well-developed social protection systems if the former employer becomes insolvent. Brazil⁷⁸ and, to a lesser extent, Australia⁷⁹ have made specific provisions for compensation to injured workers to be given higher priority in bankruptcy.

Chapter III, Article 8, of the Council of the European Communities Directive 2008/94/EC seeks to protect the rights of employees who left a business before its insolvency and had maintained rights with regard to old-age benefits in company pension schemes outside the national statutory social security schemes.⁸⁰

⁷⁸ Felsberg e Associados, Global Insolvency Law Database, *Insolvency Overview: Brazil* 24 (2000), available at www.worldbank/gild.

⁷⁹ Section 566(f), Australian Commonwealth Corporations Act 2001, available at <http://scaleplus.law.gov.au/>.

⁸⁰ The Council of the European Communities, *Council Directive 2008/94/EC of the European Parliament and of the Council on the protection of employees in the event of the insolvency of their employer* (2008).

SECTION 7: POLICY RECOMMENDATIONS

Currently there does not seem to be a perfect legal scheme for handling employee entitlements in the event of employer insolvency. Some are clearly more effective than others. Each of the schemes examined in this paper are flawed in certain ways, as 100 percent of employee entitlements are never fully protected or predictability for creditors is decreased. Employees in insolvency proceedings tend to be treated as neither “fish nor fowl” – neither creditors nor equity – with no vested financial stake in the bankrupt entity (outside of employee stock option plans). Yet, employees universally have the most to lose, as their families’ livelihood generally depends upon the wages and benefits for work performed.

Families around the developing world are frequently living on the edge of survival or hand-to-mouth, making the consequences of unemployment even more burdensome for them and the state. Additionally, employees are generally not privy to the exact financial status of their employers, so employees may be unprepared for bad news. As perhaps the most vital part of businesses everywhere, the common employee deserves to have legal protection of his/her employment claims.

This paper does not intend to suggest that an entitlement insurance fund is a cure-all in times of large corporate redundancies. Clearly such a system needs to be supported by active labor market programs, such as retraining, job search assistance and public works programs. Insurance or guarantee fund systems could significantly increase the potential for employees to realize their entitlements while minimizing the insolvency risks for other commercial stakeholders and providers of credit and goods. Based on the foregoing discussions, the following policy recommendations are suggested for consideration in the context of South African insolvency law reform.

- The distributional preference in favor of worker claims should be maintained at its current level, payable after satisfying (1) secured claims from their collateral and (2) reasonable and necessary administrative costs. Such claims may be paid ahead of other general unsecured claims, including those of public debts.
- Thresholds for repayment of worker claims should be matched to international practice, entitling workers to claim unpaid wages (inclusive of leave, holiday, absences and severance) for up to 3 months or more.
 - Thresholds may be pegged to earning status, so as to avoid exhausting bankruptcy estate funds on highly paid management and employees at the expense of adequately compensating vulnerable employees.
 - High thresholds that are likely to exhaust the bankruptcy estate and place the entire risk of insolvency on general unsecured creditors will likely have a wider adverse impact on the business environment through higher pricing and costing of contracts generally.
 - Payment preferences might also be incorporated into a guarantee fund or insurance scheme, enabling the insurer to subrogate to the rights and preference level of the insured up to a specified amount that properly allocates risk among stakeholders of a specific bankrupt and the business environment generally.
 - Few if any rules exist to determine how to set thresholds for preferences. These are frequently determined by market-specific considerations, including the number of insolvencies, the wider potential impact on employees and

general creditors, and the time necessary for employees to transition to a new job or be retrained.

- A worker wage guarantee fund should be established that ensures an almost immediate payment to vulnerable employees in respect of their claims. The guarantee fund should be entitled to subrogate to the rights of employees at the level of preference established by statute. Funding of the guarantee fund could occur through several sources, including state or budgetary funds, and an enterprise tax that is annually calibrated or recalibrated to the number of insolvencies, with potential for risk weighting by industry.
- A worker claims insurance scheme might also be considered as another means for satisfying claims that would not be satisfied by the general wage guarantee fund.
- The above measures might be complimented by worker retraining and reemployment programs, designed to facilitate the transition of redundant employees to new jobs.

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