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Schemes of Arrangements and Offers of Compromise in terms of Section 311 of the Companies Act

A discussion of new challenges posed by recent developments in the Law

A dissertation submitted to the
University of Cape Town
in fulfilment of the requirements of the degree of
Master of Law

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April 1998

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1. INTRODUCTION

Section 311 of the Companies Act, 61, 1973 ("the Act"), as amended provides:

"Compromise and arrangement between company, its members and creditors–

(1) Where any compromise or arrangement is proposed between a company and its creditors or any class of them or between a company and its members or any class of them, the court may, on the application of the company or any creditor or member of the company or, in the case of a company being wound up, of the liquidator, or if the company is subject to a judicial management order, of the judicial manager, order a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be) to be summonsed in such manner as the court may direct.

Thus Section 311 makes provision for two kinds of schemes – those between a company and its creditors and those between a company and its members

The motivation behind the takeover of a company in financial difficulties is most often the assessed loss of the company with its potential tax benefit.

Other motivations for the takeover of a company in financial difficulties may be the acquisition of the assets, goodwill, trademarks, licences and permits of the company. All of these benefits may well be forfeited or terminated if the company is wound up and the business is bought out of the company.

Thus it is often essential for a company to negotiate an agreement with its members or creditors in order to change an existing set of circumstances whilst preserving those qualities that make the company "attractive".

In many instances, the same results can be achieved by direct agreement with the members or creditors as can be achieved via Section 311 of the Act. The question thus arises, why use Section 311 at all?

The answer in short is that Section 311 provides for a compromise or arrangement, once sanctioned by the court in terms of the Section, to be binding on all creditors or members of the specific class involved.

Thus the Section allows the majority of a class of members or creditors to bind the minority, provided that the statutory majority set out in Section 311 (2) is complied with.

There are three major and distinct advantages to utilising the mechanism created by Section 311. Firstly, the acquirer of the company in financial difficulty is assured that if other previously unknown creditors appear they too will be bound by the sanctioned scheme because of the operation of Section 311(2). Thus the risk of the unknown creditors who, but for the application of Section 311, could make the acquisition too risky, is removed.

Secondly, the Section provides the machinery for overcoming the impossibility or impracticability of negotiating with large numbers of members or creditors in a particular class.

Thirdly the Section prevents a minority of members or creditors of a particular class from holding the majority and the offeror to ransom, thus making the entire scheme too expensive.

The appeal of Section 311 was summarised by Coetzee, J *in Ex Parte Lomati Landgoed Beherende (Edms) Bpk* [1] as follows:

"The purpose of Section 311 of the Act can be concisely put as being an attempted solution of the problem attendant upon attaining an agreement in the case of a large number of widely distributed people who must be contacted with a view to negotiating the same agreement with each one. Section 311 is therefore particularly applicable where it is impossible or difficult to approach everybody individually with a view to submission of the offer"

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[1] 1985 (2) SA 517 (W) at 520

A clear case having been made out in favour of the utilisation of Section 311 of the Companies Act, it now remains to discuss the developments in this area of law, from the Standard Scheme to the model utilised today and to look at the new challenges facing today's hybrid. However, in order to gain an appreciation of the present model, it is necessary to look at the history of its development and once that has been examined and once the new challenges facing it have been discussed, it may be possible to determine whether there is a future for schemes of arrangement and offers of compromise in terms of Section 311.

2. THE HISTORY OF SCHEMES OF ARRANGEMENT AND OFFERS OF COMPROMISE

Originally, schemes brought under Section 103 of the Companies Act of 1926 (the predecessor to Section 311) set out a simple scheme whereby a third party offered to acquire the claims of creditors by way of cession for a consideration that would allow secured and preferent creditors to receive no less than they would on a winding up of the company and concurrent creditors to receive more than they would on a winding up.

However, this practise was changed when the court pointed out that the scheme was not one between the company and its creditors.

The next development, invented to cure the problems raised by the courts was widely used and became know as the Standard Scheme.

In terms of the Standard Scheme the offeror made a sum of money available to a "receiver" who distributed it as a dividend to the creditors of the company in liquidation. In return for the dividend the creditors lost all further rights against the company. The claims of the creditors were then ceded or deemed to be ceded to the offeror who thereby acquired a loan account effectively equal to the company's total existing liability. In order to ensure that the scheme was one between the company and its creditors, the claims of the creditors were reduced by one cent in the Rand.

It was also common for the scheme to have been made conditional on the offeror gaining control of the company and the liquidation order being set aside.

The reasons for structuring the standard scheme as set out above were the following:

Firstly, the reduction of one cent in the Rand was thought to be necessary to satisfy the jurisdictional requirement of Section 311 (i.e. to make the scheme a genuine compromise or arrangement between the company and its creditors). Secondly, the assessed loss was preserved since the reduction of

one cent in the Rand only led to an insignificant reduction in the assessed loss of the company. The standard scheme seemed to make everyone happy. Creditors received their dividend earlier than they would have under a standard liquidation; the liquidator was relieved of many of his administrative duties such as summoning meetings and drawing accounts; the company avoided going into liquidation; the offeror acquired a going concern with all its assets at a substantial discount, along with the assessed loss of the company with insignificant reductions; and finally, the offeror had peace of mind since no previously unknown creditors could emerge at a later stage and claim against the company.

As Berman J put it in the *Multi-Bou* [2] case:

"The standard scheme of arrangement incorporating the deeming provisions whereunder claims against the company were reduced by one cent in the Rand was placed over the years in ever increasing numbers before meetings of all classes of creditors of companies being wound up, following the grant of orders of Court summoning such meetings to consider accepting or (as happened in rare cases) rejecting the standard scheme couched in the form of offers to creditors. Indeed, far more often than not nothing but good came of this practise, for creditors invariably received a greater dividend upon implementation of the scheme than they would otherwise have been paid, the third party obtained control over the company with its assessed losses and frequently some of, or even all of, its stock and equipment and the company was discharged from liquidation."

Thus the Standard Scheme was used widely and accepted widely by the courts for a number of years. The seemingly unobjectionable and apparently advantageous practise would probably have continued to the benefit and satisfaction of all concerned had the full bench of the Witwatersrand Local Division not stepped in and raised the alarm over what it regarded as a fatal

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[2] 1987 (4) SA 405 (C) at 409

defect in the Standard Scheme.

The case was *Ex-parte Kaplan & Others NNO : In re Robin Consolidated Industries Ltd* [3] ("the Robin Case"). The Standard Scheme was placed before the court and found wanting. The court rejected the Standard Scheme since it was purely an arrangement between the offeror and the company's creditors which, because it did not satisfy the jurisdictional requirement of Section 311 (ie it was not between the company and its creditors), left the court with no power to order a meeting to consider any arrangement. The court went on to state that this did not mean that a third party could not be involved in the arrangement. However, once under a proper construction of the contract the third party is the true party to the arrangement to the exclusion of one of the others, it can no longer be said to be an arrangement between the latter two parties as the privity between the company and the creditors or members, which is a vital prerequisite to the operation of Section 311, has been destroyed.

The Court held that when stripped of a large number of ancillary provisions required to put it into operation, the Standard Scheme was no more than an acquisition by the offeror of the creditors' claims and as such was a compromise between the offeror and the creditors and not one between the company and the creditors.

The court went further and in rejecting the view that the reduction of the creditors' claims by one cent in the Rand turned the whole scheme into an arrangement between the company and its creditors, stated:

"... only after cession are they (creditors' claims) 'deemed' to have been reduced by one cent in the Rand. This formulation removes even the excuse for this reduction and establishes if anything the position of the company firmly on the sidelines ..."[4]

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[3] 1987 (3) SA 413 (WLD)

[4] ibid p 425 A-C

The Court distinguished between the substance (i.e. the basic content of the scheme) and the administrative element (i.e. those conditions devised for the effective implementation of the scheme). Administrative conditions were ancillary to the basic content and standing alone were meaningless. The court held that the substance of the Standard Scheme was the reduction of the creditors claims by one cent in the Rand and the provision relating to the cession of the reduced claims to a third person for a consideration had nothing to do with the implementation of the reduction. The cession caused a myriad of ancillary conditions to be included in the Standard Scheme which are clearly separable from the reduction part and which clearly constitute an arrangement between the creditors and the third party (the offeror) instead of the company.

As a result, the court disregarded the cession part of the scheme leaving only the reduction part of the scheme which the court regarded as a useless device which could not accomplish anything.

The full bench of the Cape Provincial Division followed the reasoning of the Robin Case in *Ex part Millman & Others NNO: In re Multi-Bou (Pty) Ltd.* [5]('the Multi-Bou case').

In this case an attempt was made to counter the defects in the Standard Scheme highlighted by the Robin judgement. The offeror was to acquire, by way of cession, 99% of each creditor's claim against payment of the sum of R1.6 million. The company would, in addition, borrow the sum of R100 000 from the offeror (on loan account), which amount would then be paid to the creditors for the remaining one percent of their claims, and which would then extinguish this portion of their claims.

The proposers of this scheme contended that the company played an essential role in the scheme since the consent of the company was required for the partial cession (99%) to the offeror of each creditor's claim. Because

[5] 1987 (4) SA 405 (C)

the company was the debtor and because in effect a partial cession took place, the company (as debtor) had to consent to the partial cession in order to give it legal force and effect.

Berman J, delivering the judgement of the full bench rejected this approach and refused to grant the application. He conceded that the consent of the debtor is a prerequisite to a valid partial cession, but stated that on a true analysis, the purported partial cession was nothing of the kind. As the arrangement was dependent on its being sanctioned, it had to be regarded not as a single transaction, but as a number of separate transactions which were inter-dependent on each other and concluded simultaneously. He went on to hold that what was actually being ceded was the entire balance of the claim of each creditor and not part of it. Thus the debtor company did not have to consent to the cession in order to render it legally binding and enforceable and the arrangement was accordingly not one between the company and its creditors.

The court rejected the Scheme on the grounds that it was a sham, a disguised transaction which was structured to give the appearance and impression of an arrangement between the company and its creditors when, in substance, it was an arrangement between a third party and the creditors.

However, the full bench of the Durban and Coastal Local Division did not follow the Cape Provincial Division or the Witwatersrand Local Division in the case of *Ex parte Strydom No: In re Central Plumbing Works (Natal) (Pty) Ltd.; Ex parte Spendiff No: In re Candida Footwear manufacturing (Pty) Ltd; Ex parte Spendiff No: In re Jerseyside (Pty) Ltd.* [6] ("the Natal Case"). The court held that the Standard Scheme involved deemed, and not actual, cession of the creditors' claims. Deemed cessions required the participation of the company since they required that the company recognize a state of affairs that did not in fact exist. The court found that the proposed scheme

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[6] 1998 (1) SA 616 (D)

constituted an arrangement between the company and the creditors within the meaning of Section 311.

The deeming provision, the Court held, required the active participation of the company inasmuch as:

"... What is required to bring about the situation is agreement on the part of the company to regard a third party as its creditor in place of its actual creditor, as if the actual creditor had ceded its claim to the third party. This concept can only be given any legal effect by the actions of the company in recognizing a state of affairs as existing, which does not in fact exist". [7]

The court held that Coetzee DJP had erred in the *Robin* judgement by looking merely at the final effect of the scheme i.e. the acquisition of creditors' claims by the offeror and not at the means itself whereby this was achieved i.e. the deemed cession.

The combined effect of the above cases was that whilst the Standard Scheme was acceptable for Section 311 purposes in the Durban and Coastal Local Division, alternatives had to be sought in the Witwatersrand and the Cape.

The Orange Free State Provincial Division, in the Case of *Sackstein NO V Boltstone (Free State) (Pty) Ltd. (in liquidation)* [8] ("the Boltstone case") approved what has become known as the 'Preference Share Scheme'. This was developed as an alternative to the Standard Scheme and was approved in numerous unreported judgements in the Transvaal and the Cape. The *Boltstone Case* was the first reported judgement on the Preference Share Scheme.

In this type of scheme, the claims of the creditors, reduced by the capital sum paid to them by the receiver, would be converted into preferent share capital. The creditors would thereafter be deemed to have renounced their

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[7] Ibid, at p621 H-I

[8] 1998 (4) SA 556 (OPD)

entitlement to issue and allotment of the preferent shares, in favour of a nominee (usually the offeror) appointed by the Company.

The creditors' rights were thus limited to the right to claim the dividend paid to them from the capital sum.

The court found that this amounted to an arrangement between the company and its creditors since the creditors are directly involved (by agreeing to the conversion of their claims into capital and renouncing any entitlement to the issue of preference shares) and the Company is directly involved (by passing a resolution consenting to the transfer of the issued share capital to the nominee).

Whilst the Preference Share Scheme obviously satisfies the jurisdictional requirements of Section 311, there are other considerations which have to be examined. The most important of these is the question whether these types of schemes, like their predecessor the Standard Scheme are able to preserve the assessed loss. In this regard Section 20 (1) (a) (ii) of the Income Tax Act is vital and these schemes will be discussed later in this regard.

Suffice it to say at this stage that there was sufficient doubt in their efficiency in this area to cause the proposers of Schemes of arrangements to look for other solutions.

Subordination of Claims

Another factor which influenced the development of the Standard Scheme was highlighted for the first time in the *Robin Case*, where the court expressed concern that the standard scheme allowed the company's liabilities to remain intact. Coetzee D J P highlighted what was a major area of concern for him in the *Robin Case* at 426F to 427B:

"When discharging the winding up order, the court now sends back into the business world the same hopelessly insolvent company to trade and incur debts as before. Per se this is not illegal, but a greater potential for harm and prejudice to the public than before lurks in the state of affairs. This arises from the fact that all the debts are now consolidated in the hands of the

controller of the company. Because this enables this person, usually the offeror, to play a dominant role in any division of the assets in a future (possibly not too distant) winding-up, a new creditor who has supplied goods to such a company may find the great bulk of these goods being used to pay this big inside creditor / controller which has now arrived on the scene. In the hands of disreputable persons who become new controllers this kind of scheme concentrates awesome powers for harm. The public interest, which is clearly a proper consideration in the exercise of the courts' discretion, probably demands that, because such results are forseeably possible, this kind of scheme, even if otherwise legal, should not be countenanced."

In an attempt to overcome this problem it was suggested that the subordination or back-ranking of the ceded claims in favour of future creditors, until such time as the assets of the company exceeded its liabilities, would provide a solution to the problem.

However, Coetzee, D J P did not regard this as a satisfactory answer to the problem and instead suggested the conversion of the ceded claims into new capital.

In the *Multi-Bou case* this issue was not considered.

However, in the Natal case the issue of the company continuing to trade in insolvent circumstances was fully considered and the court held that it was not an area for concern.

Then followed two cases before Stegmann, J in which the subordination of claims was considered and rejected.

The first of these was *Ex Parte de Villiers NO: in re MSL Publications (Pty) Ltd. (in liquidation)* [9]

In this case six broad requirements were set out as guidelines for whether the court should order a meeting to be called. The court held that if it was self-

[9] 1990 (4) SA 59 (WLD)

evident when the first step of seeking leave to summon a meeting was taken, that, the proposals were ones which no court could possibly sanction at the last phase, the court should not authorise the calling of the meeting at the initial stage.

The main objection which the court had against the proposed scheme was to be found on page 86 C - J.

In essence the court felt that the subordination agreement did not address the heart of the problem. The court disagreed with the counsel for the applicant where he said that one of the consequences of the subordination agreement would be that the insolvent company would no longer be insolvent. It felt that the subordination agreement would not reduce the company's liabilities. Furthermore the court held that even were the above proposition to be correct, mere 'non-insolvency' would not solve the problem - Quoting from 86 H - J.

"The root of the problem is that the proposer wishes to use a company that has lost its capital as a trading company. In other words, the proposer wishes to engage in the risky business of trading; it wishes to use a company for that purpose; it wishes to avoid exposing any capital to the relevant risks in the manner contemplated by the Companies Act ... and at the same time, it wishes to enjoy the benefit of limited liability offered by the Companies Act. To put it plainly, it wishes to have its cake and eat it. The answer is that it cannot."

A similar scheme again came before Stegman J, in *Ex Parte Lebowa Development Corporation Ltd* [10]. The scheme was again rejected for very similar reasons. The court held that if the proposed scheme was sanctioned, the company would be free to trade in insolvent circumstances and public policy precludes courts from condoning, encouraging or facilitating the practice of trading in insolvent circumstances. The court further held that

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[10] 1989 (3) SA 71 TPD

subordination of the creditors claims effected no permanent change to the statutory ranking of claims and could be undone at any stage.

In *Cooper v A&G Fashions (Pty) Ltd: Ex Parte Millman NO* [11] in the CPD, Conradie, J. stated:

"I respectfully disagree with Ex Parte Lebowa Development Corporation in that a suitably worded subordination agreement can in principal not restore a company's solvency. In the present case the subordination agreement provides, as such agreements commonly do, that the subordinated debt is not to be enforceable until the debtor company's assets exceed its liabilities. For as long as the company's balance sheet shows that its liabilities exceed its assets the subordinated debt remains a contingent liability. It may be enforceable if, for example, the person who acquires the subordinated debt is not bound by the subordination agreement and there is no other mechanism preventing him from enforcing the subordinated debt. The better a subordination provision is drafted and the greater the protection it offers future creditors against enforcement of the subordinated debt, the smaller the contingency will be that the debtor company may be obliged to pay the subordinated debt. A contingent debt is valued according to the prospect of its becoming enforceable. In evaluating a debtor's financial position, one would not assess the debt at its face value ... for the purpose of determining what effect the subordination provision has on the solvency of the company, the subordinated debt must be evaluated in the way that contingent liabilities are evaluated."

Furthermore at 208 H - I the court stated:

"I do not, with respect, agree with Stegmann, J. that sending an insolvent company back into the business world is a social evil which a Court should not under any circumstances permit."

Finally, at 209 I, the court held:

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[11] 1991 (4) SA 204 (C)

"Saying that the court has a discretion to refuse to wind up an insolvent company, is the same as saying that it may, in its discretion, permit an insolvent company to continue trading".

The issue again came before Stegmann, J in *Ex Parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (in liquidation).* [12]

In this judgement, the learned judge set out three major arguments against allowing the company to continue doing business.

The first argument was based on the question of the company's solvency.

According to the court there exists, over and above the accepted concepts of insolvency and 'commercial' insolvency, a 'corruption' of the theory –

At 112 F:

"It starts with a premise which inverts the concept of insolvency or sees it as it were, through the looking-glass. The concept of commercial insolvency, correctly understood is not more than that a company which fails to pay its debts currently due may or may not be insolvent and should, for reasons of commercial convenience, be treated as if it is insolvent. By inverting that idea one may arrive at the corrupt and fallacious proposition, acceptable only in world on the other side of the looking-glass, that for as long as a company continues to pay its debts as they fall due it is neither commercially insolvent (because it has not failed to pay any due debts) nor insolvent in any sense, and it is accordingly not liable to be wound up. That proposition conveniently overlooks the fact that an insolvent company which continues to pay its debts as they fall due may actually be preferring current creditors at the expense of creditors whose claims have not yet fallen due.

The looking-glass world idea that a company which is in fact insolvent can demonstrate that it is not by the simple expedient of continuing to pay its debts as thay fall due, has gained currency amongst persons whose interest

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[12] 1992 (2) SA 95 (WLD)

it serves. More surprisingly, it seems to have found expression in a judgement in the Supreme Court in Natal in which it has been said (in my respectful view erroneously) that:

"from a commercial point of view, however (and this is recognised in the Companies Act), the true test of a company's solvency is not whether the company's liabilities exceed its assets but whether it is able to pay its debts."

(See Rosenbach & Co. (Pty) Ltd. v Singh's Bazaars (Pty) Ltd. 1962 (4) SA 593 (D) at 596F - 597H)."

The court criticised the idea that insolvent companies can be released back into business after a compromise.

At 114A the court stated:

"With the greatest respect to my learned Colleague, I persist in the view that, according to our law, when a company has lost 75% of its capital, it is liable to be wound up in terms of Section 344(e) of the Companies Act; that when it has lost 100% of its capital and more, so that its liabilities exceed its assets, it has become insolvent and remains liable to be wound up; and that such a company can never demonstrate its solvency, nor resist winding up, by squandering its remaining assets or such moneys as it may manage to borrow in payment of current debts, to the prejudice of creditors whose claims have not yet fallen due for payment and trade creditors whose claims have not yet fallen due for payment and trade creditors who continue to be asked to provide goods and services on credit.

For these reasons I find myself unable to accept the applicants' suggestion that Carbon Developments, the liabilities of which exceeded its assets at 30 September 1988, was nevertheless solvent because it had not at that stage defaulted on current liabilities."

Furthermore, the court expressed the opinion that these schemes should never be sanctioned where the company is insolvent. A similar attitude was

adopted by the Australian Courts in the 1970's[13].

The second argument related to the subordination or back-ranking of certain clauses. It was argued by the applicant that all the fears about insolvency are irrelevant if the controller - creditor subordinates his debts in terms of a subordination agreement. In terms of this agreement all further debts would be preferred to his claim.

The court criticised this solution on several grounds. At 115 F it stated:

"Far from suggesting, as Mr De Villiers does, that the subordination serves to restore the solvency of Carbon Development, the language of Note 10 to the financial statements, and the very step of subordinating certain claims to others, by implication **proclaims** the insolvency of Carbon Developments, for it is recognised that it will only be when the solvency of Carbon Developments has been restored (if it can ever be restored) that the situation may be dispensed with."

More importantly the court pointed out that subordination contracts may be cancelled. Since the company is very often controlled by the subordinate creditor it is possible for him to cancel the agreement at any stage after he has left the court. Furthermore, since this is a type of stipulatio alteri, every future creditor has to find out about this agreement and accept the benefit under it, before he can be benefitted.

The third major argument in the judgement related to the statutory declaration of liability: Section 424 (1) of Act 61 of 1973.

It was suggested by the court that if these Section 311 schemes were sanctioned, any chance which the creditors had of holding the directors liable for acting fraudulently or negligently, would be destroyed. Since, once the creditors have settled under a compromise agreement, they are no longer creditors and as such have no claim under Section 424 or under the common law.

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[13] see Re Data Homes (Pty) Ltd (1971 1 NSWLR 38)

The question of the efficacy of subordination agreements was finally settled by the Appellate Division in *Ex parte De Villiers and another NNO: In re Carbon Developments (Pty) Ltd (in liquidation)*[14] - an appeal against the judgement of Stegmann J (discussed earlier).

The Appellate Division held conclusively that the solvency of the company could be satisfied by subordination. This step helped in keeping the way open for the beneficial utilization of assessed losses of companies. However, a further aspect of subordination that has to be examined is the effect of Section 20 (1) (a) (ii) of the Income Tax Act. This aspect will be discussed separately later.

The acceptance of the principle of subordination in the *Cooper v A & G Fashions case*[15] in the Cape Provincial Division had important consequences for the development of the Standard Scheme in this region. It allowed for the development of what became known as the "Excluded Creditor Scheme".

The Excluded Creditor Scheme was yet another attempt by proposers of Schemes of Arrangement to obtain the protection afforded by Section 311 without reducing the assessed loss of the company materially.

In the Excluded Creditor Scheme, the offeror enters into an agreement with the company's major creditors (in value) to acquire their claims for a dividend which is slightly better than that obtainable on liquidation of the company.

A Scheme is then proposed with the remaining creditors (who, whilst they invariably are the majority in number, represent a small portion of the creditors' claims in value). Because the remaining creditors' claims have a small aggregate value the reduction of the assessed loss under Section 20 (1) (a) (ii) of the Income Tax Act is small.

However, the limitation on this type of scheme is that it can only work where the major claims against the company are held by a few creditors (the

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[14] 1993 (1) SA 493 (A)

[15] 1991 (4) SA 204 (C)

"Excluded Creditors") with whom agreements separate to the scheme of arrangement can be concluded.

In terms of the scheme of arrangement, the remaining creditors receive a dividend from the advance paid by the offeror. Upon payment of this dividend, the balance of their claims are extinguished (and not ceded to the offeror). The courts have held that this constitutes a genuine compromise between the company and its creditors or class of creditors.

Finally, the scheme consideration paid by the offeror as well as the monies paid to acquire the claims of the excluded creditors are invariably subordinated in favour of future creditors. The subordination is made binding and effective by following the principles referred to in the *A & G Fashions case*.

The Excluded Creditor Scheme has a number of inhibiting features which can make it difficult, time consuming and expensive to implement.

Firstly, the target company must satisfy the basic requirement that the excluded creditors should be few in number, but constitute the significant majority in value. This is important for ease of negotiations as well as preservation of the assessed loss.

Secondly, this type of scheme necessitates separate negotiations with each of the excluded creditors. Not only is this time consuming, but it is also made more difficult when the excluded creditors realise that their claims are essential to the offeror and that they can therefore hold the offeror to ransom. In practise this type of scheme requires the excluded creditors to have some kind of vested interest in seeing the scheme work (like on-going business with the company) otherwise they refuse to co-operate at viable levels for the offeror.

Thirdly, the excluded creditors sometimes insist on being paid for and ceding their claims regardless of whether the scheme is sanctioned or not. It is obviously vital to the offeror that cession and payment be made conditional upon sanction of the scheme.

Finally, the scheme creditors are often reluctant to sanction the scheme because the excluded creditors are receiving preferential treatment.

As a result of these difficulties the proposers of Schemes of Arrangement came up with what became known as the "New Cape Scheme". This has been considered and accepted by the Cape Provincial Division in an unreported decision.

This type of scheme is discussed by Getz & Jooste in an article titled "Section 311 of the Companies Act: Preserving the Assessed Loss"[16]

"In terms of the New Cape Scheme, the offeror provides the company (by way of a loan) with a monetary amount ('the capital sum') to enable the company to make a dividend payment to its creditors subject to the conditions that should the scheme be sanctioned then:

a) the rights of creditors to receive payment of their claims would be limited to the right to claim payment of the dividend in terms of the provisions of the Scheme;

b) no creditor would thereafter have any claim against the company (and the proposer and the receiver) for any further payment or consideration in respect of any claim;

c) the outstanding balance of the claims of the creditors of the company would be deemed to have been ceded to the proposer who would be deemed to have purchased and acquired all such claims;

d) the capital sum and the ceded claims acquired by the proposer would be subordinated (as per the subordination provisions approved in Cooper vs A & G Fashions [17])

The Cape Provincial Division sanctioned the scheme and found that it not only satisfied the jurisdictional requirements of Section 311, but also that the

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[16] Getz K and Jooste R J : Revenue Law Jooste (ed) 56

[17] 1991 (4) SA 204 (C)

deemed cession involved was not subject to the objections raised in the *Robin*[18] and *Multi-Bou* [19] cases. The reasons advanced for this are as follows:

I. In the New Cape Scheme the Company (and not as in the Standard Scheme, the offeror) pays dividends to the creditors

II. The payment by the company to the creditors is not the purchase price paid by the offeror in acquiring the claims but is instead an actual reduction of the amount owed by the company to its creditors

III. A simple part payment of the debt by the company would not as such constitute a scheme of arrangement. But the scheme involves much more than a simple part payment of a debt. In the New Cape Scheme, the creditors, in order to receive the part payments, have to accept a deemed cession of the balance of their claims. This deemed cession is not a separate transaction from the payment - the payment is conditional on agreeing to the cession.

Namex (Edms) Bpk v Kommissaris van Binnelandse Inkomste[20]

In the Appellate Division the minority judgment of Van Heerden and Van den Heever JJA came out strongly in favour of the Standard Scheme and criticised the findings of Berman J in the *Multi-Bou*[21] case that an agreement by the creditors to reduce their claims against the Company by one cent in the Rand does not involve the company. The minority held that, apart from the statutory mechanism, the reduction of a creditor's claim against a company cannot be achieved without the company's co-operation.

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[18] 1987 (3) SA 413 (WLD)

[19] 1987 (4) SA 405 (C) at 409

[20] 1994 (2) SA 265 (A)

[21] 1987 (4) SA 405 (C)

With reference to the judgement of Coetzee AJP in the *Robin*[22] case, the minority agreed that the mere reduction provision does not automatically mean that the Standard Scheme has as its object an arrangement between a company and its creditors but held that such provision does in fact involve the company and must therefore be considered in the context of the other provisions of the Scheme.

The reasoning of the minority was that whilst it is correct that one of the chief characteristics of the Standard Scheme is the Cession of the creditors claims to the offeror, the cession achieves nothing if the final liquidation order is granted. The other chief characteristic is thus the release of the company from liquidation and both the company and its creditors have an interest in achieving that.

Because of the apparently passive role played by a company in liquidation for the purposes of Section 311 one loses sight of the legal consequences for the company which result from the confirmation of the arrangement. The apparently passive role played by the company is due largely to the fact that control of the company after provisional liquidation vests in the provisional liquidator, but the company still plays an active role in the Standard Scheme.

The minority regarded the reduction of the claims by a nominal amount as unnecessary. Another significant aspect of the minority judgement is the catagoric rejection of the court's reasoning, in the *Natal* case relating to the 'deemed' cession.

Unfortunately, the majority judges in delivering their judgement found it unnecessary to make a pronouncement on the Standard Scheme. This is especially unfortunate as the minority's judgement cannot be binding on any court since a two judge Appellate Division decision cannot override a three judge decision in any local division.

However, the majority did remark that Section 311 schemes are very valuable

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[22] 1987 (3) SA 413 (W)

and useful in the business world and with that in mind, our courts should not place too strict an interpretation on the provisions of the Section. They went on to hold that in order for a company to satisfy the jurisdictional requirements of Section 311 it is not necessary for the company's active role to be considerable.

The final reason why the *Namex* decision is very important is its finding in relation to the question whether the Receiver of Revenue can be bound as a creditor by a scheme or arrangement under Section 311. It was held by the majority that whilst the Receiver of Revenue can be bound as a creditor under Section 311 this was only so in relation to claims which are known at the time of sanction. Any unknown claims could not be compromised.

Summary

Because of the Appellate Division decision in the *Carbon Developments* case which approved of subordination and the minority and majority decision in the Appellate Division in the *Namex* case which seems to hold out hope for the Standard Scheme together with the hybrid scheme in the form of the New Cape Scheme, it would seem that the obstacles raised by the Robin decision have been removed and schemes of arrangement in terms of Section 311 are feasible, perhaps unaltered, but at the very least in one of the hybrid forms.

However, the question of their feasibility cannot stop there. In addition one must examine the effect of the Income Tax and Value Added Tax Acts and these will now be looked at in more detail.

3. THE IMPACT OF THE INCOME TAX ACT

4.1 SECTION 20 (1) (a) OF THE INCOME TAX ACT

Section 20 (1) provides that in order to determine the taxable income of a person carrying on a trade in the Republic, any balance of assessed loss included during any previous year which has been carried forward from the preceding year of assessment shall be set off against the income derived by the taxpayer from such trade. However, this is subject to the proviso contained in Section 20 (1) (a) (ii) which reads.

"provided that the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession granted by or a compromise made with his creditors whereby his liabilities to them have been reduced or extinguished, provided such liabilities arose in the ordinary course of trade."

Bearing in mind that in many instances the motivation for the scheme of arrangement or offer of compromise in terms of Section 311 of the Act is the acquisition of the assessed loss of the company to utilize it for the tax advantages which attach to it, it becomes important to establish that the scheme is efficient from a tax perspective.

The first important condition contained in Section 20 (1) is that the company carry on a trade. If the company, in any year of assessment, did not carry on a trade, it is not permitted to carry forward to that year an assessed loss from the immediately preceding year and it will lose forever its right to carry forward that assessed loss. Section 20 (1) (a) of the Income Tax Act envisages a continuity in setting off an assessed loss in each year succeeding the year in which it was originally incurred. Thus from year to year a balance can be ascertained and that balance will then be carried forward to each successive year until it is exhausted.

It is not a requirement that the company must carry on a trade during the entire year of the assessment - any period of trading during the year in

question will suffice. However, it is not sufficient for the company to merely keep itself alive without trading.

Indeed, it seems, however, that an assessed loss may be carried forward provided that the company trades even if such trade does not produce income (but on the further proviso that it carried on a trade with the intention to earn an income).

Where a company in provisional liquidation has sold its business pending a scheme of arrangement or offer of compromise in terms of Section 311 of the Act, a danger exists if there is a delay in the sanction of the scheme which extends through a tax year. It may be found in these circumstances that the company has not traded for the purposes of it maintaining its assessed loss.

An important case in this regard is *Robin Consolidated Industries Ltd v CIR* [23] In this case an insolvent company had sold its business lock, stock and barrel except for certain stock which was stored in a bonded warehouse. The liquidators continued to sell off the stock after the business had been sold. The purchaser of the business undertook to make an offer of compromise in terms of Section 311 of the Act. The offer of compromise was to supercede the original sale and the provisional liquidation was then to be set aside. However, the court only sanctioned the scheme in the following tax year. The question then had to be determined whether the company had carried on a trade and was therefore able to carry forward its assessed loss: The only activity that had taken place was the sale of the goods in the bonded warehouse by the liquidators.

The company contended that the sales of the goods were effected in the course of its trading activities and that it was therefore entitled to carry forward the assessed loss.

The Commissioner on the other hand contended that the company had not carried on a trade during the relevant time and that in effecting the sales of

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[23] 1997 (2) All SA 195 (A)

goods in question, the liquidator was not carrying on a trade but was merely realising assets of the company in the course of liquidation.

The court held that there had been no trading in the ordinary sense since whilst it may have been in the normal course of trading for a liquidator to sell off assets in bulk, trade and realisation are different and sometimes opposed concepts. It went on to hold that in this instance, the transactions did not constitute the carrying on of a trade and the company was therefore prohibited from carrying forward its assessed loss. The second important condition is set out in the proviso contained in Section 20 (1) (a) (ii). In terms of the proviso, the balance of an assessed loss must be reduced by the amount or value of any benefit received by or accruing to any person resulting from a concession granted by or a compromise made with his creditors in terms whereof his liabilities are reduced or extinguished.

From the working of this proviso it is clear that in order to be tax efficient, any acquirer of a company for its assessed loss would have to minimise the amount or benefit of any compromise in order to preserve as much as possible of the company's assessed loss.

For many years the Standard Scheme was ideal in this regard since it not only satisfied the jurisdictional requirement of Section 311 of the Act, but also was tax effective (from the perspective of Section 20 (1) (a) (ii)) in that the compromise with the creditors resulted in an insignificant reduction in the assessed loss of the company.

The *Robin* [24] and *Multi-Bou* [25] judgements left proposers of schemes of arrangement with a new challenge - to come up with a scheme that not only satisfied the jurisdictional requirement of Section 311 but also was tax efficient from the perspective of Section 20 (1) (a) (ii) of the Income Tax Act.

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[24] 1987 (3) SA 413 (W)

[25] 1987 (4) SA 405 (C)

The tax efficiency of the Preference Share Scheme:

Proposers of the "Preference Share Schemes" argue that Section 20 does not apply to the schemes as the liability to repay a debt of a certain amount to creditors has been replaced with a liability to redeem preference shares at a value equal to the amount of the debt. Thus although the form of the liability has changed, the amount has stayed the same and the company has therefore not derived a benefit from the scheme sufficient to reduce the assessed loss.

However, commentators on Preference Share Schemes (as opposed to Redeemable Preference Share Schemes) seem to be unanimous in their view that the company would under this type of scheme derive a clearly defined benefit[26].

The February 1989 Taxpayer [27] contains the most detailed analysis of the requirements of Section 20 (1) (a) (ii) as well as a lengthy discussion of the tax implications of Preference Share Schemes. The requirements of Section 20 (1) (a) (ii) have to all be present before an assessed loss is reduced. These are cited as the following.

a) the amount or value of any benefit received by or accruing to the company

b) resulting from a concession granted by or a compromise made with the company's creditors

c) whereby its liabilities to them have been reduced or extinguished.

As far as requirement a) is concerned, it is submitted by the Taxpayer that

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[26] See Jooste R J Schemes of Arrangement - A new development 28 Income Tax Reporter (1989)7 (based on the incorrect assumption that the Boltstone Case concerned preference shares)

and The Taxpayer Vol. 38 (2) (February 1989)

and Getz K and Jooste R J - Section 311 of the Companies Act: Preserving the Assessed Loss Acta Juridica (1995)

[27] see note 24 above

the benefit does accrue to the company since prior to the sanction of the scheme by the court the company does owe certain debts which are due and payable to its creditors. However, after sanction, there are no debts due and payable by the company.

With regard to requirement b), this is more difficult to adjudicate on. However, The Taxpayer suggests that a persuasive approach is to examine the quid pro quo to which the creditors become entitled in settlement of their claims. If it is adequate then there is no concession - if not adequate then a concession must have been granted.

The Australian Case of Grant V Federal Commissioner of Taxation[28] is discussed in detail. In this case, the taxpayer paid $97 000 for the allotment of 97 000 preference shares with a par value of $1 each, but the court valued these preference shares at $39 770. The majority of the court held that the quid pro quo received by the taxpayer for the $97 000 spent, i.e. the 97 000 shares, had to be valued with reference to their market value of $37 770 notwithstanding the fact that in terms of company law it was not possible to pay less than $97 000 for the allotment of 97 000 $1 par value preference shares. The taxpayer was thus held liable for gift duty on the difference between the amount paid and the market value of the shares allotted.

In the minority judgement in the same case it was held that as the lawful minimum had been paid for the preference shares the allotment received was a full consideration for the money paid and there was no liability for gift duty.

The Taxpayer considered the aforesaid situation to be directly analogous to the question whether a compromise or concession has been granted where creditors receive par value preference shares for the face value of their claims. It is argued that whilst on the one hand if the share to which former creditors become entitled have a market value of less than the amount of the claim, then a concession would seem to have been granted. On the other

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[28] 7 ATR 1

hand a South African court may adopt the approach of the minority judgement that since the lawful minimum has been paid for the par value preference shares no concession or compromise can objectively be said to be present.

The Taxpayer inclines towards the majority view that the market value of the shares ought to be definitive. They cite the local case of Lace Proprietary Mines Ltd. V Commissioner for Inland Revenue[29] in favour of this approach. In the aforesaid case the court held that the taxpayer received 1 million shares as a consideration and that the shares had to be valued according to their market value.

The Taxpayer goes on to state that if the market value of the shares is less than the amount of the claims it is likely that it will be found that a concession has been granted.

With regard to the third requirement, The Taxpayer points out that there can be no doubt that the company's liabilities to its former creditors have been extinguished.

The Taxpayer therefore concludes that on their analysis of the requirements, the company may well lose a substantial portion of its assessed loss by adopting the Preference Share Scheme, rendering the Preference Share Scheme ineffective from a tax point of view.

Because of the problems associated with Preference Share Schemes the proposers of schemes tended to favour the issue of redeemable preference shares rather than preference shares. As an extra caution, the amount of the redemption was made equal to the issued price of the shares and the obligation to redeem was made actual and not contingent. It was felt that these steps reduced the likelihood of the reduction of the assessed loss.

However, in *ITC 1613* the court considered a scheme of arrangement in terms of Section 311 where redeemable preference shares were issued and

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[29] 1938 AD 267

the court had to decide whether the Commissioner for Inland Revenue was entitled to reduce the balance of the assessed loss in terms of Section 20 (1) (a) (ii).

The facts in *ITC1613* were as follows.[30]

"The company (hereinafter referred to as the Appellant) had been placed in final liquidation on 15 August 1989.

A company, D Ltd. had proposed a scheme of arrangement between the Appellant and its creditors in terms of Section 311 of the Act and the scheme was confirmed by the court on 23 January1990.

Features of the scheme of arrangement were that Appellant had been discharged from liquidation, D Ltd. acquired the existing share capital of the Appellant, Appellants liquidators were appointed as receivers for its creditors to give effect to the scheme and D undertook to provide capital to Appellant by subscribing for shares at an allotment price equal to the capital sum.

The capital sum, the net proceeds of the excluded assets and interest on these amounts were to be applied by the receivers in paying the administration expenses, fees and disbursements of the liquidators and the receivers, the fees of the Master of the Supreme Court, the net amount due to secured creditors, the claims or preferent creditors and the balance remaining to be distributed among the concurrent creditors on a pro rata basis as if payment towards the concurrent claims against the company.

In consideration for the right of creditors to receive the envisaged amounts and with effect from the effective date the claims of all creditors against the company reduced by their awards in terms of the arrangement were to be capitalised by the company on the basis of creating and allotting to a nominee of the company, being the proposer, a number of redeemable preference shares in the company as will have an aggregate issue value, including premium, equal to the face value of the claims, and these shares

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[30] Quoted from South African Tax Cases Reports p188ff

were to be subject to the same rights as the existing issued ordinary share capital of the company.

In the event the concurrent creditors received a dividend of 43, 48 cents in the Rand and, in effect, this meant that each concurrent creditor received for 56, 52 cents of each Rand which had been owing, the right to a redeemable preference share at an allotment price of 56,52 cents.

In fact, for each 100 cents of the claims not paid in cash the creditors were entitled to a share with a nominal value of 1 cent, issued at a premium of 99 cents. They were redeemable at the full issue price of 100 cents and carried a 'coupon rate', presumably on the issue-price, of 10% per annum.

The terms of the preference shares were not established in the evidence or in the dossier but they were redeemable and preferent.

Appellant's financial statements revealed that for the nine month period ended 31 March 1990, 100 additional ordinary shares were issued at an allotment price of R5 736 100, while 18 997 499 cumulative redeemable preference shares were issued at an allotment price of R18 997 499, the nominal value was R 189 975 and the share premium account was credited with R 18 807 524.

Appellant had carried forward from previous years of assessment an assessed loss of R 8 540 219 in terms of Section 20 (1) (a) of the Income Tax Act and its net deductible expenditure, i.e. tax loss, for the nine month period was R 15 090 168 so that it sought to carry forward to the following year, ending 31 March 1991, an assessed loss of R 23 630 387 in terms of Section 20 (1) (a).

The Commissioner for Inland Revenue, acting in terms of Section 20(1) (a) (ii) of the Income Tax Act 58 of 1962, reduced the balance of assessed loss by R 18 807 524 which was the amount credited to Appellant's share premium account on the issue of the preference shares.

The crisp issue for determination was whether the Commissioner for Inland Revenue was entitled to reduce the balance of assessed loss in the way that

he had.

The Court held that in order to succeed, the Appellant had to establish the absence of one of more of the following:

a) a concession granted by or a compromise with Appellant's creditors and / or

b) the receipt by or accrual to the Appellant of a benefit resulting therefrom.

In addition, if the Appellant failed to establish that one or more of these requirements was absent, the Appellant would still succeed in its appeal if the Commissioner for Inland Revenue failed to establish the amount or value of the benefit which the Appellant received.

The Court held further that there can be no doubt that the Appellant's creditors had agreed, by means of the scheme, to receive less than the face value of their claims – it held that it is true that if they had taken action to enforce the payment of their claims, they would not have been paid in full and that was obviously the reality which induced them to agree to accept, in part payment of their claims, shares of a value for lower than the face value of those claims and this could only be described as a concession, if not a compromise.

It held that the very fact that section 311 had been invoked in order to facilitate what was called an arrangement which, in casu, would have required a re-arrangement of the creditors' rights to which their actual or imposed agreement was required, indicates a concession by them.

With regards to a benefit derived, the court held that there was no doubt that the Appellant derived the benefit from the scheme of arrangement. Furthermore the benefit was received by the Appellant and was not received by nor did it accrue to anyone else, apart for the acquirer in the scheme indirectly, as the shareholder of the appellant.

The court held that it was difficult, if at all possible, to quantify or place a value on the benefit derived by the Appellant from the scheme of arrangement. The only way to quantify the benefit was if the value of the

benefit was equivalent to the value of the claims. If a creditor forgoes a part of its claim against a company, the amount abandoned is the amount of the benefit but where a creditor accepts as a substitute for a part of its claim, a stake in the company's capital, it is not immediately clear whether this is a benefit.

To establish the amount of a benefit the benefit must have an ascertainable money value and this obviously also applies to a benefit in the form of a saving from an expenditure.

Thus the court held that whilst the redeemable Preference Share Scheme under discussion clearly amounted to a concession with Appellant's creditors and further amounted to a receipt by or accrual to the Appellant of a benefit resulting therefrom, the Appellant must succeed in its appeal since on the evidence before it there was no way that the court could quantify, in monetary terms, the benefit that accrued to the appellant by reason of the conversion of trade debt into shares without a prescribed formula or deeming provision in the Income Tax Act.

Thus it would seem that, provided the Commissioner is able to place sufficient evidence before the court in Preference Share Schemes, these will fall foul of section 20 (1) (a) (ii) and will lose entirely their efficiency from a tax point of view.

The Impact of Section 20 (1) (a) (ii) on Subordination of Claims

The principle of subordination has been accepted in the Carbon Developments case.[31] The question however arises whether the subordination triggers off the reduction of the assessed loss in terms of section 20 (1) (a) (ii). In other words does a subordination of creditors claims against a company in favour of future creditors give rise to the receipt by or

[31] Ex Parte De Villiers and another NNO: In re Carbon Developments (Pty) Ltd (in liquidation) 1993 (1)

an accrual to the company of a benefit arising from a concession granted by or a compromise made with the company's creditors whereby its liabilities to them have been reduced or extinguished?

Section 20(1)(a)(ii) can only apply if all the requirements for it to operate have been satisfied. If interest at a market related rate is charged in return for agreeing to subordinate the ceded claims then, even though the company has benefited by receiving an extension of time within which to pay the claims, the liabilities have not been reduced or extinguished and Section 20(1)(a)(ii) is not applicable. If no interest is charged then the company will have benefitted from the extension and it may be shown to have had its liabilities reduced in that on subordination the company's liability is not to pay the face value of the ceded claims but the present value of the claims at an uncertain future date.

The safest route to follow would be for interest to be charged at a market related rate on the subordinated claims. One could even provide for the interest to also be subordinated. If this route is followed it is likely that subordination will be found to be tax efficient from the perspective of Section 20 (1) (a) (ii).

The Impact of Section 20 (1) (a) (ii) on Excluded Creditor Schemes

The Excluded Creditor Scheme is tax efficient from the perspective of Section 20(1)(a)(ii), in that the excluded creditors are few in number but constitute a significant majority in value and the scheme creditors (whose claims are compromised) represent a small minority in value. Thus the reduction in the assessed loss (as was the case with the Standard Scheme) is insignificant.

The Impact of Section 20 (1) (a) (ii) on New Cape Schemes

The New Cape Scheme is similarly tax efficient in that the assessed loss of

the Company is successfully preserved.

Finally, by way of a closing remark on the impact of Section 20(1)(a)(ii) of the Income Tax Act it should be noted that the minority judgement in the *Namex case* [32] has apparently opened the door again for the Standard Scheme without any of the alterations that changed it into its present day hybrid form. This being the case, it may happen in the not too distant future that the Standard Scheme with its efficiency from the Section 20 (1) (a) (ii) perspective will step into the spotlight and cause the other hybrid forms to fade into the background again.

3.2 SECTION 103(2) OF THE INCOME TAX ACT

Companies wishing to utilize an assessed loss also face a potential hurdle in the form of the anti-avoidance provisions contained in Section 103(2). Section 103(2) is invoked by the Commissioner whenever he is satisfied firstly that any agreement affecting any company or any change in the shareholding in any company or in the members' interests in a close corporation has been entered into or effected at any time before or after the commencement of the Income Tax Act 55 of 1946 and secondly that it has been entered into or effected by any person solely or mainly for the purpose of utilizing any assessed loss or balance of an assessed loss incurred by the company to avoid liability on the part of that company or any other person for the payment of any tax, duty or levy on income, or to reduce its amount, and thirdly that income has been received by or has accrued to that company during any year or assessment as a direct or indirect result of that agreement or change in shareholding.

The application of Section 103(2) results in the disallowance of the set-off of any such assessed loss or balance of assessed loss against any such income.

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[32] 1 1994(2)SA265(A)

The Appellate Division in *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* [33], held that Section 103 was clearly directed at defeating tax avoidance schemes. It did not impose a tax or relate to the tax imposed by the Income Tax Act or to the liability for it or to its incidence, but to schemes for its avoidance. So it had to be interpreted to advance the remedy provided by the section and suppress the mischief against which it was directed. The Commissioner's powers were thus not to be restricted unnecessarily by interpretation.

A common example of the type of mischief that Section 103(2) is designed to avoid is where there has been a diversion of income to the company or where the company, after a change of shareholding, earned income from activities which it had not undertaken prior to that.

However, it is vitally important that Section 103(2) is inoperative, even where there has been an avoidance of tax liability, unless the avoidance of tax liability was the sole or main purpose of the agreement.

Thus, if there was some sound business or commercial reason for the agreement, the fact that the assessed loss was also considered and taken into account (but merely as a subsidiary consideration) will not result in the application of section 103(2). The onus of proving that the sole or main purpose was not tax avoidance rests with the taxpayer.

Examples of sound business or commercial reasons for the agreement would be the purchase of the company's assets, goodwill, trademarks, permits etc.

One of the few instances where Section 103(2) would thus become a danger, in the context of schemes of arrangement, would be where the liquidator did not wait for a compromise offer under Section 311 and insisted on a separate offer being made for the assets of the company. In this instance, at the time of concluding a Section 311 arrangement, there would be no assets of any significance in the company except the assessed loss. The transaction

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[33] 1. 1975(4) SA715(A)

would thus have little or no normal commercial objective save for obtaining the tax benefit of utilizing the assessed loss and the compromise would be highly susceptible to an attack by Revenue under Section 103(2).

In general though, provided there is a sound commercial or business reason for the scheme, there is little danger posed by Section 103(2).

4. THE IMPLICATIONS OF THE VALUE ADDED TAX ACT

4.1 SECTION 22 (1) OF THE VALUE ADDED TAX ACT

The Value Added Tax Act [34]("the VAT Act") provides that where a vendor has made a taxable supply (that is, a supply which is subject to Value Added Tax ("VAT") for a consideration in money, and has paid the output tax on the supply, then if he has written off part or all of the consideration (i.e. the debt) as has become irrecoverable, he may claim an input tax deduction, in terms of Section 16(3) of the VAT Act, based on the portion written off.

However, as from 4 July 1997, Section 22 of the VAT Act was amended by the introduction of Section 22(1)(c)(iv).

Section 22(1)(c)(iv) reads as follows:

"(iv) a vendor who has transferred an account recoverable at face value on a (aa) non-recourse basis to any other person, shall not make any deduction in respect of such transfer in terms of this subsection; or (bb) recourse basis to any other person, may make a deduction in terms of this subsection only when such account receivable is transferred back to him and he has written off so much of the consideration as has become irrecoverable".

The explanatory memorandum issued by The Receiver of Revenue stipulates that the amendments to Section 22(1) were intended to apply to factoring arrangements. However, it would seem that they may well directly impact on trade creditors of a target company.

Before the introduction of the amendment where a trade debt was ceded at a value which was a discount to the face value, the discount was in practice treated as irrecoverable by the ceding vendor and a VAT input (equal to the tax fraction) was allowed by the Receiver of Revenue.

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[34] No 89 of 1991

Since the amendment however, the input tax deduction is denied to any vendor for his loss if he has transferred the trade debt on a non-recourse basis at face value.

Bennett and Kruger in the August 1997 VATGRAM[35], criticise the amendment as follows:

'It has been the practice since the introduction of VAT to allow vendors to claim input tax relief where they write off any consideration in respect of which they have accounted for output tax as irrecoverable. It did not matter whether the amount was written off as irrecoverable by virtue of the debtor not being in a position to pay it, or merely because the debt was factored. In a surprise move, Section 22 has been amended to deny a vendor a deduction where a debt is disposed of at face value on a non-recourse basis. The rationale for the change according to the Explanatory Memorandum is that in this instance the "factoring cost" is not part of the consideration for the underlying supply which has been written off as irrecoverable, rather it is the cost of earning the "factoring income". The Memorandum notes the transfer of a debt security. With respect, while the "factoring cost" does indeed constitute consideration for an exempt supply in the hands of the person factoring the debt, the fact of the matter is that the vendor will not recover that part of the consideration in respect of which he has accounted for output tax (which he effectively collects on behalf of the Fisc). He should in our view still be entitled to input tax relief.

By contrast, where the vendor disposes of his debts on a recourse basis, he is similarly denied a deduction until the debt is returned to him, if ever, and he writes the debt off as irrecoverable. We see no reason for restricting the deduction in this manner. It must be borne in mind that while the vendor will be denied any VAT relief where he factors his trade debts (unless the debts have been factored on a recourse basis and are then irrecoverable), he is

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[35] VATGRAM (1997) 3 Butterworths – Bennett, A and Kruger, D (eds)

nevertheless entitled to income tax relief in respect of the VAT portion of the "factoring cost".'

Section 22 has been further amended by the provisions of 22(1A) which reads as follows:

'(1A) Where a vendor-

(a) has made a taxable supply for consideration in money; and

(b) has furnished a return in respect of the tax period for which the output tax on the supply was payable (at the rate of tax referred to in section 7 (1) and has properly accounted for the output tax on that supply as required in terms of this Act; and

(c) has transferred the account receivable relating to such taxable supply at face value to another vendor (hereinafter referred to as the recipient) on a non-recourse basis on or after the date of promulgation of the Taxation Laws Amendment Act, 1997,

and any amount of the face value (excluding any amount of finance charges or collection costs) of such account receivable has been written off as irrecoverable by such recipient, such recipient may make a deduction in terms of section 16 (3) of an amount equal to the tax fraction (being the tax fraction applicable at the time such taxable supply is deemed to have been made) of such face value (limited to the amount paid by the recipient in respect of such face value) written off by him, the deduction so made being deemed for the purposes of the said section to be input tax.'

Bennett and Kruger[36] criticize this amendment as follows:

"The situation becomes even more unbelievable. Section 22 has been further amended to allow the person to whom a debt has been factored on a non-

[36] VATGRAM 1997(3)(Butterworths)

recourse basis to claim VAT relief if he is in effect unable to recover the full face value of the debt, limited to the amount paid by him for the debt. Why? As noted in the Explanatory Memorandum the factoring of debts constitutes an exempt supply and the consideration received by the person factoring the debt (in effect the difference between the face value of the debt and the consideration paid for it) does not attract any VAT liability. If then part of the consideration for the exempt supply is irrecoverable, why is input tax relief being granted to someone other than the person who bore the burden of the tax in the first place?

The difficulty with the amendments to the VAT Act seems to be that although they were aimed at factoring arrangements, their wording is wide enough for them to apply to schemes of arrangement in terms of Section 311. In the situation where a trade creditor in terms of a scheme in terms of Section 311 cedes his claims at face value to the proposer on a non recourse basis and realises a loss, the scheme creditor would forfeit the input credit which he would have been entitled to, had he simply written of the debt as bad.

Thus the Scheme would be unattractive to trade creditors unless the offeror included in the dividend to creditors, an amount equivalent to the input credit cost by the creditors.

This generally poses a problem to offerors as it will make the scheme not viable from a commercial point of view.

In addition it would be a problem for the liquidator to propose to the body of creditors that they would be in a better position accepting the scheme of arrangement since by virtue of the amendments to 22(i) they would clearly be worse off to the tune of the VAT input.

4.2 SECTION 22(3) OF THE VALUE ADDED TAX ACT:

Section 22(3) was inserted into the VAT Act in July 1996. The provides as follows:

"(3) Where a vendor who is required to account for tax payable on an invoice basis in terms of section 15 –

(a) has made a deduction of input tax in terms of section 16(3) in respect of a taxable supply of goods of services made to him; and

(b) has, within a period of 36 months after the expiry date of the tax period within which such deduction was made, not paid the full consideration in respect of such supply,

an amount equal to the tax fraction, as applicable at the time of such deduction, of that portion of the consideration which has not been paid shall be deemed to be tax charged in respect of a taxable supply made in the next following tax period after the expiry of the period of 12 months: Provided that the period of 12 months shall, if any contract in writing in terms of which such supply was made provides for the payment of consideration or any portion thereof to take place after the expiry of the tax period within which such deduction was made, in respect of such consideration or portion be calculated as from the end of the month within which such consideration or portion was payable in terms of that contract.

[Sub-s (3) added by s. 25 of Act No. 37 of 1996 and amended by s. 36 (C) of Act No. 27 of 1997.]"

Thus, the Section provides that the recipient of a taxable supply who has claimed an input tax deduction in relation thereto must account for output tax (equal to the tax fraction of the outstanding amount) if payment for that supply has not been made within 36 months. So if the debt is not paid there is a recoupment of the VAT input.

In terms of an amendment to this provision, effective from June 1997, the 36 month period was reduced to 12 months. However, because of an oversight in the amendment, the 36 month period was not altered to 12 months in paragraph (b) of Section 22(3).

As a result there was some confusion which was eventually settled by a media release[37] by the South African Revenue Services which stated that the 36 month period will continue to apply until the amendment is corrected in 1998 to reflect a 12 month period (probably in July 1998).

The effect of this is basically that in cases of companies in provisional liquidation (which in most instances would be unable to settle their creditor's claims during the required period) these companies would become liable to pay output tax in respect of these claims.

The danger to unsuspecting offerors who acquire debt-laden companies would be substantial – they would suddenly find themselves facing considerable hidden VAT liabilities.

The Receiver of Revenue obviously saw that there was a problem with their VAT collections where taxable supplies were made but never paid for. The logic seems to be that the supplier of goods and services would pay output VAT and that after failing to obtain payment for the supply, the debt would be written off as a bad debt and the VAT would be reclaimed. The recipient of the supply would claim input VAT when the supply was made but there was no mechanism for the recovery of that input VAT when the payment for that supply was never made.

This section obviously poses a huge danger to offerors in schemes of arrangement in terms of Section 311.

It would, in these circumstances be essential for the offeror in terms of a scheme and prior to the approval of the scheme, to approach the Receiver of Revenue to reach an agreed amount to be paid in respect of all of its existing and potential claims in the event of a sanction of the compromise.

In order to achieve this the Scheme must either be made conditional on the offeror being able to reach an agreement with the Receiver of Revenue whereby the Receiver of Revenue waives all of its Section 22(3) claims for an

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agreed consideration or, a separate class of creditor must be created for the Receiver of Revenue (in respect of its concurrent claim in terms of Section 22(3). The former route is probably preferable.

The question now arises whether the Receiver of Revenue may in fact agree to the compromise of its claim.

It would seem that the Receiver of Revenue's claim for VAT is not just a straight forward preferent claim

It is true that 99(1)(cD) of the Insolvency Act does confer a preference on the Receiver of Revenue (pari passu with certain other claims) out of the balance of the free residue in respect of VAT, interest and penalties due by the insolvent immediately prior to the sequestration of the estate of an insolvent, which, by the application of 340 of the Companies Act corresponds to the winding up of a Company.

However, the complicating factor would appear to be the wording of Section 22(3). It seems that the supplier and the recipient may agree at any time, prior to the lapse of the stipulated period, to an extension of time within which the consideration must be paid.

Whether or not the Receiver of Revenue would regard this practice as applicable in the case of liquidation, it appears that the Receiver of Revenue's claim for output tax is at least contingent on the lapse of the stipulated time.

Thus there are three categories of claims by the Receiver of Revenue.

a) claims not contingent at the date of winding up – which confer a preference on the free residue.

b) Claims no longer contingent at the acceptance of the offer of compromise – which will have no preference.

c) Contingent claims at the date of acceptance of the offer of compromise.

It is the last category of claim which causes the most problems as they are not only contingent but also unliquidated.

When attempting to get agreement from the Receiver of Revenue, a question arises in relation to these claims as to whether the Receiver of Revenue can be bound by his agreement.

In this regard the *Namex* case [38] sets out fully the powers of the Receiver of Revenue to agree to an offer of compromise.

The court held that the Commissioner could consent in respect of a known tax claim where the arrangement was for the benefit of the state.

Thus the Commissioner's claim for output tax, to the extent that it is known at the date of the creditors' meeting may form part of the arrangement to which the commissioner is entitled to agree.

The court went on to provide that if it is unknown whether the company has a further tax liability one could very seldom decide whether the waiver of a possible existing but unknown claim for tax would be to the advantage of the State or whether the unknown claim to which the waivers refers was irrecoverable.

The court in *Namex* seemed to envisage a waiver of an unknown claim and thus did not hold that the Commissioner cannot consent where a claim can be quantified.

Thus it seems that (provided that the offeror had sufficient information to make it feasible) it would be competent for the offeror to approach the Commissioner to agree to a compromise which would include a quantification of his claim that may arise in the future in respect of VAT.

In summary, a new danger has been posed to offerors in schemes of arrangement. It must be assumed that the gremlin in Section 22(3) will be

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[38] Namex v CIR 1994(2)SA265(A)

removed in July 1998 and that the operative period will then be 12 months. Offerors must obviously approach the Commissioner for Inland Revenue in an attempt to compromise his claim. However, at this stage it must be borne in mind that the issue of whether it is competent for the commissioner to compromise his claim in these circumstances, has not come before the court to be decided.

5. CONCLUSION:

Schemes of arrangement and offers of compromise in terms of Section 311 have weathered the storm in so far as the challenges posed by the varying judgements of the different divisions of the High Court.

There seems to be hope offered by the Minority judgement in *Namex* that the door might again open for the Standard Scheme and the challenges posed by the Income Tax Act, Sections 103(2) and especially Section 20(1) may be overcome as a result of *Namex*. Even *ITC1613* may offer some hope as it makes it clear that the difficulty of quantification of the benefit enjoyed still poses a problem for the Commissioner for Inland Revenue.

However, it would seem that the biggest challenge to schemes of arrangement and offers of compromise has been posed by The Value Added Tax Act. Not only does Section 22(1) cause problems by making the claims of trade creditors impractically expensive for the offeror in cases of companies with large numbers of trade creditors but Section 22(3) also poses problems for offerors, which although they may not be insurmountable, have as yet not had the possible solutions tested.

I have no doubt, having examined the history of the development of schemes of arrangement and offers of compromise, that proposers of the schemes and offers will not allow the challenges posed by the most recent amendments to the legislation to deter them for any length of time, and in the near future further variations will be introduced which will allow Section 311 to continue to play the beneficial and important role that it always has in the past.

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