

**LEGISLATING BUSINESS RESCUE IN SOUTH AFRICA: A CRITICAL  
EVALUATION**

**BY**

**DOROTHY DARKO-MAMPHEY**

**DISSERTATION**

SUBMITTED IN FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF THE  
DEGREE OF MASTER OF LAWS (LLM)  
AT THE NELSON MANDELA SCHOOL OF LAW  
UNIVERSITY OF FORT HARE

(201002039)

SUPERVISOR :PROFESSOR P C OSODE

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## **DECLARATION**

I, Dorothy Darko-Mamphey do hereby declare that, except for references specifically indicated in the text, and any other help I have acknowledged, this dissertation is wholly a product of my own academic research and analysis. It is hereby further certified that this dissertation has not previously been submitted to another University for purposes of fulfilment of the requirements of a degree.

.....

East London

## **DEDICATION**

To my late Mother and Father, Mr and Mrs Mamphey, I wish you were alive to share this achievement with me!

Also to my late siblings, Jane and Dave Mamphey, this work is for your memory!

## **ACKNOWLEDGEMENTS**

This piece of work would not have been possible without love, support, encouragement and guidance from my family. My sincere gratitude goes to all of you. Specific mention must be made of the following:

- **Jehovah God**

The Almighty God who provided me with strength and energy for this undertaking!

- **Professor P C Osode**

My supervisor, who has guided, tolerated and supported me throughout this project with his expertise and patience.

- **Maame Nicole Mamphey**

My daughter and friend, who suffered tremendously due to neglect while I was engaged with work on this dissertation.

- **My siblings**

Vicky, Esther, and Joe Mamphey, thank you very much. You inspired and encouraged me to go this far.

- **My Nephews and Nieces especially Pastor Pius Kobby Boadi**

Thank you for your support and prayers.

## **LIST OF ABBREVIATIONS**

<b>ABASA</b>	<b>Association of Business Administrators South Africa</b>
<b>AO</b>	<b>Administration Order</b>
<b>AR</b>	<b>Administrative Receiver</b>
<b>ALRC</b>	<b>Australian Law Reform Commission</b>
<b>ASIC</b>	<b>Australian Securities and Investment Commission</b>
<b>BASA</b>	<b>Banking Association of South Africa</b>
<b>CACIL</b>	<b>Centre for Advanced Corporate and Insolvency Law</b>
<b>CIPC</b>	<b>Companies and Intellectual Property Commission</b>
<b>CASAC</b>	<b>Company and Securities Advisory Committees</b>
<b>GEERS</b>	<b>General Employee Entitlements Redundancy Scheme</b>
<b>CAMAC</b>	<b>Corporations and Markets Advisory Committee</b>
<b>CVA</b>	<b>Company Voluntary Arrangement</b>
<b>DTI</b>	<b>Department of Trade and Industry</b>
<b>DOJ</b>	<b>Department of Justice</b>
<b>DOCA</b>	<b>Deed of Company Arrangement</b>
<b>EEA</b>	<b>European Economic Area</b>
<b>EU</b>	<b>European Union</b>
<b>IMF</b>	<b>International Monitoring Fund</b>
<b>INSOL</b>	<b>International Insolvency Practitioners</b>

<b>NEDLAC</b>	<b>National Economic Development and Labour Council</b>
<b>QFCH</b>	<b>Qualified Floating Charges Holder</b>
<b>SALRC</b>	<b>South African Law Reform Commission</b>
<b>SAPOA</b>	<b>South African Properties Owners Association</b>
<b>SARS</b>	<b>South African Revenue Service</b>
<b>UNICITRAL</b>	<b>United Nations Commission on International Trade Law</b>



## CHAPTER ONE

### General Introduction and Background of the Study

#### 1 1 INTRODUCTION AND BACKGROUND

Social, political and economic changes in post-apartheid South Africa have generated the need for a major reform of the legislative regime governing companies in order to ensure that that regime is capable of addressing the challenges faced in domestic and international circles, and to also meet the demands of globalisation.<sup>1</sup> These developments include the change in culture from company liquidations to commercial renewal which caused the Department of Trade and Industry (DTI) to embark on drastic reforms of South Africa's business rescue mechanism as part of the broader company law reform project.<sup>2</sup> The domestic and global environments have indeed changed drastically with corporate structures showing significant evolution.<sup>3</sup>

There are various reasons why businesses fail dismally in South Africa. Most notable among those reasons are: shortage of working capital, factors related to interest rates and the volatility of the rand, mismanagement and/fraud on the part of the management and directors, as well as the global economic meltdown in recent years.<sup>4</sup> Outdated technology, inappropriate financial management policies employed by directors, lack of marketing strategies, strikes, loose information systems are additional factors contributing to corporate failures.<sup>5</sup> Current worldwide trends have prompted the global move towards corporate rescue to prevent companies from becoming insolvent.<sup>6</sup> The new South Africa under the

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<sup>1</sup> Department of Trade and Industry "Guidelines for Corporate Law Reform: South African Company Law Reform for the 21<sup>st</sup> Century" 14 GN 1183 Government Gazette number 264493 May 2004 (hereafter The Policy Document). The Department of Trade and Industry developed this policy document to set out the basic approach to be followed in making South African company law competitive and up-to-date. See the Policy Document 5.

<sup>2</sup> *Ibid.*

<sup>3</sup> *ibid.*

<sup>4</sup> Gewer "Business Rescue options available in South Africa" Available at [www.turnaround-sa.com](http://www.turnaround-sa.com) (accessed 04-09-09). See also Davis *et al Companies and Other Business Structures in South Africa* (2011) 226-227 (where the co-authors observe that "there is no single factor that can be attributed to the failure of companies").

<sup>5</sup> Goodman "Managing a turnaround" [http://www.turning.sa.com/pdf/managingturnaround/...May\\_2004](http://www.turning.sa.com/pdf/managingturnaround/...May_2004). (accessed 10-February 2011)

<sup>6</sup> Walt "Turnaround Situations: Managing a Turnaround" <http://www.corporate-renewal.co.za/> (accessed 25-01-2011).

Constitution<sup>7</sup> has taken the responsibility of protecting each legal person's interests in all aspects of life, business interests included. Although Judicial Management of companies in financial distress had been in place for several decades, it was a "spectacular failure"<sup>8</sup> partly because it had a major weakness in that it required an order of court in order to be activated.<sup>9</sup> Informal corporate restructuring processes outside the legal process can only take place if all creditors support it<sup>10</sup> therefore it can be initiated by management and the creditors agreeing on a plan to reduce indebtedness.<sup>11</sup> Furthermore, informal creditor workout can be accessed only if the business suffers from acute and worsening financial problems.<sup>12</sup> In the informal workout, the process is outside the legal framework of judicial management and is available only if the business is distressed but economically viable.<sup>13</sup> Management remains in charge but then reaches an agreement with creditors such as banks and other financial institutions. The informal process leads to business survival and job retention.<sup>14</sup> Informal workouts have a number of distinct advantages such as:

- They are cheap and flexible;
- They ensure secrecy of the activities of directors; and
- They enable a company to avoid the stigma of corporate rescue.

However, its disadvantages are far too many such as the lack of transparency in the directors' conduct; the potential for recklessness of directors; and the absence of an enforceable moratorium as the informal workout lacks a legislative basis.<sup>15</sup> Judicial management of financially troubled companies was incorporated into the old Companies legislation,<sup>16</sup> unlike informal workouts, but there are several published academic commentaries which proposed

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<sup>7</sup> Chapter 1 Section 2 of the Constitution of the Republic of South Africa 1996 stipulates that the Constitution is the supreme law of the Republic; that any law or conduct inconsistent with it is invalid; and that the obligations imposed by it must be fulfilled.

<sup>8</sup> See Smits "Corporate administration: A proposed model" 1999 *De Jure* 80; and Olver "Judicial Management – A case for Law Reform 1986 *THRHR* 86 cited in Bradstreet "The Leak in the Chapter 6 Life Boat: Inadequate Regulation of Business Rescue Practitioners May Adversely Affect Lenders' Willingness and the Growth of the Economy" 2010 16 *SA Merc LJ* 196; Rajak and Henning "Business Rescue for South Africa" 1999 *SALJ* 268 (hereafter Rajak and Henning).

<sup>9</sup> Section 427(2) of companies Act 61 of 1973.

<sup>10</sup> Eccles, Berry and Gilmore "Debt Recovery for Creditors and the Law of Insolvency in South Africa" <http://www.standardandpoors.com/ratingsdirect> October 2007. (accessed 12-10-2010).

<sup>11</sup> Gewer "Business rescue options available in South Africa" available at [www.turnaround-sa.com](http://www.turnaround-sa.com) (accessed 04-09-09)

<sup>12</sup> *Ibid.*

<sup>13</sup> *Ibid.*

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.*

<sup>16</sup> Sections 427 - 440 of Companies Act 61 of 1973.

reforms or amendments to the said legislation in order to make corporate rescue mechanisms more pro-active.<sup>17</sup> Until 2010, South Africa had the statutory regime established by section 311 of the 1973 Companies Act which provided a remedy available to companies that were struggling to enter into a compromise with their creditors.<sup>18</sup> This court-driven process paved the way for the eventual compromise which had to be sanctioned by both the court and the creditors.<sup>19</sup> In the pursuit of reform, the Standing Advisory Committee on Company law was tasked to develop and present recommendations aimed at bringing South Africa in line with other economies with regard to business rescue and other related options.<sup>20</sup>

Judicial management had been a dismal failure since its inception in 1926 for a number of reasons. First, companies could not bind suppliers and creditors to continue their transactions with the business and at the same time deal with the existing directors in the absence of benefits to the creditors while the company is undergoing the process of judicial management.<sup>21</sup> Second, because of a lack of adequate protection by legislation, the judicial management process was susceptible to blackmail by unscrupulous stakeholders who could scupper the well-intended business rescue efforts if they did not receive additional benefits.<sup>22</sup> Third, the lack of expertise and qualifications on the part of a judicial manager to effectively turn around a distressed company contributed to the failures of judicial management; also there was considerable danger of irremediable incompetence and fraud in the area of commercial practice which often requires much business acumen and skill.<sup>23</sup> Fourth, in addition to being costly, judicial management was slow to effect or implement. It is against this background that the business rescue model has been adopted to overcome the weaknesses of judicial management.<sup>24</sup>

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<sup>17</sup> Kloppers “Judicial Management Reform – Steps to Initiate a Business Rescue” 2001 *SA Merc LJ* at 359.

<sup>18</sup> This section clearly states that where any compromise is proposed between a company and its creditors, the court can allow judicial management and that such compromise should not affect the liability of any person who is a surety for the company; offers of compromise as contemplated in this section may be implemented in order to achieve satisfactory business re-organisations in certain circumstances but face limitations in that applications to court are required to convene meetings necessary for considerations of such offers of compromise and for their sanction. See Gewer “Business Recovery and the Re-organisation of Companies in Corporate Rescue, South Africa” 06 August 2004.

<sup>19</sup> *Ibid.*

<sup>20</sup> Burdette “Some Initial Thoughts on the Development of a Modern and Effective Business Rescue model for South Africa (Part 1) 2004 *SA Merc LJ* 242.

<sup>21</sup> Gewer “Business options available in South Africa” available at <http://www.turnaround-sa.com>.(accessed 04-09-2009).

<sup>22</sup> *Ibid.*

<sup>23</sup> Rajak and Henning 268.

<sup>24</sup> *Ibid.*

Judicial Management was part of the law of corporate insolvency and served as a special and extraordinary procedure to obviate a company from being liquidated if there is a reasonable probability that it can surmount its difficulties and successfully carry on.<sup>25</sup> Traditionally, the local liquidations market has been characterised by a highly “creditor-friendly” regulatory framework, which means that the creditors essentially drive and control the liquidation process, possibly to the detriment of the debtor facing liquidity problems.<sup>26</sup>

Judicial management did not change much over the years, although a few amendments such as the Companies Act Amendment of 1932 made provision for a moratorium on claims by creditors as well as the introduction of the principle of impeachable transactions.<sup>27</sup> Over the years, a number of commissions of inquiry<sup>28</sup> deliberated on the consolidation of the Companies Act in the early 1970’s and the Masters of the Supreme Court called for the abolition of judicial management due to its low success rate; however, rather surprisingly, the Commissions recommended that it be retained under the Companies Act of 1973.<sup>29</sup>

South Africa had the advantage of learning from various business rescue provisions that had been in place in various other countries such as Canada, Germany, United States of America, France and Australia. It should be noted that for the first time, South Africa companies’ legislation<sup>30</sup> has not been anchored in the Company Law of any foreign jurisdiction. The New Companies Act 71 of 2008 represents the best breed, borrowing in each particular concept from the best in the particular jurisdiction.<sup>31</sup> In certain respects we have home – grown innovations that combine to enable South Africa to take its place amongst the best of company law jurisdictions.

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<sup>25</sup> Gibson *South African Mercantile and Company Law* (2008) 411-412. See also *Le Roux Hotel Management (Pty) Ltd v E. Rand (Pty) Ltd (Under Curatorship) Intervening* 2001 2 SA 727 ( C ); and section 427(1) of Companies Act 61 of 1973.

<sup>26</sup> Buchholz “Corporate restructuring in South Africa” KPMG July 2006. <http://www.turnaround.sa.com/.../turnaround/industry/opinions.php>

<sup>27</sup> Burdette “The Development of a Modern and Effective Business Rescue Model for South Africa” Pre-Consultation Document developed by the Centre for Advanced Corporate and Insolvency Law (CACIL), University of Pretoria, January 2004 8. (Hereafter CACIL).

<sup>28</sup> Lansdown Commission (UG of 1936), Millin Commission - Verslag Van Kommissie van Ondersoek insake die wysiging van Maatskappywet (UG 69 of 1948), Van Wyk de Vries Commission – Kommissie van Ondersoek na die Maatskappywet (Hoofverslag RP 45 of 1970) Main Report and (Aanvullende Verslag en Konsepwetsontwerp RP of 1972) Supplementary Report.

<sup>29</sup> CACIL 8-9.

<sup>30</sup> Companies Act 71 of 2008.

<sup>31</sup> Cited in *Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others* 2012 (3) SA 273 (GSJ) (Para 9).

Globalisation has led to countries adopting cross-border insolvency agreements to embrace corporate rescue reforms as the loss of opportunities to save jobs brings about obstacles to the flow of trade between different jurisdictions.<sup>32</sup> In order to realise the vision of corporate law reforms as suggested by the United Nations Commission on International Trade (UNCITRAL), the DTI, stakeholders and the legislature proposed a regulatory framework which can ensure the promotion of growth, employment, innovation, stability, good governance and international competitiveness in South Africa's corporate sector.<sup>33</sup> South Africa has therefore adopted the UNCITRAL cross border insolvency model law as many of the country's trading partners already have UNCITRAL-style business rescue procedures in place or are in the process of including one in their legislation.<sup>34</sup> Some jurisdictions<sup>35</sup> have in recent times embarked on corporate rescue reforms in order to meet global standards of best practice with regard to the prevention and avoidance of insolvency. The vision of the South African government is to comply with UNCITRAL's guide on insolvency law as the basis of any business rescue regime.<sup>36</sup>

Judicial management as enshrined in sections 427 to 440 of the Companies Act 61 of 1973 was available in respect of a company experiencing a temporary setback as a result of mismanagement or any other special circumstances; and its objective was to pursue the company's restoration to profitability by replacing existing management with a judicial manager.<sup>37</sup> For the government of South Africa, a legal framework for business rescue that would embrace the rights of all affected persons, such as shareholders, employees, creditors, and investors alike should be the targeted outcome.<sup>38</sup> This is consistent with the view that,

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<sup>32</sup> Briefing on Restructuring and Insolvency on United Nations Commission on International Trade (UNCITRAL) Model Law on cross-border insolvency February 2006, available at [www.ashurts.com](http://www.ashurts.com). (accessed 20-02-10).

<sup>33</sup> The Policy Document 9.

<sup>34</sup> The following Countries as at December 2005 had already adopted the UNCITRAL Model Law: Eritrea, Japan, Mexico, Poland, Romania, British Virgin Islands, USA, and Montenegro. See Levenstein and Winer "Turnaround Practice in South Africa: Developments in Europe and Other Jurisdictions – A Steep Learning Curve?" Available at <http://www.werksman.co.za>. (accessed 20-02-10)

<sup>35</sup> France 1984-1985, United Kingdom 1986, Netherlands 1988, Ireland 1990, Sweden 1987. See Rajak and Henning 263.

<sup>36</sup> The Policy Document 9.

<sup>37</sup> S 427(2) of the Companies Act 61 of 1973 stipulated that an application to court for a judicial management order in respect of any company may be made by any of the persons who were entitled under section 346 of the Act to make an application to the court for the winding-up of a company, and the provisions of section 346(4)(a) governing applications for winding-up applied mutatis mutandis to an application for a judicial management order.

<sup>38</sup> Consensus now exists that "the effects of insolvency are not limited to the private interests of the insolvent debtor and his or her creditors. There are other groups in society that are vitally affected by the insolvency of the

based on lessons learnt from corporate insolvencies, company law ought to create “a means for the preservation of ... viable commercial enterprises capable of making a useful contribution to the economic life of the country”.<sup>39</sup>

Business rescue has risen to the fore as a result of the current global economic meltdown that has crippled most economies, thereby leading to job losses. The reform in business rescue provisions addresses the failures of the judicial management mechanism and reflects a trend evident worldwide to implement rescue mechanisms for financially ailing companies rather than simply provide for their demise through liquidation.<sup>40</sup>

The new Companies legislation seeks to reinforce government efforts towards compliance with global best practice with regard to business rescue. The globalisation of business hedging against currency fluctuations and the shock of severe financial crises have combined to create the need for insolvency law and insolvency professionals to respond to the rescue culture to make businesses more profitable rather than dealing with the effects of bankruptcy and insolvency.<sup>41</sup>

High and increasing unemployment rates constitute a universal problem in recent times, and whenever the subject of business failure is discussed, the inevitable job losses caused by such failures are highlighted<sup>42</sup>. The DTI was significantly influenced by the substantial job losses revealed by the official figures released by Statistics South Africa. Those figures showed that: 2110 companies were liquidated in 2003 - an increase of 13.56% as compared to 2002; and that over a period of ten years, company liquidations increased by 57% thus resulting in an unemployment rate of 40%.<sup>43</sup> Accordingly, the economic rationale for the new Companies legislation and the business rescue model would be to preserve jobs as well as maintain a

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debtor, such as shareholders, suppliers, employees and customers”. Cassim *et al Contemporary Company Law* (2012) 862.

<sup>39</sup> Insolvency Law and Practice: Report of the Review Committee, Chairman Sir Kenneth Cork (Cmnd 8558, 1982) cited in Cassim *et al Contemporary Company Law* (2012) 862.

<sup>40</sup> Olver “Judicial Management – A case for Law Reform 1986 *THRHR* 86 (cited in Bradstreet “The Leak in the Chapter 6 Life Boat: Inadequate Regulation of Business Rescue Practitioners May Adversely Affect Lenders’ Willingness and the Growth of the Economy” 2010 16 *SA MERC LJ* 196.

<sup>41</sup> Gewer “Business Rescue options available in South Africa” Available at [www.turnaround-sa.com](http://www.turnaround-sa.com) (accessed 04-09-2009).

<sup>42</sup> Loubser “The Interaction between Corporate Rescue and Labour Legislation: Lessons to be drawn from the South African Experience” 2005 *INSOL International Insolvency Review* 57.

<sup>43</sup> *Ibid.*

strong competitive economy as South Africa is regarded as one of the emerging markets in the global economy.

## **1 2 RESEARCH QUESTIONS**

This study seeks to undertake a critical examination of the business rescue framework/model encapsulated in chapter 6 of South Africa's new Companies Act 71 of 2008. Accordingly, it focuses on the legal and policy issues relating to the following questions:

- What are the key features or elements of the new business rescue framework?
- Would the new business rescue framework achieve its objectives or be just as ineffective as its predecessor?
- Has the new framework taken full cognisance of the shortcomings that were experienced with the judicial management model? And
- What are the likely challenges regarding the interpretation and implementation of the new business rescue framework/model?

Prior to the entry into force of the new Companies Act, the South African Property Owners Association (SAPOA) expressed misgivings about the new business rescue framework which has now replaced the previous system of judicial management: the simple reason being that where tenants are subject to business rescue, the effect on property management companies and their clients (property-owning companies) could be enormous.<sup>44</sup> The fear was that payments for rentals would be frozen while the tenants' business would be protected by the legislation. This study would attempt to interrogate these fears or similar concerns.

Lastly, in the business world, corporate governance plays an important role. The boards of directors of companies must act as custodians of the company's business and assets.<sup>45</sup> Directors must ensure that risks and abuses are minimal in the day to day running of their

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<sup>44</sup>Eprop "Rescue Provisions in Companies Bill could negatively impact on commercial property stakeholders" available at [www.eprop.co.za/.../html](http://www.eprop.co.za/.../html). (accessed 12-08-2010).

<sup>45</sup> Institute of Directors "Code of Governance Principles for South Africa 2009 (the Draft Code)" (King III)" Corporate Governance Series February 2009 available at [www.iodsa.co.za](http://www.iodsa.co.za). (accessed 10-05-2010).

company. This study will also highlight the obligations of directors in the business rescue context and the challenges they face in discharging those obligations.<sup>46</sup>

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<sup>46</sup> Sections 75, 76, and 77 of the Companies Act 71 of 2008 stipulate the standard of directors' conduct, disclosure obligations in respect of directors' personal financial interest, and liability of directors and prescribed officers of companies.

### **1 3 DELIMITATION OF THE SCOPE OF STUDY**

Analysing two different business/corporate insolvency models can be quite extensive. For that reason, the main discussions of the study will consist of a critical analysis of the legal frameworks that regulate the two different models: judicial management and business rescue. The historical development of the two models will be traced so as to show their foundational aspects. Political, economic, social and technological forces behind the two models will also be examined.

In pursuing the questions and issues highlighted above, this dissertation covers some selected overseas jurisdictions which have already successfully embraced the corporate/business rescue model.

### **1 4 RATIONALE OF THE STUDY**

The enactment of the new Companies legislation<sup>47</sup> to replace the previous one<sup>48</sup> is expected to provide the basis for South Africa as an emerging market to grow alongside other jurisdictions<sup>49</sup> which have successfully undergone corporate rescue reforms. Corporate structures and financial instruments have undergone significant developments due to globalisation, increased electronic communication, and greater sensitivity to social and ethical concerns.<sup>50</sup> A changing environment, coupled with the need for modernisation, has resulted in the adoption of business rescue reforms in South Africa in this period of global economic meltdown. This study will consider the rationales for the reforms pertaining to business rescue within the context of the overall goals and objectives of the new Companies Act.<sup>51</sup> It will also address the need for a critical assessment and in depth comparison of the new business rescue framework/model with its predecessor, the judicial management model.

### **1 5 RESEARCH METHODOLOGY**

The study will be undertaken by way of a qualitative research methodology based largely on a critical examination and analysis of the legal sources and literature on business rescue, corporate insolvency, and related subjects. It will explore the key provisions/elements of relevant primary and secondary sources, such as legislation, case law, and published

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<sup>47</sup> Companies Act 71 of 2008.

<sup>48</sup> Companies Act 61 of 1973.

<sup>49</sup> See in this regard Angel *et al* "Briefing on Restructuring and Insolvency on UNICITRAL Model Law on cross-border insolvency" February 2006, available at [www.ashurts.com](http://www.ashurts.com) (accessed 20-02-10).

<sup>50</sup> The Policy Document 14.

<sup>51</sup> See in this regard page 13 of General Notice 166 of 2007 no 29630, 12 February 2007, Companies Bill, 2007.

academic commentaries from South Africa and the selected jurisdictions that have successfully embraced the UNICITRAL Model Law on cross-border insolvency.<sup>52</sup>

In particular, case law from South African courts based on the application of the new model and judicial decisions on judicial management will be used to provide clear interpretations of sections 427 to 440 of the old Companies Act 61 of 1973 and chapter 6 of the new Companies Act 71 of 2008.

## **1 6     OUTLINE OF CHAPTERS**

This first chapter provides a general overview of the study. It outlines the objectives, research questions, rationale and limitations of the study and research methodology.

Chapter two discusses the development of business rescue systems. It looks into the historical background and the need for a major review of business rescue mechanism in South Africa.

Chapter three examines business rescue regimes in two jurisdictions, namely the English and Australian business rescue regimes. The chapter further explores the usefulness of these regimes in determining the most appropriate business rescue mechanisms for South Africa.

Chapter four of this study, analyses the judicial management in the 1973 Companies Act. It examines the reasons why there was a compelling need for an elaborate reform of the old business rescue model.

Chapter five examines the new business rescue model in the New Act. It further explores pertinent judicial decisions with a view to determining whether the objectives of reforming the old business rescue mechanism are being achieved.

Chapter six of the dissertation provides the final conclusions. Also, recommendations are made in this chapter based on the findings of the study.

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<sup>52</sup> Companies Act 61 of 1973.

## **1 7    REFERENCING STYLE**

The referencing style used in this dissertation is that of *Speculum Juris*, an accredited law journal now published online by the Nelson R Mandela School of Law at the University of Fort Hare.<sup>53</sup> This study will therefore not have any intellectual property implications in terms of copyright law as all the works used in it will be properly acknowledged.

## **1 8    ETHICAL IMPLICATIONS OF THE STUDY**

This study will not involve any ethical implications, as questionnaires or interviews will not form part of the study.

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<sup>53</sup> See [www.speculumjuris.co.za](http://www.speculumjuris.co.za).

## CHAPTER TWO

### Development of Business Rescue Systems

#### 2.1 INTRODUCTION

The emergence as well as the importance of strong economic growth, coupled with the need to protect companies, jobs and citizens have compelled national governments, as a matter of priority, to enact statutes that can provide actors and stakeholders in the corporate world with effective business rescue mechanisms. In this respect, the need to overhaul Company Law and Insolvency Law in South Africa has been championed by legal commentators, economists and interested parties.<sup>54</sup> This has also been motivated by the demands of globalisation and because other jurisdictions have overhauled their business rescue systems in recent times.

South Africa, an emerging market with a new Constitutional<sup>55</sup> dispensation that upholds the principles of equality and modernisation, has created a legal system that has enacted other statutes<sup>56</sup> relevant for the development of a business rescue regime. Kloppers has opined that business rescue legislation should determine the nature of business entities that are covered by the statute, the circumstances in which the rescue procedure may be initiated and the procedures to be followed to initiate a business rescue.<sup>57</sup>

It has been suggested that while the number of cross-border insolvency cases has increased significantly, the adoption of legal regimes, domestic or international, equipped to address business insolvency cases of a cross-border nature has not kept pace.<sup>58</sup> The lack of such

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<sup>54</sup> Kloppers “Judicial Management Reform-Steps to Initiate a Business Rescue”2001 *SA Merc LJ* 359 (hereafter Kloppers).

<sup>55</sup> See generally the Bill of Rights in the Constitution of the Republic of South Africa 1996.

<sup>56</sup> Legislative and other measures, which reflect the South African Constitution have made possible the emergence of legislation such as the Labour Relations Act of 1995 (LRA), the Employment Equity Act of 1998 (EEA), the Broad-Based Black Economic Empowerment Act of 2003 (BBBEE) and the Promotion of Access to Information Act of 2000 (PAIA) among others.

<sup>57</sup> Kloppers 361.

<sup>58</sup> See in this regard United Nations Commission on International Trade Law Practice Guide on Insolvency Law 9. Available at [www.uncitral.org/pdf/english/texts/insolvency/05-80722\\_\(accessed:28-02-2010\)](http://www.uncitral.org/pdf/english/texts/insolvency/05-80722_(accessed:28-02-2010)) (hereafter UNICITRAL Practice Guide). The United Nations Commission on International Trade Law is a subsidiary body of the general Assembly. It prepares international legislative texts for use by states in modernising commercial

regimes has often resulted in inadequate and uncoordinated approaches that have not only hampered the rescue of financially troubled businesses and the fair and efficient administration of cross-border insolvency proceedings, but also impeded the protection and maximization of the value of the assets of the debtors.<sup>59</sup>

## 2.2 HISTORICAL BACKGROUND AND THE NEED FOR REVIEW OF BUSINESS RESCUE MECHANISMS IN SOUTH AFRICA

### 2.2.1 The origin of business rescue in South Africa

South Africa derives its history and sources of Insolvency Law from neither pure Roman Dutch Law nor pure English law; rather it appears to be a hybrid of Roman Dutch Law and English Law, with the Constitution being an additional source<sup>60</sup>. Common law and case law<sup>61</sup> have contributed to the development of South Africa's insolvency law. However, the country's early insolvency legislation had much in common with English Bankruptcy Law<sup>62</sup>.

Under the Twelve Tables,<sup>63</sup> if a debtor was unable to pay his debts, his creditors could seize him and sell him into slavery (*manus iniectio*) or, it seems, they could even cut his body into pieces<sup>64</sup>. Between 326 and 313 BC, the *lex Poetelia* was passed prohibiting the sale of the debtor into slavery in execution of a judgment debt, after which, imprisonment in a public

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law and non-legislative texts for use by commercial parties in negotiating transactions. Examples are: UNCITRAL Model Law on Arbitration and the UNCITRAL Model Law on Insolvency.

<sup>59</sup> UNICITRAL Practice Guide 9.

<sup>60</sup> See generally Sharrock *Hockly's Insolvency Law* (2005) 10-11 (hereafter Sharrock).

<sup>61</sup> See in this regard *Childerley Estate Stores v Standard Bank of S.A. Ltd* 1924 O.P.D. 163 where the presiding judge, De Villiers J, qualified the *locus classicus* on the subject of the court's powers to rescind judgments. The issue was whether the plaintiff could rely on section 26 of the Insolvency Act of 1916 which states that every disposition of property not made for value may be set aside by the court if such disposition was made by an insolvent. It was held that the whole frame of the particulars of claim indicates that Mr Berman, for the plaintiff, advanced a number of arguments in support of his main submissions which raise issues that are not covered in the particulars of claim. The court held that it has been the practise to insist on a precise statement of the ground of action in cases connected with insolvent estates and if the plaintiff in such a suit desires to rely not merely upon the provisions of the statute, but upon the common law, it is essential that his declaration should contain a count to that effect so as to give effect to the common law. The judge concluded at page 168 by stating: "We arrive at this position then that so far as *justus error* is concerned default judgments may in some cases be set aside under the Roman –Dutch law on the ground of *justus error*, and that judgments whether by default or not, may be set aside in cases mentioned on the ground of *instrumentum noviter repertum*, though some of the cases are nowadays obsolete. See also in *De Wet and Others v Western Bank Ltd* 1977 2 SA 1033 (W).

<sup>62</sup> Smith *The Law of Insolvency* (1998) 8 (hereafter Smith).

<sup>63</sup> Kleyn and Viljoen *Beginner's Guide for Law Students* (2002) 22-24. Roman Law was codified for the first time in the Law of the Twelve Tables which for example stated that creditors should not be prejudiced by a debtor who is unable to pay his debts.

<sup>64</sup> (Sharrock 10).

prison replaced sale into slavery as the punishment for the inability to pay debts.<sup>65</sup> Execution against the debtors' property, known as *missio in possessionem*, was introduced in 167 or 104 BC in terms of which the praetor issued decrees to allow creditors to possess the assets of debtors and sell them.<sup>66</sup> *Cessio bonorum* was a part of Dutch law, which allowed a magistrate to supervise the administration of an insolvent estate.<sup>67</sup>

The Ordinance of Amsterdam, passed in 1777, formed the basis of the South African Law of Insolvency.<sup>68</sup> Ordinance 64 of 1829 was re-enacted with minor additions and modifications as Cape Ordinance 6 of 1843. South Africa followed Roman Dutch law and enacted Ordinances such as Ordinance 6 of 1843 which changed and consolidated the law pertaining to the *cession bonorum*.<sup>69</sup> The first Uniform Act for the then Union of South Africa was the Insolvency Act 32 of 1916.<sup>70</sup>

All previous Insolvency Ordinances were repealed by the 1916 Act which followed the structure of the Transvaal Act 13 of 1895.<sup>71</sup> The 1916 Act was amended by Act 29 of 1926 and Act 58 of 1934.<sup>72</sup> In July 1936, the Act was replaced by the current Insolvency Act of 1936.<sup>73</sup> South Africa's present law of insolvency is to be found in Act 24 of 1936 as amended mainly by Act 99 of 1965.<sup>74</sup> After the Union, the Insolvency Act<sup>75</sup> replaced existing statutory law, was amended twice before being replaced by the Insolvency Act.<sup>76</sup>

The Cape Joint Stock Companies Limited Liability Act 23 of 1861 was the first company legislation in South Africa<sup>77</sup>. It was an almost verbatim adoption of the English Joint Stock

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<sup>65</sup> *Ibid.*

<sup>66</sup> *Ibid.*

<sup>67</sup> (Sharrock 10).

<sup>68</sup> (Smith 6).

<sup>69</sup> (Sharrock 11).

<sup>70</sup> Burdette *A Framework for Corporate of Insolvency Law in South Africa* (Part 1 of LLD Thesis, University of Pretoria, 2002) 33. (hereafter Burdette Part 1)

<sup>71</sup> Burdette 33.

<sup>72</sup> *Ibid.*

<sup>73</sup> Burdette 4 submits that the primary source of South African insolvency law is the Insolvency Act 24 of 1936, supplemented by common law as contained in Roman Dutch sources and the judgments of the courts.

<sup>74</sup> (Smith 7).

<sup>75</sup> 32 of 1916.

<sup>76</sup> 24 of 1936.

<sup>77</sup> Cronje "Historical background of South African Insolvency Law", prepared for South African Law Reform Committee and the World Bank Insolvency Law Database," June 2006 2. (hereafter Cronje) available at [www.business-rescue.co.za/historyofchapter6development/pdf](http://www.business-rescue.co.za/historyofchapter6development/pdf). (accessed 08-09-2010).

Companies Act, 1844 and the Limited Liability Act, 1855.<sup>78</sup> The South African Companies Act 61 of 1973 was therefore essentially built on foundations, which were put in place by the British in the middle of the 19<sup>th</sup> Century<sup>79</sup>. The English statutes also served as precedent in Natal, the Transvaal and the Orange Free State.<sup>80</sup> The Companies Act 46 of 1926 was based on the Transvaal Companies Act 31 of 1909, which was in turn based on the English Companies (Consolidation) Act of 1908.<sup>81</sup> The Companies Act 61 of 1973 marked a divergence between English and South African Company Law.<sup>82</sup> Cilliers *et al*<sup>83</sup> note that major departures<sup>84</sup> from the British legal system were brought about as a result of the South African Companies Act 61 of 1973 as well as formal restructuring.

It would seem that South African courts will continue to rely upon English case law.<sup>85</sup> According to Cronje that such reliance: “has to be done with circumspection, for our own statute law may not always coincide precisely with that upon which the English decisions have been based, and because differing social and economic factors may well tend to give rise to differences between company activities and their underlying concepts in the two countries”.<sup>86</sup> An important point made by Rajak and Henning<sup>87</sup> is that in 1926, South Africa was the first country after the United States of America to introduce judicial management which is now known as business rescue; the British only had their business rescue regime incorporated in their legislation in 1986.<sup>88</sup> Most jurisdictions and emerging markets have only enacted their business rescue regimes within the last twenty years.<sup>89</sup>

The Companies Act 61 of 1973 resulted from the efforts of the Van Wyk de Vries Commission which cut the umbilical cord between South Africa and English Company

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<sup>78</sup> *Ibid.*

<sup>79</sup> Policy Document 13.

<sup>80</sup> Cronje 2.

<sup>81</sup> *Ibid.*

<sup>82</sup> See generally in this regard Cilliers and Benade Corporate Law 3 (2005) 24 (hereafter Cilliers *et al*).

<sup>83</sup> *Ibid.*

<sup>84</sup> Examples are the establishment of a company having a share capital, the virtual abrogation of the *ultra vires* doctrine, etc.

<sup>85</sup> Cronje 2.

<sup>86</sup> *Ibid.*

<sup>87</sup> Rajak and Henning “Business Rescue for South Africa” 1999 *SALJ* 262 (hereafter Rajak and Henning).

<sup>88</sup> It seems ironic that although South Africa takes the source of its common law from the British, it adopted its first business rescue regime before the British.

<sup>89</sup> Cronje 16.

Law.<sup>90</sup> Perhaps the greatest separation from the United Kingdom occurred with the adoption in 1984 of the Close Corporations Act 69 of 1984, which was inspired by an English policy document recommending the introduction of a new form of incorporation for small companies, but which ironically was never implemented in the United Kingdom<sup>91</sup>. The purpose of the Close Corporations Act<sup>92</sup> was to provide a simple, inexpensive business entity offering limited liability for a single person enterprise or one involving a small number of persons. The Act has been largely successful as is witnessed by the number of Close Corporations that are registered with the Companies and Intellectual Property Registration Office.<sup>93</sup> There has been a series of amending Acts and a Standing Advisory Committee has been set up to review the South African Companies Act from time to time<sup>94</sup>. For more than a hundred years, South African company legislation has been trailing English Company Law<sup>95</sup>.

A review of South African Insolvency law went on for some years and in 1987, the South African Law Reform Commission<sup>96</sup> commenced an investigation of the Law of Insolvency in its entirety.<sup>97</sup> Two draft Bills and Explanatory Memoranda were published for comment during 1996 and 1999 with the contents intended to balance and satisfy the needs of different stakeholders such as creditors, debtors and the government in addition to addressing proposals to curb unfair advantage to some creditors; while endeavouring to strike the

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<sup>90</sup> Pretorius et al *Hahlo's South African Company Law through the Cases 1-2* (hereafter Pretorius et al).

<sup>91</sup> See in this regard The Policy Guidelines 13.

<sup>92</sup> See generally Benade et al *Entrepreneurial Law 4<sup>th</sup>* (2008) 421-422 (hereafter (Benade et al) where it is been submitted that section 72 of the Close Corporations Act 1984 deals with corporate rescue (Composition) for Close Corporations.

<sup>93</sup> Companies and Intellectual Property Commission (CIPC) is an arm of the South African Department of Trade and Industry (DTI) and a custodian of Information on Intellectual Property, Companies and Close Corporations as well as Co-operatives. It is a merger of two former directorates of the DTI: the South African Companies Registration Office and the South African Patents & Trade Marks Office. Its functions among others are to register companies and monitor information that are of questionable utilities to the commercial and investment communities. It should be noted that there had been suggestions that CIPRO be transformed to enable it provide higher service levels to the public and the business community in line with the best practice internationally. CIPRO is now the predecessor of the CIPC. Sections 185, 186 and 187 of the Companies Act 71 Of 2008 provides for the establishment, objectives and functions of the CIPC. See generally [www.cipro.gov.co.za](http://www.cipro.gov.co.za), <http://www.quickcompanies.co.za/functionsforcipro/html>; <http://www.info.gov.za/cipro/htm> (accessed 19-12-2011).

<sup>94</sup> The recent one being the Companies Act 71 of 2008.

<sup>95</sup> (Pretorius et al 1-2).

<sup>96</sup> The objectives of the South African Law Reform Commission are to conduct research with reference to all branches of the law in order to make recommendations to the government for the development, improvement, modernization or reform of the law as well as investigating matters approved by the Minister of Justice. See <http://www.justice.gov.za/salrc/htm>.

<sup>97</sup> Zulman "Developments in South African Insolvency Law" March 2002 2 (hereinafter Zulman).

appropriate balance between the rights of creditors and giving opportunity to debtors to make a fresh start.<sup>98</sup>

Burdette<sup>99</sup> suggested that business rescue and insolvency go hand in hand so that it makes sense to address these important issues simultaneously. Company Law and Insolvency Law must therefore not be treated in isolation as any drastic reform of corporate law must apply to insolvency law concurrently. In the view of Burdette,<sup>100</sup> most players in the insolvency industry support a consolidated approach to insolvency, but some feel it is unworkable because South African Insolvency Law with precedents and proper business rescue provisions is the best in the world.<sup>101</sup> A rewritten insolvency Act would therefore have the prospect of introducing great uncertainty about interpretation.<sup>102</sup> It is submitted therefore that Insolvency Law be revamped so that both Company Law and Insolvency Law can be uniform in their application.

The South African Law Reform Commission has for some years now been engaged in the revision and reform of insolvency law; including a consideration of corporate rescue.<sup>103</sup> During March 2003, the National Economic Development and Labour Council (NEDLAC)<sup>104</sup> appointed a Task Team to look into the Insolvency and Business Recovery Bill after it was decided that the Department of Trade and Industry (DTI) would be responsible for business rescue.<sup>105</sup> The Task Team finalised its consideration of the Bill and Cabinet approved the

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<sup>98</sup> *Ibid.*

<sup>99</sup> Burdette "Some Initial Thoughts on the Development of a Modern and Effective Business Rescue Model for South Africa (Part 1)" 2004 *SA Merc LJ* 241 (hereafter Burdette ).

<sup>100</sup> *Ibid.*

<sup>101</sup> Burdette 241.

<sup>102</sup> Pile "Overview of the Liquidation Industry: Rescue Remedy" *Financial Mail* June 2004 2. (hereafter Pile).

<sup>103</sup> (Smith 7).

<sup>104</sup> The National Economic Development and Labour Council Act 35 of 1994 was enacted to represent organised labour, organised business, community, and the government. Among others, the Act established a Council, known as NEDLAC (hereafter NEDLAC), to consider all significant changes to social and economic policies affecting the country. NEDLAC's aim is to make economic decision-making more inclusive, to promote the goals of economic growth and social equity. Also see Davis et al *Companies and other Business Structures in South Africa* (2011) 8 (hereafter Davis et al).

<sup>105</sup> Cronje "Recent Developments in Insolvency Laws of South Africa" April 2009 9. Available at [http://www.business-rescue.co.za/business-rescue/history\\_of\\_businessrescue/htm](http://www.business-rescue.co.za/business-rescue/history_of_businessrescue/htm). (accessed 10-09-2009) (hereafter Cronje ).

submission of the Insolvency and Business recovery Bill, 2003 to Parliament for consideration during the 2003 session of Parliament.<sup>106</sup>

The Insolvency and Business Recovery Bill was submitted to the State Law Advisers during April 2003 for certification before being tabled in Parliament.<sup>107</sup> The State Advisers certified the draft during March 2004, but the Bill was held back for instructions on the inclusion of modern provisions dealing with business rescue.<sup>108</sup> In June 2005 Cabinet approved the establishment of an Inter-Departmental Task team to look into aspects raised by the Ministerial Committee of Enquiry into the Liquidations Industry and advised that the DTI take responsibility for the reform process in the area of business rescue.<sup>109</sup> It was felt that the legal framework governing insolvencies in South Africa contained inconsistencies and overlapping provisions.<sup>110</sup> The DTI therefore took the view that there was an urgent need for the introduction of a new Insolvency and Business Rescue Bill that would clarify the role of liquidators, the winding up process, and the powers of inquiry.<sup>111</sup> Burdette<sup>112</sup> later reported that the incorporation of business rescue provisions in the Insolvency and Business Recovery Bill was accepted by the DTI in 2004. However, the Department of Justice (DOJ) in 2003 and 2004 favoured a new business rescue legislation based on the ‘Daly Model’.<sup>113</sup> It is understood that in October 2005, a creditor-friendly proposal was made by Burdette based on the UNCITRAL Legislative Guide and aligned with South Africa’s Insolvency Legislation, but it was not accepted.<sup>114</sup> A debtor- friendly business rescue legislation which is a “mix of

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<sup>106</sup> Cronje 8.

<sup>107</sup> *Ibid.*

<sup>108</sup> *Ibid.*

<sup>109</sup> Cronje 9.

<sup>110</sup>The Policy Document 43-44. The existence of large close corporations notwithstanding, there was no equivalent to section 311 of the Companies Act 61 of 1973. There was the need for examination of the various laws affecting insolvency so that the principles in each piece of legislation promote a coherent framework.

<sup>111</sup> See generally The Policy Document 43-44.

<sup>112</sup> See Burdette 241-243. Burdette was an Associate Professor, Department of Mercantile Law, Faculty of Law, University of Pretoria and championed the Development of a Modern and Effective Business Rescue Model Document for South Africa known as CACIL in 2003 – 2004. (hereafter ‘The CACIL’). Burdette steered the development of a Unified Model that raised much awareness of business rescue in South Africa. He was an advocate of a unified statute that could apply to both Insolvency and Company Laws in accordance with business rescue best practice. Burdette is a Professor of Law at Nottingham Law School, United Kingdom. South Africa has separate statutes regulating corporate and individual insolvency. The Insolvency and Business Recovery Bill was aimed at unifying company law and insolvency law.

<sup>113</sup> See generally “The History of Business Rescue Reform in South Africa” Available at [www.businessrescue.co.za/historyofchapter6/pdf](http://www.businessrescue.co.za/historyofchapter6/pdf). (accessed 10-09-2009). Mr. Daly of Daly Incorporated (a group of attorneys who specialize in business turnarounds) and Burdette proposed different corporate recovery models.

<sup>114</sup> Available at <http://www.businessrescue.co.za/historyofchapter6/pdf>. (accessed 10-09-2009).

judicial management, chapter 11<sup>115</sup> and other” was subsequently distributed in the public domain for comment in June 2006.<sup>116</sup>

The ‘Daly Proposal’ was submitted as an interim solution to the call for an urgent business rescue initiative in South Africa, that is, as a mechanism to be adopted pending the enactment of the draft Insolvency and Business Recovery Bill which would contain a more comprehensive business rescue provision.<sup>117</sup> The Daly Proposal contemplated the amendment of the existing Companies Act of 1973 to cater for the provisional liquidation order as well as expedite matters that entails the use of already existing legislation in the form of the winding-up provisions in the Companies Act to aid in the turnaround of a business until a more comprehensive Business Rescue Model was introduced.<sup>118</sup>

The Banking Association of South Africa (BASA), liquidators, and some elements in the private sector saw Daly’s Model on business rescue as an indictment of their debt recovery practices and were strongly opposed to the mechanism initially, but later appointed a task team to study the model.<sup>119</sup> BASA subsequently endorsed the Daly Model but requested amendment to the Insolvency Act to protect themselves as secured creditors. The government, through the State Law Adviser, took an active and positive role in the process and a two-fold strategy was set in motion with the Daly Model being implemented as an interim measure and a task team being appointed to draft the new business rescue legislation.<sup>120</sup> Parallel to the DOJ and DTI initiatives and on request from government, individuals from the South African Insolvency Industry formed the Task Group for Organising the Turnaround and Business Rescue Industries out of which the Association of

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<sup>115</sup> See in this regard Rochelle “Lowering the Penalties for Failure: Using the Insolvency Law as a Tool for Spurring Economic Growth - the American Experience, and Possible Uses for South Africa” 1996 2 *TSAR* 316 (hereafter Rochelle). Rochelle reported that the United States of America’s Bankruptcy Act of 1978 which is commonly called the Bankruptcy Code underwent reform which resulted in significant changes. One of the changes was the consolidation of the business reorganization chapters into one chapter called ‘chapter 11’ which allowed both restructuring of secured debt and continuance of the debtor in possession remaining in control of the company.

<sup>116</sup> See in this regard <http://www.businessrescue.co.za>. (accessed 10-09-2009).

<sup>117</sup> Gewer “Business Recovery and the Re-Organisation of Companies in Corporate South Africa” June 2010 3. (hereafter Gewer Business Recovery) available at <http://www.businessrescue.co.za>. (accessed 03-08-2011).

<sup>118</sup> Gewer Business Recovery 3.

<sup>119</sup> *Ibid.*

<sup>120</sup> *Ibid.*

Business Administrators of South Africa (ABASA) emerged<sup>121</sup>. It is suggested that the new business rescue regime adopted by the state through a workable legislation would result in a positive effect on businesses that are financially sick but that could be turned into a going concern.

## **2 2 2 Policy rationales for a business rescue mechanism in South Africa**

It should be noted that the need for transforming the Judicial Management into Business Rescue is to ensure a balance between the needs of stakeholders such as creditors, employees, the state and the community in general.<sup>122</sup> It is submitted that reorganisation allows jobs to be preserved and creditors to be paid back at least in part. A judicial decision<sup>123</sup> has suggested that judicial management has not been effective with the Masters of the Supreme Court recommending its total abolition to the Van Wyk de Vries Commission, but it is reported that the Commission of Enquiry showed faith in judicial management as a corporate rescue mechanism.<sup>124</sup> This is stated thus by Rochelle:<sup>125</sup>

“Businesses that fail should not become modern lepers but must be given another chance to be productive. Society should not reward the cautious man who buries his talent and takes no chances; it most emphatically should do everything in its power to assist the man who creates jobs... the man who strives to turn his one talent into ten...even if he fails in the attempt.”

The recent reform of South African company law expected to focus on a regulated framework within which enterprises operate to promote growth, employment, good governance, confidence and international competitiveness.<sup>126</sup> It has been suggested that any new regulation should be consistent, effective, predictable, transparent, fair and understandable and must

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<sup>121</sup> ABASA has advocated for a legislation which will give it regulatory powers over Business Administrators, set a criteria for membership and give it the power to discipline its members and deliver efficiently.

<sup>122</sup> Cronje 9.

<sup>123</sup> See generally the case of *Le Roux Hotel Management (Pty) v East Rand (Pty) Ltd* 2001 1 SA 223 where the court held that judicial management is seldom applied in South Africa due to its adversarial process that was not ideally suited to applications for judicial management orders and that negotiation between the parties would be a better option than engaging in the court process. The court said that judicial management was not an appropriate to compel Fidelity Bank to grant the respondent who is the owner of a hotel in Midrand a moratorium against its wishes. In a sharp contrast, the Commission of Enquiry (Van Wky de Vries Commission) debunked that notion and reported that the retention of the regime was justified by the success cases. Also see in this regard Rajak and Henning 226.

<sup>124</sup> Rajak and Henning 266-267.

<sup>125</sup> Rochelle 315.

<sup>126</sup> The Policy Guidelines 9.

provide flexibility and promote adaptability to an environment with fast changing technologies, economic opportunities and social circumstances.<sup>127</sup>

It is worth noting that business rescue has its roots in the United States of America<sup>128</sup> with its objective of gaining the advantage in an industrial dispute between the company and its workforce or to secure an edge in a cost-cutting war with its competitors.<sup>129</sup> In Australia, the purpose of voluntary administration is stated clearly in section 435A of the Corporations Act 2001.<sup>130</sup> In a similar vein, English Law's<sup>131</sup> aim of corporate rescue is to facilitate rescue mechanisms and produce better returns for creditors as a whole. In the United States of America, it has been submitted that the rationales for reorganisation are that creditors may receive more from reorganisation than in liquidation; that jobs may be saved; that the tax base may be preserved; and the polity left better off than the businesses that are closed or sold at an auction.<sup>132</sup>

The need to reform the business rescue regime in South Africa would be considered from the following perspectives:<sup>133</sup>

- Protecting Investment, Preserving Employment and Maximising the Debtors' Assets;
- Creating a New South Africa;
- Promoting Economic Growth and Legal Stability.

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<sup>127</sup> *Ibid.*

<sup>128</sup> It should be mentioned though that most jurisdictions model their business rescue mechanisms on Chapter 11 of the United States Bankruptcy Code; one significant point of departure that these jurisdictions follow in their business rescue process is the removal of the debtor's management during reorganizations whereas the USA has what is called "debtor in possession".

<sup>129</sup> See generally McCormack "Apples and Oranges? Corporate Rescue and Functional Convergence in the US and UK" 2009 INSOL International Insolvency Review 110 where it has been stated that Chapter 11 reorganizations under the United States Bankruptcy Code is premised on the assumption that society has an interest in the preservation or rehabilitation of corporate entities. (Hereafter McCormack).

<sup>130</sup> Australia's formal corporate rescue regime is stipulated in Part 5.3A of the Corporations Act 2001 (section 435A) commonly known as Voluntary Administration with its object being to maximize the chances of the company to continue in existence or if not possible for the company or its business to continue in existence it can result in a better return for the company's creditors and members than an immediate winding up of the company.

<sup>131</sup> Mokal and Armour "Reforming the Governance of Corporate Rescue: The Enterprise Act 2002" 2004 1. (Hereafter Mokal and Armour).

<sup>132</sup> Rochelle 320.

<sup>133</sup> See generally The Policy Document 14-18.

### 2 2 2 1 *Promoting investment, preserving employment and maximising the value of the debtors' assets*

Financial distress is the tangible symptom of business failure which if not attended to promptly and appropriately may lead to an ever increasing rate of stakeholders'<sup>134</sup> disengagement from the company.<sup>135</sup> In over two decades of existence, Judicial Management has not seen any comprehensive review, thus it makes sense to have it reviewed to meet the demands of the domestic and global environment. It is submitted that business rescue reform in South Africa must reflect global trends with regard to internationally accepted market practices.

It has been noted with much interest, the emergence of trade unions<sup>136</sup> across South Africa with the main aim of becoming intimately involved in the preservation of jobs that has prompted reform in the area of business rescue.<sup>137</sup> It is noteworthy that employees in South Africa enjoy fundamental rights which are protected in the Constitution,<sup>138</sup> and other statutes such as the Labour Relations Act,<sup>139</sup> the Employment Equity Act<sup>140</sup> and the Basic Conditions of Employment Act.<sup>141</sup> Burdette<sup>142</sup> reports that the failures of large businesses such as Central News Agency (CNA), Retail Apparel Group (RAG) and LeisureNet, among others prompted the South African government to take the necessary steps to reform the business rescue regime in the country.

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<sup>134</sup> In the corporate rescue scope, stakeholders can be said to be individuals or groups of juristic persons that contribute partially or fully to the company's operations. Examples are employees, creditors, managers, the community etc.

<sup>135</sup> September "Business rescue and Black Empowerment –Latent Symbiosis" August 2004 1.(Hereafter September). Available at <http://www.businessrescue.co.za/historyofchapter6/pdf>. (accessed 15-10-2009).

<sup>136</sup> The Congress of South African Trade Unions was launched in December 1985 after four years of unity talks between unions opposed to the apartheid and committed to a non-racial, non –sexist and democratic South Africa. Its main object is to promote organized labour with a view to protect jobs. It is understood that COSATU made representations on the review of Business Rescue Reforms on Monday 18 October 2004. See in this regard [www.cosatu.org.za](http://www.cosatu.org.za). (accessed 10-06 2010). Also see (Davis et al 10).

<sup>137</sup> *Ibid.*

<sup>138</sup> Section 23 of the Constitution of South Africa makes provision for Labour Relations Act with a focus on employees' rights.

<sup>139</sup> See generally section 197A of Act 66 of 1995.

<sup>140</sup> Employment Equity Act 55 of 1998 is one of the statutes enacted after the end of the apartheid regime in South Africa, with the aim of addressing the injustices of the past.

<sup>141</sup> Act 75 of 1997. This Act lays down the minimum conditions of service of employees.

<sup>142</sup> Burdette 241.

There is no doubt that businesses that have the prospect of surviving should be given the opportunity to do so. Liquidations are to be used as the last resort. It has been argued<sup>143</sup> that reorganisation reaps more value if the going concern can be kept intact as liquidation causes it to lose a lot of that value. In a Statistical South Africa release, key findings regarding insolvencies showed the total number of insolvencies for the first ten months of 2011 decreased by 32,2% (from 3368 to 2284) compared with the first ten months of 2010.<sup>144</sup> It is submitted that such a trend needs comprehensive legal policies and regulated framework that can avoid liquidations and save businesses.

A practical reason for the drastic review of business rescue legislation is that, in modern times, there has been a growing recognition of the need for a higher standard of corporate governance,<sup>145</sup> ethics and greater responsibility of a business entity towards the society in which it operates, for the benefit not only of investors but of all stakeholders. The creditworthiness of a company becomes questionable when third parties are reluctant to do business with the concern fearing that there is little prospect of the company extricating itself from financial difficulties.<sup>146</sup>

With globalisation being the key to international developments in recent times, critics have advocated that the new business rescue regime attempt to balance the interests of both the debtor and the creditor. It has been observed that a coordinated response by creditors of debtor companies will ensure ample time for debtors to manage the impact of struggling cash flow positions and trading in insolvent circumstances which are important factors in rescuing businesses.<sup>147</sup>

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<sup>143</sup> Rochelle 328.

<sup>144</sup> See in this regard Statistics of Liquidations and Insolvencies November 2011. Available at <http://www.statssa.gov.com> (accessed 12-12-2011).

<sup>145</sup> (Davies *et al* 4). It is noted that the concept of 'corporate governance' was first introduced in South Africa in 1994 with the publication of the King Report on Corporate Governance. In March 2002, as a result of the work of the King Committee, a second King Report on Corporate Governance for South Africa 2002 was made public. The King Committee on Corporate Governance has also released the draft Code of Governance Principles for South Africa 2009 known as "King III". This report introduced a Code of Corporate Practices and Conduct. The issuance of King III was necessitated by the anticipated new Companies Act of South Africa and changes in international governance trends. Available at <http://www.iodsa.co.za>. (accessed 12-06-2012)

<sup>146</sup> Salant "Business Rescue Operations and the Companies Act" *De Rebus*, 29 January/February 2010.

<sup>147</sup> Gewer Business Recovery 1.

Rajak and Henning<sup>148</sup> note that it is frequently the case that a creditor benefits far more from having the debtor back in the market place than from suing the debtor into extinction. A radically new rescue provision should therefore provide a mechanism under which a specified majority of creditors can approve a plan for the debtor to emerge from protection and resume normal commercial dealings.<sup>149</sup>

## 2 2 2 2 *Creating a new South Africa*

This rationale is for South Africa not to depart from global trends in the present times but to conform to modernisation. The reform of Judicial Management into a Business Rescue mechanism must recognise the uniqueness of the South African context and promote unity. The new regulation should therefore take cognisance of Black Economic Empowerment (BEE)<sup>150</sup>; in accordance with the Constitution of South Africa. It should be noted that the Constitution has ushered in a new legal order that demands that previous statutes be reformed in order to completely eradicate the remnants of apartheid and ensure equality at all levels.

It should further be noted that BEE in business rescue is pareto-superior to the current practice of economic asset ownership that restructures business transactions as it minimises leakage and avoids upfront sunken costs in deal structuring fees and advisory expenses.<sup>151</sup> This eliminates ‘deadweight losses’ which characterise business transactions.<sup>152</sup> Business rescue has the potential of contributing to South Africa’s endeavour to restructure assets ownership while achieving the direct involvement of Historically Disadvantaged Persons

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<sup>148</sup> Rajak and Henning 270.

<sup>149</sup> *Ibid.*

<sup>150</sup> See in this regard Kalula and M’Paradzi ‘Black Economic Empowerment: Can there be Trickle-down Benefits for Workers’ 2008 *Speculum Juris* 108. BEE is defined as an integrated socio-economic undertaking aimed at remedying the inequalities characteristic of apartheid. It is aimed to transform the South African economic landscape strategically by ensuring the participation of the majority of the population in the economy and the redistribution of control over the country’s economic resources.

<sup>151</sup> September 3.

<sup>152</sup> *Ibid.*

(HDPs)<sup>153</sup> in the strategic management of the assets. HDPs can achieve a sustainable and defensive strategy by way of maximising the preservation of productive assets.<sup>154</sup>

It is submitted the new political dispensation has dramatically changed the face of South African Law in that the Constitution of the Republic of South Africa now contains a justiciable Bill of Rights, which permits the courts to test any legislation in order to establish the constitutionality thereof.<sup>155</sup> No area of South African law can be analysed or evaluated without recourse to the Constitution, which is the supreme law of the country, with the Bill of Rights which regulates the relationship among citizens and thus has fundamental implications for company law.<sup>156</sup>

#### *2 2 2 3 Promotion of economic growth and legal stability*

South Africa has achieved the same kind of triple watershed that took one hundred years to occur in the United States of America.<sup>157</sup> With regard to whites, the former “frontier” of race – based opportunity is gone as there is now a greater competition for places both in education and the workplace; for blacks, the promise of economic and political equality must ring hollow, in part, until economic opportunity becomes more equal.<sup>158</sup> For blacks and whites together, the challenge is to bring the economic benefits currently enjoyed by white society to everyone, regardless of colour, hence the need for faster economic growth, inclusive of a legal system that will provide a soft landing for companies in distress.<sup>159</sup>

There is a growing recognition by companies and governments of the need for higher standards of corporate governance and ethics and greater interdependence between enterprises and the societies in which they operate.<sup>160</sup> A number of corporates in South Africa

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<sup>153</sup> September 3. Historically Disadvantaged Persons (HDPs) emerge from the ranks of the distressed company and are thus familiar with its operations. HDPs are in most cases the managers or owners of these distressed companies.

<sup>154</sup> September 3.

<sup>155</sup> The Policy Guidelines 15.

<sup>156</sup> *Ibid.*

<sup>157</sup> Rochelle 317.

<sup>158</sup> *Ibid.*

<sup>159</sup> *Ibid.*

<sup>160</sup> The Policy Guidelines 14.

and other jurisdictions have revealed serious defects in the prevailing standard of corporate governance and the administration of the law which have resulted in investors suffering extensive losses.<sup>161</sup>

It has been suggested that the regulation<sup>162</sup> should, where practically possible, attempt to balance the competing interests of economic actors and the society at large, encourage transparency and high standards of corporate governance, as well as ensure compatibility and harmonisation with best practice jurisdictions internationally.<sup>163</sup>

Companies have always tried to solve their financial crises without specifically going the legal route. Such processes include informal workouts which normally occur between debtor and creditor. Informal creditor workouts are not formally regulated but seem to have taken root in South African commerce.<sup>164</sup> These workouts entail large financial institutions joining forces to provide ailing companies with the necessary financial assistance to trade themselves out of their difficulties.<sup>165</sup> Informal workouts are effective if all creditors support the same process because any creditor can block an informal compromise by bringing an application for liquidation.<sup>166</sup>

It has been suggested that informal workouts are often successful in practice as they are applied without the support of a statutory procedure, although problems may arise through their attempted implementation.<sup>167</sup> For example, directors may face allegations of reckless trading as a result of their restructuring efforts and may accordingly be disinclined to support the rescue initiatives.<sup>168</sup> It has been explained that the most significant deficiency in the previous Companies Act<sup>169</sup> is the lack of effective mechanisms for the enforcement of duties

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<sup>161</sup> *Ibid.*

<sup>162</sup> Chapter 6 of the New Act.

<sup>163</sup> The Policy Guidelines 9-10.

<sup>164</sup> Burdette 251.

<sup>165</sup> The CACIL 15-16.

<sup>166</sup> See in this regard <http://www.turnaround-sa.com> (accessed 04-09-2009).

<sup>167</sup> *Ibid.*

<sup>168</sup> *Ibid.*

<sup>169</sup> Companies Act 61 of 1973.

which results in directors and senior management of large companies being immune from legal control<sup>170</sup> when they employ informal workouts.

Business rehabilitation mechanisms have not worked well in South Africa as most corporate defaults sent for rescue are reportedly handled on an informal basis and therefore the system is hampered by the absence of any supported guidelines for informal restructurings.<sup>171</sup> Not surprisingly, the New Act<sup>172</sup> introduces a more modern and flexible business rescue procedure to be administered by newly designated and certified business rescue practitioners,<sup>173</sup> thereby ensuring that business rescue practitioners have appropriate professional qualifications.<sup>174</sup> It is emphasised that the need for business rescue mechanisms should not only embrace practitioners with professional qualifications but also practitioners who can consistently be accountable, impartial and transparent.<sup>175</sup>

Gewer<sup>176</sup> has opined that informal workouts are often successful in practice but can be problematic in their implementation because of lack of a statutory procedure, as any creditor may preclude the informal restructuring by instituting liquidation proceedings. He has further argued that the informal workouts employed by these companies do not result in the crystallisation of the claims of all creditors against the company in question and the possibility may arise of creditors unknown at the time of the restructuring later asserting claims which vitiate any reorganisation plans.<sup>177</sup> Consequently, while the lack of legislative

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<sup>170</sup> Section 76 of the New Act attempts to make directors more liable with regards to how they manage companies. This will be highlighted elsewhere in this dissertation.

<sup>171</sup> Johnson and Meyerman “Insolvency Systems in South Africa: Strengthening the Regulatory Framework”. United States Agency for International Development (USAID) December 2010 2. Available at <http://www.fps.org.za>. (accessed 02-03-2011). (hereafter Johnson and Meyerman).

<sup>172</sup> Regulation 133 of Companies Regulation Draft for Public Comment set out the qualifications for persons who may be appointed as business rescue practitioners. Rajak and Henning 268 have submitted that there has been a foreseeable danger in appointing judicial managers who lack business acumen and skill to turn around distressed companies. It was subsequently suggested by Rajak and Henning 286 that the Association of Insolvency Practitioners of South Africa (AIPSA) must provide training for Insolvency Practitioners to empower them for business rescue purposes.

<sup>173</sup> See generally CACIL 63 where it is reported that in jurisdictions such as the United States of America, it is mainly lawyers that are appointed to implement Chapter 11 cases. In Australia and United Kingdom, insolvency practitioners are mainly accountants. In South Africa, the business rescue practitioner must belong to a legal accounting or business management profession that is regulated by an authority prescribed by the Minister.

<sup>174</sup> Johnson and Meyerman 2.

<sup>175</sup> Johnson and Meyerman 8.

<sup>176</sup> Gewer Business Recovery 1.

<sup>177</sup> *Ibid.*

provisions supporting informal creditor workouts does not limit their availability, however the process does not bind creditors who are therefore free to apply for the liquidation of the debtor in appropriate circumstances.<sup>178</sup> An effective business rescue culture should have both informal and formal legal processes that work co-operatively to facilitate attempts to maximise the value of businesses in financial distress.<sup>179</sup> It has been suggested that both informal and formal processes of business rescue need to work together and the conduct of each in the shadow of a potential sale of assets through liquidations makes everyone worse off.<sup>180</sup>

## 2.3 COMMON ELEMENTS OF BUSINESS RESCUE SYSTEMS

### 2.3.1 Which businesses should be rescued?

Identifying entities that meet the requirement of getting protection should be the benchmark for the consideration of a company to be rescued as a company can be stable but its viability questionable. It is reported that businesses that need to be rescued should not confuse stability with viability.<sup>181</sup> In actual fact “dead ducks must be buried and lame ducks reviewed for potential viability”.<sup>182</sup> A clear perspective is therefore vital to identify business entities that can be viable. Cooper<sup>183</sup> argues that most liquidations have no positive economic effect. Business debtors must therefore be given the necessary assistance when they are in distress to keep them viable.

A broad social and economic distinction exists between business debtors and consumer debtors.<sup>184</sup> Consumer debtors acquire their debts by way of the acquisition of goods and services for their own use and consumption and not as part of any business operation,

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<sup>178</sup> The CACIL 16.

<sup>179</sup> Harris and Legg “What Price is Investor Protection? Class Action v Corporate Rescue” 2002 *INSOL LJ* 194. (Hereafter Harris and Legg).

<sup>180</sup> Harris and Legg 194.

<sup>181</sup> Cooper ‘Building Effective Insolvency Systems, Central, South America and Caribbean Workshop’ 31 October 2000 3. (hereafter Cooper) It should be noted that at the time this workshop was held, Cooper was the president of INSOL International. (hereafter Cooper).

<sup>182</sup> Cooper 3.

<sup>183</sup> *Ibid.*

<sup>184</sup> See in this regard Rajak and Henning 270.

whereas business debtors acquire their debts while engaged in business.<sup>185</sup> Jurisdictions such as the United States of America, France, Germany and Japan have a single business rescue provision for business debtors that are companies and for other types of business debtors.<sup>186</sup> The system of bankruptcy in the United States of America<sup>187</sup> is completely foreign to South Africa's legal system and so it is impossible to envisage an all-inclusive business rescue system for this country, which does not draw a distinction between business debtors that are companies and other business debtors.<sup>188</sup>

Kloppers<sup>189</sup> argues that business rescue should be available for partnerships, close corporations,<sup>190</sup> individual business persons and business trusts.<sup>191</sup> He suggests that if a more encompassing business rescue system is to be introduced, it should be contained in an Insolvency Act which deals with trade or business debtors as a group<sup>192</sup>. A further distinction should be drawn between different trade or business debtors for the application of different business rescue procedures based on the notion that some trade debtors are bigger than others.<sup>193</sup> In *Rustomjee v Rustomjee (Pty) Ltd*,<sup>194</sup> it was held that a private company with no more than two or three members with few shares does not allow the company to apply for a relief, rather the extent and scope of the business activities of the company, its assets and

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<sup>185</sup> *Ibid.*

<sup>186</sup> Kloppers 368.

<sup>187</sup> See in this regard section 101 of the American Bankruptcy Reform Act which draws no distinction between debtors who may invoke it.

<sup>188</sup> Kloppers 368.

<sup>189</sup> *Ibid.*

<sup>190</sup> In the Revised Act (Companies Act 71 of 2008), the close corporation has been done away with as a category of new registrations. However, close corporations can remain in existence for an indefinite period or deregistered or dissolved in terms of the Close Corporations Act. Section 13 of the Companies Act 71 of 2008 stipulates that no company may be converted to a Close Corporation.

<sup>191</sup> See generally CACIL, where Burdette agreed with Kloppers that a business rescue regime in South Africa should be available for all business entities. CACIL attempted to unify the Winding-up provisions of the Companies Act and the Close Corporations Act with those of the Draft Insolvency Bill published by the SALRC in 1996. It is worth noting that although no provision was made for a compromise by a close corporation in terms of section 311 of the Old Act, section 72 of the Close Corporations Act 69 of 1984 provides for sequestration of a Close Corporation if it is unable to pay its debts.

<sup>192</sup> Burdette's Unified Model under the Insolvency and Business Recovery Bill although approved by the Cabinet of South Africa on 5th March 2003 was not preferred over the Daly Model which was supported by BASA. The Daly Model proposed ways of avoiding situations where creditors short-circuited the legal process of debt recovery by going straight to liquidation proceedings instead of business rescue.

<sup>193</sup> See in this regard the case of *Rustomjee v Rustomjee (Pty) Ltd* 1960 2 SA 753 (D) where it was held that judicial management was not intended for small private companies. This decision was confirmed in *Tobacco Auctions Ltd v AW Hamilton (Pty) Ltd* 1966 2 SA 451 (R) where it was held that the number of members or issued shares alone should not determine whether judicial management is appropriate, but that the extent and scope of the business activities of a company, its assets and liabilities and the nature of its difficulties should also be taken into consideration when deciding whether judicial management would be successful.

<sup>194</sup> 1960 SA 758 (D).

liabilities and the nature of its difficulties are all relevant factors in deciding its application for relief. The court further held that, fact that the company only has a few members or shares was not a deciding factor; rather all other reasons were to be considered in adjudicating before an application to place the company under judicial management including tests such as the viability of the company as a going concern.

It is plausible to submit that if the Close Corporations Act<sup>195</sup> has provisions to apply for winding up then the business rescue reforms must include close corporations. However, Kloppers<sup>196</sup> argues that where the business-rescue procedure opts for the involvement of a neutral third party to control and manage the business debtor while the business rescue is in operation, it would be more appropriate to have different business rescue procedures for individuals and other business debtors such as companies. According to him, South African business rescue procedure should make provision for a neutral third party to take control of the assets and management of the business debtor while it is subject to the rescue procedure.<sup>197</sup> Kloppers<sup>198</sup> provides two reasons for this: firstly, a system where the business debtor stays in control and manages the business assets is so completely foreign to the South African experience that it is almost impossible to envisage such a rescue scheme in South Africa. Secondly, if the steps to initiate a business rescue are simplified in order to avoid the high cost of court involvement, it can create difficulties of persuading creditors to accept new implementation procedures where the business debtor stays in control and manages the business assets.<sup>199</sup>

There are further recognised distinctions between the different forms of business debtors based on the number of participants. The close corporation is limited to ten natural persons, the partnership to twenty persons, the private company to fifty members and the individual business debtor to a single person (Sole Proprietor).<sup>200</sup> In the new Act,<sup>201</sup> a clear distinction is

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<sup>195</sup> Section 2(2) of the Close Corporations Act 69 of 1984 stipulates that the close corporation is a separate legal entity and enjoys the benefits of perpetual succession. The New Act recognizes that existing close corporations should be free to retain their current status until such time as their members may determine that it is in their interest to convert to a company. See (Davis et al 27).

<sup>196</sup> Kloppers 369.

<sup>197</sup> See in this regard Kloppers 369.

<sup>198</sup> *Ibid.*

<sup>199</sup> *Ibid.*

<sup>200</sup> Kloppers 370, also see generally (Cilliers *et al* 4-6).

made between categories of companies namely: profit and non-profit companies. A profit company incorporated<sup>202</sup> under the New Act<sup>203</sup> can be state owned, public company, private company or a personal liability company. It has been observed that the intention of the legislator in regard to business rescue is that, business rescue mechanisms can be available to companies that fall within section 8 of the new Act. In the Old Act,<sup>204</sup> the section 21 company not for gain does not have a share capital so its status does not allow it to access automatic income tax advantages.<sup>205</sup> The business rescue provisions in the New Act are to protect companies which have the main object of making profit.<sup>206</sup> Non - profit companies cannot qualify for business rescue because their objects and policies are limited and restricted<sup>207</sup> therefore the principles of profit companies cannot apply.

It has been argued,<sup>208</sup> that although the public company requires at least seven members and has no restriction on the maximum number of members that it may have, even so, a proposal for some distinction in terms of size based on the number of participants in a business entity may be meaningless because the type of entity is not necessarily an accurate indication of its size.

It should be noted though that a distinction of businesses that are eligible for business rescue can be made based on the size of the business transactions that it undertakes, as stipulated in the Income Tax Act 58 of 1966.<sup>209</sup> Businesses that have to report to the South African Revenue Service (SARS) on either a six-monthly or two-monthly basis and with a specific

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<sup>201</sup> See generally section 8 of the New Act.

<sup>202</sup> (Davis *et al* 23)

<sup>203</sup> See section 8(2) of the New Act.

<sup>204</sup> See in this regard Benade *et al* 76, where it is explained that a special kind of company not for profit under the Old Act may only be incorporated as a company limited by guarantee, that is, a section 21 company or association not for gain. The main object of a section 21 company is to promote religion, arts, sciences, education, charity, recreation or any other cultural or social activity or communal or group interests.

<sup>205</sup> (Benade *et al* 76).

<sup>206</sup> Chapter 6 of the New Act.

<sup>207</sup> See generally Schedule 1 of the New Act which sets out the provisions concerning non-profit companies.

<sup>208</sup> Kloppers 370.

<sup>209</sup> See generally Section 38 of Income Tax Act 58 of 1962 and section 72 of Value Added Tax Act 89 of 1991 which draw distinctions between entities that are allowed to be taxed and those that are obliged to register as tax vendors respectively. Also see Kloppers 370 where the author reports that the reasoning behind distinguishing between big business and small business would be to devise a more flexible and less costly business rescue scheme for the smaller business regardless of the form of those businesses. It should be noted that at present the distinction is drawn between businesses with a turnover of R300 000 or more per year and those with a turnover of less than R300 000.

turnover have created a precedent for distinguishing between business debtors on the basis of size in monetary terms.<sup>210</sup>

Another component of a modern business –rescue system is that<sup>211</sup> the distinction between incorporated and unincorporated associations is the one which goes deep in several legal systems, but in those which received the English common law, it expresses itself in insolvency and bankruptcy with the former applying to companies. The difficulties in dealing with partnerships have existed in English common law<sup>212</sup> and are no less apparent in South Africa.<sup>213</sup>

In both the United States of America and the United Kingdom insolvent debtors may seek the protection of business rescue systems irrespective of whether those debtors are companies incorporated under the provisions of a Companies Act, partnerships or individual traders, where the previous South African provision for business rescue known as judicial management was only available to companies incorporated under the South Africa Companies Act 1973.<sup>214</sup> The DTI in consultations with other stakeholders and legal critics promoted the new Companies Act which contains business rescue provisions for companies.<sup>215</sup>

### **2 3 2 Extent of business rescue protection**

In general terms, a moratorium is placed on the debtor against any claims by the creditors during the process of business rescue. In the United Kingdom and Australia, secured creditors are favoured against the rest of the creditors of a company in terms of security.<sup>216</sup> The floating charge emerged in the 1860's and 1870's in England as a means by which companies were able to obtain loans without having to offer the security of fixed assets

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<sup>210</sup> Kloppers 370.

<sup>211</sup> *Ibid.*

<sup>212</sup> Section 221 of the United Kingdom Insolvency Act 1986 (hereafter UKIA) stipulates that the compulsory winding-up provisions are extended to what are called unregistered companies, which includes partnerships.

<sup>213</sup> Rajak and Henning 272.

<sup>214</sup> Rajak and Henning 273.

<sup>215</sup> Business rescue provisions for natural persons, partnerships and trusts must still be developed.

<sup>216</sup> See in this regard Rajak and Henning 279 where it is reported that the security in question is known in the United Kingdom system as the floating charge which has a deep and abiding place in the Commonwealth credit and security systems. It is explained further that the floating charge becomes fixed over all the movable assets of the debtor at the time of crystallization.

either because they did not own fixed assets or because the assets were already fully mortgaged to other lenders.<sup>217</sup>

Rajak and Henning<sup>218</sup> suggest that business rescue mechanisms when put in place must aim at recovering any loans regardless of the effect of the sale of its assets on the fragile business. They argue that business rescue should not be only incidental to the selfish needs of dominant creditors but also to other creditors as it is on the debtor.<sup>219</sup> Turnaround strategies should be presented and managed to enable the debtor function, to encourage suppliers to continue supplying, to secure continuous lending from banks, and to find private equity funding.<sup>220</sup>

## 2 4 INTERNATIONAL INITIATIVES

In 1997, UNCITRAL adopted a model law on cross-border insolvency with the aim of promoting co-operation among states for the efficient administration of cross-border insolvencies; providing more certainty for trade and investment; protecting and maximising the value of the debtor companies' assets and facilitating the rescue of financially troubled businesses thereby protecting investments and preserving employment.<sup>221</sup>

Economic globalization and integration over the last decade has vastly increased the number of companies that operate, own assets, or otherwise conduct business in multiple countries.<sup>222</sup> Hammer and McClintock argue that<sup>223</sup> while this integration has created great wealth, it has also had a profound impact in the context of business failure.<sup>224</sup> According to them, some years ago, insolvencies and reorganisations with significant international connections were relatively rare, whereas today, it is increasingly unusual to find a major case without at least

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<sup>217</sup> Rajak and Henning 279.

<sup>218</sup> Rajak and Henning 280.

<sup>219</sup> *Ibid.*

<sup>220</sup> See in this regard Royds and Van der Walt, 'Improving Turnarounds and Business Rescue: How Government can Contribute and how TMA-SA can Assist' available at <http://www.tma-sa.com> (accessed 10-10-2010).

<sup>221</sup> See generally "Restructuring and Insolvency Briefing: UNCTRAL Model Law on Cross Border Insolvency" [http:// www.ashurts.com](http://www.ashurts.com) (accessed 20-02-2010).

<sup>222</sup> Hammer and McClintock "Understanding Chapter 15 of the United States Bankruptcy Code: Everything You Need to Know about Cross-Border Insolvency" 258 (hereafter Hammer and McClintock).

<sup>223</sup> *Ibid.*

<sup>224</sup> *Ibid.*

some international aspects”.<sup>225</sup> They further argue that nowhere have these trends had a more profound impact than in North America where the United States, Mexico, and Canada comprise one of the closest and most extensive trading blocks in the world as they have been relatively quick to adopt some form of the Model Law.<sup>226</sup> The total trade among the three nations was approximately \$865 billion in 2006, and many multinational corporations have operations in all three countries;<sup>227</sup> this increasing interdependence has also resulted in a sharp spike in the number of insolvencies with significant consequences in some or all of the three nations.<sup>228</sup>

In order to address proactively this rapid proliferation of cross-border insolvencies, insolvency organisations and the international community generally undertook a number of efforts to enhance international cooperation and coordination.<sup>229</sup> Hammer and McClintock report that the European Union Regulation on Insolvency Proceedings 2000 (EU Regulation)<sup>230</sup> and the UNCITRAL Model Law have objectives of cooperation that include the preservation of value for all parties with interest in cross-border insolvency cases and the rescue of troubled businesses so as to protect investment and preserve employment.<sup>231</sup>

INSOL International together with the World Bank has undertaken to score insolvency regimes in various jurisdictions in Europe.<sup>232</sup> What is important and what was emphasised is that multi-national corporations will not invest in a country where there is an unstructured insolvency regime.<sup>233</sup> It is obvious that once an investor invests in a country and things go wrong, such an investor would want an insolvency regime in place to protect recoveries.<sup>234</sup> Jurisdictions should therefore consider core areas that can effect insolvency proceedings,

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<sup>225</sup> *Ibid.*

<sup>226</sup> Hammer and McClintock 258.

<sup>227</sup> *Ibid.*

<sup>228</sup> *Ibid.*

<sup>229</sup> *Ibid.*

<sup>230</sup> The UNCITRAL Model Law is more limited in its aims than the EU Regulation as it only seeks to promote recognition and assistance between different jurisdictions, rather than determine (as the [EU Regulation] does) which country’s insolvency law will prevail but also it has a wider geographical reach and potentially applies worldwide.

<sup>231</sup> Hammer and McClintock 260.

<sup>232</sup> Levenstein “Turnaround Practice in South Africa: Developments in Europe and Other Jurisdictions” INSOL Europe 2-3.

<sup>233</sup> *Ibid.*

<sup>234</sup> *Ibid.*

how the assets of the estates are dealt with, the eventual realisation by creditors and whether or not a business reorganisation system is in place.<sup>235</sup>

UNCITRAL in partnership with the IMF and INSOL has put in place a Legislative Guide on Insolvency Law that will universally serve as a guide to economies in designing statutes for the protection of companies that are on the brink of collapse.<sup>236</sup> The United Nations General Assembly has adopted a resolution<sup>237</sup> binding member states to strive to keep their businesses going. The purpose of the Legislative Guide on Insolvency Law is to help governments prepare comprehensive interventions that can deal with debtors who are struggling with financial difficulties but have a prospect of success, without compromising creditors.<sup>238</sup>

## 2 5 CONCLUSION

It looks as though the path to business rescue has been slow but has finally become a reality. This development seems to be partly informed by the suggestion that effective, speedy and fair procedures are important needs of stakeholders and should form the basis of the reforms.<sup>239</sup> Drastic business rescue reforms must be positively embraced by stakeholders as they have been internationally proved to be successful. While informal processes can be cost effective, highly successful and give the directors a lot of power, they can result in abuse of power since no monitoring of management exist.

The addition of a new category of business rescue professionals would offer the opportunity for the restructuring professionals to be skilled, regulated and equipped to address the woes of financially distressed companies. It has been submitted<sup>240</sup> that a radically reformed business rescue regime in South Africa would minimise the risk to the lender by carefully tailored monitoring provisions that take account of the interests of borrowers who want the freedom and financial resources to help build the fresh infrastructure required in the new

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<sup>235</sup> *Ibid.*

<sup>236</sup> UNCITRAL Model Law on Cross – Border Insolvency, UN Document A/52/158(1997) Model Law.

<sup>237</sup> 59/40 of 2 December 2004 which was adopted by member states and thus bind these states to UNCITRAL's Cross Border Insolvency Model.

<sup>238</sup> UNCITRAL Legislative Guide on Insolvency Law 26 Para 18.

<sup>239</sup> *Ibid.*

<sup>240</sup> Rajak and Henning 287.

South Africa and the interests of lenders who want some security set against the risk of lending.

## CHAPTER THREE

### Business Rescue Regimes in Australia and the United Kingdom

#### 3 1 INTRODUCTION

In recent years, the impact of globalisation has determined the pace of jurisdictions moving from liquidations to business rescue processes. In particular, the last two to three decades, have seen countries overhaul their legal systems to help struggling businesses rather than closing them.<sup>241</sup> In this chapter, analysis would be made of the English and Australian regimes of business rescue as they are useful in determining the rescue mechanisms most appropriate for an emerging market such as South Africa.

For both jurisdictions, the key elements of modern business rescue regimes will be analysed by considering:

- The type/types of entities that are eligible for protection;
- Initiation of the rescue process;
- Appointment of supervisor/administrator;
- Powers /Duties of supervisor/administrator;
- The effect of a moratorium on creditors' claims;
- The role of the courts; and
- The rights of interested parties, especially creditors, shareholders, employees and the Community.

An assessment of business rescue mechanisms in these selected jurisdictions will be made after brief comparisons of the two economies have been done. Kloppers<sup>242</sup> argues that steps to initiate business-rescue mechanisms range from an order of the court to a mere debtor's resolution. Although the two jurisdictions under discussion differ widely on the procedures, some factors are common to both economies.

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<sup>241</sup> Available at [http:// www.business-rescue.co.za](http://www.business-rescue.co.za). (accessed 10-09-2009).

<sup>242</sup> Kloppers 361.

## 3 2 AUSTRALIA

### 3 2 1 Origins

Until recent times Australia has borrowed much of its general corporate law and insolvency law in particular from England. A review of these laws took place in the 1980's resulting in a much less court orientated<sup>243</sup> system for processing company rescues.<sup>244</sup> The earliest adopted procedure for rescuing companies in financial difficulty was the Scheme of Arrangement which was initially developed in the United Kingdom through a series of legislations starting with the Joint Stock Companies Act of 1870.<sup>245</sup> By 1928<sup>246</sup>, the philosophical basis of the Scheme of Arrangement had been established in English law. All Australian states directly adopted the provisions of the Joint Stock Companies Act and many other jurisdictions with Anglo legal heritage, such as South Africa, followed suit.<sup>247</sup> Australia includes its corporate insolvency provisions in its general company law statute.<sup>248</sup>

Australian Company Law generally, and its insolvency laws, have developed from statutes enacted by individual states.<sup>249</sup> For reasons to do with the interpretation of the Australian Constitution, company law was until the 1980's treated essentially as a state matter.<sup>250</sup> Despite the integration of commercial activity throughout Australia, company legislation did not always provide for consistent treatment even in matters of corporate insolvency.<sup>251</sup> This may be partially attributable to the fact that the development of insolvency law in Australia did not necessarily occur through a coherent display of principles applicable to both individuals and corporations but more often as a series of specific issues dealt with when some form of crises developed that needed to be managed.<sup>252</sup>

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<sup>243</sup> Anderson "The Australian Corporate Rescue Regime: Bold Experiment or Sensible Policy?" 2001 *International Insolvency Review* 82 (hereafter Anderson Part 1). He notes in his article that the rejection of the court as a significant authority for controlling the economic rescue or otherwise of the company and the fact that the trigger for the process can be in the hands of the directors has been a bolder experiment.

<sup>244</sup> *ibid.*

<sup>245</sup> Anderson "Viewing the Proposed South African Business Rescue Provision from an Australian Perspective" 2008 *PERJ* 106 (hereafter Anderson Part 2).

<sup>246</sup> See Anderson Part 2 106, where it is noted that Queensland inserted provisions equivalent to section 2 of the United Kingdom Act of 1870 in 1889 and New South Wales and Victoria followed in 1892.

<sup>247</sup> Anderson Part 2 106.

<sup>248</sup> In South Africa, the proposal for incorporating insolvency provisions into the companies' legislation was proposed in Centre for Advance Corporate and Insolvency Law (hereafter CACIL) which was engineered by Burdette, but the DTI opted for legislation which deals separately with Company Law and Insolvency Law.

<sup>249</sup> Anderson Part 2 106.

<sup>250</sup> *Ibid.*

<sup>251</sup> *Ibid.*

<sup>252</sup> *Ibid.*

In 1961, Australia enacted a regime, called official management, which was closely modelled on South Africa's judicial management.<sup>253</sup> However, in 1993 following wide spread agreement that official management was well-nigh useless as a business rescue regime, Australia passed the Corporate Law Reform Act, which repealed the legislation that created official management and replaced it with a new business rescue regime called voluntary administration.<sup>254</sup> Official management was activated by a resolution of the company's creditors, by which the company would be put under the control of an insolvency practitioner for a period of up to three years during which time a general moratorium operates.<sup>255</sup> Sealy<sup>256</sup> argued that despite its relative informality and lack of expense, official management never gained popularity because the only purpose for which the procedure could be invoked was the unrealistic one of paying in full, within a predetermined time, all the company's outstanding debts. Also it was not contemplated that it might lead to any form of compromise or debt rescheduling. The Australian reforms followed a report of the Australian Law Commission which is universally known as the Harmer Report.<sup>257</sup> This report urged the replacement of official management with voluntary administration that had already proved to be successful in the management of bankruptcy of individuals.<sup>258</sup>

### **3 2 2 Voluntary administration in Australia: Background and rationales**

This section deals with the brief history and policy objectives of the Australian legislation regarding voluntary administration. The Harmer recommendations became law<sup>259</sup> and came into force in 1993. The voluntary administration procedure was included in the Corporate Law Reform Act enacting the relevant provisions as Part 5.3A of the Corporations Law, which is federal law in Australia. Although Part 5.3A was implemented in 1993, it remained

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<sup>253</sup> Rajak and Henning 263.

<sup>254</sup> *Ibid.*

<sup>255</sup> Sealy *Corporate Rescue Procedures-Some Overseas Comparisons: Perspectives on Company Law* (1995) 137 (hereafter Sealy).

<sup>256</sup> (Sealy 137).

<sup>257</sup> Australian Law Reform Commission, Part II, and Summary of Report 45: *General Inquiry into Insolvency* Australian Government Publishing Service Canberra 1988 [http://: www.camag.gov.au](http://www.camag.gov.au) (accessed 02-02-2010) (hereafter Harmer Report).

<sup>258</sup> See New Zealand 31 where it has been explained that, in 1992, as a result of the Harmer Report, Australia introduced the Voluntary Administration procedure in its Corporate Law Reform Act 1992. It should be noted that Part 5.3A of the Corporations Act also contains provisions dealing with a "Deed of Company Arrangement" which is a rescue plan that may be adopted only as a result of Voluntary Administration, although creditors may instead vote in favour of a winding up of the company instead. (Part 5.3A Corporations Law will hereafter be Part 5.3A).

<sup>259</sup> (Sealy 138).

untouched until recent amendments were passed in August 2007.<sup>260</sup> The subsequent enquiry by the Joint Parliamentary committee on Corporations and Financial Services into the need for reforming Australia's insolvency laws became necessary because of concerns raised by the Corporations and Markets Advisory Committee (CAMAC) on the application of Part 5.3A.<sup>261</sup> CAMAC deliberated on whether the adoption of a corporate rescue model that provided for 'debtor in possession' during the period of rescue and for entry into the rescue process before a company becomes insolvent was appropriate for Australia.<sup>262</sup> However, the recommendations made by CAMAC did not propose 'debtor in possession'<sup>263</sup> during the period of the rescue process.

The intention of the legislator in enacting voluntary administration in Australia was to establish a system that is capable of swift implementation, uncomplicated, cost effective; and flexible.<sup>264</sup> The objectives of corporate rehabilitation in Australia state that voluntary administration should ensure that the business, property and affairs of a company to be administered maximise as much as possible the chances of the company's business continuing existence and also, result in a better return for the company's creditors and members than would be the case if the company was led into an immediate winding up.<sup>265</sup> This objective can be achieved by selling some or all of the business and scheduled debts owed by the debtor. Furthermore, it has been noted that another fundamental objective of the voluntary administration provisions is speed.<sup>266</sup>

It has been submitted that the concept of corporate rescue and the Australian voluntary administration regime seek a balance between the Latin rules of "*ut res magis valeat quam preat*" and "*pacta sunt servanda*", which require : "a rehabilitation regime that facilitates and encourages rescue so that the transaction shall not perish but flourish with contracts being

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<sup>260</sup> According to Anderson 108, the reasons for Part 5.3A not been utilized. It might be that, it only became necessary due to the global economic downturn of 1990 that brought about drastic corporate reforms in Australia.

<sup>261</sup> Anderson 109.

<sup>262</sup> See generally *Report on Rehabilitating Large and Complex Enterprises in Financial Difficulties*, October 2004 <http://www.camac.gov.au>. (Accessed 03-12-2010).

<sup>263</sup> In a sharp contrast, the United State of America's Chapter 11 of the Bankruptcy Act of 1978, allows the continuance of the debtor to be at the realm of affairs during the period of reorganization.

<sup>264</sup> *Sellas 2* explains that the primary purpose of Part 5.3A is to provide a flexible and relatively inexpensive procedure pursuant to which a company may obtain a breathing space, so that it can attempt a compromise or arrangement with its creditors aimed at saving the company or the business and the return to creditors. If successful, the arrangement will be set out in a deed of company arrangement, which binds the company and the creditors. If the attempt fails, the legislation provides for an automatic transition to liquidation.

<sup>265</sup> Section 435A of the Corporations Act 2001.

<sup>266</sup> "*Improving Australia's Corporate Insolvency Laws*" - Issues Paper by Parliamentary Joint Committee on Corporations and Financial Services, May 2003 13 (hereafter PJCCFS).

carried out.”<sup>267</sup> This represents a fine equilibrium between those championing the promotion of corporate rescue at the expense of the creditor’s absolute priority rights and those who see the rights of creditors in insolvency and rehabilitation as paramount.<sup>268</sup>

It should be emphasised that the courts have frequently referred to the objectives of corporate rescue in their efforts to interpret the legislation, based on the view that the objectives are useful in cases where the court is asked to use its powers.<sup>269</sup> Australian judicial decisions indicate that the courts are prepared to take different factors into consideration and not just apply a simple test of assets over liabilities. In *Bank of Australasia v Hall*<sup>270</sup> the validity of a conveyance by a debtor to a creditor was questioned under the Insolvency Act 1874. The wording in sections 107 and 108 of Insolvency Act 1874, provided that the company must be unable to pay its debts as it becomes due from its own money: meaning that the debtor must at all times in question have had sufficient cash in hand or been able to obtain, by sale or pledge of his available assets, command of sufficient money to satisfy all debts that were anticipated to fall due and become ascertained in the reasonably immediate future. The court held that the question was not whether the debtor would be able, if given time, to pay its debts out of its assets but whether it is presently able to do so with monies actually available. The court concluded that its task was to decide whether the company was suffering from a temporary lack of liquidity. In *Dunn v Shapowloff*<sup>271</sup> the court interpreted the words “ability to pay” by applying a commercially realistic test of what constitutes ability to pay. According to the court, the ability to pay debts owed by the company at the time of the administration process must be determined in a realistic way by reference to the facts of each case taking into consideration, inter alia, the company’s assets and liabilities and the nature of the circumstances of the company’s activities.

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<sup>267</sup> See in this regard Blazic “In search of a Corporate Rescue Culture: A Review of the Australian Part 5.5A Legislation” October 2010 2. <http://ro.uow.edu.au/sbshdr/2010>. (hereafter Blazic) (accessed (15/02/2011))

<sup>268</sup> See Blazic 4.

<sup>269</sup> Section 447A of the Corporations Act allows the court to make broad orders as to how Part 5.3A can operate.

<sup>270</sup> 1907 4 CLS 1514.

<sup>271</sup> 1978 ACLC 159. Also see Bills Committee on Corporate Rescue, “Insolvent Trading Provisions and Experience in Australia and in the United Kingdom” 3-4 (hereafter Insolvent Trading Provisions). available at <http://www.camac.gov.au>. (accessed 10-04-2011).

### 3 2 3 Type/Types of entities that are eligible for protection

The Australian voluntary administration regime is available to any company that is registered under the Australian Companies Act and which is insolvent or likely to become insolvent.<sup>272</sup> It is therefore suggested that these companies may be small, large or complex. Kloppers<sup>273</sup> has argued that before the voluntary administration regime became operational, it was generally thought that the procedure would only be employed in relation to small to medium-sized companies. According to Sealy,<sup>274</sup> in Australia, there is an advantage in situations where the administrative regime has proved its worth and dealt with challenges and problems, but when it comes to small business the case for jumping over the same elaborate and costly hurdles is not a compelling one.<sup>275</sup> Sealy has therefore argued that:

“Less clear-cut is the decision whether the choice between the procedures should be left to the parties themselves and general market forces; or made a matter for judicial discretion; or restricted by the legislation itself so that for example, a company with less than \$X.000 of debts or paid-up capital, should be obliged unless the court orders otherwise to use the voluntary procedure.”<sup>276</sup>

It should be noted however, that the Australian corporate rescue regime is founded on provisions that can cover all companies. The ultimate goal is the going concern of the debtor company irrespective of its size.<sup>277</sup> It has been argued that the eligibility of companies for rescue could be determined according to minimum thresholds regarding one or two of the following:<sup>278</sup>

- Revenues;
- Liabilities;
- Number of creditors and outstanding contracts;
- Number of employees;
- Number of active subscribers or other related companies; and/or
- Number of locations or operations in Australia or elsewhere.

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<sup>272</sup> Rajak and Henning 274.

<sup>273</sup> Kloppers 372.

<sup>274</sup> (Sealy 144).

<sup>275</sup> *Ibid.*

<sup>276</sup> (Sealy 145).

<sup>277</sup> *Ibid.*

<sup>278</sup> See generally the introductory pages of “*Rehabilitating Large and Complex Enterprises in Financial Distress Discussion Paper 2003.*” <http://www.camac.gov.au>. (accessed 10-04-2011) (Hereafter Discussion Paper On Australia).

The entity that qualifies for corporate rescue mechanisms in Australia may be a product of financial arrangements and any corporate group whose structure is adapted, rather than merely the size of an enterprise whether listed or not.<sup>279</sup>

### **3 2 4 Initiation of the Rescue Process**

Procedurally, the appointment of an administrator commences the voluntary administration process.<sup>280</sup> It should be noted that on appointment, the control of the company and its property, business and affairs is vested in the administrator who acts as the company's agent.<sup>281</sup> The administrator must be considered as pivotal to the corporate rescue process. The powers of all other officers of the company may not be exercised except with the administrator's written approval.<sup>282</sup> Section 437C does give effect to the administrator's appointment through the suspension of the powers of the directors and other officers.<sup>283</sup> During such suspension, the company officers are not removed from their offices per se but the administrator can remove and appoint directors if he or she so desires.<sup>284</sup> The company's directors must give such assistance to the administrator as reasonably required by the administrator, including details of the company's assets and liabilities, and handing over of books and company records.<sup>285</sup>

The administrator after having taken control of the company's affairs must as a matter of priority investigate the financial position of the company, with a view to making a recommendation to a meeting of creditors about what should be done with the company and its business.<sup>286</sup> The administrator may also seek further support from the directors by requiring them to meet him and to provide additional information on matters such as the financial circumstances of the company.<sup>287</sup>

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<sup>279</sup> *Ibid.*

<sup>280</sup> Section 435C (1) of the Corporations Act 2001.

<sup>281</sup> Section 437B of the Corporations Act 2001.

<sup>282</sup> With regard to ss437A and 437D the administrator has control of the company's business, property and affairs as well as the ability to carry on or terminate the rescue procedure as well as sell the business.

<sup>283</sup> In contrast, Fridman 337 reports that in Canada, the Companies Creditors Arrangement Act provides that the incumbent board of directors remains in place subject to court supervision, usually exercised through the appointment of a court-appointed monitor over the company's affairs.

<sup>284</sup> Sections 437C (1) and 437C (1A).

<sup>285</sup> Under section 438C.

<sup>286</sup> See section 438A in this regard.

<sup>287</sup> Cassidy *Corporations Law: Text and Cases* (2005) 346. (hereafter Cassidy)

### 3 2 5 Appointment of the Administrator

As indicated above, the administration formally starts on the appointment of an administrator.<sup>288</sup> Such administrator as required must be a registered<sup>289</sup> liquidator.<sup>290</sup> There are three ways in which an administrator may be appointed to take over the affairs of a company. First and foremost, where the majority of the directors think that the company is likely to become insolvent in the near future, they may pass a resolution to appoint an administrator.<sup>291</sup> It is submitted that the directors of the company must genuinely believe on reasonable grounds that the company was insolvent or likely to be insolvent in the future.<sup>292</sup> It appears that voluntary administration procedure having been initiated by the directors alone, does not require for any application to be made to the court.

It should be noted that the appointment of an administrator cannot be done if the company is already being wound up.<sup>293</sup> But in the case of *FAI Workers Compensation (NSW) Ltd v Philkor Builders Pty Ltd*<sup>294</sup> the court held that the appointment of an administrator may be made after an application has been filed in court for the winding up of the company. Australian courts have, however, been strict on the provision that the appointment of the administrator be done upon the resolution of the majority of the directors. *In Wagner v International Health Promotions*<sup>295</sup> the appointment of the administrator was set aside by the court because the directors did not go through the process of arriving at a majority resolution on whether the company was on the verge of insolvency. They had a telephone conversation on the company being insolvent. The issue the court had to deal with was whether a telephonic meeting of directors on the state of affairs in the company constitutes a resolution. The court held that a resolution by the directors should be recorded in minutes taken during a

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<sup>288</sup> Section 435C (1) of Corporations Act 2001.

<sup>289</sup> Under s448B, the administrator must be a qualified liquidator registered by the Australian corporate regulator, ASIC. South Africa, in its corporate rescue provisions has in section 138 of the New Act, outlined the requirement of a qualified and registered practitioner to oversee the business rescue process.

<sup>290</sup> Carrie and Yan *An Analysis of Corporate Rescue Objectives: Voluntary Administration in Australia, Administration Order in the United Kingdom and Provisional Supervision in Hong Kong* (Honours Degree Joint Dissertation submitted to Hong Kong Baptist University, 2010) 5.

<sup>291</sup> Section 436A (1) of Corporations Act 2001.

<sup>292</sup> (Cassidy 343).

<sup>293</sup> Section 436A (2) of Corporations Act 2001.

<sup>294</sup> 1996 20 ACSR 592. In this case that the application to decide the winding up of the company was to be heard on 21<sup>st</sup> September. The appointment of the administrator was done according to section 436A(1) of the Corporations Act 2001 based on a resolution taken by the directors earlier on that day.

<sup>295</sup> 1994 14 ACSR 466.

meeting in which a resolution would be proposed; although this was not a requirement, it was a necessity.

The court held that the requirements in section 436A of the Corporations Act 2001 should be complied with to avoid wrongful unofficial administration. In order not to defeat the objects of the procedure, it was further held that Part 5.3A should not be allowed to be used where there appears to be an ulterior purpose behind the appointment of an administrator by directors.<sup>296</sup>

Secondly, appointment of an administrator may be made by a liquidator or provisional liquidator of the company in writing if he or she thinks that the company is or will become insolvent.<sup>297</sup> There is however a limitation on the liquidator; if he or she wishes to appoint himself or herself, leave of the court must be obtained.<sup>298</sup> Circumstances in which a liquidator may wish to utilise the administration procedure could include situations where the company is in a members' voluntary winding up and the view is formed that the company is insolvent or likely to be insolvent<sup>299</sup>. Other circumstances may be where the moratorium provided for by Part 5.3A would assist the liquidator or the provisional liquidator in implementing a plan to dispose of the business as a going concern.<sup>300</sup>

Finally, an appointment may be made by a secured creditor who has a "charge"<sup>301</sup> over the whole or substantially the whole of the company's property if the secured creditor is entitled to enforce the charge.<sup>302</sup> However, the appointment may not be made if the company is already being wound up. Section 441A of Corporations Act stipulates that the substantial charge holder is protected because he/she can always act to enforce the charge during the period after the commencement of the administration process.

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<sup>296</sup> See in this regard the case of *Aloridge v Christianos* 1994 12 ACLC 237. (Hereafter Aloridge's case).

<sup>297</sup> Section 436B (1).

<sup>298</sup> See in this regard the case of *Deputy Commissioner of Taxation v Foodcorp Pty Ltd* 1994 12 ACLC 508 where the court allowed the appointment of the liquidator as the administrator for the company.

<sup>299</sup> Sellars 3.

<sup>300</sup> *Ibid.*

<sup>301</sup> The Oxford Dictionary of Law 2001 74 defines a "charge" as an interest in company property created in favour of a creditor example as a debenture holder, to secure the amount owing. A fixed charge is attached to specific assets while preventing the company from dealing freely with those assets without the consent of the lender. A floating charge does not immediately attach to any specific assets but 'floats' over all the company's assets until crystallization. In the event of the company not paying the debt the creditor can secure the amount owing in accordance with the terms of the charge. The Australian legislation sometimes uses the term "charge" rather than the more generic "secured creditor".

<sup>302</sup> Section 436 C (1).

In terms of Australian statute, the three ways discussed above are the only ways in which an administration may be commenced and once appointed, the administrator may only be removed at the first meeting of the creditors<sup>303</sup> or by the court.<sup>304</sup> In *McDonalds v Hansemann*<sup>305</sup>, without departing from the legislature,<sup>306</sup> the court held that it is possible to appoint two or more persons as joint administrators.<sup>307</sup>

The procedure regarding appointment of the administrator as stipulated in section 448A is designed to ensure a speedy resolution of the position of the company.<sup>308</sup> However this lack of formality associated with the appointment of the administrator does place a huge burden on him/her to act diligently.<sup>309</sup> A written consent<sup>310</sup> to the appointment of the administrator is mandatory and must be submitted to the ASIC by the end of the first business day after the appointment.<sup>311</sup> A written notice must also be given to other parties not involved in the appointment of the administrator, that is, the company if not the appointer and any charge holder whose charge covers the whole or substantially the whole of the assets of the company if not the appointer.<sup>312</sup> Also, notices of the appointment of an administrator should be published in appropriate newspapers within three business days.<sup>313</sup>

The administrator in a voluntary administration must be seen as an expert and independent and should, therefore, be allowed to work without any interference whatsoever; otherwise,

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<sup>303</sup> Section 436E.

<sup>304</sup> Section 449B.

<sup>305</sup> 1998 28 ACSR 49.

<sup>306</sup> Section 450E. Also see the case of *McDonalds v Hanselmann* 1998 28 ACSR 49 where it was held that when creditors agree to a winding up, both administrators become liquidators under section 446A of the Corporations Act. In this case, Wernard Electric Motors Pty Ltd entered into an agreement with the son of the company's director whereby it sold certain equipment. The director resolved that the plaintiffs be appointed as administrators in terms of section 448A of the Corporations Act and that they would act jointly and severally. The creditors, on the other hand, resolved that the company be placed in liquidation. The plaintiffs commenced proceedings against the son of the director seeking a declaration that the said agreement was not a commercial transaction and an order that the son of the director pay the liquidators the amount of the benefits obtained by him. The question arose whether the liquidators had been validly appointed because the resolution empowered them to act jointly and severally. The court questioned the applicability of section 446A (4) of the Corporations Act which says the administrator of the company becomes a liquidator. Subsequently, the court held that there was considerable doubt as to whether it was proper. In the view of the court, where there is one administrator, the administrator becomes the liquidator of the company. The court held that in the Context of the Corporations Law, where there is one administrator that becomes the liquidator and where there are two administrators, they both become the liquidator of the company and proceed to act jointly and severally. See paragraph 20-30 of *McDonald and Another v Hanselman*.

<sup>307</sup> Section 450A of Corporation Act.

<sup>308</sup> See generally section 448A of the Corporations Act.

<sup>309</sup> See generally section 435A of the Corporations Act.

<sup>310</sup> Section 448A stipulates that the administrator must consent to his/her appointment before notice of the appointment is lodged with the ASIC.

<sup>311</sup> See section 450A.

<sup>312</sup> Section 450A.

<sup>313</sup> Section 450 A.

courts can act swiftly if there is evidence of interference.<sup>314</sup> It is important to note that the independence of the administrator cannot be compromised for the common reasoning that all stakeholders will be excluded as he / she investigates the affairs of the company.<sup>315</sup> Based upon the recommendations of the Harmer Report, the following features of voluntary administration are expected to ensure sufficient independence for the administrator:<sup>316</sup>

- The persons eligible to be appointed as administrators must be registered insolvency practitioners possessing appropriate qualifications and experience in insolvency practice.
- Stakeholders with a close connection to the company cannot be administrators.
- The administrator must declare associations with the company and any circumstances which may make it difficult for the administrator to act impartially.
- Directors cannot remove an administrator.
- Lack of independence<sup>317</sup> of an administrator may be ground for removal of the administrator by the court.

The issue of Independence of the administrator has been tested in the case of *Cresvale Far East v Cresvale Securities*<sup>318</sup> where the main issue was whether if there is a personal

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<sup>314</sup> (Cassidy 346-347).

<sup>315</sup> Anderson and Dickfos 'The Sovereign Voluntary Administrator: The Position of The Voluntary Administrator *vis a vis* the Company Stakeholders' available at [www.camac.gov.au](http://www.camac.gov.au). (accessed 26-03-2012).

<sup>316</sup> Harmer Report para 72.

<sup>317</sup> In contrast, case law has been inconsistent on the issue of independence of administrators. In the case of *Huxtable v Calnan Oldfield Pty Ltd* (administrator appointed) 2010 FCA 769, Mr. Calnan, a director of the company met with Mr. Huxtable (Huxtable was a previous advisor for the company and an insolvency practitioner) and briefed him on the issues affecting the company and discussed the possibility of Mr. Huxtable being appointed administrator. Mr. Huxtable subsequently applied to the Federal Court under Part 5.3A of the Corporations Act 2001 to confirm his appointment as procedurally valid. The other director and a shareholder of the company acknowledged that there was a need for an administrator but opposed the appointment of Mr. Huxtable on the basis of conflict of interest. Barker J held that Mr. Huxtable could continue to function as administrator of the ailing company. The decision of the court shows that an advice given by an insolvency practitioner is not an absolute barrier to subsequent appointment as an administrator on the grounds of conflict of interest.

<sup>318</sup> *Cresvale Far East v Cresvale Securities* 2001 37 ACSR 394 (hereafter Cresvale case). This case was complex and concerned the appointment of an administrator by one of the companies in a group of companies and a subsequent decision to execute a Deed of Company Arrangement (DOCA). The court found that the DOCA would circumvent proper investigation of dubious transactions. It also found that the majority creditor in value had tried to remove the administrator twice but failed due to the casting vote of the administrator. The court heard that the administrator was biased towards a faction in the company. There was indeed a perception of strong bias in the behavior of the administrator towards one of the factions in the company. Austin J doubted there was a general rule that the administrator should exercise the casting vote to prefer the view of the majority in number. The court held that its power under section 600B of the Corporations Act 2001 to set aside or vary a resolution passed because of a casting vote permitted by the court to review the administrator's reason for exercising the casting vote. Furthermore the review is not confined as to whether the administrator acted honestly but whether he or she properly exercised the casting vote in the interest of the creditors as a whole. In view of the court there is a doubt whether there is a general rule that the administrator should exercise the

relationship with directors or other significant stakeholders or where there is other substantial involvement with the company prior to the administration or evidence of imposition of an administrator on the debtor company, the court has the power to remove an administrator and appoint another.<sup>319</sup> It seems likely that interference from directors would hamper the administrator in the investigation of the affairs of the company with regard to its books and records. The administrator works in good faith without interference so as to provide an alternative rescue mechanism for the company rather than allow the company to be plunged into liquidation. In *Bovin Land Lease Pty Ltd v Willy*<sup>320</sup> the court held that the scope and objects of Part 5.3A established implied duties of the administrator to be independent and impartial and that the administrator should be removed from office under section 449B of the Corporations Act because of his previous connections with the shareholder and the major creditor which consequently caused a reasonable observer to perceive the partiality of the administrator. Section 449C<sup>321</sup> states that where the administrator dies, becomes prohibited from acting or resigns, he or she may be replaced by the same group which appointed him or her.

### **3 2 6 The powers and duties of the administrator**

The Australian system provides the administrator with wide powers to control the company's business, property and affairs in the course of voluntary administration;<sup>322</sup> he controls all the financial affairs of the company;<sup>323</sup> terminating or disposing of all or part of the business or property;<sup>324</sup> and performing and exercising all the functions and powers of the company or its officers. In addition, in terms of section 438D of the Corporations Act, the administrator must lodge a report with ASIC pertaining to past or present officers of the company who may have committed any offence that contributed to the insolvency of the company. In addition, the report made by the administrator must contain any evidence regarding any officer of the company. For the creditors to be kept informed during the administration process, the

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casting vote to prefer the view of the majority in view of the majority in value over the view of the majority in number.

<sup>319</sup> Section 448C.

<sup>320</sup> 2003 NSWSC 467.

<sup>321</sup> Corporations Act.

<sup>322</sup> Sections 437A. This section does not allow the administrator to terminate prior existing contractual rights. If an administrator chooses to repudiate a contract, the other party will be left with a claim which is an unsecured claim against the company for damages.

<sup>323</sup> Section 451C states that if the administrator, in good faith, makes a payment or enters into a transaction, that act is valid and effectual for the purposes of the Corporations Act and cannot be set aside in a subsequent winding up of the company.

<sup>324</sup> Section 442C.

administrator is required to call a first meeting of creditors within five business days<sup>325</sup> of his or her appointment, to consider the appointment of a committee of creditors.<sup>326</sup> The purpose for holding two meetings by the administrator is two-fold. Under the Australian system, one of the purposes is to appoint a committee of creditors should the creditors decide to do so and the other purpose is to replace the administrator should creditors vote to do so.<sup>327</sup>

The administrator, after conducting all the necessary investigations<sup>328</sup> for whichever rescue process is decided on by the company, is required to call a second meeting<sup>329</sup> of the creditors within 28 court days<sup>330</sup> of his or her appointment. The court had to decide in *Australasian Memory Pty Ltd and Another v Brien and Another*<sup>331</sup> whether a second meeting of creditors held outside the prescribed period constituted a procedural irregularity under an administration order. The respondents who were the administrators had irregularly convened the second meeting of creditors by holding the meeting 8 days earlier than prescribed by section 439 of the Corporations Act. The meeting was held as a matter of urgency in an attempt to sell the company as a going concern. At the time the meeting was held, no director or creditor complained that the meeting was held early. The appellant (the company represented based by the resolution of the directors) subsequently sought to have the statutory demand set aside on grounds that the second meeting of creditors was not convened in accordance with section 439A of the Corporations Act and therefore respondents had not been validly appointed as liquidators. The issue for the High Court was whether an order can be made under section 447A (1) to alter the way in which section 439A(2) of the Corporations Act applies to a company. The appellants contended that section 447A should not be construed as authorising the making of an order that would permit departure from the time table for a second meeting that is prescribed by section 439A of the Corporations Act. The court dismissed the appeal by holding that section 447A (1) of the Corporations Act is wide enough to confer power to make orders which will have effect in the future but which

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<sup>325</sup> Section 436E.

<sup>326</sup> The initial timing of the meeting of creditors and the administrator which must be held within five business days as stipulated in section 436E has now been changed with the meeting now to be held within eight business days as stipulated in Corporations Amendment (Insolvency) Act 2007 Schedule 4.

<sup>327</sup> Section 439A– 439C.

<sup>328</sup> Section 438A.

<sup>329</sup> Specifically under section 436E. In terms of the Corporations Act, a second meeting of creditors (the “proposal meeting”) that the administrator has to convene, in general, within 21 days of his or her appointment and that has to be held, in general, within 5 business days those 21 days to consider whether the company should be administered under DOCA, wound-up or in an unusual case, revert to normal operations under its directors.

<sup>330</sup> The meeting must be held within 35 days of the administrator’s appointment where Easter or Christmas intervenes. Also see section 439A (5).

<sup>331</sup> 2000 34 ACSR 250.

are occasioned by something that has been done or not done under the other provisions of Part 5.3A of the Corporations Act.

The administrator must present to the creditors details of reports, statements and arrangements which explain whether it would be in the interest of the company's creditors to execute a deed of company arrangement;<sup>332</sup> whether the company should be wound up and whether or not it would be in the interest of the company's creditors for the administration to come to an end.<sup>333</sup>

### **3 2 7 Effect of Deed of Company of Company Arrangement (DOCA)**

Creditors may decide to execute a deed of company arrangement (DOCA)<sup>334</sup> if the resolution is not set aside, end the administration or wind up the company.<sup>335</sup> A DOCA must identify:

The property that is to be available to pay creditors' claims as well as the nature and duration of any moratorium period for which the deed provides;

- the extent to which the company is to be released from its debts;
- the conditions for the deed to come into operation;
- the conditions for the deed to continue in operation;
- the circumstances in which the deed will terminate; and the order in which the proceeds of realised property available to satisfy creditors' claims is to be distributed and the day on or before which claims must have arisen if they are to be admissible under the deed.<sup>336</sup>

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<sup>332</sup> Australian Corporations Regulation 5.6.21(2) (3) (4). A resolution will not be carried if a majority of the creditors present in number vote against and a majority of those present in value vote against. If there is a deadlock between the number and the votes, then the administrator has a casting vote. Austin J in the *Cresvale* case was critical of the administrator casting a vote at a second meeting of creditors if there is a deadlock. According to the judge: "if the proposal would achieve the objectives partial to a director, unfair to major creditors and will thwart the proper investigation as to whether there is a potentially serious wrongdoing, then the objectives of efficiency and business continuity must yield to the justice of the alternative".

<sup>333</sup> Section 439A (4). The creditors in that meeting may resolve to execute a deed of company arrangement, (DOCA), terminate the administration or have the company wound up. Sometimes the meeting is adjourned for a further period of up to 60 days.

<sup>334</sup> Harris and Legg 197 explain that a DOCA is essentially a compromise between the debtor company and its creditors which will typically involve an extension of the moratorium against unsecured creditors and a compromise on the timing or amount of debt payment. A DOCA may involve a substantial reorganization of the debtor company's corporate and business structure including asset sales and the sell off of "non-core" units.

<sup>335</sup> Section 439C.

<sup>336</sup> Sellars 7.

The company must execute the DOCA within twenty one days of the resolution<sup>337</sup> by creditors and the administrator. The administrator's powers under the DOCA depend on the terms of the deed, and the ability to supervise the company's activities.<sup>338</sup> It is important to note that the administrator is not well protected under a DOCA as in a voluntary administration since there is no indemnity from the company assets unless provided for in the DOCA.<sup>339</sup> Section 444D stipulates that all creditors are bound by the deed except secured creditors and lessors of property being leased by the company. Also, an administrator may apply to the court to prevent a secured creditor or lessors from realising or otherwise dealing with their security.<sup>340</sup> The effect of section 444D is to prevent secured creditors or property owners from bringing court proceedings.<sup>341</sup> Also, they cannot apply for the winding up of the company without leave of the court.<sup>342</sup>

A DOCA terminates if the court so orders on application by either the company, a creditor or any interested party where a resolution has been adopted by creditors on grounds of the DOCA being based on materially false or misleading information.<sup>343</sup> Alternatively, where there has been a material contravention of the deed, or where the deed is oppressive or prejudicial to creditors or contrary to the interests of the creditors as a whole, the DOCA can be terminated.<sup>344</sup> Furthermore, the creditors of the company can make a resolution at a meeting terminating the deed at a meeting that has been convened under section 445F<sup>345</sup> by a notice setting out the proposed resolution<sup>346</sup> or after satisfying the conditions specified in the termination of deed.<sup>347</sup> In *Bovis Land v Willy*<sup>348</sup> the court held that a DOCA may be

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<sup>337</sup> See generally section 444B.

<sup>338</sup> Fridman 339.

<sup>339</sup> Section 443D-443F stipulates that the administrator has an indemnity under voluntary administration. The administrator however is liable for any debts incurred in the performance or exercise of his or her powers as administrator for services rendered, goods bought or property hired, leased or occupied. While it seems harsh the administrator is indemnified.

<sup>340</sup> Sections 444D (2) and (3), 444F.

<sup>341</sup> Section 444E.

<sup>342</sup> Section 444E.

<sup>343</sup> See generally Section 445D.

<sup>344</sup> Section 445D(1)(f)(i).

<sup>345</sup> In terms of section 445F of the Corporations Act, creditors of a distressed company can meet to consider termination of a DOCA if it so requested in writing by the creditors whose value of claims against the company is not less than 10% of the value of all the creditors' claims against the company.

<sup>346</sup> Section 445A.

<sup>347</sup> Section 445C.

<sup>348</sup> 2003 NSWSC 476. The facts were that Bovis Land Lease Ltd and Interline Interior Linings Pty Ltd disagreed on a contract between them and claimed breach of contract from one another. Bovis Land Lease Pty Ltd commenced proceedings against Interline Interior Linings Pty Ltd after an administrator Mr. Javorsky was appointed by Mr. Willy, the company's liquidator at the request of the major shareholder and creditor. The issue that the court had to deal with was on which grounds the DOCA could be terminated. The court held that a DOCA can be terminated if there were material omissions from the administrator's report that failed to provide

terminated on the basis that termination is in the interest of creditors as a whole or the administrator's report contained material omissions as a result of which effect could not be given to it without injustice.

### **3 2 8 Effect of moratorium**

As with almost all corporate rescues, a moratorium on legal actions against the debtor company is intended to allow the stakeholders work out plans to rescue the business. One of the effects of the appointment of an administrator is the triggering of a moratorium in the course of voluntary administration which amongst other things prevents the company being wound up, prevents charges being enforced, prevents an owner or lessor recovering property which is being used by the company, prevents proceedings being commenced or continued against the company and any enforcement action in relation to proceedings already instituted.<sup>349</sup>

In addition to the moratorium on actions against the company under administration, there is a stay on creditors enforcing any guarantees given by directors (or their relatives) for any liability of the company.<sup>350</sup> It is possible that unscrupulous directors may attempt to hide assets from the creditors, favour certain creditors over others, incur artificial liabilities, make gifts to relatives or friends or transfer the business and assets to another company.<sup>351</sup> Such transactions would be unfair to the general body of unsecured creditors and thus leaves an avenue for abuse. The most important exception to the moratorium is that which allows a charge holder to appoint its own receiver with regard to the company's property and, for this purpose, the charge holder must act within 14 days of the appointment of the administrator.<sup>352</sup>

The moratorium represents an abridgement of the proprietary rights of creditors and freedom of contract.<sup>353</sup> It has been argued that the rationale for the exception is to place the holder of the charge in a position to achieve an orderly realisation of the company's assets.<sup>354</sup> The enforcement by the secured creditor holding a charge or charges over the company's property

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information on the parties' abilities to fund the proposed litigation against the claims by Bovis, the nexus between a consultant to the deed administrator (Mr. Javorsky) and the major shareholder and the facts and legal propositions that gave rise to the cause of action.

<sup>349</sup> See generally sections 440D, 440G, 440F of Corporations Act.

<sup>350</sup> Discussion paper on Australia 6.

<sup>351</sup> PJCCFS 14.

<sup>352</sup> Sellars 4.

<sup>353</sup> PJCCFS 13.

<sup>354</sup> Sellars 5.

does not bring the administration to an end; however the property of the company will be under control of the chargee or a receiver appointed by the chargee, and the administrator will effectively have no assets to administer and no indemnity out of the assets of the company.<sup>355</sup> Once the charge is activated, a notice of enforcement is given to the administrator.<sup>356</sup>

It should be noted that there are other exceptions when a moratorium has been put in place. A secured creditor who takes steps to enforce a charge prior to the appointment of an administrator may continue to enforce that security. Similarly, a creditor may enforce a charge in relation to perishable property, notwithstanding the appointment of an administrator; and where an owner or lessor of property used by the company takes steps before the beginning of the administration to recover the property, that recovery process will be allowed to continue.<sup>357</sup>

### **3 2 9 Role of the court**

In the Australian system, it seems clear that although the court does not unnecessarily involve itself in voluntary administration, it still plays a number of important roles. For example, the court may make any order about how Part 5.3A should operate in relation to a particular company.<sup>358</sup> Furthermore, the court is empowered to make any order it deems necessary to protect the interest of the company's creditors<sup>359</sup> while still under administration.<sup>360</sup> In addition, the court can make an order declaring that the appointment of an administrator is valid<sup>361</sup> and review the administrator's remuneration if it was fixed by creditors.<sup>362</sup> Another role of the court during administration is extending the time periods for meetings and curing failures to comply with mandatory time periods.<sup>363</sup> The court may grant leave to an administrator to dispose of property if the property is owned or leased by a third party to the company under administration but subject to the satisfaction of the court that

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<sup>355</sup> Section 447 B of the Corporations Act.

<sup>356</sup> Section 440F of Corporation Act.

<sup>357</sup> Sellars 5.

<sup>358</sup> In terms of Part 5.3A of the Corporations Act, the court plays a variety of roles during the duration of administration of a company's affairs by an administrator.

<sup>359</sup> Section 440J of Corporation Act stipulates that creditors are required to obtain leave of the court to enforce guarantees against directors, their spouses, *de facto* spouses or their relatives.

<sup>360</sup> In terms of Section 447B Corporation Act, ASIC or a creditor can apply to the court to make orders to protect creditors when the company is under administration.

<sup>361</sup> Section 447C.

<sup>362</sup> Section 449E.

<sup>363</sup> Section 439B(6).

adequate arrangements have been made to protect the secured creditor or the owner of the property.<sup>364</sup>

Similarly, the court may grant leave to the administrator of a company to dispose of property of the company subject to a charge or property used or occupied by the company or in the company's possession with someone else as the owner or lessor, subject to arrangements being made to adequately protect the interests of the charge holder or owner.<sup>365</sup> Meanwhile, an administrator can apply to the court for directions either in connection with his or her performance or in relation to his or her powers.<sup>366</sup>

In terms of Section 447A, the court has general powers to make orders which are appropriate with regard to a voluntary administration. In *Australasian Memory Pty Ltd and Another v Brien and Another*,<sup>367</sup> the jurisdiction of the court to make remedial orders in relation to administration orders had to be decided by the court. It was held that section 447A is not properly described as a general power standing apart from the scheme found in Part 5.3A of the Corporations Act. In the view of the court, section 447A of the Corporations Act is an integral part of the legislative scheme that enables the making of orders which alter the way Part 5.3A of the Corporations Act is to operate and how section 439A is to apply. The court can order that the administration of a company should end<sup>368</sup> due to the company becoming solvent or the administration process is being abused<sup>369</sup> or extending the time period to remove the administrator.<sup>370</sup> The court can also make orders binding on dissenting creditors.<sup>371</sup>

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<sup>364</sup> Section 444F. it should be noted however, that the court will make such an order if it is satisfied that the interest of the owner or the lessor will be adequately protected and also, the purpose of the deed will be achieved.

<sup>365</sup> Section 442C.

<sup>366</sup> Section 447D.

<sup>367</sup> 2000 ACSR 252.

<sup>368</sup> Section 445D. See also *Australasia Memory Pty Ltd v Brien and Another* 2000 ACSR 252 where the court held that it may order under section 447A(1) of the Corporations Act that an administration should come to an end subject to conditions on application made by either the company, creditor or the administrator.

<sup>369</sup> An administration may be terminated by the court under s 447A if it is being abused. In *Aloridge's* case, the court found that the appointment of the administrator had been made, not in the interest of the company or its creditors, but to wrest control of the company's affairs from the provisional liquidator. Burchett J held that the mandate of the administrator must be terminated.

<sup>370</sup> In the case of *Cawthorn v Keira Constructions Pty Ltd* 1994 ACLC 369, the question the court had to deal with was whether it had power to extend time under section 447A and/or section 1322 of the Corporations Act, regardless of the mandatory wording of the time limit in section 439B. Young J held: "The emphasis is on formality and flexibility. The emphasis is also on speed of action. The procedure does not allow the indefinite administrations which can occur, for example, under the United States Chapter 11 approach. The emphasis is also on appropriate protection of creditor's interests, so that they will find that they are not unduly disadvantaged by the short moratorium proposed. It seems to me that this reinforces the construction that I have

### 3 2 10 Rights of interested parties: Creditors and shareholders

It is stipulated in the Corporations Act 2001,<sup>372</sup> that creditors have the choice of accepting a proposal for a DOCA and opt for liquidation of the company. In *Selim v McGrath*<sup>373</sup> the court dismissed a challenge by the owner of Pan Pharmaceuticals Company (director) of the way creditor voting rights were dealt with by the administrator, Mr McGrath. Voluntary administration places control over the future of the debtor squarely on the shoulders of the creditors.<sup>374</sup> These creditors can remove and replace the administrator if they desire to do so.<sup>375</sup> This may occur where the administrator is regarded by creditors as being too sympathetic to the existing management of the company.<sup>376</sup> A debtor company will be placed in a creditors' voluntary winding up with the administrator as the liquidator if the liquidation alternative is adopted by creditors.<sup>377</sup> In this case, a similar transition from administration into a creditors' voluntary winding up will occur; the same applies where the company fails within twenty one days to execute the DOCA that was agreed upon by creditors and also where the creditors terminate the DOCA and resolve that the company should be wound up.<sup>378</sup>

The courts in recent times have held that a DOCA cannot be used to compromise the rights of creditors to pursue claims against third parties,<sup>379</sup> as happened in the Lehman Brothers

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placed on section 447A, that the court has plenary powers to do whatever it thinks is just in all of the circumstances, but the court is to bear in mind when exercising those powers the rights of the various groups of people that are affected by voluntary administration, and that there is a very great public interest in not permitting such voluntary administration to go on for a long period of time".

<sup>371</sup> See in this regard ss 444D (2), (3), 444F, 445B.

<sup>372</sup> Section 439C.

<sup>373</sup> 2003 NSWSC 927. Pan Pharmaceuticals Ltd appointed voluntary administrators after its Therapeutic Goods Administration (TGA) license was suspended and products manufactured by the company (Pan) after May 2003 were recalled. A DOCA was proposed to transfer the company to a Sydney-based businessman, Mr. Fred Bart. The creditors at their second meeting considered the possibility of approving a DOCA, terminating the administration order or winding-up the company. The administrator, Mr. McGrath, used his casting vote as chairman of the meeting to place the company in liquidation after the creditors had resolved to reject the proposed DOCA. Mr. Selim being the major shareholder challenged the decision to liquidate the company. The court dismissed his application. Barrett J stated "the voting rights of 'contractual' claimants at the creditors meeting were not contentious, but the rights of the 'non-contractual' claimants to vote on the future of Pan was."

<sup>374</sup> Harris and Legg 197.

<sup>375</sup> Section 436E.

<sup>376</sup> Section 436E(4)(a).

<sup>377</sup> See section 446A.

<sup>378</sup> Sellars 8.

<sup>379</sup> See in this regard Bochenek, "Third Party Claims and DOCA: The Lehman Brothers DOCA Fails" April 2010. Available at <http://www.cliffordchance.com> (accessed 10-12-2010). (Lehman Brothers Asia Holdings Limited being Lehman Australia's biggest creditor). Lehman Brothers Ltd, LB Holdings Plc and LB UK RE Holdings were placed under administration by way of an application to court by relevant directors on 15<sup>th</sup> September, 2008.)

case.<sup>380</sup> In the case of *Sons of Gwalia v Margaretic*<sup>381</sup> the court held that shareholders claims were recognised. It stated that there was no statutory purpose supporting an extension of the operation of a DOCA beyond governing the rights and obligations of the company in administration. The judgment indicates clearly that the Australian courts are ready to protect the interests of affected parties in corporate rescue processes.

### **3 2 11 Rights of interested parties: Employees and the community**

With Australia's employee entitlement regime being amongst the most comprehensive in the world, it is no surprise that a key challenge to any company or business restructuring relates to employees.<sup>382</sup> The safety net for employee entitlements provided under the General Employee Entitlements Redundancy Scheme (GEERS) is only applicable to companies in liquidation, thereby excluding companies under a DOCA. There is no doubt that employee entitlements should be protected in corporate rescue processes and the preservation of jobs needs to be prioritised.<sup>383</sup>

The administrator is not personally liable for the entitlements of any employee, unless the employment contracts are adopted or new contracts of employment are entered into. This follows from the fact that the appointment of an administrator does not automatically terminate the employment of company employees.<sup>384</sup> However, employee entitlements that arise prior to the voluntary administration are not usually paid during the process; rather, payments are made depending on whether there is a DOCA or the company is returned to the

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<sup>380</sup> In the Lehman Brothers case, the creditors passed a resolution for the execution of a DOCA which shareholders alleged was misleading and evidenced deceptive conduct on the part of the creditors. The validity of the DOCA was also contested on the basis that the release set out in the DOCA was not within the scope of Part 5.3A. The court held that the DOCA was null and void. The High Court of Australia dismissed an appeal against the judgment of the Federal Court of Australia which found the DOCA approved by the creditors of Lehman Brothers Australia Limited void and that the company must be wound up. The implication of the High Court's decision was that a DOCA cannot operate to release third parties from claims which may be brought against them by company creditors.

<sup>381</sup> 2007 HCA 1. In a recent development, the government of Australia in its corporate insolvency law reform package (see in this regard Bowen "Corporate insolvency Law reform Package" Australian Government Treasury 14 September 2010) <http://www.treasury.gov.au> (accessed 12-03-2011) in consultation with stakeholders such as CAMAC has resolved to reverse the effect of the High Court's decision in *Sons of Gwalia v Margaretic* which determined that in a corporate winding up, certain compensation claims by shareholders against the company were not subordinated below the claims of other creditors. According to Bowen, "Any direct benefits to aggrieved shareholders arising from non-subordination are outweighed by the negative impacts on shareholders generally as a result of restrictions on access to, and increases in, the cost of debt financing for companies." This was however contrasted in the decision in *Re Opes Prime Stockbroking Ltd* (Receivers and Managers Appointed) (In Liquidation) 2009 258 ALR 362. In that case the Federal Court of Australia held that a Scheme of Arrangement could validly release a creditor's claim against third parties provided there is a nexus between the release and the relationship between the creditor and the insolvent company.

<sup>382</sup> Blazic 14.

<sup>383</sup> *Ibid.*

<sup>384</sup> See generally ASIC *Voluntary Administration: A Guide for Employees* December 2010.

directors or placed in liquidation.<sup>385</sup> But employees have the right, if funds are left over after payment of the fees and expenses of the administrator, to be paid their outstanding entitlements in priority to other unsecured creditors.<sup>386</sup>

The Australian legislation creates a situation where the interests of (government) revenue and the wider community can be protected.<sup>387</sup> Directly or indirectly, section 443BA imposes a liability on the administrator for certain income remittances.<sup>388</sup> That section specifically entreats the administrator to pay to the Commissioner of Taxation the amounts payable under the remittances provision because of a deduction made by the administrator during the voluntary administration process. Cassidy has argued that although the administrator may be considered to be acting as the company's agent, he may nevertheless be personally liable for debts incurred, goods or property obtained or used in the course of the administration.<sup>389</sup> Furthermore, Fridman has submitted that section 443BA must be considered as a protection for the 'wider interests' of the community.<sup>390</sup> Suffice to say that the employees make up a critical part the community.

### **3 3 Voluntary administration in Australia: Strengths and weaknesses**

The framework and regulations of voluntary administration in Australia provide for the procedure and consequences thereof. The reasoning behind the Australian approach of appointing an administrator is the fact that court-based systems, as adopted in jurisdictions such as the United States of America and Canada, lead to unnecessary delays and costly litigation that result in even smaller dividends for creditors, as well as dissipation of the company's remaining funds.<sup>391</sup> It is worth noting that the voluntary procedure as designed to commence without the involvement of the court is aimed at ensuring that the directors are able to deal with the company's insolvency in a swift and effective manner, and to punish directors who allow the company to trade while it is insolvent.<sup>392</sup>

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<sup>385</sup> *Ibid.*

<sup>386</sup> *Ibid.*

<sup>387</sup> Fridman 2.

<sup>388</sup> See in this regard section 443C which says the administrator is not liable for the company's debts. The exception here is the administrator can be liable for the company's debt if compliance with section 443BA is neglected.

<sup>389</sup> Cassidy 347.

<sup>390</sup> Fridman 2.

<sup>391</sup> Anderson 113.

<sup>392</sup> Anderson 114.

As explained by Anderson, directors are open to liability where the company is allowed to trade on while insolvent but that is a cheap means of dealing with an ailing company.<sup>393</sup> Sight should not be lost on the fact that directors have the responsibility to ensure that a company is managed properly, and that the shareholders can resolve to remove them if they do not meet the accountability criteria.<sup>394</sup> Sealy has argued that it is a weakness of the Australian legislation to suggest that the whole focus of the reform appears to have been very much on the small business in a relatively uncomplicated insolvency situation, leaving nothing equivalent to the court-supervised administration for cases which are more complex.<sup>395</sup> The Harmer Committee recommended the appointment of administrator by shareholders' resolution but the recommendation has not been adopted in Australia, which creates a gap in the Australian<sup>396</sup> procedure in terms of the interest of shareholders in the company and suggests that shareholders have no proprietary interest left in an insolvent company.<sup>397</sup>

Since there is no initial application to court, voluntary administration can be cheaper and more attractive to investors. However, room for argument has been created, in that voluntary administration is open to abuse and has been abused by company directors<sup>398</sup> who seem to favour voluntary administration since they appoint the administrator and can, therefore, escape scrutiny of their conduct.<sup>399</sup> It has been noted strongly that administrators must be given sufficient powers and duties to investigate and report wrongful conduct, given the fact

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<sup>393</sup> *Ibid.*

<sup>394</sup> See in this regard Esser and Havenga "Shareholder Participation in Corporate Governance" *Speculum Juris* 2008 78. (Hereafter Esser and Havenga.) Also sections 198A (1) and 203D of the Australian Corporations Act 2001.

<sup>395</sup> Sealy 144.

<sup>396</sup> The UK's rescue mechanism is silent on the interest of shareholders, but a recent directive from the European Union will see the rights and interests of shareholders being recognized. The Companies (Shareholder Rights) Regulations 2009 (SI 2009/1632) is to implement the shareholder Rights Directive (2007/36/EC) in the UK. The new requirements apply on top of the existing obligations in Part 13 of the Companies Act 2006. The Directive only applies to traded companies with shares on the European Economic Area's regulated market; however it is important to note that a number of the changes will affect all companies. <http://www.insolvency.co.uk> (accessed 10-02-2011).

<sup>397</sup> Anderson 115.

<sup>398</sup> See Insolvency Trading Provisions 4. It has been explained here that in the Australian legislation, there are criminal and civil aspects of actions against directors. Where a director allows a company to trade while insolvent, and this is done knowingly, intentionally or recklessly and was either dishonest with a view to gaining advantage or was intended to deceive or defraud, the director is guilty of a criminal offence. A convicted director(s) is prohibited from managing a company for five years. The maximum penalty payable is \$200,000 and/or imprisonment for 5 years. Civil penalties are similar to criminal penalties, but do not include automatic disqualification. A director may also be ordered to pay compensation. A liquidator or in some circumstances, a creditor may sue a director for compensation. The ASIC has the power to take actions against a director for insolvent trading. Creditors may also take proceedings against directors with consent of the liquidator.

<sup>399</sup> Insolvency Trading Provisions 4.

that administrators have been reluctant to 'bite the hand' that appointed them, namely the directors.<sup>400</sup>

In another criticism of voluntary administration, it has been noted that although directors initiate the procedure, creditors are allowed to decide the fate of the company through the DOCA.<sup>401</sup> Creditors have no concern with what happens to the company after a DOCA has been put in place unless they are to receive further payments, and so creditors can sanction the return of the company to directors without any assurance that the company is now solvent. Such criticism of creditor control would seem to advocate a wider role for state or practitioner control in the public interest which would have to be justified by statistics as to the level of harm relative the cost of more intense regulation.<sup>402</sup> It has been argued, however, that this reflects more of a liquidation perspective of insolvency procedures, where shareholders may have no interest in an entity that is being wound up and has no funds available for any stakeholders except outside creditors<sup>403</sup>. On the other hand, a corporate rescue is more likely, if it is successful, to mean a continuing interest in the corporate entity from the shareholders.<sup>404</sup>

The power of the administrator in Australia to cast a vote during the all important second meeting of the creditors can effectively encourage conflict of interest on the part of the administrator to make sure that the deed that he or she has proposed is accepted.<sup>405</sup> According to Sellars,<sup>406</sup> a technical concern about voluntary administration raised by commentators is that, the length of the statutory time frames and the details of the voting procedures create problems during the administration process.

Sellars has opined that another critical factor pertaining to the success of voluntary administration is the availability of skilled, honest and independent administrators as most of the complaints relating to voluntary administration are based on alleged abuse by

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<sup>400</sup> New Zealand 33.

<sup>401</sup> New Zealand 33.

<sup>402</sup> *Ibid.*

<sup>403</sup> Anderson 114.

<sup>404</sup> *Ibid.*

<sup>405</sup> CASAC has rejected this criticism on the basis that smaller value creditors needed to be protected so a proposal to decide by majority was prejudicial on smaller value creditor. The Insolvency Practitioners Association of Australia has suggested that voting should be cast in favour of those with the greatest value.

<sup>406</sup> Sellars 11.

administrators who are too close to management; hence independence is, allegedly, missing during the process.<sup>407</sup>

Based on the above discussions, there is no doubt that the Australian corporate rescue procedure is more creditor-friendly than its counterparts in other jurisdictions such as South Africa and United States of America which are more of debtor-friendly. In most jurisdictions which have embarked on robust insolvency reforms, it appears that almost each one of them aims at saving businesses as well as protecting the interests of all parties.

## **3 4 UNITED KINGDOM**

### **3 4 1 Background and rationales**

The onset of a ‘rescue culture’ in the United Kingdom can be seen in the 1960s when the preservation of going concerns, and, principally, of the employment generated by them, became a desirable outcome alongside the maximisation of realisations for secured creditors.<sup>408</sup> At that time, the primary medium for ‘business rescues’ was the receivership under the powers contained in a floating charge usually granted to banks and similar financial institutions.<sup>409</sup> Such a charge would enable the creditor to appoint a receiver and manager of the company who when appointed, became its agent.<sup>410</sup> The receiver and manager could carry on the company’s business for sale as a going concern or dispose of its assets piecemeal.<sup>411</sup> The receivership<sup>412</sup> was not an insolvency process per se but rather the manner in which a creditor holding a floating charge and fixed charges<sup>413</sup> could enforce its

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<sup>407</sup> Sellars 11.

<sup>408</sup> *A Review of Company Rescue and Business Reconstruction Mechanisms*: Report by the Review Group, Department of Trade and Industry and HM Treasury, May 2000 12 (hereafter *Rescue Mechanisms*).

<sup>409</sup> *Rescue Mechanisms*.

<sup>410</sup> *Rescue Mechanisms* 12.

<sup>411</sup> *Ibid.*

<sup>412</sup> Receivership is the process used by the holder of a charge, usually bank, when the company is not complying in terms of a loan. In most cases the administrative receiver will carry on the company’s business and try to sell the business or assets to satisfy the claim of the bank. The administrative receiver can even petition for the winding up of the company, in any event once his task of selling the assets is completed, it may be that the only remaining option is to wind up the company. <http://www.contactlaw.co.uk/receivership> .(accessed 10-03-2011).

<sup>413</sup> See in this regard Oxford Dictionary of Law, 2003 74. A fixed charge is attached to specific assets such as plant and machinery; while in force, it prevents the company from dealing freely with those assets without the consent of the lender; in contrast, a floating charge does not immediately attach to any specific assets but ‘floats’ over all the company’s assets. Until this point the company is free to deal freely with such assets. A floating charge is suitable for circulating assets such as cash and stock in trade whose value fluctuates.

security. The considerations of the rescue culture, which the Cork Committee's Report<sup>414</sup> espoused, were focussed on the benefits to be had by both secured creditors and the community at large in terms of businesses and jobs preserved as a result of floating charge receiverships. The Cork Report viewed such receiverships as the obvious and preferred means of business rescue.<sup>415</sup> However, in 1985, the United Kingdom adopted provisions for two forms of business rescue procedure: The Administration Order (AO) and The Company Voluntary Arrangement (CVA), which are somehow interrelated because administrative orders try to effect a CVA or Scheme of Arrangement.<sup>416</sup>

Section 425 of the United Kingdom Companies Act 1985 (UKCA) provides for the non-insolvency remedy called a Scheme of Arrangement which can be complex because there is no moratorium and is therefore difficult to organise.<sup>417</sup> The CVA was conceived as a simple form of compromise procedure whereby a debtor company could put a proposal to creditors, supervised by an independent practitioner who will report to the court on the viability of the proposal.<sup>418</sup>

It is worth noting<sup>419</sup> that English corporate insolvency law has been reshaped by the Enterprise Act 2002 (the Act) with the relevant provisions, which came into force on 15 September 2003, bringing about the most significant changes to insolvency law in the UK for over 15 years. However, the use of the two procedures, AO and CVA, has been disappointingly low. Furthermore, the procedure is virtually inefficient as it fails to maximise value for creditors, lacks transparency and accountability and is outdated.<sup>420</sup> There has

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<sup>414</sup> The Insolvency Law Review Committee under the chairmanship of Sir Kenneth Cork (Cmnd.8558 1982), paragraph 204 (hereafter The Cork Report) recommended substantial changes to the Insolvency provisions of the Companies Act 1985, with the principal objective of the reforms aiming at enabling companies in financial difficulties to be rescued before sliding into insolvency. <http://www.insolvency.gov.uk>. (Accessed 10-09-2010). Also see Lowry and Dignam, *Company Law* 1998 431 (hereafter Lowry and Dignam). The Cork Report explained that the "well-being of those dependent on enterprise which may be the life blood of a region...the chain reaction consequences upon any failure... creditors, employees and the community can suffer if enterprises are not protected". Cork Report para 204.

<sup>415</sup> Rescue Mechanisms 13.

<sup>416</sup> New Zealand 33.

<sup>417</sup> New Zealand 33.

<sup>418</sup> *Ibid.*

<sup>419</sup> Mokal and Armour, *Reforming the Governance of Corporate Rescue: The Enterprise Act 2002* 2004 1. (Hereafter Mokal and Armour Part 1). Also see McCormack "Apples and Oranges? Corporate Rescue and Functional Convergence in the US and UK" 2009 *INSOL International Insolvency Review* 110 (hereafter McCormack) where it has been observed that the functional convergence of UK has partly come about through the enactment of the Enterprise Act 2002 which had the specific objective of tilting UK law in a westerly direction with the aim of the legislation being to borrow some of the best features of the corporate reorganization chapter in the USA Bankruptcy Code – chapter 11-but at the same time avoiding its pitfalls. The Enterprise Act has amended the UK Insolvency Act 1986.

<sup>420</sup> Mokal and Armour Part 1 3.

therefore been felt the need for drastic reforms as most jurisdictions have been undertaking reform of their corporate rescues regimes in recent times.<sup>421</sup>

The Act has been designed with the object of facilitating the development of a corporate rescue culture and to produce better returns for creditors as a whole.<sup>422</sup> It makes as a point of departure three principal changes to the previous company rescue procedures in the UK, namely:<sup>423</sup>

- The abolition of the administrative receivership as it gives unhealthy power to creditors holding floating charges, and who because of their secured status lacked sufficient incentives to rescue failing companies;
- The refashioning of the administrative procedure to be flexible as well as foster accountability. The administrator must act in accordance with a statutory hierarchy of objectives and justify his or her course of action; and
- The abolition of the Crown's preferential status in insolvency proceedings and replacing it with a proportion of floating charge recoveries made for the general unsecured creditors.

### **3 4 2 The Administration Order (AO) in the United Kingdom**

The creation of the AO procedure in the UKIA had the aim of attempting to fill the vacuum in cases where companies had not granted a floating charge to a lender and, as a result, their business could not be rescued by the conventional means of a receivership.<sup>424</sup> The extent to which the AO was to be a junior complement to receivership was shown in the creation of a veto of AO proceedings exercisable by the holder of a floating charge in favour of administrative receivership.<sup>425</sup>

The objectives of administration have been introduced in the Act and are as follows:

- The company (business)<sup>426</sup> should be rescued as a going concern;<sup>427</sup>

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<sup>421</sup> *Ibid.*

<sup>422</sup> Mokal and Armour Part 1 1.

<sup>423</sup> *Ibid.*

<sup>424</sup> Rescue Mechanisms 13.

<sup>425</sup> *Ibid.*

<sup>426</sup> Boyle and Birds argue that the first objective of administration order is preservation of the business of the company rather than preservation of company as an empty corporate shell. Boyle and Birds *Company Law* (2009) 832. (Hereafter Boyle & Birds).

<sup>427</sup> See in this regard paragraph 3(1) (a) of Schedule 16 – Schedule B1 to Insolvency Act 1986 as amended by Enterprise Act 2002. (Hereafter Enterprise Act 2002).

- achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without being in administration);<sup>428</sup> or
- Realising property in order to make a distribution to one or more secured preferential creditors.<sup>429</sup>

It has been argued that the first objective of rescuing the company as a going concern, must be given priority unless the administrator<sup>430</sup> believes it is not reasonably practicable or that the administration would achieve a better result for the company's creditors as a whole and that the interests of the creditors of the company as a whole will not be harmed.<sup>431</sup> In *Doltable Ltd v Lexi Holdings plc*<sup>432</sup> Doltable, a company which owned land with development potential applied to be placed under an administration order as it could not pay its debt as they fell due although it had substantial assets in the form of land. Doltable submitted that an administration order would rescue the company as a going concern because it would enable a sale to take place at a price that would yield a surplus to the members; it would also put the company and the property in the hands of an independent professional and prevent the receiver from continuing to pursue options that he had not investigated fully or properly. Lexi, which was a respondent creditor, submitted that the application was an abuse of the administration process because its function was to prevent Lexi from enforcing its security. The court held that in the applicant company's circumstances, an administration order would not likely achieve the purposes of section 3 (a) (b) (c) of the Enterprise Act and there was no evidence as to the likelihood of a refinancing being achieved. The court further held that in a liquidation rather than administration, the creditors would be no worse off, nor indeed would they be any better off. Accordingly, the court refused Doltable's application. In *AA Mutual International Insurance Co Ltd*<sup>433</sup> the court held that paragraph 11 of schedule B1 of the UKIA provides that the court could grant an administration order if it is satisfied that the company is or is likely to become unable to pay its debts and on consideration

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<sup>428</sup> Para 3(1)(b) of Enterprise Act 2002.

<sup>429</sup> Para 3(1)(c) of Enterprise Act 2002.

<sup>430</sup> In terms of paragraph 5 of the Enterprise Act 2002, the administrator is an officer of the court whether or not he is appointed by the Court. Para 6 -9 of the Enterprise Act places general restrictions on the person who qualifies as an administrator. A person may be appointed as administrator of a company only if he is qualified to act as an insolvency practitioner and not of a company which is in liquidation by virtue of resolution of a voluntary winding up or a winding up order. A person cannot be appointed as an administrator if he has a liability in respect of a deposit which it accepted in accordance with the Banking Act 1979. Furthermore a person cannot be appointed as an administrator of a company which effects or carries out contract of insurance.

<sup>431</sup> Mayson, French & Ryan *Company Law* (2010-2011) 665. (Hereafter Mayson, French & Ryan).

<sup>432</sup> 2005 EWHC 1804 (Ch).

<sup>433</sup> 2004 EWHC 2430 (Ch).

whether if an administration order is made, a better result will be achieved for the company's creditors than in a winding up.

Goode has noted that the administration procedure is designed to fill a gap which previously existed in corporate insolvency law in that there was no mechanism by which a company could be put under outside management for the benefit of unsecured creditors and the company itself.<sup>434</sup> There was also no effective step that that could be taken to safeguard the company and its assets from precipitate action by creditors, for example, a levy of execution, enforcement of security or putting the company into winding-up while steps were being taken to put the company back on its feet.<sup>435</sup>

McCormack has argued that a mandatory displacement of management in favour of external administration is an intrinsic feature of administration in the UK which is in striking contrast to reorganisation under the United States of America's "debtor in possession" strategy.<sup>436</sup> It is submitted that the US's chapter 11 imposes greater burdens on the debtor business than The Act in the UK.<sup>437</sup>

### **3 4 3            Type/Types of Entities that are Eligible for Protection under the Administrative Order**

In the United Kingdom, entities which could be eligible for protection are companies registered under the Companies Act and who, by virtue of such registration, become incorporated and legal persons as well as all other associations of people; excluding partnerships.<sup>438</sup> However, since the enactment of the Insolvent Partnerships Order in 1994, a full range of statutory business rescue regimes has been available to partnerships.<sup>439</sup>

The UK Insolvency Code includes the regime of individual voluntary arrangement which allows the individual debtor to petition the court for an interim order, which if so granted, will effect a stay on all proceedings against the petitioner.<sup>440</sup> Section 8(4) of the UKIA stipulates that an administration order cannot be made where the company is in liquidation.

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<sup>434</sup> (Goode 17).

<sup>435</sup> *Ibid.*

<sup>436</sup> McCormack 113.

<sup>437</sup> See in this regard Conway "A Comparison: Company Rescue under UK Administration and US Chapter 11" 18 May 2010 4. <http://www.insolvency.gov.uk/an/ha/5527/houseofcommonslibrary> (accessed 15-03-2011).

<sup>438</sup> Rajak and Henning 217-273.

<sup>439</sup> See generally Rajak and Henning 271-273.

<sup>440</sup> *Ibid.*

The administration order procedure is not available where the company is an insurance company within the meaning of the Insurance Companies Act 1982.<sup>441</sup> Section 8(4) of the UKIA stipulated that authorised institutions within the meaning of the Banking Act 1987 cannot be granted an administration order but section 735 of the Companies Act 1985 allows banks<sup>442</sup> to be granted an administration order if the need arises.<sup>443</sup>

### 3 4 4 Initiation of the rescue process

The AO is a court order which can be made on various grounds.<sup>444</sup> In addition to satisfying the court that the company is nearly insolvent, the applicant<sup>445</sup> may lodge a petition for the company to be placed under an administration order.<sup>446</sup> It has been argued that where the company itself is the applicant, a petition should be presented in the name of the company only if a general meeting of shareholders has so resolved; otherwise where the company's articles of association expressly delegated the power to petition in the company's name to its board of directors, the board should resolve to do so.<sup>447</sup> In this regard, individual members or shareholders cannot petition for an administration order in that capacity, irrespective of the extent of their shareholding.<sup>448</sup> The directors as applicants for the order must act unanimously or by a resolution duly approved by a majority, taken at a properly constituted board meeting.<sup>449</sup>

In terms of section 8 of the UKIA, the granting of an Administration Order requires the court to ascertain whether the company is or likely to be, unable to pay its debts. The proof

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<sup>441</sup> (Goode 287).

<sup>442</sup> Clokey "The Bradford and Bingley Plc Compensation Scheme: Assessment Notice in respect of Shares and Subscription Rights" July 2010 15. <http://www.insolvency.gov.uk> (accessed 12-02-2011). Clokey has submitted that the administration order in the United Kingdom should also be available to banks. As a valuer for Bradford and Bingley (a subsidiary of Barclays Bank UK) Clokey noted with concern that shareholders did not receive compensation save for the expected outcome if the institution had been placed under administration.

<sup>443</sup> (Goode 287) has opined that banks which are companies within the meaning of the Companies Act are no longer excluded due to the Banks (Administration Proceedings) Order 1989 .

<sup>444</sup> See generally (Goode 17-18). The reasons for the court order are to enable the administrator who has been appointed by the court to manage the company for the benefit of creditors generally with a view to secure the survival of the company as a going concern, the approval of voluntary arrangement and the realization of the company's assets.

<sup>445</sup> On who qualifies to apply for an administration order in the United Kingdom, see the discussion of 'appointment of administrator' below.

<sup>446</sup> See section 9(1) of UKIA.

<sup>447</sup> See generally Kloppers 363-366.

<sup>448</sup> Kloppers 363-366.

<sup>449</sup> Kloppers 364.

required is on a balance of probabilities as in civil cases generally.<sup>450</sup> The other requirements are as follows:

- (a) Establishment of the possibility of the company surviving as a going concern;
- (b) Approval of voluntary arrangement, compromise or arrangement between the company and other interested parties; and
- (c) The realisation of the company's assets would yield greater proceeds than would be possible on a winding-up.<sup>451</sup>

And further, the three disqualifying conditions must be absent, namely, that the company must not have gone into liquidation; an administrative receiver has not been appointed or if one has been appointed there should be consent from the person who has been appointed; and the ailing company must not be an insurance company, a recognised bank or a licensed financial institution.<sup>452</sup>

In terms of section 9(2) of the UKIA, prior notice of the petition must be given to an administrative receiver appointed under a crystallised floating charge.<sup>453</sup> A notice must also be given to any person who has appointed, or is or may be entitled to appoint an administrative receiver of the company, and as soon as practicable after filing the petition, the petitioner must also give notice of his presentation to any sheriff or other officer who, to his or her knowledge is charged with an execution or other legal process against the company or its property.<sup>454</sup> Once the court is satisfied that the company has met the requirements to be granted an administration order, it uses its discretion to do so. However in *Hammonds v Pro-Fit USA Ltd*,<sup>455</sup> the respondent company which was a wholly-owned subsidiary of a parent

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<sup>450</sup> Section 8(1) of the UKIA. (Goode 68) noted that the phrase 'inability to pay its debt' should be read within the meaning of section 123(1)(e) and section 123(3) of the Insolvency Act. According to him, the court would consider as a sufficient ground the fact that a creditor has made a written demand for an amount in excess of 750 pounds, which has remained unpaid. The tests for "inability to pay" are the cash-flow test which enables the applicant to prove that factually the company cannot meet its debt obligations and the balance-sheet test which is an alternative test of insolvency. The company will be deemed to be insolvent if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities.

<sup>451</sup> Section 8(1) in particular stipulates that it was necessary to show that the company was, or likely to become, unable to pay its debts and that an administration order was likely to achieve one or more of the statutory purposes.

<sup>452</sup> Section 8(4) of the UKIA. Kloppers 366 submits that C 50 and C37 of Insurance Company Act of 1982 and the Banking Act of 1979 respectively, provide grounds for disqualifying these companies (banks and insurance entities) from entering into administration orders.

<sup>453</sup> Section 9 (2) of UKIA.

<sup>454</sup> Rule 2.6A of the Insolvency Rules of 1986 (SI 1986 No 1925).

<sup>455</sup> 2007 EWHC 1998 (Ch).

company and was largely owned and controlled by members of the same family dealt in intellectual property rights and related know-how and confidential information relating to stretch tapes and fabrics. In 2002, the respondent's parent company granted a licence to a US corporation to enable it use the stretch tape technology. However, all dealings with the US were conducted by the respondent, which collected the royalties under the licence. A serious dispute arose between the respondent and the US licence in which the respondent came to the conclusion that the US licence was in breach of contract and that it was entitled to terminate the licence. The litigation led to debts for the companies with unpaid invoices amounting to 400 000 pounds. The applicants and another creditor of the respondent entered into negotiations with a view to restructuring its debts to enable repayment of both debts over a period of four years. The negotiations broke down and the applicants applied for an administration order. The court held that although it did not consider the application for administration order compelling, it had to grant the order so as to allow transfers of the company's assets to be investigated by the administrator.

### **3 4 5 Appointment of the administrator**

It is worth noting that the routes for activating administration proceedings are twofold: through the courts and out of the courts. The procedure for a court appointment commences with an application made by one or more of the following legal persons: the company; the directors of the company; one or more creditors; the clerk of a magistrate's court in connection with the enforcement of a fine imposed on the company under section 87A of the Magistrates Court Act 1980; or the supervisor of a voluntary arrangement of the company.<sup>456</sup>

In terms of Schedule B1, the 'out of court' appointment process enables the holder of a floating charge, the company, or its directors to make an appointment.<sup>457</sup> It should be noted that the right of directors of a company to appoint an administrator is enshrined in the Enterprise Act, as directors can easily be aware of impending crises in their company and should therefore be able to take action before the company collapses.<sup>458</sup> Sometimes the company or its directors may wish to appoint an administrator out- of- court on a more

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<sup>456</sup> See in this regard the UKIA Schedule B1, paragraphs 10 and 12.

<sup>457</sup> UKIA Sch B1 paragraphs 14-34.

<sup>458</sup> *Ibid*,

restricted ground; in such a situation, notice of five business days must be given to any Qualified Floating Charges Holder (QFCH),<sup>459</sup> who would then appoint an administrator.<sup>460</sup>

Where an administration application has been made to the court under Schedule B paragraph 11, every QFCH must be notified of the application.<sup>461</sup> If a QFCH desires, he or she has the right to petition the court to have a specific person appointed as administrator.<sup>462</sup> The appointment of an administrator by the company or directors would however give the board more influence over proceedings than the creditors although in most cases the board seem to be part of the problems of the company.<sup>463</sup>

In terms of the Act,<sup>464</sup> the holder of a floating charge cannot appoint an administrator unless the holders of qualifying floating charges which have priority are given two business days' written notice or have themselves given written consent to the appointment of the administrator. Hannigan has argued that few creditors who are not holders of qualifying floating charges are likely to have any interest in seeking to put the company into administration.<sup>465</sup>

### **3 4 6 Powers and duties of the administrator**

The administrator has duties of skill, care and efficiency as well as speed in pursuing the functions entrusted to him or her.<sup>466</sup> It is a requirement that the administrator be qualified

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<sup>459</sup> UKIA Paragraph 26 of Sch B1 of UKIA. Sch B1 paragraph 26. QFCH means qualified floating charge holders of the company.

<sup>460</sup> UKIA, Sch B1 paragraphs 22, 12, 16, and 35(2).

<sup>461</sup> UKIA Sch B1 of paragraph 12.

<sup>462</sup> *ibid.*

<sup>463</sup> Mokal and Armour 4.

<sup>464</sup> UKIA Schedule B1 paragraph 15.

<sup>465</sup> Hannigan *Company Law* (2009) 622.

<sup>466</sup> See in this regard Schedule B1 para 4 of the UKIA. In the cases of *Kyrris v Oldham* 2003 EWCA Civ 1506 (Court of Appeal) and *Re Charnley Davies* (No 2)1990 BCLC760, the courts held that administrators owe their common law duties to the company for which they act. In the Charnley case, the administrator was appointed to manage the business affairs of the company for the purpose of realizing the assets more advantageously than would be achieved on a winding-up. The company was in a desperate financial state with no money to pay wages to its employees. The administrator decided it would be impossible to borrow the money needed to continue trading and therefore sold the business. The creditors petitioned the court for an order that the administrator should pay compensation to the company on grounds that the affairs of the company had been negligently managed by the administrator in a manner that was unfairly prejudicial to the creditors by selling the business in undue haste resulting in much less value being attributed to the business. The court held that the administrator owed a duty to a company to take reasonable care to obtain the best price in the circumstances as he reasonably perceived them, including a duty to take reasonable care in choosing the time at which to sell property. The court further held that an administrator was a professional insolvency practitioner and would only be liable if he made an error which an ordinary skilled insolvency practitioner would not have made. The court

enough to competently execute the duties that have been entrusted to him or her and not depart from the duties thereof.<sup>467</sup> The administrator is required to exercise his powers in the interest of the company's creditors<sup>468</sup> and must perform his functions quickly and efficiently.<sup>469</sup>

The administrator's powers are extremely broad, and must be exercised in accordance with decisions taken under the 'crises constitution' of the company prescribed by the administration regime.<sup>470</sup> The administrator may for example reach an early conclusion with regards to the sale of the company's assets<sup>471</sup> if it would achieve a better result for the company's creditors than preserving the business as a going concern.<sup>472</sup> However the administrator has a duty in setting out proposals for achieving the purpose of the administration order to explain why the business cannot be revived.<sup>473</sup> The test here is what the administrator 'thinks' and not what she or he believes.<sup>474</sup> While the state of a man's mind may be as much a fact as the state of his indigestion, the 'thinks' test leaves little scope for

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concluded that the administrator was not negligent neither had the petitioners proved loss of value for the business. In *Kyrris v Oldham*, the applicant claimed damages for breaches of the administrators' common law duty of care owed to unsecured creditors. Dyson J agreed with Thorpe J that the administrator's fiduciary duties are owed to the company. The court held that in the absence of special circumstances, the administrator owes his duties to the company and not the creditors, individually or collectively.

<sup>467</sup> UKIA Schedule B1 paragraph 4.

<sup>468</sup> UKIA Sch B1 paragraph 3(2).

<sup>469</sup> UKIA Sch B1 paragraph 5.

<sup>470</sup> Mokal and Armour 16.

<sup>471</sup> In *Re T & D Industries plc (in administration); Re T & D Automotive Ltd (in administration)* 2000 BCLC 471-472, the applicants were appointed the administrators of two related companies. In terms of schedule 16-B1 of the UKIA paragraph 59 and chapter 40 of the Enterprise Act, the administrator has the power to do all things as might be necessary for the company's affairs, business and property in accordance with any directions given by the court. It is a requirement that the administrator meets the creditors to discuss the assets of the company. After two weeks of their appointment as administrators, the applicants decided as a matter of urgency to dispose of assets before obtaining the approval of creditors. The applicants asked the court to determine whether they are entitled to do so without a specific direction from the court. The court held that on its true construction, section 17(2) (a) of the UKIA cut down the administrator's powers under section 14 of the Insolvency Act as provided by the administration order, thus an administrator could dispose of company assets without the leave of the court unless the administration order provided otherwise. A conclusion to the contrary, requiring the administrators to apply for directions whenever they wished to do something, would involve the administrators in potential delay and expense. The court further held that it was inconsistent with the policy of the administration system which was meant to be a more flexible, cheaper and comparatively informal alternative to liquidation. The court also questioned the real benefit for anyone requiring administrators to apply for directions in terms of section 17(2) of UKIA as such application would normally be made without notice, and the court would almost always conclude that the answer was either obviously favourable or that the decision was a commercial or administrative one for the administrator. Thus obtaining a direction from the court would normally be a waste of time and money unless such a direction ensured that the administrator was thereafter free from any liability to anyone including creditors.

<sup>472</sup> UKIA Sch B1 paragraph 67. In terms of this provision, the administrator's powers allow him or her to take custody and control of all the property and assets of the company.

<sup>473</sup> See in this regard UKIA Sch B1 paragraph 49(2)(b).

<sup>474</sup> Mokal and Armour "The New UK Corporate Rescue Procedure - the Administrator's Duty to Act Rationally" *International Corporate Rescue* 2004 1 3. (Hereafter Mokal and Armour Part 2).

judicial review.<sup>475</sup> It is not generally the practise of the courts to second-guess the commercial judgment of administrators and other discretionary decision makers.<sup>476</sup> The administrator must pursue the performance of his or her functions rationally and in good faith.<sup>477</sup> Judicial precedents in the UK have been referring to the *Hastings –Bass* principle in instances where the administrator is considered not to be in default of his duties to act rationally and not harm interested parties.<sup>478</sup> It should be borne in mind that the legislature places a burden on the administrator not to unnecessarily harm the interest of the creditors as a whole.<sup>479</sup>

### **3 4 7 Effect of moratorium**<sup>480</sup>

Corporate rescue regimes in recent times have applied the rule of stay of proceedings while the company is reorganising itself and the UK's system is no different. Rajak and Henning have argued that the UK has developed a cautious approach to the moratorium in respect of an insolvent or near-insolvent debtor.<sup>481</sup> It should however be remembered that there is virtually no jurisdiction in which the court may not lift the moratorium for lack of good faith on the part of the debtor, as the onus of proof is on the debtor to establish its entitlement to protection.<sup>482</sup>

The moratorium provisions in the UK preclude the creditors from taking enforcement action against the company or its assets during the rehabilitation period without the consent of the court but the administrator may give consent for enforcement action to be taken, the aim of the moratorium being to give the company a breathing space to allow survival prospects to be

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<sup>475</sup> *Ibid.*

<sup>476</sup> (Boyle and Birds 832-833).

<sup>477</sup> Makal and Armour 3.

<sup>478</sup> In *Re Hastings-Bass* 1975 Ch 25 41, the Court of Appeal's decision which dealt with the duties of the administrator, has become a rule that explains the fiduciary duties with regard to the administrator's objectives in the administration process and how those objectives should be pursued.

<sup>479</sup> UKIA Sch B1 paragraph 3(4).

<sup>480</sup> See generally UKIA Sch B1 paragraph 43. Para 44 provides an interim moratorium which prohibits third parties from taking action against the company. The interim moratorium lasts until an administrator is appointed at which stage it becomes final or 10 days beginning on the date the notice of intention to appoint was filed at court. In a recent case *Cornercare Limited* 2010 EWHC 893 (Ch), the court found that a notice of intention to appoint an administrator was properly filed in court but it was not possible for the appointment to be completed within the requisite 10-day period due to funding difficulties. The judge held that it was a legitimate reason why an administrator had not been appointed within the 10-day period.

<sup>481</sup> Rajak and Henning 275.

<sup>482</sup> *Ibid*

assessed.<sup>483</sup> The legislation with regard to the moratorium states that: “No legal process including legal proceedings, execution, distress and diligence may be instituted or continued against the company or property of a company in administration except with the consent of the administrator or with the leave of the court”.<sup>484</sup> In *Hudson and Others v Gambling Commission (Re Frankice (Golder Green) Ltd and Others*,<sup>485</sup> the companies were subject to licence reviews by the Gambling Commission (which wanted to investigate the conduct of the management prior to the administrators’ appointment but the administrators did not want the Commission to undertake a review prior to the sale of the companies. They argued that if the reviews were allowed and the licences withdrawn, the companies would not be able to trade lawfully. The Commission did not accept that the review was barred as a “legal process” under the moratorium within the meaning of paragraph 43 of the UKIA. The court after taking all interests into account, refused to allow the Commission to continue the review until after completion of the contracts of sale, thereby allowing the companies to be rescued and thereby saving the employees’ jobs. Most importantly, the decision in this case demonstrates that the objectives of saving a business and employment should not be compromised by the interest of one particular stakeholder.

Corporate rescue laws in the UK do not prohibit set-offs as the exercise of a right of set-off is not a security right and, therefore, should not fall within the scope of the moratorium.<sup>486</sup> In particular, a mutual set-off should be allowed so that parties can meet their obligations when the moratorium comes into operation in order to produce a more equitable distribution of creditors voting rights.<sup>487</sup> In *Re Kaupthing Singer v Friendlander*,<sup>488</sup> the court of appeal

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<sup>483</sup> *Ibid.*

<sup>484</sup> UKIA Chapter 40 Sch B1 paragraph 43(6) as amended by the Enterprise Act 2002. In *Bristol Airport plc and Another v Powdrill and Others* 1990 BCLC 585 a charter airline company operating out of several United Kingdom airports became insolvent and an administration order was granted to enable it carry on business. The administrators decided that there was a real prospect of a sale of the company’s business on terms beneficial to the body of creditors. However, Bristol airport, an unsecured creditor of the company, sought leave ex parte to exercise in respect of two of the company’s aircrafts, its statutory right under section 88 of the Civil Aviation Act 1982 to detain the aircrafts for unpaid charges. It was granted leave to detain the aircrafts until an inter parties hearing of its application to detain. Birmingham airport also obtained leave ex parte to detain the aircrafts. The judge held that the two airports required the leave of the court under section 11 of the UKIA before exercising their statutory right to detain the aircrafts and in the exercise of his discretion; he refused to grant such leave. He further held that Birmingham airport had acted in contempt of court in detaining the aircrafts before obtaining leave to do so from the court. The court further held that the restriction on any legal process based on the moratorium extends to any legal or quasi-legal proceedings such as arbitration proceedings.

<sup>485</sup> 2010 ALL ER (D) 59.

<sup>486</sup> See in this regard “Lehman Brothers Administration Update” <http://www.clifordchance.com>. (assessed 15-03-11)

<sup>487</sup> *Ibid.*

<sup>488</sup> 2010 EWCA Civ 518.

clarified the application of the administration mechanism to set-off in respect of debts falling due in the future. The Court of Appeal held that a set-off can be applied as of the date on which the administrator gives notice of intention to make a proposed distribution of funds among creditors. It appears that the judgment of the case was very useful for office-holders and administrators and for the treatment unsecured creditors equally during the period of the moratorium.

### 3 4 8 The role of the court

The court's involvement in the administration procedure in the UK is quite significant. Flynn has opined that the court provides direct guidance in situations in which there is inevitably going to be some trade-offs<sup>489</sup> between the rights of parties and office-holders.<sup>490</sup> Furthermore, the court promotes the administrator's strategies for survival, in whole or in part, of the company and the businesses affiliated to the company under administration.<sup>491</sup>

The courts require the administrator to exercise his or her professional and commercial judgment in deciding matters so as to obviate as far as possible the need for applications to be made to the court and, in addition, fulfil the objectives of the administration order.<sup>492</sup> In terms of the Act,<sup>493</sup> the court may on hearing an administration application, make the administration order sought<sup>494</sup> or dismiss the application.<sup>495</sup> The court, in addition, has the

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<sup>489</sup> A set-off is defined in the Oxford Dictionary of Law 457 as a monetary cross-claim that is also a defence to the claim made in the action by a claimant. Any claim by a defendant to a sum of money that is used as a defence may set off against the claimant claim.

<sup>490</sup> See generally Flynn, "Administrative Support to the Judiciary in the UK Insolvency System" 7-8 February 2001. Available at [http://: www.web.worldbank.org/.../contentMDK](http://www.web.worldbank.org/.../contentMDK) (accessed 20-10-2010)

<sup>491</sup> *ibid*

<sup>492</sup> *Ibid.*

<sup>493</sup> UKIA Chapter 40 Schedule 16 paragraph 13(1)(a) as amended by the Enterprise Act of 2002.

<sup>494</sup> In *Re AA Mutual International Co Ltd* 2004 EWHC 2430 (Ch), the question arose whether the court has jurisdiction to make an administration order and if so, whether an order ought to be made. The debtor was an insurance company which was authorized under the Insurance Company Act 1982 to underwrite specified classes of insurance business went into a run-off in 1987 after its authorization to conduct business terminated. However, it remained authorized under Pt 4 of the Financial Services and Markets Act 2000 to perform its obligations under existing contracts, including the settlement of claims. In 2004 the company applied for the appointment of administrators to conduct its affairs because it was likely to become insolvent and unable to pay its debts. The court had to consider the merits of article 6 of Council Directive 73/239 of July 1973 on co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of a business of direct insurance other than life insurance and the making of an administration order under paragraph 11 of Schedule B1 of the Insolvency Act 1986 on insurance companies. The court held that the effect of articles 2 (g) and 4 of the 2001 Directive was that the court had the exclusive power and jurisdiction to decide on reorganizational measures including the winding up of the company.

<sup>495</sup> UKIA Chapter 40 Schedule 16 paragraph 13(1) (b) as amended by the Enterprise Act of 2002.

power to adjourn the hearing conditionally or unconditionally and make an interim order which restricts the exercise of the directors' powers.<sup>496</sup>

### **3 4 9 Rights of interested parties: Creditors and shareholders**

It is worth noting that creditors of any corporate entity may be secured and unsecured. However, the rights of secured creditors reign supreme when it comes to the law of insolvency globally. Generally the secured creditor has no veto on a company going into administration but it has an effective veto on the identity of the person appointed as administrator.<sup>497</sup> Although the administrator is not under a duty to call a creditors' meeting if he thinks the company has insufficient property to enable a distribution to unsecured creditors, he must summon a meeting if requested to do so by creditors.<sup>498</sup> It is important to note that creditors cannot take legal action against the company without leave of the court.<sup>499</sup> The administrator can sell the company prior to approval by the creditors without leave of the court.<sup>500</sup>

Goode has argued that where there are alternative courses of action which will benefit creditors only, and another which with a little delay, will confer benefits on employees and shareholders without significant detriment to the creditors, then it is a legitimate function of insolvency law to have regard to those wider interests.<sup>501</sup> This suggests that the interests of the society must be protected during corporate restructuring and not only those of the creditors as stipulated in paragraph 3 (1) of Sch B1 which seeks to promote creditors' wealth maximisation.<sup>502</sup>

It may seem obvious but the greater the shareholding of an individual, the greater are his/her rights and power within the company. In most cases shareholders are appointed as directors of a company and cannot put a company under administration in terms of the Act.<sup>503</sup> The shareholder, who is a director, however has got a fiduciary duty to other shareholders.<sup>504</sup> It has been suggested that there appears a standard practice for shareholders to keep a stake in a

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<sup>496</sup> UKIA 1986 Chapter 40 Schedule 16 paragraph 13(1) (c) (d), 13(3) (a) as amended by the Enterprise Act of 2002.

<sup>497</sup> See generally UKIA Schedule B1 paragraph 68 as amended by Enterprise Act of 2002.

<sup>498</sup> UKIA Sch B1 paragraph 52(2).

<sup>499</sup> See in this regard "A Guide for Creditors" <http://www.insolvency.gov.uk/eiir.html> (assessed 10-03-2011).

<sup>500</sup> UKIA Sch B1 paragraph 68.

<sup>501</sup> (Goode 45).

<sup>502</sup> *Ibid.*

<sup>503</sup> See in this regard The Companies Shareholders Rights Regulation 2009(SI 2009/1632) <http://www.insolvency.gov.uk> (accessed 11-03 2011)

<sup>504</sup> *Ibid.*

restructured company and depending on the size of the stake; the existing shareholders may put up new capital.<sup>505</sup>

### **3 4 10 Rights of interested parties: Employees and the community**

McCormack seems to have agreed with Goode when he argued that the UK system requires that the interests of employees be protected during reorganisation processes through consultations of all parties, and that terms and conditions of employment be protected, seeing that UK law is more of a pro-employee system.<sup>506</sup> In sharp contrast, shareholders benefit more during reorganisation as their monies are ploughed back and their investments continue.<sup>507</sup>

Employees' rights are to be protected as much as possible during the administration process in the UK. What this means in this regard is that if the employer is insolvent and under administration, the employees' rights have to be protected whether the business is transferred or taken over as a going concern.<sup>508</sup> If the business continues to trade, it is likely that many employees will retain in their position. While the company remains in administration, employees' salaries are guaranteed by the administrator.<sup>509</sup> However if the business is sold some of the employees may become redundant.<sup>510</sup> If all or part of the business is sold, employees must be transferred with the business under the same terms and conditions of employment.<sup>511</sup>

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<sup>505</sup> In a sharp contrast with this view expressed by McCormack 123, the Daily Telegraph (05 July 2010) published an article which sought to suggest that shareholders had been prejudiced. In the said article entitled "No Compensation for Bradford and Bingley Shareholders", the Independent valuer of the stricken business Bradford and Bingley, announced that some 935 000 shareholders were affected which saw its loan book nationalized and its savings arm sold to Spanish giant Santander in September 2008 during the financial crisis. The move was a disappointment for investors but the valuer made the decision after weighing up representations from a wide range of groups and individuals. The valuer Peter Clokey said "this is a very sad day not only for B & B shareholders but UK shareholders in general". <http://www.telegraph.co.uk> (accessed 11-03-2011).

<sup>506</sup> McCormack 121.

<sup>507</sup> *Ibid.*

<sup>508</sup> See in this generally McCormack 121-122.

<sup>509</sup> See in this regard <http://www.companydebt.co.uk>. (Assessed 13-02-11).

<sup>510</sup> *Ibid.*

<sup>511</sup> The Labour Laws of South Africa does not depart from the Labour Laws in the United Kingdom. Section 197 of the Labour Relations Act 66 of 1995 in South Africa stipulates that when any business is transferred as a going concern, the employment contracts are also transferred. The rights and obligations of employment must continue, and the employees' continuity of employment is not interrupted. Also see Kopel *Guide to Business Law* (2010) 211. (Hereafter Kopel)

The European Union has introduced directives regarding the transfer of business as a going concern during solvent and insolvent situations.<sup>512</sup> Employees' interests and rights are protected during administration, but in the recent case of *Unite the Union and Others v Noetel Networks Limited*<sup>513</sup> employees who were dismissed during administration applied to the court for relief on the ground that they were not consulted on their dismissals. According to the employees, their contracts had been breached as they were unfairly dismissed. Furthermore, they contended that they were discriminated against during the selection process that preceded their dismissals. The court held that the position of the employees was the same as that of unsecured creditors, and that this had to be distinguished from the position where a claimant has a 'right' in the company's property. The court sided with the administrator and held that employees' claims were capable of being provable debts without there being the need to obtain a favourable finding from the employment tribunal.

### **3 4 11 Termination of administration**

In terms of the Act, the appointment of an administrator shall cease to have effect at the end of the period of one year beginning from the date on which it takes effect but on the application of an administrator the court may by order extend his term of office for a specified period; accordingly, an administrator's term of office may be extended for a specified period not exceeding six months.<sup>514</sup> On application by the administrator of a company, the court may order that the appointment of an administrator should cease to have effect from a specified time. However, this application shall be made only if the administrator thinks the purpose of the administration cannot be achieved and that the company should not have entered into the administration or the creditors' meeting requires him to make such an application.<sup>515</sup>

Termination of the administration order can be filed in the court by the administrator if the purpose of the administration has been achieved.<sup>516</sup> Where an improper motive in placing the company under administration is alleged, a creditor can apply to the court to have the

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<sup>512</sup> See Joubert et al "The Expected Impact of Labour Law Principles on South Africa's New Corporate Rescue Mechanism (including a Comparison with the Position in the European Union (EU))." <http://www.businessrescue.co.za>. (accessed 10-09-2009) (hereafter Joubert). The EU has introduced directives to bind the United Kingdom and other member states on regulations that can safeguard employees' rights in the event of transfers of businesses. See the European Commission Acquired Rights Directive of 1998 which has been consolidated and replaced by Directive 2001/23/EC of March 2001.

<sup>513</sup> 2010 EWHC 826.

<sup>514</sup> UKIA Chapter 40 Sch 16 paragraph 76 (1) (2) (a) (b) as amended by the Enterprise Act 2002.

<sup>515</sup> UKIA Chapter 40 Sch 16 paragraph 79(1) (2) (a) (b) (c) as amended by the Enterprise Act 2002.

<sup>516</sup> See generally UKIA Chapter 40 Sch 16 paragraph 80 as amended by the Enterprise Act 2002.

administration order stopped and the company placed under a winding-up order on a public interest petition.<sup>517</sup>

### **3 5 COMPANY VOLUNTARY ARRANGEMENT (CVA)**

#### **3 5 1 Background and rationales**

The other business rescue procedure in the United Kingdom, the CVA, was also introduced by the Insolvency Act 2000<sup>518</sup> based on the recommendations of the Cork Committee and was conceived as a simple form of compromise procedure whereby a debtor in financial distress could put a proposal to creditors, evaluated by an independent practitioner who would report to court on the viability of the proposal.<sup>519</sup> Section 1(1) of the UKIA<sup>520</sup> defines a CVA as ‘a composition in satisfaction of debts or a scheme of arrangement of affairs’. A CVA does not result from a court order and/or the actions of a secured creditor as in the case of administration; it is rather a compromise agreement between a company and its unsecured creditors.<sup>521</sup> In *Commissioners of Inland Revenue v Adam & Partners Ltd*,<sup>522</sup> the company’s major creditor was a bank which held a fixed and a floating charge. In addition, the company owed the Inland Revenue (the tax collection authority of the United Kingdom) 21,671.76 pounds. The court dismissed an appeal to revoke or alternatively suspend a creditor’s voluntary arrangement on grounds that the arrangement unfairly prejudiced the interest of the major creditor which was a bank. The Inland Revenue was not, however, able to pursue the claim as it had prescribed. Although preferential and non-preferential creditors<sup>523</sup> were unlikely to receive anything under the agreement, it was anticipated that the major creditor would receive a better return under the CVA than under any alternative insolvency procedure.

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<sup>517</sup> UKIA Chapter 40 Sch 16 paragraph 81 as amended by the Enterprise Act 2002.

<sup>518</sup> UKIA Chapter 45 Sch 17 as amended by Enterprise Act 2002.

<sup>519</sup> New Zealand 33.

<sup>520</sup> UKIA.

<sup>521</sup> Lamont & Holland “CVAs: The Rough Guide” available at <http://www.landmarkchambers.co.uk>. (accessed 25-08-2012).

<sup>522</sup> 2001 1 BCLC 223.

<sup>523</sup> In sharp contrast, it was held in *IRC v Wimbledon Football Club Ltd and Others* 2004 EWHC 655, that if a third party purchases an insolvent company under administration chosen for good commercial reasons of his own and then uses his own assets or funds to pay creditors of the company, that did not amount to payment of non preferential creditors in priority to preferential creditors contrary to section 4(4) of the UKIA. Section 4(4) required the company’s assets, not those of a third party, to be applied in payment of the preferential creditors in full ahead of any payment to non-preferential creditors in an administration, and assets which did not and never would belong to the company legally or beneficially and which had in no way been contributed to by the company did not fall within the ambit of section 4(4) (a) of the UKIA.

Lowry and Dignam have noted that a CVA allows a company to enter into a voluntary arrangement with its creditors by way of a straight forward procedure that may enable the company to organise its way out of financial distress.<sup>524</sup> Other purposes of a CVA are to allow companies the opportunity to avoid liquidation and continue trading, return value to creditors, provide real prospects of a return for shareholders, preserve economic activity and save jobs.<sup>525</sup> CVA procedures can be said to be legally binding, debtor friendly and cheap.<sup>526</sup> CVAs are considered to be flexible agreements which do not typically promise the repayments of all debt owed by the failing company; if it is accepted by creditors, the repayments of the debts are expected to be more than would otherwise be raised should the company proceed into formal liquidation.<sup>527</sup> CVAs are intended also to provide for a compromise of debts, collection and distribution of dividends by the approved supervisor.<sup>528</sup>

### **3 5 2 Types of entities eligible for protection**

The CVA in the UK system is designed to be used for small<sup>529</sup> sized companies which are more prone to failures and not for large and complex companies. Hence, partnerships are also allowed to go through the CVA process.<sup>530</sup> When partners in a partnership or the directors of a company enter into a CVA, they remain in control of the company.<sup>531</sup> It is important to note that contrary to administration, CVAs are more of a Chapter 11 of the United States of America's corporate rescue mechanism with the 'debtor in possession'.<sup>532</sup>

The Insolvency Act 2000 introduced the provision allowing small companies to receive a moratorium. The requirement for a company to qualify for a CVA entails that the company must have annual turnover of not more than 6.5 million pounds and a balance sheet total of not more than 3.26 million pounds;<sup>533</sup> and a labour force fewer than 50 employees.<sup>534</sup>

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<sup>524</sup> (Lowry and Dignam) 433.

<sup>525</sup> Steven "Company Rescue's Complete Experts Guide to the Company Voluntary Arrangement Process" 2010 17 <http://www.companyrescue.co.uk> (accessed 10-03-2011). A CVA is a deal between the company and its secured and unsecured creditors involving an undertaking to repay the creditors from future profits or deals if assets are sold.

<sup>526</sup> Anderson "A Guide for British Property Federation Members on Company Voluntary Arrangements" April 2007 1-3.

<sup>527</sup> Anderson 1-3.

<sup>528</sup> (Lowry and Dignam) 433.

<sup>529</sup> United Kingdom Companies Act (hereafter UKCA) section 328.

<sup>530</sup> *Ibid.*

<sup>531</sup> Rajak and Henning 282.

<sup>532</sup> *Ibid.*

<sup>533</sup> See generally paragraphs 2 – 4 Schedule A1 of the UKIA.

Furthermore, the company must not be a holding company of a group of companies which does not qualify as a small group or a medium-sized company in terms of section 465.<sup>535</sup> It should be noted that the CVA provisions exclude certain companies involved in financial services such as banking and insurance as well as companies connected with the financial markets.<sup>536</sup> Furthermore a company cannot be placed under a CVA if it is already under administration,<sup>537</sup> or in liquidation (if the company is in compulsory liquidation)<sup>538</sup> or under administrative receivership.<sup>539</sup>

### 3 5 3 Initiation process

The directors of the debtor company have to make a proposal to the creditors for a voluntary arrangement by approaching an insolvency practitioner who will accept appointment as a nominee to act in relation to the voluntary arrangement either as a trustee or otherwise for the purpose of supervising its implementation.<sup>540</sup> A committee of creditors may be allowed to be established with the aim of assisting the administrator of the CVA to discharge his/her functions as well as obtaining interested parties' views on matters relating to the insolvency.<sup>541</sup> In terms of the UKIA, the directors must file with the court the terms of the proposed arrangement, a statement of the company's affairs and the opinion of the nominee.<sup>542</sup> In CVAs, proposals are drawn up which may involve delayed or reduced payments of debt, capital restructuring and an orderly realisation of assets, in which creditors must agree to accept less than they are owed and to be repaid over a longer period of time.<sup>543</sup>

CVAs are never an easy option for the company, as creditors are unlikely to agree to anything that does not offer substantially better terms than a less rescue-orientated insolvency

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<sup>534</sup> UKCA section 382.

<sup>535</sup> Section 465 of the United Kingdom Companies Act 2006 defines a Medium sized Company as having a turnover of not more than 25.9 million pounds, a balance sheet of not more than 12.9 million pounds with a work force of not more than 250 employees.

Available at <http://www.legislation.gov.uk/ukpga/content>.

<sup>536</sup> (Boyle and Birds) 824.

<sup>537</sup> See in this regard chapter 40 Schedule 17 paragraph 10 (b) of the Enterprise Act 2002.

<sup>538</sup> Where the company is being wound up by a liquidator.

<sup>539</sup> Administrative Receivership is the process where an Insolvency Practitioner is appointed by a debenture holder (lender) to realize a company's assets and thereafter pay the preferential creditors as well as the debenture holder's debts.

<sup>540</sup> Section 1(1) Of UKIA 1986 Part 1 chapter 40 Schedule 17 paragraph 10(a) as amended by Enterprise Act of 2002.

<sup>541</sup> Anderson 2.

<sup>542</sup> Schedule A1, paragraph 7 of the Insolvency Act 1986.

<sup>543</sup> Steven "Expert Guide to the Company Voluntary Arrangement Process" available at <http://www.companyrescue.co.uk>. (accessed 20-08-2012).

procedure.<sup>544</sup> The nominee chairs the meeting of the committee of creditors and if the majority supports the option of a CVA procedure, the nominee will inform the court of the result of the meeting at which time the CVA will be implemented.<sup>545</sup> The question one has to ask is: what if an interested party petitions the court about the proposal of a CVA? In the case of *RE Dollar Land (Feltham) and Others*<sup>546</sup> the court had to decide on the issue whether a winding –up order should be rescinded if there was a real prospect that a CVA proposal would be approved by the company’s directors. The court held that Section 4A of the UKIA<sup>547</sup> applies to decisions on approval of CVAs. Accordingly, if the majority of creditors vote for a CVA proposal, then it has to be approved.

With the acceptance of the process by secured and unsecured creditors as well as shareholders, the proposal becomes binding on all interested parties including those who objected to the CVA process. As with any business rescue procedure, the supervisor must serve in the interest of all affected parties so as not to depart from statutory requirements.

### **3 5 4 Effect of moratorium**

CVAs with a moratorium are a form of ‘debtor in possession’ corporate reorganisation procedure which allows the existing management to remain in control during the reorganisation process contrary to what obtains under the administration procedure.<sup>548</sup> CVAs initially did not have a moratorium under the UKIA. The recent amendment of the insolvency laws in the UK have introduced made a provision requiring the nominee to request a moratorium of 28 days after being given notice of the proposal and to submit a report to the court stating whether, in his opinion, (a) the statement of the company’s affairs is valid; (b) the proposed CVA has a reasonable chance of being approved and implemented; (c) meetings of the company and its creditors should be summoned to consider the proposal; and

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<sup>544</sup> *Ibid.*

<sup>545</sup> See generally sections 3 - 5 of UKIA. These sections practically require the nominee to hold meetings with creditors with regard to the consideration and implementation of proposals.

<sup>546</sup> 1995 BCC 740.

<sup>547</sup> UKIA as amended by the Enterprise Act of 2002. Section 4A of the UKIA generally applies to a decision under section 4 with respect to the approval of a proposed voluntary arrangement. The decision has effect if in accordance with the rules, it has been taken by both meetings under sections 3 and 4 of the UKIA. Meetings summoned under section 3 decide whether to approve the voluntary arrangement with or without modifications.

<sup>548</sup> (Boyle & Birds 827).

(d) the company is likely to have sufficient funds available during the proposed moratorium period to enable it carry on its business.<sup>549</sup>

Where the directors<sup>550</sup> of an eligible company intend to make proposal for a CVA they may take steps to obtain a moratorium for the company.<sup>551</sup> The provisions of Schedule 1A of the UKIA have effect in respect of companies that are eligible for a moratorium and provide for the procedure for obtaining the moratorium as well as the procedure applicable in relation to the approval and implementation of a CVA where such a moratorium is or has been in force.<sup>552</sup> In terms of the UKIA,<sup>553</sup> where a company has rented premises a landlord cannot forfeit the lease by peaceable re-entry for non-payment of rent or breach of any other condition of the lease except with leave of the court.<sup>554</sup>

### 3 5 5 Terminating CVAs

In terms of the Act,<sup>555</sup> a CVA may come to an end prematurely if the voluntary arrangement with approval which has taken effect under section 4A or paragraph 36<sup>556</sup> of Schedule A1

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<sup>549</sup> Section 2(2) of the Insolvency Act 2000.

<sup>550</sup> It is important to note that in sharp contrast to the administration process in the UK where the administrator conducts investigations into the company's affairs, the legislation is silent on the directors of a company making a proposal for a CVA conducting any investigation into the affairs of the company.

<sup>551</sup> See section 1A(1) of the UKIA.

<sup>552</sup> Section 1A(2) of the UKIA .

<sup>553</sup> See schedule A1, paragraph 12, UKIA.

<sup>554</sup> In the recent case of *Mourant and Co Trustees Limited and Anor v Sixty UK Limited (in administration) and Others* 2010 EWHC 1890 (Ch), an application under section 6(1) IA of the UKIA by landlords to revoke approval of a CVA on the grounds of unfair prejudice succeeded. Under the terms of the CVA, the landlords of closed retail stores were to lose the benefit of third party guarantees without adequate compensation or sufficient justification. Henderson J covered wide topics such as the CVA, section 6 of the UKIA, unfair prejudice and material irregularity in his judgment. Henderson J concluded that the CVA was fatally flawed and ordered that it be set aside. In a related case law, the court held in *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* 2007 EWHC 1002 that a CVA could be structured in a manner that would deprive a creditor landlord of a third party guarantee for the liabilities of the insolvent tenant if enforcing the guarantee would give rise to a right of recourse by the third party against the debtor company. In the Prudential Assurance case, Powerhouse with financial support from its holding company, PRG, acquired assets of the Powerhouse business. Some landlords of the stores including claimants, took the parent company's guarantees or indemnities from PRG in respect of Powerhouse's obligations under the leases. Subsequently, Powerhouse got into financial difficulties and the directors proposed a CVA. The rights and obligations of all creditors other than those in respect of Powerhouse's closed premises were to be unaffected by the CVA. Two groups of closed premises landlords, challenged the validity of the CVA seeking a declaration that it was ineffective and/or invalid in so far as it purported to affect their rights against persons other than Powerhouse or, alternatively, in so far as the CVA purported to constitute an express release by the claimants of their rights against persons other than Powerhouse. They also claimed an order that the creditors' approval of the CVA be revoked pursuant to section 6 of the UKIA because it was unfairly prejudicial to them as creditors of powerhouse. The court held that on the true construction of the statutory provisions, each creditor was a party to the arrangement by virtue of being, and in the capacity of a creditor, of the company and not any third party which had the benefit of and could enforce the rights and obligations of the CVA.

<sup>555</sup> Section 7B of Insolvency Act 1986.

has ceased to have any effect or has not been fully and effectively implemented in respect of all persons bound by the arrangement in terms of section 5(2)(b)(i).<sup>557</sup> In *Re Rathbone Kitchens Ltd*<sup>558</sup> the court had to assess the reasons why a CVA had to be terminated. The issues that the court had to consider were whether the company failed to comply with the terms of the voluntary arrangement resulting in the company resolving on a voluntary winding up; whether the voluntary arrangement was terminated as a result of the company's default or voluntary liquidation. The directors of Arthur Rathbone Kitchens Ltd had proposed a CVA after the company suffered acute cash-flow difficulties. The essence of the proposal approved by 90% of the creditors was that the company would trade itself out of its insolvency, pay post-CVA debts as they fell due and periodically pay over to the supervisor (nominee) certain sums of money for distribution amongst the creditors. The company failed to keep up with the payments as they fell due. The supervisor informed the company of his intention to petition for a compulsory winding up as he was required to do under the CVA if the company was in default. Shareholders of the company then resolved on a creditors' voluntary liquidation and appointed a voluntary liquidator. The supervisor, in turn, applied for compulsory liquidation and directions from the court on whether the appointment of the voluntary liquidator was valid and whether such appointment had (automatically) terminated the CVA. The voluntary liquidator after being served the petition responded that the petition was a waste of time and questioned whether the supervisor had *locus standi* to bring the petition. The voluntary liquidator also submitted that the funds held by the supervisor should be paid over to him whether or not the CVA had been terminated, and whether or not the winding up resolution was valid. The court held that the person who was carrying the functions under section 7 (2) of the UKIA was entitled to apply to the court for directions under section 7 (4) of the UKIA as to whether the CVA was dead or alive. It therefore concluded that the supervisor had a *locus standi* to bring the petition. However, section 84 of the UKIA prescribed the circumstances where the members of the company may resolve on a voluntary liquidation. The court, therefore, held that the members did have the power to pass a resolution for the liquidation of the company and appoint a voluntary liquidator. The court, in addition, held that the conduct of the voluntary liquidator was partisan, lacked

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<sup>556</sup> In terms of section 4A of chapter 45 of Insolvency Act 1986, a decision taken by creditors' meeting differs from the that taken by the company meeting. Section 4A (2) stipulates that the decision by the creditors has effect in accordance with the rules it has been taken by both meetings or taken by the creditors meeting .

<sup>557</sup> In terms of Section 5(2)(b)(i) of the Insolvency Act 1986 , where a decision approving a CVA has effect under section 4A of the Insolvency Act 1986 , the arrangement binds every person who in accordance with the rules was entitled to vote at that meeting (whether or not he was presented or represented .

<sup>558</sup> 1997 2 BCLC 281.

independence and impartiality as required. Under the circumstances, the court concluded that the creditors were faced with the choice of continuing with the voluntary liquidation or petitioning for a compulsory order. In its view, the CVA had failed and was thus terminated. Accordingly, the court made a compulsory winding-up order. The effect was that the creditors were discharged from the voluntary arrangement and instead looked to the alternative regime of winding up.

Despite doubts about the effectiveness of CVAs, the Insolvency Service of the United Kingdom is consulting about proposals to extend it to large and medium sized companies and also explore avenues whereby extra funding will be made available to companies affected by the current global economic recession.<sup>559</sup>

### **3 6            ASSESSMENT OF CORPORATE RESCUE IN THE UNITED KINGDOM**

In relation to corporate rescues in the UK, the two formal procedures discussed above, will be assessed in the following discussion. For the company in financial distress, a CVA can be an effective alternative to either administration or liquidation proceedings. It is important to note that since a CVA can be implemented within a company in liquidation, the stigma<sup>560</sup> can be avoided. A CVA may be used by a company that wishes to wind down trading in an orderly fashion thereby making it a cost-effective alternative to formal liquidation of a company.<sup>561</sup> However, a CVA cannot be made binding on secured or preferential creditors without their consent.<sup>562</sup> In CVAs no new capital is required as the existing assets are often utilized.<sup>563</sup> It is important to note that for the duration of the CVA creditors receive dividends from time to time. However under the administration procedure, creditors receive no dividends.<sup>564</sup> It seems

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<sup>559</sup> (Boyle and Birds 827).

<sup>560</sup> It is a common cause that companies employed in the process of CVA find it difficult to win the confidence of creditors even if rights and obligations of creditors are observed.

<sup>561</sup> See in this regard Conway “Company Voluntary Arrangements” September 2009 4. <http://www.insolvency.gov.co.uk/sn/ha/5169/houseofcommonslibrary> (accessed 11-02-2011).

<sup>562</sup> Lamont & Holland “CVAs: The Rough Guide” available at <http://www.landmarkchambers.co.uk>. (accessed 25-08-2012).

<sup>563</sup> Steven “Company Rescue’s Complete Experts Guide to the Company Voluntary Arrangement Process” 2010 49 <http://www.companyrescue.co.uk> (accessed 10-03-2011).

<sup>564</sup> Steven “Company Rescue’s Complete Experts Guide to the Company Voluntary Arrangement Process” 2010 50 <http://www.companyrescue.co.uk> (accessed 10-03-2011).

obvious that since the legislation with regard to CVAs is silent on wrongful trading by directors, a nominee cannot pursue directors for wrongful trading.<sup>565</sup>

In assessing business rescue processes in the UK, McCormack has argued that there is some ambiguity in the legislation about the merits of reorganisation versus liquidation of ailing enterprises and about the interests that corporate reorganisation law should protect.<sup>566</sup> It would seem that the ambiguity is deliberate to obscure, or gloss over, difficult choices between potentially competing goals.<sup>567</sup> The Cork Committee report provides a bow in the direction of goals other than creditor wealth maximisation, hence the report recommended that the aims of a good modern insolvency law must include reorganisation of effects of insolvency not limited to the private interests of the insolvent and his creditors, acknowledging that other interests of the society are affected by the insolvency and its outcomes.<sup>568</sup>

It is observed that shareholders are not actively involved in the United Kingdom rescue system. This is obvious from the fact that creditors are the only stakeholders considered when it comes to decision making regarding the process of rescuing a company.<sup>569</sup> It has also been noted that neither the Administration Order (AO) nor the Company Voluntary Arrangement (CVA) have anything like the new value exception to the absolute priority principle, though it appears to be standard practice for existing shareholders to keep a stake in a restructured company and depending on the size of the stake, the existing shareholders may put in some fresh capital.<sup>570</sup> A great deal of flexibility may be included in a rescue plan under the AO or CVA, apart from the deference shown to secured creditors whose ability to enforce their collateral (security) cannot be adversely affected without their consent.<sup>571</sup>

It is trite that CVAs in contrast to administration orders cut costs as there is no need to hire an external administrator which is rather expensive. Goode has therefore noted that a CVA, in contrast to an administration order which comes with high cost in its implementation, does not depend on existing or likely insolvency and preserves the concept of debtor in possession, avoiding at least some of the cost of external management.<sup>572</sup> However, in CVAs the ability

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<sup>565</sup> *Ibid.*

<sup>566</sup> McCormack 116.

<sup>567</sup> *Ibid.*

<sup>568</sup> *Ibid.*

<sup>569</sup> McCormack 120.

<sup>570</sup> McCormack 123.

<sup>571</sup> *Ibid.*

<sup>572</sup> (Goode 337).

of the company to obtain funding for the purpose of continuing the business is hampered by the lack of restrictions on the enforceability of charges over book debts and other debts in the absence of an AO.<sup>573</sup> This inhibits the use of receipts from its trading activities to finance the business and pay dividends to creditors willing to participate in a rescue plan.<sup>574</sup>

### 3 7 CONCLUSION

This chapter has discussed the business rescue procedure known as voluntary administration in Australia as well as those known as administration and company voluntary arrangement in the United Kingdom. It is significant to see that both jurisdictions aim at similar objectives in their corporate rescue legislation. The main objective of corporate rescue in these jurisdictions is to assist ailing companies get back on their feet as going concerns. Most jurisdictions have undergone consultations with stakeholders to reform their corporate rescue mechanisms. It seems that the Australian system of corporate rescue allows troubled companies to voluntarily enter the rehabilitation process which makes it easier to find solutions to their problems without many of delays.<sup>575</sup>

The United Kingdom's workable systems of AO and CVA as rescue procedures have been reformed in recent times, and provide a flexible and easy process of reorganising companies that are in distress. CVAs when utilized can cut excessive costs related to court as well as professional involvement which make it more attractive to small and medium sized companies<sup>576</sup>. While this is true, a critical question about the CVA which lingers on is: Why should management who mismanaged the company into distress stay on during its reorganization process?

The aims of a good and modern insolvency law should include recognising the effects of insolvency that are not limited to the private interests of the insolvent and his creditors and safeguarding the other interests of the society or other groups in society which are vitally affected by insolvency and its outcomes.<sup>577</sup>

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<sup>573</sup> *Ibid.*

<sup>574</sup> (Goode 337).

<sup>575</sup> Cassidy 344.

<sup>576</sup> (Mayson, French & Ryan 637-634).

<sup>577</sup> The Cork Committee Report at paragraph 198 expressed the view that preservation of viable commercial enterprise is capable of making a useful contribution to the economic life of the country.

## CHAPTER FOUR

### Comparative Analysis and Evaluation of Chapter XV of the Companies Act 61 of 1973

#### 4 1 INTRODUCTION

Jurisdictions far and near have put strategies in place to achieve the objectives of corporate rescue in order to enhance economic development among others. In the early 1920's' South African companies legislation introduced a concept known as judicial management to serve as a corporate rescue mechanism. It is a common knowledge that judicial management aims at rescuing a business rather than placing the business into liquidation. In South African law, liquidation is the preferred option in spite of the fact that a statutory procedure of judicial management for the rescue of insolvent or almost insolvent companies has been available in South African company law for almost a century.<sup>578</sup>

This chapter will attempt to critically analyse Judicial Management and its application since its inception in South Africa. An evaluation will be done to demonstrate its success or otherwise in the past years although company law has undergone series of amendments,<sup>579</sup> which have one way or the other, affected judicial management. This chapter will also examine:

- The Role of the Provisional and Final Judicial Manager in Judicial Management;
- The Role of Creditors and Members of the Affected Company during Judicial Management ; and
- The strengths and weaknesses of judicial management responsibilities in relation to the Judicial Management process although the courts and interested parties have a role to play as is the case with the business rescue process in other jurisdictions. The functions Provisional and Final Judicial Managers will be critically analysed to determine whether or not their functions contribute to the success or otherwise of judicial management.

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<sup>578</sup> Loubser "Judicial Management as a Business Rescue Procedure in South Africa" 2004 *Merc LJ* 138.

<sup>579</sup> See generally Burdette Part 1. He explains in his thesis that series of amendments which South African Company Law has gone through are by virtue of recommendations made by commissions such as the Landsdown Commission of 1936 and the Millin Commission of 1948. The Van Wyk de Vries Commission of 1973 was urged by the Masters of the Supreme Court to abolish Judicial Management because of its low success rate but the commission refused concluding that it should be retained even if it has a low success rate. Also see Rajak and Henning 266.

## 4 2 JUDICIAL MANAGEMENT<sup>580</sup> IN SOUTH AFRICA<sup>581</sup>

### 4 2 1 Background and rationales

Judicial management was introduced with the initial enactment of the statutory provision in 1926. However, certain changes<sup>582</sup> were made by a number of amending Acts between 1926 and 1973.<sup>583</sup> It has been argued<sup>584</sup> that judicial management is a special and extraordinary procedure that finds no place in the English Companies Legislation and, accordingly, guidance on the interpretation of those sections of the South African statute that deal with judicial management cannot be sought from decisions of the English courts. The progressive approach of South African company law was not based on any precedent in the English Companies Act which is the usual source of inspiration for matters relating to the legal regulation of companies in South Africa. In fact, it was not until 1986 that Britain inaugurated its first statutory business rescue provisions.<sup>585</sup>

It has been noted<sup>586</sup> elsewhere that the United Kingdom initiated its corporate rescue culture only in the 1960's. However, the amendments of South African company law over the years

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<sup>580</sup> See in this regard <http://www.standardandpoors.com> (accessed 12-10-2010). The Insolvency Process in South Africa can be put into three stages under the umbrella of a distressed company: Scheme of Arrangement or Compromise, Judicial Management and/or Winding Up. Scheme of Arrangement or Compromise and/or Judicial Management aims at reorganization, whereas the object of Winding-Up is for the company to enter into liquidation.

<sup>581</sup> Rochelle "Lowering the Penalties for Failure : Using the Insolvency Law as a Tool for Spurring Economic Growth ; the American Experience, and Possible Uses for South Africa" 1996 2 *Tydskrif vir die Suid-Afrikaanse Reg* 316 (hereafter Rochelle) submits that America's Bankruptcy Act of 1898 adopted strategies to save businesses and in the 1920's the statute was amended to allow reorganizations. It seems that South Africa's judicial management concept took its root from the American legislation on Bankruptcy.

<sup>582</sup> Initially the process did not include a moratorium on claims by creditors, but the amending Act of 1932 added a moratorium to protect the debtor in judicial management. Rajak and Henning "Business Rescue for South Africa" 1999 *SALJ* 265,(hereafter Rajak and Henning) submit that the change was inspired by the depression in the early 1930s and the fear that money lent to farmers might have to be recalled quickly as a result of the possible insolvency of lending companies.

<sup>583</sup> Rajak and Henning 265.

<sup>584</sup> Gibson et al: *South African Mercantile and Company Law* (2008) 411 (hereafter Gibson). Also see Rajak and Henning 262-263 where the authors agreed with Gibson that Judicial Management did not emerge from English law although South Africa takes most of its laws from English statutes and it therefore becomes a mystery as to where Judicial Management emerged from and how it found its roots firmly in the South African legal system. South African common law has shown that Judicial Management does not originate from England. In *Western Bank Ltd v Laurie Fossati Construction (Pty) Ltd (under Judicial Management; Western Bank Ltd v Laurie Fossat Plant Hire (Pty) Ltd (under Judicial Management* 1974 3 SA ALL 424 (E), Hart AJ noted:"the procedure known as "judicial management" which was introduced into our law in 1926, has no counterpart as far as I know, in similar legislation in England although I believe that there is some attempt or a similar form in Australia".

<sup>585</sup> *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* 2001 2 SA 727 738.

<sup>586</sup> See chapter three of this dissertation which analyses the corporate rescue mechanisms of other jurisdictions.

saw the emergence of section 311<sup>587</sup> of the Companies Act 61 of 1973<sup>588</sup> which was closely modelled on the British rescue process.<sup>589</sup>

Judicial management aims at enabling companies which are suffering a temporary setback due to mismanagement or other special circumstances, to avoid liquidation and become successful business concerns once again.<sup>590</sup> In addition, jobs may be saved, the tax base preserved and the polity left better off than where the distressed company's business is closed or sold at an auction.<sup>591</sup> Furthermore, judicial management aims at postponing<sup>592</sup> the liquidation of a company which is in difficulty and to provide a moratorium<sup>593</sup> for that company for a period long enough to enable that company meet its obligations.<sup>594</sup> In *Re: Griffin v Edwardfin Investment Holdings Ltd*<sup>595</sup> the facts of the case were that the company was successful as it appeared from its audited financial statements. The global economic crises in the past decade however, adversely affected the company's ability to attract capital with the result that the down-turn in the global economy caused an accumulated investment opportunity loss of approximately R25 million which suggested that the company was going through a cash flow crises and needed a rescue instead of a winding-up. Contrasting

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<sup>587</sup> The rationale of this section is to allow a compromise or an arrangement between the company and its creditors, a company and its members or combination of creditors and the members to negotiate claims against the company through mechanisms which are created contractually during unfavourable trading conditions.

<sup>588</sup> Companies Act 61 of 1973.

<sup>589</sup> See generally sections 425 – 427 of the United Kingdom Companies Act 1985. See also Rajak and Henning 263.

<sup>590</sup> Benade: *Entrepreneurial Law 4<sup>th</sup> ed* (2008) 413. (Hereafter Benade *et al*). In *Silverman v Doornhoek Mines Ltd* 1935 TDP 349, the court held that there is a reasonable probability that the company would be able, if given time, to meet all its liabilities and remove the reason for its liquidation. However, it was going to take several years before it can do so out of the repayments of capital and interest to which it was entitled under a mortgage bond. The shareholders in the company were opposed to the company being sold as they sought to benefit at the expense of creditors if the company was placed under judicial management. The court had to consider whether to make an order for immediate liquidation of the company which would benefit the creditors or postpone liquidation to benefit the shareholders.

<sup>591</sup> Rochelle 320.

<sup>592</sup> In sharp contrast, the court in *Silverman v Doornhoek Mines Ltd* 1935 TDP 353, held that it is difficult to see how it would be just and equitable to grant postponement of judicial management against the wishes of the applicant in the absence of any indication that it will be in the interest not only of the applicant but also of other creditors to grant such a postponement.

<sup>593</sup> In terms of section 428(2)(c), the directions by the court to the company must contain provisions whereby all actions, proceedings, the executions of writs, summonses and other processes against the company must be stayed and not proceeded on without leave of the court. In *Samuel Osborn SA Ltd v United Stone Co Ltd (Under Judicial Management)* 1938 WLD 229 it was held that the object of judicial management was to provide a struggling company with more time and not to protect it against bad claims; however, there will be instances where the merits of a claim may be taken into account. At its lowest, there must be at least a serious claim as opposed to a frivolous one. An applicant must have a claim against the company. It was further held by the court that it is irrelevant whether the claim arose before or after the company was put under judicial management.

<sup>594</sup> *Western Bank v Laurie Fossati Construction (Pty) Ltd (Under Judicial Management)* 1974 4 SA 607 at 611.

<sup>595</sup> Case No 1630/2009, Unreported decision of the High Court of South Africa Kwazulu-Natal, Pietermaritzburg, 22 May 2009.

liquidation to judicial management Snyman J in *Lief v Western Credit (Africa) Pty Ltd*<sup>596</sup> remarked:

“A winding-up order, in its nature, is intended to bring about the dissolution of the company, whereas the purpose of a judicial management order is to save the company from dissolution. An important feature of a winding-up order is that upon such an order being granted there is a *concursum creditorum*. A judicial management order on the other hand usually provides for a moratorium in respect of the company’s debt in the hope that it will lead ultimately to the payment of all creditors and the resumption by it of normal trading... A winding-up order is usually granted where a company is in fact insolvent, whereas a judicial management order is usually granted where a solvent company has run into financial difficulties...”<sup>597</sup>

In *Le Roux Hotel Management (Pty) Ltd and Another v E Rand (Pty) Ltd (FBC Fidelity Bank Ltd)*<sup>598</sup> it was held that the court was obliged to apply the established common law principles and to treat judicial management as an extraordinary measure, not as an alternative to liquidation. The court further observed that the adversarial process is not ideally suitable for applications for an order of judicial management. The court in *Ben Tovim v Ben Tovim and Others*<sup>599</sup> were seen as adopting a conservative approach in proceeding on the view that it is a requirement for applicants to show a strong probability that by proper management the company would be able to surmount its difficulties and in regarding judicial management orders as a special privilege to be granted only in extraordinary circumstances;<sup>600</sup> and not against the wishes of major creditors. The court further held that an applicant basing his case for a judicial management order, which after all is a special concession and only granted in exceptional circumstances on scanty information does not get a reprieve.<sup>601</sup>

In terms Section 427 (3) of the Companies Act 61 of 1973, when an application for the winding-up of a company is made to court and it appears to the court that if the company is placed under judicial management the grounds for its winding-up may be removed and that the granting of a judicial management order would be just and equitable,<sup>602</sup> the court may

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<sup>596</sup> 1966 3 SA 344.

<sup>597</sup> Pretorius *et al Hahlo’s South African Company Law Through the Cases* 736.(hereafter Pretorius *et al*).

<sup>598</sup> 2001 2 SA 728. (para 61 at 744H/I). Contrasting this view of the courts, Kloppers at 378 disagreed arguing that there is nothing in the statute which indicates that judicial management was not an alternative to liquidation.

<sup>599</sup> 200 3 SA 264.

<sup>600</sup> In *Ben Tovim v Ben Tovim and Others* 2000 3 SA 264, the court held that judicial management as an extraordinary legal remedy is authorized in exceptional circumstances.

<sup>601</sup> In *Ben Tovim v Ben Tovim and Others* 2000 3 SA 264, the applicant (Gershon) did not sufficiently establish a reasonable probability that if placed under judicial management, the company would be enabled to meet its obligations and become a successful concern. Van Heerden J at 272 stated “there was nothing positive on the papers filed to show the probability that judicial management would have the desired result. A mere confident hope expressed in affidavits and not sufficiently supported by concrete evidence is not enough.”

<sup>602</sup> Meskin *Henoschberg on Companies Act* 4<sup>th</sup> ed 1985 927 (hereafter Henoschberg) submitted that the requirement of ‘just and equitable’ is that justice and equity is to be determined with reference to the rights and

grant the order in respect of that company. In *Ben –Tovim v Ben –Tovim & Others*<sup>603</sup>, the court stated clearly the four conditions that must be met before a court can place a company under judicial management:

1. The company in question must either -

Be unable to pay its debts or probably be unable to meet its obligations;

2. The company must either -

Not have become a successful concern; or be prevented from becoming a successful concern;

3. There must be a reasonable probability that, if the company is placed under judicial management, the company will be enabled to pay its debts or meet it's

obligations and become a successful concern; and

- 4 it must appear to the court that, it would be just and equitable to grant the judicial management order.<sup>604</sup>

It is submitted that the onus<sup>605</sup> of proving whether the company is in distress lies on the applicant. If it appears to the court that the company will if placed under a final judicial

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interests of the members and creditors of the company in all the circumstances which has led to the company being placed under judicial management. In the case of *Marsh v Plows SA Ltd* 1949 (1) PH E4 C, the court refused to grant a judicial management order in the face of opposition by an execution creditor where *inter alia* there was no unanimity amongst either the creditors or the members as to whether there should be judicial management or winding up. In the view of the court, the circumstances were not just and equitable for the execution creditor, which could be delayed in the exercise of his rights based on speculations on future possibilities.

<sup>603</sup> 2000 3 SA 325.

<sup>604</sup> It should be noted however that the conditions are not individually decisive but are to be looked at cumulatively in all matters involving an application for a judicial management order. In *Gushman v TT Gushman & Son (Pty) Ltd & Others* 2009 JOL 23589 (ECM) Nhlanguhala J emphasized that an examination of the facts of the application is necessary to determine if the applicant has discharged the onus with which he is encumbered in terms of section 427(1) of the Companies Act 61 of 1973. The applicant was a director and a shareholder of the company. The first respondent is described as TT Gushman & son (Pty) Ltd a private company. The second respondent is Donna Siphokazi Gushman. The third respondent was First National Bank and a creditor. The other respondents were shareholders of the company. The facts thereof as stated by the applicant were that, there is a long history of managerial problems in existence within the company which prevented the company from becoming a successful concern. The company bought houses for the respondents without the resolution of the board. More so, appointment of new accountants was made without the authority to do so. The applicant concluded in his evidence that it will be just and equitable to place the company under judicial management.

<sup>605</sup> Loubser at 145 submitted that the burden of proof is a crucial requirement of judicial management. She further argued that, the burden of proof has to be a reasonable probability and not merely a possibility and that

management order re-emerge as a successful concern, the provisional order may be discharged.<sup>606</sup> The court can however, refuse to grant a final judicial management order. In *Tenowitz v Tenny Investment (Pty) Ltd*<sup>607</sup> the court refused to grant a final judicial management order, because it considered that the applicant had not discharged the onus of proving that the company would become a successful concern in a reasonable time if such order was granted. The court opined that the provisions of section 427(1) of Companies Act 61 of 1973 relating to the circumstances under which a company may be placed under judicial management must be read subject to the provisions of section 432 of the Companies Act 61 of 1973. Section 427 (1) provides that a judicial management order in respect of a company may be granted if it appears just and equitable to do so and there is a reasonable probability that, if it is placed under judicial management, it will be enabled to pay its debt and meet its obligations. While section 427 of the Companies Act 61 of 1973 does not specifically say so, it would seem that the postulated test of a reasonable probability that the company concerned will be enabled to pay its debts applies at the stage when a provisional judicial management order is sought.”<sup>608</sup>

It is important to note that the High Court is the only court in South Africa which has got the jurisdiction to hear an application for judicial management<sup>609</sup> after application to the court.<sup>610</sup> This implies that the application<sup>611</sup> may be made by the company facing financial challenges itself, by one or more of its creditors, by one or more of its members or jointly by any of them.<sup>612</sup>

Courts have the sole discretion of granting judicial management orders.<sup>613</sup> Once the court is satisfied that all the requirements for placing a company under judicial management have

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the fact that the company must at the time of the application already be commercially insolvent or unable to meet its obligations, and that chances of success may depend on unknown factors such as the co-operation of major creditors or even employees and trade unions, make it difficult to prove the existence of a reasonable probability.

<sup>606</sup> See in this regard section 432(2) and (3) of the Companies Act 61 of 1973.

<sup>607</sup> 1979 2 SA 680 (E).

<sup>608</sup> 1979 2 SA 680 (E) at 683/B.

<sup>609</sup> Loubser “Judicial Management as a Business Rescue Procedure in South African Corporate Law” 2004 SA *Merc LJ* 151.

<sup>610</sup> Section 427 (2) of the Companies Act 61 of 1973 stipulates that “an application to Court for a judicial management order in respect of any company may be made by any persons entitled under section 346 (4) to make an application to Court for the winding-up of a company, and the provisions of section 346(4) as to the application for winding-up shall *mutatis mutandis* apply to an application for judicial management.”

<sup>611</sup> An important point to note is that section 346(4) read with section 427(2) of the Companies Act 61 of 1973 means that a copy of the application to the court for judicial management, must include supporting affidavits which must be lodged with the Master of the High Court.

<sup>612</sup> Section 346 of the Companies Act 61 of 1973.

<sup>613</sup> See generally Section 427 of the Companies Act 61 of 1973.

been met, there is nevertheless a discretion to be exercised judicially by the court as to whether a judicial management order should be granted or not.<sup>614</sup> It is thus stated by Gibson:<sup>615</sup>

“I have not been able to find a single authority for the proposition that if a company could be run more efficiently and more profitably, that by itself constitutes a ground for granting the judicial management order. On the contrary there is an avalanche of authority to the effect that a judicial management order is only appropriate where “internal control mechanisms?” and “domestic remedies” were entirely ineffectual in overcoming its eternal problems, especially if those arose from clashes between the personalities of the various directors.”

#### **4 2 2 Appointment of the provisional judicial manager**

The court in terms of section 428(1)<sup>616</sup> may appoint the provisional judicial manager<sup>617</sup> when granting a provisional judicial management order. On the return day,<sup>618</sup> the court after hearing the application for an order in terms of section 428(1),<sup>619</sup> grant a provisional judicial management order and may dismiss the application or make any order that it deems just.<sup>620</sup> Benade *et al*<sup>621</sup> submit that section 432<sup>622</sup> of the 1973 Companies Act provides a stringent

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<sup>614</sup> *Ben-Tovim v Ben-Tovim and Others* 2000 (3) SA 325 (C) at 330-331. Similarly, the court in *Gushman v TT Gushman and Son (Pty) & Others* 2009 JOL 23589 (ECM) held that the issue to be decided was whether the applicant had satisfied the court that there was a reasonable probability that if the company was placed under judicial management, it would be enabled to pay its debts or meets its obligations. The court will then be clothed with a discretionary power to decide whether or not to grant the judicial management order.

<sup>615</sup> (Gibson *et al* 412).

<sup>616</sup> Section 428 (1) of the Companies Act 61 of 1973 stipulates that the court may on application under section 427(2) or (3) grant a provisional judicial management order, stating the return day, or dismiss the order that it deems just.

<sup>617</sup> See in this regard (Cilliers *et al* 483) where it is submitted that only a person who qualifies to be a liquidator may be appointed as provisional judicial manager. Similarly, section 448B of the Corporations Act 2001 of Australia stipulates that only a qualified liquidator registered by the Australian Corporate Regulator, the Australian Securities and Investment Commission (ASIC) can be appointed as an administrator to oversee the rescue process of a company facing financial difficulties.

<sup>618</sup> The provisions of section 432(1) of the Companies Act 61 of 1973 states that the return day must not be later than sixty days after the date of the provisional order but may be extended by the court on good cause shown. In effect, the return day serves the purpose of discharging the provisional order whether concomitantly with an application for winding-up of the company. See also Henochsberg 930.

<sup>619</sup> Companies Act 61 of 1973.

<sup>620</sup> (Cilliers *et al* 482).

<sup>621</sup> (Benade *et al* 414-415).

<sup>622</sup> Companies Act 61 of 1973.

test<sup>623</sup> which allows the court to be in a better position to judge the company's prospects of becoming a successful concern.

There are a number of considerations affecting the appointment of a provisional judicial manager or managers.<sup>624</sup> For one, the provisional judicial manager should not have any previous affiliation with the company. Consequently, the provisional judicial manager cannot be an official of the company. The neutrality of the judicial manager was considered in *Rennie v Holzman*<sup>625</sup> where the judicial manager was identified as an officer of the company. The court held that the judicial manager should not be part of management of the company, an affected member nor employee. The facts of the case were that the applicants (shareholders) alleged that the judicial managers (respondents) misapplied, retained or became liable or accountable to the company for money and were guilty as they breached the faith entrusted in them in relation to the company as a result of which the business of the company was during judicial management carried on recklessly and/or with intent to defraud creditors of the company and the respondents were knowingly parties thereto. The applicant accordingly launched proceedings in which he seeks an order in terms of section 424(1)<sup>626</sup> and prayed to the court for the respondents to be personally liable and repay the money by virtue of breach of faith or trust in relation to the company. The issue that the court had to deal with was whether section 423<sup>627</sup> of the Companies Act 61 of 1973 applies to a judicial manager and/or a provisional judicial manager, and if so, whether the court should exercise its discretion. The court held that the position/office of judicial manager falls within the ambit of section 423 of the said Companies Act.

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<sup>623</sup> (*Pretorius et al 735*) submit that the test to be satisfied before a final judicial management order is granted is that on the return day, the presiding judge will be in a better position to judge the company's prospects of becoming a successful concern than the court granting a provisional judicial management order. The test propounded by section 432 of the 1973 Companies Act for the granting of a final judicial management order is also more stringent than under section 195 of the Companies Act 46 of 1926 (as amended) which only prescribed the reasonable probability test.

<sup>624</sup> *Henochsberg* 939.

<sup>625</sup> 1987 4 All SA (C)1989 3 SA 599.

<sup>626</sup> Section 427(1) of the Companies Act 61 of 1973.

<sup>627</sup> Section 423 of the Companies Act 61 of 1973 stipulates that where in the course of the winding-up or judicial management of a company it appears that any person who has taken part in the formation or promotion of the company, or any past or present director or any officer of the company has misapplied or retained or become liable or accountable for any money or property of the company or has been guilty of any breach of faith or trust in relation to the company, the court may on the application of the Master, or the liquidator or any creditor or member or contributor of the company, enquire into the conduct of the promoter, director or the officer concerned and may order him to repay or restore the money or property or any part thereof, with interest at such rate as the court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retention, breach of faith or trust as the court thinks just.

Another requirement is that, the judicial manager should be independent. The independence<sup>628</sup> of the provisional judicial manager was emphasised in *Theron v Natal Markagente (Edms) Bpk*<sup>629</sup> where the court held that to be appointed a judicial manager whether provisional or final, the independence and impartiality of the manager should not be compromised under any circumstance. Accordingly, the auditor of the company was disqualified from being appointed as a provisional judicial manager.<sup>630</sup>

#### **4 2 3 The role and duties of the provisional judicial manager in the judicial management process**

Judicial management as a business rescue mechanism in South Africa utilises the appointment of a provisional judicial manager and then a final judicial manager. In Hong Kong, the rescue procedure for companies known as Provisional Supervision allows a provisional supervisor to be appointed to oversee the process and decide on appropriate solutions for the distressed company.<sup>631</sup> In a striking contrast, jurisdictions such as Australia, United Kingdom and Canada appoint managers or administrators to take over the affairs of the company for the purposes of rescuing it.<sup>632</sup>

It is required that upon the appointment of the provisional judicial manager, the assumption of managerial duties, the recovery and entry into possession of all assets of the company should take effect within seven days of being appointed.<sup>633</sup> The provisional judicial management order must contain directions that the company is under the management of a provisional judicial manager subject to the supervision of the court, that those vested with the management up to then be divested thereof<sup>634</sup> and empowers the provisional judicial manager

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<sup>628</sup> Similarly jurisdictions such as United Kingdom and Australia have provisions in relation to corporate rescue mechanisms which require the administrator to be independent, impartial and not to be an official of the company.

<sup>629</sup> 1978 4 SA 898 (N). See also the Harmer Report para 72. In *Cresvale Far East v Cresvale Securities* 2001 37 ACRS, the independence of the administrator was tested. See also *Huxable v Calnan Oldfield Pty* 2010 FCA 769.

<sup>630</sup> Section 429 (b) (i) of the Companies Act 61 of 1973. This provision also prohibits the auditor from being appointed as a liquidator in the winding-up process of a company.

<sup>631</sup> See in this regard Carrie and Yan *An Analysis of the Corporate Rescue Objectives: Voluntary Administration in Australia, Administration Order in the United Kingdom and the Provisional Supervision in Hong Kong* (Honours Degree in Business Administration, Hong Kong Baptist University April 2010) 23.

<sup>632</sup> In the United Kingdom the administrator when appointed, starts with the rescue processes in accordance with the legal requirements of the administration process relating to the rescuing an ailing company. In Australia, the administrator also, upon appointment, starts straight away with the rescue process.

<sup>633</sup> Section 430(a) (b) of the Companies Act 61 of 1973.

<sup>634</sup> Section 428 (2) (a) of the Companies Act.61 of 1973.

to raise money,<sup>635</sup> subject to the rights of creditors.<sup>636</sup> The provisional judicial manager is required to inform the Registrar of Companies of his letter of appointment and to prepare a detailed report<sup>637</sup> containing details of the general affairs<sup>638</sup> of the company.

#### **4 2 4 The role of creditors and members during judicial management**

The separate meetings of creditors, debenture-holders<sup>639</sup> and members of the company where the report of the provisional judicial manager is to be presented are held under the chairmanship of the Master of the High Court.<sup>640</sup> It is important to note that the purpose of the meetings<sup>641</sup> is to consider the report of the provisional judicial manager and decide on the desirability of placing the company under final judicial management, taking into account the prospects of the company becoming a successful concern.

The meetings must consider the passing of a resolution granting preference to liabilities incurred by the provisional judicial manager in the conduct of the company's business.<sup>642</sup> The chairman<sup>643</sup> of the respective meetings must submit a report<sup>644</sup> to the court of the proceedings at each meeting and in particular of the reasons for its decisions on the desirability or

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<sup>635</sup> (Cilliers *et al* 483).

<sup>636</sup> This provision of section 428 (2) (c) of the Old Act stipulates the rights of shareholders being limited during the period of provisional judicial management. The section states that the authority of shareholders is irrelevant when it comes to the raising of money by the provisional judicial manager.

<sup>637</sup> In terms of Section 430 (C) (i)-(v) of the Companies Act 61 of 1973, a report would be presented to explain the investigation made by the provisional judicial manager with a detailed account of the general state of affairs of the company, including a statement of assets and liabilities of the company, details of claims by creditors; and reasons for the company's problems.

<sup>638</sup> It should be noted that in terms of section 430(c) of the Companies Act 61 of 1973 the provisional judicial manager is to conduct a general and thorough investigation as to the reasons why the company should be placed under judicial management. It is required that the directors give the maximum cooperation to the provisional judicial manager in his/her bid to investigate the affairs of the company.

<sup>639</sup> Oxford Dictionary of Law 136 defines debenture as a document that acknowledges and contains the terms of a loan to a company. Debentures may be issued to a single or series of creditors in order to raise finance for the company which may result in a trust being created within the debenture in favour of such creditors. The company is then required to appoint a trustee for debenture holders to ensure that the financial activities of the company are managed in the interests of the group of creditors. Finance raised by the issue of debentures is known as 'loan capital' which is contrasted with 'share capital', the holders of which are company members.

<sup>640</sup> (Cilliers *et al* 485).

<sup>641</sup> Section 431 (b) of the Companies Act 61 of 1973 stipulates that the meeting convened must be held in a manner prescribed by section 412 of the Companies Act 61 of 1973 in respect of a meeting in the winding-up of a company.

<sup>642</sup> See in this regard section 431 (2) of the Companies Act 61 of 1973.

<sup>643</sup> Section 431 (1) of the Companies Act 61 of 1973 empowers the Master of the High Court to chair the meetings convened under section 429 of the Companies Act 61 of 1973.

<sup>644</sup> It is important to note that the report must contain the details of the investigation carried out by the provisional judicial manager on the viability or otherwise of the company being placed under final judicial management.

otherwise of judicial management.<sup>645</sup> On the return day, the court may after consideration of the opinion and wishes of the company; and the report of the provisional judicial manager under section 430 of the Companies Act 61 of 1973 grant a final judicial management order.<sup>646</sup> The court is not however, obliged to grant a final judicial management order without careful consideration. In *Ladybrand Hotel (Pty) Ltd v Segal*<sup>647</sup> the court dealt in detail with the factors to be taken into consideration before a provisional order of judicial management is made final. It remarked that the considerations are: firstly, the dearth of information laid before the court in the application; secondly, the merits of the application based on such information as may be gathered from the papers and thirdly, the affidavit of the provisional judicial manager attached to the replying affidavit of the applicant. It was thus emphasised by Erasmus J:

“A[n] applicant basing his case for a judicial management order, which after all is a special concession granted in exceptional circumstances on scanty information and generalisations, does at his own peril, moreover, when merely the confirmation of the rule is opposed on the return day, a postponement in order to submit further information may, be more readily granted than in a case where in addition there is a counter-application that the applicant be placed in liquidation. After considering the provisions of section 432(2)<sup>648</sup> it does not appear to me that the applicant will, if placed under final judicial management order, be enabled to become a successful concern, and in view also of the first and third aspects of the application discussed in this judgment it is my view that it is not just and equitable that the rule be made final.”<sup>649</sup>

The court may also consider the number of creditors who did not prove claims at the first meeting of creditors and the amounts and nature of their claims in addition to the reports of the Master<sup>650</sup> and the Registrar.<sup>651</sup> It may then grant a final judicial management order if it appears the company if placed under final judicial management order will become a successful concern.<sup>652</sup> It is important to note that the creditors of the affected company whose claims arose before the granting of a judicial management order in respect of the company may at a meeting convened by the judicial manager or provisional judicial manager,

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<sup>645</sup> Section 431(3) of the Companies Act 61 of 1973.

<sup>646</sup> Section 432(2) of the Companies Act 61 of 1973.

<sup>647</sup> 1975 SA 271, (O).

<sup>648</sup> Companies Act 61 of 1973.

<sup>649</sup> *Ladybrand Hotel (Pty) Ltd v Segal and Another* 1975 2 All SA 268 at 271.

<sup>650</sup> The Master means the Master of the Supreme Court in relation to a company in respect of which application is made to the court for a winding-up order or judicial management order or a company being wound up by the court or under judicial management, the Master having jurisdiction in the area of the court which issued the winding up or judicial management order.

<sup>651</sup> Section 1 of the Companies Act 61 of 1973 defines the Registrar as the Registrar of Companies appointed under section 7 of the Companies Act 61 of 1973. The Registrar was appointed by the Minister subject to the laws governing the public service.

<sup>652</sup> Section 432(2)(c), (d) and (e) of the Companies Act 61 of 1973.

resolve that all liabilities incurred or to be incurred by the judicial manager or the provisional judicial manager in the conduct of the company business shall be paid in preference to all other liabilities not already discharged exclusive of the costs of the judicial management, and thereupon all claims based upon such first-mentioned liabilities shall have preference in the order in which they were incurred over all unsecured claims against the company except claims arising out of the judicial management.<sup>653</sup>

It is a requirement that, the final judicial manager or provisional judicial manager follow the procedure<sup>654</sup> of convening a meeting of the creditors of the company. The provisional judicial manager or the judicial manager as the case may be shall preside over a meeting<sup>655</sup> and the laws relating to insolvency shall apply *mutatis mutandis* in respect of the conduct of any such meeting, the right to vote, the manner of voting with the purpose of voting on creditors' claims which is determined by the calculation of the value of votes as if such meeting were a meeting of creditors in an insolvent estate. Provided that for the purposes of voting at any such meeting convened by a provisional judicial manager or judicial manager, the claims of creditors shall be determined to the satisfaction of the judicial manager or provisional judicial manager.<sup>656</sup>

#### **4 2 5 Duties and powers of the final judicial manager<sup>657</sup>**

The first and immediate duty of the final judicial manager is to take over from the provisional judicial manager and assume the role of management of the company.<sup>658</sup> The final judicial

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<sup>653</sup> Section 435(1)(a) of the Companies Act 61 of 1973 provides a remedy in relation to debts incurred by the judicial manager or the provisional judicial manager. (Cilliers *et al* 489) submit that the purpose of providing the preference in the provision is to enable a company placed under a judicial management order acquire credit more readily for its business transactions.

<sup>654</sup> The judicial manager or the provisional judicial manager must send written notice by registered post at least ten days before the date of the meeting, as specified in the notice, to every creditor of the company whose name and address is known to him, and also by notice in one or more newspapers circulating in the district where the company's main place of business is situated. Section 435(2) (b) states that the notice shall comply with provisions of section 40 (3) (c) of the Insolvency Act 24 of 1936, and shall appear at least ten days before the date of the meeting.

<sup>655</sup> Section 435(2) states that a written notice of meeting convened by the provisional judicial manager or the judicial manager shall be addressed and sent to every creditor by registered post at least 10 days before the date of the meeting, and also by notice in one or more newspapers circulating in the district where the company's main place of business is situated.

<sup>656</sup> Section 435(3) of the Companies Act 61 of 1973.

<sup>657</sup> It appears that the legislation (sections 427-440 of Companies act 61 of 1973) is silent on the appointment of a final judicial manager, contrary to (section 429(b) (i) which specifically stipulates that the Master without delay appoints a provisional judicial manager after the provisional judicial management order has been granted) . It should be noted however that section 431 (4) of the Companies Act 61 of 1973 states: "the provisions of the Companies Act relating to the proof of claims against a company which is being wound up and to the nomination and appointment of a liquidator of any such company shall *mutatis mutandis* apply with reference to the proof of claims against a company which has been placed under judicial management and the nomination and appointment of a judicial manager of such company."

manager has the responsibility to conduct such management, subject to the orders of the court, in such a manner as he may deem most economic and most promotive of the interests of the members and creditors of the company.<sup>659</sup> It should be noted that in terms of section 428 (3) of the companies Act 61 of 1973, the court which had jurisdiction to grant the provisional judicial management order may at any time and in any manner, on application of a creditor, a member, the provisional manager or the Master, vary the terms of such order or discharge the provisional judicial management order. In *Ex Parte Judicial Managers, CTC Bazaars (SA)*<sup>660</sup> the court held that a judicial manager has *locus standi* to apply to the courts in terms of section 311 of the Companies Act 61 of 1973<sup>661</sup> for an order convening a meeting of creditors to consider an offer of compromise.<sup>662</sup> Consequently, it is competent for the judicial manager to apply to a court for a variation of the terms of the judicial management order.<sup>663</sup>

Furthermore, the final judicial manager has the responsibility of keeping and preparing accounting records and financial statements as the company or its directors would have been obliged to keep or prepare if it had not been placed under judicial management.<sup>664</sup>

It should be acknowledged that the final judicial manager is responsible for convening regular meetings of the creditors where he must submit reports showing the assets and liabilities of the company, its debts and obligations as verified by the auditor<sup>665</sup> of the

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<sup>658</sup> Section 433 (a) of the Companies Act 61 of 1973.

<sup>659</sup> Section 433(b) of the Companies Act 61 of 1973. The final judicial manager must act in accordance with the directions of the court and should not depart from the legislation, as well as provisions of the memorandum and articles of association of the company. Shrand *The Law and Practice of Insolvency Winding-up of Companies and Judicial Management* 3 ed (1997) 333 (hereafter Shrand) submits that if there is any conflict, the directions of the court and the requirements of the Companies Act 61 1973 will prevail over the provision of the memorandum and articles of association of the Company.

<sup>660</sup> 1938 CPD 496. See also (Shrand 333).

<sup>661</sup> The provisions of section 311 of the Companies Act 61 of 1973 provides a machinery whereby a compromise or arrangement can be made between the company and/or its creditors and its members with regard to their claims against the company.

<sup>662</sup> (Benade *et al* 267) explains a compromise as an agreement between a company and its creditors/or its members which terminates a dispute about the rights of the parties to be compromised or some difficulties in enforcing them. The parties to the compromise must however, be the company, on the one hand, and the members and/or creditors, on the other hand.

<sup>663</sup> (Shrand 333).

<sup>664</sup> Section 433(f) of the Companies Act 61 of 1973.

<sup>665</sup> Section 438 of the Companies Act 61 of 1973 clarifies the position of the auditor in the company as not ceasing after the granting of the judicial management order. Notwithstanding the granting of the judicial management order in respect of any company and for so long as the order is in force, the appointment and reappointment of an auditor and the rights and duties of an auditor shall continue to apply.

company and all the information which is necessary to acquaint creditors with the state of affairs of the company at the end of the financial year.<sup>666</sup>

Although the final judicial manager's role is of much importance, it appears that the examination of the company's affairs and transactions to ascertain whether any director, past director, officer or past officer is or appears to be personally liable for damages or compensation to the company or for any debts or liabilities of the company by the final judicial manager is very crucial.<sup>667</sup>

At the stance of the final judicial manager, the law of insolvency shall apply *mutatis mutandis* in relation to every disposition of property which if made by an individual could for any reason be set aside by the court.<sup>668</sup> It should be noted that although the final judicial manager takes control and management of the company, his authority is limited in relation to the disposal of the company's assets.<sup>669</sup>

#### **4 2 6 Termination of judicial management**

The final judicial manager has the *locus standi* under section 433<sup>670</sup> to apply to the court for the termination of the judicial management order if he is of the opinion that the existence of the judicial management order is not achieving the desired results.<sup>671</sup> In cancelling any such order, the court shall give directions as may be necessary for the resumption of the management and control of the company by the officers thereof, including directions for the convening of a general meeting of members for the purpose of electing directors of the

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<sup>666</sup> See in this regard section 433(h) – (i) of the Companies Act 61 of 1973. It has been submitted in respect of these provisions that any interim report is sent out to members of the company and in the case of a private company, not later than six months after the end of the financial year. It is important to note that the final judicial manager consequently must lodge with the Master copies of all the documents submitted at the meetings.

<sup>667</sup> Section 433(k) of the Companies Act 61 of 1973. In *Re: Griffin v Edwardfin Investment Holdings Ltd case no 1630/2009 and Stapleton and Others v Edwafin Investment Holdings Limited case no 3656/2009*, Unreported decision of the High Court of South Africa Petermaritzburg Kwazulu-Natal, 22 May 2009, Skinner AJ held that the applicants for a judicial management order did not contend that there has been any maladministration that the grant of the order would serve to eradicate.

<sup>668</sup> Section 436 (1) and (2) of the Companies Act 61 of 1973. It is submitted that the purpose of this provision is to correspond with a sequestration order under the Insolvency Act 1936. In the case of the insolvent, there shall be a presentation to the court of an application in pursuance of which a judicial management order is granted.

<sup>669</sup> Section 434(1) of the Companies Act 61 of 1973 states that the final judicial manager must ask leave of the court before disposal of the company's assets.

<sup>670</sup> Section 433 of the Companies Act 61 of 1973.

<sup>671</sup> Section 440 of the Companies Act 61 of 1973. This provision enables the court to cancel the judicial management order and thereupon the judicial manager shall be divested of his functions.

company.<sup>672</sup> It is has been suggested that the cancellation of a final judicial management order applies in situations whereby the order has achieved its desired results or where a creditor or the judicial manager applies for a winding up order against the company.<sup>673</sup>

As the court pointed out in *Ex Parte Beak: In re Westelike Bergrafnis Genootskap (Edms) Bpk*<sup>674</sup> a winding up order had to be made simultaneously upon the cancellation of the judicial management order and therefore a rule *nisi* was granted calling upon interested parties to show cause why the company should not be wound up. It was said in this case that where the court is satisfied that a company which carried on the business of funeral insurance and which had been placed under judicial management was unable to pay its debts and if it was just and equitable that the company be wound up, a cancelling of the judicial management order should be made and the judicial managers discharged. Interested parties can however show cause why the company should not be wound up. It is submitted that if at any time the judicial manager is of the opinion that the continuation of the judicial management will not enable the company to become a successful concern, he may apply to the court which may after not less than fourteen days' notice by registered post to all members and creditors of the company, cancel the judicial management order and issue a winding up order for the company.<sup>675</sup>

Although mismanagement of a company's affairs may contribute to the grounds for placing a company under judicial management, the court in *Samuels v Nicholls*<sup>676</sup> heard application by a creditor, Mr Woolf Samuels, who sought the discharge of the judicial manager and a cancellation of the judicial management order. Clayden J held that an allegation of mismanagement or complete incompetence of the judicial manager does not warrant the cancellation of the judicial management order. In the view of the court, section 198<sup>677</sup> was not intended to provide a creditor or a shareholder, who did not oppose the granting of judicial management order, with the right to one month later press for the liquidation of the company because he changed his mind; moreover, an allegation that a

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<sup>672</sup> Section 440 (2) of the Companies Act of 1973.

<sup>673</sup> Henochsberg 958.

<sup>674</sup> 1951 (1) SA 362 (SWA).

<sup>675</sup> See in this regard section 433(l) of the Companies Act 61 of 1973.

<sup>676</sup> 1948 2 SA 256-257.

<sup>677</sup> Section 198 of the Companies Act 46 of 1926 as amended stipulates that if at any time, after the issue of a judicial management order, an interested party can apply to the court which granted the judicial management order acknowledge that for any reason the order is undesirable to remain in force, the court in its opinion, upon considering prima facie may cancel such order.

judicial manager is mismanaging the company is not a ground for the discharge of a judicial management order.<sup>678</sup>

In terms of the Act,<sup>679</sup> in cancelling the judicial management order, the court shall give directions as may be necessary for the resumption of the management and control of the company by the officers thereof, including directions for the convening of a general meeting for the purpose of electing directors of the company.

### **4 3 CASE STUDY: *BLYVOORUITZICHT GOLD MINING COMPANY***<sup>680</sup>

The continuing troubles faced by DRDGOLD Limited<sup>681</sup> provide a useful case study to examine how successful or not judicial management was as a business rescue mechanism in South Africa. DRDGOLD made history in November 2009 when it became the first mining company in the South African mining industry to proactively request provisional judicial management.<sup>682</sup> The company announced on 9<sup>th</sup> November 2009, that in a bid to save its 74%-owned Blyvoor mine from liquidation, it intended to apply to the High Court for a judicial management order. Management acknowledged that restructuring at the company flowing from the consultation process in terms of Section 189A of the Labour Relations Act<sup>683</sup> was not delivering the expected turnaround to save the company from plunging into liquidation.<sup>684</sup>

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<sup>678</sup> Henochsberg 959 argues that Section 440 of the Companies Act 61 of 1973 Act should not be construed as prohibiting the person who obtained the final judicial management order from thereafter at any time seeking its cancellation and its replacement by a winding-up order, but if the situation is that he has simply changed his mind and no new facts are before it affecting the desirability of stopping or continuing the final judicial management order, it is suggested that the court should ordinarily refuse to allow him give effect to his change of mind.

<sup>679</sup> Section 440 (2) of Companies Act 61 of 1973.

<sup>680</sup> See in this regard <http://www.adndigital.com> (accessed 21-03-2010). Blyvoorrzicht (Blyvoor) is a 74% owned subsidiary of DRDGOLD.

<sup>681</sup> DRDGOLD Limited is a mid-tier, unhedged gold producer and the fourth largest gold mining company in South Africa with 6 409 employees and 1 749 contractors. Its geographical analysis of shareholders as at June 2010 was United States of America 60.7%, South Africa 23.7%, Europe 15.4% and Other Countries 0.2%. The company is engaged in underground and surface gold mining, exploration, extraction, processing and refining.

<sup>682</sup> See in this regard DRDGOLD Sustainable Development Report 2010 14 available at <http://www.Drdgold.com> (accessed 02-06-2011).

<sup>683</sup> Labour Relations Act 66 of 1995 as amended. Consultations in terms of section 189 is a requirement of the employer with regards to retrenchment in situations where a company is going through financial distress.

<sup>684</sup> See in this regard DRDGOLD Sustainable Development Report 2010 14 available at <http://www.Drdgold.com> (accessed 02-06-2011).

The near collapse of DRDGOLD was driven by a number of factors. It was said by management that the court application for a judicial management order became necessary due to the following reasons:

- the 16% drop in the average Rand gold price received between 1 April 2009 and 30 September 2009 due to the strengthening of the Rand against the US Dollar;
- extensive damage caused during May 2009 to higher-grade underground production areas at No 5 Shaft by seismic activity, restoration of which was expected to take some time to complete;
- power utility Eskom's higher winter tariffs, compounded by a 33% rate price increase and the likelihood of further increases;
- the protracted wage strike by the National Union of Mineworkers, which resulted in the loss of 8000 ounces of gold production worth R60 million;
- A sharp decline in the gold price between February and May 2009, from R317 000/kg to R240 000/kg.<sup>685</sup>

The management was granted a provisional judicial management order in terms of the Act<sup>686</sup> on 12 November 2009.<sup>687</sup> The effects of the Provisional judicial management order were as follows:

- Managing Blyvoor mine would become the responsibility of a provisional judicial manager to be appointed by the Master of the High Court;<sup>688</sup>
- The mine was not allowed to settle any debts incurred prior to the granting of the order without the approval of the judicial manager;<sup>689</sup>
- The provisional judicial manager will manage the company and prepare a detailed report to the registrar as required;<sup>690</sup>
- Interested parties may approach the court and provide reasons why the order should be dismissed or confirmed as a final judicial management order;<sup>691</sup> and

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<sup>685</sup> See in this regard DRDGOLD Sustainable Development Report 2010 14 available at <http://www.drdgold.com> (accessed 02-06-2011).

<sup>686</sup> Section 428 (1) of the Companies Act 61 of 1973.

<sup>687</sup> Section 428 of South African Companies Act 61 of 1973.

<sup>688</sup> Section 428 (1) of the Companies Act 61 of 1973.

<sup>689</sup> The contents of a provisional judicial management order directs that while the company is under judicial management all actions, proceedings, the execution of all writs, summonses and other processes against the company be stayed and not proceeded with without the leave of the court. In terms of section 428(3) of the Companies Act 61 of 1973, the order may be varied or discharged on the application of the applicant or a creditor, a member, the provisional judicial manager or the Master.

<sup>690</sup> See generally section 430 of the Companies Act 61 of 1973.

- If at any stage the company becomes profitable, any interested party including DRDGOLD may bring an application to lift the provisional order.<sup>692</sup>

### 4 3 1 DRDGOLD: The Road to recovery

The four provisional judicial managers appointed by the master of the High Court were granted a 28-day extension<sup>693</sup> to enable a report on the affairs of Blyvoor to be filed, compiled and submitted for consideration.<sup>694</sup> On 17th march 2010, the joint judicial managers provided in their report guidance on the rehabilitation of panels damaged in seismicity as well as the opening up and development of areas accessed through the mine's project.<sup>695</sup> Towards the end of the third quarter of the 2010 financial year, Blyvoor's situation had improved and DRDGOLD applied to the High Court for the lifting of the provisional judicial management order based on the following submissions:<sup>696</sup>

- For the period November 2009 to February 2010, Blyvoor had traded at an unaudited profit of R33.6 million and generated cash flows after capital expenditure of R27.5 million;
- Outstanding debt to creditors' at the time that the provisional judicial management order was granted had been reduced from R39 million to R2 million;<sup>697</sup>
- Majority of pre-judicial management debts had been paid in full and all trade creditors were back on normal terms;<sup>698</sup>
- Monthly production of gold had increased from 272kilograms to 315 kilograms and
- The gold price had risen from R240 000/kg to R265 000/kg.

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<sup>691</sup> (Benade et al 414).

<sup>692</sup> Sections 432(2) and (3) of the Companies Act 61 of 1973 stipulates that "if the court is of the opinion that the company will be enabled to become a successful concern under judicial management and that it is just and equitable to order it, it may grant a final judicial management order; if not it will *discharge the provisional order* or make any order it may deem just."

<sup>693</sup> In terms of section 432(1) of the Companies Act 61 of 1973, any return day fixed under section 428 of the Companies Act 61 of 1973 shall not be later than sixty days after the date of the provisional judicial order but may be extended by the court on good cause shown.

<sup>694</sup> See in this regard I Net Bridge [http://www. Miningmx.com](http://www.Miningmx.com) where it was reported by DRDGOLD that the High Court had granted extension of judicial management (accessed 21-03-2010).

<sup>695</sup> In terms of section 430(c) (i)-(vi) of the Companies Act 61 of 1973, the provisional judicial manager is required to investigate and provide a detailed report on the affairs of the company.

<sup>696</sup> See in this regard DRDGOLD Sustainable Development Report 2010 14 available at <http://www.drdgold.com> (accessed 02-06-2011).

<sup>697</sup> *Ibid.*

<sup>698</sup> Section 435 (1) of the Companies Act 61 of 1973 generally permits creditors of a company whose claims arose before the granting of a judicial management order to resolve all financial liabilities incurred or to be incurred with the provisional judicial manager exclusive of costs of the judicial management.

On 13 April 2010, the High Court after considering the above representations, granted the lifting of the judicial management order. It should be noted that the success story of DRDGOLD under provisional judicial management includes the fact that it did not lead either to job losses or infringement of interested parties rights.<sup>699</sup>

#### **4 4 JUDICIAL MANAGEMENT: STRENGTHS AND WEAKNESSES**

The success of judicial management in South Africa became evident in a few cases although there are criticisms that the mechanism was a failure.<sup>700</sup> The underlying factors below relating to the inefficiency of judicial management should be examined in order to determine ways of making any rescue business rescue mechanism function effectively.

##### **4 4 1 Requirement to qualify for judicial management**

The availability of judicial management for specific categories of companies<sup>701</sup> and the requirement of a debtor who must be seen to be one capable of recovery to the point where it is able to pay all its debts in full is outdated, unrealistic and often contrary to the wishes and interests of both the debtor, creditor and other interested parties in the company.<sup>702</sup> Kloppers<sup>703</sup> agrees with Rajak and Henning<sup>704</sup> who argued that insolvency or pending insolvency should not be a requirement as it restricts the usage of judicial management and that the earlier a company recognises that it is in financial distress and is allowed to re-organise itself, the better the chances of avoiding eventual liquidation .

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<sup>699</sup> DRDGOLD Sustainable Development Report 2010 16 available at <http://www.drdgold.com> (accessed 02-06-2011).

<sup>700</sup> See in this regard Johnson and Meyerman “Insolvency systems in South Africa: Strengthening the Regulatory Framework” <http://www.fps.org> December 2010. (accessed 02/03-2011) 18.

<sup>701</sup> Rajak and Henning 268 had suggested that the judicial management mechanism should be made available for all business entities. But see *Tobacco Auctions Ltd v A W Hamilton (PVT) Ltd* 1966 2 SA 500 (R) where the court had to consider the principle whether judicial management proceedings are really intended to apply to a small company. The court said that if a company is a private company with no more than two or three members or even with few issued shares, it is not a sufficient reason for holding that section 265 of the Companies Act 46 of 1926 is an appropriate form of relief. Further, the fact that a company only has a few members is only a factor to be taken into account together with all other factors in deciding whether it should be placed under judicial management. In the view of the court the company had only two shares, and had already disposed of its assets. The court therefore refused the application to place the company under judicial management.

<sup>702</sup> Section 427(1)(a) of the Companies Act 61 of 1973 stipulated that the company before applying for a judicial management order must be unable to pay its debts.

<sup>703</sup> Kloppers 376.

<sup>704</sup> Rajak and Henning 268.

In the view of Kloppers, making insolvency or near insolvency a condition for judicial management, sharply contrasts the process with rehabilitation of companies under Chapter 11 of the Bankruptcy Code of the United States of America.<sup>705</sup> Rochelle<sup>706</sup> agrees with Kloppers'<sup>707</sup> opinion in which it has been stated that a company's entry into judicial management must be based on the company's insolvency before being permitted to apply for business rescue. In sharp contrast, the requirement in the United States of America is that the debtor qualifies for filing not by being insolvent, but rather by its status which must fit section 109<sup>708</sup> of the United States Bankruptcy Code.

#### **4 4 2 Adversarial nature of judicial management**

It is important to note that one of the greatest difficulties of judicial management can be said to be the process of its application and implementation due to the requirement of the court's active involvement.<sup>709</sup> Similarly, the United Kingdom and Hong Kong<sup>710</sup> have rescue mechanisms which are court sanctioned and therefore require an adversarial approach. In a striking contrast, Australia in relation to the rescue of distressed businesses and making them a going concern again, requires the opposite of an adversarial approach. In Australia the process to rescue distressed businesses involve very little court involvement, thus making the process, simple, cost effective, and swift.<sup>711</sup> Josman J in *Re Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd*<sup>712</sup> pointed out that the applicants who wanted the hotel placed under judicial management should rather engage in negotiations than in a court process as the

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<sup>705</sup> Kloppers 376 submits that in terms of the rehabilitation process in the United States of America, no conditions are laid down for entry and the management of the company is entitled to use the business rescue provisions as 'a matter of right.'

<sup>706</sup> Rochelle 318.

<sup>707</sup> Kloppers 376.

<sup>708</sup> Section 109 of the Bankruptcy Code classifies the debtor to be business debtors such as partnerships, individuals, and companies.

<sup>709</sup> Sections 195(1) of the Companies Act 46 of 1926 corresponding with section 427(1) of the Companies Act 61 of 1973.

<sup>710</sup> See in this regard Carrie and Yan *An Analysis of the Corporate Rescue Objectives: Voluntary Administration in Australia, Administration Order in the United Kingdom and the Provisional Supervision in Hong Kong* (Honours Degree of Business Administration Joint Dissertation submitted to Hong Kong Baptist University, April 2010) (hereafter Carrie and Yan) 6 and 23 where it was submitted that Hong Kong's reorganization of a distressed company is stipulated in section 166 of the Companies Ordinance (CO) and heavily relies on the court for application, approval and implementation. It should be noted though that Hong Kong in response to the global financial crises, introduced a Provisional Supervision procedure (similar to judicial management in pre-2010 South Africa) which unlike United Kingdom, is initiated by the company and its directors rather than creditors of the company.

<sup>711</sup> See in this regard chapter 3 of this dissertation.

<sup>712</sup> 2001 2 SA 727-729.

adversarial process was not ideally suitable for applications for judicial management orders. Courts have made clear their inclinations towards non-interference in internal affairs of companies and propose that judicial management is not an appropriate remedy for settlement of internal disputes among management of a company on the basis of the salutary principle of non-interference.<sup>713</sup> It is true that court processes are cumbersome, costly and time consuming. However, Kloppers<sup>714</sup> argues that the idea of the application to court is to obtain an independent and impartial decision after any possible objections had been made and therefore, creditors would be more satisfied and have more trust in the whole process if they are given the opportunity to be heard in a court of law. In the view of Kloppers, this consideration is counterbalanced by the cost and the delay inherent in an application to court to place a company under judicial management.<sup>715</sup>

#### **4 4 3 Rights of employees during judicial management**

A liquidation order requires all employment contracts to be suspended and terminated 45 days after the appointment of a liquidator.<sup>716</sup> It is not known however if this applied during judicial management although section 439 of the Companies Act 61 of 1973 stipulates that certain provisions relating to winding up shall apply as if the company under judicial management were a a company being wound up and the judicial manager is a liquidator. It has been suggested that judicial management has been made far less attractive because any attempted rescue of a distressed business will invariably involve the downsizing of the company's workforce either as a straightforward cost-saving measure or because the operation of certain viable or loss-making parts of the company's business are halted.<sup>717</sup> Consequently, the statute<sup>718</sup> was silent on the effects on employment contracts when the judicial management order is granted by the court. Employees of companies under judicial management can however be protected under South Africa's insolvency laws.<sup>719</sup>

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<sup>713</sup> *Ben – Tovim v Ben Tovim and Others* 2000 3 SA 264 (C), and *Makhuva and Others v Lukoto Bus Service (Pty) Ltd and Others* 1987 3 SA 376 (V) at 393 H – 394I.

<sup>714</sup> Kloppers "Judicial Management Reform- Steps to Initiate a Business Rescue" 2001 *MERC LJ* 372.

<sup>715</sup> *Ibid.*

<sup>716</sup> Loubser *Some Comparative Aspects of Corporate Rescue in South African Company Law* (LLD Thesis, UNISA 2010) 45.

<sup>717</sup> Loubser "The Interaction Between Corporate Rescue and Labour Legislation: Lessons to be Drawn from the South African Experience" *INTERNATIONAL INSOLVENCY REVIEW* 2005 64.

<sup>718</sup> Sections 427-440 of the Companies Act 61 of 1973.

<sup>719</sup> Section 197B of Insolvency Act 24 of 1936 (as amended) entreats the employer facing financial difficulties to advise his employees about the situation through a consulting party such as the trade union as stipulated in

Section 197B<sup>720</sup> although very wide, compels the employer in financial distress to communicate with the employees regarding the effects that the financial difficulties may have on the business during a winding up. It has been suggested that an application for judicial management could result in an order for liquidation being issued by the court which can happen as a result of the application of an intervening creditor after all the requirements of notice to employees have been complied with by the applicant.<sup>721</sup> However, the situation is not so clear where an application for judicial management contains a prayer for alternative relief and the court refuses a judicial management order but indicates that a liquidation order will be granted as the alternative relief; as in such case no notice would have been given to the employees.<sup>722</sup>

#### **4 4 4 Lack of qualified and skilled judicial managers**

The role of the judicial manager, whether provisional or final, despite being invested with considerable powers and apparently required to carry out functions of considerable public significance, lacks statutory regulation laying down provisions in respect of qualification, competence and suitability.<sup>723</sup> The Harmer Report<sup>724</sup> in its proposals recommended that the administrator who is to be appointed must be a registered, qualified insolvency practitioner with vast experience in insolvency practice. Similarly in Hong Kong, a solicitor holding a practice certificate issued under the Legal Practitioners Ordinance and certified accountants registered under the Professional Accountants Ordinance may be appointed as a provisional supervisor.<sup>725</sup> In South Africa, liquidators were permitted to be judicial managers. Rajak and

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section 189 of the Labour Relations Act of 1995. See also Loubser “The Interaction Between Corporate and Labour Legislation: Lessons to be Drawn from the South African Experience” *INTERNATIONAL INSOLVENCY REVIEW* 2005 61. Loubser 59 submits however that the provisions in the Insolvency Act do not consider judicial management assisting employees although the Chief State law Advisor opined on 24th October 2003 in the Business Report that he foresees judicial management becoming more widely used after the defects in the system have been cured.

<sup>720</sup> Insolvency Act 24 of 1936 and Labour Relations Act 66 of 1996 have been amended with effect from 1 January 2003 and 1 August 2002 respectively to comply with the requirements of global labour practices and the bill of rights enshrined in the South African Constitution.

<sup>721</sup> Loubser “The Interaction Between Corporate Rescue and Labour Legislation: Lessons to be Drawn from the South African Experience” *INTERNATIONAL INSOLVENCY REVIEW* 2005 63.

<sup>722</sup> *Ibid.*

<sup>723</sup> Rajak and Henning 268.

<sup>724</sup> See in this regard the Hammer Report paragraph 72. The Hammer Report 45 was published after the Australian Law Reform Commission conducted an enquiry into the Law of Insolvency. Available at <http://www.alrc.gov.au>. (Accessed 02/02/2010).

<sup>725</sup> Smart and Booth “Corporate Rescue: Hong Kong Developments” *ABL LAW REVIEW* 2002 2.

Henning<sup>726</sup> argued that, liquidators appointment as judicial managers is not sensible as liquidators are skilled or trained to close businesses and not save them.

#### 4 4 5 “Creditors Take All”

The South African insolvency system has been creditor friendly with the notion that creditors must always benefit if the debtor becomes insolvent.<sup>727</sup> Loubser argues that lack of automatic moratorium<sup>728</sup> and the fact that the focus of judicial management was placed on protecting the interest of creditors, similar to the situation in a winding-up, rather than on the rescue of the business, made judicial management defective.<sup>729</sup> It is argued further that a successful rescue is thus narrowly defined as the one that enables full payment of its debts by the company which has in turn directly resulted in judicial management being regarded as an extraordinary remedy that infringes on the rights of creditors. In *Tenowitz and Another v Tenny Investment (Pty) Ltd; Spur Steak Ranches (Pty) Ltd v Tenny Investments (Pty) Ltd*, Smallberg J noted that:

“Where a company is unable to pay its debts, an unpaid creditor has a right *ex debito justitiae* to have it placed in liquidation.”<sup>730</sup>

The facts of the case were that the company had liabilities in excess of R100 000. The secured creditor, Barclays Bank held a security of claim amounting to R53 000. Unsecured

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<sup>726</sup> Rajak and Henning 268.

<sup>727</sup> Sections 10(c) and 12 (1)(C) of the Insolvency Act 24 of 1936. In *Meskin and Co v Friedman* 1948 2 SA 555 at 416(W), the court held that during winding-up, the creditor must prove that he will benefit from the process. The court found that a substantial number of creditors were opposed to the sequestration on the grounds that it will not be to the advantage of all creditors. It held that the views and wishes of a majority or even a substantial proportion of creditors are of great assistance to the court in deciding where the advantage to the creditors lies, but the test is not whether the majority of creditors, either in number or value, would benefit financially. The court emphasized that courts must weigh up all the advantages, indirect as well as direct, and find where the balance of advantage lies.

<sup>728</sup> Loubser “Judicial Management as a Business Rescue Procedure in South Africa” 2004 SA Merc LJ 162. In terms of Section 440D of Australia’s Corporations Act 2001, there is an imposition of moratorium on all claims against the debtor during the period of administration. Section 441A however permits secured creditors to continue with existing enforcement proceedings that commenced prior to the administrator’s appointment. Claims by secured creditors are an exception to this provision although creditors with an enforceable security over “the whole or substantially the whole of the company’s property” may take enforcement action, and may only do so within the first 13 business days of the administration. It should be noted that South Africa’s judicial management mechanism lacked the provision of moratorium on claims against the debtor during the process of reorganization.

<sup>729</sup> Loubser “Judicial Management as a Business Rescue Procedure in South Africa” 2004 SA Merc LJ 162.

<sup>730</sup> 1979 SA 680 E at 683 A-B.

and preferent creditors claims amounted to R42 000. Assets and fixed deposit had a book value of R50 000. The judge stated that:

“although the judicial management order may have to continue for some years before all creditors are paid in full, it is my considered opinion and my respectful submission that the judicial management order should be granted to afford the respondent an opportunity to extricate itself from its financial difficulties to the benefit of the respondent and creditors in general”<sup>731</sup>

Judicial management as a rescue mechanism does not require a plan or a provision for negotiating with creditors when the company is in crisis.<sup>732</sup> It is suggested that this defect in the process does not allow for monitoring where a major restructuring is needed. It has however been submitted that the judicial manager’s sole control of the business and the fact that he must act in the interest of shareholders and creditors, created a divided set of loyalties which may have led to decisions that were potentially not in the interest of creditors.<sup>733</sup>

#### **4 5 CONCLUSION**

Despite the general notion that judicial management was a failure, the minute success of its application could have served as a guide in reforming it with a view to increasing its success rate. It is submitted that, more value can be realised if a regulated plan for restructuring ailing businesses is put in place by the legislature. It is further submitted that any radically reformed business rescue mechanism must consider the rights of all interested parties and stakeholders in the business community. South Africa must keep pace with other jurisdictions in terms of trade and effective legal regulation relating to corporate rescues.<sup>734</sup>

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<sup>731</sup> *Tenowitz and Another v Tenny Investments (Pty) Ltd Spur Steak Ranches (Pty) Ltd v Tenny Investments (Pty) Ltd* 1979 SA 680 E at 685 F.

<sup>732</sup> Johnson and Meyerman 18.

<sup>733</sup> *Ibid.*

<sup>734</sup> Carrie and Yan 29.

## CHAPTER FIVE

### Critical Analysis of the Business Rescue Mechanism under Chapter Six of the Companies Act 71 of 2008

#### 5 1 INTRODUCTION

Most critical observers in South Africa and beyond will agree that South Africa has developed progressively by revamping its Companies Act to promote economic growth in addition to attracting foreign investment. In the late 1990s, the country's business rescue system was considered to be in need of complete overhaul and transformation from judicial management<sup>735</sup> to a modern business rescue mechanism. This chapter will examine the new business rescue mechanism introduced by the Companies Act 71 of 2008<sup>736</sup> which has been developed based on similar corporate rescue systems in other jurisdictions, especially the United States of America, the United Kingdom and Australia.<sup>737</sup>

It is trite that every country needs a strong economy based on companies that can engage in efficient production and provision of goods and services. The general philosophy permeating through the business rescue provisions is the recognition of the value of the "business rescue" and not the "company rescue".<sup>738</sup> Chapter 6 of the New Act provides a mechanism aimed at saving financially distressed companies rather than liquidating them if viability exists. The need for an effective business rescue mechanism has been sharply highlighted by the recent collapse of two South African low-cost airlines. In the more recent of the two cases, 1time Airline Holdings has been placed under liquidation in November 2012 after trading with an

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<sup>735</sup> Judicial management as discussed in the previous chapter had existed in the corporate world since 1926 but with the business world changing in response to globalization pressures, the South African government and other stakeholders were determined to effect reforms of the company rescue system in the old companies legislation, hence the birth of 'business rescue' in place of judicial management. See Smits "Corporate administration: A proposed model" 1999 *De Jure* 80.

<sup>736</sup> The Companies Act 71 of 2008 will hereafter be referred to as the "New Act"

<sup>737</sup> Rushworth "A Critical Analysis of the Business Rescue Regime in the Companies Act 71 of 2008" 2010 376. (Hereafter Rushworth). Available at [www.companylaw.uct.ac.za/research/rushworth](http://www.companylaw.uct.ac.za/research/rushworth).

<sup>738</sup> *Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others* 2012 (3) SA 273 (GSJ) Paragraph 12.

estimated R320 million in short-term debt and after the failure of negotiations with its creditors which had been going on since March 2012.<sup>739</sup> In the earlier case of Velvet Sky Airlines, a major creditor, BP Southern Africa, applied to court for the airline's liquidation and contended that the debtor company's requests for adjournment would only have the effect of delaying the inevitable liquidation.<sup>740</sup> The airline was placed under provisional liquidation in May 2012 after major fuel supply companies decided to stop supplying fuel to the airline because their bills were not being paid.

In the discussion below, attempt will be made to analyse the new business rescue mechanism with a view to determining its prospects of rescuing distressed businesses. The said Chapter 6 of the New Act consists of two parts: business rescue proceedings and compromise with creditors. However, given the focus of this study on business rescue, this chapter examines only the business rescue provisions of the New Act.

## **5 2 BUSINESS RESCUE: POLICY RATIONALES**

The definition of 'business rescue' in the New Act sets out the aims of preventing businesses from failing. In terms of the New Act, 'business rescue' means proceedings initiated to facilitate the rehabilitation of a company that is financially distressed by providing for the temporary supervision and management of the affairs, business and property of the company.<sup>741</sup> Furthermore, a temporary moratorium on the rights of claimants against the company or in respect of property in its possession is created.<sup>742</sup> In addition, business rescue

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<sup>739</sup> Noble "Liquidated 1Time Airlines highlights the Need for Strong Cash Flow Management "Available at [http:// www.ITINews.co.za](http://www.ITINews.co.za) (accessed 07/11/2012).

<sup>740</sup> See in this regard <http://www.fin24.companies/TravelAndleisure/Velvet-Sky-liquidated20120621>. (accessed 22-06-2012) Eventually, on 11 May 2012 Gyanda J dismissed a second application for implementation of a business rescue plan. Gyanda J's reasons for dismissing the application among others were that the application to place Velvet Sky Airlines under business rescue provided scant detail and might be a ploy to delay liquidation proceedings.

<sup>741</sup> Section 128(1) (b) (i) of the New Act.

<sup>742</sup> Section 128 (1) (b) (ii) of the New Act.

aims at the development and implementation of an approved plan that can save the company by restructuring its affairs, business, property, debt and other liabilities, as well as its equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis.<sup>743</sup> This is now being referred to as the ‘primary objective’ of business rescue under the New Act.<sup>744</sup> And where it is not possible for the company to so continue in existence, business rescue aims to secure a better return for the company’s creditors or shareholders than would result from the immediate liquidation of the company.<sup>745</sup> Similarly, the latter is now being referred to as the ‘secondary objective’ of the business rescue mechanism.<sup>746</sup>

It should be noted that any strong and emerging modern economy, such as South Africa, will enact legislation that seeks to protect businesses. While it is quite healthy and normal for a company to fail, the downside of this is that it may have a major impact on the economy and the employees who are employed by that company; in circumstances where there is a winding-up the revenue generated by that company will be lost to the economy, and the resultant job losses may have an extremely negative impact on the communities from where these businesses are operated.<sup>747</sup> The fundamental purpose of a business rescue is, therefore, to prevent a debtor from going into liquidation, with the attendant loss of jobs and possible misuse of economic resources.<sup>748</sup> In the recent case of *Koen and Another v Wedgewood Village Golf and Country Estate (Pty) Ltd and Others*,<sup>749</sup> the court made the following instructive statement specifically regarding the policy rationales behind the new business rescue mechanism:

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<sup>743</sup> *Ibid.*

<sup>744</sup> See Cassim *et al* 864

<sup>745</sup> Section 128(1) (b) (iii) of the New Act.

<sup>746</sup> See Cassim *et al* 864

<sup>747</sup> Davis *et al Companies and Other Business Structures* in South Africa (2009) 163 (hereafter referred to as Davis *et al*).

<sup>748</sup> Cassim *et al Contemporary Company Law* (2011) 785 (hereafter referred to as Cassim *et al*).

<sup>749</sup> 24850/11 2011 ZAWCHC 464, para 14.

“It is clear that the legislature has recognised that the liquidation of companies more frequently than not occasions significant collateral damage, both economically and socially, with attendant destruction of wealth and livelihoods. It is obvious that it is in the public interest that the incidence of such adverse socio-economic consequences should be avoided where reasonably possible. Business rescue is intended to serve that public interest by providing a remedy directed at avoiding the deleterious consequences of liquidations in cases in which there is a reasonable prospect of salvaging the business of a company in financial distress ....”

Accordingly, as legislated in the New Act, the business rescue proceeding must be a debtor-friendly procedure that is flexible, uncomplicated and swift to implement.<sup>750</sup>

### 5 3 INITIATING THE BUSINESS RESCUE PROCESS

The New Act allows for two possible ways of initiating the business rescue process.<sup>751</sup>

Business rescue is a formal process which may be initiated by the board of a company based on either a voluntarily adopted resolution,<sup>752</sup> or in the absence of a board resolution, a court order sought by an affected person<sup>753</sup> to place the company under supervision and commence business rescue proceedings.<sup>754</sup> In *Cape Point Vineyards (Pty) Ltd v Pinnacle Point Group*

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<sup>750</sup> *Ibid.*

<sup>751</sup> Joubert, Van Eck and Burdette “The expected impact of labour law principles on South Africa’s new corporate rescue mechanism including a comparison with the position in the European Union” available at <http://www.business-rescue.co.za/businessrescue/mhtml:file> (accessed 10-12-2011).

<sup>752</sup> Section 129(1) of the New Act.

<sup>753</sup> Section 128(1) of the New Act defines an ‘affected person’ for the purposes of business rescue proceedings as a shareholder or creditor of the company, any registered trade union representing employees of the company and any of the employees of the company not represented by a registered trade union. In *A G Petzetakis International Holdings Limited v Petzetakis Africa (Pty) and Others* 3589/11 2012 ZAGPGJHC paragraphs 4, 5, and 11, the court held that the National Union of Metalworkers of South Africa (NUMSA) is a registered trade union which represents employees and that in terms of section 130(4) of the Companies Act 71 of 2008, it has an automatic right to participate in the business rescue proceedings as an ‘affected person’ without the need of an order to do so. In the view of the court if the person is an ‘affected person’ such person has a right to participate in the hearing. Furthermore, if the person wishes to file affidavits, the court will obviously need to regulate the procedure to be followed to ensure fairness to all concerned. In this case, Petzetakis Africa (Pty) Ltd was in financial trouble and unable to pay its debts, with its assets amounting to R60 million and its liabilities amounting to R225 million. The business rescue application was preceded by the commencement of litigation which included liquidation application by Sasol Polymers, a division of Sasol Chemicals Industries Ltd. The court had to hear an application made by NUMSA to postpone the business rescue proceedings. Coetzee AJ held that the application for postponement of the business rescue proceedings could not be allowed due to the merits of the case. In the view of the court, although the affected person has a right to participate in the business rescue proceedings, the exercise of such right must not prejudice other interested parties.

<sup>754</sup> Section 131(1) of the New Act.

*Ltd and Another (Advantage Projects Managers (Pty) Ltd Intervening)*<sup>755</sup> the court held that affected persons need not apply for leave to intervene in the application for business rescue; rather affected persons have the right to participate in the hearing. However, if the person wished to file affidavits, the court would obviously need to regulate the procedure to be followed to ensure fairness to all concerned.<sup>756</sup> The court heard that the applicant had successfully applied for an order under section 131 of the New Act for the first respondent, a financially distressed company, to be placed under supervision, and for business rescue proceedings to be commenced. The court ordered that costs in the application should be borne by the distressed company. Conversely, the court held that although section 131 of the New Act does not expressly empower the court to make such an order, the court has the power under section 131 to make a costs order. The court stated that although a statute may in a specific instance vary the usual general jurisdiction regarding costs, the mere absence of an express provision for the court to make a costs order in a particular type of statutory proceeding does not mean that the court has no such power.

In *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd*,<sup>757</sup> Eloff AJ pointed out that the business rescue application must address the cause of the probable demise or failure of the company's business, and offer a remedy that has a reasonable prospect of being sustainable and should not prolong the agony, that is, by substituting one debt for another without there being a light at the end of a not-too-lengthy tunnel.<sup>758</sup> The court further suggested that it was necessary for an application to indicate the

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<sup>755</sup> 2011 5 SA 600 (WCC) 606 H-607A.

<sup>756</sup> See para 21.

<sup>757</sup> 2012(SA) 423(WCC).

<sup>758</sup> 2012 (SA) 423 (WCC) para 24. In this case, Zoneska Investments launched an application for the compulsory winding-up of the respondent, Midnight Storm Investments 386 Ltd, based on its inability to pay its debts being the outstanding balance of monies lent and advanced by Zoneska to the respondent in terms of a written agreement of loan. See para 16. But for the application subsequently launched by Southern Palace Investments 265 (Pty) Ltd for business rescue proceedings to be commenced in respect of the respondent in terms of the provisions of section 131 (1) of the New Act, there was no reason for the winding-up application

likely cost of the business rescue, and where the money to pay the business rescue practitioner will come from.<sup>759</sup>

Furthermore, the court in *Koen and Another v Wedgewood Village Golf and Country Estate (Pty) and Others*<sup>760</sup> held that a person making an application for a business rescue in terms of section 131(1) of the New Act must satisfy the court that there is a reasonable prospect that the subject company can be rescued in the relevant sense by being placed under supervision.<sup>761</sup> In the view of the court, the information or evidence that will suffice to meet the requirement will depend on the object of the proposed business rescue, viz, whether it is to achieve the continued existence of the company on a solvent basis, or alternatively, to allow the company's business to be managed for an interim period to allow for a better return to the company's creditors or shareholders than would result from the immediate liquidation of the company.

It should be noted that although the voluntary resolution by the board that places the distressed company under business rescue restricts the company from doing so when liquidation proceedings have been initiated by or against the company, the court order sought by an affected person<sup>762</sup> allows the company to be placed under business rescue proceedings

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of Zoneska not to be granted. The court dismissed the business rescue application of Southern Palace on the basis that the contents were extremely terse, vague and uninformative. See para 24.

<sup>759</sup> Para 26.

<sup>760</sup> 24850/11 2011ZAWCHC 464.

<sup>761</sup> *Ibid*, paras 17, 19, 20 21 and 23. In this case, the applicants were the purchasers of a vacant plot which was a sub divisional unit on the area of land which the company was engaged in developing as a golf estate. The plot was acquired at a price which appears to have been determined on the assumption that it would lie within a fully developed estate. The company's expenditure proved it was unable to sustain its development operations as its principal funder, Nedbank, refused to extend its exposure hence work on the development consequently grounding to a halt. Nedbank as a creditor, was owed R60 million and to its holding company (under liquidation) in a sum of R118 million. The applicants (Mr and Mrs Koen) wanted the company placed under supervision to achieve business rescue objective. The court held that the applicants fell woefully short of furnishing the court with the material required to make an assessment of whether a reasonable prospect of business rescue succeeding existed.

<sup>762</sup> In *Engen Petroleum Ltd v Multi Waste Ltd* 33410/11 (GSJ), the court took the approach that an affected person would not require leave of the court to intervene but that such leave may however be necessary as a procedural requirement. In this case, an urgent application was brought by an intervening creditor, Engen Petroleum Limited (Engen) to oppose the grant of an order for the placement of the respondent companies under supervision and to commence business rescue proceedings. It was common cause that another creditor, Alondra

even if a liquidation order has been served on the company.<sup>763</sup> Significantly, however, the procedure is that if the liquidation proceedings have already been commenced by the company or against the company at the time an application for business rescue is made, the court will suspend the liquidation application and adjudicate on the issue whether the business rescue procedure should be allowed and the liquidation proceedings terminated.<sup>764</sup> In addition, the court has the power to enforce any security against the company if it considers it just and equitable to do so.<sup>765</sup> In *Firststrand Bank Limited v imperial Crown Trading 143 (Pty) Ltd*,<sup>766</sup> the court held that in terms of section 131(1) of the New Act, where liquidation proceedings have been commenced by or against the company at the time application is made for an order placing the company under supervision and commencing business rescue proceedings, it would be anomalous to hold that what was meant by liquidation proceedings being initiated by or against the company for the purposes of section 129(2)(a)<sup>767</sup> differed from what was meant by liquidation proceedings by or against the company in terms of the purposes of the New Act. Another restriction that the New Act places on the company's resolution for business rescue is that, the board's resolution has no force or effect unless it is filed with the Companies and Intellectual Property Commission

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Trading CC, had also instituted winding-up proceedings against the respondent. The court held that the business rescue application was bristling with procedural irregularities. In terms of section 131 of the New Act, a copy of an application to place a company under business rescue must be served on each affected person in the prescribed manner. Moreover, Regulation 124 of The Companies Regulation GNR351 in Government Gazette (GG) 34239 of 26 April 2011, specifically provides that an applicant in court proceedings is required in terms of section 130(3)(b) or section 131(2)(b) to notify affected persons that an application has been made to a court. The court therefore held that an applicant must satisfy the court that all reasonable steps have been taken to notify all affected persons known to the applicant. The court further held that a business rescue application falls to be dismissed where there was no compliance or even substantial compliance with the requirements laid down in the New Act and Regulations.

<sup>763</sup> (Cassim *et al* 790).

<sup>764</sup> Section 131(6) (a) (b) of the New Act.

<sup>765</sup> Section 131(7) of New Act.

<sup>766</sup> 129/2011(KZD). See Delport, Vorster, Burdette, Esser & Lombard *Henochsberg on the Companies Act 71 of 2008* (2011) 453. (hereafter Delport, Vorster, Burdette, Esser & Lombard *Henoschsberg*).

<sup>767</sup> Section 129(2)(b) of the New Act states that subject to subsection 129(2)(a) of the New Act, a resolution for placing a company under business rescue may not be adopted if liquidation proceedings have been initiated by or against the company and it has no force or effect until it has been filed.

(the Commission).<sup>768</sup> Furthermore, within five business days after the company has adopted and filed the resolution, the company must publish a notice of the resolution, and its effective date, in the prescribed manner to every affected person, including the notice of a sworn statement of the facts relevant to the grounds on which the board's resolution was founded.<sup>769</sup> A distinct advantage however, of authorising the board of directors to make the decision to place the company under business rescue is that it avoids unnecessary delay and cost.<sup>770</sup>

The board's resolution may be set aside if an affected person in relation to the company successfully applies to the court for such an order on the grounds that there is no reasonable basis for believing that the company is financially distressed, or there is no reasonable prospect of rescuing the company or the company failed to satisfy the procedural requirements set out in section 129 of the New Act.<sup>771</sup> What is important though is that there should be reasonable grounds to believe that the company is financially distressed and there appears to be a reasonable prospect of rescuing the business.<sup>772</sup> The New Act however stipulates that the company must be regarded as financially distressed at a particular time if it appears to be reasonably unlikely that the company will be able to pay all its debts as they fall due and payable within the immediately ensuing six months.<sup>773</sup> In addition, the company which is financially distressed must show a reasonable likelihood that it will be insolvent within the immediately ensuing six months.<sup>774</sup>

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<sup>768</sup> Section 129(2) (b) the New Act.

<sup>769</sup> Section 129(3) (a) of the New Act. See also Loubser "The Business Rescue Proceedings in the Companies Act of 2008: Concerns and Questions (Part 1) 2010 *TSAR* 502.

<sup>770</sup> (Cassim *et al* 785).

<sup>771</sup> Section 130(1) (a) (i) (ii) (iii) of the New Act. See also (Davis *et al* 169).

<sup>772</sup> Section 129(1) (a) and (b) of the New Act.

<sup>773</sup> Section 128(1) (f) (i) of the New Act. See also Rushworth 2010 *Acta Juridica* 377.

<sup>774</sup> Section 128(1) (f) (i) of the New Act.

The prescribed tests consist of a cash flow insolvency test based on the inability of the company to pay its debts and a balance -sheet test<sup>775</sup> based on the value of assets of the company relative to the amount of its liabilities at any particular time.<sup>776</sup> In sharp contrast, a company may be compulsorily wound up where the court is satisfied that the company is indeed insolvent in terms of either one of the test where it is demonstrated that the company is likely to be insolvent which then leads to the appointment of an administrator.<sup>777</sup>

### **5 3 1 Appointment and removal of the business rescue practitioner**

The New Act makes it obligatory for the company to appoint a business rescue practitioner.<sup>778</sup> Such a practitioner must fulfill certain requirements before he or she can be appointed. Section 138<sup>779</sup> requires that the business rescue practitioner must satisfy the requirements of being a person who member in good standing of a profession subject to regulation by a regulatory authority prescribed by the Minister;<sup>780</sup> not subject to an order of

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<sup>775</sup> In *Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others* 2012 (3) SA 273 Paragraph 4 the court held that the financially distressed company must comply with the requirement of the company being unable to pay all of its debts as they become due and payable within the immediately ensuing six months or becoming insolvent within the immediately ensuing six months before qualifying for the balance sheet or commercial insolvency test.

<sup>776</sup> Rushworth 2010 *Acta Juridica* 377.

<sup>777</sup> Boyle & Birds *Company Law* (2009) 813-814 (hereafter referred to as Boyle & Birds).

<sup>778</sup> Section 129(3) (b) of the New Act stipulates that a business rescue practitioner who satisfies the requirements of section 138, and who has consented in writing to act must oversee the business rescue process.

<sup>779</sup> Section 138 of the New Act.

<sup>780</sup> Section 138(2) of the New Act stipulates that the Minister of Trade and Industry may designate one person or association to regulate the practice of persons as business rescue practitioners. It has been submitted by Johnson and Meyerman "Insolvency systems in South Africa: Strengthening the regulatory framework" 2010 22 (hereafter Johnson and Meyerman). Available at <http://www.fps.org> (accessed 02/03-2011). The regulations accompanying the New Act provide for prospective business rescue practitioners to be licensed by a designated Commission having certification, oversight and monitoring responsibilities for such professionals. They also note that the business rescue practitioner need not belong to a particular profession such as a lawyer or accountant but should rather be a practitioner that possesses interdisciplinary skills, including knowledge of business management, accounting and financial procedures unique to financially distressed businesses. In contrast, under the United Kingdom's administration procedure, Hannigan *Company Law* (2009) 620 (hereafter Hannigan) has opined that the administrator is only required to be a qualified insolvency practitioner as stipulated by the Insolvency Act 1986, Sch B1, and para 5 as well as an officer of the court. The rationale for requiring the administrator to be an officer of the court is based on the fact that officers of the court are held to high standards of conduct.

probation in terms of section 162(7) of the New Act;<sup>781</sup> would not be disqualified from acting as a director of the company in terms of section 69(8) of the New Act;<sup>782</sup> does not have any other relationship with the company such as would lead a reasonable and informed third party to conclude that his/her integrity, impartiality or objectivity is compromised by that relationship; and most importantly, is not related to a person who has a relationship with the director or the practitioner of the company.<sup>783</sup>

An affected person is entitled to apply to the court for an order setting aside the appointment of the business rescue practitioner on grounds that the business rescue practitioner does not satisfy the requirements of section 138 of the New Act in that he or she is not independent of the company or its management or lacks the necessary skills, having regard to the company's circumstances.<sup>784</sup> It should be noted however that in the event of the court making an order to set aside the appointment of the business rescue practitioner, the court is required to appoint an alternate business rescue practitioner who satisfies the requirements of section 138 of the New Act, recommended by, or acceptable to a majority of the independent creditors.<sup>785</sup>

The business rescue practitioner's appointment is effective only if the company filed a notice of the appointment within two business days after making the appointment and proceeded to publish a copy of the notice of appointment to each affected person within five

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<sup>781</sup> Section 162(7) of the New Act states that a court may make an order to place a person under probation if while serving as a director the person failed to vote against a resolution despite the inability of the company to satisfy the solvency and liquidity tests and acted in a manner inconsistent with the duties of a director.

<sup>782</sup> This provision states clearly that a person is disqualified as a director if a court of law has prohibited that person from acting as a director, or declared that person to be delinquent, or if the person is an unrehabilitated insolvent, is prohibited in terms of any public regulation from being a director of a company or if the person has been convicted due to misconduct.

<sup>783</sup> Section 128(1) (g) of the New Act. (Davis *et al* 168) submit that an employee of a company is not related to that company. A person however is related to the company if she or he has the ability to influence materially the policy of the company and can exercise an element of control. Further he or she is also related to a director or business rescue practitioner if they are married, live together in a relationship similar to marriage, or are relatives separated by no more than three degrees.

<sup>784</sup> Section 130(1) (b) (i) (ii) (iii) of the New Act.

<sup>785</sup> Section 130(6) (a) New Act.

business days after the notice was filed.<sup>786</sup> In terms of the New Act the only procedure for removing the business rescue practitioner is by an order of court<sup>787</sup> made pursuant to the request of an affected person.<sup>788</sup> The court may remove the business rescue practitioner from office on the grounds that he or she is incompetent and has failed to perform the duties and functions bestowed on him or her, has engaged in unethical or illegal conduct, lacks independence in performing his duties, or has a sense of conflict of interest.<sup>789</sup> The business rescue practitioner can also be relieved of his duties due to incapacitation to perform his duties and is unlikely to regain that capacity within a reasonable time.<sup>790</sup> In terms of the Act though, the company or the creditor who nominated the practitioner must appoint a new practitioner in the event of death, resignation or removal from office, subject to the right of an affected person to bring a fresh application in terms of section 130(1) (b) of the New Act to set aside that new appointment.<sup>791</sup>

### **5 3 2 The powers and duties of the business rescue practitioner**

It has been observed that the duties and powers of the business rescue practitioner are focused largely on managing the day to day affairs of the company, investigating the cause of its financial distress and developing and implementing a business rescue plan for the company. The success of the business rescue proceedings depends to a large extent on the competency, skill and experience of the business rescue practitioner.<sup>792</sup> The practitioner has full management control of the company in substitution for its board and pre-existing management.<sup>793</sup> Although the practitioner may delegate any power or function to anyone

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<sup>786</sup> Section 129(4) (a) (b) of the New Act. See also (Davis *et al* 166).

<sup>787</sup> See generally section 130 of the New Act.

<sup>788</sup> Section 139(2) of the New Act. See also Rushworth 2010 *Acta Juridica* 390.

<sup>789</sup> Section 139 (2)(a)-(e) of the New Act .

<sup>790</sup> Section 139 (2) (f) of the New Act.

<sup>791</sup> Section 139(3) of the New Act. See also Rushworth 2010 *Acta Juridica* 391.

<sup>792</sup> (Cassim *et al* 805).

<sup>793</sup> See generally section 140(1) (a) of the New Act .

who was part of the board or pre-existing management of the company if he deems fit,<sup>794</sup> in terms of the New Act, the practitioner also has the power to remove from office any person who was part of the pre-existing management of the company<sup>795</sup> or appoint a person as part of the management whether to fill a vacancy or not.<sup>796</sup>

The business rescue practitioner however appointed is an officer of the court<sup>797</sup> and must report to the court in accordance with any applicable rules or orders made by the court.<sup>798</sup> It should be emphasized however that the responsibilities and duties are accompanied with liabilities as set out in sections 75 to 77.<sup>799</sup> Although the business rescue practitioner may not be liable for any act or omission in good faith in the course of the exercise of the powers and performance of the duties bestowed on him, he may be held liable in accordance with any relevant law for the consequences of any act or omission amounting to gross negligence.<sup>800</sup>

An important safeguard is that, if the business rescue process concludes with an order placing the company in liquidation, the business rescue practitioner may not be appointed as a liquidator of the company.<sup>801</sup> In sharp contrast, *Gamble J in Nedbank Ltd v Bestvest 153 (Pty) Ltd*<sup>802</sup> held that a plan which proposed that although the financially distressed company could not be rescued as a going concern, a business rescue practitioner should be appointed in order to sell the company's sole asset was credible where such a move is shown to be financially

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<sup>794</sup> Section 140(1) (b) of the New Act. See also (Cassim *et al* 804).

<sup>795</sup> Section 140(1) (c) (i) the New Act.

<sup>796</sup> Section 140(1) (c) (ii) of the New Act.

<sup>797</sup> Similarly (Hannigan 620) is of the view that the United Kingdom's administration procedure for business rescue regards the administrator as an officer of the court and must take orders from the court where necessary.

<sup>798</sup> Section 140(3) (a) of the New Act.

<sup>799</sup> Section 140(3) (b) of the New Act.

<sup>800</sup> Section 140(3) (i) (ii) of the New Act. Sections 75 and 76 of the New Act set out the director's liability in terms of the Act. Section 75 explains the director's personal financial interest in a company, while section 76 sets out the standards of directors' conduct. In terms of section 77 of the Act, directors and other prescribed officers are liable for mismanagement and unauthorized conduct related to the company.

<sup>801</sup> (Cassim *et al* 806).

<sup>802</sup> WCC Case No 21857/2011 delivered on 12 June 2012. In this case the court held that one would expect an applicant for business rescue in circumstances where it seeks to have the company's sole asset sold (*in casu* in effect to itself or more correctly to its nominee of which it will be a majority if not sole shareholder) to set out what the reasonable cost would be of bringing the building (*in casu* the hotel development) to completion in order for the business to be commercially viable, what the prospects are of raising the finances required for the completion of the building, how best the building when completed can attain commercial viability, for example whether it can be developed in the same manner or another or sold to a prospective purchaser.

more beneficial for creditors than if the company were to be wound up. The court stated that, based on a purposive approach to the interpretation of sections 128 and 131 of the New Act, such a plan was permissible under the legislation.<sup>803</sup>

### **5 3 3 Legal consequences of a business rescue procedure**

One of the legal consequences of an order placing a company business rescue is the placing of a moratorium on the financially distressed company. This automatic stay of proceedings consists of a moratorium on legal proceedings and on the property interests of the business during the business rescue process.<sup>804</sup> Generally, the effect of the moratorium is to give the business a breathing space and thereby provide it with the opportunity to make arrangements with its creditors and members for the rescheduling of its debts and the reorganization and restructuring of its affairs.<sup>805</sup> It is interesting to note here that the United Kingdom's administration order makes provision for an interim moratorium which is similar to the above moratorium that forms a critical part of South Africa's new business rescue procedure.<sup>806</sup>

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<sup>803</sup> Companies Act 71 of 2008.

<sup>804</sup> See generally sections 133-134 of the New Act.

<sup>805</sup> (Boyle & Birds 836).

<sup>806</sup> It is argued that Sch B1, para 44 of the United Kingdom's Enterprise Act 2002 stipulates that in certain circumstances prior to the formal appointment of the administrator, an interim moratorium precluding actions against the company by creditors and others is put in place to ensure that the status *quo* of the company is preserved. In effect, the interim moratorium applies where an application for an administration order has been made to the court, a qualifying floating charge holder has filed with the court a copy of a notice of intention to appoint an administrator or the company directors have filed with the court a copy of a notice of intention to appoint an administrator. Furthermore, in sharp contrast to South Africa's moratorium, the duration of the United Kingdom's moratorium in its administration procedure depends on the route into administration which is being pursued. If the administrator is to be appointed by the court, the moratorium applies where an administration application has been made and the application has not yet been granted or dismissed or the application has been granted but the administration order has not yet taken effect. In situations where the administrator is to be appointed by a qualifying floating charge holder, the moratorium applies from the time when a copy of the notice of intention to appoint is filed with the court until the appointment of the administrator takes effect or the period of five business days beginning with the date of filing. On the other hand, if the administrator is to be appointed by the company or the board, the moratorium applies from the time when the copy of the notice of intention to appoint is filed with the court until the appointment of the administrator takes effect. See generally (Hannigan 620-621).

In relation to legal proceedings, the distressed company is extensively protected against any enforcement action.<sup>807</sup> However it is important to note that the New Act creates a number of exceptions to the general moratorium on legal proceedings during business rescue process which similarly, the United Kingdom's Companies Act requires as follows:<sup>808</sup> where the practitioner has consented in writing;<sup>809</sup> where the court considers it just and equitable;<sup>810</sup> where the claim is made by way of set-off<sup>811</sup> irrespective of whether those proceedings commenced before or after the business rescue proceedings began;<sup>812</sup> where the proceedings consists of criminal proceedings against the company or any of its directors or officers<sup>813</sup> or proceedings concerning any property or right over which the company exercises the powers of a trustee.<sup>814</sup>

The New Act provides that during business rescue proceedings, a guarantee or surety by a distressed company in favour of any other person may not be enforced by any person against the company except with leave of the court and in accordance with any terms the court considers just and equitable.<sup>815</sup> In *Investec Bank Ltd v Bruyns*<sup>816</sup>, the court distinguished between the general moratorium provision in terms of section 133(1) of the New Act and the

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<sup>807</sup> Section 133(1) of the New Act.

<sup>808</sup> According to Boyle & Birds 839, the United Kingdom's statutes, namely, Part VII of the Companies Act 1989, Financial Collateral Regulations 2003, SI 2003/3112, give effect to the European Commission (EC) Financial Collateral Directive, Directive 2002/EC which encapsulates similar exceptions in relation to automatic stay of proceedings against a company under administration.

<sup>809</sup> Section 133(1) (a) of the New Act.

<sup>810</sup> Section 133(1) (b) of the New Act.

<sup>811</sup> Oxford Dictionary of Law 2003 457 defines the 'set-off right' as a monetary cross-claim that is also a defense to the claim made in the action by the plaintiff. Any claim by a defendant to a sum of money that is used as a defence may be set off against the claimant's claim.

<sup>812</sup> Section 133(1) (c) of the New Act.

<sup>813</sup> Section 133(1) (d) of the New Act. See also (Cassim *et al* 794).

<sup>814</sup> Section 133(1) (e) of the New Act.

<sup>815</sup> Section 133(2) of the New Act. See also *Investec Bank Ltd v Bruyns* 19449/11 WC 14 November 2011 page 6 para 14.

<sup>816</sup> 19449/11(WCC) 14 November 2011. The facts of the case were that the plaintiff asked for summary judgment against the defendant on various claims, the first claim being an amount of R1 115 933, 44, other claims amounting to R11 811 721, 86 were based on suretyships the defendant executed in the plaintiff's favour for the debts of Golf Development International Holdings (Pty) Ltd and Winners Circle 111 (Pty) Ltd, both in liquidation. In the view of the court, there is no reference in the suretyship to business rescue proceedings, since the suretyships were executed before the enactment of the New Act. The court granted the application for summary judgment and ordered the defendant to pay the plaintiff.

specific provision relating to sureties and guarantees contained in section 133(2) of the New Act. In the view of the court this provision deals specifically with the enforcement of claims against the company based on guarantees and suretyships, and stipulates that claims against the company may be enforced only with the leave of court.<sup>817</sup> Moreover, the provision explicitly referring to a contract of suretyship by a company and to its enforcement by another person against the company does not protect the surety in respect of the debts of a company.<sup>818</sup> In the *Investec Bank* case, Roger AJ further held that the statutory moratorium in favour of a company that is undergoing business rescue proceedings is a defence in *personam* which is a personal privilege or benefit in favour of the company.<sup>819</sup> Furthermore, if any right to start business rescue proceedings or otherwise assert a claim against a company is subject to a time limit, the measurement of that time limit must be suspended during the company's business rescue proceedings.<sup>820</sup> However, Cassim *et al* argue that this provision in the New Act protects third parties, in that the period during which the company is under business rescue is not counted when calculating the time limit to which the claim against the company is subject.<sup>821</sup>

The New Act contains provisions of automatic stay on the company's property interests. In the course of business rescue proceedings, notwithstanding any agreement stating otherwise, no person may exercise any right in relation to property lawfully possessed by the company unless the business rescue practitioner consents thereto in writing; and in this respect ownership of the property is irrelevant.<sup>822</sup> However, the business rescue practitioner may not unreasonably withhold his consent and must consider the purposes of the business rescue

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<sup>817</sup> See in this regard Delport, Vorster, Burdette, Esser & Lombard *Henochsberg* 474.

<sup>818</sup> *Investec Bank Ltd v Bruyns* 19449/11(WCC) 14 November 2011.

<sup>819</sup> *Investec Bank Ltd v Bruyns* 19449/11(WCC) 14 November 2011 paragraph 18.

<sup>820</sup> Section 133(3) of the New Act.

<sup>821</sup> (Cassim *et al* 794).

<sup>822</sup> Werksmans Incorporated "Chapter 6 of the Companies Act 71 of 2008 - Business Rescue and Compromise with Creditors – Guidelines for the South African Banking Sector" available at <http://www.werksman.co.za>, (accessed 20-02-2011).

provisions, the circumstances of the company, the nature of the property and the rights<sup>823</sup> claimed in respect of it.<sup>824</sup>

It has been submitted that before a company under business rescue disposes of property over which a third party has any security or title interest, such company must obtain the third party's consent unless the proceeds of the disposal will be sufficient to cover the third party's claim during the business rescue proceedings and in addition, the company must pay as much of the proceeds to that third party as are owing or provide security to the reasonable satisfaction of the third party.<sup>825</sup> Rushworth<sup>826</sup> has however argued that there seems to be some overlapping between the moratorium restriction against legal proceedings in respect of property lawfully in the company's possession, which is subject to a practitioner or court consent, and the specific restriction against a person exercising any right in respect of property in the lawful possession of the company, whether or not owned by the company, where the practitioner, but not the court, may agree to the exercise of such a right.

It can be very difficult for a company to obtain capital when it is subject to business rescue proceedings, as creditors will be concerned that they may not be paid.<sup>827</sup> In order to address this uncertainty, section 132 (2) of the New Act contains provisions that clearly permit the company to use its assets as security for loans and provides that these creditors, irrespective of whether they were given security for their claims, must be repaid before any other unsecured creditors.<sup>828</sup> Also the New Act provides that to the extent that any remuneration, reimbursement for expenses or other amount of money relating to employment becomes due and payable by the company to an employee during the business rescue

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<sup>823</sup> (Cassim *et al* 796) submit that this right is subject to section 136(2) of the New Act which confers on the practitioner a discretion to cancel or suspend the agreement but also creates as a remedy for the third party to claim for damages only.

<sup>824</sup> *Ibid.*

<sup>825</sup> *Ibid.*

<sup>826</sup> Rushworth *Acta Juridica* 385.

<sup>827</sup> (Davis *et al* 170).

<sup>828</sup> *Ibid.*

proceedings, but is not paid to the employee, the debt or obligation is regarded as part of post-commencement financing and will be paid in order of preference.<sup>829</sup>

After payment of the business rescue practitioner's remuneration and costs and other claims arising out of the business rescue proceedings, all claims irrespective of whether or not they are secured will have preference in the order in which they were incurred over all unsecured claims against the company.<sup>830</sup> It should be noted however that if business rescue proceedings are superseded by a liquidation order, the preference in terms of section 135 of the New Act, will remain in force except to the extent of any claims arising out of the cost of liquidation.<sup>831</sup>

#### **5 3 4 Effect of business rescue on employees and employment contracts**

The New Act protects those employed in a distressed company before the commencement of business rescue proceedings, by providing that despite any provision of an agreement to the contrary, the employees must continue to be employed on the same terms and conditions, except to the extent that changes occur in the ordinary course of attrition or the employees and the company, in accordance with applicable labour laws, agree on different terms and conditions.<sup>832</sup> In *Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others*<sup>833</sup> the court said that the primary goal of the business rescue process is the prevention of unnecessary liquidations of companies and the subsequent loss of employment. The court further opined that employees must stand to gain substantial benefits from business rescue proceedings which precede liquidation.

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<sup>829</sup> Section 135(1) (a) and (b) of the New Act.

<sup>830</sup> Section 135(3) of the New Act. (Davis *et al* 170).

<sup>831</sup> Section 135(4) of the New Act.

<sup>832</sup> Section 136(1) (a) (i) (ii) of the New Act.

<sup>833</sup> 2012 (3) SA 273 (GSJ) Paragraph 15.

Furthermore, any retrenchment of employees contemplated in the company's business rescue plan is subject to section 189 and section 189A<sup>834</sup> of the Labour Relations Act 66 of 1995 and other applicable employment-related legislation.<sup>835</sup> The New Act states that subject to sections 35A and 35B of the Insolvency Act 24 of 1936, the business rescue practitioner may cancel or suspend entirely, partially or conditionally any provision of an agreement to which the company is a party at the commencement of the business rescue process.<sup>836</sup> However, employment contracts are not affected by this provision.<sup>837</sup> Any party to an agreement that has been suspended or cancelled by the business rescue practitioner may assert a claim against the company only for damages.<sup>838</sup>

Lastly where liquidation proceedings were converted into a business rescue process, the liquidator will be a creditor of the company to the extent of any outstanding claim for his remuneration and expenses incurred before the business rescue commenced.<sup>839</sup>

## **5 4 THE ROLE AND RIGHTS OF AFFECTED PERSONS**

### **5 4 1 Creditors and creditors' committees**

A creditor, defined by the Companies Act 71 of 2008 as an affected person<sup>840</sup> in a relation to a company, is entitled to a notice of each court proceeding, decision, meeting or other relevant event concerning the business rescue process and to participate in the court

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<sup>834</sup> Loubser "The Interaction Between Corporate Rescue Legislation: Lessons to be Drawn from the South African Experience" 2005 *INTERNATIONAL INSOLVENCY REVIEW* 66, where the author submitted that the company in financial distress has the obligation to engage in meaningful joint consensus seeking with the employees' representatives or the employees themselves to find ways to avoid or minimize dismissals as well as devise a method for selecting the employees to be dismissed and decide on the amount of severance pay for dismissed employees.

<sup>835</sup> Section 136(1)(b) of the New Act. See also Bradstreet "The New Business Rescue: Will Creditors sink or Swim" 2011 *SALJ* 375.

<sup>836</sup> Section 136(2) of the New Act. See also Rushworth *Acta Juridica* 387.

<sup>837</sup> *Ibid.*

<sup>838</sup> Section 136 (3) of the New Act. See also (Davis *et al* 171).

<sup>839</sup> See section 136(4) of the New Act in this regard.

<sup>840</sup> Section 128(1) (a) (i) of the New Act defines the shareholder as an affected person of the company in distress.

proceedings.<sup>841</sup> The creditors in a distressed company informally participate in the proceedings by making proposals for a business plan to the practitioner. In addition, the creditors formally participate in the business rescue proceedings as required by the New Act.<sup>842</sup> Furthermore, a creditor of a distressed company has the right to vote to amend, approve or reject a proposed business rescue plan and can propose the development of an alternative plan or in furtherance of that, present an offer to acquire the interests of any or all creditors in terms of section 153 of New Act .<sup>843</sup>

The New Act provides expressly that the creditors are entitled to form creditors' committees to assist the business rescue practitioner through consultations during the development of the business rescue plan.<sup>844</sup> In terms of section 149 of the New Act, the committee(s) of creditors if formed may consult with the practitioner on matters relating to the business rescue proceedings. These committees are however not permitted to direct or instruct the practitioner,<sup>845</sup> but may receive and consider reports relating to the business rescue proceedings.<sup>846</sup> In addition, the committees of creditors must act independently of the practitioner to ensure fair and unbiased representation of the creditor's interests.<sup>847</sup> It should be noted that as required by the New Act, a person may be a member of the committee of creditors if only the person is an independent creditor,<sup>848</sup> an agent, proxy or attorney of an

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<sup>841</sup> Section 145(1) (a) and (b) of the New Act.

<sup>842</sup> Section 145(1) (c) of the New Act.

<sup>843</sup> Section 145(2) (a) and (b) of the New Act. Section 153 of the New Act sets out the provisions on an alternative route to go if the business rescue plan is rejected. This will be discussed in details elsewhere in this chapter.

<sup>844</sup> Section 145 (3) of the New Act. See also (Davis *et al* 175).

<sup>845</sup> Section 149(1) (a) of New Act.

<sup>846</sup> Section 149(1) (b) of the New Act.

<sup>847</sup> Section 149(1) (c) of the New Act.

<sup>848</sup> The Companies Act 71 of 2008 in Section 128(1) (g) (i) and (ii) defines an independent creditor as a person who is a creditor of the company, including an employee of the company who is a creditor in terms of section 144(2) of the Act. Such a person should not also be related to the company, a director or the business rescue practitioner.

independent creditor, or other person acting under a general power of attorney or authorized in writing by an independent creditor.<sup>849</sup>

If the business rescue proceedings were instituted by an affected person, the appointment of the practitioner nominated by the affected person will be subject to ratification by the majority of creditors' voting rights at the first creditors meeting.<sup>850</sup> Within ten business days of being appointed, the business rescue practitioner must convene and preside over a first meeting of creditors at which, the creditors must be informed whether or not the company has a reasonable prospect of being rescued as well as receiving proof of creditors' claims against the company by the creditors.<sup>851</sup> If any decision during the proceedings requires the support of the holders of creditors' voting interests, a secured creditor or unsecured creditor has a voting interest equal to the amount owing to that creditor by the company.<sup>852</sup>

The New Act expressly states that a concurrent creditor who would be subordinated in a liquidation has a voting interest, as independently and expertly appraised and valued at the request of the practitioner, equal to the amount, if any that the creditor could reasonably expect to receive in such a liquidation of the company.<sup>853</sup>

It should be noted however that the business rescue practitioner must determine whether a creditor is independent or not and should request a suitably qualified person to independently and expertly appraise and value the voting interest<sup>854</sup> of the creditor.<sup>855</sup> Furthermore, the business rescue practitioner must within 15 days before the date of the meeting contemplated in section 151 of the New Act, give a written notice of the determination, or appraisal and

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<sup>849</sup> Section 149(2) (a)-(c) of the New Act.

<sup>850</sup> Cliffe Dekker Hofmeyr Attorneys "Business Rescue Matters: Shareholder Involvement in Business Rescue Proceedings" available at <http://www.cliffedekker-hofmeyr.com/newcompaniesact/pdf>. (accessed 04-08-2010).

<sup>851</sup> Section 147(1) (a) (i) of the New Act.

<sup>852</sup> Rushworth *Acta Juridica* 389.

<sup>853</sup> Section 145(4) (b) of the New Act.

<sup>854</sup> Section 128(1) (j) of the New Act defines "voting interest" as an interest recognized, appraised and valued in terms of section 145(4)-(6) of the New Act.

<sup>855</sup> Section 145(5) (a) and (b) of the New Act. See also Rushworth *Acta Juridica* 398.

valuation to the person concerned.<sup>856</sup> What is important though is that within five business days after receiving notice of a determination, a person may apply to a court to review the business rescue practitioner's notice of determination of an independent creditor's voting interest or review, re-appraise and re-value the creditors' voting interest with regard to the distressed company.<sup>857</sup>

At any meeting of creditors, other than the meeting contemplated in section 151 of the New Act, all that is needed for decisions to be valid and binding is the support of holders of a simple majority of the independent creditors' voting interests voted on the matter, however this provision does not apply to a meeting that is convened for the purpose of considering a business rescue proposal.<sup>858</sup>

It has been submitted that the claims of creditors who provided companies with finance during business rescue proceedings should be paid in the order in which they were incurred and in preference to all unsecured claims against the company, with claims to be secured to the lenders by utilizing any asset of the company to the extent that it is not otherwise encumbered.<sup>859</sup> Consequently, creditors of distressed companies are afforded latitude in deciding the direction of business rescue proceedings and can use the process as an effective mechanism to achieve returns that could exceed those expected in a liquidation.<sup>860</sup> In *Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others*,<sup>861</sup> Claassen J held that the application of a company seeking a business rescue order must place facts before the court to indicate that creditors will get a better return than liquidation. Furthermore, the court held that liquidation is more appropriate in the case of a

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<sup>856</sup> See generally section 145(5) (c) of the New Act.

<sup>857</sup> Section 145 (5) (a) subject to section 145 (6) (a) of the New Act.

<sup>858</sup> (Cassim *et al* 814-815).

<sup>859</sup> Cliffe Dekker Hofmeyr Attorneys "Business Rescue Matters: Shareholder Involvement in Business Rescue Proceedings" available at <http://www.cliffedekker-hofmeyr.com/newcompaniesact/pdf>. (accessed 04-08-2010).

<sup>860</sup> *Ibid.*

<sup>861</sup> 2012 (3) SA 273 (GSJ).

deadlock because where there are many pending disputes between the various interested parties, mediation by a business practitioner will not be appropriate.<sup>862</sup>

In *Swart v Beagles Run Investments 25 (Pty) Ltd (Four Creditors Intervening)*<sup>863</sup> the court held that where an application for business rescue entails the weighing – up of the interests of the creditors and the company, the interests of the creditors should carry the day. The court further held that there was no merit in placing the company under business rescue as there was absolutely no basis for contending that the company will in future be able to carry on business on a solvent basis, and seeing that no case was made out that the granting of a business rescue order will place the creditors of the respondent in a better position than they would be in a winding-up.

## 5 4 2 Shareholders

Shareholders can play a significant role in business rescue proceedings. Shareholders of the company have the right to be notified of important events and to participate in court

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<sup>862</sup> 2012 (3) SA 273 (GSJ). In this case, the debtor company owned immovable properties known as the Kyalami Racetrack Complex. The company developed the properties into sub-portions and sold or leased them to end users at a profit. It appeared that the company's only source of income was rental received from a lessee which rental was described in the lease to be equal to the monthly interest payable to one of the respondent creditors (Nedbank) which was a major shareholder with 30% shareholding in the financially distressed company. For over a year before the hearing, the company had not received any rental and therefore defaulted in payments due to Nedbank. Accordingly, Nedbank issued summons against the company resulting in the company being ordered to pay Nedbank the sum of R31 578 095 plus 12% interest. The company applied for business rescue but Nedbank and another creditor opposed the application opting for liquidation of the company. Classen J held that business rescue was not appropriate, the reasons being that although there are negative connotations surrounding liquidations, they are not per se negative since in certain cases, they may yield a better financial return for the creditors. Secondly, the applicants had become embroiled in a litany of pending court cases which militates against the granting of a business rescue order. Classen J held that the uncertainties of the court cases, which the parties had pending against one another would necessarily make any plan proposed by the business rescue practitioner subject to a variety of contingencies and outcomes which he or she would not be able to define in advance in precise terms to the creditors, in order for them to make a properly informed decision as to whether they should vote for or against the plan.

<sup>863</sup> 2011 5 SA 422 (GNP) 428H- I 426,431G -I. The facts were that the sole director and shareholder of the company one Mr. Swart brought an urgent application seeking an order placing the company under supervision and to commence business rescue proceedings under section 131 (4) (a) of the New Act 71 of 2008. Certain intervening creditors opposed the application and sought a winding up order on grounds that the application for business rescue is an abused of a process, and a culmination of a number of attempts to avoid and postpone payment of the respondent debts in that the applicant has demonstrated in his application a complete negation of the rights of creditors and has carried on the business of the respondent company under admittedly insolvent circumstances, recklessly and under circumstances where a number of transactions ought to be set aside in terms of the insolvency Act 24 of 1936. The creditors contended that the director used the company as if the company was his alter ego, conducted the affairs of the company without paying attention to the creditor and the company's obligations to them as creditors. According to the creditors, the respondent prevented the intervening creditors from exercising their rights in terms of the law inter alia by giving notice of intention to oppose the winding up application, but never filing papers therein, while on common cause facts, it was clear that the respondent is insolvent and unable to make payments of its debts.

proceedings and any other events relating to the business rescue proceedings.<sup>864</sup> In terms of the New Act the effect that business rescue proceedings have on shareholders are that, an alteration in the classification or status of any issued securities of a company, other than by way of a transfer of securities in the ordinary course of business is invalid and prohibited except to the extent that the court otherwise directs or contemplates in an approved business plan developed by the business rescue practitioner.<sup>865</sup> Shareholders may require the business rescue practitioner to provide security on application to the court to secure the interests of the company and affected persons.<sup>866</sup>

The Act clearly stipulates that the business rescue practitioner is obliged to consult shareholders prior to the formulation of the business rescue plan for consideration and possible adoption.<sup>867</sup> In terms of section 152 (1)(a) of the New Act, at a meeting convened in terms of section 151,<sup>868</sup> the practitioner must introduce the proposed business plan for consideration by the creditors and if applicable, by the shareholders. It has however been submitted that the reference to “shareholders” is incorrect, as it is the holders of any class of the company’s securities that may possibly be entitled to vote on the acceptance or rejection of the business rescue plan.<sup>869</sup> Although the holders of any class of the company’s securities would include a shareholder, it is not only shareholders that will be entitled to vote on the plan. Furthermore, it is only where the business rescue plan proposes to alter the rights of the

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<sup>864</sup> Section 146 of the New Act.

<sup>865</sup> (Delpont, Vorster, Burdette, Esser & Lombard *Henochsberg* 479).

<sup>866</sup> Cliffe Dekker Hofmeyr Attorneys “Business Rescue Matters: Shareholder Involvement in Business Rescue Proceedings” available at <http://www.cliffedekker-hofmeyr.com/newcompaniesact/pdf>. (Accessed 04-08-2010).

<sup>867</sup> In terms of section 150(1) of the New Act.

<sup>868</sup> This provision stipulates that the practitioner must convene and preside over a meeting of creditors and other holders of a voting interest, called for the purpose of considering the proposed rescue plan within 10 business days after the publication of that plan.

<sup>869</sup> (Delpont, Vorster, Burdette, Esser & Lombard *Henoschsberg* 525).

holders of any class of the company's securities, that the holders of such securities will be entitled to vote in favour of or against the adoption of the plan.<sup>870</sup>

### 5 4 3 Directors

It is a requirement that directors of a distressed company cooperate fully to enable the business rescue practitioner execute the duties bestowed on him. During a company's business rescue proceedings, each director of the company must attend to the request of the practitioner at all times, and provide the practitioner with any information about the company's affairs as may reasonably be required.<sup>871</sup>

Each director of the company must deliver to the practitioner all books and records that relate to the affairs of the company and are in the director's possession.<sup>872</sup> It should be borne in mind that the effect of this provision is to enable the practitioner to gain access to all the information that can assist in conducting a credible investigation into the business and affairs of the company in order to determine whether the business can be rescued as a going concern.<sup>873</sup> Section 142(2) of the New Act requires that any director of the company, who knows where other books and records relating to the company are being kept, must without delay inform the business rescue practitioner as to the whereabouts of those books and records.

The directors have the responsibility of providing the business rescue practitioner within five business days of the commencement of the business rescue proceedings, or longer if the practitioner allows, a statement of affairs containing<sup>874</sup> any material transactions involving the company or the assets of the company, that occurred within 12 months immediately

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<sup>870</sup> *Ibid.*

<sup>871</sup> Section 137(3) of the New Act. See also (Cassim *et al* 800).

<sup>872</sup> Section 142 (1) of the New Act.

<sup>873</sup> See generally section 142 of the New Act.

<sup>874</sup> Section 142(3) (a)-(f) of the New Act.

before the business rescue proceedings were initiated; any court, arbitration or administrative proceedings, including enforcement proceedings that involves the company; the assets and liabilities of the company, its income and disbursements within the preceding 12 months and the number of employees and any collective agreements relating to the rights of employees; any debtors and their obligations to the company as well as the rights and claims against the company by creditors.<sup>875</sup> No person is permitted as against the practitioner of the distressed company to retain possession of any books or records of the company or to claim or enforce a lien over such books or records.<sup>876</sup>

In terms of section 22 of the New Act, directors need to be aware of the circumstances in which they can be held personally liable for the debts of a company should it be placed into liquidation. It is therefore incumbent upon the directors to ensure that when the warning signs are evident, they immediately take legal and financial advice and place the company either into business rescue or liquidation or cease trading.<sup>877</sup> In *Lidino Trading 580 CC v Cross Point Trading (Pty) Ltd*<sup>878</sup>, the court heard that a company was created with a favourable Black Economic Empowerment (BEE) profile with two directors. It was established to do contract work but was unable to perform such work due to lack of co-operation and trust between the directors. The BEE profile was never used or needed, but the point remained that the company was created with that aim. Furthermore, the court heard that there was a deadlock which resulted in the management of the company's affairs being so divided that the company was unable to properly carry on its business. One of the two directors felt oppressed and prejudiced after their relationship soured. It appeared that the two directors were hopelessly at loggerheads, litigating against each other. One of the directors wanted the

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<sup>875</sup> *Ibid.*

<sup>876</sup> Section 142(4) of the New Act.

<sup>877</sup> *Werksmans Incorporated* "South Africa: The New companies Act 71 of 2008 - Reckless Trading and the Personal Liability of Directors", available at <http://www.mondaq.com/x/>.(accessed 20-08-2011).

<sup>878</sup> Case no 2130/2012. Unreported. Heard on 16 August 2012 at the Free State High Court, Bloemfontein, judgment delivered by Kruger J on the 23<sup>rd</sup> August 2012.

company to be placed into liquidation while the other applied to place it under business rescue in terms of section 131 of the New Act as the company was not commercially or factually insolvent. Following the decision in the earlier case of *Oakdene Square Properties*,<sup>879</sup> the court held that in the case of deadlock, liquidation is more appropriate than business rescue. According to the court, “it is difficult to see how any business rescue plan can succeed” in such circumstances.<sup>880</sup> The Company was, therefore, placed under provisional liquidation.

A company may not carry on business recklessly, with gross negligence, with the intent to defraud or for any other fraudulent purposes or under insolvent circumstances.<sup>881</sup>

It is submitted that the impact which trading recklessly could have on the company and in particular the consequences for directors, means that the directors must constantly monitor the company’s financial position and ensure that appropriate action is taken to prevent insolvency.<sup>882</sup>

While investigating the affairs of the company, if the business rescue practitioner concludes that there is evidence in the dealings of the company before the business rescue proceedings commenced, of voidable transactions or failure by the company to perform any material obligation relating to the company, or reckless trading, fraud or other contravention of any law relating to the company, the practitioner must forward the evidence to the appropriate authority for further investigation and possible prosecution.<sup>883</sup>

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<sup>879</sup> 2012 (3) SA 273 (GSJ).

<sup>880</sup> Para 24.

<sup>881</sup> Ernst & Young “The Companies Act: A Synopsis for Directors”, available at <http://www.isoleso.co.za/images/companyact/pdf> (accessed 29-06-2010).

<sup>882</sup> *Ibid.*

<sup>883</sup> Section 141(2) (c) (i) (ii) of the New Act.

#### **5 4 4 Registered trade union representing employees/employees not represented by a registered trade union and employee committees**

The New Act identifies two types of employees in a company. These are the employees represented by registered trade unions and unrepresented employees. Section 144 (1) of the New Act specifically states that employees may exercise their rights as set out in the business rescue provisions whether they are represented by a registered trade union or not. What is important though is that those represented by a registered trade union can exercise their rights collectively in accordance with applicable labour laws;<sup>884</sup> whereas those not represented by a registered trade union may elect to exercise their rights either directly, or by proxy through an employee organization or representative.<sup>885</sup>

Consequently, any remuneration, reimbursement for expenses or any other amount of money relating to employment due and payable by the company to an employee at any time before the beginning of the company's rescue proceedings, and which has been paid to that employee immediately before the beginning of those proceedings makes the employee a preferred unsecured creditor.<sup>886</sup>

The New Act confers on the employee whether represented by a registered trade union or not a right to receive a notice of each court proceedings, decision, meeting or other relevant event concerning the business rescue proceedings and such notice must be given to the employees at their workplace in addition to being served at the head office of the relevant trade union.<sup>887</sup> It also entitles employees to participation in any court proceedings arising during the business rescue proceedings; to formation of a committee of employees' representatives; to consultations with the business rescue practitioner during the development of the business rescue plan, and to sufficient opportunity to review any such plan and prepare the submission

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<sup>884</sup> In terms of section 144(1) (a) (i) and (ii) of the New Act.

<sup>885</sup> Section 144(1) (b) of the New Act. See also (Cassim *et al* 809).

<sup>886</sup> Section 144(2) of the New Act.

<sup>887</sup> See in this regard section 144(3) (a) of the New Act. See also Rushworth *Acta Juridica* 397.

contemplated in section 152(1)(c) of the New Act.<sup>888</sup> Furthermore, the employee is entitled to be present and may make a submission to the meeting of the holders of voting interests before a vote is taken on any proposed business rescue plan as contemplated in section 152(1)(c) of the New Act ; and to vote with creditors on a motion to approve a proposed business rescue plan, to the extent that the employee is a creditor; and upon the rejection of the proposed business rescue plan, to propose the development of an alternative plan or present an offer to acquire the interests of one or more affected persons as contemplated in section 153 of the New Act.<sup>889</sup>

The New Act specifies that a medical scheme, or a pension scheme including a provident scheme, for the benefit of the past or present employees of the company is an unsecured creditor of the company under financial distress to the extent of any amount that was due and payable by the company to the trustees of the scheme at any time before the beginning of the business rescue proceedings.<sup>890</sup> Similarly, in the case of a defined pension scheme, the scheme is an unsecured creditor to the extent of the present value at the commencement of the business rescue proceedings of any unfunded liability under that scheme.<sup>891</sup> It should be noted that the rights of employees discussed above, are all in addition to any other rights arising or accruing in terms of any law, contract, collective agreement, shareholding, or security or court order.<sup>892</sup>

In addition to the rights conferred on employees in a distressed company, the employees have the right to form employee committees like creditors.<sup>893</sup> The New Act requires that within ten business days after the appointment of the business rescue practitioner, a first meeting of employees' representatives must be held which must be presided over by the business rescue

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<sup>888</sup>Section 144(3) (a) – (g) of the New Act.

<sup>889</sup> *Ibid.*

<sup>890</sup> Section 144(4) (a) of the New Act. See also (Davis *et al* 171).

<sup>891</sup> In terms of Section 144(4) (b) of the New Act.

<sup>892</sup> Section 144 (5) of the New Act.

<sup>893</sup> See generally section 148 of the New Act.

practitioner.<sup>894</sup> The employees who are represented by a registered trade union and those that are not represented are entitled to notice of every meeting that will be held by the business rescue practitioner which should set out clearly date, time, venue and agenda of the meeting.<sup>895</sup> During the meeting, the employees must be informed of any reasonable prospects of rescuing the company.<sup>896</sup> After the business rescue practitioner has given the information to the employees, the representatives of the employees may determine whether or not employees' committees should be appointed and, if so, they may then appoint the members of such committee.<sup>897</sup> The New Act, in provisions similar to those made in respect of the creditors' committee (s), permits the committee of the employees to consult with the practitioner on any matters relating to the business rescue proceedings, but it may not instruct or direct the business rescue practitioner.<sup>898</sup> The committee of employees may however receive and consider reports relating to the business rescue proceedings' and must act independently of the practitioner to ensure fair and unbiased representation of the employees' interests.<sup>899</sup> In terms of the New Act, a person cannot be a member of the committee of employees unless such person fulfills the requirements of being an independent employee of the company, an agent, holder of proxy or an attorney of an independent employee, or other person acting under a general power of attorney; or an authorization in writing by an independent employee.<sup>900</sup>

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<sup>894</sup> Section 148(1) of the New Act. See also (Davis *et al* 172).

<sup>895</sup> In terms of Section 148 (2) (a) and (b) of the New Act. See also Rushworth *Acta Juridica* 401.

<sup>896</sup> Section 148(1) (a) of the New Act.

<sup>897</sup> Section 148(1) (b) of the New Act.

<sup>898</sup> Section 149(1) (a) of the New Act.

<sup>899</sup> Section 149(1) (b) and (c) of the New Act.

<sup>900</sup> In terms of section 149(2) (a) - (c) of the New Act.

## 5 5 THE DEVELOPMENT AND IMPLEMENTATION OF BUSINESS RESCUE PLANS

It is appears that the core function of the business rescue practitioner is to prepare a business rescue plan that can salvage the company from its woes. The New Act requires that the business rescue practitioner must consult with the creditors, affected persons and the company's management on a prepared business rescue plan for consideration and adoption.<sup>901</sup> Loubser however argues that reason for section 150(2) (a)(vi) of the New Act is rather obscure since the business rescue practitioner is specifically instructed by the New Act to consult the creditors before he prepares a business rescue plan and it must be expected that the creditors will make several proposals.<sup>902</sup> The business rescue plan must contain all the information reasonably required to assist affected persons in deciding whether or not to accept or reject the plan.<sup>903</sup> The New Act sets out the form of the business rescue plan which is required to be categorized into three parts. Part A must deal with the background of the plan. Part B must deal with the proposals of the plan and Part C must comprise of assumptions and conditions. Part A which forms the background of the business rescue plan must contain a complete list of all the material assets of the company, as well as an indication as to which assets were held as security by creditors when the business rescue proceedings began.<sup>904</sup> The said Part A should also include a complete list of the creditors of the company when the business rescue proceedings began, as well as an indication as to which creditors would qualify as secured, statutory preferred and concurrent in terms of the insolvency laws as well as an indication of which the creditors have proved their claims.<sup>905</sup> Should the company be placed into liquidation, the dividend that each creditor of the company would

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<sup>901</sup> Section 150(1) of the New Act.

<sup>902</sup> Loubser "The Business Rescue Proceedings in the Companies Act of 2008 : Concerns and Questions (Part 2) *TSAR* 2010 (4) 692.

<sup>903</sup> Section 150(2) of the New Act. See also (Cassim *et al* 817).

<sup>904</sup> In terms of Section 150(2) (i) of the New Act.

<sup>905</sup> Section 150(2) (ii) of the New Act. See also (Cassim *et al* 807).

receive must form part of the background of the business rescue plan.<sup>906</sup> A complete list of the holders of the company's issued securities should be disclosed as well as a copy of the written agreement concerning the practitioner's remuneration and a statement stating whether the business rescue plan includes a proposal made informally by a creditor of the company.<sup>907</sup>

The contents of Part B of the business rescue plan must deal with the proposals which must include details of the nature and duration of any moratorium for which the business rescue plan makes provision, release from payment of debts and conversion of debts into equity in the company.<sup>908</sup> Furthermore, the property of the company that is to be available to pay creditors claims, the order of preference in which the proceeds of the property will be applied to pay creditors if the business plan is adopted and the benefits of adopting the business rescue plan as opposed to the benefits that would be received by creditors if the company is placed in liquidation in addition to the effect that the business rescue plan will have on the holders of each class of the company's issued securities must form part of the proposals.<sup>909</sup>

With regard to Part C which sets out assumptions and conditions of the business rescue plan, the New Act clearly stipulates the contents as being a statement of the conditions that must be satisfied if any for the business rescue plan to come into operation and be fully implemented,<sup>910</sup> the effect if any that the business rescue plan contemplates on the number of employees and their terms and conditions of employment,<sup>911</sup> the circumstances in which the business rescue plan will end,<sup>912</sup> and a projected balance sheet of the company and statement

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<sup>906</sup> Section 150(2) (iii) of the New Act.

<sup>907</sup> Rushworth *Acta Juridica* 402.

<sup>908</sup> (Davies *et al* 176).

<sup>909</sup> See in this regard section 150(2) (b) (iv), (v), (vi) and (vii) of the New Act.

<sup>910</sup> In terms of section 150 (2) (c) (i) (aa) and (bb) of the New Act.

<sup>911</sup> Section 150(2) (c) (ii) of the New Act. See also (Cassim *et al* 807).

<sup>912</sup> Section 150(2) (c) (iii) of the New Act.

of income and expenses for the ensuing three years prepared on the assumption that the business plan is adopted.<sup>913</sup>

The projected balance sheet of the company and statement of income and expenses must include a notice of any material assumptions on which the projections are based and may include alternative projections based on varying assumptions and contingencies.<sup>914</sup> The proposed business rescue plan must conclude with a certificate by the practitioner stating that any actual information provided appears to be accurate, complete and up to date, and that the projections provided are estimates made in good faith on the basis of factual information and assumptions as set out in the statements.<sup>915</sup> In terms of the New Act, the business rescue plan must be published by the company within 25 business days after the date on which the practitioner was appointed or unless the court by order permits a much longer time upon application by the company or the holders of a majority of the creditors voting interests.<sup>916</sup>

## **5 6 DURATION AND TERMINATION OF BUSINESS RESCUE PROCEEDINGS**

Regarding the time frame for business rescue proceedings as set out in the New Act, it is stated a company's business rescue proceedings should come to an end within three months after its commencement, or such longer period as the court may permit upon application by the business rescue practitioner.<sup>917</sup> The business rescue practitioner therefore has the responsibility of preparing a report on the progress of the business rescue proceedings and to provide an update at the end of each subsequent month until the end of the business rescue proceedings.<sup>918</sup> It should be noted that the report that has been prepared and updated must be

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<sup>913</sup> See in this regard section 150(2) (c) (iv) (aa) and (bb) of the New Act.

<sup>914</sup> Rushworth *Acta Juridica* 402.

<sup>915</sup> (Cassim *et al* 808).

<sup>916</sup> Section 150(5) (a) and (b) of the New Act.

<sup>917</sup> In terms of section 132(3) of the New Act.

<sup>918</sup> Section 132(3) (a) of the New Act. Loubser "The Business Rescue Proceedings in the Companies Act of 2008 : Concerns and Questions (Part 2) *TSAR* 2010 (4) 698.

delivered to each affected person in the prescribed manner with copies to the court if the business rescue proceedings was subjected to the courts order.<sup>919</sup>

The New Act provides that business rescue proceedings begins when the company files a resolution to place itself under supervision or applies to the court for consent to file a resolution in terms of sections 129(3) or 129(5)(b).<sup>920</sup> Alternatively, an affected person may apply to the court for an order placing the company under supervision in terms of section 131(1) or during the course of liquidation proceedings, or proceedings to enforce a security interest a court makes an order placing the company under supervision.<sup>921</sup>

The termination of business rescue proceedings takes effect when the court set aside the resolution or the order that began the proceedings or converts the business rescue proceedings into liquidation.<sup>922</sup> The business rescue practitioner may file a notice of termination of the business rescue process with the Companies and Intellectual Property Commission (CIPC);<sup>923</sup> business rescue plan has been rejected, and no affected person has taken action to extend the proceedings<sup>924</sup> or the plan has been adopted and the practitioner has subsequently filed a notice of substantial implementation of the plan.<sup>925</sup>

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<sup>918</sup>Johnson and Meyerman 21.

<sup>919</sup> See generally section 132(3) (b) (i) (ii) of the New Act.

<sup>920</sup> Section 132(1) (a) (i) (ii) of the New Act. See also in this regard (Davis *et al* 169).

<sup>921</sup> In terms of section 132(1) (b) and (c) of the New Act.

<sup>922</sup> Section 132 (2) (a) (i) and (ii) of the New Act. See also (Cassim *et al* 792).

<sup>923</sup> Section 132(2) (b) of the New Act.

<sup>924</sup> In terms of section 132(2) (c) (i) of the New Act.

<sup>925</sup> Section 132(2) (c) (ii) of the New Act.

## 5 7 A CRITIQUE OF THE BUSINESS RESCUE MECHANISM UNDER THE NEW ACT

### 5 7 1 Involvement of the court

The New Act<sup>926</sup> was promulgated to address the shortcomings of the Old Act.<sup>927</sup> Although the New Act attempts to address the short comings in the Old Act, there are a number of concerns that have been raised. Most notable amongst them is the involvement of the court in the initiation and management of business rescue proceedings. Section 131 of the New Act permits an affected person to apply to the court at any time for an order placing the company under supervision and commencing business rescue proceedings. This process can be cumbersome as court processes are expensive, time consuming and subject to unnecessary delays.<sup>928</sup> This was one of the reasons why the court in *Oakdene Square Properties*<sup>929</sup> rejected the application for business rescue preferring the liquidation of the company instead.<sup>930</sup> According to C.J. Claasen J:

“Having regard to the provisions of section 128 to 154 of the Act, once a company is placed under supervision and business rescue proceedings have commenced, such proceedings are open-ended, and could probably include further applications to court and carry on for a considerable period of time. This would be even more so where there are parties involved who are seeking to obstruct the creditors of the relevant company ....”<sup>931</sup>

In sharp contrast, voluntary administration in Australia is initiated merely by the decision of the relevant party in writing under the common seal of the company whereby the administrator is appointed by the directors and the issue a notice of administration in the prescribed manner does not require the involvement of legal practitioners.<sup>932</sup> It has therefore

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<sup>926</sup> See generally sections 128-155 of the New Act.

<sup>927</sup> In terms of sections 427 – 440 of the Old Act.

<sup>928</sup> See generally Johnson and Meyerman “Insolvency systems in South Africa: Strengthening the Regulatory Framework” <http://www.fps.org> December 2010 2. (accessed 02/03-2011) (Hereafter Johnson and Meyerman).

<sup>929</sup> 2012 (3) SA 273 (GSJ).

<sup>930</sup> Para 6.

<sup>931</sup> *Ibid.*

<sup>932</sup> Kloppers “Judicial Management Reform - Steps to Initiate a Business Rescue” 2001 *SA Merc LJ* 371.

been suggested that the Australian system is superior to the new South African business rescue model on the basis of cost and ease of implementation of voluntary administration.

## **5 7 2 Requirement of proof in applications for business rescue**

According to statistics as at 27 March 2012, 428 notices of commencement of business rescue proceedings had been filed at the CIPC, with 13 of them discarded for being invalid filings, and only 7 successfully completed business rescue plans<sup>933</sup> (including Bylvooruitsights Mine).<sup>934</sup> Judgments that have been handed down by the courts thus far have identified a “reasonable prospect” of success of business rescue as a critical requirement for the success of any application for business rescue.<sup>935</sup>

In the case law discussed above, it appears the courts are unwilling to grant applications for business rescue without proper consideration of whether the company will indeed be viable after the business rescue process and whether the purpose of the New Act<sup>936</sup> in relation to financially distressed companies will be achieved. The courts carefully scrutinize the applications for business rescue before deciding whether or not to grant them.<sup>937</sup> Furthermore, the courts do not approve of vague averments in applications for business

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<sup>933</sup> Lotheringen “Business Rescue“ <http://www.lssa.org/za>. (Accessed 10-11-2012). Also available at <http://www.dti.gov.za>.

<sup>934</sup> See Chapter 4 of this dissertation.

<sup>935</sup> See in this regard paras 17, 19,20 in the case of *Koen and Another v Wedgewood Village Golf and Country Estate (Pty) and Others* 24850/11 2011ZAWCHC 464. Also see *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012(SA) 423(WCC) para 24 where Eloff J in delivering the judgment opined that although every case must be considered on its own merits, the company under consideration must have a reasonable prospect of being sustainable if granted opportunity of implementing a business rescue plan . in *Nedbank Ltd v Bestvest 153 (Pty) Ltd* WCC case number 21857/2011, Gamble J at para 33 held that the real issue is whether the company has shown upon its application for a business rescue, a reasonable prospect of rescuing the company by placing it under the supervision of a business rescue practitioner.

<sup>936</sup> Section 7k of the New Act stipulate that the purpose of the New Act is to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.

<sup>937</sup> In *Southern Place Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012 (2) SA 432 (WCC) paragraph 24, the court pointed out that the business rescue application must address the cause of the demise or failure of the company’s business, and offer a remedy that has a reasonable prospect of being sustainable.

rescue.<sup>938</sup> It stands to reason that a lesser standard of proof or evidence will not be accepted simply because an applicant for business rescue is seeking to achieve the so called “alternative object”<sup>939</sup> rather than the primary object of business rescue under the New Act.

### **5 7 3 Authority of the business rescue practitioner**

The New Act grants the business rescue practitioner a wide range of powers some of which are a cause for concern. Subject to sections 35A and 35B of the Insolvency Act 34 of 1936, despite any provision of an agreement to the contrary, during business rescue proceedings, the provisions of the New Act grant the business rescue practitioner the discretion to cancel or suspend current contracts of the company, partially or conditionally or any provision of an agreement to which the company is a party at the commencement of the business rescue period, other than an employment agreement.<sup>940</sup> It has been submitted that this provision may enable the business rescue practitioner to cherry-pick portions of contracts that are in his favour while suspending obligations under other provisions of the same contract that impose a burden or monetary obligation on the debtor company, which would seem patently unfair.<sup>941</sup> However section 136(3) of the New Act provides a remedy by stipulating that any party to an agreement that has been suspended or cancelled may assert a claim for damages.

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<sup>938</sup> In *Prospec Investments (Pty) Ltd v Pacific Coast Investments 97 Ltd and Another* (5000/2011) [2012] ZAFSHC 130, the applicant was a creditor of the first respondent, the company. The application for business rescue was opposed by the second respondent who was also a creditor of the company. Both the applicant and the second respondent were therefore “affected persons” in terms of section 128(1)(a)(i) of the New Act. After considering the application, Van der Merwe J held that vague and speculative averments will not be sufficient for a court to grant an application for business rescue. (See paragraph 117). In the view of the court, the applicant did not show a reasonable prospect of a better return than would be obtainable in a winding up. (Paragraph 27).

<sup>939</sup> Ramlall “The Judicial Development of Business Rescue Proceedings in South Africa: A Step in the Right Direction” 2012 *Speculum Juris*.

<sup>940</sup> Section 136 (2) of the New Act. See also Loubser “The Business Rescue Proceedings in the Companies Act of 2008 : Concerns and Questions (Part 2) *TSAR* 2010 (4) 690.

<sup>941</sup> Johnson and Meyerman 21.

## 5 7 4 Rights of Secured Creditors

In terms of the New Act, a secured or unsecured creditor has a voting interest equal to the value of the amount owed to that creditor by the company.<sup>942</sup> The New Act states that a concurrent creditor who will be subordinated in liquidation has a voting interest, as independently and expertly appraised and valued at the request of the practitioner, equal to the amount, if any, that the creditor could reasonably expect to receive in a liquidation of the company.<sup>943</sup> While the creditor's participation in the business rescue process is guaranteed, such rights as they relate to secured creditors are problematic.<sup>944</sup> Such rights of creditors could be undermined if placed in a common class of creditors where the entire creditors vote on a percentage dividend offered to all creditors.<sup>945</sup> It is further argued that requiring a secured creditor to accept a dividend amount lower than the value of its loan amounts to rewriting of the collateral agreement by virtue of a vote from creditors who are subordinate in repayment right to the secured creditor. It is suggested that the potential adverse effect of this approach is likely to cause secured creditors to vote against the plan in order to force a liquidation in which such creditors will be assured of realizing the full value of their collateral.

## 5 8 CONCLUSION

As is apparent from the above analysis of Chapter 6 of the New Act, the value and advantages of the adoption and implementation of this business rescue framework will become concrete and easier to appreciate over time with its application in the business

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<sup>942</sup> Section 145(4) (a) of the New Act.

<sup>943</sup> Section 145(4) (b) of the New Act. See also Rushworth *Acta Juridica* 398.

<sup>944</sup> Johnson and Meyerman 21.

<sup>945</sup> *Ibid.*

community. Although business rescue is not the remedy for every company in financial distress, it has already proved to be a successful mechanism for some.<sup>946</sup> Companies in financial trouble should promptly seek early advice from business rescue experts before considering filing for business rescue given that the consequences intended and otherwise, are far reaching.<sup>947</sup> It is clear that the drafters of the New Act, in particular Chapter 6, considered the needs of ailing businesses, the economy and the community at large hence business rescue is very much a consultative and inclusive procedure. Accordingly, the business rescue practitioner has a responsibility to pursue the success of a business rescue plan by including all stakeholders. Unlike judicial management under the Old Act, the business rescue mechanism of the New Act is expected to save businesses suffering financial setbacks although it still has to be tested.

It should be noted however that liquidations in South Africa have declined sharply.<sup>948</sup> This might be indicative of a positive impact of the promulgation of Chapter 6 of the New Act.

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<sup>946</sup> Smith “Companies Still Don’t Understand the Protection and Remedies in the New Business Rescue Laws” available at: <http://www.hrfuture.net/directory-23/php>.(accessed 11-11-2012).

<sup>947</sup> *Ibid.*

<sup>948</sup> According to Statistics South Africa’s figures released on 22<sup>nd</sup> October 2012, the number of liquidations decreased by 15.5% in the first nine months of 2012 compared with the first nine months in 2011. Liquidations between July and September 2012 have been down by 29.3% compared to a year earlier. See in this regard [www.iol.co.za/business-rescue-laws-takinghold/business](http://www.iol.co.za/business-rescue-laws-takinghold/business) report/portal. (accessed 07-11-12).

## CHAPTER SIX

### Recommendations and Conclusion

#### 6 1 INTRODUCTION

South Africa's quest for an effective formal corporate rescue procedure started with the introduction of judicial management by the Companies Act of 1926 with the idea of attempting to rescue an insolvent company instead of engaging in liquidation.<sup>949</sup> Since then, the concept of business rescue has received much attention in international corporate law. This study has covered some of the challenges faced by the corporate world as the development and implementation of business rescue mechanisms emerges. In the preceding chapters, the study examined the development of business rescue systems in South Africa, United Kingdom, Australia and the challenges faced by these jurisdictions as well as the influence of the United Kingdom and Australia on South Africa's corporate law.<sup>950</sup>

This study has covered some of the problematic issues of judicial management which were in the Old Act<sup>951</sup> and of business rescue in the New Act<sup>952</sup> and the New Act as Amended.<sup>953</sup> As already highlighted, judicial management turned out to be outmoded, expensive, inconsistent, and improbable and above all accelerated job losses.<sup>954</sup> Accordingly, the business rescue

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<sup>949</sup> Loubser "Tilting at Windmills? The Quest for an Effective Corporate Rescue Procedure in South African Law" available at <http://www.unisa.ac.za/..Inagurallecture.html>. 1. (accessed 10-11-2012) (hereafter Loubser).

<sup>950</sup> See generally Chapter 2 and 3.

<sup>951</sup> Section 427-440 of Companies Act 61 of 1973.

<sup>952</sup> Chapter 6 of Companies Act 71 of 2008.

<sup>953</sup> Chapter 6 of the Companies Amendment Act 3 of 2011.

<sup>954</sup> Chapter 2.

mechanism in the New Act is designed to protect investment, preserve employment, maximise the debtors' assets and protect all affected persons in the company.<sup>955</sup>

More specifically, chapter three of this study focused on business regimes in the United Kingdom and Australia. The study has attempted to analyse business rescue purposively as South Africa derives its history, common law, case law and sources of insolvency law from these jurisdictions.<sup>956</sup> The analysis that emerged from looking at these jurisdictions which have similar business rescue regimes showed that companies can be saved from liquidations.<sup>957</sup> Although some challenges<sup>958</sup> emerged from the study's findings on these jurisdictions, the goals of business rescue mechanisms have nevertheless been pursued. Critically analysing United Kingdom's Administration Order and Company Voluntary Arrangement give the reader a clear understanding of how inefficient these procedures have been in the modern day insolvency law of the United Kingdom.<sup>959</sup> In spite of that observation, the CVA can be an effective alternative to liquidation for a company in financial distress.<sup>960</sup>

Chapter 4 focused on judicial management. It dealt in great detail with its application in South African Company law although it underwent a series of amendments.<sup>961</sup> While judicial management was a statutory<sup>962</sup> mechanism aimed at rescuing businesses, liquidation was the

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<sup>955</sup> *Ibid.*

<sup>956</sup> See discussions in Chapter three.

<sup>957</sup> *Ibid.*

<sup>958</sup> The analysis revealed that due to a gap in the Australian legislature on the rights and interest of shareholders are not protected although the Harmer Committee has recommended that the shareholder must have a proprietary interest in an insolvent company. See chapter three. It also emerged that creditors are allowed to decide the fate of the company through DOCA and therefore have no concerns with what happens to the company after the implementation of a DOCA, unless they receive further payments. Furthermore, in Australia, the power of the administrator during voluntary administration to cast a vote when creditors are meeting for the second time encourages conflict of interest. See chapter three.

<sup>959</sup> See Chapter three.

<sup>960</sup> *Ibid.*

<sup>961</sup> See discussions on chapter 4. It is important to note that South African Company Law has been amended after recommendations made by commissions such as Landsdown Commission of 1936, Millin Commission of 1948 and the Van Wyk de Vries Commission of 1973.

<sup>962</sup> See sections 427-440 of the Old Act.

preferred option for almost a century.<sup>963</sup> The question that this study asked is: why was liquidation preferred to judicial management? An attempt has been made by the study to find out why liquidation was the preferred option despite a statutory mechanism aimed at rescuing businesses.

Chapter 5 examines chapter 6 of the Companies Act 71 of 2008 (the New Act) as against Companies Act 61 of 1973 (the Old Act). It is trite that legislation such as the Old Act needed reform in order to align with international standards and pursue the objective of inclusivity of all stakeholders in the composition of companies operating in the new South Africa. An attempt has been made in the study to analyse and evaluate the key elements of the new business rescue mechanism.<sup>964</sup> This analysis and evaluation provide a clear indication whether the purpose of the new mechanism is achievable. Finally, recommendations are made in this chapter relating to some aspects of the new business rescue mechanism which is already being tested by the judiciary.

## **6 2 RECOMMENDATIONS**

### **6 2 1 Reducing the role and involvement of the court in the operation of the business rescue mechanism**

As noted in the discussion in chapter 4, one of the greatest weaknesses of judicial management was its adversarial nature. In chapter 5, this study showed that a court- driven process of business rescue still persists in Chapter 6 of the New Act. The most pertinent question the study is raising here is whether the drafters of the New Act could not have

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<sup>963</sup> See discussions on chapter 4.

<sup>964</sup> See discussions on chapter 5.

adopted the Australian business rescue mechanisms?<sup>965</sup> Be that as it may, the study noted that the court's involvement in the administration procedure is quite significant as the court promotes the administrators' strategies for survival.<sup>966</sup>

In sharp contrast, the framework and processes in Australia relating to voluntary administration are less court-driven.<sup>967</sup> The Australian approach is to avoid unnecessary delays and costly litigation that result in smaller dividends for creditors and dissipation of company funds.<sup>968</sup> In South Africa, chapter 6 of the New Act which deals with business rescue has not moved away from a court-driven process prompting questions as to the rational of promulgating a reformed business rescue mechanism to replace judicial management which was perceived as a failure.

Experience has proven that, practically, the appointment of a business rescue practitioner emerges from a court order which causes unnecessary delay sometimes resulting in the company being subject to a business rescue order without anyone to supervise it, thus causing immense damage that could prejudice the successful implementation of a business rescue plan.<sup>969</sup> It has been submitted that where an application is made to court on the basis that the company is financially distressed and urgently requires the appointment of a business rescue practitioner, if the application is opposed, the court order for business rescue process may only be granted some weeks later thus leaving the company unsupervised in the interim.<sup>970</sup> It

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<sup>965</sup> See chapter 3 of this study. In comparing the United Kingdom and Australia, the researcher noted that Australia adopts less court-driven mechanisms for saving distressed businesses.

<sup>966</sup> See discussions on chapter 3.

<sup>967</sup> *Ibid.*

<sup>968</sup> *Ibid.*

<sup>969</sup> Levenstein "Business Rescue – Problems and Pitfalls" <http://www.icsa.za/documents/2011/SpeakerPresentations/EricLevenstein.pdf/> 33 (accessed 10-10-2012).

<sup>970</sup> Levenstein 17.

is suggested that the company continues to function as normal while a business rescue order is granted and a practitioner is appointed.<sup>971</sup>

## **6 2 2 Strengthening protection of the rights and interests of shareholders**

In terms of section 7(k) of the New Act (as amended) the purpose and application of the New Act (as applied to business rescue) is to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders. Section 128 (1) of the New Act provides that an ‘affected person’ includes:

- A shareholder or creditor of the company;
- Any registered trade union representing employees of the company; and
- Each employee of the company or their representatives, if any of the employees are not represented by a registered trade union.

It appears that the shareholder as an affected person is prejudiced during business rescue proceedings. The employees in terms of section 144 of the New Act can form employee committees like creditors.<sup>972</sup> The employee’s rights are seemingly equated to those of the director while the rights of the shareholder seem limited.<sup>973</sup> It has been noted that the shareholders in Australia can remove directors, thus enhancing the position of the shareholders.<sup>974</sup> Loubser<sup>975</sup> argues that the amended version of chapter 6 of the New Act as it

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<sup>971</sup> *Ibid.*

<sup>972</sup> See the discussions in Chapter 5.

<sup>973</sup> See chapter 3 where it is noted that the shareholder who is a director has fiduciary duties under administration.

<sup>974</sup> See chapter 3. A shareholder in Australia plays a significant role in the voluntary administration procedure. However, the Harmer Committee’s recommendations on shareholders have not been adopted thus creating a gap in relation to the proprietary interests of shareholders.

<sup>975</sup> Loubser “The Business Rescue Proceedings in the Companies Act 2008: Concerns and Questions: (Part 2) 2010 (3) *TSAR* 695-696.

currently stands, does not empower the shareholder as an affected person who is present at the meeting<sup>976</sup> to make a proposal requiring the business rescue practitioner to prepare and publish a revised plan in a company going through a business rescue order thus the shareholder being prejudiced in a way. Contrary to the almost powerless situation of shareholders, including those whose rights may be directly affected by the plan, trade unions and unrepresented employees have specifically been given the right to be present at the meeting enabling them to propose the development of an alternative business rescue plan.<sup>977</sup> The researcher therefore recommends that the shareholder be awarded more ‘reasonable’ rights in subsequent amendments to the business rescue provisions.

### **6 2 3 Review of the superior position of creditors relative to other affected persons**

The New Act provides for distinct functions for creditors in the business rescue process thus creating the potential for prejudicial effects on the interests of other affected persons.<sup>978</sup> It has been submitted that the creditor-friendly culture still appears to have a strong influence on the courts which proves that society’s culture and perceptions cannot be changed overnight by new legislation.<sup>979</sup> The result is that the New Act as reformed as it is, still lays emphasis on the interests of the creditor over those of other affected persons and the company. It has also been submitted that the creditor can sue the business rescue practitioner in the event of the business rescue plan failing and the company subsequently goes into liquidation.<sup>980</sup> It appears that recent case law has cautioned against the prejudicial impact of postponements of the

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<sup>976</sup> Loubser 696 submits that in terms of section 146(e)(i) of the New Act the right given to “each holder” of any security of the company” to propose the development of an alternative plan in accordance with section 153 of the new Act is far more limited than would appear at first sight.

<sup>977</sup> Loubser 696.

<sup>978</sup> Section 145 of the New Act put a lot of emphasis on the rights and interests of the creditor. .

<sup>979</sup> Loubser 10. See also *Swart v Beagles Run Investments 25 (Pty) Ltd and Others* 2011 (5) SA 422 (GNP) 26597/11[2011] ZAGPPHC 103 (paragraph 41) judgment delivered on 30/11/2011. The court held that “where an application for business rescue, as it was the case in applications for judicial management, entails the weighing –up of the interests of the creditors and the company, the interest of the creditors must carry the day”.

<sup>980</sup> Levenstein 29.

business rescue application on creditors of the company.<sup>981</sup> In the view of the courts, business rescue proceedings must be conducted expeditiously because delays in such proceedings hinder creditors from enforcing their claims.<sup>982</sup>

Although the creditor must always be allowed to protect his interest wherever a company becomes insolvent, it is recommended that any future amendment of the Companies Act attempt to balance the rights of all affected persons.

#### **6 2 4 Avoid excessive rigidity in the courts approach to applications for business rescue**

The courts in South Africa have begun applying the new business rescue provisions as enshrined in Chapter 6 of the New Act. This development will soon enable a credible assessment whether chapter 6 of the New Act has a real potential to save distressed companies. However, in most of the judgments delivered by the courts, the business rescue applicants have not been able to convince the courts that the statutory remedy should be available to their distressed companies.<sup>983</sup> Suffice to say that the courts are unwilling to grant the business rescue order to companies without the applicants discharging the onus of proof. It has been submitted that courts recognize the desirability of a company in distress continuing business through business rescue but nevertheless found it necessary to caution against the possible abuse of the business rescue procedure by rendering the company

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<sup>981</sup> Ramlall “The Judicial Development of Business Rescue Proceedings in South Africa: A Step in the Right Direction” 2012 *Speculum Juris*.

<sup>982</sup> *Ibid.*

<sup>983</sup> See chapter 5 where some of these cases have been discussed.

temporarily immune to actions by creditors so as to enable the directors or other stakeholders pursue their own ends.<sup>984</sup>

## **6 2 5 Developing business rescue practitioners into a new industry**

The study in chapter 4 showed that judicial managers lacked skills and the qualifications required to rescue a distressed company. The chapter also showed that judicial managers were usually liquidators who are inclined to sell the companies and not to save them, thus more businesses went through the liquidation route.<sup>985</sup> The New Act has however prescribed requirements pertaining to the business rescue practitioner's functions and terms of appointment.<sup>986</sup> Section 138 of the Companies Amendment Act stipulates that the business rescue practitioner must be a member in good standing of a legal, accounting or business management profession and must be a holder of a license<sup>987</sup> issued by the CIPC. The question that is arising is when is the accreditation of the required profession going to be in place as business rescue proceedings are already being managed by practitioners. Bradstreet<sup>988</sup> submits that in the United Kingdom, a legislation regulating the qualification and discipline of members of insolvency practitioners is in place to ensure that members are not only qualified and independent but they are guarded to maintain integrity. In furtherance, the United Kingdom's practitioners are required to be members of the Law Society of

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<sup>984</sup> Koonhof "The Judicial Development of Business Rescue Proceedings in South Africa: A Step in the Right Direction" 2012 *Speculum Juris*.

<sup>985</sup> See the discussions on chapter 4.

<sup>986</sup> Part B of Chapter 6 of the Companies Amendment Act 3 of 2011.

<sup>987</sup> Lotheringen has submitted that the CIPC investigate business turnaround practices locally and internationally before final licenses are granted to applicants to oversee business rescue proceedings. Prior to the issue of the final license, any business that is financially distressed and wants to start rescue proceedings can file the notice prescribed in the New Act with the CIPC. The distressed company is required to identify a prospective practitioner that will apply to the CIPC to be issued with an urgent license. See Lotheringen "Business Rescue" <http://www.lssa.org/za>. (Assessed 10-11-2012).

<sup>988</sup> Bradstreet "The leak in the Chapter 6 of Life Boat: Inadequate Regulation of Business Rescue Practitioners may Adversely Affect Lenders' Willingness and the Growth of the Economy" 2010 SA *Merc LJ* 195. (Hereafter Bradstreet).

England and Wales and the Institute of Chartered Accountants<sup>989</sup> in England and Wales, although being a specialized professional in litigation and financial analysis hardly seem the most worthy candidates for managerial tasks.<sup>990</sup> It has been argued further that the qualification required in terms of section 138 of the New Act is neither here nor there in that ‘membership in good standing’ can hardly be equated to an ability an ability to effect a successful rescue, unless such membership necessarily attest to such an ability as creditors cannot rely on such membership to conclude that a practitioner is able to effect what is in their best interests without further details about<sup>991</sup> practitioner’s personal qualifications.<sup>992</sup> The researcher therefore recommends that a recognized and accredited institution of learning be commissioned to design and deliver a comprehensive training programme for prospective business rescue practitioners to ensure that they are equipped with the skills and technical knowhow required to successfully handle distressed companies. The current provision<sup>993</sup> appears rather vague. However, the CIPC has established a Business Rescue Accreditation Model Liaison Committee to monitor business rescue practitioners.<sup>994</sup>

## **6 2 6 Extending the claims moratorium to outstanding taxes due to the South African Revenue Service (SARS)**

In terms of section 145(4)(a) and (b) of the New Act, in respect of any decision that requires the support of the holders of creditors’ voting interests, a secured or unsecured creditor has a

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<sup>989</sup> *Ibid.* Bradstreet submits that these accountants still take advice from insolvency lawyers.

<sup>990</sup> *Ibid.* (McCormack *Corporate Rescue Law: An Anglo-American Perspective* 2008 cited in Bradstreet).

<sup>991</sup> Bradstreet 205.

<sup>992</sup> Bradstreet 207 submits that the interim requirements for the appointment of business rescue practitioner seem rather broad as the practitioner may be an accountant, an attorney, a liquidator or business turn around practitioner or a person holding a degree in law, commerce or business management who has experience in conducting business rescue proceedings.

<sup>993</sup> See Section 138 (1) (a) of chapter 6 of the Companies Amendment Act 3 of 2011.

<sup>994</sup> See the discussion by Lothingen “Business Rescue” <http://www.lssa.org/za>, <http://www.dti.gov.za>.(accessed 10-11-2012).

voting interest equal to the value of the amount owed to that creditor by the company and a concurrent creditor who would be subordinated in a liquidation has a voting interest, as independently and expertly appraised and valued at the request of the practitioner, equal to the amount, if any, that the creditor could reasonably expect to receive in a liquidation. This provision was at the centre of the landmark judgment in the case of *Commissioner of SARS v Beginsel No & Others*.<sup>995</sup> It has been submitted that while the judgment in this case<sup>996</sup> dealt with substantive aspects of the new business rescue regime, most of the other judgments dealt with its procedural aspects and the instances in which a court will be inclined to grant a business rescue.<sup>997</sup> In the *SARS v Beginsel* case, the judge took the view that the position taken by the SARS Commissioner failed to balance the rights and interests of the relevant stakeholders. It has however been argued that section 133 of the Companies Amendment Act provides that the moratorium is not applicable in the case of proceedings instituted by a regulated authority in the execution of its duties after written notification to the business rescue practitioner – which raises the fear that there will be no moratorium on SARS collecting outstanding taxes owed to it.<sup>998</sup> It is therefore recommended that the moratorium-related provisions be amended so as to expressly create an obligation on the SARS to grant

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<sup>995</sup> See the case of *Commissioner of South African Revenue Service v Beginsel NO & Others* (case No 15080/12) [2012] ZAWCHC 194 judgment delivered on 31<sup>st</sup> October 2012. In this case, three shareholders applied to the court for an order of business rescue. The court on the 14<sup>th</sup> October 2011, granted the order. The respondents business rescue practitioners, aimed at achieving the objects of section 128 (1) (b) (iii) of the New Act and at first meeting of creditors, resolved that business rescue plan should be prepared and published. The applicant, SARS, provided a proof that shows the company's indebtedness to it. (Paragraph 8). SARS averred on its interpretation of section 145(4) (a) and (b) of the New Act, the decision to adopt the business rescue plan was invalid and unlawful. SARS insisted that it should be ranked a preferent creditor and regard its status as such. (Paragraph 12). The business rescue practitioners refused this request with the explanation to the effect that the classification of creditors in terms of sections 96 – 102 of the Insolvency Act 24 of 1936, was not applicable to Chapter 6 of the New Act. Moreover, irrespective of whether SARS was a preferent or concurrent creditor, it did not impact on SARS' voting on the proposed business plan (paragraph 13). SARS prayed to the court to place interdict on the business rescue practitioners to place the company in liquidation. (Paragraph 15). In passing judgment, the court held that the New Act does not create statutory preference as set out in the Insolvency Act and that if the legislation had intended to prefer SARS above other creditors in the business rescue proceedings, it would have explicitly say so. Accordingly, the court held that SARS is not a preferent creditor in business rescue as it will be in liquidation.

<sup>996</sup> 15080/12[2012]ZAWCHC 194 (31-10-2012).

<sup>997</sup> Levenstein and Barnett "No preferential Creditor Status for SARS in a Business Rescue" <http://www.werksmans.co.za/> (accessed 15-12-12).

<sup>998</sup> Tabata and Boyes "The New Companies Act: Business Rescue" <http://www.stbb.co.za/stbb/./pdf> (accessed 15-12-2012).

relief to distressed companies as required by the moratorium on claims against companies placed under business rescue orders.

### **6 3 CONCLUSION**

The aim of this study has been to explore the progressive development of business rescue mechanisms in South Africa focusing especially on the mechanism created by Parliament in chapter 6 of the New Act and using the business rescue mechanisms of other jurisdictions as comparative reference points. Accordingly, the study examined judicial management under the Old Act as well as business rescue under the New Act and the New Act as Amended. In this regard, the purpose was to identify the causes of the failures of judicial management and the potential for the success of business rescue.

To achieve the above stated aims, the study has attempted to examine the reasons why judicial management was seen as an extra ordinary measure to save businesses and why it was underutilized by stakeholders.<sup>999</sup> The most significant aspect of Chapter 6 of the New Act is the development of a structured business rescue plan that has to be put in place by the business rescue practitioner with the approval of the affected persons.<sup>1000</sup> This was clearly missing under judicial management where the judicial manager was not obligated to develop such a plan to make the distressed business viable again.<sup>1001</sup>

The purpose and provisions of Chapter 6 of the New Act as amended introduce principles relating to business rescues which brings South Africa in line with international principles of

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<sup>999</sup> See discussions in chapter 4.

<sup>1000</sup> See discussions in Chapter 5.

<sup>1001</sup> See the discussions above.

business turnarounds as they exist in foreign jurisdictions and therefore, the success of business rescue will be closely monitored to ensure that South Africa sets a good example not only nationally but also internationally.<sup>1002</sup> Although not all applications to place companies under business rescue have been successful, it appears the promulgation of chapter 6 of the Companies Amendment Act 3 of 2011 and the Regulations as published on 26 April 2011, have addressed some of the problematic issues with the New Act.

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<sup>1002</sup> See generally the discussion by Lotheringen “Business Rescue” <http://www.lssa.org/za>, <http://www.dti.gov.za>.(accessed 10-11-2012).

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