Business Recovery and Insolvency Werks - Item [60721]: News Release

Business Recovery and the Re-Organisation of Companies in Corporate South Africa - an update

In this edition, Paul Winer, Eric Levenstein and David Gewer of the firm's Business Recovery and Insolvency Department, set out the latest trends in South Africa in respect of the worldwide evolution of corporate turnaround in failing companies.

The current status of turnarounds and business recoveries in South Africa and the United Kingdom is dealt with as well as the director's role in corporate recoveries.

CONTENTS – BUSINESS RECOVERY AND THE RE-ORGANISATION OF COMPANIES IN CORPORATE SOUTH AFRICA – AN UPDATE
ERIC LEVENSTEIN

For several years, there has been a growing recognition amongst the world's financial institutions that, as creditors, they can achieve better returns through supporting an orderly and expeditious rescue or workout of a business in financial difficulty than by forcing it into formal insolvency.

This realisation has coincided with efforts worldwide by regulatory and official authorities to encourage financial institutions to co-operate with each other when dealing with debtor companies to which they are collectively exposed, particularly in cases involving large exposures. More recently, in South Africa, financial institutions and government are in the process of supporting initiatives designed to encourage creditors to take a collective approach to debtor companies in difficulty. There seems to be a genuine wish by industry in South Africa to avoid the social and economic impact of major business failures where viable alternatives exist and in order to limit the damage to financial institutions that can result from unexpected and major debtor insolvencies. The impact of insolvencies on employment in South Africa is well documented and in this regard Trade Unions across the spectrum have become intimately involved in the aforementioned process.

The key is an early reaction to a debtor company in financial difficulty. A co-ordinated response by the creditors of such debtor companies will give time to help manage the impact of struggling cash flow positions and trading in insolvent circumstances.

A recognition by corporate South Africa of the principles of corporate recovery and workouts will importantly create an opportunity to explore and evaluate options for maximising recoveries for all creditors and indeed the employees of companies.

Without doubt, a rescue orientated local insolvency regime will create material advantages for both debtor companies and their creditors in the expeditious implementation of informal or proposed legislative based rescues or workouts. When compared with the smaller dividend available after insolvency, the unpredictable costs and the uncertainties of a formal insolvency, this we believe will become a viable alternative in corporate South Africa.

What follows in this publication sets out some of the current thinking in regard to corporate rescue in South Africa and the current state of affairs in respect of corporate recovery models and new legislation proposed by, inter-alia, Professor David Burdette of the University of Pretoria's Centre for Advanced Corporate and Insolvency Law (UNISA) and Mr Patrick Daly of Daly Inc.

The theme throughout is that time is crucial in rescues and workouts. Delay in reacting to a debtor company experiencing financial difficulty prolongs commercial uncertainty and increases the costs of the process and erodes value for creditors.

The various corporate recovery proposal suggestions that are currently being made in South Africa at present, are designed to expedite rescues of companies and therefore increase the prospects for success so that the debtor company and creditors can move the process to a speedy resolution in a relatively structured manner.

THE STATUS OF THE UNIFIED INSOLVENCY ACT AND THE PROPOSALS FOR BUSINESS RESCUE IN SOUTH AFRICA

David Gewer

South African Insolvency Law is set to be overhauled by the proposed introduction of a statute aimed at unifying the insolvency provisions presently contained in the Companies Act, the Close Corporations Act and the Insolvency Act. The new act is also expected to create a statutory mechanism for the implementation of a business rescue regime in South Africa. Professor David Burdette of UNISA has been at the forefront of these proposals but the exact form of such mechanism is still subject to debate.

The only methods of achieving business rescue presently in our law are judicial management, offers of compromise as contemplated in section 311 of the Companies Act and business rescues achieved through "informal workouts". Each of these are unsuitable for various reasons.

Judicial management is a mechanism which may be implemented when a company "is unable to pay its debts or is probably unable to meet its obligations" and "there is a reasonable probability that", if it is placed under judicial management, the company will become a successful concern. This is achieved by the appointment of a judicial manager who conducts the affairs of the company in an effort to restore its profitability.

Judicial management, which may be seen as a "pseudo-business rescue" provision, has unfortunately failed dismally in practice and companies placed in judicial management are almost invariably subsequently placed into liquidation. This is due to the fact that judicial managers often lack the industry expertise necessary to effect a turnaround. Companies placed into judicial management are required to deal with the stigma associated therewith and the resultant reluctance of suppliers to continue supplying the company. The company may also experience difficulty in obtaining access to funding. This obviously results in the company's restored financial viability being highly unlikely.

Section 427(1)(a) of the Companies Act also imposes an unnecessary burden on a company applying for judicial management in that it requires the company to be unable to pay its debts or to be probably unable to meet its obligations whereas a workable business rescue regime should allow a company access to a form of protection at a stage prior to being in dire financial straits. To force a company to wait for the point of virtual insolvency may defeat the whole purpose of a corporate turnaround venture.

Offers of compromise as contemplated in section 311 of the Companies Act 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 the consideration of such offers of compromise and for their sanction. A company in financial distress may not be able to survive the delays occasioned thereby. Additionally, a creditor is not bound by an offer of compromise until the sanction thereof and the possibility exists of a creditor applying for the liquidation of a company notwithstanding a pending offer of compromise. This method of business rescue accordingly makes no provision for the interim period during which the company awaits the sanction of an offer of compromise by the Court.

Whilst informal workouts (workouts effected other than through the utilisation of a statutory procedure) are often successful in practice many problems may arise through their attempted implementation. Any creditor may preclude the informal restructuring by instituting liquidation proceedings. Directors of a company and other parties involved (e.g. financiers) may face allegations of reckless trading as a result of their restructuring efforts and may accordingly be disinclined to support the rescue initiatives. Dispositions of the company's assets which may be a prerequisite to any successful restructuring may also possibly be set aside in terms of the relevant provisions of the Insolvency Act (as having been made without value or in the preference of certain creditors) in the event of the company subsequently being placed into liquidation. Additionally, these types of workouts do not result in the crystalisation 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 plan.

From the aforegoing it is patently clear that a workable statutory business rescue regime is required in South Africa. Such regimes, in differing forms, presently exist in many countries worldwide including The United Kingdom, Australia and The United States, where the "Chapter 11" procedure has a high success rate. It is, however, obviously necessary to develop a business rescue regime which suits our unique circumstances, rather than simply transplanting a system in use abroad.

The United Nations Commission on International Trade Law (UNCITRAL) has comprehensively discussed "business re-organisation", which is briefly defined as –

"[A] process of restructuring an insolvent entity in order to [rescue the debtor and] rescue the financial well being and the viability of the business, by way of various means possibly including debt forgiveness, debt rescheduling, debt equity conversions and sale of the business or parts of it as a going concern"

It is also considered that maximum value for creditors may be obtained through re organisation rather than liquidation. The process would have a positive effect on the economy by protecting employment, protecting creditors and saving businesses facing financial ruin.

A proposal known as "The Daly proposal" has been submitted as an interim solution to the call for an urgent business rescue initiative in South Africa i.e. as a mechanism to be adopted pending the enactment of the draft Insolvency and Business Recovery Bill (which will contain a more comprehensive business rescue provision). The Daly proposal contemplates the amendment of the existing Companies Act to cater for the implementation of business rescues (in circumstances where possible) after the grant of a provisional liquidation order. A provisional liquidator with turnaround experience is to be appointed and the Court would grant a return date of a minimum of 60 days upon which the Court would again hear the matter in order to decide whether to place the company in question into final liquidation or whether to discharge the provisional liquidation order in the event of a successful turnaround. Upon such date the provisional liquidator must furnish the Master of the High Court with a report which sets out his/her findings regarding the financial status of the company, an assessment on whether the company can trade out of its financial difficulties and the means of rescue proposed. Whilst this proposal will at least expedite matters in that it 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 the business, the proposal will only be a temporary solution until a more comprehensive Business Rescue model is introduced. The proposal has limitations in that, inter alia, aside from the many legal consequences which ensue upon the provisional liquidation of the company, (e.g. the effect on contracts to which the company is a party) the obvious effect of a provisional liquidation order is the immediate reluctance of any financial institution or any other party to supply funding to the company and the reluctance of any creditor to continue to supply credit, which may be prerequisites to any successful turnaround.

The introduction of a workable statutory business rescue model in South Africa and the regulation of individuals entitled to act as "turnaround practitioners" is long overdue and awaited with interest. This will obviously result in the preservation of employment, the enhancement of the value of enterprises where the implementation of the mechanism is possible, increased long term returns for creditors and other stakeholders, the expedition of recovery by creditors against entities in financial difficulty and the general positive effects of the aforegoing on the country's economy.

THE DIRECTORS ROLE IN CORPORATE TURNAROUND IN SOUTH AFRICA
ERIC LEVENSTEIN

Recent suggestions in South Africa of a new "business rescue" regime will result in substantial pressure being placed on directors who continue to operate insolvent companies to embrace either a turnaround strategy or a liquidation as early as possible.

The concept of the limited liability company is under attack in several countries. In certain jurisdictions, the concept of limited liability is seen as a stumbling block for creditors who wish to impose personal liability on directors for acting in a reckless manner or with intent to defraud creditors.

Those who believe that limited liability is meritorious, would state that it encourages entrepreneurship and investment with attendant risks. Others argue that limited liability offers a wall of protection to unscrupulous directors who deal with the company's capital base in a reckless manner and which results in the transfer of commercial risk to unwitting creditors.

The general trend is for corporate directors to take on greater accountability and transparency in the running of corporate entities. In South Africa, section 424 of the Companies Act No. 61 of 1973 (as amended) ("the Companies Act") specifies four incidences where a person may be held personally liable when conducting business: trading recklessly; with intent to defraud creditors of the company; with intent to defraud creditors of some person other than the company; and for any fraudulent purpose.

Recent decisions in South Africa give a clear indication of the court's awareness of the problems faced by creditors when dealing with companies trading in insolvent circumstances. What is becoming increasingly clear is that directors need to understand the differentiation between actual insolvency and commercial insolvency when conducting company operations.

In South African Law, actual insolvency is deemed to occur when liabilities exceed the market value of assets at the date of the application for the liquidation of the company. The fact that debts remain unpaid, or that the debtor has sought a moratorium, or compromise with its creditors, is indirect evidence of commercial insolvency.

Commercial insolvency is the inability to pay debts as and when they fall due. Evidence of commercial insolvency may enable a court to conclude that the debtor's liabilities in fact exceeds the value of its assets ie such company is actually insolvent.

In the 1998 case of Philotex (Proprietary) Limited & Others v J R Snyman & Others, the court stated that when the business of the company has been carried on recklessly, or with intent to defraud creditors or for any fraudulent purpose, any person who was knowingly a party to such conduct may be held personally liable for the debts of the company. This case set the tone in respect of the attitude of our Courts in setting the boundaries of reckless behaviour on the part of directors in corporate South Africa.

In overseas jurisdictions, company directors are now the subject of intense public scrutiny. Law reform bodies, legislators and judiciaries all appear to favour expanding the duties of directors and furnishing creditors with stronger legal recourse. Legislators and courts have imposed tougher obligations on directors over the last ten years as a principal means of protecting unsecured creditors – seemingly the most vulnerable parties in corporate insolvency.

In the New Unified Bill on Insolvency law, currently before the South Africa cabinet, amendments have been made whereby any person who was knowingly an accomplice to reckless or fraudulent trading in the event of a liquidation, will be personally liable without limitation for the debts of the company. Indeed, such persons may face criminal proceedings. Furthermore, it has been proposed that company managers should not cause or allow debts to be incurred knowing that there was little likelihood of their being repaid and may also be held to be personally liable.

In terms of the new proposals, proof of insolvency will be easier to establish and will include-

· where liabilities (including prospective and contingent liabilities) of the debtor company exceed its assets, fairly valued when the debt was incurred; or

· when offences are committed in respect of the accounting records of the debtor company during the period when the debt was incurred; or

· where the person failed to take all reasonable steps to ensure that the accounting records in respect of the period during which the debt was incurred are surrendered or transferred to the liquidator upon winding up.

The above will constitute prima facie evidence that the particular person, at the time the debt was incurred had reasonable grounds to believe that the debtor would be unable to pay its debts as and when they fell due.

Therefore the current legislative proposals make it clearly apparent that directors and prospective directors of companies need to be aware of the legal implications of trading a company in insolvent circumstances.

In South Africa the duties of directors are founded in common law, while others arise from the Companies Act. Further, duties are contained in the companies Articles of Association. The King II Report is widely regarded as the world's most progressive inclusive model of corporate governance. The report recognises that obligations to shareholders are paramount. The King II Report addresses risk management specifically and as a core element of corporate governance. The responsibility for risk management, according to the King II Report, resides in the board of directors. Various persons within companies assist directors with the day to day management of the company, but the buck stops with the board. Directors need to oversee the business of the company and form their own opinion on the effectiveness of the company and its ability to deal with risk.

In regard to the recent proposals of corporate turnaround and rescue in South Africa, it is becoming increasingly apparent that directors will require an enhanced sense of responsibility to recognise early on that a company is in financial difficulties and that a filing for a recovery procedure must be made. The earlier that this is done the better, and will result in a more substantial recovery for creditors.

It is suggested therefore that companies need to develop a system of risk management and internal control that results in a more efficient reaction time to signals reflecting financial stress so as to improve the potential for corporate recovery.

The ability by directors to identify key risks which would affect the value of shareholders in companies will require an ability to identify physical and operational risks, human resource risks, technology risks, business continuity and disaster recovery risks, credit and market risks and compliance risks. The ability of directors to identify and manage a situation where a company commences trading in insolvent circumstances is critical to such directors personal liability in terms of section 424 of the Companies Act. The commencement of what is known as the "twilight" period is essential. It is during this period, when a company commences trading in insolvent circumstances, that would render directors vulnerable to attack by creditors subsequent to a liquidation.

Judicial recognition of this twilight period in South Africa came as early as 1989 in the matter of Ex parte Lebowa Development Corporation 1989 (3) SA 71(d) 117F in which Judge Stegmann held that -

"Public policy requires that the court should play its part in eliminating the evil practice of causing or allowing companies to trade in insolvent circumstances and that the court should do nothing to facilitate, encourage or condone such practice by anyone regardless of his moral or financial standing."

It was in Judge Stegmann's view that when a company trades whilst insolvent, the creditors of the company are exposed to "unauthorised risk" which was unacceptable.

In the matter of Ex Parte De Villiers and Another NNO In Re: Carbon Developments 1992 (SA) 95, Judge Goldstone refuted the views expressed by Judge Stegmann and stated -

"If the view taken by Stegmann J in regard is correct, it would follow that for decades in South Africa, the officers of a vast number of private companies (unbeknown to them and notwithstanding generally accepted practice in the commercial world) have acted unlawfully and dishonestly. It is a common occurrence for a private company to embark on trading with a nominal paid up share capital and to finance its business operations by way of members loans. Frequently these loans are treated as if they are part of the capital of the company."

Judge Goldstone quoted with approval the following statements by Judge Buckley in an unreported judgment in the United Kingdom.

"In my judgment there is nothing wrong in the fact that directors incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fall due. What is manifestly wrong is if directors allow a company to incur credit at a time when the business is being carried on in such circumstances that it is clear that the company will never be able to pay its creditors. However, there is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them to get over the bad times."

According to Judge Goldstone -

"In short, the mere carrying on of business by directors does not constitute an applied presentation to those with whom they do business that the assets of the company exceeds its liabilities. The implied representation is no more than that the company will be able to pay its debts as and when they fall due."

It is therefore apparent that each particular situation that a director might face is fraught with difficulty. The subjective state of mind of a director can be extremely problematic when he has to consider whether or not a company is trading in insolvent circumstances.

In order to understand these concepts, directors have to educate themselves in respect of when it will become necessary to file for business recovery in the new dispensation.

It will be necessary for directors to consciously establish an appropriate corporate culture within their own organisation so as to clearly recognise an insolvent trading situation at an early stage.

Directors in certain companies will operate differently from those which might be appropriate for other companies. Directors require an understanding of the roles of their particular board, each directors roles, powers, duties and responsibilities when assessing financial risk and trading in insolvent circumstances.

In summary, the King Report on corporate governance has previously stated -

"Directors have awesome responsibilities and they must be properly prepared to carry out their duties"

Proper preparation and understanding by directors of the parameters of trading in insolvent circumstances will determine the limits of their responsibilities. Unfortunately, the lack of such understanding on the part of directors has resulted in many companies being wound up with the unfortunate consequences that follow such as retrenchments, litigation, massive creditor losses and the devastating affect that such events have on the South African economy as a whole.

What has been clear in our experience is that many directors have a fundamental lack of knowledge as to what in fact their duties are, a lack of understanding as to how far they must go in verifying information put to them by management and lastly, a lack of appreciation as to the nature and extent of their possible liability to creditors.

Unfortunately for many of these directors, an appreciation of these fundamentals comes far too late and when they are giving evidence in the witness stand at a section 415 or 417 enquiry in terms of the Companies Act!

IS THE TAIL WAGGING THE DOG ?
ANDREW CONQUEST AND JIM STEWART-KOSTER- GRANT THORNTON, LONDON

Managing a business effectively when times are good is difficult - but we think we'd all agree that managing a business in troublesome times is even more problematical.

Increasingly many otherwise profitable groups are finding themselves held back by underperforming or non-core subsidiaries or divisions. This is an area of company management where decision-making has to be strategic and be made for the benefit of the entire group.

Increasingly we are finding that owners of UK and European operations are seeking solutions for exiting their underperforming or loss-making businesses or divisions in a controlled way which mitigates their potential loss and protects the group's reputation. These circumstances will have arisen as a result of a number of factors, not least a worldwide industry restructuring or merely failed investment propositions.

This approach can be particularly of benefit to non-resident shareholders and holding companies domiciled in other countries, where arm's length advice is required, and may be found wanting; local management may be presenting an intentionally rosy picture of operations, when the true picture is markedly less so.

This article explains what solutions are available and the opportunity for you to help your clients.

Exit strategies

In situations where a corporate group comprises a wide range of businesses, or indeed a narrower (but underperforming) range of businesses, a number of factors may conspire against top management. The non-core or underperforming business unit may be utilising a disproportionate share of management time, suffering from low employee morale and, most importantly of all, leaking cash. Therefore management may prefer to arrest the absorption of these precious resources and facilitate an efficient and orderly restructuring, workout (with or without an insolvency process) or closure of the non-core or underperforming business unit in question.
In our experience, if this business is not identified early enough, or if it is identified and then ignored, it can quickly end up as the tail wagging the much bigger dog.

Our research has highlighted that there are up to 7,000 loss-making subsidiaries with turnover of over £3m trading in the United Kingdom - a statistic which shows that there are many otherwise profitable groups which need to take tough decisions with some of their subsidiaries.

Options and keys to success

We consider three options (or more, should aspects of each approach be combined) to deal with the business unit concerned:

· turnaround / restructuring
· going concern disposal; and
· orderly closure and exit.

Of course, the approach (or blend of approaches) taken will depend on each group's overall circumstances and its specific requirements.

There are several keys to delivering a successful outcome but four stand out:

· early diagnosis coupled with a clear mandate for action;
· contract review;
· planning; and
· employee participation / buy-in.

Early diagnosis and a mandate for action

Making an early diagnosis and securing a clear mandate for action maximises the number of options available.

Operational management must be encouraged to keep a close eye on the performance of their business units, not only in relation to Key Performance Indicators, but also on a 'big picture' level, so they spot and can diagnose (or if they lack expertise, request a diagnosis of) an underperforming business unit. To the operational management involved, such processes may appear to lead to their own demise, which may be another factor conspiring against top management in their attempts to monitor their business. Clearly, where relevant, this impression must be managed.

In the event a problem is diagnosed, it is then necessary for top management / shareholders to set down a clear and unambiguous mandate for action. In the first instance, this will ordinarily result in a detail diagnostic exercise being completed, including a contract review, followed by a detailed planning exercise.

Contract review

Particularly when facing difficulties, a business must be aware of its rights and obligations (indeed, a lack of awareness of such rights and obligations may be a contributing factor to its underperformance and/or the difficulties being faced).

The business is shortly likely to enter a period of substantial upheaval. Accordingly, management must be aware of all areas where potential difficulties may arise, and must arm itself with the knowledge of how to best mitigate the downsides.

Several potentially difficult areas include:

· termination / redeployment of employees;
· winding up pension schemes;
· meeting environmental obligations;
· meeting obligations to customers;
· realisation of assets (ownership, warranties, disposal contracts, etc);
· meeting obligations to suppliers and creditors;
· identifying and accounting for contingent liabilities (eg contractual counterclaims); and
· taxation.

All the above require a significant element of legal advice to determine the strategy for mitigating and controlling liabilities and maximising asset realisations. It is obviously sensible that top management commence a review of such areas of the business as soon as is practicable.

Planning

Effective project management of the process is an essential ingredient. The uniqueness of each business prevents the application of a 'one-size-fits-all' approach when putting together a plan for the orderly and efficient resolution of the business unit's affairs. As a result we have developed a detailed methodology which is tailored to meet the specific needs of the business in question.

Project management is the focus. A detailed plan is built, identifying the critical path (that is the sequence of activities which determine the project completion date) for completion of the project. This plan is updated as the project is completed and, as such, is a necessarily dynamic document. Importantly it also acts as a fundamental cornerstone of risk assessment analysis.

Employee buy-in

A plan for the orderly and efficient resolution of the business unit's affairs is doomed to fail without appropriate management and employee buy-in. Without such a buy-in, costs increase disproportionately, not only in financial and resource terms, but also in terms of the risks facing the rest of the group. Some examples are:

· reputation: disenfranchised employees will not do the group's reputation any favours;
· industrial sabotage (manufacturing, IP): another potential course of action which a disenfranchised employee may take:
· industrial action / claims for unfair dismissal, etc: another potential pitfall that will cost dearly both financially and in terms of management resource.

Consequently, the early engagement of employees is another key factor in successfully resolving the business unit's affairs. Conversely these issues may be determinants of a particular course of action as a result of unacceptable risks being identified.

Conclusion

The quicker a problem child is identified and referred for help (lawyers and accountants) to experts in this field, the more likely it is that its parents will reap the rewards. Typically sectors which are likely to benefit from this approach are those going through a period of restructuring such as the automotive component industry. In the United Kingdom manufacturing capability generally has been and still is moving East, leading to restructuring issues.

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