

COMMENTS ON COMPANIES BILL

CHAPTER 6 – BUSINESS RESCUE

1. GENERAL COMMENTS

1.1 The explanatory memorandum that accompanied the Companies Bill is not very helpful as all it does is make a few general comments regarding the introduction of the business rescue model. These comments are political in nature, especially the reference to participation by employees.

1.2 It does not appear that this new business rescue model has taken full cognisance of the shortcomings currently experienced with judicial management. In addition, the goals and objectives as stated in the definition of ‘business rescue’ are not aligned with the content of the provisions of the procedure as a whole.

1.3 The proposed model appears to be cumbersome and does not provide for a speedy and efficient resolution of a company’s financial problems by implementing a plan within a short time frame. It would appear that the procedure can be dragged out for a period of months, or perhaps even years. Without an incentive (liquidation) to spur the stakeholders on into reaching agreement on a plan to save the company, it is doubtful whether a speedy resolution will be reached and consequently the objective of saving the company will in all likelihood not be achieved.

1.4 The ‘insolvency event’ mentioned in clause 131(1)(a) differs from the provisions contained in the Draft Insolvency and Business Recovery Bill that will in future regulate the winding-up of companies. The provisions of these two draft pieces of legislation should at least be aligned with one another. In addition, it needs to be mentioned that an ‘insolvency event’ in terms of the proposed business rescue procedure can easily be manipulated in order to bring a company into the ambit of the business rescue procedure, and this makes the procedure open to abuse.

1.5 The ordinary resolution (as opposed to a special resolution) required in order to enter the business rescue procedure, is open to abuse. This also applies to the

simple majority that is required for the acceptance of the plan and for approving actions by the supervisor.

1.6 It is not clear who the DTI proposes using as ‘supervisors’ of this procedure. All that is mentioned is that a supervisor must have the ‘prescribed qualifications’, whatever those may be. If professionals are not used in this profession, it has no reasonable chance of succeeding. In addition, there are no provisions dealing with the personal liability of the supervisor under this procedure. It should be clear that if the supervisor is not held personally liable, it is probable that the creditors will have to absorb losses under the business rescue procedure in addition to the losses they have already incurred prior to the procedure being implemented.

1.7 Although it is stated that the business rescue proceeding brings about a temporary moratorium, the clause dealing with a general moratorium does not clearly state when the moratorium commences or terminates.

1.8 The cumbersome provisions dealing with suppliers and employees will hamper the implementation, use and stated objectives of this procedure. For example, I have my doubts regarding the legality and workability of the provisions that oblige suppliers to continue supplying to the company under supervision after the commencement of the procedure. While the provisions regarding employee participation are noble in their intent, it is my opinion that these will hamper rather than promote the speedy resolution of a company’s financial crisis.

1.9 I have my doubts regarding the determination of the supervisor’s remuneration as provided for in the model. Making provision for the company and the supervisor to reach an agreement in this regard does not appear to me to be a wise move. Should it not be the creditors who determine what the supervisor’s remuneration should be?

1.10 From terms such as ‘overwhelming evidence’ and ‘senior unsecured creditor’ that are used in this chapter, it is clear that the provisions themselves have been drafted by a person or persons emanating from a foreign jurisdiction. As far as I am aware, South Africa does not employ the term ‘overwhelming evidence’ as a burden

of proof. In addition, there is no such thing as a 'senior unsecured creditor' under South African insolvency law.

1.11 Although there is a general clause dealing with the supervisor's power to investigate reckless trading and voidable transactions by the company, the proposed model does not contain any detailed provisions as to how these aspects are to be redressed. It is hardly sufficient for the supervisor to instruct the management of the company to 'rectify the[se] matter[s]'. Likewise, the provisions dealing with unexecuted contracts appear to be incomplete.

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1.13 The provisions dealing with the adoption of a business rescue plan are not complete, and do not take cognisance of all the possible permutations regarding creditor participation or non-participation. In addition, the provisions allow for so much intervention and counter-intervention by the stakeholders, that one wonders if a plan will ever be agreed upon.

1.14 Making use of foreign specialists to draft local or domestic legislation is a hazardous undertaking at the best of times. The provisions of chapter 6 are a clear indication of this. From the provisions of Chapter 6 as a whole, it is clear that the drafter(s) attempted to create a procedure that is more debtor-friendly than creditor-friendly. The introduction of an ordinary resolution as opposed to a special resolution in order to enter the procedure is one example of this. Other examples are the simple majority required by the supervisor to obtain authorisation to do most things, the company and the supervisor being able to enter an agreement regarding the remuneration payable to the supervisor, and the simple majority required in order to accept a plan. While this may go down well in jurisdictions that have debtor-friendly systems (eg the USA), it does not sit well with a country such as South Africa which has a creditor-friendly insolvency system. Despite opinions to the contrary by the

DTI, business rescue forms part of insolvency law. Consequently, any business rescue regime that is introduced has to be aligned with the country's insolvency laws. South Africa has a creditor-friendly insolvency system where creditors have entrenched rights, for example the right to apply for the winding-up of a company that is unable to pay its debts. One cannot, therefore, introduce a system of business rescue whereby the rights of creditors under the insolvency laws can be circumvented by entering a debtor-friendly business rescue regime. One can only imagine how this will be abused by company directors in practice, and the resultant impact it will have on the South African economy. In my opinion any new business rescue regime must be controlled primarily by the creditors, as they are the stakeholders that have the most to lose in monetary terms. This must be balanced by the rights of the employees of the company, who form an integral part of the business. The South African economy is a developing one, and is unable to absorb large amounts of debt that can easily be evaded by entering a debtor-friendly business rescue regime.

1.15 Another obvious shortcoming of the business rescue model is the fact that it will only apply to companies and not to other forms of business enterprise such as close corporations, business trusts, partnerships and sole proprietorships. As stated in earlier comments to the DTI, a business rescue procedure is part of insolvency law and should be included in the uniform Insolvency Act currently in process.

1.16 In sum, I do not believe that the model submitted to me for comment is a realistic solution in the South African context. Designing a system which is an obvious amalgam of the various systems from which the DTI's advisors originate, carries with it the risk that it will be unworkable in a jurisdiction with very different socio-economic dynamics. In addition, I do not believe that the proposed model complies with the international norms and standards as espoused by the UNCITRAL Legislative Guide on Insolvency Law and the World Bank's Principles for Effective Creditor Rights and Insolvency Systems. Considering that the World Bank is currently in the process of assessing South Africa's insolvency laws (including any existing or proposed new business rescue models), this is cause for concern. In my opinion the model will not achieve its stated objective, and will in all probability end up being as ineffective as judicial management currently is.

2. SPECIFIC COMMENTS

2.1 Winding-up provisions

2.1.1 Clause 29(1) makes provision for a special resolution to wind up a company voluntarily which may be “by the company, or by the creditors”. Winding up “by the company” applies to a company which is solvent and this is dealt with in the rest of clause 29. Winding up “by the creditors” is a procedure intended for insolvent companies, but this is not dealt with any further in clause 29 (apart from a provision in clause 29(5)(b)(ii) and clause 29(8)(b)(ii)(bb) regarding the exercise of powers subject to directions or authority given by creditors). In addition, clause 30 deals with winding-up by a court order. Clause 30(1)(b)(i) deals with the winding up by the court of an insolvent company upon the application by a creditor of the company. The rest of the section deals with all other cases where a company can be wound up by court order. However, all these matters are dealt with in the Unified Insolvency Bill. These aspects need to be re-examined in order to avoid duplication and the likely confusion that will follow.

2.1.2 Although Chapter XIV of the current Companies Act 61 of 1973 will continue to apply after the Companies Bill comes into operation, the drafters seem to have lost sight of the fact that section 424 of the current Companies Act makes provision for reckless and fraudulent trading. However, clause 93 of the Companies Bill contains a new provision regarding these aspects. Will both these sections find application once the Companies Bill is promulgated?

2.2 Business rescue provisions

2.2.1 If the business rescue procedure is to achieve its stated goals (see the definition of “rescuing the company” in clause 130(1)(e)), a balance should be struck between provisions that can be applied with relative ease but which cannot be easily abused. Examples of how these provisions can be abused with ease are i) clause 132(1) sets a low hurdle to be complied with for a company to initiate business rescue; ii) an ordinary resolution by shareholders is required (as opposed to a special resolution required for winding-up) or a decision by the board of the company; iii) shareholders or the board who wish to initiate a business rescue would quite easily be

able to believe that the company is insolvent or may imminently become insolvent, or could easily arrange for an insolvency event to occur, eg by not reacting to a demand for payment of a debt.

2.2.2 While the initiation of a business rescue proceeding should not be too cumbersome, the serious consequences of initiating such a proceeding should be borne in mind. For example, i) all legal proceedings are suspended or prohibited in terms of clause 136; ii) post-commencement finance obtained by the company during the business rescue procedure, apparently without the need for authority by creditors, has a preference over unsecured claims (clause 138(3)), which remains in force if liquidation is the end result (clause 138(4)); iii) despite any provision in an agreement to the contrary, suppliers (or persons who contracted to supply) must continue that supply goods, services or inputs that the management of the company regard as essential to the conduct of the business (clause 139(1)(a)); iv) the company may unilaterally abrogate or suspend any provision of a contract other than a contract of employment against a claim for damages (clause 139(2)); v) the supervisor may authorise the company to borrow post-commencement finance in priority to existing obligations in order to fund ongoing business activities (clause 143(1)(c)); vi) the supervisor is entitled to remuneration for services and expenses incurred as agreed in writing with the company, payable as operating costs and if not fully paid it ranks with priority before all other secured or unsecured creditors (clause 146).

2.2.3 While it is relatively easy for a company to enter the business rescue proceeding, the hurdle that an affected person (shareholder, creditor, trade union or unrepresented employee) has to clear in order to have the proceeding set aside is extremely high. For example, i) a court application is required, which involves high costs and other risks (clause 133(1)); ii) the person seeking to have the proceeding set aside has to notify each affected person (shareholders, creditors, trade unions and unrepresented employees) of the application (clause 133(3)(b)); iii) the business rescue proceeding will only be set aside if there is 'overwhelming evidence' supporting the applicant's allegation that there is no reasonable prospect of rescuing the company (clause 133(5)). The proposed procedure to adopt a resolution to begin business rescue proceedings is open to extensive abuse, and it is submitted that the right to object to the resolution by application to court is merely illusory. It is essential

that a balance should be struck between provisions that can be applied with ease, but which are not open to abuse.

2.2.4 It is not clear when “liquidation proceedings [have] been initiated” as contemplated in clause 132(2)(a). This needs to be stated more clearly (see for example sections 348 and 352 of the Companies Act 61 of 1973 where the commencement of winding-up is defined).

2.2.5 Clause 132(3)(a) makes provision for the publication of a notice in the “prescribed manner” to every affected person. There are similar provisions used elsewhere in the Bill. However, nowhere in the Bill is the prescribed manner of publication discussed. See also clause 134(8)(b) and (e) in this regard.

2.2.6 In terms of clause 132(3)(b) the Commission may decide on an extension of time for the appointment of a supervisor. How long will it take for the Commission to make this decision? In view of the possibility of an extension by the Commission, it is difficult to see how will it be decided whether the resolution has lapsed, and therefore become a nullity, in terms of clause 132(4)(a) due to the fact that the company has failed to comply with clause 132(3)(b). Can it not be expected of a company to make suitable arrangements for the appointment of a supervisor within 5 days? This can be done in the same resolution in terms of which the business rescue procedure is commenced.

2.2.7 Clause 133(6)(a) states that the court must appoint an alternate supervisor recommended by, or acceptable to, the holders of a majority of the independent creditors’ voting interests. It is not clear how the court will determine the views of the majority of independent creditors’ voting interests referred to in this clause, or in clauses 134(6) and 134(9)(b), in the absence of a meeting or similar procedure in such cases. In addition it is submitted that even if there was a procedure in place in order to determine the wishes of creditors, it is no simple matter determining the majority of independent creditors’ voting interests, or even to identify who qualify as independent creditors.

2.2.8 The definition of ‘security’ in clause 1 of the Bill is certain to cause confusion. Although this definition does not apply to clauses 29(3), 134(7), 135(1)(c) or 160 (which deals with court proceedings or matters before the Master), the definition is inappropriate when used in the context of clauses 137(3), 147(4), and 153(3)(a) where security is used in the sense of security for a claim. While it is clear that ‘secured’ refers to a creditor with security and ‘unsecured’ to a creditor without security (see clauses 138(3), 146(2)(c), 147(1) and (3), 148(4), and 153(3)(b)), a clearer definition should be included to avoid confusion.

2.2.9 Clause 134(2) states that an application to begin a business rescue proceeding suspends any liquidation proceedings that have already been commenced until such time as the court has adjudicated upon the application, or the business rescue proceedings have ended. The precondition for the business rescue application is that an insolvency event must have occurred and that the company has not adopted a resolution to begin a business rescue proceeding. It is submitted that it would be quite simple to arrange for an insolvency event to occur, for example a failure to react within 15 business days to a demand requiring payment. This provision is in stark contrast to clause 132(2)(a) which provides that a company may not adopt a business rescue resolution if liquidation proceedings have already been initiated. A more sensible option would be to provide that business rescue proceedings do not suspend liquidation proceedings, but that the court has a discretion to suspend any liquidation proceedings that have already been commenced. Considering that contracts of employment will be suspended under liquidation proceedings (no work, no pay) but maintained under a business rescue proceeding, this provision is also open to abuse.

2.2.10 It would appear that the reference in clause 135(1)(c) to clause 134(6), should actually be to clause 134(7).

2.2.11 It is not clear why clauses 136(1)(e) and 137(2) have been included. Section 12 of the Trust Property Control Act provides that the property of a trust and proceedings as a trustee are distinct from the trustee’s personal property or proceedings.

2.2.12 Without personal liability for supervisors it is ludicrous to leave a decision to obtain post-commencement finance, with a preference for repayment, to the company in terms of clause 138(2) subject to the authority of the supervisor in terms of clause 143(1)(c). While it is accepted that post-commencement finance can be an important factor in saving a company and should therefore be possible to obtain, it is submitted that an agreement by the majority of the creditors in number and value would be a more realistic option. Clause 138(1)(a) creates the impression that post-commencement financing has to be approved by creditors at some stage – this is probably an error as a previous version of these provisions did in fact provide for creditors’ authorisation for post-commencement finance.

2.2.13 The following clauses are not clear enough and require expansion:

2.2.13.1 Clause 138(3)(a) – it is not clear when money which becomes due and payable to employees, were incurred;

2.2.13.2 Clause 139(1)(a)(ii) – what is meant by the condition that suppliers must be paid on a concurrent basis?

2.2.13.3 Clause 139(3) – it is not clear whether the claim of a liquidator is preferent or where it ranks in terms of such a preference.

2.2.14 In clause 141(a) reference is made to the ‘prescribed qualifications’ of supervisors. Those referred to in paragraphs (b) and (c) do not help much. Business rescue will require high levels of skill, independence and integrity from those who are to qualify as supervisors. This profession should be regulated from day one, and it is submitted that there should be extensive consultation with all stakeholders regarding the prescribed qualifications of supervisors.

2.2.15 It is inappropriate for the supervisor to direct the management of the company to rectify any possible reckless trading, voidable transactions and breach of duty by the board that may have occurred prior to the business rescue proceeding (clause 144 (2)(c)) – this is something that should be done by the supervisor. The same goes for the recovery of misappropriated assets that may have occurred prior to the business rescue proceeding.

2.2.16 Although clause 153(3)(g) provides that a copy of the written agreement concerning the supervisor's remuneration must accompany a business rescue plan, it is not healthy to leave it to the supervisor and the company to agree on the supervisor's remuneration for services and expenses incurred as provided in clause 146. This provision is open to serious abuse, especially since there are no effective mechanisms in place for creditors to oppose the amount of the remuneration. This also creates problems in the sense that the supervisor can hardly be seen to be at 'arm's length' from the company when they have determined his or her fee. It seems a better option for the creditors to agree to the supervisor's remuneration.

2.2.17 In terms of clause 147(1) an employee is afforded a claim as a 'senior unsecured creditor' for any money due and payable by a company before the business rescue proceedings commenced. In the case of insolvency law there are limitations on the amounts and periods of the preferent claims of employees, and claims by directors of the company (or members of a close corporation) which is the insolvent debtor do not enjoy any preference at all. It is submitted that it will create anomalies and opportunities for abuse if different rules apply to business rescues. Since the term 'senior unsecured creditor' is unknown under South African law, it may be a good idea to define this term and to state how the order of preference functions.

2.2.18 It would appear from clause 153(2)(h) that the order of preference of claims may be determined in the business rescue plan. What happens to claims that currently qualify as preferent claims under the Insolvency Act, for example claims by the South African Revenue Service? Even ignoring the current preferences, this arrangement would be risky to say the least and will no doubt lead to abuses in practice. Regarding claims generally, there is no provision as to how claims should be proved (see clauses 153(3)(b) and 155(5)(c)).

2.2.19 The definition of 'Master' in section 1 appears to be incorrect as he is appointed in terms of section 2 of the Administration of Estates Act 66 of 1965 and not in terms of the Superior Courts Act.

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**(DRAFTED FOR *TMA-SA* AND *ABASA* IN MY CAPACITY AS DIRECTOR
OF THESE TWO ORGANISATIONS)**