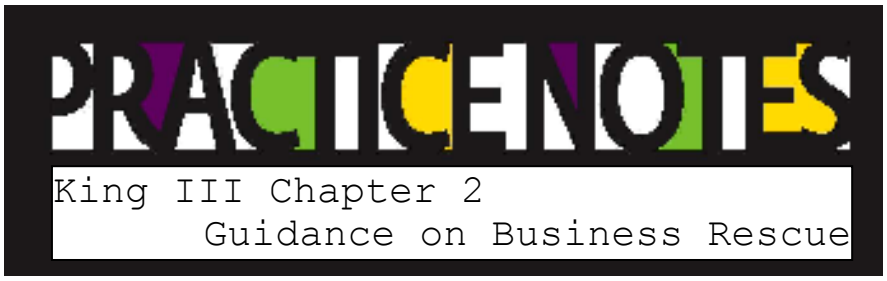

September 2009

Guidance on Business Rescue

Business Rescue[1] is a completely untested new procedure, therefor this chapter aims to not only highlight aspects of the new procedure that would impact upon directors of companies, but also to provide as full an explanation as possible as to how the new procedure will work once it is implemented in 2010.

Both the directors and shareholders of a company have a continued interest and stake in the company. The directors should play a direct role in bringing about the rescue of the company, be it by initiating rescue via a board resolution, providing continued leadership in the running of the business while trading during the business rescue procedure, subject to the authority of business rescue practitioner, or helping to design, and if adopted, implement a business rescue plan devised by the business rescue practitioner. Shareholders may initiate business rescue by applying for a court order, may participate in voting on the business rescue plan if their shareholding is affected by the plan, can propose the development of an alternative plan, and present an offer to acquire the interests of any or all of the creditors or other holders of the company's securities.

The decision to save financially distressed companies through workout, sale, merger, compromise with creditors, or Business Rescue must be made with due consideration of the respective advantages and disadvantages of each. Whilst Business Rescue overcomes weaknesses in saving financially distressed companies informally, it has disadvantages of its own.

Informal arrangements between creditors and financially distressed companies to save it, commonly known as workouts, have been taking place privately prior to the Companies Act of 2008, and are likely to continue after promulgation. Workout may break down, however, due to the company being harassed by creditors not forming part of the arrangement; and information, negotiation and control asymmetries between the company and creditors, and amongst creditors.

The advantage of Business Rescue over workout is the moratorium on claims against the company preventing harassment by creditors, the business rescue plan mitigating information asymmetries, voting rules mitigating coordination problems amongst creditors, and the right to suspend or cancel contracts, with affected parties asserting a claim for damages only.

Business Rescue, however, has disadvantages affecting its viability.

Research on overseas business rescue shows that generally, its direct costs are higher than workout mostly due to legal fees incurred. Its highest cost, however, are indirect costs brought about by public knowledge of

[1]In order to avoid confusion, the term 'business rescue' will only be used to indicate the formal Business Rescue procedure as contained in Chapter 6 of the Companies Act 2008.

financial distress, which manifests itself as loss of prestige, goodwill, credit, employees, customers, and suppliers until such time as financial distress has been mitigated.

Furthermore, during the period until the business rescue plan is considered for adoption, at which time new financial arrangements may be made, a company under supervision still needs to pay certain expenses to prevent its position deteriorating to a point that it cannot be rescued, and it needs to remain solvent. Companies not able to do so, are unlikely to survive Business Rescue.
It follows that commencement of Business Rescue should happen earlier when the degree of financial distress is less rather than later. Additionally, companies able to enter business rescue with pre-negotiated business rescue plans and funding (pre-packaged business rescue), whether flowing from workout or not, are likely to fare better.

Many of the aspects highlighted in the report are based on interpretations of the various legislative provisions and how Business Rescue may viewed relative to informal mechanisms to save financially distressed companies, and it is possible that others may interpret the provisions differently. The real test of the new business rescue procedure, and of the comments and recommendations highlighted in this report, will only be tested once Chapter 6 of the Companies Act 2008 comes into operation in 2010.

Definitions

There are a number of important definitions contained in section 128 of the Act, and which relate to the operation of the Business Rescue procedure as a whole. Company management and the Board should be aware of these important definitions, as they impact on the rights and obligations of directors.

"affected person" (section 128(1)(a)):

In terms of section 128(1)(*a*), an affected person in relation to a company means:

i. a shareholder of the company;
ii. a creditor of the company;
iii. any registered trade union representing employees of the company; or
iv. each employee (or their representative) who is not represented by a registered trade union.

This definition is important as "affected persons" have been given specific rights under the business rescue mechanism, as will appear more clearly from the sections in this chapter.

"business rescue" (section 128(1)(b):

Section 128(1)(*b*) contains the definition of 'business rescue', and means proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for:

i. the temporary supervision of the company, and of the management of its affairs, business and property;
ii. a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and
iii. the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company."

"financially distressed" (section 128(1)(e)):

"Financially distressed", in reference to a particular company at any particular time, means that it appears to be:

i. reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months, or
ii. reasonably likely that the company will become insolvent within the immediately ensuing six months.

"independent creditor" (section 128(1)(g):

This definition describes an independent creditor as a person who:

i. is a creditor of the company, including an employee of the company who is a creditor in terms of section 144(2) and
ii. is not related to the company, a director or the practitioner (an employee of a company is not related to that company solely as a result of being a member of a trade union that holds shares in that company[2]).

Commencing business rescue

The board, and not the company itself through its members, commence the procedure. The board of a company may resolve to commence voluntary Business Rescue proceedings and place the company under supervision, if the Board has reasonable grounds to believe that:

- the company is financially distressed, and
- there appears to be a reasonable prospect of rescuing the company.

Although from a general reading of section 129 it appears that the commencement of the procedure is voluntary, the provisions of section 129(7) appear to contradict this. Section 129(7) states that if the Board of a company has reasonable grounds to believe that the company is financially distressed, but the Board has not adopted a resolution contemplated in section 129(1), then the Board has to deliver a written notice to each

[2] See s 128(2).

affected person setting out the criteria in section 128(1)(*f*)[3] that are applicable to the company, and its reasons for not adopting a resolution to commence the Business Rescue procedure.

From this subsection it is clear that there is an obligation on the directors of a company to at least consider the adoption of a resolution in terms of section 129(1) if the company is financially distressed, and an obligation to inform affected persons if a decision is made not to commence such proceedings in circumstances where the company is financially distressed as defined by the Act.

It may be in the interest of the company to prevent or overcome financial distress through a private workout, sale, merger; or compromise with creditors as per section 155, rather than to commence with Business Rescue. The obligation to inform affected persons of the Board's decision not to commence business rescue proceedings therefore has serious repercussions, especially if one considers that this may lead to either creditors or employees of the company (either by their own volition or through the representative trade union) to apply for either the winding-up of the company or for the commencement of a compulsory Business Rescue procedure.[4]

Although this section places an obligation on the company's Board to notify affected persons if a decision is taken not to adopt a business rescue resolution despite the fact that the company will be unable to pay its debts or may become insolvent in the ensuing six months, there is no sanction should the Board fail to comply.

Directors should on a continual basis monitor the likelihood of the company being unable to pay its debts as they fall due in the immediately ensuing six months, or the company becoming insolvent in the immediately ensuing six months. In such a case the Board will have to do one of two things:

- adopt a resolution commencing the voluntary Business Rescue procedure in Chapter 6 of the Companies Act whereby the company will be placed under the supervision of a practitioner, or
- send a written notice to each affected person of the company setting out the financial position of the company and explaining why a decision has been made by the Board not to voluntarily commence Business Rescue proceedings.

It is important to take note of the fact that a resolution passed by the Board of a company for the voluntary commencement of Business Rescue in terms of section 129(1) is precluded where liquidation proceedings have already been commenced against the company.[5] The resolution adopted by the

[3] S 129(7) actually refers to the criteria in s 128(1)(e), but this is clearly a typing error.
[4] S 131 makes provision for a compulsory business rescue procedure and can be commenced by an affected person at any time. If the company's Board has admitted that it is financially distressed in its notice to affected persons in terms of s 129(7), it would be a simple matter to prove to the court that the company is financially distressed as required by s 131(4)(a)(i).
[5] S 129(2)(a).

Board in terms of section 129(1) is also not of any force and effect until such time as it has been filed with the Companies Commission.[6]

The adoption of a resolution in terms of section 129(1) results in a number of procedural obligations on the part of the company. In terms of section 129(3), the company must, within 5 business days after the adoption of the resolution:

- publish a notice of the resolution, and its effective date, in the prescribed manner to every affected person.[7] The notice must include a sworn statement of the facts relevant to the grounds on which the Board resolution was founded;[8] and
- appoint a suitable business rescue practitioner who has consented to the appointment in writing.[9]

In addition to the above, once the practitioner has been appointed the company must:

- file a notice of the appointment of a practitioner within two business days after making the appointment;[10] and
- publish a copy of the notice of appointment of the practitioner to each affected person within five business days after the notice was filed.[11]

If a company which has passed a resolution for the commencement of voluntary Business Rescue in terms of section 129 fails to comply with any of the provisions of section 129(3) or (4), the resolution to begin Business Rescue proceedings and place the company under supervision 'lapses and is a nullity'.[12] In addition to this, the company may not file a further resolution for the commencement of voluntary Business Rescue (in terms of section 129(1)) for a period of three months after the date on which the lapsed resolution was adopted.[13]

This provision may also have the unintended consequence that otherwise perfectly validly passed resolutions lapse and become a nullity due to an unintentional omission when attempting to comply with the statutory requirements. For example, it is quite conceivable that a company may in good faith omit one or more smaller creditors, or one or more individual employees who are not represented by a registered trade union, when publishing a notice to affected persons in terms of section 129(3)(*a*). It would be inefficient if the resolution to commence the Business Rescue procedure were to lapse and become a nullity every time this happened.

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[6] S 129(2)(b).
[7] S 129(3)(a).
[8] Ibid.
[9] S 129(3)(b).
[10] S 129(4)(a).
[11] S 129(4)(b).
[12] S 129(5)(a).
[13] S 129(5)(b). However, a company may approach the court by way of an ex parte application and on good cause shown the court may allow the company to file a further resolution within the three month period.

While it would appear that when a company does not fully satisfy the procedural requirements it is an automatic consequence that the resolution lapses and becomes a nullity, it should be noted that section 130(1)(a)(iii) provides that an affected person may approach the court and ask for the resolution to be set aside, *inter alia* on the basis that the company has not fully satisfied the procedural requirements set out in section 129.

Nevertheless, it follows that the board must ensure that the company maintains a list of contact details of all effected persons for purposes of notifying affected persons when required, thereby inter alia avoiding voluntarily commencement of business rescue to be challenged on procedural grounds.

The first thing the court may do when considering such an application, is to set aside the resolution in terms of section 130(5)(*a*)(i) on the grounds[14] that:

- there is no reasonable basis for believing that the company is financially distressed;
- there is no reasonable prospect of rescuing the company;
- the company has failed to satisfy the procedural requirements set out in section 129, or
- if, having regard to all of the evidence, the court is of the opinion that it is otherwise just and equitable to do so.[15]

The second thing the court may do is to provide the practitioner with sufficient time to form an opinion on whether or not the company appears to be financially distressed,[16] or whether there is a reasonable prospect of rescuing the company.[17] If after receiving the practitioner's report in this regard, the court may set aside the resolution if it concludes that the company is not financially distressed, or if there is no reasonable prospect of saving the company.[18]

Finally, if the court sets aside the resolution under paragraphs (*a*) or (*b*) of subsection 5, it may make any further and appropriate order, including:

- an order placing the company in liquidation;[19] or
- if the court has found that there were no reasonable grounds for believing that the company would be unlikely to pay all of its debts as they became due and payable, an order for costs against any director who voted in favour of the resolution to commence business rescue proceedings.[20] The court will, however, not grant a costs order if it is satisfied that the director acted in good faith and on the

[14] See s 130(1)(a).
[15] S 130(5)(a)(ii).
[16] S 130(5)(b)(i).
[17] S 130(5)(b)(ii).
[18] S 130(5)(b).
[19] S 130(5)(c)(i).
[20] S 130(5)(*c*)(ii).

basis of information that the director was entitled to rely upon in terms of the provisions of section 76(4) and (5).[21]

Once the Board has adopted a resolution to commence voluntary Business Rescue proceedings in terms of section 129(1), the company[22] may not thereafter adopt a resolution to begin liquidation proceedings. However, if the resolution to commence Business Rescue proceedings has lapsed in terms of section 129(5), or if the Business Rescue proceedings have ended in accordance with the provisions of section 132(2), then the company may adopt a resolution in terms of which liquidation proceedings are commenced.[23]

Directors should take note that where the Board does not commence business rescue proceedings, section 131 allows for a *compulsory* route into business rescue by affected persons approaching a court.

An affected person may not apply to court to have a company placed under business rescue if the company itself has already adopted a resolution in terms of section 129, thereby placing the company under voluntary business rescue proceedings.[24]

Where an affected person does bring an application for an order placing the company under supervision and commencing business rescue proceedings, such applicant must serve a copy of the application on the company and the Commission[25] and notify each affected person of the application in the prescribed manner.[26]

It is also important to note that each affected person has the right to participate in the hearing of an application in terms of this provision.[27]

If the court is satisfied that the company is:

- financially distressed;[28] or
- the company has failed to pay over any amount in terms of an obligation under or in terms of a public regulation, or contract, with respect to employment-related matters;[29] or
- it is otherwise just and equitable to do so for financial reasons,[30]

the court may make an order placing the company under supervision and commencing business rescue proceedings if there is a reasonable prospect of

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[21] *Ibid*. Section 76 deals with standards of directors conduct, and subsections (4) and (5) detail the information that directors are entitled to rely on in the execution of their duties.
[22] Take note: the resolution to commence Business Rescue proceedings is adopted by the Board of the company, while the resolution to commence liquidation proceedings is commenced by the members of the company.
[23] S 129(6).
[24] S 131(1).
[25] S 131(2)(*a*).
[26] S 131(2)(*b*).
[27] S 131(3).
[28] S 131(4)(*a*)(i).
[29] S 131(4)(*a*)(ii)
[30] S 131(4)(*a*)(iii).

rescuing the company.[31] If this option is followed by the court, the court may make a further order appointing an interim practitioner who satisfies the requirements of section 138, and who has been nominated by the affected person who applied for the court order in the first place.[32] Such an appointment is an interim one, but can be ratified by the holders of a majority of the independent creditors' voting interests at the first meeting of creditors as contemplated in section 147.[33]

If liquidation proceedings have already been commenced by or against the company at the time an application is made to court for the commencement of business rescue proceedings by an affected person, the application for business rescue proceedings will suspend the liquidation proceedings[34] until such time as:

- the court has adjudicated upon the application for business rescue proceedings;[35] or
- the business rescue proceedings end (if the court grants the order for the commencement of business rescue proceedings).[36]

It follows that whilst the Board of a company cannot pass a resolution for the voluntary commencement of Business Rescue in terms of section 129(1) if liquidation proceedings have already been commenced against the company, shareholders, as affected persons, may apply to a court to place the company under supervision under such circumstances in terms of section 131(6).

If the court does not place the company under supervision thereby commencing business rescue proceedings, the court may dismiss the application and make any further necessary and appropriate order, including placing the company in liquidation.[37]

The court may grant a business rescue order and an order appointing an interim business rescue practitioner at any time during the course of any liquidation proceedings, or proceedings in terms of which any security is enforced against the company.[38]

A company that has been placed under compulsory supervision in terms of this section may not adopt a resolution placing itself in liquidation until such time as the business rescue proceedings have ended in terms of the provisions of section 132(2).[39] In addition, the company must also notify each affected person of the order (placing the company under compulsory business rescue proceedings) within five business days after the date of the order.[40]

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[31] S 131(4)(*a*).
[32] S 131(5).
[33] *Ibid*. S 147 deals with the first meeting of creditors.
[34] S 131(6).
[35] S 131(6)(*a*).
[36] S 131(6)(*b*).
[37] S 131(4)(*b*).
[38] S 131(7).
[39] S 131(8)(*a*).
[40] S 131(8)(*b*).

Appointing the practitioner

It is recommended that directors resist the temptation of appointing a business rescue practitioner that is seen to be 'friendly' to their cause, as this will inevitably lead to the challenge of that person's appointment in terms of section 130(1)(*b*) or (*c*), or the credibility of the business rescue plan being adopted in terms of section 152 to be adversely affected as a consequence.[41] Clearly it would be in the directors' interest if they were to appoint a person who will be seen by all the affected persons as an independent, skilled and objective practitioner with integrity that will have all stakeholders' interests at heart.

An affected person may ask the court to set aside the appointment of a practitioner on the grounds that the practitioner:

- does not satisfy the requirements of section 138; or
- is not independent of the company or its management; or
- lacks the necessary skills, having regard to the company's circumstances.

An affected person wishing to bring an application in terms of section 130 must:

- serve a copy of the application on the company and the Commission;[42] and
- notify each affected person of the application in the prescribed manner.[43]

Each affected person has a right to participate in the hearing of an application in terms of section 130.[44]

If the court finds that the practitioner appointed by the company does not satisfy the requirements of section 138; or is not independent of the company or its management; or lacks the necessary skills, having regard to the company's circumstances, then the court may make an order setting aside the appointment of the practitioner.

If the court does issue an order setting aside the appointment of the practitioner, the court must appoint an alternate practitioner who has been recommended by, or is acceptable to, the holders of a majority of the independent creditors' voting interests who were represented at the hearing before the court.[45] The provisions are silent as to what would happen if the person has not been recommended, or is not acceptable to, the holders of the majority of the independent creditors' voting interests represented at the hearing before the court.

[41] This is dealt with in para 5.3.1.3 below.
[42] S 130(3)(*a*).
[43] S 130(3)(*b*). This subsection does not state what the 'prescribed manner' is.
[44] S 130(4).
[45] S 130(6)(*a*).

The only circumstances in which a business rescue practitioner can be required to provide security for his or her proper administration of the business rescue procedure, is when a resolution has been adopted by a company's for the voluntary commencement of a business rescue procedure and an affected person has applied to court for the provision of security.

Not only is the provision of security by the practitioner not required initially in a voluntary business rescue proceeding, but it can never be asked for where the court has ordered a compulsory business rescue procedure. It is conceivable that an affected person will apply to court for the provision of security by the practitioner in each and every case when a company adopts a resolution for voluntary business rescue, and it is submitted that all practitioners should be required to furnish security for the full value of the assets of the company in which they have been appointed.

Although the form of the security is not mentioned in the legislation, it is accepted that the bond of security will be the same as the ones currently provided by liquidators and trustees to the Master of the High Court in liquidations and sequestrations, consisting of an undertaking by the practitioner and guaranteed by an acceptable short-term insurance provider. The security bond can be furnished to the Commission, and the Commission's office can be responsible for ensuring that these bonds are either cancelled or issues, as the case may be.

Duties of directors during business rescue

Section 137(2) determines what is required of the directors of the company during a business rescue proceeding. In terms of this section each director of the company:

- must continue to exercise the functions of director, subject to the authority of the practitioner;[46]
- has a duty to the company to exercise any management function within the company in accordance with the express instructions or direction of the practitioner, to the extent that it is reasonable to do so;[47]
- remains bound by the requirements of section 75[48] concerning personal financial interests of the director or a related person;[49] and
- to the extent that a director acts in accordance with bullet points 2 and 3 above, is relieved from the duties of a director as set out in section 76, and the liabilities set out in section 77, other than the those set out in section 77(3)(a), (b) and (c).[50]

The reference to section 77 is a reference to the liability of directors and prescribed officers in terms of the Companies Act 2008. While a director of a company under business rescue is clearly exempt from liabilities such as being held liable in terms of the common law for breach of a fiduciary duty

[46] S 137(2)(*a*).
[47] S 137(2)(*b*).
[48] S 75 deals with directors' personal financial interests.
[49] S 137(2)(*c*).
[50] S 137(2)(*d*).

or a delict, such director can still be held liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having:

- acted in the name of the company, signed anything on behalf of the company or purported to bind the company despite the knowledge that he or she lacked the authority to do so;
- acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22(1); or
- been a party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose.

The effect of section 137(2)(d) is to make the provisions of *inter alia* section 22(1), which deal with reckless and fraudulent and insolvent trading, applicable to directors while the company is under supervision in terms of a business rescue proceeding.

Section 22(1) prohibits the directors from trading in a reckless and fraudulent manner, or from trading in insolvent circumstances. While it is understandable that the legislature wishes to prevent the directors from trading in a reckless and fraudulent manner, it must be borne in mind that it will be the practitioner, and not the directors, that will be in charge of the company's trading. The directors will merely be carrying out the (lawful) instructions of the practitioner. Also, considering that the trigger mechanism for entering a business rescue procedure is the financial distress of the company, it is hard to see how the directors will not be party to the company trading under insolvent circumstances where the practitioner has made a decision to continue trading during the business rescue proceedings.

In addition to the specific provisions set out in section 137(2), section 137(3) states that during the business rescue proceedings each director of the company must attend to the requests of the practitioner at all times, and provide the practitioner with any information about the company's affairs as may reasonably be required.

If during the business rescue proceedings the Board, or one or more directors of the company, purports to take any action on behalf of the company that requires the approval of the practitioner, that action is void unless approved by the practitioner.[51]

A business rescue practitioner is also given the right to apply to court for the removal of a director from office.[52] This right may be exercised at any time during the business rescue procedure, and the application to remove the director may be made on the following grounds:

- the director has failed to comply with a requirement of Chapter 6 (the chapter dealing with business rescue);[53]

[51] S 137(4).
[52] S 137(5).
[53] S 137(5)(*a*).

- the director has, by an act or omission, impeded or is impeding the practitioner in the performance of his or her powers and functions, the management of the company by the practitioner, or the development or implementation of a business rescue plan.[54]

The right of a practitioner to apply to court for the removal of a director is in addition to the right of any person to apply for an order to declare a director delinquent or under probation under section 162.[55]

Section 140 sets out the general powers and duties of the business rescue practitioner. These powers are in addition to the specific powers that may have been afforded to the practitioner under any other provision of Chapter 6.

The practitioner, in addition to any other powers and duties conferred by other provisions of the business rescue procedure:

- has full management control of the company in substitution for its Board and pre-existing management;[56]
- may delegate any power or function of the practitioner to a person who was part of the Board or pre-existing management of the company;[57]
- may remove from office any person who forms part of the pre-existing management of the company;[58]
- may appoint a person as part of the management of the management of a company, whether to fill a vacancy or not (subject to the provisions of section 140(2));[59]
- is responsible for the development of a business rescue plan that must be considered by affected persons;[60]
- is responsible for the implementation of any adopted business rescue plan.[61]

Although the commencement of a business rescue proceeding (whether it be voluntary or compulsory) effectively replaces the management of a company with a business rescue practitioner, it is important to note that the pre-existing management of the company is not completely displaced in that it will still function as such during the business rescue procedure, albeit under the authority of the practitioner.

Despite the business rescue practitioner taking over control of the company, the company's pre-existing management will still be obliged to function as such under the strict instructions of the practitioner. In order to ensure that this is done as efficiently as possible, it is essential that all the role-players understand what their function is during the business rescue procedure.

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[54] S 137(5)(*b*)(i)-(iii).
[55] S 137(6).
[56] S 140(1)(*a*).
[57] S 140(1)(*b*).
[58] S 140(1)(*c*)(i).
[59] S 140(1)(*c*)(ii).
[60] S 140(1)(*d*)(i).
[61] S 140(1)(*d*)(ii).

The rights of employees

Clause 144(3) sets out the rights of employees to inter alia

- receive notice of court proceedings, decisions, meetings or other relevant events concerning business rescue;
- participate in any court proceedings relating to the business rescue;
- form a committee of employee representatives;
- be consulted by the supervisor during the development of a business rescue plan, and to be afforded sufficient opportunity to review any such plan and prepare a submission thereon;
- be present and make a submission to the meeting before voting takes place on the acceptance or rejection of a plan;
- vote with creditors on a motion to approve a business rescue plan;
- if the business rescue plan is rejected, to propose the development of an alternative plan or to present an offer to acquire the interests of one or more affected persons.

In addition to this, clause 148 provides for a first meeting of employees' representatives. At this meeting the supervisor must inform the employees' representatives whether or the representative thinks the company can be rescued, and a decision can be taken to decide whether or not to appoint an employees' committee. If it is decided to appoint such a committee, then the meeting appoints the members of the committee. There are strict notice requirements for the first meeting of employees' representatives.

The employees' representatives must be afforded an opportunity to address the meeting at which a business rescue plan is proposed. Section 153(1)(b)(ii) provides for the right of an affected person to make a binding offer to purchase the voting interests of one or more persons who opposed the adoption of the business rescue plan.