

**SOME COMPARATIVE ASPECTS OF CORPORATE  
RESCUE IN SOUTH AFRICAN COMPANY LAW**

by

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## SUMMARY

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South African company law has provided for the rescue of financially distressed companies since 1926 when the statutory procedure of judicial management was introduced by the Companies Act 46 of 1926. Unfortunately, judicial management has never been regarded as a successful corporate rescue procedure and for most of its existence it has been severely criticised on many grounds. The Companies Act 61 of 1973 that replaced the Companies Act 46 of 1926 did very little to improve this situation and judicial management remained underutilised. As a result, the Companies Act 71 of 2008 now introduces two newly-created corporate rescue procedures in the form of business rescue proceedings and the compromise with creditors.

This study analyses judicial management and the new corporate rescue procedures to establish whether the identified weaknesses of judicial management have been adequately and effectively addressed in the new procedures. A comparative study with similar procedures in England and Germany is undertaken to determine whether the South African legislature has delivered on its promise to create a system of corporate rescue that will meet the needs of a modern South African economy.

Several weaknesses in the new procedures are identified and a number of recommendations are made to improve the relevant provisions and to assist in providing South African company law with an efficient and acceptable corporate rescue regime.

### KEY TERMS

Administration; Business recovery; Business rescue; Corporate insolvency; Corporate rescue; Compromise; Financial distress; Insolvency practitioners; Judicial management; Mismanagement; Moratorium; Reorganisation; Voluntary arrangement

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# CHAPTER 1

## INTRODUCTION

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### 1 THE NEED FOR BUSINESS RESCUE

A company is an integral part of the community in which it does business, and it has a direct impact on the economic and thus the social well-being of that community through its employees, suppliers and distributors, to mention but a few.<sup>1</sup> Consequently, the failure of a company affects far more people than merely its employees and creditors. In the case of a large mining company, for example, a whole community or town could be ruined if that company collapses.<sup>2</sup> It is also true that company shareholders are no longer an elitist group of cash-flush investors: as a result of privatisation, demutualisation and the special issue of shares to historically disadvantaged South Africans,<sup>3</sup> individual shareholding has increased in South Africa. Furthermore, behind the corporate veil of the institutional investor, one now finds the majority of a country's working population because institutional investors such as trade unions, pension funds and other retirement funds are investing their money in listed companies in particular.<sup>4</sup>

This said, one of the advantages of a successful corporate rescue is that it prevents or limits job losses. In a country such as South Africa where unemployment figures are unacceptably high,<sup>5</sup> this is even more relevant. Having a successful and effective corporate rescue regime or procedure is thus of great importance to the economic growth and stability of this country.

A further argument for an effective business<sup>6</sup> rescue regime is that this is

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<sup>1</sup> Mongalo "Company Law" at 114.

<sup>2</sup> See 25 August 2009 *Business Report* at 13 which refers to a report released by the Mining Qualifications Authority that mining towns could become "ghost towns" as a result of job losses in the mining industry.

<sup>3</sup> For example the Sasol Inzalo shares: see 10 July 2008 *Business Day* at 1 where it was reported that the Post Office had to extend its working hours to cope with the rush of buyers on the last day of the offer.

<sup>4</sup> Hill "Role of the Shareholder" at 208. See also Loubser "Shareholders" at 372-373.

<sup>5</sup> In the period July to September 2009 the unemployment rate in South Africa was 24,5 per cent counting only those still actively engaged in job seeking: Statistics South Africa *Statistical Release P0211 Quarterly Labour Force Survey Quarter 3, 2009* available at <<http://www.statssa.gov.za>> accessed on 4 February 2010.

<sup>6</sup> Although the title of this thesis uses the term "corporate rescue" because the South African procedures that are discussed apply only to companies, in most other countries the rescue procedure also applies to business entities other than corporations, and the terms "corporate rescue" and "business rescue" are therefore used interchangeably.

apparently one of the factors that foreign investors take into account when deciding whether to invest in a country.<sup>7</sup>

In many legal systems, including those of the United States of America,<sup>8</sup> England, Australia, Germany and France the realisation that there are many good reasons for attempting to rescue a company or its business if it has the potential to survive, has resulted in special statutory provisions for business rescues being introduced.<sup>9</sup>

It is, of course, possible to rescue a company or other form of business enterprise by using informal and thus unregulated methods or by using statutory procedures that are not specifically aimed at business rescue, such as liquidation and compromise.<sup>10</sup> There are certain disadvantages attached to these procedures, varying from their high cost and the cumbersome processes involved to the lack of protection of company assets against individual creditors who are unwilling to support an informal rescue attempt.<sup>11</sup> However, these procedures fall outside the ambit of this thesis which concentrates on formal, dedicated statutory business rescue procedures enjoying the protection and advantages specific to a regulated rescue regime.

## 2 JUDICIAL MANAGEMENT

South African company law has made provision for a formal corporate business rescue procedure in the form of judicial management since the inception of the Companies Act 46 of 1926.<sup>12</sup> This was before the principles of a fresh start or a rescue culture had found general acceptance in most comparable systems,<sup>13</sup> and the English Companies (Consolidation) Act of 1908<sup>14</sup> on which the Companies Act of

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<sup>7</sup> This was stated by Mr Roger Baxter, Chief Economist of the Chamber of Mines of South Africa, at a lecture, "Black Economic Empowerment - Transformation in the Mining Industry", delivered to participants in the Certificate in Advanced Corporate Law and Securities Law Programme at the University of South Africa, Pretoria on 17 July 2008.

<sup>8</sup> For the history of bankruptcy reform in the United States, see Rochelle "Lowering the Penalties" at 315.

<sup>9</sup> Keay "To Unify" at 62-63; Rajak and Henning "Business Rescue" at 263.

<sup>10</sup> Milman and Durrant *Corporate Insolvency* at 32; Belcher *Corporate Rescue* at 13 and 116. As far as South Africa is concerned, this is only true of the compromise in terms of s 311 of the Companies Act 61 of 1973 which provides for a compromise or arrangement between a company, its members and creditors. The compromise with creditors in terms of s 155 of the Companies Act of 2008 is specifically intended as a rescue procedure and will be discussed in Chapter 2, part 4.

<sup>11</sup> Milman and Durrant *Corporate Insolvency* at 32.

<sup>12</sup> Hereafter the Companies Act of 1926.

<sup>13</sup> Rochelle "Lowering the Penalties" at 315-316.

<sup>14</sup> 8 Edw VII 7 (c 69).

1926 had largely been based,<sup>15</sup> did not provide for a rescue procedure.<sup>16</sup>

However, judicial management was never regarded as an effective rescue measure for companies in financial distress.<sup>17</sup> This remained the general view even after the present Companies Act 61 of 1973<sup>18</sup> came into operation and effected substantial amendments to the judicial management procedure.

In his judgment in *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* Josman J referred to judicial management as “a system which has barely worked since its initiation in 1926”.<sup>19</sup> This is, with respect, not completely true. The Van Wyk de Vries Commission<sup>20</sup> specifically based its decision to retain judicial management in the Companies Act of 1973 on the fact that judicial management had been extremely successful in a number of cases.<sup>21</sup> In spite of receiving representations for the abolition of judicial management because of a low success rate<sup>22</sup> and instances of abuse, the Commission expressed the view that the notable successes that had been achieved justified its retention.<sup>23</sup>

### 3 COMPANY LAW REFORM

In the policy paper published by the Department of Trade and Industry in May 2004<sup>24</sup> which contained guidelines on its corporate law reform project, insolvency and corporate rescue were specifically mentioned as areas that needed to be reviewed and improved in a new company law.<sup>25</sup> The policy paper stated that judicial management was rarely used and even more rarely led to a successful rescue. It therefore expressed the intention “to create

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<sup>15</sup> Cilliers, Benade et al *Corporate Law* par 2.06.

<sup>16</sup> The Minister of Justice explained to Parliament that the procedure was derived from English and American law which provided for the appointment of receivers in equity to assist an important concern when it was feared it might go into liquidation: *Union of South Africa House of Assembly Debates*, 25 February 1926, vol 6, col 1138-1139.

<sup>17</sup> Some of the criticism is discussed in Chapter 2, part 2.

<sup>18</sup> Hereafter the Companies Act of 1973.

<sup>19</sup> [2001] 1 All SA 223 (C) at 238. See Smith “Major Creditor” for a discussion of this case.

<sup>20</sup> The Commission of Enquiry into the Companies Act appointed in 1963 under the chairmanship of Mr Justice J Van Wyk de Vries: see Cilliers, Benade et al *Corporate Law* par 2.15.

<sup>21</sup> *Main Report of the Commission of Enquiry into the Companies Act* (RP 45 of 1970) at 525.

<sup>22</sup> However, this rate is described as “far from unfavourable” when compared to those of rescue procedures in England and the USA: see Brown *Corporate Rescue* at 824.

<sup>23</sup> *Main Report of the Commission of Enquiry into the Companies Act* (RP 45 of 1970) at 524.

<sup>24</sup> *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform* GN 1183 in *Government Gazette* No 26493 of 23 June 2004.

<sup>25</sup> Par 4.6.2.

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a system of corporate rescue appropriate to the needs of a modern South African economy".<sup>26</sup>

Prior to this, there had been at least two other initiatives to reform our business rescue regime. Firstly, Cabinet approved a draft Insolvency and Business Recovery Bill<sup>27</sup> that combined the Law Reform Commission's draft Insolvency Bill<sup>28</sup> with those provisions in the Companies Act of 1973 regulating the liquidation of companies, judicial management<sup>29</sup> and compromise,<sup>30</sup> to form the basis of a new consolidated Act, although several amendments to the original draft Bill were apparently deemed necessary.<sup>31</sup>

The other project, announced on 11 February 2004 by the Chief State Law Adviser,<sup>32</sup> involved plans by the Government to make a fund of R2 billion a year available to assist in the rescue of struggling companies. In a further development it was reported in April 2004<sup>33</sup> that a new Business Rescue Bill was being drafted to regulate this rescue procedure and was expected to be ready in May 2004. Nothing further happened regarding this project and it was apparently abandoned.

However, in any event it is clear that these two initiatives have now been superseded by the new Companies Act,<sup>34</sup> which introduces a new business rescue procedure (rather unimaginatively called "business rescue proceedings")<sup>35</sup> in Chapter

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<sup>26</sup> Par 4.6.2.

<sup>27</sup> Drafted by the Centre for Advanced Corporate and Insolvency Law at the University of Pretoria as part of a project which resulted in the *Final Report Containing Proposals on a Unified Insolvency Act* that was published in August 2000.

<sup>28</sup> This Bill reflected comments received by the Law Reform Commission after the publication of its previous draft Bill in 1996: *Review of the Law of Insolvency: Draft Insolvency Bill and Explanatory Memorandum*, Working Paper 66, Project 63 (1996).

<sup>29</sup> As an interim measure the current provisions on judicial management were retained with only a few amendments until more research had been done: Burdette "Unified Insolvency Legislation" at 55ff.

<sup>30</sup> Similar provisions contained in the Close Corporations Act 69 of 1984 were also included.

<sup>31</sup> This was announced in the Cabinet Statement of 5 March 2003 reported at <<http://www.gcis.gov.za/newsroom/releases/cabstate/2003/030305.htm>> accessed on 7 February 2010.

<sup>32</sup> *Business Day* 11 February 2004 at 1; *Business Report* 11 February 2004 at 17 reported this announcement.

<sup>33</sup> *Business Day* 22 April 2004 at 1.

<sup>34</sup> Act 71 of 2008, hereafter the Companies Act of 2008.

<sup>35</sup> I have consistently expressed reservations (for example at the Workshop on Business Rescue to which I was invited by the Department of Trade and Industry in 2007) about this name because it is also the generic name for all business or corporate rescue procedures in other jurisdictions and will inevitably lead to confusion. The procedure could have been termed "supervision" or even "company supervision" since the definition of business rescue specifically refers to supervision of the company (in s 128(1)(b)) and the business rescue practitioner was termed a supervisor in all versions of the Companies Bill up to the very last one, the Companies Bill B61D-2008 published in November 2008.

6 to replace judicial management when the new Companies Act comes into force.<sup>36</sup> The Companies Act of 2008 also introduces a new procedure for a compromise with creditors which provides an alternative to the business rescue procedure.<sup>37</sup>

It is of some concern that in spite of the substantial changes that the Companies Act of 2008 will effect to many of the existing statutory and common-law principles of corporate law, including the introduction of a completely new rescue procedure, it was introduced into Parliament only 16 months after the publication of the first draft Bill<sup>38</sup> and was approved by Parliament on 19 November 2008 – barely five months later. It seems inevitable that some serious weaknesses and problems will emerge when the Companies Act of 2008 is implemented, particularly as the Act was not preceded, as is usually the case with new legislation effecting a total reform of the existing law, by an investigation and full report of a commission of experts.<sup>39</sup> For example, the current Companies Act 61 of 1973 was the result of a detailed report by the Commission of Enquiry into the Companies Act explaining and substantiating every single proposed provision.<sup>40</sup> The report<sup>41</sup> of this Commission is still, more than thirty years after the Act came into operation, of great assistance in interpreting the provisions of the Companies Act.

Commentators on the German insolvency legislation have also remarked that the interpretation and explanation of some of its provisions would have been impossible without consulting the detailed explanatory notes that accompanied the official draft legislation<sup>42</sup> and the later amendments effected by the parliamentary portfolio

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<sup>36</sup> The new Act is expected to come into operation in July 2010 or soon thereafter. In terms of s 225 of the Act it may not come into operation until at least a year after the President has assented to it, which happened on 8 April 2009: *Government Gazette* No 32121 of 9 April 2009.

<sup>37</sup> See Chapter 2, part 4.

<sup>38</sup> The draft Bill was first published on 13 February 2007. The Companies Bill B61 - 2008 was published by the Department of Trade and Industry on 27 June 2008 and introduced into Parliament in the same week in terms of GN 677 in *Government Gazette* No 31104 of 30 May 2008.

<sup>39</sup> Keay "To Unify" at 63 specifically points out that the legislative measures reforming insolvency law in the United States, England and Australia were all preceded by substantial delay and scrutiny after comprehensive reports by commissions created for this purpose. He also (at 67) refers to the serious defects in the first Insolvency Bill in England caused by its hurried drafting and relatively little "public airing" and debate on the Bill. The same could be said of the Companies Act of 2008.

<sup>40</sup> The Commission was appointed in 1963 under the chairmanship of Mr Justice J van Wyk de Vries and is generally known as the Van Wyk de Vries Commission.

<sup>41</sup> *Main Report of the Commission of Enquiry into the Companies Act* (RP 45 of 1970).

<sup>42</sup> *Begründung des Regierungsentwurfs der Insolvenzordnung* (3 March 1992) Bundestags-Drucksache 12/2443.



committee.<sup>43</sup> Unfortunately, South African practitioners will not have anything resembling these reports to assist them in the interpretation of the provisions of our new companies legislation.<sup>44</sup> Therefore I have attempted to identify some of the provisions regulating the business rescue proceedings which may be difficult to interpret owing to a lack of clarity in their drafting, confusing terminology and contradictions.

A further complicating factor is that the main drafter of the Companies Act of 2008 was a Canadian consultant who to all appearances was not very familiar with South African law in general or corporate law in particular. One cannot therefore assume that a particular provision was drafted with an existing South African common-law principle or statute in mind. Some provisions also appear to directly contradict established principles of South African law, and it will have to be left to the courts to decide whether this was unintended or intentional.<sup>45</sup> The danger of using a foreign drafter who is not familiar with South African conditions, rather than any of the many available South African experts on corporate law, is further illustrated by Martin<sup>46</sup> in her discussion on the attempt by some other countries to transplant the American Chapter 11 reorganisation procedure<sup>47</sup> into their legal systems without taking into consideration that “[i]nsolvency systems profoundly reflect the legal, historical, political, and cultural context of the countries that have developed them”. A country adopting a new system (particularly in respect of business rescue or discharge of debts) should therefore “consider local culture when enacting new laws”.<sup>48</sup>

Another factor that needs to be considered in any evaluation of the Companies Act of 2008 is the intention of the Department of Trade and Industry to phase out the close

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<sup>43</sup> *Bericht des Rechtsausschusses des Deutschen Bundestages* (13 April 1994) Bundestags-Drucksache 12/7302. See Uhlenbruck and Berscheid *Insolvenzordnung* at 5 and Chapter 4, part 1. See also Chapter 3 on the importance of the report of the Cork Committee that preceded the relevant legislation in England.

<sup>44</sup> The policy document published by the Department of Trade and Industry only described in very general terms the policy considerations that were to be followed in drafting the new legislation: see *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Reform* GN 1183 in *Government Gazette* No 26493 of 23 June 2004. A *Memorandum on the Objects of the Companies Bill, 2008* was attached to the Bill but again described only the general objects of the legislation without going into any detail on specific provisions. As far as the business rescue proceedings are concerned, these objects deal mainly with the protection of workers' interests.

<sup>45</sup> A perfect example is provided by the provision on uncompleted contracts which is in direct contradiction to basic principles of our law of contract: see Chapter 2, part 3.6.2.

<sup>46</sup> “History and Culture” at 4.

<sup>47</sup> Regulated by Chapter 11 of the United States Bankruptcy Code, Title 11, United States Code.

<sup>48</sup> “History and Culture” at 35.

corporation as a business form<sup>49</sup> on the basis that under the new legislation the simplified incorporation and running of small companies will make close corporations redundant.<sup>50</sup> Therefore, no further close corporations will be registered nor will any more companies be permitted to convert to close corporations once the Companies Act of 2008 comes into operation.<sup>51</sup> Existing close corporations will be allowed to continue as such for an indefinite period<sup>52</sup> but will be encouraged to convert to companies under the new dispensation. As a preliminary to the eventual disappearance of close corporations, and to harmonise the law regulating the two business forms in the interim period, several provisions of the Companies Act of 2008 are made applicable to close corporations in place of the existing ones in the Close Corporations Act, 69 of 1984.<sup>53</sup> Included among these are the provisions regulating the new business rescue proceedings, which will thus apply to close corporations as well.<sup>54</sup>

This thesis examines, in a comparative study, some of the defects and weaknesses of judicial management which could be blamed for its failure to function as an effective corporate rescue procedure. The purpose of this comparative study is to identify some of the main weaknesses of judicial management and to establish the extent to which they have been successfully or adequately addressed in the new business rescue proceedings contained in the Companies Act of 2008. For that reason judicial management is discussed in some detail in spite of the fact that soon it will no longer be part of South African company law.

## 4 METHODOLOGY

In the first part of Chapter 2, a general overview of judicial management in South Africa is given, and some of the specific weaknesses or contentious issues that might have contributed to its failure, are highlighted. The problematic issues that will be examined in the comparative studies are then identified.

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<sup>49</sup> A decision described by Du Plessis "Reflections and Perspectives" at 268-269 as "surprising" and "difficult to justify", considering its undoubted success as a business form in South Africa. This view is supported by many corporate lawyers, including the eminent British commentator Prof JH Farrar, who states that the reasons for this decision are "far from clear": "Corporate Governance" at 228.

<sup>50</sup> *Memorandum on the Objects of the Companies Bill, 2008* at 217.

<sup>51</sup> Schedule 5 (Part 2) to the Companies Act, 2008.

<sup>52</sup> *Memorandum on the Objects of the Companies Bill, 2008* at 217.

<sup>53</sup> Schedule 5 (Parts 4-8) to the Companies Act, 2008.

<sup>54</sup> Schedule 5 (Part 6) to the Companies Act, 2008, discussed in Chapter 2, part 3.2.

In the second part of Chapter 2, the corresponding provisions of the new business rescue proceedings contained in the Companies Act of 2008 are discussed and compared with judicial management. The chapter closes with a discussion of the new compromise procedure introduced by the Companies Act of 2008 as an alternative to business rescue proceedings.

In Chapters 3 and 4, the problem areas identified in Chapter 2 are examined by way of a comparative study of statutory business rescue procedures in two other legal systems – the English and the German – showing how they regulate or deal with the same issues or situations. Where a specific business rescue procedure applies to all business debtors, and not only to companies, this is explained at an early stage in the discussion on the entities to which the procedure applies. However, the rest of the discussion of such a procedure is mainly restricted to its specific application to ordinary companies.

Chapter 3 deals with the statutory business rescue procedures in English law. The law of England was chosen for two reasons: firstly, because of the influence that English law has had on South African law in general and company law in particular.<sup>55</sup> Secondly, English insolvency law, which includes corporate insolvency law, has twice been subjected to extensive reforms. The first reform resulted in insolvency legislation that for the first time made specific provision for two dedicated statutory business rescue procedures. The second reform was aimed at rectifying deficiencies that had been identified in these business rescue procedures and resulted in major amendments to both procedures. However, many other changes have been introduced by way of several amendments to the Insolvency Rules, which unfortunately makes finding the most recent and applicable law an extremely complicated task as textbooks struggle to keep up. According to Goode,<sup>56</sup> one needs “to find one’s way around provisions which are randomly dispersed among the body of the Act, the bizarrely numbered Schedules A1 and B1 and the Insolvency Rules, with seemingly no logic in the distribution nor any conception that it might be useful if all the provisions dealing with the same subject were brought together...”<sup>57</sup>

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<sup>55</sup> Cilliers, Benade et al *Corporate Law* pars 2.03-2.17.

<sup>56</sup> *Corporate Insolvency* at vii.

<sup>57</sup> The Insolvency Service is currently engaged in a project (with completion date expected to be April 2011) to amend and modernise the Insolvency Rules and combine them with all the other secondary

The German system of insolvency and business rescue is discussed in Chapter 4. The German insolvency legislation was the result of a long reform process in which, as also initially intended by the South African authorities, American legislation originally served as a model for its drafters although the final result differs quite substantially from the American procedure. The German model was chosen because it is a fairly recent one and its drafters had the advantage of being able to learn from the experience gained by other reformers of insolvency laws. It also differs from most other procedures in that it is not a dedicated business rescue procedure, but merely one option available as part of normal insolvency proceedings. The German procedure resembles judicial management in some aspects, notably the fact that it must be commenced by order of court, as well as the existence of an unregulated profession of insolvency administrators. It was also chosen because there is very little research on the new German insolvency legislation by South African researchers.

This comparative study is intended to indicate the best way of dealing with the identified problems and to consider the extent to which the new corporate rescue procedures conform to the generally accepted principles of modern statutory business rescue regimes. In addition, this study investigates whether the new procedures present us with solutions more viable than those presented by judicial management. The conclusion in Chapter 5 thus consists mostly of my recommendations to improve the existing provisions of Chapter 6 of the Companies Act 71 of 2008 where I consider them to be deficient or problematic.

Although the policy paper on the reform of South African corporate law issued by the Department of Trade and Industry specifically mentioned that the provisions of the American business rescue procedure would be considered in creating an appropriate corporate rescue system for South Africa,<sup>58</sup> the United States of America was not chosen as one of the countries for this comparative study. There are several reasons for this decision. Firstly, many South African researchers on business rescue

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legislation in one piece of legislation: *The Insolvency Service Modernisation and Consolidation of Secondary Insolvency Legislation - Update March 2009* available at <<http://www.insolvency.gov.uk>> accessed on 23 March 2009.

<sup>58</sup> *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Reform* GN 1183 in *Government Gazette* No 26493 of 23 June 2004, par 4.6.2.

have included America in their comparative studies, partly because of its accessibility to English speakers but also because over time several critics of judicial management have proposed that South Africa should introduce a business rescue procedure based on the American business rescue model.<sup>59</sup> There is therefore considerable research available in South Africa on the American Chapter 11 reorganisation procedure. Furthermore, the United States of America has a debtor-friendly insolvency system, as opposed to the creditor-friendly system of South Africa and other countries such as England.<sup>60</sup> As will be shown in this thesis, there is very little in the proposed new South African business rescue proceedings that indicates a change in this culture but rather the opposite, including the special provisions that have been created to strengthen the position of employees in their capacity as post-commencement creditors of the company.<sup>61</sup> Another reason is the fact that the most prominent feature of the American rescue procedure, namely the concept of debtor in possession where the business owner retains full control of the running of the business, has not been incorporated into the new South African procedure.<sup>62</sup>

## **5 ISSUES THAT ARE EXAMINED**

For the purposes of the comparative study contained in Chapters 3 and 4, the problems that have been identified for further examination in this thesis have been classified into the following eight main issues:

- I Entities to which the procedure applies. This encompasses the identification of the forms or types of business enterprise to which a particular statutory business rescue procedure applies.
  
- II Power to initiate the procedure. Under this heading I deal with the persons who may or who, under certain circumstances, are obliged to initiate the procedure and the sanctions against them if they fail to do so.

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<sup>59</sup> See generally Rajak and Henning "Business Rescue"; Rochelle "Lowering the Penalties"; Smits "Corporate Administration"; *Guidelines for Corporate Law Reform*, par 4.6.2.

<sup>60</sup> Franken "Bankruptcy Regimes" at 650; Moss "Bankruptcy Cultures" at 121; Rochelle "Lowering the Penalties" at 318.

<sup>61</sup> See Chapter 2, part 3.1.

<sup>62</sup> See Chapter 2, part 3.7.2 on the powers of the directors.

- III Requirements for opening a business rescue procedure. The circumstances or conditions under which a business will qualify for the rescue procedure in each legal system are considered. This is an important aspect of any business rescue procedure since the chances of successfully rescuing a business are obviously much better if an attempt is made at the first signs of financial difficulties, rather than waiting until the company is hopelessly insolvent.
  
- IV Procedure to commence the procedure. I investigate the nature or form of the procedure initiating the rescue which could either be a formal application to court resulting in a court order, as required for judicial management, or a more informal procedure, such as the filing of documents with the court or another regulatory body. In those cases where an application to court is required, the discussion under this point investigates whether there must be a specific application for the rescue procedure or whether it can also be initiated by an application for liquidation or even a neutral application that leaves it to the court to decide on the appropriate form of relief.
  
- V The moratorium. A moratorium on actions and other judicial processes against a company is generally regarded as an important, if not essential part of any business rescue procedure. The issues that are specifically examined are whether a moratorium automatically results from the rescue procedure, at what moment it starts and whether its duration is limited to a stipulated period. The extent of, and exceptions to, the moratorium are also discussed.
  
- VI Managing the rescue procedure. This concerns the question whether the debtor is in charge of the business during the rescue operation or whether an outsider, such as an insolvency practitioner, is appointed to take over.<sup>63</sup> Where an outsider is appointed, the qualifications required for appointment to this position are considered, as well as how and by whom he or she is appointed to and removed

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<sup>63</sup> Flessner *Sanierung* at 222 describes this as one of the most important questions to be answered right at the beginning of a rescue procedure. As will appear from the discussion on South Africa's new rescue procedure, this is one of the questions that have not been answered very clearly: see Chapter 2, part 3.7.2.

from this position. In dealing with the issue of management of the rescue procedure, I have concentrated on the appointment, required qualifications and removal from office of any outsider who is appointed to manage or oversee the rescue procedure. I have not gone into the specific powers of such a person in great detail, except to the extent that I discuss the residual powers (if any) of the previous management, that is, the board of directors. It is my view that the relevant Act must contain provisions that ensure the appointment of a suitably qualified, competent and regulated professional who can be removed from office if necessary. In this case, the specific powers assigned to this person become less important than when inadequate or almost no regulation (as is presently the case in South Africa) enables the appointment of an incompetent, inexperienced or untrustworthy person.

VII The rescue plan. In this section, I investigate the role, if any, of a formal rescue plan as part of a particular business rescue procedure. This includes looking at the contents and nature of a rescue plan as well as at what stage in the rescue procedure and by whom a plan should be submitted and the parties who must approve it. The effects of approval or adoption of the plan are also considered.

VIII Termination of the rescue procedure. I examine whether the rescue procedure is terminated automatically after a specified period, or whether a court order or other formal act is required. This includes consideration of the question whether the duration of a rescue procedure should be strictly limited or whether it should be decided by the court or by the person managing the business during the rescue process.

It should be noted that the thesis does not attempt to examine every issue or problem associated with judicial management or the new business rescue proceedings. Many of these aspects constitute viable topics for extensive research on their own. Examples of such topics include the role that shareholders should be allowed play in the rescue process, the exact division of powers between the existing management of the company and the business rescue practitioner who may be appointed, the extent to which employees and employment contracts should be

protected, the financing of a business during a rescue procedure (the so-called post-commencement financing), the effect of a rescue procedure on uncompleted contracts and the powers of the person in charge of the rescue process to have detrimental dispositions by the debtor set aside, to name but a few. I do, however, briefly mention or discuss some of these aspects where necessary or relevant.

In my research I focus most particularly on the commencement and initial stages of a rescue procedure, that is, who may take the first steps, what the requirements are, how the procedure is commenced and who should be in charge of the company during the rescue process. It is my belief that if the fundamentals are in place to enable a company to access a rescue procedure timeously and fairly easily, but without the procedure lending itself to abuse, and steps are taken to ensure that the rescue is managed by a suitably qualified and supervised person, the exact details of the actual rescue process become less important and should not be prescribed too rigidly, to allow some business and commercial factors to be taken into account. I believe that this view is supported by the fact that although the Companies Act of 1973<sup>64</sup> contains detailed and clear provisions setting out the powers and duties of a judicial manager during judicial management, these provisions are of no consequence because it has become almost impossible to place a company under judicial management.<sup>65</sup>

## **6 ABBREVIATIONS AND REFERENCES**

In the text, the surname of the writer(s) and keywords taken from the title are used when reference is made to textbooks and articles. The full reference of every cited source is in the bibliography and follows directly underneath the short reference used in the text and footnotes. The full citation of court cases is provided every time reference is made to the case.

Although I attempted to use a consistent style of referencing, this has not always been possible or practical. German textbooks, for example, tend to show the name of the specific writer of each chapter, and normally I would have done the same in my references. However, in some instances it is the name of the textbook and not so

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<sup>64</sup> In Chapter XV.

<sup>65</sup> See Chapter 2, part 2.4. On the other hand, the provisions on the new business rescue proceedings probably do not contain sufficient information on this aspect: see Chapter 2, part 3.7.2.



much those of the writer and the chapter that he or she wrote that is relevant and then I have used the name of the textbook. This is particularly in the case of textbooks that seem to represent the views of a group of academics and practitioners who have associated themselves with a specific place, such as the *Hamburger Kommentar*, *Frankfurter Kommentar* and *Heidelberger Kommentar*. In my view, the identification of the groups is far more relevant than the name of the individual who wrote the particular chapter.

Another important point in regard to German legal texts is the fact that cases are not referred to by their names but by the court, the seat of the court and the date on which the decision was made, followed by a reference to the journal in which the decision was published. In the index of cases, German cases have therefore been arranged according to the status of the court and then its seat. Although the references are to journals, they follow the German style of referencing, namely the abbreviated name of the journal (without italics), the year of publication (without brackets), followed by the page numbers: for example, Oberlandesgericht Brandenburg ZIP 2001, 1153-1154. This is intended to distinguish them very clearly from references to articles that may have appeared in these journals. Since the German insolvency courts are more or less the equivalent of our local magistrates' courts, their decisions are not binding on other courts and their significance lies in the fact that they show different views on statutory provisions and procedures. These decisions are summarised by the writers of textbooks to indicate general trends, and I have therefore not referred to many of these decisions directly but rather to the relevant textbooks. Judgments by the Federal High Court or the Constitutional Court are of course binding, and I have referred directly to the important ones where relevant.

The abbreviations used for journals in references to decided cases are the following: NJW - *Neue Juristische Wochenschrift*; NZI - *Neue Zeitschrift für das Recht der Insolvenz und Sanierung*; ZInsO - *Zeitschrift für das gesamte Insolvenzrecht*; ZIP - *Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis*.

For practical reasons the masculine form is used throughout and should be assumed to include the feminine form.

With the approval of my promoter, Prof Alastair Smith, I have not included a word index at the end of this thesis because every country tends to have its own very specific terminology in respect of business rescue procedures. A specific term would therefore

be found on every page of one chapter, but almost nowhere else. To facilitate finding a reference to any particular topic I have, instead, compiled a very detailed Table of Contents and I have also used the same structure and numbering of parts in each chapter. Part 2.4, for example, always deals with the requirements for commencement of the procedure in every chapter, while part 2.7.2 consistently covers the powers and duties of the directors of the company during a rescue procedure.

To the best of my knowledge and belief, the law stated in this thesis was correct as at 30 November 2009.

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## CHAPTER 2

# SOUTH AFRICA

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### 1 INTRODUCTION

Although judicial management has been part of South African company law for almost a century, it has never been widely accepted or used, in spite of attempts to improve it by amendments to the relevant legislation.<sup>1</sup> As will be illustrated in the first part of this Chapter, this is partly due to some inherent weaknesses of the procedure itself but also to the extremely conservative approach initially adopted by the courts when dealing with judicial management applications, thereby establishing a body of precedents to which other courts were bound.<sup>2</sup> Legal commentators have also been almost unanimous in their criticism of judicial management, even referring to it as a “dismal failure”.<sup>3</sup>

The Companies Act 71 of 2008<sup>4</sup> was passed by Parliament on 19 November 2008 and assented to by the President on 8 April 2009.<sup>5</sup> The Act is expected to come into force on or shortly after 1 July 2010 and contains the provisions regulating the new business rescue proceedings that will replace judicial management, as well as providing for a compromise with creditors outside business rescue proceedings.<sup>6</sup> The two new procedures are intended to give effect to one of the purposes of the Act contained in section 7. This purpose is to “provide for the efficient rescue and recovery of financially distressed companies” but in such a way that “the rights and interests of all relevant stakeholders” will be balanced.<sup>7</sup>

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<sup>1</sup> See Olver *Judicial Management* at 4-12 for a history of the problems experienced in practice and amendments effected to the relevant legislative measures to counter these problems.

<sup>2</sup> See in particular part 2.4.4 below on this aspect. The conservative approach of the courts as an impediment to the success of judicial management is also mentioned in *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* [2001] 1 All SA 223 (C) at 238.

<sup>3</sup> Burdette “Unified Legislation” at 57. See also Burdette “Business Rescue Model (Part 1)” at 248-250; Kloppers “Judicial Management” at 423; Kloppers “Judicial Management Reform” at 371ff; Olver “Law Reform” at 86-87; Rajak and Henning “Business Rescue” at 267-268; Smits “Corporate Administration” at 85-86. However, not all the criticism is justified, such as Cilliers, Benade et al *Corporate Law* par 26.03 stating that one of the major disadvantages of judicial management is that it negatively affects the creditworthiness of the company. This cannot be regarded as an inherent or particular weakness of judicial management since most, if not all, rescue procedures have this effect: see Finch *Corporate Rescue* at 372 and 457 regarding the damage to a company’s reputation that administration in England can cause, or that directors fear it will cause.

<sup>4</sup> Hereafter referred to as the Companies Act of 2008.

<sup>5</sup> *Government Gazette* No 32121 (Notice 421) of 9 April 2009.

<sup>6</sup> The new procedures are discussed in parts 3 and 4, respectively, of this Chapter.

<sup>7</sup> Section 7(k) of the Companies Act of 2008.

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In this Chapter I will first discuss judicial management, concentrating on those issues I have identified as most problematic,<sup>8</sup> followed by a discussion of the same aspects in respect of the new business rescue proceedings, incorporating some comparisons between the two procedures. As far as possible, I will endeavour to follow the same structure and headings in the discussions of both judicial management and business rescue proceedings to facilitate a comparative study between the two procedures. Finally, I will discuss the compromise with creditors that has now been introduced as an alternative rescue procedure for a company.

## **2 JUDICIAL MANAGEMENT**

### **2.1 Definition and purpose**

The Companies Act of 1973<sup>9</sup> does not contain a definition of judicial management, and one therefore has to rely on the requirements for and contents of both a provisional and a final judicial management order to explain its nature and purpose. Essentially, a judicial management order vests the management of an unsuccessful company in a judicial manager under the supervision of the court, and divests the persons currently managing the company of their powers of management, if the court is satisfied that the company has the ability to become a successful concern.<sup>10</sup>

It is clear from the requirements as well as case law that judicial management has only one recognised purpose, namely the rescue of the company itself, in its entirety. The rescue of only its business or a viable part thereof is not an acceptable outcome and neither is a better return for creditors of shareholders.<sup>11</sup>

### **2.2 Entities to which judicial management applies**

The court may grant a judicial management order in respect of “any company” that meets the requirements stipulated in section 427(1) of the Companies Act of 1973.<sup>12</sup>

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<sup>8</sup> See Chapter 1, part 5.

<sup>9</sup> All references to sections of an Act in part 2 of this Chapter will be to the Companies Act of 1973 unless specifically stated otherwise.

<sup>10</sup> Sections 427 and 432.

<sup>11</sup> See *Millman NO v Swartland Huis Meubileerders (Edms) Bpk; Repfin Acceptances Ltd intervening* 1972 (1) SA 741 (C) at 744-745; *Ben-Tovim v Ben-Tovim and Others* 2000 (3) SA 325 (C) at 332; Blackman et al *Companies Act* at 15–3.

<sup>12</sup> The requirements for a provisional and a final judicial management order are discussed in part 2.4 below.

The wording of this provision, coupled with the very fact that judicial management is regulated by the Companies Act,<sup>13</sup> very clearly limits the application of judicial management to a company as defined in the Companies Act of 1973.<sup>14</sup> Therefore, other forms of business such as close corporations,<sup>15</sup> partnerships and business trusts cannot be rescued by using judicial management.<sup>16</sup> Although this aspect of judicial management has been criticised on the grounds that there should be only one formal rescue procedure which applies to all business forms,<sup>17</sup> the new business rescue proceedings will once again apply primarily to companies.<sup>18</sup>

### **2.3 Power to initiate judicial management**

An order of the division of the High Court within whose area the registered office or main place of business of the company is situated,<sup>19</sup> is required to place a company under judicial management.<sup>20</sup> This is one of the grounds on which judicial management has frequently been criticised since the formal application to, and order of, the court required to place a company under judicial management render this procedure expensive and onerous, making it unsuitable for smaller companies in particular.<sup>21</sup> The simplification of the procedure to commence business rescue proceedings must therefore be recognised as one of its major benefits.<sup>22</sup>

The application for a judicial management order may be brought by anyone who is entitled to apply for the winding up of the company.<sup>23</sup> Therefore, the application may be made by the company itself, one or more of its creditors (including contingent or

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<sup>13</sup> See generally Loubser “Business Rescue” for a discussion of the significance and effect of the type of Act (ie Companies Act, Insolvency Act or separate Act) in which a business rescue procedure is contained.

<sup>14</sup> A company is defined in s 1 of the Act as being a company incorporated under this Act or a company which existed immediately prior to commencement of this Act under any law repealed by this Act.

<sup>15</sup> See part 3.2 below on the (in my view misguided) application of business rescue proceedings to close corporations.

<sup>16</sup> See Loubser “The Unincorporated Business” at 446-449 regarding the procedures available for other business forms.

<sup>17</sup> See, for example, Burdette “Unified Legislation” at 48-49; Keay “To Unify” at 73-74; Kloppers “Judicial Management” at 418; Kloppers “Judicial Management Reform” at 368; Rajak and Henning “Business Rescue” at 268ff; Smits “Corporate Administration” at 94.

<sup>18</sup> See part 3.2 below.

<sup>19</sup> Section 12(1) of the Companies Act of 1973.

<sup>20</sup> Section 427 of the Companies Act of 1973.

<sup>21</sup> Kloppers “Judicial Management Reform” at 371; Rajak and Henning “Business Rescue” at 268ff.

<sup>22</sup> See part 3.3.1 below.

<sup>23</sup> Section 427(2).

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prospective creditors), one or more of its members<sup>24</sup> or jointly by any of them.<sup>25</sup>

A substantial degree of uncertainty exists in respect of the power of directors to apply for the winding up of the company (and by implication thus also for a judicial management order). This was caused by some earlier decisions in which it was held that an application for winding up by “the company” had to be interpreted as the company in general meeting, which meant that such an application could be brought only with the consent of the general meeting.<sup>26</sup> A contrary position was taken by the courts in *Ex parte Tangent Sheeting (Pty) Ltd*<sup>27</sup> and in *Ex parte Graaff-Reinet Rollermeule (Edms) Bpk*,<sup>28</sup> where it was decided that an application for liquidation of the company could be authorised by a resolution of the directors.

The matter seemed to be settled, but once again, there is some uncertainty about the authority of the board of a company to apply for liquidation (and thus also for judicial management) as a result of the decision in *Ex parte New Seasons Auto Holdings (Pty) Ltd*,<sup>29</sup> where the court held that such an application was not part of the management of a company and could also be abused by directors who have been guilty of mismanagement and want to cover their tracks.<sup>30</sup> Even if this is accepted as correct, the question is whether the same argument would apply to an application for judicial management which is specifically intended to rescue the company and ensure its survival. A strong argument could be made that this is one of the main duties of the management of company. However, since the power to apply for judicial management is expressed with direct reference to the power to apply for liquidation, it must probably be presumed that if directors may not apply for liquidation, the same rule applies to judicial management.<sup>31</sup>

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<sup>24</sup> Who must have been registered as a member for at least six months immediately before the application (s 346(2)).

<sup>25</sup> Section 346(1). Although the liquidator of a company is not specifically authorised by the Act to apply for judicial management, the courts have on occasion allowed it: *Common Fund Investment Society Ltd v C O C Trust Co Ltd* 1968 (4) SA 137 (C). According to Olver “Judicial Management” at 51, the explanation is that the courts probably regard this as an application by the company itself.

<sup>26</sup> *Ex parte Russlyn Construction (Pty) Ltd* 1987 (1) SA 33 (D); *Ex parte Screen Media Ltd* 1991 (3) SA 462 (W). The opposite had, however, previously been held in *Ex parte Edenvale Wholesalers and General Suppliers (Pty) Ltd* 1959 (2) SA 477 (W).

<sup>27</sup> 1993 (3) SA 488 (W).

<sup>28</sup> 2000 (4) SA 670 (E).

<sup>29</sup> 2008 (4) SA 341 (W).

<sup>30</sup> At 343.

<sup>31</sup> This problem has been avoided in the new rescue proceedings because neither the directors nor the company may apply to court for a business rescue order: see part 3.3.2 below.

A judicial management order may also be granted when an application for the winding up of a company is before the court if the stipulated requirements of the Companies Act of 1973 for a judicial management order are met.<sup>32</sup> Although it is unlikely that the courts have made much use of this power, considering their general reluctance to grant judicial management orders even when specifically applied for, it at least probably influenced the decision to grant a similar power to the courts in the provisions regulating the new business rescue proceedings.<sup>33</sup>

## **2.4 Requirements for a judicial management order**

Section 427(1) of the Companies Act of 1973 provides that a company may be placed under judicial management if, by reason of mismanagement or for any other cause, the company is unable to pay its debts or is probably unable to meet its obligations, has not become or is prevented from becoming a successful concern and there is a reasonable probability that if the company is placed under judicial management, it will be enabled to pay its debts or meet its obligations and to become a successful concern. In addition, the section also requires that it must appear just and equitable to the court to grant a judicial management order.<sup>34</sup>

Although the heading of section 427 suggests that this section contains the requirements for both a provisional and a final judicial management order, the requirements contained in this section are those for a provisional judicial management order.<sup>35</sup> The wording of section 432 that sets out the requirements for a final order differs to some degree from that of section 427(1) although the requirements were probably intended to be the same.<sup>36</sup>

The reference to mismanagement as a possible cause for the company's financial problems is a remnant of the original provisions contained in section 195(1) of the Companies Act of 1926 in which mismanagement constituted separate and specific grounds for a judicial management order.<sup>37</sup> Since this is not the case under

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<sup>32</sup> In terms of s 427(3).

<sup>33</sup> See part 3.5.2.4 below.

<sup>34</sup> For a detailed discussion of the requirements for a judicial management order, see Loubser "Judicial Management" at 141-150.

<sup>35</sup> Issued in terms of s 428(1): see part 2.5.1 below.

<sup>36</sup> See part 2.4.3 below.

<sup>37</sup> See Loubser "Judicial Management" at 142.

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the Companies Act of 1973,<sup>38</sup> the reference to mismanagement was not only unnecessary but also perpetuated the perception that the management of a company was always to blame for the company having to be placed under judicial management. This almost certainly played a role in directors remaining hesitant to apply for judicial management to avoid this stigma.

However, the reasons for the company's financial difficulties are not irrelevant in an application for judicial management, since they will have to be considered by the court in determining whether the company will probably be enabled to become a successful concern and to pay its debts if placed under judicial management,<sup>39</sup> and possibly even whether it is just and equitable to grant the order.<sup>40</sup>

#### **2.4.1 Inability to pay debts**

The first specific requirement for a provisional judicial management order is that the company must be unable to pay its debts or must probably be unable to meet its obligations.<sup>41</sup> Since there is no provision in terms of which a company will be deemed to be unable to pay its debts for the purposes of a judicial management application,<sup>42</sup> the inability to pay debts, also referred to as commercial insolvency, must be proved.<sup>43</sup> Actual or balance-sheet insolvency where the liabilities of the company

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<sup>38</sup> Olver "Judicial Management" at 47; Meskin et al *Henochsberg* at 925; and Blackman et al *Companies Act* at 15–6 all share the view that judicial management is available to a company irrespective of the reason for its problems. This was confirmed by the court in *Gushman v TT Gushman & Son (Pty) Ltd and Others* [2009] JOL 23589 (ECM) at 18-19. However, Cilliers, Benade et al *Corporate Law* par 26.01 refers to "mismanagement or other special circumstances" as being the reasons for the company's setback, although there is nothing in the wording of s 427(1) to substantiate the view that there must have been special circumstances causing the problems.

<sup>39</sup> Discussed in part 2.4.3 below.

<sup>40</sup> This requirement is discussed in part 2.4.4 below. The importance of the reasons for the company's failure in determining whether judicial management is appropriate is stressed by Meskin et al *Henochsberg* at 925, and this view was confirmed in *Ex parte Onus (Edms) Bpk; Du Plooy NO v Onus (Edms) Bpk en Andere* 1980 (4) SA 63 (O) at 66; and *Porterstraat 69 Eiendomme (Pty) Ltd v PA Venter Worcester (Pty) Ltd* 2000 (4) SA 598 (C) at 615.

<sup>41</sup> Section 427(1)(a).

<sup>42</sup> Section 345, which describes these circumstances for the purposes of an application for winding up of a company, has not been made applicable to judicial management. In spite of this, Olver "Judicial Management" at 49 states that the meaning of "inability to pay debts" in s 427 is the same as in s 345, but provides no authority for this view. Meskin et al *Henochsberg* at 926 holds the contrary, and, I submit, correct view that s 345 does not apply in this context.

<sup>43</sup> A possible exception would be where an application for the winding up of a company is made based on one of the situations set out in s 345 and it appears to the court that the grounds for the company's winding up may be removed if it is placed under judicial management. In terms of s 427(3) the court may then make an order placing the company under judicial management if it also appears that the company will become a successful concern and it would be just and equitable: see further part 2.4.5



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exceed the value of its assets, is not recognised as grounds for a judicial management order.<sup>44</sup>

As an alternative to the inability to pay its debts, it may be proved that the company is probably unable to meet its obligations. The Act does not contain any explanation of what is meant by “obligations” but it may be assumed to have a wider meaning than merely the payment of debts, and to include any contractual obligations that the company must perform. According to Olver this also includes the probable future inability of the company to meet its obligations.<sup>45</sup> However, since the requirement is stated in the present tense in the Act, I submit that this would only apply to an inability to meet its obligations in the immediate or foreseeable future.

The requirement that the company must already be unable to pay its debts results in a substantially reduced chance of the company being successfully rescued. It is obvious, and generally accepted, that if remedial action is taken at an early stage of a company’s financial problems, preferably before the company has become insolvent or unable to pay its debts, the company has a considerably better chance of surviving.<sup>46</sup> In most business rescue procedures therefore, if a company is likely to become unable to pay its debts, this is also accepted as one of the grounds for commencement of such procedure.<sup>47</sup>

#### **2.4.2 Failure to become a successful concern**

The reason for the second requirement,<sup>48</sup> namely that the company has not become, or is prevented from becoming, a successful concern is not clear since a company that is unable to pay its debts or probably unable to meet its obligations is very obviously not a successful concern. The Act also does not indicate at what point or under what circumstances a company would be regarded as not being a successful concern, and this rather vague requirement is thus an unnecessary addition to the very difficult requirements that have to be proved for a judicial management order.

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below. However, Blackman et al *Companies Act* at 15–5 believes that even here the application for liquidation must have been based on the inability to pay debts.

<sup>44</sup> This differs from the grounds for business rescue proceedings in terms of the Companies Act of 2008 where both alternatives are recognised: see part 3.4.1.1 below.

<sup>45</sup> “Judicial Management” at 50.

<sup>46</sup> See Kloppers “Judicial Management Reform” at 375-376; Smits “Corporate Administration” at 87.

<sup>47</sup> See Chapter 3, part 2.3.2; Chapter 4, part 2.4.2.

<sup>48</sup> In s 427(1)(b).

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### 2.4.3 Reasonable probability that it will be enabled to pay debts or meet obligations and become a successful concern

A very heavy burden of proof rests on the applicant as a result of the requirement that the court must be satisfied that a reasonable probability (and not merely a possibility) exists that the company will be enabled to pay its debts or meet its obligations and become a successful concern if placed under judicial management.<sup>49</sup> Therefore, a provisional judicial management order may not be used to establish whether judicial management will succeed in rescuing the company,<sup>50</sup> nor will a judicial management order be granted because it would achieve a better result for creditors than an immediate winding-up order.<sup>51</sup> By contrast, a better result for creditors is specifically recognised as an acceptable outcome of the new business rescue proceedings, although the benefits of such a provision are doubtful.<sup>52</sup>

It appears as though section 432 places an even heavier burden of proof on the applicant to obtain a final judicial management order. One of the requirements of this section is that it must appear to the court that the company will be enabled to become a successful concern, rather than a probability that it will become a successful concern. In *Tenowitz and Another v Tenny Investments (Pty) Ltd*<sup>53</sup> the court interpreted this wording as setting a higher standard of proof, but in *Ex parte Onus (Edms) Bpk; Du Plooy NO v Onus (Edms) Bpk en Andere*<sup>54</sup> the court did not agree with this view and held that the same burden of proof applied to an application for a provisional and a final order, namely that of a reasonable probability.

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<sup>49</sup> Section 427(1). This was also stressed by the Appellate Division (as it was then) in *Noordkaap Lewendehawe Ko-operasie Bpk v Schreuder en 'n Ander* 1974 (3) SA 102 (A) at 110. However, the court did not require a *strong* probability as was the case in *Silverman v Doornhoek Mines Ltd; Smith v Doornhoek Mines Ltd* 1935 TPD 349 at 353.

<sup>50</sup> *Kotzé v Tulryk Bpk en 'n Ander* 1977 (3) SA 118 (T) at 122.

<sup>51</sup> *Marais v Leighwood Hospitals (Pty) Ltd* 1950 (3) SA 567 (C); *Irvin & Johnson Ltd v Oelofse Fisheries Ltd* 1954 (1) SA 231 (E); *Millman v Swartland Huis Meubileerders (Edms) Bpk* 1972 (1) SA 741 (C); *Tenowitz and Another v Tenny Investments (Pty) Ltd* 1979 (2) SA 680 (E).

<sup>52</sup> See part 3.1 below.

<sup>53</sup> 1979 (2) SA 680 (E) at 683. See *Hahlo* at 603. The court found the reason for the more onerous burden of proof in the fact that on the return day, when the granting of a final order has to be considered, the court would be in a much better position to judge the prospects of the company because of the various reports that have to be submitted (see par 4.3 below). Cilliers, Benade et al *Corporate Law* pars 26.10 and 26.27 seems to support this interpretation, although it is mentioned in par 26.10 fn 12 that there are conflicting opinions on the matter.

<sup>54</sup> 1980 (4) SA 63 (O). The court (at 66) referred to two cases in which no heavier burden of proof seemed to have been required: *Kotzé v Tulryk Bpk en 'n Ander* 1977 (3) SA 118 (T) and *Ladybrand Hotel (Pty) Ltd v Segal and Another* 1975 (2) SA 357 (O).

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However, there is general consensus that the requirement that the company must be enabled to pay its debts means that all debts must be paid in full and within a reasonable time.<sup>55</sup> Usually this leads to the further requirement that the court must be satisfied that the company will be able to find the necessary funds or financing to pay its debts.<sup>56</sup>

I submit that the provision requiring the applicant to show that judicial management will enable the company to pay its debts and become a successful concern should be viewed as a single requirement, although the wording of section 427(1) is not clear in this regard.<sup>57</sup> It may safely be assumed that once a company becomes able to pay its debts it will be a successful concern.<sup>58</sup>

It is clear from this requirement that the corporate entity itself must be rescued by judicial management, and not just the business of the company, or a viable part thereof.<sup>59</sup>

This requirement and its restrictive interpretation by the courts have been severely criticised as being too stringent and so difficult to prove that most companies with financial difficulties are precluded from obtaining a judicial management order.<sup>60</sup> Considering the fact that at the time of the application to court for a provisional order it must be proved that the company is already unable to pay its debts, it will always be extremely difficult and often quite impossible to satisfy the court that all the company's debts will be paid if a judicial management order is granted.

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<sup>55</sup> Henning "Judicial Management" at 306 and cases cited there. See also *Ben-Tovim v Ben-Tovim and Others* 2000 (3) SA 325 (C) at 332. However, see Loubser "Judicial Management" at 145 for a discussion of the apparent contradiction of this provision by the inclusion of a judicial manager as one of the persons who may enter into a compromise with creditors (and members) of the company in terms of s 311.

<sup>56</sup> See *Porterstraat 69 Eiendomme (Pty) Ltd v PA Venter Worcester (Pty) Ltd* 2000 (4) SA 598 (C) at 616 and 620; *BOE Bank Ltd v Upbeatprops 63 (Pty) Ltd and Others* 2001 JDR 0821.

<sup>57</sup> This was also the interpretation of Van Heerden J in *Ben-Tovim v Ben-Tovim and Others* 2000 (3) SA 325 (C), referred to with approval by Nhlangulela J in *Gushman v TT Gushman & Son (Pty) Ltd and Others* [2009] JOL 23589 (ECM) at 3. Section 432(2), which contains the requirements for a final judicial management order, refers only to the company becoming a successful concern and not to payment of its debts.

<sup>58</sup> Smalberger J in *Tenowitz and Another v Tenny Investments (Pty) Ltd* 1979 (2) SA 680 (E) at 683 said as much when he stated that "the company becoming a successful concern presupposes that it will be able to pay its debts". This interpretation is echoed by Cilliers, Benade et al *Corporate Law* par 26.10.

<sup>59</sup> To achieve this, the company would have to be wound up and the liquidator given the authority to continue the business and to sell the viable part of it as a going concern in terms of s 386(3) and (4) of the Companies Act of 1973.

<sup>60</sup> Rajak and Henning "Business Rescue" at 267-268; Smits "Corporate Administration" at 86; Burdette "Unified Legislation" at 58. See part 3.1 below regarding the possibility of a rescue of only the business of a company by the use of the new business rescue proceedings.

#### 2.4.4 Just and equitable

The requirement that it must appear just and equitable to the court to grant a judicial management order, is probably the most problematic one of all the requirements contained in section 427(1). This requirement was taken over from the requirements for judicial management contained in the Companies Act of 1926<sup>61</sup> where it was set in a completely different situation, namely where a court was authorised to issue an order for judicial management even though the application before it was for the winding up of the company.<sup>62</sup> Since no indication is given in the Companies Act of 1973 as to what circumstances would satisfy this requirement,<sup>63</sup> the courts adopted several interpretations. The most widely accepted one, largely based on the interpretation of this requirement as set in the Companies Act of 1926, is that judicial management is a special privilege and an extraordinary procedure that infringes on the rights of creditors to liquidate a company to obtain payment of their claims and should therefore be ordered only under very special and exceptional circumstances.<sup>64</sup>

Other interpretations of this requirement include that judicial management is probably not intended for a small private company<sup>65</sup> or that it should be granted only if there is no other appropriate remedy available.<sup>66</sup>

<sup>61</sup> In s 195(1).

<sup>62</sup> See Loubser “Judicial Management” at 147-150 for a discussion of the origins and history of this requirement and the resulting incorrect interpretation attached to it.

<sup>63</sup> In terms of s 344(h) of the Companies Act of 1973, “just and equitable” is one of the grounds on which a company may be wound up, and this was found to be sufficiently vague for the courts to compile a list of categories into which cases constituting this ground would usually fall: see *Rand Air (Pty) Ltd v Ray Bester Investments (Pty) Ltd* 1985 (2) SA 345 (W).

<sup>64</sup> See, for example, *Silverman v Doornhoek Mines Ltd*; *Smith v Doornhoek Mines Ltd* 1935 TPD 349; *Ladybrand Hotel (Pty) Ltd v Segal and Another* 1975 (2) SA 357 (O) at 359; *Kotzé v Tulryk Bpk en 'n Ander* 1977 (3) SA 118 (T) at 122; *Ben-Tovim v Ben-Tovim and Others* 2000 (3) SA 325 (C) at 331; *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* [2001] 1 All SA 223 (C) at 233; *Gushman v TT Gushman & Son (Pty) Ltd and Others* [2009] JOL 23589 (ECM) at 24. As Kloppers “Judicial Management” at 426 correctly points out, there is nothing in the legislation that merits the treatment of judicial management as an extraordinary measure.

<sup>65</sup> For example, in *Rustomjee v Rustomjee (Pty) Ltd* 1960 (2) SA 753 (D) at 758; *Ronaasen and Others v Ronaasen & Morgan (Pty) Ltd* 1935 CPD 562 at 563. The opposite and, I submit, more correct view that other considerations such as the size and activities of the business should determine whether judicial management is an appropriate remedy was expressed in *Tobacco Auctions Ltd v AW Hamilton (Pvt) Ltd* 1966 (2) SA 451 (R) at 453.

<sup>66</sup> *Makhuva and Others v Lukhoto Bus Service (Pty) Ltd and Others* 1987 (3) SA 376 (V); *Repp v Ondundu Goldfields Ltd* 1937 CPD 375 at 379-380; *Ben-Tovim v Ben-Tovim and Others* 2000 (3) SA 325 (C). But see Meskin et al *Henochsberg* at 925 where it is submitted that the mere fact that a company's domestic procedures could be invoked to overcome its difficulties is not a sufficient ground for refusing a judicial management order; the moratorium may in fact be necessary in some cases to enable the company to use these procedures after termination of judicial management.

I submit that this requirement is completely unnecessary considering the already strenuous requirements that an applicant for judicial management has to meet, and probably contributed quite substantially to the failure of judicial management to become a popular and successful corporate rescue measure. A similar, and equally vague requirement also appears in the Companies Act of 2008, although fortunately only as one of the grounds on which a court may issue an order commencing business rescue proceedings, and not as a requirement in all instances.<sup>67</sup>

#### **2.4.5 Requirements where the application is for winding up**

In terms of section 427(3) of the Companies Act of 1973 the court may grant a judicial management order when an application is heard for the winding up of a company. A provisional judicial management order may be issued if it appears to the court that such an order would remove the grounds for winding up the company, would result in the company becoming a successful concern, and granting such an order would be just and equitable. Although these requirements seem to differ quite substantially from those that apply when the application is for judicial management, Olver<sup>68</sup> argues that it is unlikely that the courts would adopt a different test here from the one used to decide whether a provisional order should be granted in terms of section 427(1).

### **2.5 Procedure to commence judicial management**

The applicant for a judicial management order must lodge a copy of the application and every supporting affidavit with the Master of the High Court at the seat of the court before presenting his application to court.<sup>69</sup> The Act requires only this limited prior notification of the intended application, thereby also limiting the potentially damaging result to a company's reputation and business which wider prior notification would almost certainly have. This is in sharp contrast to the very unfortunate requirement in the Companies Act of 2008 which requires prior notification of an application to court for the

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<sup>67</sup> See part 3.4.2 below.

<sup>68</sup> "Judicial Management" at 42.

<sup>69</sup> Section 427(2) read with s 346(4)(a) of the Companies Act of 1973. The notice requirement is far more limited than that required for an application for winding up: see Loubser "Corporate Rescue and Labour Legislation" at 61-64 for a discussion of the notice requirements set by labour legislation for an application for winding up and the problems created by the fact that judicial management was not included or considered in the relevant legislation.

commencement of business rescue proceedings to every shareholder, creditor and employee or trade union representing employees of the company.<sup>70</sup>

### **2.5.1 The provisional judicial management order**

If the court is satisfied that all the requirements have been met, it may grant a provisional judicial management order, dismiss the application, or make any other order that it deems just.<sup>71</sup> Since commentators agree that the power of the court to make any order it deems just when refusing to make a final judicial management order does not include the power to order the winding up of the company, it must be assumed that the same principle applies here.<sup>72</sup> This means that if the court dismisses the application for judicial management, a specific application for winding up of the company will have to be brought in a separate action.

There is some uncertainty as to whether “any other order” includes the power to grant a final judicial management order immediately. Olver<sup>73</sup> submits that a provisional order must first be granted, and that “any other order” does not include a final order although it has been so interpreted in some instances.

The introduction of a provisional order was in fact recommended in the Van Wyk de Vries Report<sup>74</sup> to provide an opportunity for creditors in particular to voice their opinion and oppose the making of a final order if they wish to do so. This offsets the disadvantages of not being notified of the intended application before it is heard by the court for the first time. Although it is clear that having to approach the court twice before a final judicial management order is obtained, adds to the already substantial costs of the procedure, the alternative of notifying creditors before the application is presented to court is, I submit, too harmful to the company’s business and reputation and its chances of being successfully rescued, to be acceptable.<sup>75</sup>

A provisional judicial management order must stipulate a return day on which the court will decide whether to grant a final order.<sup>76</sup> The return day may not be more than

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<sup>70</sup> See part 3.5.2.1 below.

<sup>71</sup> Section 428(1).

<sup>72</sup> See part 2.5.2 below.

<sup>73</sup> “Judicial Management” at 55.

<sup>74</sup> Paragraph 51.05 at 528.

<sup>75</sup> See part 3.5.2.1 below.

<sup>76</sup> Section 428(1).

sixty days after the date of the provisional order.<sup>77</sup>

It is the duty of the Master of the High Court to appoint a provisional judicial manager as soon as a provisional judicial management order has been issued.<sup>78</sup>

A provisional judicial management order has the effect that all the property of the company is deemed to be in the custody of the Master until the appointment of a provisional judicial manager.<sup>79</sup> This measure is intended to prevent the directors from disposing of company assets during the inevitable delay between the issuing of the provisional judicial management order and the appointment of the provisional judicial manager.<sup>80</sup> However, there is no provision to protect the company from being stripped of its assets by directors before the provisional order is made.<sup>81</sup>

The most important duty of a provisional judicial manager,<sup>82</sup> apart from taking control of all the assets and of the management of the company, is to prepare a report containing a description of the general state of affairs of the company, a list of the company's assets and liabilities with details of each creditor and his claim, an explanation of the reasons for the company's problems and how the capital required to continue the business will be raised.<sup>83</sup> The provisional judicial manager is also required to express his opinion on the prospects of the company becoming a successful concern and the removal of the facts or circumstances that are preventing the company from becoming a successful concern.<sup>84</sup>

Another duty of the Master is to convene separate meetings of the creditors, members and debenture-holders of the company after a provisional judicial management order has been issued.<sup>85</sup> These meetings are held to consider the above-mentioned report of the provisional judicial manager and decide whether judicial management is desirable; nominate a person for appointment as final judicial manager if the order is made final; give creditors the opportunity to prove their claims against the company; and to decide whether

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<sup>77</sup> Section 432(1). This date may be extended by the court on good cause shown.

<sup>78</sup> Section 429(b)(i). See part 2.7.1.1 below regarding the appointment of both the provisional and the final judicial managers.

<sup>79</sup> Section 429(a).

<sup>80</sup> In terms of s 429(b)(i) the Master must appoint such a provisional judicial manager without delay.

<sup>81</sup> The same problem has been identified in the English system of administration: see Chapter 3, part 2.4.

<sup>82</sup> His duties are set out in s 430.

<sup>83</sup> Section 430(c)(i)-(v).

<sup>84</sup> Section 430(c)(vi).

<sup>85</sup> Section 429(b)(ii). See part 3.7.1.1 below on the difference in the procedure in business rescue proceedings and the potential problems it may cause.

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the creditors should pass a resolution to accord preference over unsecured pre-judicial management claims to post-commencement liabilities incurred in the conduct of the company's business during judicial management.<sup>86</sup>

The reports of the proceedings of each of these meetings, prepared by the chairperson, must be taken into account by the court when deciding whether to grant a final judicial management order.<sup>87</sup>

### **2.5.2 The final judicial management order**

In terms of section 432(2), the court must consider the opinions and wishes of creditors and members of the company as reported by the chairperson, and the reports of the provisional judicial manager, the Master and the Registrar of Companies on the return day stipulated in the provisional order. The court may grant a final judicial management order if it appears that the order will enable the company to become a successful concern and that it is just and equitable. The final order must direct that the management of the company will vest in the final judicial manager, subject to the supervision of the court, and order the provisional manager to hand over all matters to the final judicial manager if he is not the same person.<sup>88</sup>

Alternatively, the court may discharge the provisional order or make any other order it may deem just.<sup>89</sup> There is general consensus that "any other order" does not include a winding-up order, even if the court refuses to order judicial management and believes that the company should be liquidated. A winding-up order may be issued only if there is a proper application to wind up the company before the court,<sup>90</sup> otherwise the court should simply discharge the provisional order.<sup>91</sup>

The detailed duties and powers of the judicial manager set out in the Companies Act of 1973 are subject to the memorandum and articles of association of the company,

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<sup>86</sup> Section 431(2).

<sup>87</sup> Section 432(2).

<sup>88</sup> Section 432(3)(a).

<sup>89</sup> Section 432(2).

<sup>90</sup> Section 346(1)(f) of the Companies Act of 1973 specifically authorises a provisional judicial manager to apply for the winding up of the company if the provisional judicial management order is discharged. Meskin et al *Henochnberg* at 941 submits that this does not exclude the locus standi of a creditor or any of the other possible applicants listed in s 346(1) in such a case.

<sup>91</sup> Meskin et al *Henochnberg* at 941; Blackman et al *Companies Act* at 15–19. See part 3.5.2.5 below on the express power now given to the courts to order liquidation of the company when dismissing an application for the commencement of business rescue proceedings.



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in so far as they are not inconsistent with the judicial management order.<sup>92</sup>

Section 434(2) provides that if any money becomes available to the judicial manager he must, in so far as circumstances permit, use the funds to pay the claims of creditors dating from before the judicial management order was issued, but only after payment of the costs of judicial management and of conducting of the company's business.<sup>93</sup>

The requirement that creditors must prove their claims in the same way as in a winding-up procedure,<sup>94</sup> coupled with the provision that payment must be made in accordance with the law relating to insolvency,<sup>95</sup> implies that only creditors who have formally lodged their claims may be paid. This seems an anomaly when considering that judicial management is supposed to result in the full recovery of the company and the ability to pay all its debts, but has evidently been accepted without question in practice.<sup>96</sup> This must surely be one of the reasons why judicial management is widely regarded as merely a first (and mostly unnecessary) step towards liquidation!

The question whether the provisions regulating the rescue of a company or its business should be contained in a Companies Act or whether it properly belongs in an Insolvency Act is pertinently raised by these provisions. It has now once again been raised by the provisions regulating business rescue proceedings which are housed in the Companies Act of 2008 but include several references to insolvency law.<sup>97</sup>

Although a judicial manager takes over the control and management of the company, he is not authorised to dispose of the company's assets except in the ordinary course of the company's business or with the approval of the court.<sup>98</sup>

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<sup>92</sup> Section 433.

<sup>93</sup> Section 434(2). It is clear that the payment of creditors is always an important issue in judicial management.

<sup>94</sup> Section 431(2) and (4).

<sup>95</sup> Section 434(3).

<sup>96</sup> Blackman et al *Companies Act* at 15–29.

<sup>97</sup> See part 3.2 below.

<sup>98</sup> Section 434(1). A judicial manager was given leave by the court to sell all the assets of the company as a going concern in *Ex parte Vermaak* 1964 (3) SA 175 (O) and in *Ex parte Joubert* 1970 (3) SA 511 (T), but in *Ex parte Paterson NO: In re Goodearth Estates (Pty) Ltd* 1974 (4) SA 281 (E) it was refused. With respect, the last-mentioned decision seems to be correct, since one of the reasons for this restriction is to prevent judicial management from being turned into an unofficial (and thus unsupervised) liquidation of the company by the judicial manager: Olver "Judicial Management" at 9-10; Blackman et al *Companies Act* 15–27ff.

The terms of the final judicial management order may be varied by the court that granted it, on application by the Master, the final judicial manager or a representative acting on behalf of the general body of creditors by virtue of a resolution passed by a majority in value and number of them at a creditors' meeting.<sup>99</sup> Apart from an application for cancellation of the judicial management order,<sup>100</sup> this is the only measure available to creditors (but not to members)<sup>101</sup> who have concerns about the course of the judicial management process or the actions of the judicial manager. The usefulness of this measure to prevent a judicial manager from acting in a harmful or incompetent manner is doubtful when one considers that a meeting of "the general body of creditors"<sup>102</sup> would first have to be arranged (obviously without any assistance from the judicial manager) to obtain the required mandate. The section furthermore requires a mandate in terms of a resolution by a majority in value and number of "such" creditors (that is, the general body of creditors) and not merely of those creditors attending the meeting – an almost impossible task! Even if all these hurdles are overcome successfully, there is some doubt as to whether a court would be prepared to allow the use of this measure to challenge the conduct of a judicial manager, since the prevailing view seems to be that the court should vary the order only if it is necessary for the purposes of the judicial management of the company.<sup>103</sup>

## 2.6 The moratorium

### 2.6.1 Moratorium on legal proceedings

A provisional judicial management order may provide that all actions, proceedings, the execution of all writs, summonses and other processes against the company will be stayed during judicial management and may only proceed with the leave of the court.<sup>104</sup>

<sup>99</sup> Section 432(4).

<sup>100</sup> See parts 2.7.1.3. and 2.9 below.

<sup>101</sup> A member, the applicant for the judicial management order, a creditor, the provisional judicial manager or the Master may apply for variation or discharge of a provisional judicial management order: s 428(3).

<sup>102</sup> In terms of s 412, which has been made applicable to judicial management by s 439, this would presumably include only creditors who have proved their claims against the company.

<sup>103</sup> *Meskin et al Henochsberg* at 942. See further part 2.7.1.3 below on the uncertain legal position regarding a judicial manager's removal from office.

<sup>104</sup> Section 428(2). In *Lief NO v Western Credit (Africa) (Pty) Ltd* 1966 (3) SA 344 (W) it was held that no *concursum creditorum* is created by a judicial management order. As a result, in *Transkei Development Corporation Ltd v Oshkosh Africa (Pty) Ltd* 1986 (1) SA 150 (C) at 154 it was held that set-off automatically takes place between debts incurred before and those incurred after judicial management even if the judicial management order puts a moratorium on claims against the company.

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A moratorium on enforcement actions against the company is thus not an automatic result of a judicial management order but must specifically be applied for. Since a moratorium is one of the major advantages of any rescue procedure, judicial management is unlikely to succeed without such an order.<sup>105</sup> It is unclear whether a court may order a moratorium on only some actions or whether it has to order a total moratorium on all actions or none at all. Furthermore, the moratorium is not specifically limited to civil actions,<sup>106</sup> and it would seem that a general moratorium will also include a stay on criminal actions against the company.

However, what is clear from the wording of this provision is that a moratorium does not discharge or release the company from payment of its debts, but merely protects the company from enforcement of these claims during judicial management. Although this would seem to be the obvious meaning of a moratorium, the drafters of the Companies Act of 2008 seem to have confused these two completely different principles in dealing with uncompleted contracts to which the company is a party at the commencement of business rescue proceedings.<sup>107</sup>

Section 432(3) does not provide for a moratorium in the case of a final judicial management order, but it must be assumed that it will automatically be included if a provisional order containing a moratorium is made final. Some commentators have interpreted the fact that section 432(3) does not contain any reference to a moratorium as having the effect that the court cannot grant leave for the lifting of a stay after the final judicial management order has been given.<sup>108</sup> I submit that this interpretation is probably not correct since this section's complete omission of any reference to a moratorium in the case of a final judicial management order is unlikely to mean that one part of the provisions dealing with the moratorium in respect of a provisional order would still apply (that is, the possibility that a moratorium may be ordered), but not the other part of the provisions which allows the court to lift the moratorium on a particular legal action.

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<sup>105</sup> Cilliers, Benade et al *Corporate Law* par 26.01-26.02; Blackman et al *Companies Act* at 15–12 and 15–21; Henning "Surchéance" at 538.

<sup>106</sup> Both s 359(1)(a) of the Companies Act in respect of the effect of liquidation on legal proceedings and s 20(1)(b) of the Insolvency Act 24 of 1936 in respect of the effect of sequestration on an insolvent's property, specifically refer to a stay on civil proceedings.

<sup>107</sup> See part 3.6.2 below.

<sup>108</sup> Cilliers, Benade et al *Corporate Law* par 26.29 fn 42.

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There seems to be no discernible reason why the legislation should not have provided for an automatic moratorium resulting from both a provisional and a final order, but there are compelling reasons why it should. The court has been given a clear discretion whether to order a stay, and it is thus possible that for some reason a court could decide to grant a judicial management order but refuse to order a moratorium. In such a case the judicial management is virtually doomed to failure because the company is not protected from creditors enforcing their claims.

### **2.6.2 Effect on contracts**

The judicial manager is specifically authorised to apply to court for the setting aside of voidable and undue preferences<sup>109</sup> made by the company before the application for judicial management was presented to court, if the company is unable to pay its debts.<sup>110</sup> As the inability to pay its debts is one of the requirements for a company to be placed under judicial management,<sup>111</sup> it is unclear why this condition should be specifically stated. However, the provision itself is a major advantage since it creates the possibility that a judicial manager may reverse financially prejudicial contracts entered into by the company before judicial management or to retrieve assets that are important for the continuation of the company's business.<sup>112</sup>

Contrary to the case of liquidation,<sup>113</sup> other provisions of insolvency law have not been made applicable to judicial management, which means that existing contracts are not affected. The judicial manager cannot refuse to perform in terms of any uncompleted contracts since the company will not be protected against orders for specific performance, except to the extent that a moratorium applies, which can be lifted by the court.<sup>114</sup> Employment contracts are not mentioned at all and therefore also remain unaffected by a judicial management order.<sup>115</sup>

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<sup>109</sup> As regulated by ss 26-34 of the Insolvency Act 24 of 1936.

<sup>110</sup> Section 436.

<sup>111</sup> See part 2.4.1 above.

<sup>112</sup> See part 3.6.2 on the rather otiose provision regulating voidable transactions in the case of business rescue proceedings.

<sup>113</sup> Section 339.

<sup>114</sup> See Bertelsmann et al *Mars* at 222-225 regarding the effect on uncompleted contracts if the company is in liquidation.

<sup>115</sup> This is in contrast to liquidation where they are immediately suspended by a liquidation order and automatically terminated 45 days after appointment of a final liquidator: s 38 of the Insolvency Act 24 of 1936 read with s 339 of the Companies Act. All the provisions of labour legislation applicable to

## 2.7 Managing the procedure

### 2.7.1 The provisional and final judicial managers

#### 2.7.1.1 Appointment

##### 2.7.1.1.1 Provisional judicial manager

As soon as a provisional judicial management order has been granted, the Master of the High Court must appoint a provisional judicial manager in accordance with the policy determined by the Minister,<sup>116</sup> to take over the management of the company.<sup>117</sup>

Since the Companies Act of 1973 does not contain a prescribed procedure for such appointment, the Master will usually follow the same procedure as that for the appointment of a provisional liquidator<sup>118</sup> by appointing a provisional judicial manager from his panel<sup>119</sup> of insolvency practitioners who enjoys the support of the majority of creditors.<sup>120</sup>

The consistent view of our courts that judicial management is an infringement of the rights of creditors to liquidate the company and obtain immediate payment of their claims,<sup>121</sup> also ensures that the Master would invariably appoint a provisional judicial manager favoured by the creditors.

The requirement that this appointment must be in accordance with a policy determined by the Minister,<sup>122</sup> was introduced into the Companies Act by the Judicial Matters Amendment Act,<sup>123</sup> partly in reaction to persistent allegations of corruption in the appointment of liquidators in particular.<sup>124</sup> The Minister is authorised<sup>125</sup> to determine a

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solvent companies will therefore apply to a company under judicial management: see generally Loubser "Corporate Rescue and Labour Legislation". On the other hand, the effect of the new business rescue proceedings on employment contracts, are expressly stipulated in the Companies Act of 2008: see part 3.1 below.

<sup>116</sup> Section 15(1A). See further below.

<sup>117</sup> Section 429(b)(i).

<sup>118</sup> In terms of s 368, which also does not prescribe any specific procedure for the appointment of a provisional liquidator.

<sup>119</sup> No legal basis exists for the appointment of such a panel and in Germany a similar practice was declared unconstitutional by the German Constitutional Court: see Chapter 4, part 2.7.1.2.5.

<sup>120</sup> This is referred to as the "requisition system" that attempts to ensure continuity by appointing a person who will be supported by the majority of creditors for appointment as final liquidator or judicial manager. See Calitz and Burdette "Insolvency Practitioners" at 732-735; and Loubser "Insolvency Practitioners" at 124-126.

<sup>121</sup> See 2.4.4 above.

<sup>122</sup> Although the Companies Act falls under the jurisdiction of the Minister of Trade and Industry, the reference here is to the Minister of Justice and Constitutional Development: see the definition of "Minister" in s 1(1) of the Companies Act.

<sup>123</sup> Act 16 of 2003.

<sup>124</sup> See eg *Financial Mail* of 28 February 2003 at 25; *Business Day* 28 August 2002 reported at <<http://www.bday.co.za>> visited on 30 August 2002.

<sup>125</sup> In s 15(1A)(a).

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policy for the appointment of provisional judicial managers (as well as curators bonis, trustees, provisional trustees, co-trustees, liquidators and co-liquidators) by the Master of the High Court. The purpose of the legislation was explained as being first to create uniform procedures in all the Masters' offices for the appointment of these functionaries and thereby promoting the image of insolvency practitioners and of the Masters' Division, and secondly to promote consistency, fairness, transparency and the achievement of equality (for persons previously disadvantaged by unfair discrimination) in these appointments.<sup>126</sup> However, no such policy has yet been published in the *Government Gazette* or tabled in Parliament as required by the legislation.<sup>127</sup> In spite of this, some judges seem to regard themselves bound to apply an internal policy document issued by the Minister long before the introduction of section 15(1A)(a) and which clearly has no legal basis.<sup>128</sup>

Strictly speaking, any such policy can apply only to those functionaries who are appointed by the Master, such as the provisional judicial manager, and not to those whose nomination by creditors must merely be accepted and confirmed (or not) by the Master, such as the final judicial manager. However, the Master is authorised to appoint a co-judicial manager in addition to the one nominated by creditors, and in such a case the official policy would apply once it has been properly proclaimed.<sup>129</sup> By all appearances, the Master is already using this power to enforce his unofficial policy by the appointment of co-liquidators and co-judicial managers.

#### 2.7.1.1.2 *Final judicial manager*

The person or persons whose names are to be submitted to the Master for appointment as final judicial manager(s) are nominated at the meetings of creditors and members convened by the Master after a provisional judicial management order

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<sup>126</sup> *Memorandum on the Objects of the Judicial Matters Amendments Bill, 2003* par 2.2.

<sup>127</sup> Section 15(1A)(b).

<sup>128</sup> Meskin et al *Insolvency Law* at 4.1 (in fn 9A) and again at 4.22 (fn 3A) refers to two such judgments, namely *Distributive Catering Hotels and Allied Workers' Union v The Master of the High Court and Others* [2006] JOL 17093 (T) and *SACCAWU v Master of the High Court* [2007] 4 All SA 1034 (T) and describes the basis for these decisions as "doubtful" and the internal policy document as having "no standing in law".

<sup>129</sup> Section 374 authorises the Master to appoint a co-liquidator, and this provision will also apply to judicial managers in terms of s 431(4), which makes those provisions relating to the nomination and appointment of a liquidator applicable to the nomination and appointment of judicial managers.

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has been issued.<sup>130</sup> The nomination and appointment of a final judicial manager are regulated *mutatis mutandis* by the provisions which apply to the nomination and appointment of a liquidator of a company which is being wound up.<sup>131</sup> In most cases the same person who was appointed as provisional judicial manager will be nominated by the creditors at their meeting<sup>132</sup> and then appointed as final judicial manager by the Master.<sup>133</sup> However, the Master is authorised to refuse to appoint the nominated person without having to supply reasons for his refusal.<sup>134</sup>

If the judicial management order is not made final on the return day, the court may make an order for the winding up of the company if a proper application for such order is before it.<sup>135</sup> The Companies Act does not prohibit the subsequent appointment of either a provisional or final judicial manager as liquidator for the same company.

#### 2.7.1.2 Qualifications

The Master may appoint any person as a judicial manager, except the auditor of the company or a person disqualified under the Companies Act of 1973 from being appointed as a liquidator in a winding up.<sup>136</sup>

The disqualifications for nomination or appointment as a liquidator of a company that is being wound up are found in section 372 of the Companies Act and are very general in nature. The list includes the normally disqualified persons namely insolvents, minors and other persons under legal disability, non-residents of South Africa, corporate bodies, agents of creditors who hold power of attorney to vote on behalf of these creditors at creditors' meetings, any person removed from an office of trust by the Court for misconduct or a person disqualified from being a director by an order of court. Furthermore, any person who has been convicted anywhere in the world of the crimes of theft, fraud, forgery or uttering a forged document, or perjury, and sentenced to imprisonment without the option of fine or to a fine exceeding R20, is also disqualified, as is a person who has influenced or attempted to influence

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<sup>130</sup> Section 431(2). See part 2.5.1 above.

<sup>131</sup> Section 431(4).

<sup>132</sup> Convened by the Master in terms of s 429(b)(ii): see part 2.5.1 above.

<sup>133</sup> In terms of s 431(4).

<sup>134</sup> Sections 370(1) and 431(4). See further Loubser "Shareholders" at 375-376.

<sup>135</sup> Section 346(1) authorises the provisional judicial manager, inter alia, to apply for winding up of the company.

<sup>136</sup> As set out in ss 372 and 373.

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someone by means of any misrepresentation or reward, to nominate or vote for, or effect his appointment as liquidator of any company. A director or officer of the company acting as such at any time during the immediately preceding twelve months is specifically disqualified.<sup>137</sup>

Finally, a person may be disqualified from appointment as a liquidator permanently or for a limited period, in terms of an order of court on application by any interested person as a result of dishonest conduct in his capacity as liquidator or proposed liquidator.<sup>138</sup> The grounds for such an order relate to accepting or soliciting payment of part of the remuneration or commission of a person employed in the liquidation of the company or improperly obtaining votes for his nomination or appointment as liquidator.<sup>139</sup>

As already mentioned above, the Master of the High Court may also refuse to appoint or to confirm the appointment of a person whom he believes to be unsuitable, and in such a case need not supply any reasons for his decision.<sup>140</sup>

The only positive qualification for appointment as provisional or final judicial manager is that the person must furnish security for the proper performance of his duties.<sup>141</sup> The fact that judicial managers (and liquidators) are not required to have any professional training and that membership of a professional body is not compulsory means that there is virtually no control over the activities of negligent, dishonest or incompetent judicial managers.

There is wide consensus that this complete lack of requirements for appointment as judicial manager is one of the main reasons why judicial management in South Africa does not have a high success rate.<sup>142</sup> Since a judicial manager is not disqualified from appointment as liquidator where judicial management fails and the

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<sup>137</sup> Section 372(i). An auditor is also disqualified but subject to an exception. This will obviously not apply to judicial management, as there is a blanket prohibition on the appointment of the company's auditor as judicial manager.

<sup>138</sup> In terms of s 373.

<sup>139</sup> Section 373(a) and (b).

<sup>140</sup> See part 2.7.1.1.2 above.

<sup>141</sup> Sections 429(b)(i) and 375(1) respectively. But see part 3.7.1.2 below regarding business rescue practitioners who will generally not be required to provide security.

<sup>142</sup> Olver "Judicial Management" at 2 explains that already in 1926, when the introduction of judicial management was debated in Parliament, Sir Drummond Chaplin suggested that special business qualifications should be required for appointment as judicial manager. See also Burdette "Unified Legislation" at 57; Rajak and Henning "Business Rescue" at 268; Loubser "Insolvency Practitioners" at 125-126.



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company is subsequently wound up, the failure of judicial management could even have a financial advantage for a judicial manager.<sup>143</sup>

### 2.7.1.3 Vacation of or removal from office

The term of office of a provisional judicial manager lasts until the court grants a final judicial management order or discharges the provisional order.<sup>144</sup>

A final judicial manager is automatically divested of his functions if the court cancels the judicial management order.<sup>145</sup> The court must then give whatever directions may be necessary for the future management and control of the company by its officers, including directions for the convening of a general meeting of members to elect directors.<sup>146</sup> The last-mentioned provision could be an indication that the directors of a company are automatically removed from office when the company is placed under judicial management, but could also merely refer to the possibility that none of the previous directors are still in office at the time that the final judicial management order is cancelled.<sup>147</sup>

In contrast to the Companies Act of 1926 that specifically provided for an application to court for the removal and substitution of a judicial manager<sup>148</sup> (who was directly appointed by the court in the original order),<sup>149</sup> the Companies Act of 1973 makes no express provision for the removal of a judicial manager. I submit that section 379 of the Act, which provides for the removal of a liquidator by the Master or the court, does not apply to judicial management since section 431(4) makes only those provisions of the Companies Act of 1973 dealing with “the nomination and appointment of a liquidator” applicable to a judicial manager. Furthermore, section 431 very specifically deals only with the first meetings of creditors and members

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<sup>143</sup> This omission is addressed in the Companies Act of 2008 that contains a blanket prohibition on the appointment of the business rescue practitioner as liquidator in a subsequent winding up of the company: see part 3.9.1.1 below .

<sup>144</sup> Section 429(b)(i).

<sup>145</sup> Section 440(1). See part 2.9 below for a discussion of the cancellation of the order.

<sup>146</sup> Section 440(2).

<sup>147</sup> The Act is clear about the fact that the directors are divested of their management powers: see further part 2.7.2 below.

<sup>148</sup> In s 196(2).

<sup>149</sup> In *Samuels v Nicholls and Another* 1948 (2) SA 255 (W) at 260 the court therefore held that an unsuitable judicial manager did not make the judicial management itself undesirable and an application for cancellation of the judicial management order was not the appropriate remedy in this instance.

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where the nomination of a final judicial manager takes place and cannot be presumed to include provisions dealing with his resignation or removal.<sup>150</sup>

Section 432(4) of the Companies Act of 1973 which provides for an application to court for the variation of the terms of the order is also not applicable since the judicial manager is not appointed by the court as part of the judicial management order, but by the Master of the High Court. In at least one instance, the court held that it had an inherent power to remove a judicial manager.<sup>151</sup> The only alternative would be an application for cancellation of the judicial management order, which would be a very drastic step to take merely to remove an incompetent or dishonest judicial manager.<sup>152</sup>

The same uncertainty exists in respect of the question whether a judicial manager may resign from office. The Companies Act of 1973<sup>153</sup> provides that a liquidator may request the Master to relieve him of his office or direct him to resign, and also, in a different section,<sup>154</sup> prescribes the procedure that must be followed to nominate and appoint a liquidator to fill any vacancy that may occur in the office of liquidator. Although the last-mentioned section could be regarded as one relating to the nomination and appointment of a liquidator and thus applicable to judicial management,<sup>155</sup> the provision regulating his resignation cannot. In the absence of a specific provision allowing the judicial manager to resign, it cannot simply be assumed that he has such a right. The resignation of a judicial manager would probably be interpreted by creditors as a sign that the judicial management is failing, with a resultant loss of faith in the process, while the break in continuity during this particularly sensitive period in a company's business will almost certainly impact negatively on the outcome of the rescue attempt. It is therefore not surprising that in some jurisdictions the person steering the rescue process

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<sup>150</sup> In *Ex parte the Judicial Manager of Die Transvaalse Begrafnis Genootskap (Eiendoms) Beperk* 1946 TPD 649 at 651, De Villiers J stated that provisions applicable to liquidation could not by implication apply to judicial management as well because the two processes were not parallel. However, see Meskin et al *Henochnsberg* at 944 for the opposite view. Blackman et al *Companies Act* at 15–18 seems ambivalent about the issue, first admitting that s 379 does not, “strictly speaking”, deal with the nomination and appointment of a liquidator, then arguing for a broad interpretation of this phrase to include the removal of a liquidator but conceding that the context of s 431(4), namely the meetings of creditors and members, would present a problem when applying this broader meaning to the section.

<sup>151</sup> *The Master v Bell NO* 1955 (3) SA 100 (T) cited with apparent approval by Blackman et al *Companies Act* at 15–25.

<sup>152</sup> This omission is not repeated in the Companies Act of 2008 where provision is made for the removal of a business rescue practitioner by an order of court: see part 3.7.1.3 below.

<sup>153</sup> Section 378(2).

<sup>154</sup> Section 377.

<sup>155</sup> In terms of s 431(4).

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has no, or only a limited right to resign from office.<sup>156</sup> However, it could be argued that forcing a person to remain in office against his will could also harm the process. In my view, the solution to this problem would be to restrict the right of such a person to resign from office to ensure that he may only resign if he is no longer able to perform his duties properly.<sup>157</sup>

### 2.7.2 Powers and duties of the directors

Any person vested with the management of the affairs of a company is divested of this power from the date of a provisional judicial management order in respect of the company.<sup>158</sup> Therefore, the directors of a company lose their powers and authority to manage the company as soon as the company is placed under provisional judicial management, and apparently lose even other powers such as the power to call the annual general meeting or to perform other routine duties since these are specifically vested in the judicial manager.<sup>159</sup>

It is not clear whether the directors also cease to hold office on the granting of a judicial management order, or whether they are merely divested of all, or most of their powers. Section 440(2) provides that when cancelling a judicial management order, the court may give directions for the convening of a general meeting of members to elect directors for the company,<sup>160</sup> which implies that a judicial management order has the effect of removing the directors from office.<sup>161</sup> However, the subsection specifically refers to “such directions as may be necessary” which could also mean that the court should order a general meeting only if it is necessary because there are no directors left to resume management of the company. Since the Act specifically states that the judicial manager “shall ... assume the management of the company”<sup>162</sup> and no mention is made

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<sup>156</sup> See Chapter 3, part 2.7.1.3 and Chapter 4, part 2.7.1.3.

<sup>157</sup> See part 3.7.1.3 below regarding the apparent unrestricted right of a business rescue practitioner to resign from office.

<sup>158</sup> Sections 428(2)(a) and 432(3)(a).

<sup>159</sup> Section 433(f)-(g). This was also stated very clearly in *Alpha Bank Bpk en Andere v Registrateur van Banke en Andere* 1996 (1) SA 330 (A) at 352.

<sup>160</sup> See part 6 below regarding the termination of judicial management.

<sup>161</sup> Blackman et al *Companies Act* at 15–21 are the only commentators who make a pertinent statement to the effect that directors cease to hold office on the making of a judicial management order. Others merely state that directors are divested of their powers (which could mean the same thing): Cilliers, Benade et al *Corporate Law* par 26.18; Meskin et al *Henochnsberg* at 936 and 945.

<sup>162</sup> Section 433(a).

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of any duties to be fulfilled by the directors, it must be assumed that the directors of a company are automatically divested of their office when the company is placed under judicial management.<sup>163</sup>

## 2.8 Rescue plan

There is no statutory provision for the development or drafting of a rescue plan as part of the judicial management process. The report of the provisional judicial manager setting out the current situation of the company, the reasons for its problems, the manner in which capital will be raised to enable the company to continue trading and the chances of a successful rescue of the company, is the closest to any formal rescue plan contained in the current procedure.<sup>164</sup> Several commentators on judicial management have argued that a reasonably detailed plan of action to save the company plays an important role in a successful rescue and have identified the lack of any provisions for the formulation and acceptance of such a rescue plan as one of the reasons for the failure of judicial management.<sup>165</sup> The lack of a compulsory and proper rescue plan, combined with the fact that the process is managed by a judicial manager who is not required to have any qualifications, training or experience in running, let alone rescuing a company, unavoidably creates a substantial risk to the possible success of the rescue process.<sup>166</sup>

## 2.9 Termination of judicial management

The Companies Act of 1973 does not stipulate a period for the duration of judicial management, and as a rule the order is granted for an indefinite period.<sup>167</sup> Therefore,

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<sup>163</sup> This is also the view held by Blackman et al *Companies Act* at 15–43 and, apparently, Meskin et al *Henochsberg* at 959. Both these textbooks refer to *Ex parte Niven* 1957 (1) SA 10 (SR) in which it was held that the local predecessor of s 440(2) also authorised the court to appoint a manager until the general meeting of members could elect directors.

<sup>164</sup> See part 2.5.1 above.

<sup>165</sup> Kloppers “Judicial Management” at 427; Rajak and Henning “Business Rescue” at 286; and Smits “Corporate Administration” at 103.

<sup>166</sup> See part 3.8 below on the detailed requirements for a business rescue plan that is compulsory in all business rescue proceedings.

<sup>167</sup> In *Keens Electrical (Jhb) (Edms) Bpk en 'n Ander v Lightman Wholesalers (Edms) Bpk* 1979 (4) SA 186 (T) at 189, De Villiers AJ stated that the Court had a discretion to determine a fixed period for judicial management but that it was usually undesirable to do so. The courts have made it clear, however, that judicial management must fulfill its purpose within a reasonable time, as creditors should not be expected to wait indefinitely for payment of their claims: see *Marsh and Another v Plows (SA)*

the only way to terminate the judicial management of a company is by an order of the court that granted the judicial management order.<sup>168</sup>

The judicial manager or any person having an interest in the company may apply for cancellation of a judicial management order.<sup>169</sup> The judicial manager is compelled to apply for the cancellation of the judicial management order and for an order for the winding up of the company if he comes to the conclusion during the process that judicial management will not succeed.<sup>170</sup>

The court may, on application, cancel a judicial management order if it appears that the purpose of the order has been fulfilled or that, for whatever reason, it is undesirable for the judicial management order to remain in force.<sup>171</sup> In those cases where the application is brought on the grounds that judicial management has failed in its purpose to rescue the company, it will usually (and must, if brought by the judicial manager)<sup>172</sup> include an application for a winding-up order in respect of the company. Section 440(1), in terms of which an application for cancellation of a judicial management order is brought, does not prescribe that a rule *nisi* should be issued before the final order is granted. However, the general view seems to be that a rule *nisi* would first be issued, except if all interested parties have consented to the cancellation of the order or the cancellation order is sought by the judicial manager as a preliminary to applying for liquidation of the company.<sup>173</sup>

## 2.10 EVALUATION OF JUDICIAL MANAGEMENT

It is clear that the failure of judicial management to function as a viable business rescue regime is at least partly due to the fact that judicial management has always

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*Limited* 1949 (1) PH E4 (C) at 10-11; *Marais v Leighwood Hospitals (Pty) Ltd* 1950 (3) SA 567 (C) at 572; *Irvin & Johnson Ltd v Oelofse Fisheries Ltd* 1954 (1) SA 231 (E) at 237.

<sup>168</sup> Section 440(1).

<sup>169</sup> Section 440(1) does not stipulate who would qualify as a person with an interest in the company, but according to *Meskin et al Henochsberg* at 959, it would include a member, a creditor (including a prospective or contingent creditor), and a person who has a pecuniary or proprietary interest as a result of a section 311 compromise or arrangement which provides for the cancellation of judicial management.

<sup>170</sup> Section 433(l).

<sup>171</sup> Section 440(1).

<sup>172</sup> Section 433(l).

<sup>173</sup> *Meskin et al Henochsberg* at 958; *Blackman et al Companies Act* at 15–43; Cilliers, Benade et al *Corporate Law* par 26.43. The case law supplied to substantiate this view unfortunately deals only with the Companies Act of 1926. As already illustrated in this Chapter, the application of such case law to the present Companies Act of 1973 is often not reliable.

been regarded as an extraordinary remedy which infringes on the rights of creditors and should consequently be available only under very special circumstances.<sup>174</sup> This approach ignores the fact that the rescue of a company would have benefits extending much further than the company's immediate creditors.

It is also clear that the procedure suffers from a number of shortcomings. These include the unavoidable involvement of the court which renders the procedure costly, slow and cumbersome. This situation is exacerbated by the fact that only a provisional order is issued on the first application and an applicant therefore has to approach the court for a second time to obtain a final judicial management order.

Another serious disadvantage is the excessively stringent requirements for both a provisional and a final judicial management order and the burden of proof on the applicant which is almost impossible to discharge.

The lack of a provision for an automatic moratorium on all actions, proceedings, execution of writs, summonses and other processes against the company during judicial management creates a degree of uncertainty because there is no guarantee that the court will include a moratorium in a judicial management order.

The uncertainty over whether directors are merely divested of all their powers by a judicial management order or whether they are in fact automatically removed from office is another problem. It furthermore appears that in all cases, directors are assumed to be directly responsible for the failure of a company and no provision is made for their knowledge of and experience in the business of the company to be made available to the judicial manager.

One of the most important and serious defects in judicial management is the complete lack of regulatory control over and qualifications for judicial managers as well as the absence of a provision in the Act for the removal of judicial managers in cases of incompetence or abuse. This means that a judicial manager may be appointed without having the necessary experience or expertise, and is then left to carry out his functions without any real oversight or control. It also opens the door to abuse of the process through the control of a judicial manager by a major creditor who is not really interested in a rescue of the company or the business.

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<sup>174</sup> See part 2.4.4 above.

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The absence of any requirement for a formal rescue plan to be submitted by the judicial manager indicating how the rescue of the company would be approached is another contributing factor that allows the judicial manager to act without any identifiable policy or plan for which he could be held accountable.

Lastly, the fact that only an order of court can terminate judicial management means that a judicial manager is not under any pressure to complete his task within a specified period and can continue to earn fees for an indeterminate period without making any real progress. Again, the lack of any control by a professional organisation means that he will not be held accountable for any unprofessional or dubious actions.

### **3 BUSINESS RESCUE PROCEEDINGS**

#### **3.1 Definition and purpose**

The term “business rescue” is defined in section 128(1)(b) of the Companies Act 71 of 2008<sup>175</sup> as proceedings to facilitate the rehabilitation of a company that is financially distressed<sup>176</sup> by means of three measures: “(i) the temporary supervision<sup>177</sup> 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 equities in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it 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.”

Although the definition refers to the rehabilitation of a company that is financially distressed, this is not the only (or always a) requirement for the commencement of

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<sup>175</sup> In parts 3 and 4 of this Chapter, all references to statutory provisions will be to the Companies Act of 2008, unless specifically stated otherwise.

<sup>176</sup> As defined in s 128(1)(f) and discussed in part 3.4 below.

<sup>177</sup> Defined in s 128(1)(j) as the oversight imposed on a company during its business rescue proceedings. See part 3.7.1 below for a discussion on the business rescue practitioner who is appointed to fulfil this duty.

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business rescue proceedings. As will become clear from the discussion below, this is only one of the two requirements for initiating the proceedings and in the case of commencement by order of court, the requirement of financial distress can be substituted by two other possibilities that may not necessarily be an indication of financial distress.<sup>178</sup> The definition is therefore slightly misleading in this respect.<sup>179</sup>

In spite of naming the procedure “business rescue proceedings”, thereby implying that it concerns the rescue of a company’s business (or part of its business), it is clear from the definition that the main purpose of the proceedings is to rescue the company as a whole. The definition refers to the rehabilitation of a *company*<sup>180</sup> and a plan to rescue the *company* in a manner that maximises its chances of surviving in a solvent state. It is therefore more a corporate rescue procedure than a business rescue.<sup>181</sup> In this respect it resembles judicial management, except to the extent that survival of the whole company is the only acceptable outcome of judicial management.<sup>182</sup>

The reference to the continued existence of the company in a state of solvency is also problematic since it shows some similarity with the requirement for a judicial management order of a reasonable probability that the company will be able to pay all its debts if placed under judicial management.<sup>183</sup> A business rescue plan may provide for a moratorium on the payment of debts until payment can eventually be made from future earnings of the company, or post-commencement financing may replace the claims of some creditors.<sup>184</sup> In both these instances the company will not immediately become solvent, but will be given the opportunity to become solvent by being allowed to continue trading.<sup>185</sup> The reference to the solvency of the company should therefore be removed.

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<sup>178</sup> See parts 3.4.1 and 3.4.2 below.

<sup>179</sup> See Chapter 5, part 2.4.1 on my proposal for an amended definition of financial distress that will also remove this objection.

<sup>180</sup> My emphasis.

<sup>181</sup> The definition of “rescuing the company” in s 128(1)(h) that equates this phrase with achieving the goals contained in the definition of “business rescue” does not change the position because, apart from the reference to a better return for creditors and shareholders, these goals all refer to the rehabilitation or rescue of the company, never the business of the company

<sup>182</sup> See part 2.1 above.

<sup>183</sup> Section 427(1) of the Companies Act of 1973 discussed in part 2.4.3 above.

<sup>184</sup> See part 3 below.

<sup>185</sup> For this reason, during business rescue proceedings and until the rescue plan has been implemented in full, a company should be excluded from the provisions of s 22(1)(b), which prohibits insolvent trading by a company: see part 3.7.1.3.2.



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The second possible outcome of a rescue plan, namely a better return for creditors or shareholders, echoes the second stated object of the administration procedure in English law.<sup>186</sup> It is significant, however, that the English provision only refers to a better return for creditors and not for shareholders. As will become clear in the discussion below, shareholders play almost no role in the proposed business rescue proceedings, and it is doubtful whether their interests will be given any serious consideration in a rescue plan; any benefit for them resulting from a successful rescue of the company will be purely incidental.<sup>187</sup> The use of the words “a better return than ... immediate liquidation” also clearly implies eventual liquidation and payment of a dividend rather than full payment to creditors. In most insolvent liquidations there are insufficient funds available even for the payment of a dividend to concurrent creditors, and there would certainly not be any payment to shareholders. Their inclusion in the definition is therefore essentially meaningless: the only possible benefit for them lies in a rescue of the company as a whole and its return to profitability.

Even the inclusion of a better return for creditors than in immediate liquidation as one of the objects of business rescue is misleading and not really beneficial. Apart from the inevitable and highly undesirable association with insolvency that it creates,<sup>188</sup> it is difficult to understand how this could be achieved by business rescue proceedings. Although it is often argued that a sale of the business as a going concern during business rescue, rather than a piecemeal sale of the company’s assets, will result in a higher price being reached, this argument assumes that a liquidator will always sell the assets individually rather than the whole business. This is not the reality of today: liquidators can, and often do sell a viable business owned by a company in liquidation as a going concern.<sup>189</sup> A liquidator may also be authorised to continue running the business if necessary for the beneficial winding up thereof.<sup>190</sup> There is thus no need for a business rescue to be commenced simply to keep the business running until a

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<sup>186</sup> See Chapter 3, part 2.3.2.

<sup>187</sup> See also Loubser “Shareholders” at 387-388.

<sup>188</sup> See further part 3.2 below.

<sup>189</sup> A perfect example can be found in the sale of all the assets (including the buildings) of a company (only referred to as Darbel) after the company’s liquidation. The company had manufactured Rolux and Wolf lawn mowers under licence. The purchasers of the assets believed that the business was still viable, particularly since the names of these products were well-known, and they thus proceeded to successfully save the business: see *Sunday Times* 22 November 2009 at 10.

<sup>190</sup> Section 386(3) and (4)(f) of the Companies Act of 1973.

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purchaser is found. Furthermore, if the company is put through the whole process of a business rescue before an unavoidable liquidation, this will result in substantial extra costs that must be paid from the company's already insufficient assets. These costs are the remuneration and expenses of the business rescue practitioner and the costs of the business rescue, including the remuneration payable to employees after commencement of business rescue proceedings.<sup>191</sup> It will also take longer before creditors are paid. All of these factors will prejudice the creditors, particularly the concurrent creditors, instead of resulting in a better return for them. This appendage to the definition of business rescue should thus simply be removed.

Ironically, the only group of people who will be able to gain substantial benefits from business rescue proceedings preceding a liquidation, namely the employees, are not mentioned in the definition at all. The Companies Act of 2008 provides in no uncertain terms that "employees of the company immediately before the beginning of [business rescue] proceedings continue to be so employed on the same terms and conditions".<sup>192</sup> Employment contracts are also specifically excluded from a business rescue practitioner's power to cancel or suspend agreements to which the company is a party.<sup>193</sup> Furthermore, section 135(1) classifies any remuneration, reimbursements or other payments that become due and payable by the company to its employees during business rescue proceedings, as post-commencement finance. These claims are afforded super-preference rights, ranking them just after the costs of the business rescue proceedings and the business rescue practitioner's remuneration and costs, and before any claims for other forms of post-commencement finance, whether secured or not, and all unsecured claims against the company.<sup>194</sup> Should the business rescue proceedings be superseded by a liquidation order, these preferent rights will remain in force, without any limit on either the amounts or the period of remuneration.

If one compares these rights to those of employees of a company that is liquidated immediately, the benefits to be gained by employees from preceding business rescue proceedings become abundantly clear. In terms of section 38(1) of

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<sup>191</sup> A cost that can be limited during winding up by only retaining the services of employees who are necessary for continued trading by the company: see the discussion below.

<sup>192</sup> Section 136(1)(a).

<sup>193</sup> Section 136(2).

<sup>194</sup> Section 135(3)(a).

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the Insolvency Act<sup>195</sup> the liquidation of an employer company suspends all contracts of service with its employees from the date on which an order of winding up is issued. During this period of suspension of their contracts, employees are not required to render services nor are they entitled to remuneration in terms of the contracts.<sup>196</sup> The suspended contracts will, however, automatically terminate 45 days after the date of appointment of a final liquidator, except in respect of those employees who have reached agreement with the liquidator on their continued employment.<sup>197</sup>

The special rights granted to employees in the Companies Act of 2008 therefore present them with an opportunity to earn remuneration for a few extra months and a very real potential for abuse.<sup>198</sup>

### **3.2 Entities to which business rescue proceedings apply**

Just like judicial management, the new business rescue proceedings are contained in the new Companies Act<sup>199</sup> and not in the present or in a future Insolvency Act. This inevitably means that the proceedings were designed for and will apply primarily to companies<sup>200</sup> and not to other business forms.

However, the rescue proceedings will also apply to close corporations in the interim period until this business form finally disappears.<sup>201</sup> I believe that this decision will not achieve any identifiable benefits or advantages in respect of the rescue of close corporations. Apart from the fact that the business rescue proceedings are far too onerous and complicated for the close corporation with its small membership,<sup>202</sup> and generally inappropriate as a result of the vast differences in structure and management

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<sup>195</sup> Act 24 of 1936. Section 38 is made applicable to the winding up of a company unable to pay its debts by s 339 of the Companies Act of 1973.

<sup>196</sup> Section 38(2).

<sup>197</sup> Section 38(9).

<sup>198</sup> See part 3.3.2.3 on their right to apply for a business rescue order.

<sup>199</sup> In Chapter 6 that deals with business rescue and compromises with creditors.

<sup>200</sup> Section 1 defines a company as “a juristic person incorporated in terms of this Act”, once it comes into operation, as well as one that was registered or converted from a close corporation to a company in terms of the Companies Act 61 of 1973, and a company that was in existence and recognised as a company by the Companies Act of 1973 immediately before the date on which the Act comes into operation.

<sup>201</sup> In terms of Item 6 of Schedule 3 to the Companies Act of 2008. See Chapter 1, part 2 for the reasons behind this decision.

<sup>202</sup> Section 2(1) of the Close Corporations Act limits it to a maximum of ten members.

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between a company and a close corporation,<sup>203</sup> it was also unnecessary to create a new rescue procedure for close corporations. The drafters of the Companies Act of 2008 seem to have been completely unaware of a very effective and adequate business rescue procedure contained in the Close Corporations Act itself.<sup>204</sup> Under the circumstances I submit that close corporations are unlikely to use the new rescue procedure and I will therefore not include the provisions as they would apply to close corporations in my discussion of the business rescue proceedings.

The decision to keep the business rescue proceedings in the new Companies Act rather than moving it to the planned consolidated Insolvency Act<sup>205</sup> has been severely criticised in submissions on the Companies Bill to the Portfolio Committee on Trade and Industry. These critics argue that business rescue is an insolvency procedure because it is triggered by insolvency or imminent insolvency of the company<sup>206</sup> and its provisions should therefore be aligned with those of insolvency law.<sup>207</sup> It is my submission that the legislation should strive for the exact opposite: business rescue should not be tainted by an association with insolvency law as the stigma of bankruptcy has been identified as one of the reasons why company boards have been unwilling to apply for judicial management.<sup>208</sup> Business rescue should be regarded as an independent corporate procedure to assist companies in financial

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<sup>203</sup> For example, a close corporation does not have directors, and management functions are exercised by all or some of its members: s 46(a) of the Close Corporations Act. No guidance is given in the Companies Act of 2008 whether the directors of a company should be substituted by all the members of a close corporation or merely those members who are actively involved in the management of the close corporation. A written resolution signed by all members is required for the voluntary winding up of a close corporation (s 67 of the Close Corporations Act) and it could be argued that the same should apply to a resolution to enter business rescue proceedings: see part 3.3.1 below.

<sup>204</sup> Section 72 (that is not repealed) provides for a composition that may be offered to creditors at any time after commencement of liquidation. Section 72(11) specifically allows the composition to provide for an application to court for the setting aside of the winding up of the corporation if the composition is accepted by the required majority of creditors. If successful, this would obviously result in a rescue of the corporation. The process is managed by the liquidator and is thus also cost-effective.

<sup>205</sup> *Memorandum on the Objects of the Companies Bill, 2008* at 217. See Chapter 1, part 2 regarding a future consolidated Insolvency Act. In terms of Item 9 of Schedule 5 to the Companies Act of 2008, the provisions of the Companies Act of 1973 relating to the winding up of insolvent companies will continue to apply until adequate alternative legislation (presumably the new consolidated insolvency legislation) has been brought into force.

<sup>206</sup> See part 3.4 below regarding the requirements for commencement of business rescue proceedings.

<sup>207</sup> Institute of Directors *Comments* at 7; KPMG *Comments* at 7; TMA *Comments* at 33. See also generally on the issue of unified legislation, Burdette “Unified Legislation”; Burdette “Business Rescue Model (Part 1)” at 256; and Keay “To Unify”.

<sup>208</sup> See Loubser “Business Rescue” at 161-162 and 169-170. See also Brown *Corporate Rescue* at 654-657; Finch *Corporate Insolvency* at 372 and Parry “Introduction” at 15 on the similar view of directors in England regarding company administrations.

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difficulties, preferably before actual or commercial insolvency has set in, to survive these crises and not as merely another route to inevitable liquidation.<sup>209</sup> Unfortunately the Department of Trade and Industry, although confirming this view in its reaction to the criticism mentioned above, did not follow through in the legislation on its policy to separate business rescue proceedings from insolvency. Instead, the two are linked by requiring that the company must be on the verge of insolvency to enter business rescue proceedings,<sup>210</sup> and by repeatedly making some principles of insolvency law applicable to the rescue proceedings, such as the order of preference in which creditors must be paid.<sup>211</sup>

### **3.3 Power to initiate business rescue proceedings**

The Companies Act of 2008 provides for two ways of commencing business rescue proceedings: a resolution by the board of directors or an order of court.<sup>212</sup>

#### **3.3.1 Resolution by the board**

Although the heading of section 129 uses the term “Company resolution”, which would usually also include a resolution by the members in general meeting,<sup>213</sup> only the board of a company may take a resolution to begin business rescue proceedings voluntarily.<sup>214</sup> In this respect the procedure differs from administration in England, where both the company (in general meeting) and the directors are specifically authorised to take such a resolution.<sup>215</sup> As the directors would be the first to know about impending financial problems, and calling a meeting of members would furthermore take time and publicise the company’s financial situation before the

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<sup>209</sup> See further my comments in this regard on the requirements for business rescue proceedings in part 3.4 below.

<sup>210</sup> See part 3.4 below.

<sup>211</sup> This is particularly true of the prescribed contents of the business rescue plan: see part 3.8 below.

<sup>212</sup> Sections 129 and 131 respectively. See part 3.5 below for a detailed discussion of the procedure that has to be followed in each instance.

<sup>213</sup> See part 2.3 above. The first Draft Companies Bill published in 2007 did provide that the shareholders could by ordinary resolution decide to commence voluntary business rescue proceedings, but this option was no longer present in the Companies Bill 2008. However, it probably explains the reference to a company resolution and not a board resolution in the heading of this section.

<sup>214</sup> In the absence of any specific requirement in this regard in the Memorandum of Incorporation, the resolution would have to be taken by the majority of the directors at a board meeting (s 73(5)) or by written consent of the majority of directors without a meeting being held (s 74).

<sup>215</sup> See Chapter 3, part 2.3.1.

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company were protected by a moratorium,<sup>216</sup> it is probably unnecessary to grant this power to members as well.

This procedure constitutes a major improvement on judicial management as there is no involvement by the court at this stage.<sup>217</sup> The procedure is thus faster, simpler and much less expensive to commence than judicial management. It also allows the board of directors to act immediately once they realise that the company is heading for insolvency and needs the protection and the breathing space that business rescue proceedings will provide, during which a rescue of the company or its business can be attempted.

### 3.3.2 Application to court

An application to court for an order commencing business rescue proceedings may be brought by any “affected person”,<sup>218</sup> defined as a shareholder, a creditor, any registered trade union representing employees of the company and any employee (or his representative) who is not represented by a registered trade union.<sup>219</sup> Neither the company nor the directors (in their capacity as such)<sup>220</sup> are therefore authorised to apply.<sup>221</sup> The exclusion of both the board and individual directors from the list of applicants is regrettable since no board resolution to commence rescue proceedings may be taken after liquidation proceedings have been initiated, even if the board is convinced that the company can be rescued.<sup>222</sup> Furthermore, a director who believes that the company is financially distressed and should be placed under supervision, but who is outvoted by other directors, will not be able to apply to court in his capacity as director for a business rescue order, in spite of being subject to, among other

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<sup>216</sup> See part 3.6 below.

<sup>217</sup> By contrast, the High Court must be approached at least twice to obtain a final judicial management order: see part 2.5 above.

<sup>218</sup> Section 131(1).

<sup>219</sup> Section 128(1)(a).

<sup>220</sup> The Act recognises the possibility that a director can be an affected person: see s 130(2) discussed in part 3.5.1.3 below. A director will often be an affected person by virtue of being a shareholder. Since a director can also be an employee of the company if a contract of service has been concluded (Cilliers, Benade et al *Corporate Law* par 10.05), it would be interesting to see whether such a director will be recognised by our courts as an affected person in his capacity as an employee and entitled to all the special rights afforded to employees.

<sup>221</sup> Although a director may not apply directly for a business rescue order in his capacity as director, a court may make such an order in appropriate circumstances where a director has applied for relief from oppressive or prejudicial conduct by the company (s 163(2)(c)). See part 3.5.2.5 below.

<sup>222</sup> Section 129(2)(a) discussed in part 3.5.1.1 below.

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things, the risk of personal and criminal liability for trading under insolvent circumstances.<sup>223</sup> I submit that the risk of potential liability of a director for failing to act, or to act in good time, should be mitigated by giving individual directors the power to act when the board refuses to do so.<sup>224</sup>

### 3.3.2.1 Shareholders

As in the case of judicial management,<sup>225</sup> individual shareholders have been given the power to apply to court for business rescue proceedings. This power could be a remnant from judicial management where every person who was authorised to apply for liquidation could apply for judicial management, or merely the result of the blanket authority given to every affected person without much consideration having been given to its meaning or consequences. No other comparable system allows a single shareholder to bring such an application, and even allowing shareholders to apply as a group and representing the company is rare.<sup>226</sup>

Shareholders will seldom have the information available to prove the requirements for such an order,<sup>227</sup> and since they are effectively excluded from playing any meaningful role during course of the rescue of the company, it is doubtful whether this power will amount to any real benefit for shareholders.<sup>228</sup>

### 3.3.2.2 Creditors

In spite of the fact that the meaning of the term “creditor” is well established and fully understood in South African law to be a creditor in the usual sense of the word,<sup>229</sup> and not even the Insolvency Act 24 of 1936 contains such a definition, the first draft of the

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<sup>223</sup> In terms of ss 22(1)(b), 77(3)(b) and 214(1)(c) respectively.

<sup>224</sup> Individual directors in Germany have been given the power to apply for the opening of insolvency proceedings for this very reason: see Chapter 4, part 2.3. In England, where directors also run the risk of liability for wrongful trading, individual directors may not apply for an administration order but the board may do so if the decision is supported by the majority of the directors: see Chapter 3, part 2.3.2.

<sup>225</sup> See part 2.3 above.

<sup>226</sup> In England the company may apply in terms of a resolution by the general meeting but individual members may not: see Chapter 3, part 2.2.2. In Germany shareholders are not allowed to apply individually or collectively: see Chapter 4, part 2.3.

<sup>227</sup> See part 3.4 below.

<sup>228</sup> See, for example, part 3.7.1 below regarding the creditors’ right to make the final decision on the choice of business rescue practitioner and part 3.8 on the very limited rights of shareholders with regard to the approval of a rescue plan. See also, generally, Loubser “Shareholders”.

<sup>229</sup> Bertelsmann et al *Mars* at 372.

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Companies Bill<sup>230</sup> introduced into Parliament contained a definition of a creditor for the purposes of business rescue proceedings.<sup>231</sup>

A creditor was defined as a person to whom the company owed money under any arrangement immediately before the start of business rescue proceedings, irrespective of whether the money was already due and payable. A person providing post-commencement finance to the company was specifically excluded, except to the extent that this person was a creditor before providing such finance. In my submission on the Companies Bill to the Portfolio Committee on Trade and Industry, I pointed out that the definition was flawed in several respects: firstly, the definition referred only to persons to whom the company owed money although a person could also be a creditor as a result of services, products or property that the company was obliged to deliver in terms of a contract. Secondly, the reference to “arrangement” limited the obligation to some form of agreement although performance by the company could be due as a result of, for example, a court order or statutory obligation. Thirdly, although stating right at its beginning that only a person to whom the company owed money before business rescue was a creditor, the definition specifically excluded post-commencement finance (which was already excluded because it arose after the beginning of business rescue) but then qualified that to exclude once again any debt due to such a person before business rescue started. I submitted that this was an unnecessary complication of a fairly simple matter and would undoubtedly cause considerable uncertainty. My recommendation that the definition should be removed was accepted by the Department of Trade and Industry and the Portfolio Committee, and the definition was accordingly scrapped.

### 3.3.2.3 Trade unions and employees

The inclusion of trade unions and even individual employees – who do not have to be creditors of the company to qualify – in the list of persons who may apply for an order commencing business rescue proceedings seems excessive and has no equivalent in any other comparable system.<sup>232</sup> However, this must be seen as part

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<sup>230</sup> Bill B 61A - 2008.

<sup>231</sup> As s 128(1)(e).

<sup>232</sup> In England only creditors, the company and its directors may apply: see Chapter 3, part 2.2.2. In Germany only the debtor company, directors and creditors may apply: Chapter 4, part 2.3. In the United States of America a petition for a Chapter 11 reorganisation under the Bankruptcy Code (Title 11, United States Code) may be filed only by the debtor company or by its creditors: Bankruptcy Rules



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of the protection of “the interests of workers” which is prominently featured as an object of the new business rescue proceedings.<sup>233</sup>

The disadvantage mentioned above in respect of shareholders, namely that they would not usually have access to the information required to prove the grounds for commencement of rescue proceedings, has been eliminated in the case of trade unions by section 31(3) of the Companies Act of 2008. This section gives any trade union the right to demand access to company financial statements<sup>234</sup> through the Commission<sup>235</sup> and subject to such conditions as the Commission may determine, for the purpose of initiating business rescue proceedings. The use of the word “must” in this subsection makes it very clear that neither the company nor the Commission may refuse a trade union’s demand for such access even if they suspect that the trade union is abusing this power and has no serious intention to apply for the commencement of business rescue proceedings. There is no limit on how often this demand may be made and no liability for abuse of the right, in spite of the fact that the reputation and creditworthiness of a company can be seriously damaged if it becomes known that such a demand has been made.

The right to apply for business rescue proceedings to commence grants a very powerful right to a single employee who may be tempted to abuse it because of a completely unrelated grievance against the company. It may also be used as a bargaining tool by a trade union in wage negotiations: if the company refuses a demand for higher wages because it cannot afford to pay it, the trade union or employees may threaten to use that as proof of inability to pay debts and thus grounds for business rescue proceedings. An unfounded application will eventually be refused by the court, but by the time the application is heard, substantial damage would have been done to the company’s reputation, credit rating and its business in

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1002(a) and 9001(1)-(3).

<sup>233</sup> *Explanatory Memorandum on the Companies Bill* part 12 at 222.

<sup>234</sup> In terms of the definition in s 1, these would include annual and provisional annual financial statements, interim or preliminary reports, group and consolidated financial statements, and any financial information contained in a prospectus, circular or provisional announcement of results. Since these would have been published already, it is unclear why the company should be required to make them available, unless the intention behind this subsection is to give trade unions access to confidential and unpublished financial information of the company.

<sup>235</sup> The Companies and Intellectual Property Commission (hereafter referred to as “the Commission”) will be established in terms of s 185 of the Companies Act of 2008 and will be the successor to the current CIPRO.

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general, especially as prior notice of the application must be given to all creditors, shareholders and employees of the company.<sup>236</sup> A company would therefore go to great lengths to avoid such an occurrence.

The risk it poses to a company at the very least needs to be counterbalanced by a section providing that the court may issue an order for payment of damages to the company against an applicant for business rescue who abuses the procedure, or whose application is found to be malicious or vexatious. Such a provision could be similar to the one providing for personal liability for abuse of the process in winding up applications that is presently found in the Companies Act of 1973.<sup>237</sup>

### **3.4 Requirements for commencement of business rescue proceedings**

#### **3.4.1 Resolution to begin business rescue proceedings**

The board of directors of a company may take a resolution<sup>238</sup> to voluntarily commence business rescue proceedings in respect of the company if they have reasonable grounds for believing that the company is financially distressed and there seems to be a reasonable prospect of rescuing it.<sup>239</sup>

The stipulation that the board must have reasonable grounds for believing that the two preconditions for such a resolution exist seems to indicate that the directors voting in favour of the commencement of business rescue proceedings must first really believe that these requirements are present,<sup>240</sup> and secondly that they must have good reasons for this belief. It is assumed that the omission of the words “and did believe” does not mean that the directors need not actually believe that the requirements for business rescue have been satisfied, although section 76(4)(a)(iii), for example, stipulates that a director would have satisfied his duty of care and skill if he “had a rational basis for believing, and did believe that the decision was in the

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<sup>236</sup> In terms of s 131(2)(b) read with s 128(1)(a).

<sup>237</sup> Section 347(1A) of the Companies Act of 1973.

<sup>238</sup> See 3.5.1 below for a discussion of the prescribed procedure and formalities.

<sup>239</sup> Section 129(1).

<sup>240</sup> In Australia, s 436A(1)(a) of the Corporations Act, 2001 contains a similar requirement that the directors who vote for the resolution initiating administration must be of the opinion that the company is insolvent or likely to become insolvent at some future time. This has been interpreted to mean that the directors must form a real bona fide opinion to this effect: Robson *Corporations Law* 483.

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best interests of the company.” In the interests of clarity and certainty it would have been preferable if all sections in the Act dealing with the belief or opinion of a director had been similarly worded in so far as they were intended to have the same meaning.

The requirement that the board must have reasonable grounds for believing, and not merely that reasonable grounds must exist, implies that the test is both objective and subjective: whether a reasonable person, with the knowledge, experience and insight (or lack of it) of the directors, would believe that these circumstances exist. However, one of the grounds for applying to court to have such a resolution set aside is that “there is no reasonable basis” for the belief that the company is financially distressed, and another is “that there is no reasonable prospect for rescuing the company”.<sup>241</sup> This seems to require a purely objective test. Clearly the same test should consistently apply, and I submit that the test encompassing both a subjective and objective element should be used to conform with the general standards set for the conduct of directors in the Companies Act of 2008.<sup>242</sup>

#### 3.4.1.1 Financially distressed

According to the definition in the Companies Act of 2008, a company will be financially distressed if at any particular time “it appears to be 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”,<sup>243</sup> or “it appears to be reasonably likely that the company will become insolvent”<sup>244</sup> within the next six months.<sup>245</sup>

The original definition<sup>246</sup> also contained as a first possibility that a company would be financially distressed if it is unable to pay its debts as they fall due and payable, and its liabilities exceed its assets. In my submission to the Portfolio Committee on Trade

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<sup>241</sup> Section 130(1)(a)(i) and (ii). See part 3.5 below.

<sup>242</sup> Section 76(3)(c) requires a director to exercise his duties with the care and skill reasonably expected from a person carrying out the same functions (objective test) and having the general knowledge, skill and experience of that director (subjective test). Section 76(4)(a)(iii), which specifically deals with decisions taken by a director, also provides for a test that considers whether the director, based on his knowledge of the matter, had a rational basis for believing that the decision was in the best interests of the company.

<sup>243</sup> Section 128(1)(f)(i).

<sup>244</sup> Although its meaning is clear because of the alternative requirement of inability to pay its debts in s 128(1)(f)(i), the use of the term “insolvent” as opposed to the full description of the liabilities exceeding the assets is unfortunate since the word “insolvent” can also refer to commercial insolvency (the inability to pay debts as they fall due).

<sup>245</sup> Section 128(1)(f)(ii).

<sup>246</sup> In the Companies Bill, 2008.

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and Industry I submitted that there was no discernible reason why a double insolvency test – both commercial and actual – should be set when the resolution (or court order)<sup>247</sup> was based on the present financial situation of the company, but only one of the two was required when it was based on the company's expected situation in the six months immediately following. If a company is at present unable to pay its debts, it is also reasonably unlikely to be able to pay all of them as they fall due in the next six months, and the company would therefore automatically qualify under the second option. Furthermore, an inherently viable and healthy company may experience an unexpected and temporary cash-flow problem, possibly caused by external factors such as an earthquake, a factory fire, failure of an important supplier or labour unrest. Although it would be unable to pay its debts, such a company would not be able to use business rescue proceedings to obtain protection against claims by creditors while its problems were being solved, because its liabilities would not exceed its assets. A company should be allowed to enter business rescue proceedings at the first signs of financial problems, and insisting that it must be actually insolvent as well as unable to pay its debts forces the company to wait until its chances of being successfully rescued have been greatly diminished. It is an obvious and widely accepted fact that the sooner a rescue procedure is invoked, the greater the chances of a successful rescue are. Finch<sup>248</sup> refers to intervention at a sufficiently early stage once a company encounters financial difficulties as a key issue in the success of a rescue procedure.

My submission was accepted, and as a result the first option in the test for financial distress, based on the company's present financial situation, was removed. However, my recommendation that the company's present insolvency or inability to pay its debts should constitute financial distress was not implemented. The difference is probably more academic than real as proof of the company's present insolvency or inability to pay its debts will surely also be proof of the same situation prevailing in the immediately ensuing six months. However, amplifying the remaining two tests to include the company's present financial situation would have been preferable and easy.<sup>249</sup>

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<sup>247</sup> Financial distress is also one of the grounds on which a court may order business rescue proceedings to commence: s 131(4)(a)(i). See part 3.4.2 below.

<sup>248</sup> *Corporate Insolvency* at 248.

<sup>249</sup> See Chapter 3, part 2.4.1 where the present and future inability of a company to pay its debts are contained in the same requirement for the commencement of the administration procedure in England.

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In their submission to the Portfolio Committee on Trade and Industry, KPMG auditors suggested that the period of six months stipulated in the tests for financial distress should be increased to 12 months.<sup>250</sup> This proposal was not accepted and the period remains at six months. In other jurisdictions with a comparable requirement, no future period is specified but as this has led to uncertainty in at least one country, a specified period is probably preferable.<sup>251</sup> A period of six months, however, is too short and may deprive a company of the opportunity to take the necessary steps to protect itself in good time from a financial risk or impending crisis that is foreseeable more than six months prior to its occurrence, such as a claim for damages or other legal action. Since the financial planning of a company usually stretches over the next (financial) year, a period of 12 months seems more appropriate.

Generally, however, this is a major improvement on the equivalent requirement for judicial management which requires proof that the company is (already) unable to pay its debts.<sup>252</sup>

#### 3.4.1.2 Reasonable prospect of rescuing the company

Contrary to the very stringent requirements of judicial management, where proof is required of a probability that the company will become a successful concern,<sup>253</sup> the board only needs reasonable grounds to believe that there appears to be a reasonable prospect of rescuing the company.<sup>254</sup> The choice of the word “prospect”, which could mean either a possibility or a probability<sup>255</sup> is regrettable, but must be taken to mean a reasonable possibility in this instance.<sup>256</sup> It would have been preferable if the drafters had chosen the word “possibility” and used it consistently

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<sup>250</sup> KPMG *Comments* at 13.

<sup>251</sup> In England it is accepted that the inability to pay must occur in the not too distant future, but this is not indicated in the relevant provisions (see Chapter 3, part 2.3.1); in Australia s 436A(1)(a) of the Corporations Act, 2001 merely requires a company to be likely to become insolvent at some future time to qualify for voluntary administration but in New Zealand even this was regarded as setting the threshold too high and thus changed to “may in the future become insolvent” (Brown “New Zealand” at 270-271). See Chapter 4, part 2.4.2 on the uncertainty in German insolvency law resulting from the lack of a specified period.

<sup>252</sup> Section 427(1)(a) discussed in part 2.4.1 above.

<sup>253</sup> See 2.4.3 above.

<sup>254</sup> Section 129(1)(b).

<sup>255</sup> *Oxford Thesaurus* at 378.

<sup>256</sup> This is also the meaning attributed to “a real prospect” in English case law. See Chapter 3 in part 2.3.2 on this and on the problems experienced in England where there was uncertainty whether proof of a possibility or a probability of achieving the purpose of administration was required.

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throughout Chapter 6 to avoid any uncertainty and, considering our experience with and case law on judicial management, to make it clear that it differs from judicial management in this respect.<sup>257</sup>

The term “rescuing the company” is defined in the Companies Act of 2008 to mean achieving the goals contained in the definition of “business rescue”.<sup>258</sup> The purpose of the definition of “rescuing the company” is unclear, as the definition of “business rescue” refers to two goals that are merely aspects of the rescue procedure (the temporary supervision and moratorium) and not independent goals, while the third goal primarily refers to the rescue of the company: it thus becomes a circular definition.<sup>259</sup> If the intention was to indicate that rescuing the company could also mean something else, such as a rescue of the business only, or achieving a better return for creditors or shareholders, the definition has failed in its purpose. The definition of “business rescue” does not contain any reference to a rescue of a company’s business or part of it, and the mention of a better return for creditors or shareholders as something of an afterthought right at the end is difficult to reconcile with the term “rescuing the company”. The reference to the “rehabilitation” of a company in the main body of the definition of “business rescue” is also not covered.

The definition of “rescuing the company” is a clumsy attempt to widen the meaning of a phrase that should not have been used in the first place if something else was intended, and is in any event not supported by the other provisions that all point towards a rescue of the company itself.

### **3.4.2 Court order to begin business rescue proceedings**

A court may make an order commencing rescue proceedings if satisfied on the same two requirements discussed above, namely that the company is financially distressed and there is a reasonable prospect for the rescue of the company.<sup>260</sup> Compared to the requirements for a board resolution, the test is stricter in this instance: the court must not merely be satisfied that there are reasonable grounds to believe that the

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<sup>257</sup> To add to the confusion, the word “likelihood” (of the company’s continued existence) is used in the definition of “business rescue” in s 128(1)(b)(iii).

<sup>258</sup> Section 128(1)(h).

<sup>259</sup> Section 128(1)(b)(iii).

<sup>260</sup> Section 131(4)(a).

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company is financially distressed and that there appears to be a reasonable prospect of rescuing the company, but must be satisfied that the company is financially distressed and there is a reasonable prospect of rescuing the company. Although the applicant bears a substantially lighter burden of proof than in the case of judicial management,<sup>261</sup> it is doubtful whether this in itself will be of much use since in most instances it will be very difficult, if not impossible, for an outsider to prove that a company is financially distressed.<sup>262</sup> Therefore, it is unfortunate that there is no provision for a deemed inability of the company to pay its debts based on external evidence and similar to the provisions for the winding up of a company.<sup>263</sup>

The Companies Act of 2008 also provides for two alternative grounds in substitution for the requirement of financial distress, on which an order for business rescue proceedings may be made by the court.

The first of these is that the company has failed to pay over any amount that is due in terms of a contractual or statutory obligation relating to employment matters.<sup>264</sup> The Act does not provide any further details on these payments, but non-payment of salaries to employees will almost certainly fall into this category since salaries are due in terms of contractual obligations relating to employment. The statutory obligations referred to in this subsection will include payments due to medical aid funds, pension funds, the South African Revenue Service, the Workmen's Compensation Fund and the Unemployment Insurance Fund. The reason for this ground is that companies with cash-flow problems allegedly sometimes retain these contributions to alleviate their problem.<sup>265</sup> However, the provision in its present form requires only one payment to be missed, which could be as a result of an administrative or systems failure by the company or its bank, or other reasons not indicative of or related to financial difficulties.

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<sup>261</sup> See 2.4.3 above.

<sup>262</sup> With the possible exception of trade unions who may request financial information from the company, although it would depend on exactly how much information they may demand: see part 3.3.2.3 above.

<sup>263</sup> In s 345 of the Companies Act of 1973. See Chapter 3, part 2.4.1 regarding such deeming provisions for the administration procedure in England, and Chapter 4, part 2.4.1 for the situation in Germany where the Federal High Court has laid down certain guidelines in this regard.

<sup>264</sup> Section 131(4)(a)(ii).

<sup>265</sup> According to COSATU in its submission on the Companies Bill to the Portfolio Committee on Trade and Industry: *Business Report* 21 August 2008 at 1. This trend was also confirmed by the Institute of Retirement Funds specifically in relation to deductions for employee benefits which employers in financial difficulties were increasingly keeping instead of paying it over to the retirement funds: *Business Report* 28 July 2009 at 4.

Therefore, I submit that non-payment of these amounts should occur over a stipulated minimum period or frequency before it constitutes a ground for rescue proceedings, and at least two consecutive payments should be missed.<sup>266</sup>

The second ground that may substitute financial distress is if the court is satisfied that “it is otherwise just and equitable ... for financial reasons”.<sup>267</sup> The Companies Act of 2008 does not provide any definition or explanation of this extremely vague ground and it is not at all clear what circumstances would be required to constitute this ground. It is also not clear whether these financial reasons should be related to insolvency but not covered by the definition of financial distress, such as a company that may become insolvent or unable to pay its debts over a longer time than stipulated in the definition. It could possibly also be relied on by shareholders or employees who are of the opinion that as a result of the current mismanagement of the company, it is likely to fail over the longer term. On the other hand, because the definition is completely open to interpretation, it could be argued that anything connected to the finances of the company should be considered by the court, even if the company is completely solvent and not presently running any risk of becoming insolvent or unable to pay its debts. However, the second requirement for an order commencing business rescue proceedings, applicable to all instances, namely that there must be a reasonable prospect of rescuing the company, seems to indicate that the financial reasons must be connected to financial problems and failure of the company. Everything will depend on the interpretation given by the courts to this requirement and what would be regarded as just and equitable. Considering the very restrictive interpretation given by our courts to the requirement of just and equitable for judicial management orders, it is unlikely that the courts will allow this commencement ground to be used to widen the scope of business rescue proceedings.<sup>268</sup>

In the light of the above difficulties I recommend that the two alternative grounds in their present form should be removed and should instead be incorporated into a provision for deemed financial distress.<sup>269</sup>

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<sup>266</sup> In Belgium, the failure to pay such amounts triggered an official financial investigation and possible business rescue measures, but only after payments had been missed for at least six months: s 7 of the now repealed (with effect from 1 April 2009) Judicial Composition Act (Wet betreffende het Gerechtelijk Akkoord) of 17 July 1997.

<sup>267</sup> Section 131(4)(a)(iii).

<sup>268</sup> See part 2.4.4 above.

<sup>269</sup> See Chapter 5, part 2.4.1.



## 3.5 Procedure to commence business rescue proceedings

### 3.5.1 Board resolution to begin business rescue

#### 3.5.1.1 Formalities and effects

A resolution by the board of directors of a company to voluntarily begin business rescue proceedings will have to comply with the requirements for board meetings and resolutions in general.<sup>270</sup> This means that, unless the Memorandum of Incorporation provides otherwise, the resolution need not be unanimous, but must be taken by majority vote.<sup>271</sup>

Such a resolution may not be adopted, however, if liquidation proceedings have already been initiated by or against the company.<sup>272</sup> The choice of the term “initiated” is unfortunate as it is not clear whether this is intended to be the same as the commencement of winding up, which is specifically defined in the Companies Act,<sup>273</sup> or whether an earlier moment is meant.<sup>274</sup> A voluntary winding up commences on registration of the special resolution authorising it,<sup>275</sup> but one could argue that it is initiated as soon as notice of the meeting at which the resolution will be proposed is given,<sup>276</sup> or as soon as the resolution has been passed. A winding up by the court is deemed to commence at the time of presentation of the application to court,<sup>277</sup> but here it could be argued that it is initiated as soon as a copy of the application is lodged with the Master of the High Court<sup>278</sup> or even sooner. It would be advisable to use the word “commence” consistently where the statutorily established point in the procedure is meant.<sup>279</sup>

The business rescue resolution will come into force only when it is filed with the Companies and Intellectual Property Commission,<sup>280</sup> and the rescue proceedings officially

<sup>270</sup> Set out in ss 73-74.

<sup>271</sup> Section 73(5) (especially s 73(5)(d)) and (7).

<sup>272</sup> Section 129(2)(a). By contrast, a court order commencing business rescue proceedings will suspend any liquidation proceedings that have already commenced: see part 3.5.2 below. Similar provisions exist regarding the administration procedure in England: see Chapter 3, parts 2.3.2 and 2.5.1.

<sup>273</sup> Sections 348 and 352, respectively, of Act 61 of 1973. As already mentioned above in part 3.2, the provisions of the Companies Act of 1973 on insolvent winding up will, for the time being, continue to apply after promulgation of the new Companies Act.

<sup>274</sup> In England, where the same rule applies, the provision has been phrased very clearly that a resolution appointing an administrator may not be taken if the company is already “in liquidation”: see Chapter 3, parts 2.2 and 2.5.1.

<sup>275</sup> Section 352(1) of the Companies Act of 1973.

<sup>276</sup> In terms of s 199(1) this must be at least 21 days before the meeting is held.

<sup>277</sup> Section 348. See further in this regard part 3.5.2.6 below.

<sup>278</sup> As required by s 346(4)(a).

<sup>279</sup> Section 131(6) of the Companies Act of 2008 refers to the suspension of liquidation proceedings that have already been commenced when an application for business rescue proceedings is made.

<sup>280</sup> Section 129(2)(b).

commence on the date of such filing.<sup>281</sup> The Act does not require any prior notice of an intention to file,<sup>282</sup> nor are any other formal requirements prescribed such as the registration of the board's resolution.<sup>283</sup> The company must within five business days<sup>284</sup> after filing the resolution notify every affected person<sup>285</sup> of the resolution, the date on which it became effective and the grounds, set out in a sworn statement, on which it was taken.<sup>286</sup>

Within the same period of five business days after filing the business rescue resolution, the company<sup>287</sup> must also appoint a business rescue practitioner to oversee the company during its business rescue proceedings.<sup>288</sup> Notice of his appointment must be filed with the Commission within two business days after making the appointment, and every affected person must be furnished with a copy of this notice<sup>289</sup> within five business days after the appointment.

Failure to appoint a business rescue practitioner or to notify each affected person of the business rescue resolution or the appointment of a business rescue practitioner

<sup>281</sup> Section 132(1)(a)(i).

<sup>282</sup> See Chapter 3, part 2.5.1 for a discussion of such a requirement in England.

<sup>283</sup> The possibility exists that formal requirements may be prescribed in the regulations made in terms of the Act although it seems unlikely in the absence of any indications to this effect in s 129. Regulation 134(8) of the Companies Regulations, 2010 published for public comment in Notice 1664 *Government Gazette* No 32832 of 22 December 2009 (hereafter referred to as the draft Companies Regulations) requires only that a Notice of Commencement of Business Rescue Proceedings (Form CoR 134.1, which has not as yet been published for comment) must be attached to a resolution that is filed in terms of s 129.

<sup>284</sup> The company may apply to the Commission for more time in which to comply: s 129(3). The drafters of this Act seemed to be unaware of the existence of the Interpretation Act 33 of 1957 in which the reckoning of days is laid down (in s 4) and thus deemed it necessary to define the term in very much the same way in s 5(3).

<sup>285</sup> In terms of s 128(1)(a) this means every shareholder, creditor, registered trade union representing the company's employees and every employee (or his representative) who is not represented by a registered trade union.

<sup>286</sup> Section 129(3)(a) requires that the company must publish the notice in the prescribed manner. The only section dealing with publication of notices and other prescribed documents is s 6, which requires that it must be in the prescribed form or in plain language (s 6(4)) and may be transmitted electronically directly to the intended recipient on condition that it must be easy for the recipient to print it in reasonable time and at reasonable cost (s 6(10)). This means that the company has to send this notice to each and every affected person, and may not simply publish a notice in a newspaper or a website. Undoubtedly, this will prove to be an extremely costly and onerous burden on the company, particularly as various notices have to be sent to affected persons during the course of the proceedings. The Draft Regulations have unfortunately not brought any relief: Regulation 134(2) requires that the notice must be delivered to every affected person, as well as posted on the company's website, on SENS if it is a listed company and at its registered offices, and advertised in a daily newspaper.

<sup>287</sup> Although the Act uses the word "company" in s 129(3)-(4) when dealing with the appointment of the business rescue practitioner and the resulting formalities that must be complied with, it is clear that in this instance the word is inappropriate, as it is clearly the board of directors which has the right to appoint the practitioner.

<sup>288</sup> Section 129(3)(b). See part 3.5.1 below regarding the appointment and qualifications of a business rescue practitioner.

<sup>289</sup> Or "publish ... to each affected person" as s 129(4) rather quaintly puts it.

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in the manner and within the periods prescribed by the Act will have the result that the business rescue resolution lapses and becomes a nullity.<sup>290</sup> It is not clear whether this provision also falls under the rather strangely worded section 218(1) of the Companies Act of 2008 in terms of which no resolution is rendered void by a provision to that effect in the Act unless a court declares it to be void.<sup>291</sup> The question would be whether “a nullity” (the term used in section 129(5)(a)) was intended to mean the same as “void”, or alternatively, whether it was intended to mean “pro non scripto”, that is, as if it never existed. Depending on the interpretation attributed to this provision by the courts, it could mean that the resolution would remain valid until a court order has been obtained declaring it void, or it could mean that the resolution immediately and automatically becomes of no force and effect as soon as the stipulated number of business days have expired without the necessary requirements having been met. The last-mentioned possibility seems to be a very extreme consequence of what could be a mere oversight resulting in the notification being one or two days late. Although the addition of the word “lapses” could be an indication that this was indeed the intended result, a contrary interpretation is indicated by the fact that the failure to comply with the procedural requirements of section 129 is listed as one of the grounds on which a court may set aside the business rescue resolution taken by a board of directors.<sup>292</sup> If a business rescue resolution lapsed automatically, there would be no reason to apply to court for an order setting it aside on these grounds. Until a court pronounces on the exact meaning of these provisions, it remains one of the mysteries of the new Act. For that reason I believe that it should simply be scrapped.<sup>293</sup>

Failure by the company to comply with the above-mentioned requirements also has the result that the company may not file another business rescue resolution within three months after the date on which the lapsed resolution was taken, except with the consent of the court, obtained on application by the company and for good cause shown.<sup>294</sup> This relatively short period is to be welcomed considering how easily a company may fail to comply with all the requirements by, for example, accidentally

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<sup>290</sup> Section 129(5)(a).

<sup>291</sup> The section also applies to an agreement, Memorandum of Incorporation or rules of a company.

<sup>292</sup> Section 130(1)(a)(iii). See part 3.5.1.3 below.

<sup>293</sup> See Chapter 5, part 2.5.1.1.

<sup>294</sup> Section 129(5)(b).

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not notifying some affected persons, or being a day late with the notification. All would depend, of course, on whether a company which was in breach of one of these requirements may assume that the resolution is valid until challenged in court, which could take more than three months and therefore hardly seems worth the trouble! Considering these uncertainties and the very limited benefit that would result from this provision, it should ideally be scrapped.<sup>295</sup>

In the majority of cases a business rescue practitioner will probably be appointed at the same time that the rescue resolution is taken since a board is unlikely to take a business rescue resolution without having decided on, and obtained the consent of a specific business rescue practitioner. There is no logical reason why the Act has separated the two steps, whereas combining them will enable the company to save costs by notifying affected persons of both events simultaneously.<sup>296</sup>

Once the directors have taken a resolution to commence business rescue proceedings, and for as long as it is valid and the rescue proceedings are continuing, the company may not adopt a resolution to begin liquidation proceedings.<sup>297</sup> The prohibition does not specifically refer to a special resolution for a voluntarily winding up of the company<sup>298</sup> although the use of the word “begin” may indicate this to be the case. The question then arises whether a special resolution by the company that it be wound up by the court<sup>299</sup> is still allowed.<sup>300</sup> For the sake of certainty, the prohibition should state clearly whether both a resolution for voluntary winding up and one to apply to court for liquidation are prohibited during rescue proceedings.

### 3.5.1.2 Failure to adopt a business rescue resolution

If the board of a company does not adopt a resolution to commence business rescue proceedings although it has reasonable grounds to believe that the company is

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<sup>295</sup> See Chapter 3, part 2.3.1 regarding the prohibition in English law against a board appointing an administrator within 12 months after a previous appointment ceased, to prevent serial filings. No such general limit has been placed on the appointment of a business rescue practitioner.

<sup>296</sup> There is only one resolution by the board, namely the one appointing the administrator, in the English administration procedure. The filing of this resolution constitutes the commencement of administration: see Chapter 3, part 2.5.1.

<sup>297</sup> Section 129(6).

<sup>298</sup> In terms of s 349 of the Companies Act of 1973.

<sup>299</sup> In terms of s 344(a) of the Companies Act of 1973.

<sup>300</sup> Although this would not be an action against the company (because the company would be the applicant), it may nevertheless be covered by the moratorium (discussed in part 3.6 below) as an action relating to property belonging to the company.

financially distressed, the board must deliver a written notice to each affected person explaining which of the stipulated grounds for financial distress<sup>301</sup> apply to the company and why no business rescue resolution has been taken.<sup>302</sup> The reason for this provision is clearly to prevent company boards from continuing to trade in spite of warning signs that the company is in serious financial trouble and further to prevent them from leaving the employees and creditors in the dark until the company is so hopelessly insolvent that it cannot be rescued and simply has to close its doors. The aim is thus to furnish the affected persons with information and also proof of the company's financial distress to enable them to apply for business rescue proceedings themselves while the possibility of a successful rescue still exists.

This provision was obviously drafted when the definition of "financial distress" still included the company's present insolvency or inability to pay its debts.<sup>303</sup> Since this requirement now refers only to a future situation that appears likely to occur but may in fact not occur, it seems irresponsible to expect a board to send out such a damaging notice in spite of the possibility that the expected insolvency or illiquidity may not come about.

The delivery of such a notice will undoubtedly have severely damaging consequences for a company: credit facilities and overdrafts will be cancelled, suppliers will insist on being paid cash on delivery and creditors will demand immediate payment of their claims. The company will probably be unable to do any business and its chances of being successfully rescued once an court order for the commencement of rescue proceedings has been obtained are very slim. As a result this provision is expected to be of little, if any, benefit to affected persons.

A further problem is caused by the absence of any specified period within which a company's board must deliver such a notice after realising that the company is in financial distress. It must therefore be assumed that the notice has to be delivered immediately. This will make it almost impossible for a board to enter into negotiations with creditors to agree on a pre-packaged business rescue plan<sup>304</sup> before taking the

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<sup>301</sup> In the definition of "financially distressed" in s 128(1)(f) of the Companies Act of 2008.

<sup>302</sup> Section 129(7).

<sup>303</sup> See part 3.4.1.1 above.

<sup>304</sup> A pre-packaged business rescue (or "pre-packs" as they are often referred to) is described by the Turnaround Management Association of Southern Africa as crafting and negotiating a business rescue plan informally, with the intent of placing the company under voluntary business rescue only once that

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business rescue resolution. In practice these pre-packaged rescue plans are often used by turnaround practitioners because they substantially increase the possibility of a successful rescue of the company. Among other advantages, such a plan shortens the period in which a company is subject to formal business rescue proceedings by avoiding long drawn-out negotiations with creditors because the major creditors would already have agreed informally to the rescue plan.<sup>305</sup> It also encourages boards to initiate rescue proceedings because they know that they have the support of the major creditors. In addition, creditors are warned of and consulted on the intended business rescue attempt and are therefore more inclined to support it. However, if a board is compelled immediately to inform all affected persons of the company's financial distress before they have had time to engage with creditors on a pre-packaged rescue plan, the opportunity would be lost because any shareholder, creditor or trade union would now have the necessary proof that the company is in financial trouble and could apply for either business rescue proceedings or liquidation of the company.

The board of a company in financial distress that decides not to commence business rescue proceedings or liquidation will probably do so for one of three reasons: the first and most obvious reason would be that the board members do not believe that there is a reasonable prospect of saving the company. Even in such a case they are required to notify affected persons, in spite of the fact that they may intend applying for liquidation of the company. The notice does not seem to serve a discernible purpose in this situation and it would have been preferable to require the existence of both preconditions for a business rescue resolution before such a notice has to be delivered.

The other two possible reasons for not taking a business rescue resolution are that the directors either believe that they can trade the company out of its temporary financial dilemma in the foreseeable future (perhaps having done so before),<sup>306</sup> or

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is done: *TMA Comments* at 25. See also Chapter 3, part 2.8.2 for an official definition of pre-packaged plans in England which differs slightly in that it refers only to pre-arranged sales of the business.

<sup>305</sup> See Chapter 4, part 2.8.1 on the German procedure that specifically caters for such a pre-packaged plan to shorten the duration of the proceedings. See also Chapter 3, part 2.8.2 for the position in England where special requirements for pre-packs have been introduced.

<sup>306</sup> Section 22(1)(b) prohibits trading under insolvent circumstances by the company and a director who knowingly acquiesced in the carrying on of the company's business in contravention of s 22(1) can be held liable for any resulting loss or damages suffered by the company (s 77(3)(b)), but this is unlikely to be a major deterrent. "Insolvent" is not defined in the Act, and since the same term clearly refers only

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hope to award themselves some benefits or even strip the company of assets, before closing down. In both cases the directors have good reasons to keep the situation a secret from creditors in particular. It is doubtful, therefore, whether any board will voluntarily comply with this section. No provision has been made for any sanction against directors if they fail to deliver the notice, and in most cases, boards will probably simply ignore this obligation.<sup>307</sup>

In the light of the seriously detrimental effects such a notice will have on the future of a company and the probability that it will not be of any real advantage to affected persons, I believe that this provision should be scrapped. It should be replaced by a provision compelling a board to take such a resolution within a reasonable (or specified) period<sup>308</sup> after they become aware that the requirements for a business rescue resolution are present.<sup>309</sup> Failure to do so must result in the potential personal liability of the directors for debts of the company incurred during the period of financial distress and which the company is unable to pay. However, the potential disadvantage of forcing directors to commence business rescue proceedings as soon as a company complies with the definition of financial distress is that it may have exactly the opposite effect to that hoped for. Directors may prematurely decide on liquidation of the company while there is still a possibility of a rescue simply to avoid the risk of personal liability in terms of the Act.

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to the situation of the liabilities exceeding the assets in s 128(1)(f), while the definition of “solvent” in s 4(1)(a) also refers to the company’s assets being equal to or exceeding its liabilities, it could be argued that trading while the company is unable to pay its debts (that is, while commercially insolvent) will not amount to a contravention of s 22(1). This interpretation of “insolvent circumstances” has now been confirmed by regulation 21(1) of the draft Regulations, which prescribes the notice that a company must file if s 22(1)(b) applies to it. Regulation 21(1) refers only to trading when the company’s “liabilities exceed its assets”. This corresponds to the position taken by our courts that trading while commercially insolvent is not automatically regarded as reckless and thus grounds for the personal liability of directors in terms of s 424 of the Companies Act of 1973, but only if directors incur debts under circumstances where the reasonable businessman would realise that the company will not be able to pay those debts: see *Philotex (Pty) Ltd and Others v Snyman and Others*; *Braitex (Pty) Ltd and Others v Snyman and Others* 1998 (2) SA 138 (SCA); *Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (in liquidation)* 1993 (1) SA 493 (A).

<sup>307</sup> Although the possibility of personal liability exists in terms of s 218(2) for any contravention of the Act, this provision is too vague and too wide to be of any real assistance. It would also be extremely difficult to prove contravention of the Act in this instance.

<sup>308</sup> For the sake of certainty, a specific period that is determined by the Department of Trade and Industry after consultation with turnaround practitioners on what they regard as reasonable is preferable. In Germany the period is three weeks: see Chapter 4, part 2.3. Smits “Corporate Administration” at 97 also recommended the introduction of a provision compelling directors to file for the rescue procedure within a specified number of days after becoming aware of the company’s financial distress.

<sup>309</sup> As set out in s 129(1) discussed in part 3.4 above.

### 3.5.1.3 Objections to a business rescue resolution

The Act contains three measures that are intended as remedies against the very real potential for abuse by company boards of their power to start business rescue proceedings and appoint the business rescue practitioner of their choice. It is debatable whether the costly and time-consuming remedy of obtaining an order of court will prove to be a very effective weapon against abuse, but making it too easy to reverse a board's decisions will undoubtedly undermine the success of the business rescue proceedings. The potential abuse of the procedure is an unavoidable risk that must be taken in order to encourage boards to initiate business rescue proceedings where and when necessary.<sup>310</sup>

#### 3.5.1.3.1 *Setting aside the business rescue resolution*

After the directors of a company have taken<sup>311</sup> a resolution to commence business rescue proceedings, and until a business rescue plan has been formally adopted,<sup>312</sup> any affected person may apply to court to have the resolution set aside on the grounds that there is no reasonable basis to believe<sup>313</sup> that the company is financially distressed,<sup>314</sup> or there is no reasonable prospect that the company will be rescued,<sup>315</sup> or the company has failed to comply with the procedural requirements set out in section 129.<sup>316</sup> It is unclear whether the use of the present tense in phrasing the first two grounds for setting aside the resolution (that “there is no reasonable ...”) is merely an example of bad drafting, or was intended to mean that the court may consider the situation of the company at the time of the application, rather than at the time that the resolution was

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<sup>310</sup> Steiner “Insolvency Bill” at 62, in discussing the corporate rescue procedures in England, stated that it was almost impossible to reconcile the desire for a relatively cheap and straightforward moratorium regime, with the need to prevent unscrupulous company directors from abusing the procedure.

<sup>311</sup> Section 130(1), in terms of which the application must be brought, specifically refers to the adoption of a resolution and not the filing thereof, although the resolution will not have any force or effect until it has been filed (section 129(2)(b)). An applicant will thus apparently not have to wait until the resolution is filed before bringing the application, although he would then be running the risk that the board may change its mind and not file the resolution at all.

<sup>312</sup> In terms of s 152, discussed in part 3.8 below.

<sup>313</sup> See part 3.4.1 above regarding the apparent difference in the test for “reasonable” between the requirements for taking the resolution and having it set aside by the court. The test here seems to be completely objective.

<sup>314</sup> Section 130(1)(a)(i).

<sup>315</sup> Section 130(1)(a)(ii).

<sup>316</sup> Section 130(1)(a)(iii). The procedure required by s 129 is discussed in part 3.5.1.1 above.



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taken in terms of the requirements stipulated in the Act.<sup>317</sup> Since the practitioner has specifically been given a duty to apply to court for the discontinuation of the business rescue proceedings as soon as he becomes aware that there is no reasonable prospect for the company to be rescued<sup>318</sup> or to file a notice of termination of the rescue proceedings if the company is no longer financially distressed,<sup>319</sup> there is no apparent reason why affected persons should be able to take over this power and to override the decision of the practitioner not to end the business rescue proceedings. If this was the intention of the legislature, a far better option would have been to allow creditors to take a majority decision instructing the practitioner to terminate the proceedings, similar to the power of creditors to do so under the English system of administration.<sup>320</sup>

An affected person who is also a director of the company and in this capacity voted in favour of the business rescue resolution may not apply unless he can satisfy the court that he supported the resolution in good faith while relying on information that later proved to be false or misleading.<sup>321</sup> Apart from this very limited possibility, the directors of a company do not otherwise have the power to terminate business rescue proceedings that commenced as a result of their resolution, and have to rely on the business rescue practitioner to do so.<sup>322</sup>

The applicant must serve a copy of the application on the company and the Commission and notify each affected person in the prescribed manner.<sup>323</sup> Every affected person has the right to participate in the hearing of this application.<sup>324</sup> This seems an unnecessary complication since the court should surely be able to decide the matter on the evidence and information provided by the applicant, the directors and, in particular, the practitioner who should provide an independent and professional opinion.<sup>325</sup>

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<sup>317</sup> See s 129(1) and part 3.4.1 above.

<sup>318</sup> Section 141(2)(a)(ii), discussed in part 3.9.1 below.

<sup>319</sup> Section 141(2)(b)(ii), discussed in part 3.9.2 below.

<sup>320</sup> See Chapter 3, part 2.9.2.

<sup>321</sup> Section 130(2)(a).

<sup>322</sup> See part 3.9 below.

<sup>323</sup> Section 130(3). The subsection uses the word “notify” but in terms of s 6(10) this apparently means the same as to “publish a notice” which is used in s 129. Using the same term throughout would have been preferable, unless the regulations under the Act, which have not as yet been published, indicate a difference.

<sup>324</sup> Section 130(4). It must be hoped that they do not exercise this right, as the participation of just some of the shareholders, creditors and trade unions could result in a fairly simple application becoming a costly, drawn-out affair with the resultant immeasurable damage to the company’s business.

<sup>325</sup> See part 3.7.1.2 on the qualifications and intended regulation of business rescue practitioners.

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The court may set aside the business rescue resolution on any of the three stipulated grounds on which such an application may be based, or simply because the court regards it as otherwise just and equitable to do so.<sup>326</sup> There is no indication in the Companies Act of 2008 what would constitute a just and equitable ground for setting aside a board's resolution to commence business rescue proceedings. A crucial question is whether our courts will interpret this phrase in the same way as in cases decided on the just and equitable requirement for judicial management. This would prove disastrous for the new procedure since any application by a creditor who insists on immediate winding up of the company would then almost always be regarded as a just and equitable reason to set aside the resolution unless very special and extraordinary circumstances exist.<sup>327</sup> This has the potential to limit severely the chances of business rescue proceedings becoming accepted by company boards, because of the possibility of a creditor being able to terminate the process at any time and without any special grounds. Considering the history of this requirement for judicial management, the drafters should have avoided this phrase or at least attempted to indicate with more clarity exactly what it entails.<sup>328</sup>

Should the court require more information before deciding whether or not to set aside the resolution, it may ask the business rescue practitioner for a report indicating whether, in his opinion, the company appears to be financially distressed, or whether there is a reasonable prospect of rescuing it.<sup>329</sup> Although it is stipulated that the business rescue practitioner should be allowed sufficient time to form an opinion on the matter, the business rescue practitioner will probably already have investigated the company's circumstances by the time the application is heard. The court is not in any way bound by the practitioner's report and must still come to its own conclusion, albeit influenced by the report, on whether the company is financially distressed or whether there is a reasonable prospect of rescuing the company. The subsection does not make any reference to the court using this report to decide whether it would be otherwise just and equitable to set aside the resolution.

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<sup>326</sup> Section 130(5)(a).

<sup>327</sup> See part 2.4.4 above.

<sup>328</sup> In terms of s 131(4)(a)(iii) the court may order the commencement of business rescue proceedings if the company is not financially distressed but it is just and equitable "for financial reasons". However, there is no indication that the meaning of "just and equitable" should be similarly qualified or limited here.

<sup>329</sup> Section 130(5)(b)(i)-(ii).

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If the court sets aside the resolution, it may make any further order that may be necessary and appropriate, including an order that the company be placed under liquidation.<sup>330</sup> Although probably intended to be the outcome if the court finds that the company has no reasonable chance of being rescued, this is not stipulated in the relevant subsection, and a court should therefore be able to issue a liquidation order irrespective of the grounds on which the resolution was set aside.

If the court sets aside the resolution because 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”, the court may order any director who voted in favour of the business rescue resolution to pay the costs of the application.<sup>331</sup> It is unfortunate that the subsection does not use the term “financially distressed” to describe the circumstances under which a director may be held liable: this is, after all, how the precondition for taking the resolution is stipulated.<sup>332</sup> The second situation described in the definition of financial distress, namely that the company is reasonably likely to become insolvent in the ensuing six months, is not in any way covered by the phrase describing the basis for holding a director liable for costs, and apparently a board resolution based on this option does not carry the same risk!

Furthermore, section 130(5)(c)(ii) refers to the belief that the company would be unlikely to pay all its debts. The requirement for financial distress refers to the company becoming “unable” to pay its debts. There could be many reasons, not connected to any form of financial distress, why a company would be unlikely to pay all its debts, for example because a creditor’s claim is disputed. That is surely not what the drafters of the Companies Act of 2008 intended, and once again emphasises the importance of consistency and correct terminology.

Apart from the uncertainty created by the lack of consistency in the terminology, the impression is also created that this is a purely objective test. If the court finds that there were no reasonable grounds for believing that the company would be unable to pay all its debts as they became due and payable, the possibility of personal liability for costs arises. A director’s personal expertise, experience and knowledge

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<sup>330</sup> Section 130(5)(c)(i).

<sup>331</sup> Section 130(5)(c)(ii).

<sup>332</sup> In s 129(1)(a).

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may apparently not be taken into consideration to establish whether he had reasonable grounds for his belief, in spite of the subjective element allowed elsewhere. Considering the Department of Trade and Industry's aim of encouraging directors to make use of the rescue proceedings as soon as the first signs of financial difficulties appear, the provision is counter-productive. Directors will hesitate to take this route if there is a real danger of personal liability for costs if they eventually appear to have been overcautious when viewed with the advantage of hindsight by the court. Furthermore, it may actually encourage directors to choose liquidation over business rescue proceedings since there is no risk of personal liability for an application for winding up made in good faith.

However, the court may not make an order for costs against a director who can satisfy the court that he acted in good faith and on the basis of information that he was entitled to rely on in terms of section 76(4) and (5).<sup>333</sup>

It is quite possible that section 130(5)(c)(ii) was intended to apply only to the original first test for financial distress which was later scrapped and was based on the current inability of the company to pay its debts.<sup>334</sup> This is what the wording of the provision seems to imply, apart from the fact that it would be extremely unfair to penalise the directors for misjudging a struggling company's ability to pay all its debts in the next six months. Therefore the provision should be amended at least to reflect a subjective test whether the grounds for deciding to commence rescue proceedings were reasonable.

In general, it must be said that the possibility that a court may at any time, and almost up to the end of the rescue proceedings, second-guess the board and the business rescue practitioner and overturn a board's decision to start these proceedings could lead to an element of uncertainty that may not be conducive to a successful rescue and could also be abused to delay its finalisation. However, it remains to be seen whether this will have any serious effects on the potential success of business rescue proceedings.

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<sup>333</sup> Section 130(5)(c)(ii). Section 76 sets out the standards of directors' conduct and subsections (4) and (5) describe the circumstances in which a director will satisfy his obligations to act in the best interests of the company and with the required degree of care, skill and diligence.

<sup>334</sup> See part 3.4.1.1 above.

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### 3.5.1.3.2 *Replacing the business rescue practitioner*

An affected person may also apply to court for an order setting aside the appointment of the business rescue practitioner on the grounds that the practitioner does not satisfy the requirements of section 138,<sup>335</sup> is not independent of the company or its management<sup>336</sup> or lacks the necessary skills required by the company's specific circumstances.<sup>337</sup> The last-mentioned ground is not stipulated as a requirement for appointment as a business rescue practitioner, and this provision effectively introduces an additional requirement through the back door. It is submitted that this requirement should have been added to section 138(1). The suitability of a practitioner for the specific case is an important factor and should always be taken into consideration before he is appointed.<sup>338</sup>

A director who voted in favour of the business rescue resolution is also disqualified from bringing this application unless he satisfies the court that he acted in good faith but on the basis of false or misleading information.<sup>339</sup> Since there is no such restriction if the application is brought in terms of section 139(2) and the grounds for both applications are very similar, a director would be able to avoid this obstacle by simply basing his application on section 139(2).<sup>340</sup>

The applicant must serve a copy of the application on the company and the Commission and notify each affected person of the application.<sup>341</sup> Each affected person also has the right to take part in the hearing of the application by the court,<sup>342</sup> and the same objections raised above on the right of every affected person to become involved in the matter apply in this case.

If the court sets aside the appointment of a practitioner, it must appoint an alternative one who meets the requirements of section 138 and is recommended by or acceptable to the majority in value<sup>343</sup> of the independent creditors who were represented

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<sup>335</sup> This section prescribes the qualifications of business rescue practitioners and is discussed in detail in part 3.7.1.2 below.

<sup>336</sup> It is not clear why the independence of the practitioner should be stated as a separate ground for removal since it is already included in the qualifications contained in s 138(1)(d)-(e). It has merely added to the uncertainty surrounding this qualification: see part 3.7.1.2 below.

<sup>337</sup> Section 130(1)(b)(i)-(iii).

<sup>338</sup> See Chapter 4, part 2.7.1.2.2 regarding this requirement in Germany.

<sup>339</sup> Section 130(2)(b).

<sup>340</sup> See part 3.7.1.3 below.

<sup>341</sup> Section 130(3).

<sup>342</sup> Section 130(4).

<sup>343</sup> The drafters of the Companies Act of 2008 have chosen to ignore (if they were at all aware of it) the well-established concepts in South African law of majority in value and majority in number of creditors

in the hearing before the court.<sup>344</sup> Independent creditors are defined as those creditors, including employees, who have claims against the company that were payable before the beginning of the business rescue,<sup>345</sup> and who are not related to the company, a director of the company or the business rescue practitioner.<sup>346</sup> No mention is made here of any requirement that the substitute practitioner must be suitable for the specific case. Furthermore, this provision is based on the assumption that (some) creditors would be represented during the hearing, but creditors may not always be prepared to incur the costs this would involve. The Act does not provide for the possibility that the application could have been brought by a shareholder or trade union who may not necessarily be a creditor, and no independent creditors were represented in court. One can only hope that the requisition system will not rear its ugly head in a mutated form in this instance, with all the possibilities for abuse and corruption that accompanies it.<sup>347</sup>

To complicate matters even further, section 130(6)(a) that provides for the appointment of a substitute practitioner by the court in this instance seems to be contradicted by section 139(3) which states that the company or creditor,<sup>348</sup> as the case may be, who nominated the (original) practitioner must appoint a new practitioner if a practitioner is removed from office.<sup>349</sup> Since section 139(1)(a) also refers to the removal of a practitioner in terms of section 130, such a removal should be assumed to be included in the provisions of section 139(3). However, in view of the conflict between these provisions, it must be accepted that the drafters did not intend (and probably did not even realise that they were) including the situation where a practitioner who was appointed by the board is removed by an order of court in

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(see Bertelsmann et al *Mars* 17.10-17.30). They have instead opted for a complicated and hitherto unknown concept of “voting interest” of creditors to be calculated according to s 145(4) and which finally comes down to a majority in value, albeit in a far more convoluted way. Furthermore, every secured creditor has a voting interest equal to the full value of his claim, and not just to the unsecured part: s 145(4)(a).

<sup>344</sup> Section 130(6)(a).

<sup>345</sup> Section 128(1)(g) read with ss 128(2) and 144(2).

<sup>346</sup> In terms of s 2(1)(a)-(b) and s 2(2) an individual is related to a company if he has the ability to materially influence the policy of the company and can exercise an element of control, and is 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 two degrees.

<sup>347</sup> See generally Calitz and Burdette “Insolvency Practitioners” and Loubser “Shareholders” at 375 regarding the requisition system followed by the Master’s offices in the appointment of provisional liquidators and judicial managers.

<sup>348</sup> In actual fact the applicant could have been a shareholder or trade union and not necessarily a creditor: s 131(5) discussed in part 3.5.2.5 below.

<sup>349</sup> Or dies or resigns. See part 3.7.1.3 below on the vacation of and removal from office of a practitioner.

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terms of section 130. In such a case, his substitute must therefore be appointed by the court as stipulated in section 130(6)(a). If such a practitioner is removed as a result of an application in terms of section 139, however, the directors have the right to appoint the substitute practitioner.

Section 130(6)(b) contains a very curious provision relating to an order for the replacement of a business rescue practitioner. This subsection states that if the court makes such an order, the provisions of section 130(5)(b), if relevant, also apply to the newly appointed practitioner. The last-mentioned subsection concerns the situation where an application for the setting aside of the business rescue resolution is made and the court requires the practitioner to provide more information on whether the requirements for such a resolution are present or not.<sup>350</sup> It is not at all clear whether the legislature by inserting section 130(6)(b) intended that an application for the replacement of a business rescue practitioner can result in the setting aside of the whole resolution of the directors, thereby terminating the business rescue proceedings. If this is indeed the case (and it is difficult to find any other possible explanation for this provision), at least two main objections can be raised against the provision: first, there is the fact that a court may apparently *mero motu* and without such an application before it, order the termination of the business rescue proceedings based on the report of a practitioner who is new to the case and could even have been nominated by the creditors with the specific intention (read: instructions) to sink the process. Creditors who are opposed to a rescue attempt but who are unable to prove the requirements for having the rescue resolution set aside could abuse this possibility to achieve the same purpose.

The second objection is that it appears to be an unnecessary waste of time and money to appoint a new business rescue practitioner only to terminate the rescue proceedings shortly thereafter. I believe that this provision adds an unnecessary complication to the procedure and should be removed. It is not the duty of the court to judge the viability of the rescue proceedings if no such application has been made, and even if it were, there is no reason why the original practitioner should not be entrusted with the task of providing the report, considering that this is supposed to be an independent professional and member of a regulated profession.<sup>351</sup>

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<sup>350</sup> See part 3.5.1.3.1 above.

<sup>351</sup> See part 3.7.1.2 below on the intended regulation of the profession.

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### 3.5.1.3.3 *Requiring the practitioner to provide security*

The third measure provides for an application to court by an affected person for an order requiring the business rescue practitioner to provide security for an amount and on conditions that the court considers necessary to secure the interests of the company and any affected persons.<sup>352</sup> It is an entrenched principle of South African corporate and insolvency law that any provisional or final liquidator, judicial manager or trustee must provide security for the proper performance of their duties, and in the case of final appointments it is a precondition for their official appointment by the Master of the High Court.<sup>353</sup> Therefore it is difficult to understand why this principle was not adhered to in the appointment of a business rescue practitioner as well, considering that he is put in control of the management and quite probably of substantial assets of a company. An order of court should not be necessary to obtain security from the practitioner and considering his wide powers and position of trust, it should be a precondition for his appointment. The *King Code of Corporate Governance* also recommends that where a board appoints a business rescue practitioner, it should ensure that the practitioner furnishes security for the value of the assets of the company.<sup>354</sup>

## **3.5.2 Court order to begin business rescue proceedings**

### 3.5.2.1 Notification of application

Any affected person may apply to court for an order to commence business rescue proceedings and place a company under supervision if the company has not adopted a resolution to commence business rescue proceedings.<sup>355</sup> The applicant must serve a copy of the application on the company and the Commission, and notify each affected person.<sup>356</sup> The consequences of the required notification to every affected person will almost certainly be dire for the company. The moratorium that will protect the company against legal action by creditors comes into effect only once business rescue proceedings have commenced,<sup>357</sup> and creditors who have now been informed that this

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<sup>352</sup> Section 130(1)(c). See part 3.7.1.2 below for a detailed discussion of this aspect.

<sup>353</sup> Sections 368, 375(1), 429(b)(i) and 431(4) respectively of the Companies Act of 1973, and ss 18(1) and 56(2) of the Insolvency Act of 1936.

<sup>354</sup> Institute of Directors *King Code of Governance for South Africa 2009*, recommendation 2.15.4.

<sup>355</sup> Section 131(1).

<sup>356</sup> Section 131(2).

<sup>357</sup> Section 133(1). That is, unless the proceedings commence before the order has been issued, as discussed in part 3.5.2.6. See further part 3.6 below on the moratorium.



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is imminent will not waste any time in attempting to obtain payment and taking enforcement action against the company while it is still possible. Apart from its dwindling assets, the company will also not have access to further capital and find it almost impossible to continue running its business.<sup>358</sup> Even a company that had not been in financial distress before will almost certainly become so after the required notification to affected persons.

### 3.5.2.2 Right of affected persons to participate in hearing

Each affected person also has the right to participate in the hearing of this application.<sup>359</sup> Although the sentiments behind this provision are laudable, because employees in particular are often the last to know about their company's financial problems, it will almost certainly lead to protracted hearings and escalating costs, especially in the case of larger companies, because of the adversarial nature that now characterises the procedure. Trade unions and major creditors would feel compelled to participate to ensure that their interests are protected. The Companies Act of 2008 goes to great lengths to protect the interests of creditors and employees right through the business rescue process, and I would submit that it is unnecessary to complicate the matter at this early stage by affording each and every affected person the opportunity of joining the fray. It should be left to the court to make a decision purely on the basis of whether the company is in financial distress and whether there is a reasonable possibility that it can be rescued, without the emotional and subjective elements that employees, shareholders and creditors will bring into the case. Forcing the court to weigh up all the various interests loses sight of the purpose of this procedure, namely to afford a company with the potential to survive the best chance of doing so. It would be advisable to follow the example of English law where a restriction has been placed on persons who may participate in the hearing to ensure that the court is not flooded with dissenting views based purely on self-interest of the various persons.<sup>360</sup>

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<sup>358</sup> See Chapter 3, part 2.5.2 and Chapter 4, part 2.5 regarding the situation in England and Germany respectively where no general notification is required before the order is given or at least some moratorium has been put in place to protect the company.

<sup>359</sup> Section 131(3).

<sup>360</sup> See Chapter 3, part 2.5.2.

### 3.5.2.3 Application after liquidation has commenced

An application for business rescue may be made even after liquidation proceedings have been commenced by or against the company, and this will have the effect of suspending the liquidation proceedings until the court has refused the application for business rescue or, if the application is granted, until the business rescue proceedings have ended.<sup>361</sup>

The wording of this provision is problematic because the drafters chose not to follow the wording of the Companies Act of 1973 where a clear distinction is made between the commencement of winding up by the court<sup>362</sup> (which refers to the start of the process until the dissolution of the company) and legal proceedings, referring to court proceedings.<sup>363</sup> The question now is whether the phrase “liquidation proceedings” in the Companies Act of 2008 refers to legal proceedings in a court,<sup>364</sup> which would mean that an application for a business rescue order may only be made until a final winding-up order has been issued and the legal proceedings have thus ended.<sup>365</sup> It would also exclude the possibility of suspending a voluntary liquidation that was commenced by a members’ resolution since no court proceedings are involved.<sup>366</sup> However, it could also have the same meaning as in the phrase “business rescue proceedings” which refers to the whole process, including everything that follows after the order has been granted and right up to where the business rescue terminates.<sup>367</sup> This interpretation seems highly probable when considering that the application is specifically stated to be in terms of section 131(1)<sup>368</sup> that, in turn, provides that the application may be made “at any time”.

Depending on the interpretation given to this provision, it thus appears quite possible that an application for business rescue proceedings may be made at any stage during the winding up of a company until the Master has confirmed<sup>369</sup> the

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<sup>361</sup> Section 131(6).

<sup>362</sup> Section 348 of the Companies Act of 1973.

<sup>363</sup> For example in s 358 of the Companies Act of 1973.

<sup>364</sup> This is the more usual meaning of “proceedings” in South African law (Hiemstra and Gonin *Regswoordeboek* at 106) although often preceded by the word “legal” to make its meaning clearer.

<sup>365</sup> This is the situation in England where there is a clear provision that only the liquidator may apply for an administration order in respect of a company that is in liquidation: see Chapter 3, part 2.3.2.

<sup>366</sup> In terms of s 349 of the Companies Act of 1973.

<sup>367</sup> See s 132 and part 3.9 below on the termination of rescue proceedings.

<sup>368</sup> According to s 131(6) regulating an application during liquidation proceedings.

<sup>369</sup> In terms of s 408 of the Companies Act of 1973. Confirmation has the effect of a final judgment (s 408).

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liquidation and distribution account filed by the liquidator.<sup>370</sup>

Needless to say, the uncertainty created by the confusing use of terminology is highly undesirable and should be clarified by amending the provision. I submit that once a final liquidation order has been issued, or the resolution for a voluntary winding up of a company has been registered, it should not be possible for an affected person to apply for a business rescue order. The possibilities for abuse are endless, particularly in view of the considerable financial advantage to be gained by employees if liquidation of the company is preceded by business rescue proceedings.<sup>371</sup>

#### 3.5.2.4 Order during liquidation proceedings

The court has also been given the power to make an order for commencement of business rescue proceedings “at any time during the course of any liquidation proceedings or proceedings to enforce any security against the company”.<sup>372</sup> No specific application for a business rescue order therefore needs to be before the court.<sup>373</sup> The use of the word “proceedings” is once again confusing and unclear, although in this provision it probably refers to legal or court proceedings because this is where a court would mainly be involved and able to identify appropriate cases for rescue proceedings.

However, the question remains open whether a court could issue an order for the commencement of business rescue proceedings during legal proceedings at a later stage of liquidation, for example when the liquidator applies for a disposition by the company to be set aside.<sup>374</sup> Although the chances of successfully rescuing a company that is already in the advanced stages of a winding up are slim, special circumstances could possibly arise in a specific situation which could make business rescue proceedings desirable. I submit that in such a case the liquidator is the appropriate person to decide whether these exceptional circumstances exist and to bring the necessary application. Unfortunately, the careless use of the word

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<sup>370</sup> In terms of s 403 of the Companies Act of 1973.

<sup>371</sup> See part 3.1 above.

<sup>372</sup> Section 131(7).

<sup>373</sup> The courts have a similar power to order judicial management when hearing an application for winding up: see part 2.4.5 above. In England, however, this is not possible since an administration order may be granted only if there is a specific application for such an order before the court: see Chapter 3, part 2.5.2.

<sup>374</sup> In terms of s 340 of the Companies Act.

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“proceedings”, combined with the absence of any proper explanatory document, has once again made it very difficult to ascertain whether the drafters of the legislation have this situation in mind. By contrast, the provisions regulating the circumstances under which an administrator may be appointed by a court in England clearly stipulate that no administrator may be appointed for a company that is in liquidation, subject to the specific exception that an administrator may be appointed by the court on application by the liquidator of the company.<sup>375</sup>

#### 3.5.2.5 Powers of the court

If the court is satisfied that the prescribed conditions and requirements<sup>376</sup> have been met, it may make an order placing the company under supervision and commencing business rescue proceedings,<sup>377</sup> and may appoint an interim business rescue practitioner nominated by the applicant.<sup>378</sup> This interim practitioner must also meet the requirements for appointment set out in section 138, but the appointment is provisional because it is subject to ratification by the first meeting of creditors.<sup>379</sup> Alternatively, the court may dismiss the application and make any appropriate and necessary order, including one for liquidation of the company.<sup>380</sup> The last-mentioned power is an improvement on the situation under judicial management where the court does not have the power to order the winding up of the company when dismissing an application for judicial management.<sup>381</sup>

Although it is not referred to in any of the provisions in Chapter 6 of the Companies Act of 2008 regulating the commencement of business rescue proceedings by an order of court, another possibility has been created by section 163 of the Act. This section authorises a director or shareholder of a company to apply to court for relief from any oppressive or unfairly prejudicial act, omission or conduct of its business by the company or a related person, or the exercise of the powers of a director or prescribed officer of the company that is oppressive, unfairly prejudicial or unfairly disregards the interests of the

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<sup>375</sup> See Chapter 3, parts 2.2 and 2.3.2.

<sup>376</sup> As discussed in part 3.4.2 above.

<sup>377</sup> Section 131(4)(a).

<sup>378</sup> Section 131(5). See further part 3.7.1.1 regarding the appointment of the interim and final business rescue practitioners, including the misleading use of the word “may”.

<sup>379</sup> Section 131(5).

<sup>380</sup> Section 131(4)(b).

<sup>381</sup> See part 2.5.2 above.

applicant.<sup>382</sup> The court hearing such an application is specifically given the option of issuing an order placing the company under supervision and commencing business rescue proceedings<sup>383</sup> if satisfied that the circumstances required for such an order apply.<sup>384</sup>

### 3.5.2.6 Commencement of business rescue proceedings

The business rescue proceedings formally begin when a person applies to court in terms of section 131(1)<sup>385</sup> or, if the order is made during the course of liquidation proceedings or proceedings to enforce a security interest,<sup>386</sup> when the actual order placing the company under supervision is made.<sup>387</sup>

The stipulation that rescue proceedings begin when a person applies to court for such an order is extremely unfortunate. Firstly, it is not clear whether “applies to court” has the same meaning as presenting an application to court, which is the moment when a winding up by the court commences<sup>388</sup> and which has been explained by case law to be the exact moment when the papers are lodged with the Registrar of the court.<sup>389</sup> This is probably what the drafters intended, but as they chose not to use the existing statutory expression and no definition is provided in the Act, it could be argued that the words “applies to court” mean the actual appearance in court by the applicant and his legal representative.

Secondly, this provision is irreconcilable with the wording of section 131(1) that provides for an application to court for an order *commencing*<sup>390</sup> business rescue proceedings. Therefore, although according to section 131(1) the proceedings are commenced by an order of court, in terms of section 132(1)(b) they start much sooner.

Thirdly, there is substantial potential for unnecessary complications as a result of business rescue proceedings possibly commencing before an order to this effect has been issued. There was no similar provision in respect of judicial management, which

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<sup>382</sup> Section 163(1).

<sup>383</sup> Section 163(2)(c).

<sup>384</sup> In s 131(4)(a). See part 3.4.2 above.

<sup>385</sup> Section 132(1)(b).

<sup>386</sup> In terms of s 131(7).

<sup>387</sup> Section 132(1)(c). From time to time, one gets the impression that the drafters could not decide whether to refer to the rescue procedure as commencing rescue proceedings or placing a company under supervision. As a result, there is no consistency in references to the procedure: in this case there is only reference to placing the company under supervision, and not to commencing rescue proceedings.

<sup>388</sup> In terms of s 348 of the Companies Act of 1973.

<sup>389</sup> See *Nel and Others NNO v The Master and Others* 2002 (3) SA 354 (SCA) at 358; *Development Bank of Southern Africa Ltd v Van Rensburg and Others NNO* 2002 (5) SA 425 (SCA) at 431-432.

<sup>390</sup> My emphasis.

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consequently started when a provisional order was issued, and for good reasons. No specific legal consequences of the commencement of business rescue proceedings are stipulated in the Companies Act of 2008.<sup>391</sup> Instead, the provisions contained in Chapter 6 consistently use the words “during business rescue proceedings”. One cannot avoid the impression that the drafters really had in mind the period after the court order had been issued or the board resolution had been filed. If all the legal consequences of a business rescue commenced by an order of court come into force before the order is issued, which is what this provision implies, it would, for example, mean that the general moratorium on legal proceedings that applies “during” the proceedings comes into effect and the directors’ authority and powers to manage the company are curbed, but without a practitioner to take over these duties. The obvious further question then is what happens if the court refuses to grant an order for business rescue proceedings after the process has already started! This must surely rank as one of the most ill-considered provisions in the Companies Act of 2008.<sup>392</sup>

A company that has been placed under supervision<sup>393</sup> may not “adopt a resolution placing itself in liquidation” until the business rescue has ended.<sup>394</sup> The wording of this provision differs slightly from the similar one that applies to a company whose board has taken a business rescue resolution.<sup>395</sup> However, the wording of this prohibition seems to refer specifically to a voluntary winding up. Unfortunately, there is no detailed report or proper explanatory memorandum available to explain whether the difference in wording between the two provisions has any significance or is just one more example of inconsistent and careless drafting.

The company must also “notify each affected person of the order within five business days after the date of the order”.<sup>396</sup> The need for this provision, and the costs involved in informing every affected person, must be questioned. Every affected person has already been informed of the applicant’s intention to apply, and those persons who regarded it as

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<sup>391</sup> Unlike specific provisions in the Companies Act of 1973 which apply after commencement of winding up, such as the prohibition on transfer of shares or disposition of property in s 341.

<sup>392</sup> Once again, the example of English law could have been used where administration commences with the appointment of an administrator, whether in terms of an order of court or a resolution by the company or its directors: see Chapter 3, part 2.3.

<sup>393</sup> In terms of s 131.

<sup>394</sup> Section 131(8)(a).

<sup>395</sup> See part 3.5.1.1 above.

<sup>396</sup> Section 131(8)(b).

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necessary would have followed or intervened in the court proceedings. The business rescue practitioner must furthermore convene a meeting of creditors and one for representatives of the employees within ten business days after his appointment (which in this case is the same date as the order) and will thus have to give notice to them again.<sup>397</sup> Employees who are owed money by the company at the time of the order are classified as preferred unsecured creditors<sup>398</sup> and will thus be included in the notice to creditors. All employees (or their trade unions), including those who are not creditors of the company, have been given the right to form a committee of employees' representatives<sup>399</sup> and are entitled to be consulted by the business rescue practitioner.<sup>400</sup> It seems to place an unnecessary administrative and cost burden on the company to require repeated notification during the process to each individual affected person.<sup>401</sup> Notification should be limited to those specific instances where affected persons are able to influence the outcome, such as the application to court or meetings where they have to vote on a particular matter.

The multiple and often quite unnecessary notifications that have to be given to affected persons will add substantial costs to the procedure and ultimately discourage its use.<sup>402</sup> Finch specifically mentions the notification requirements in the administration procedure in England and the resulting expenses as part of the "intricate procedural burdens" which could lead to creditors opting for other procedures.<sup>403</sup>

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<sup>397</sup> Section 147(1). As stated above, the court may appoint an interim business rescue practitioner when granting the order.

<sup>398</sup> Section 144(2).

<sup>399</sup> Section 144(3)(c).

<sup>400</sup> Section 144(3)(d).

<sup>401</sup> See, for example, the required notice to every trade union and employee not represented by a trade union (in terms of s 144(3)(a)), and to each creditor (in terms of s 145(1)(a)) of each court proceeding, decision, meeting or other relevant event concerning the business rescue proceedings.

<sup>402</sup> Regulation 134 of the draft Regulations specifically excludes the far less expensive possibility of merely advertising any notice concerning business rescue proceedings in a daily newspaper. Consequently, regulation 8, read with Table CR 3 in Annexure 3 to the draft Regulations, will apply, requiring that notices to affected persons must be sent to each individual person by fax, email or registered post. Apart from the excessive direct costs involved, a listed company would probably not have any information in respect of the holders of its uncertificated shares and would have to obtain it, at substantial additional cost, from STRATE or the relevant Central Securities Depository Participants.

<sup>403</sup> *Corporate Insolvency* at 395. The comment by Rajak "Rescue of Insolvent Companies" at 27 that administration was so expensive that a company had to be "very rich to afford administration proceedings" could probably also apply to business rescue proceedings because of the many administrative and notification requirements.

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## 3.6 The moratorium

### 3.6.1 Moratorium on legal proceedings

#### 3.6.1.1 Interim moratorium

No provision has been made for an interim moratorium that would protect the company before the official commencement of business rescue proceedings. Although no such provision exists in the case of judicial management either, the difference is that no prior notification to creditors, shareholders or employees is required before an application for judicial management is brought and most of them will be informed only after the provisional judicial management order, which will probably include a moratorium, has been issued.<sup>404</sup> Depending on the interpretation of the provision specifying the moment of commencement of business rescue proceedings started by an order of court,<sup>405</sup> it is possible that a company may be exposed to a run on its assets by creditors in the period between the compulsory notification of the intended application and the order of the court that would result in the automatic moratorium. Unfortunately, in the absence of any explanatory document, it is unclear whether the drafters of the Companies Act of 2008 anticipated this risk.

A comparison with the legislation in England and Germany reveals that both systems provide for some form of interim moratorium to protect the company during this sensitive stage. In England an automatic interim moratorium provides essentially the same wide-ranging protection against winding up and other legal processes against the company or its property as the final moratorium, and is in force from the making of an application to court for an administration order until the order is granted or dismissed.<sup>406</sup> In Germany there is no provision for a general interim moratorium to come into effect automatically, but a stay of execution can be ordered by the insolvency court as soon as an application for the opening of insolvency proceedings has been filed and without any specific application for such a stay being necessary.<sup>407</sup>

#### 3.6.1.2 Final moratorium

For the duration of the business rescue proceedings there is a general moratorium on

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<sup>404</sup> See Loubser "Corporate Rescue and Labour Legislation" at 62-63.

<sup>405</sup> Discussed in part 3.5.2.6 above.

<sup>406</sup> See Chapter 3, part 2.6.1.

<sup>407</sup> See Chapter 4, part 2.5.1



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commencing or continuing with legal proceedings, including enforcement actions, against the company or in relation to any property owned by the company or lawfully in its possession, in any forum.<sup>408</sup> Unlike the situation in England where both the passing of a resolution and the making of a court order for the winding up of a company in administration are specifically prohibited,<sup>409</sup> winding up is not specifically mentioned in the moratorium applicable to business rescue proceedings. This effectively means that an application for the winding up of the company may be brought without any obligation on the applicant to first have the business rescue proceedings terminated or set aside by satisfying the court that the rescue of the company is no longer a reasonable or viable option. The only precondition would be the consent of the practitioner or the court to institute this action against the company. This is clearly not an acceptable situation.

The moratorium automatically comes into effect on commencement of the business rescue proceedings, and this constitutes a major improvement on judicial management where a moratorium has to be specifically applied for and ordered by the court.<sup>410</sup> The moratorium is not absolute, as several exceptions are listed in the Act. Firstly, legal proceedings may be instituted or continued with the written consent of the business rescue practitioner<sup>411</sup> or leave of the court.<sup>412</sup> Furthermore, a set-off against a claim made by the company in legal proceedings commenced before or after the start of the business rescue proceedings is allowed,<sup>413</sup> as are criminal proceedings against the company or any of its directors or officers.<sup>414</sup> Finally, proceedings regarding any property or rights over which the company exercises the powers of a trustee are also excluded from the moratorium.<sup>415</sup>

The moratorium allowed under judicial management does not specify that legal proceedings in respect of the company's property as well as other property lawfully in its possession are stayed, but has the same effect as it contains a blanket moratorium on all actions, proceedings, the execution of all writs, summonses and other processes against

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<sup>408</sup> Section 133(1).

<sup>409</sup> See Chapter 3, part 2.6.2.

<sup>410</sup> See part 2.6 above.

<sup>411</sup> Section 133(1)(a).

<sup>412</sup> Section 133(1)(b). The court is specifically authorised to make its consent subject to suitable conditions.

<sup>413</sup> Section 133(1)(c).

<sup>414</sup> Section 133(1)(d). It is not clear why criminal proceedings against directors should be excluded since these are not proceedings against the company.

<sup>415</sup> Section 133(1)(e).

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the company without the leave of the court. It also does not provide for any exceptions.<sup>416</sup>

I submit that as far as the wording of the general moratorium is concerned, the section in the Companies Act of 1973 is preferable to that of section 133(1): a blanket prohibition against all (civil) legal actions against the company, irrespective of the grounds or specific property rights concerned, provides more clarity than the attempt to list all possibilities of rights that may be the subject of legal proceedings.

The exceptions, however, are to be welcomed, particularly the option of obtaining the business rescue practitioner's consent to institute legal proceedings and not having to approach the court. Although it is doubtful that business rescue practitioners would often be prepared to give this consent, there may be cases where a business rescue practitioner would prefer unavoidable legal proceedings to be instituted or finalised as soon as possible.

Special provision is made for the enforcement of any guarantee or surety given by a company, in that it may be enforced against the company only with the consent of the court and subject to any conditions that the court may consider just and equitable.<sup>417</sup> It is unclear why the drafters felt the need to provide for this situation in a separate subsection: a business rescue practitioner should surely be trusted to refuse consent to any proceedings that would be harmful to the rescue process, in which case the court has to be approached for its consent anyway.<sup>418</sup>

As a result of the moratorium, prescription on a claim against the company will not run during the company's business rescue proceedings.<sup>419</sup>

### **3.6.2 Uncompleted contracts**

In addition to the moratorium, the Companies Act of 2008 also protects the company against actions based on breach of any contract to which the company was a party at the commencement of the rescue proceedings. In an unfortunately worded, unclear

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<sup>416</sup> Section 428(2) of the Companies Act of 1973.

<sup>417</sup> Section 133(2).

<sup>418</sup> Once again, the lack of a proper and detailed Explanatory Memorandum that may have contained a good reason for this decision is proving to be a source of frustration.

<sup>419</sup> The wording of s 133(3) that contains this provision is unnecessarily convoluted: it provides that the measurement of the time must be suspended during business rescue proceedings if a claim against the company is subject to a time limit. Nevertheless, at least it brings certainty to the question whether prescription will run during the moratorium, which was not the case under judicial management: see Blackman et al *Companies Act* at 15–22.

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and extremely contentious provision,<sup>420</sup> the business rescue practitioner is given the right to suspend or cancel entirely, partially or conditionally any provision of such an agreement other than an agreement of employment, despite any provision to the contrary contained in the contract.<sup>421</sup> Although not stipulated in the provision, it is obvious that the business rescue practitioner would also have this right in respect of the whole agreement and not just individual sections. This view is supported by the next subsection that refers to the right of any party to “an agreement that has been suspended or cancelled” to claim damages from the company.<sup>422</sup> There is no indication whether such a claim will be regarded as part of the costs of the rescue proceedings<sup>423</sup> but it is more likely to be treated as an ordinary unsecured claim.

It must be assumed that what the drafters of the legislation intended was to regulate the fulfilment or not of uncompleted contracts to which the company is a party at the commencement of the rescue proceedings. There is a lot to be said for allowing the business rescue practitioner a choice whether to fulfil an uncompleted contract or not, especially contracts that are detrimental to the company or could defeat the rescue attempt, without running the risk of a court ordering specific performance against the company or the business rescue practitioner being held personally liable for breach of any duty to the company. However, allowing the practitioner to suspend part or the whole of a contract for an indefinite period, leaving the other contracting party in limbo, is unacceptable, as is the right to cancel some provisions the business rescue practitioner does not like, but to enforce those he does. Would that, for example, allow the business rescue practitioner to demand delivery in terms of a contract of sale but to cancel or suspend the payment provision or the one providing for retention of title? Or to demand payment of a loan extended to the company but to cancel the condition stipulating that the company must provide security? The wording of this provision also

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<sup>420</sup> In its presentation on the Companies Bill to the Portfolio Committee on Trade and Industry, the Banking Association of South Africa stated that this provision would introduce significant risks into contracts, causing higher costs, and undermine South Africa’s corporate contractual law: *Business Report* 14 August 2008 at 1.

<sup>421</sup> Section 136(2). The provision is also made subject to ss 35A and 35B of the Insolvency Act of 1936, which respectively regulate transactions on an exchange on sequestration of the estate of a market participant, and unperformed obligations arising from a master agreement if the estate of one of the parties to the agreement is sequestrated. Since both these provisions specifically apply only after sequestration of the debtor’s estate (or liquidation of the debtor company in terms of s 339 of the Companies Act of 1973) and neither of these situations are present, this part of s 136(2) is meaningless.

<sup>422</sup> Section 136(3).

<sup>423</sup> In terms of s 135(3) the claimants would then enjoy preference rights to payment.

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seems to imply that the business rescue practitioner may cancel or suspend a term of the contract that has already been fulfilled, such as security that has already been provided for a loan or stopping payment for a leased asset while continuing to use it and not being compelled to return possession to the owner. This would be contrary to every established principle of our law of contract and would effectively amount to the cancellation of vested rights.<sup>424</sup> I do not believe that any legislation could have this effect, even if it were the intention of the legislature. I would also argue that the power to suspend or cancel a provision of an agreement does not include the power to cancel the completed effects of this provision: the power to cancel a provision requiring the registration of a bond as security for a loan, for example, could not possibly include the power to cancel the already registered bond.

It seems obvious that all the above implications could not and should not have been the intention, but there is nothing in the wording of this very wide provision that limits the rights of the business rescue practitioner in this regard.<sup>425</sup> The drafters appear to have confused a moratorium, protecting the company from legal action, with the option of terminating a contract and avoiding future liabilities of the company because fulfilment would prejudice the business rescue proceedings.

It is regrettable that the drafters of this provision did not take cognisance of the manner in which the matter is regulated in our insolvency law as applied in judicial management in *CCA Little & Sons v Niven*.<sup>426</sup> The basic common-law principle is that specific performance will not be ordered against an insolvent estate, and should the liquidator of a company refuse to render performance under an uncompleted contract, the other party will have merely a concurrent claim for damages based on breach of contract as well as the right to cancellation for breach of contract.<sup>427</sup> If the liquidator chooses to continue an uncompleted contract, he has to offer full performance and

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<sup>424</sup> However, this is how it was interpreted by the Banking Council of South Africa and the South African Property Owners' Association, who both objected strenuously to this provision: respectively reported in *Business Times* 14 August 2008 at 1 and *Business Report* 23 July 2008 at 1.

<sup>425</sup> Solomon and Boltar "Section 136(2)" also argue that, given their ordinary meaning, this is exactly what the effect of the words used in s 136(2) will have, giving the practitioner not only the power to "cherry pick" between different provisions of an agreement, but even between the rights and obligations in one provision of an agreement. As an example, they use the absurd effect that this provision could have on a loan agreement where the practitioner could retain the provision making a loan to the company, but could cancel or suspend the provisions obliging the company to pay interest, provide security or even repay the loan.

<sup>426</sup> 1965 (3) SA 517 (SRA).

<sup>427</sup> Bertelsmann et al *Mars* at 222.

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may demand the same.<sup>428</sup> Almost the same result has been achieved by the German insolvency legislation in which the insolvency administrator has been given the right to choose between fulfilment or not of uncompleted contracts, but does not have the right to choose partial performance, and certainly also not to suspend any part of a contract.<sup>429</sup> Special provisions furthermore protect the other party from being left in uncertainty over the future of the contract for longer than necessary – apparently not a point of concern to the drafters of the Companies Act of 2008.

The wording of this provision requires several drastic amendments. If this is not done, one can only hope that the courts, when faced with this provision, will interpret it according to the accepted principles of our law, in particular our law of contract, and not allow what is essentially a unilateral amendment of a contract by the practitioner. If the practitioner does not want to fulfil all the terms of an agreement, it should be regarded as a repudiation of the contract which will release the other party from performance and afford him the right to cancel the contract and claim damages from the company for breach of contract. If, on the other hand, the practitioner chooses to demand performance in terms of the contract, the company must be bound to fulfil all its contractual obligations as well.

### **3.7 Managing the procedure**

#### **3.7.1 The business rescue practitioner**

##### **3.7.1.1 Appointment**

If business rescue proceedings result from a resolution by the board of directors, the board also appoints the business rescue practitioner and must do so within five business days after filing the business rescue resolution.<sup>430</sup> Although the subsection refers to the appointment of a single business rescue practitioner, the definition of a business rescue practitioner includes the possibility of two or more persons appointed jointly to oversee a company during business rescue proceedings.<sup>431</sup> Every business

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<sup>428</sup> Where it has been deemed necessary, the Insolvency Act of 1936 has amended these principles in respect of certain specific types of contracts: see Bertelsmann et al *Mars* at 225ff.

<sup>429</sup> See Chapter 4, part 2.6.2.

<sup>430</sup> Section 129(3)(b). The section actually refers to the “company” that must appoint the business rescue practitioner, but in this instance it must be assumed that the reference is to the board acting on behalf of the company.

<sup>431</sup> Section 128(1)(d).

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rescue practitioner must meet the stipulated requirements<sup>432</sup> and provide his or her written consent to be appointed.<sup>433</sup> A notice of the business rescue practitioner's appointment must be filed with the Commission within two business days, and must also be published to every affected person within five business days after filing this notice.<sup>434</sup>

If the court makes an order for business rescue proceedings to commence,<sup>435</sup> it may appoint an interim business rescue practitioner nominated by the applicant.<sup>436</sup> This appointment will, however, be subject to approval by the majority in value of the independent creditors at the first meeting of creditors.<sup>437</sup>

Although the use of the word "may" in section 131(5) appears to give the court a discretion whether to appoint an interim business rescue practitioner or not, it is difficult to imagine how an order for business rescue proceedings can be issued and implemented without such an appointment. Unlike the position under a provisional judicial management order,<sup>438</sup> there is no provision for the temporary custody of the company's assets until the appointment of a business rescue practitioner. Furthermore, whereas the Master of the High Court is tasked with convening the first meetings of creditors in judicial management,<sup>439</sup> in business rescue proceedings this is the duty of the (interim) business rescue practitioner. Without a business rescue practitioner this will simply not happen and the business rescue proceedings will not progress.

Under the circumstances I would suggest that the provision should be amended to make the appointment of an interim business rescue practitioner by the court obligatory if an order for commencement of business rescue proceedings is granted.

If a court sets aside the appointment of a business rescue practitioner who was appointed by the board of directors,<sup>440</sup> the court must appoint another business rescue practitioner who meets the stipulated requirements.<sup>441</sup>

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<sup>432</sup> In s 138 discussed in part 3.7.1.2 below.

<sup>433</sup> Section 129(3)(b).

<sup>434</sup> Section 129(4). See s 129(5) and the discussion in part 3.5.1.1 above on the consequences of failure by the directors to comply with these requirements.

<sup>435</sup> In terms of s 131(4) discussed in part 3.4.2 above.

<sup>436</sup> Section 131(5).

<sup>437</sup> In terms of s 147(1) this meeting must be convened by the business rescue practitioner within ten business days after his appointment.

<sup>438</sup> Section 429(a) of the Companies Act of 1973.

<sup>439</sup> Section 429(b)(ii).

<sup>440</sup> On application by an affected person in terms of s 130(1)(b).

<sup>441</sup> See part 3.5.1.3.2 above for a discussion of these requirements.

If a business rescue practitioner dies, resigns or is removed from office by the court in terms of its powers to remove a practitioner at any time on one of the stipulated grounds,<sup>442</sup> a new business rescue practitioner must be appointed by the company (again, presumably, this means the directors) if the previous one was appointed by them, or by the creditor<sup>443</sup> who nominated the previous one.<sup>444</sup>

The reasoning behind this provision is difficult to understand in the case of a business rescue practitioner having been removed by the court on one of the grounds stipulated in the Act and which mainly refer to incompetence or dishonesty. Firstly, the applicant who has gone to the trouble and incurred the costs of bringing the application should surely at least have been given the opportunity to nominate a new practitioner. Although the appointment of such a nominated person could then be made subject to confirmation by the creditors, I do not recommend it since the new appointment could happen at a late stage of the business rescue proceedings when the period of uncertainty over who will be taking the process further should be limited as far as possible. Secondly, the person or persons who appointed or nominated the first business rescue practitioner have already demonstrated their lack of judgment in choosing an inappropriate practitioner, and there is no reason why they should be given another chance to do so. Removing this power may encourage company boards and creditors to be very careful when appointing, or approving the appointment of a business rescue practitioner at the start of the proceedings.

### 3.7.1.2 Qualifications

Unlike the judicial manager, a business rescue practitioner has to meet certain stipulated requirements to qualify for appointment.<sup>445</sup> The relevant provision refers to the appointment of a “person” as business rescue practitioner, which, according to the definition contained in the Companies Act of 2008 itself, would include a legal person or corporation.<sup>446</sup> Although there could have been some doubt as to whether

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<sup>442</sup> As set out in s 139(2): see part 3.7.1.3 below.

<sup>443</sup> The subsection seems to assume that the original applicant, who may nominate the interim practitioner, was a creditor, although it could have been a shareholder, trade union or employee: s 131(5).

<sup>444</sup> Section 139(3).

<sup>445</sup> Section 138(1). Unlike the situation in England (see Chapter 3, part 2.7.1.2), there is unfortunately no provision for criminal liability for acting without the proper qualifications.

<sup>446</sup> The definition of “person” in s 1 of the Companies Act of 2008 states that it includes a juristic person, and s 2 of the Interpretation Act 33 of 1957 also provides that “a person” includes legal persons.

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this was the intended meaning, or merely one more example of careless drafting,<sup>447</sup> the draft Companies Regulations have now made it clear that a juristic person or partnership<sup>448</sup> may be appointed as business rescue practitioner on condition that “the individual determined by that juristic person or partnership to be responsible for performing the functions of practitioner in terms of Chapter 6 of the Act must satisfy the requirements of this regulation.”<sup>449</sup> Regulation 133 (which is the one referred to) requires that until the Minister has promulgated minimum qualifications for the accreditation of business rescue practitioners, the requirements for appointment as the business rescue practitioner for a state-owned or public company or a company required in terms of regulation 29(1)(a) or (b) to have its annual financial statements audited,<sup>450</sup> are that the “person” must be an attorney, accountant, liquidator or business turnaround practitioner who has been admitted or registered as such for at least ten years (and, in the case of an attorney or auditor, predominantly engaged in commercial practice during that time), or must have a degree in law, commerce or business management and have at least ten years experience in conducting business rescue proceedings.<sup>451</sup> In the case of any other company, the period of ten years standing or experience in the above qualifications is reduced to five years.<sup>452</sup> Although the word “person” is used in regulation 133(2), it must in this instance be taken to mean an individual since no partnership or juristic person can meet these requirements, for example by having a degree or being an attorney or liquidator!

Several problems resulting from the draft regulation itself and its effect on section 138(1) can be identified. The first and most serious one is that in terms of the regulation, the individual determined by the juristic person or partnership must satisfy the requirements of the regulation itself but there is no reference to section 138(1), which contains the requirements for appointment as a practitioner. On the face of it,

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<sup>447</sup> Section 69, for example, also refers to the appointment of a person as director, but a juristic person is specifically disqualified by s 69(7)(a).

<sup>448</sup> Although s 138(1) does not provide for the appointment of a partnership, and a partnership is not included in the definition of a “person”, the drafters of the regulations seem to assume that a partnership is somehow also eligible. One has to wonder whether they are aware of the fact that a partnership does not enjoy legal personality in South African law.

<sup>449</sup> Draft regulation 133(3).

<sup>450</sup> These are profit or non-profit companies who hold assets in a fiduciary capacity for a broad range of people who are not related to the company, as well as certain non-profit companies.

<sup>451</sup> Draft regulation 133(2)(a).

<sup>452</sup> Draft regulation 133(2)(b).



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this appears to be correct since it is the juristic person or partnership that is appointed as practitioner and that should therefore satisfy the statutory requirements. However, both section 138(1)(b)<sup>453</sup> and section 138(1)(c)<sup>454</sup> refer to disqualifications in respect of directors and thus only apply to individuals.<sup>455</sup> Not only is it therefore impossible to apply them to a juristic person or partnership, but they cannot be applied to the responsible individual determined by the juristic person or partnership either, since he is not the formally appointed business rescue practitioner and these requirements have not been made applicable to him by the relevant regulation or section 138. This effectively means that a company may be appointed as a business rescue practitioner in spite of the fact that its directors, members or employees are disqualified by these two sections from being appointed directly. Furthermore, there is nothing to prevent the company from then nominating one of these disqualified individuals to perform the duties of a business rescue practitioner since such individual is not required by the regulation or the Act to satisfy the requirements of section 138(1). Although the possibility of nominating a disqualified individual will be eliminated once a procedure and qualifications for accreditation as a business rescue practitioner are in place, it will not alter the fact that two of the statutory qualifications for appointment as a business rescue practitioner will have to be ignored when a juristic person is appointed because they cannot be applied to a juristic person.<sup>456</sup> It is also difficult to see how juristic persons or partnerships can be accredited as business rescue practitioners when they are unable to satisfy two of the requirements stipulated in section 138(1).

Regulation 133(3) is closely modelled on section 90(3), which allows a company to appoint a firm<sup>457</sup> as its auditor and leaves it to the firm to determine the responsible individual. However, unlike regulation 133(3), section 90 requires both the appointed firm and the individual auditor chosen by the firm to be responsible for the audit, to satisfy all the stipulated requirements for appointment as an auditor of the

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<sup>453</sup> The person may not be subject to an order of probation in terms of s 162(7): see part 3.7.1.2.2 below.

<sup>454</sup> The person would not be disqualified from acting as a director of the company in terms of s 69(8): see part 3.7.1.2.3 below.

<sup>455</sup> In terms of s 69(7) a juristic person is ineligible to be a director of a company and the disqualifications in s 69(8) are, as a result, quite obviously formulated to apply to an individual.

<sup>456</sup> Since a partnership is not recognised as a separate legal entity in South African law, it could be argued that every partner will have to satisfy the requirements set for individual business rescue practitioners.

<sup>457</sup> Defined in s 1 of the Auditing Profession Act 26 of 2005 as a partnership, company or sole proprietor.

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company.<sup>458</sup> It is impossible to explain why neither section 138(1) nor draft regulation 133(3) was similarly phrased, particularly when one considers that an auditor is an outsider from a highly regulated profession who is appointed to perform a very specific and limited task. By contrast, a business rescue practitioner takes almost complete control of the management and assets of the company.<sup>459</sup> These are undoubtedly compelling reasons why it should be ensured that an appropriately qualified individual takes responsibility for this function.

I also regard it as highly undesirable that a court may appoint a juristic person or partnership as practitioner without any indication or guarantee regarding the identity of the specific individual who will be responsible for performing these functions. Neither the court nor the affected persons will be able to judge whether a person who is capable and experienced enough to act in this particular matter will be nominated. Furthermore, since the appointment of a practitioner by the court is subject to ratification by the creditors at their first meeting,<sup>460</sup> the question arises whether the creditors may merely reject the individual determined by the appointed practitioner firm without having to refuse ratification of the appointment of the juristic person or partnership as business rescue practitioner. Essentially it comes down to the degree of control the creditors will have over the determination of a specific individual, and in this regard the regulations contain no guidelines. There is also nothing in the Act or regulations preventing a partnership or juristic person from nominating a different individual to replace the original nominee at any time during the course of the proceedings; this could indeed be necessary if the designated individual leaves the appointed juristic person or partnership. Needless to say, this could lead to a further lack of confidence in the possibility of a successful outcome of the procedure.

Another obvious problem created by the interim provisions contained in regulation 133(2) is that presently no official system exists for the registration or admission to the profession of either liquidators or business turnaround practitioners. It is not at all clear whether membership of any voluntary organisations such as the

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<sup>458</sup> Section 90(2) contains the qualifications for a firm or person to be appointed as an auditor, and s 90(3) stipulates that the individual determined by the firm must also satisfy these requirements. In addition, the Auditing Profession Act of 2005 requires the registration of the firm itself as an auditor, as well as of every partner if it is a partnership, or of every shareholder and director in the case of a company.

<sup>459</sup> See part 3.7.2 below.

<sup>460</sup> In terms of s 131(5).

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Association of Insolvency Practitioners of South Africa (AIPSA) or the Turnaround Management Association Southern Africa (TMA-SA) would be acceptable instead. If not, all liquidators and business rescue practitioners without the stipulated degrees will automatically be disqualified. This result will almost certainly meet with strong resistance from these persons and organisations.

Considering the many complications and disadvantages that the appointment of a partnership or juristic person could create in respect of the qualifications, duties, responsibilities and any personal liability of the business rescue practitioner, it is my belief that only individuals should be eligible for appointment as business rescue practitioners.<sup>461</sup>

The present requirement that both provisional and final judicial managers must give security for the proper performance of their duties before they may be appointed<sup>462</sup> is not repeated in the Companies Act of 2008 as a requirement for appointment as business rescue practitioner. A business rescue practitioner appointed by the board of a company after taking a resolution to begin business rescue proceedings may be required to provide security but only if so ordered by the court on application by an affected person.<sup>463</sup> No corresponding provision exists for an interim or final business rescue practitioner appointed after a court has ordered the commencement of business rescue proceedings. Requiring every business rescue practitioner to provide security will provide some protection to affected persons. This is particularly important because they have no say in the appointment of a business rescue practitioner by the board of the company and can only have him removed by an order of court – an onerous and expensive process that may take several weeks.

### *3.7.1.2.1 Membership of a regulated profession*

The first specific qualification for appointment as a business rescue practitioner is that the person must be “a member in good standing of a profession subject to regulation by

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<sup>461</sup> See Chapter 2, part 2.7.1.2 on the specific provision in English law that only an individual can be authorised and qualified to act as an insolvency practitioner. See also Chapter 4, part 2.7.1.2.1 regarding the exclusion of corporate entities and firms and the various views on this matter in Germany.

<sup>462</sup> Section 429(b)(i) in respect of a provisional judicial manager, and s 375(1), which requires security for appointment as final liquidator and applies to the final judicial manager in terms of s 431(4). A provisional liquidator is also required to give security (s 368) and so are the provisional trustee of a sequestrated estate (s 18(1) of the Insolvency Act 24 of 1936) and the final trustee (s 56(2)).

<sup>463</sup> Section 130(1)(c). See the discussion of this provision in part 3.5.1.3.3 above.

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a regulatory authority prescribed by the Minister<sup>464</sup> to regulate the practice of business rescue practitioners.<sup>465</sup> The wording of this provision implies that only one professional organisation will be designated to regulate business rescue practitioners, and that this will be an organisation specifically intended for these practitioners, rather than an existing organisation or organisations, such as the ones for attorneys or auditors.<sup>466</sup>

A person or association may be designated as the regulatory body only if it is committed to achieving the purposes of Chapter 6 of the Companies Act of 2008, “functions predominantly to promote sound principles and good practice of business turnaround or rescue” and either has the necessary human, financial and operational resources, as well as administrative procedures and safeguards, to carry out its duties in terms of Chapter 6, or presents the Minister with a credible plan on how these resources will be developed or acquired.<sup>467</sup> The Minister may impose reasonable conditions on the designated regulatory body regarding its functions and powers,<sup>468</sup> and make regulations prescribing minimum qualifications for admission to the profession of business rescue practitioner and the procedures that the designated person or association will have to follow in carrying out its functions and powers.<sup>469</sup>

Although the wording of sections 138(1)(a) and 138(2) creates the impression that the Minister can simply designate an appropriate and possibly already existing body for this purpose, the matter has been complicated by the definition of a “regulatory authority” in section 1. In terms of this definition, a regulatory authority is “an entity established in terms of national or provincial legislation responsible for regulating an industry, or sector of an industry”. The regulatory body for business rescue practitioners will therefore have to be a statutory body established by legislation. As a result, regulation 129(1) of the draft Companies Regulations establishes a Business Rescue Practice Regulatory Board as “a juristic person, to function as an organ of state within the public administration, but as an institution outside the public service.” The composition of the Board is prescribed in regulation 130 to consist of a total of 18 persons (presumably meaning “individuals” here)

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<sup>464</sup> In terms of s 138(2).

<sup>465</sup> Section 138(1)(a).s

<sup>466</sup> See Loubser “Insolvency Practitioners” at 128 and 131 in respect of the situation in England and Australia where this profession is largely confined to members of the auditing profession and law societies.

<sup>467</sup> Section 138(2).

<sup>468</sup> Section 138(3)(a).

<sup>469</sup> Section 138(3)(b).

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of whom ten will be appointed directly by the Minister for a term of three years, including the chairperson and deputy chairperson. Of the other persons appointed by the Minister, two must be entitled to practise and have experience in practising as business rescue practitioners, two must have successfully owned or managed a small or medium enterprise for at least five years, two must be knowledgeable and experienced in company law and another two in commercial accounting practice.<sup>470</sup> The other eight members of the Board must be designated by the Turnaround Management Association – South Africa (two members), the Law Society of South Africa (also two members), and one member each by the Banking Association of South Africa, Business Unity South Africa, the South Africa Institute of Chartered Accountants, and the South Africa Institute of Professional Accountants.<sup>471</sup>

All members of the Board are subject *mutatis mutandis* to the same qualifications and provisions applicable to members of the Companies Tribunal,<sup>472</sup> the Takeover Regulation Panel<sup>473</sup> and the Financial Reporting Standards Council.<sup>474</sup> This means that they must comply with the requirements of section 205 of the Act, which excludes any individual who is an office-bearer of any political party, movement or body; has a conflicting financial interest; is disqualified in terms of section 69 from serving as a company director; or has been declared mentally unfit or disordered by an order of court.<sup>475</sup> Members of the Board are also subject to section 206, which regulates conflicts of interest, and section 207, which regulates the resignation or removal from office of a member.<sup>476</sup> Although the Business Rescue Practice Regulatory Board will thus ostensibly have the same standing and status as the other three regulatory agencies mentioned above, it is regrettable that unlike the others, this Board was not established in terms of a section of the Companies Act of 2008 itself but rather by regulation. One cannot escape the impression that the drafters of the legislation did not initially realise the implications of the definition of a “regulatory authority” and were also under the impression that a much simpler and less formal procedure could

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<sup>470</sup> Regulation 130(1)(a).

<sup>471</sup> Regulation 130(1)(b).

<sup>472</sup> Established in terms of s 193 of the Act.

<sup>473</sup> Established in terms of s 196.

<sup>474</sup> Established in terms of s 203.

<sup>475</sup> Regulation 130(3)(b).

<sup>476</sup> Regulation 130(3)(c).

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be followed by the Minister to designate a professional body for business rescue practitioners. Regulation 130 almost seems like an afterthought to solve this problem, an impression that is strengthened by the fact that section 138(3) authorises the Minister to impose reasonable conditions on the designated regulatory body regarding its functions and powers, and to make regulations prescribing the procedures to be followed in carrying out its functions and powers, but does not contain any reference to the actual establishing of the Board by regulation.

The creation of a professional body specifically for business rescue practitioners must be welcomed since it will now be possible to set minimum standards of academic and practical qualifications and act against delinquent and unethical members of the profession. It is nevertheless unfortunate that the basic minimum standards are not contained in the Companies Act of 2008 itself but will be prescribed by regulation. The success of the new business rescue proceedings depends largely on the quality of the professionals who have to use them, and it is difficult to judge the desirability or effectiveness of many provisions without knowing the final standards that will be set for business rescue practitioners, such as whether they will be qualified in law or commerce, will be subject to some form of internship or minimum period of practical experience and whether they will have to pass a standardised examination. Prescribed requirements contained in an Act also afford more certainty because they are more difficult to amend than regulations and have more status. In most jurisdictions where similar professions are properly regulated, fairly detailed qualifications are prescribed in the relevant Act itself.<sup>477</sup> The Board will now be required to advise the Minister on the qualifications for and accreditation of business rescue practitioners<sup>478</sup> within two years after the Regulations have come into operation, after which the Minister will promulgate the requirements for accreditation by way of regulation.<sup>479</sup> This means that for a period of at least two years after the Act has come into operation there will be uncertainty over the exact requirements and qualifications for business rescue practitioners.

Another issue that requires clarification in the Act is that section 138(1)(a) merely requires that a person must be a member of the regulated profession. However,

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<sup>477</sup> See Chapter 3, part 2.5.1.2 regarding the requirements in England where it is stipulated that minimum standards must be set regarding (academic) qualifications, training and experience.

<sup>478</sup> Regulation 132(1).

<sup>479</sup> Regulation 133(1) and (2).

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regulation 133 refers to the requirements for “accreditation” as business rescue practitioners, and regulation 132(1)(b) lists the “accrediting, and suspending or withdrawing the accreditation” of business rescue practitioners as part of the duties of the Business Rescue Practice Regulatory Board. It will obviously not be possible to be a member of the regulatory body in the way that an attorney is a member of the Law Society of South Africa, for example, and much more than mere membership of the profession is required. The wording of the Act should thus be amended to require that a person must be an accredited business rescue practitioner to qualify for appointment in a particular case.

#### *3.7.1.2.2 Not subject to order of probation*

The second requirement for appointment as business rescue practitioner is that the person may not be subject to an order of probation in terms of section 162(7).<sup>480</sup> A court may make such an order on several grounds relating to inappropriate conduct of an individual<sup>481</sup> while serving as the director of a company.<sup>482</sup> An order of probation will have the result that, for a period of no more than five years,<sup>483</sup> this person may serve as a director only to the extent allowed by the order,<sup>484</sup> for example only for a private company or a company of which this person is the sole shareholder.<sup>485</sup> Although an order of probation is thus not an absolute disqualification for appointment as a director but only to the extent stipulated in the order, the wording of section 138(1)(b) implies that any such order renders the individual completely ineligible for appointment as a business rescue practitioner.

The grounds for an order of probation are the following:

- (i) Failure to vote against a resolution taken in contravention of statutory liquidity

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<sup>480</sup> Section 138(1)(b).

<sup>481</sup> Only individuals may be appointed as directors: s 69(7)(a).

<sup>482</sup> Section 162(7) and (8).

<sup>483</sup> Section 162(9)(b). The exact period of probation is determined by the court when making the order.

<sup>484</sup> Section 69(5).

<sup>485</sup> Section 162(10)(d)(ii).

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and solvency requirements<sup>486</sup> at a meeting<sup>487</sup> where he was present.<sup>488</sup>

- (ii) Acting in a manner that is materially inconsistent with the duties of a director.<sup>489</sup>

It is unclear whether the fact that the provision does not refer to an actual breach of a director's duties means that even inappropriate behaviour that does not quite amount to a contravention of the statutory duties of a director<sup>490</sup> could also constitute grounds for the order of probation.<sup>491</sup>

- (iii) Acting in an oppressive or prejudicial manner against a shareholder or director as described in section 163(1), or supporting a decision of the company to act in this way,<sup>492</sup> if the court is satisfied that placing the person under probation is justified when considering the circumstances and conduct of the company or close corporation, and the conduct of the director in respect of the entity's management, business and property at the time.<sup>493</sup>

- (iv) If, within any period of ten years after the date on which this section of the Companies Act of 2008 came into operation,<sup>494</sup> the person was a director of more than one company or managing member of more than one close corporation, irrespective of whether he held these positions concurrently, sequentially or at unrelated times, and, while he held these positions, two or more of these entities did not pay all its creditors in full or meet all of its obligations, unless this was in terms of a business rescue plan (but only if the business rescue proceedings were started by a board resolution)<sup>495</sup> or in terms of a compromise.<sup>496</sup> The court may

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<sup>486</sup> For example, when approving financial assistance for the purchase of the company's own shares: s 44(3).

<sup>487</sup> The subsection does not refer specifically to a board meeting, and the failure to vote against such a resolution at a general meeting of shareholders should thus also be considered as grounds for an order of probation.

<sup>488</sup> Section 162(7)(a)(i).

<sup>489</sup> Section 162(7)(a)(ii).

<sup>490</sup> Contained in ss 75-76 of the Companies Act of 2008.

<sup>491</sup> Section 77(3), for example, contains a list of grounds on which a director may be held liable to the company for any loss or damages suffered by the company as a result of these actions. These grounds are in addition to the liability of a director for a breach of his fiduciary duties and duty of care, skill and diligence.

<sup>492</sup> Section 162(7)(a)(iii).

<sup>493</sup> Section 162(8)(a).

<sup>494</sup> Section 162(7)(b) refers to the effective date, which is defined in s 1 as the date on which the relevant provision came into operation in terms of s 225. Therefore, misdemeanours of a director which happened before the Companies Act of 2008 came into operation will not count against him.

<sup>495</sup> In terms of s 129.

<sup>496</sup> In terms of s 155.



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place a person under probation for this reason only if it is satisfied that the failure of the company or close corporation to meet its obligations was wholly or partly due to the way in which the company or close corporation was managed and the declaration is justified, having regard to the circumstances of this matter and person's conduct at the time.<sup>497</sup>

The application for a probation order may be brought by a company, a shareholder, director, company secretary or prescribed officer of that company, a registered trade union or other representative of employees of the company,<sup>498</sup> or by the Commission or Takeover Regulation Panel.<sup>499</sup> The application must be brought while the person who is to be placed under probation is still a director of the company or was a director within the 24 months immediately preceding the application.<sup>500</sup>

#### *3.7.1.2.3 Not disqualified from acting as director*

A person may also not be appointed as a company's business rescue practitioner if he would be disqualified from acting as a director of the company in terms of section 69(8).<sup>501</sup> This means that he must not be an unrehabilitated insolvent, not be prohibited in terms of any public regulation to be a director of the company, not have been removed from an office of trust on the grounds of misconduct involving dishonesty within the last five years, and not have been convicted and sentenced to imprisonment without the option of a fine, or a fine exceeding the prescribed amount, for theft, fraud, forgery, perjury or an offence involving fraud, misrepresentation or dishonesty, or in connection with the promotion, formation or management of a company or a contravention of the Companies Act of 2008 and a number of specified other Acts.<sup>502</sup> The last-mentioned disqualification also ends five years after completion of the sentence.<sup>503</sup>

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<sup>497</sup> Section 162(8)(b).

<sup>498</sup> Section 162(2).

<sup>499</sup> Section 162(3).

<sup>500</sup> Section 162(2)-(3).

<sup>501</sup> Section 138(1)(c). Section 69(11) refers to the possible exemption from these provisions by the court, but as this is not mentioned in s 69(8) or in s 138, it would not apply to the appointment of a practitioner.

<sup>502</sup> Listed in s 69(8)(b)(iv)(cc).

<sup>503</sup> Unless extended by the court on application by the Commission: s 69(9).

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Furthermore, in terms of this requirement a person would be disqualified from being appointed as a business rescue practitioner if a court order has been issued prohibiting him from acting as a director of any company or declaring him to be delinquent.<sup>504</sup> Unlike an order of probation, an order of delinquency is either unconditional and effective for the lifetime of the person<sup>505</sup> or subject to any conditions deemed appropriate by the court and effective for a period of at least seven years.<sup>506</sup> The grounds for a declaration of delinquency therefore relate to more serious offences, such as acting as a director while ineligible or disqualified or in contravention of an order of probation, grossly abusing the position of director, or intentionally or through gross negligence causing harm to the company.<sup>507</sup>

It is unfortunate that this requirement has been linked to the disqualification of directors rather than directly listing an adapted version of these grounds for disqualification as they would apply to business rescue practitioners. As a result, the grounds listed in section 69(8), which have clearly not been drafted to apply to juristic persons because section 69(7) excludes them from being appointed as directors, have quite inappropriately now become applicable to juristic persons that may be appointed as business rescue practitioners. Furthermore, it is unclear whether the conditions to which an order of delinquency may be made subject by the court will also apply to acting as business rescue practitioner or whether this is a blanket disqualification for the duration of the order.

#### *3.7.1.2.4 No compromising relationship with company*

The next requirement, which essentially means that the person must be independent from the company and that there should be no conflict of interests, is found in most jurisdictions,<sup>508</sup> even ones like Germany in which the profession of rescue practitioner is not strictly regulated.<sup>509</sup> This is clearly of great importance and one of the measures to prevent an abuse of the procedure, particularly where the directors may appoint the practitioner.

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<sup>504</sup> In terms of s 162 of the Companies Act of 2008 or s 47 of the Close Corporations Act of 1984.

<sup>505</sup> In terms of s 162(6)(a) if the order is based on the grounds set out in s 162(5)(a) or (b).

<sup>506</sup> In terms of s 162(6)(b) if the order is based on the grounds contained in s 165(5)(c)-(f).

<sup>507</sup> The grounds for a delinquency order are listed in s 162(5).

<sup>508</sup> See Loubser "Insolvency Practitioners" at 131-134 regarding this qualification in Australia and the *Legislative Guide on Insolvency Law* drafted by the UNCITRAL Working Group V (Insolvency Law).

<sup>509</sup> See Chapter 4, part 2.7.1.2.4.

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However, the drafters of the Companies Act of 2008 have once again, in an effort to cover every possibility instead of stating the general rule, succeeded in phrasing a fairly simple principle in such a convoluted and complicated manner that it has resulted in a vague and unclear requirement that will create a substantial degree of uncertainty until a court has pronounced on its exact meaning.

Section 138(1)(d) namely provides that a person may be appointed as the business rescue practitioner of a company only if he has no “other<sup>510</sup> relationship with the company” that “would lead a reasonable and informed third party to conclude that the integrity, impartiality or objectivity of that person is compromised by that relationship”. The meaning of an individual’s “relationship” with a juristic person is explained in section 2(1)(b) as the direct or indirect control, as determined in section 2(2), of the juristic person by the individual. The control of a company by an individual is defined as the ability of the individual, together with any related person, to exercise or control the exercise of a majority of the voting rights of shareholders, or the right to appoint or elect, or control the appointment or election of directors of the company who control the majority of votes on the board.<sup>511</sup>

This definition of “relationship” is extremely limited and essentially excludes only a majority or influential shareholder from being appointed as the company’s business rescue practitioner.<sup>512</sup> One has to wonder whether the drafters had possibly forgotten about their definition in the Act and had intended the word to have a wider meaning, as it normally has in this context,<sup>513</sup> to include the company’s external auditors, legal advisors, bankers and major creditors in the list of persons who may not be appointed. This is the result that the requirement should have achieved, but does not. Once again,

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<sup>510</sup> The use of this word is absolutely incomprehensible as there is no previous mention of any relationship, and the question thus is: other than what? Other than being the business rescue practitioner, although he has not as yet been appointed? Or other than a relationship in respect of the business rescue proceedings, such as advising the company on a pre-packaged plan or other aspect before the actual proceedings start? See the discussion below on the resulting uncertainty whether a practitioner who advises and assists the company in the preliminary stages before the board takes a resolution to start business rescue proceedings, is now disqualified from appointment as the business rescue practitioner for this company because of their prior relationship.

<sup>511</sup> Section 2(2)(a)(ii). The circumstances in which a juristic person will be regarded as related to another juristic person are also explained in s 2(1)(c) by reference to direct or indirect control as defined in s 2(2), or if one is a subsidiary of the other or if the same person controls both of them.

<sup>512</sup> In terms of s 66(4)(b) at least 50 per cent of a profit company’s directors must be elected by the shareholders.

<sup>513</sup> See Chapter 4, part 2.7.1.2.4 in respect of this requirement in Germany.

in the absence of a detailed report or explanatory document, one would have to guess what the drafters' intentions were. Judging by the fact that both a conflict of interests and a lack of independence of the practitioner constitute grounds for his removal by the court,<sup>514</sup> it seems probable that they intended to formulate a wider disqualification than the application of the definition of a relationship to this requirement would allow.

One of the major concerns raised by the business turnaround industry in respect of this requirement is that it is unclear whether a practitioner who assisted the company in the development of a pre-packaged rescue plan<sup>515</sup> would be disqualified from appointment as the company's business rescue practitioner.<sup>516</sup> If so, he will also be disqualified from appointment as part of the company's management and as advisor to the company or practitioner.<sup>517</sup> It would be absurd to exclude the person who has taken the preliminary steps and knows more about the company's financial situation and business than anybody else. Furthermore, he would probably already have been involved in negotiations with major creditors who would be more inclined to support the rescue attempt if he were appointed as the business rescue practitioner. He clearly is the obvious choice to complete the process, but it all depends on the meaning of the word "relationship" and also on whether a reasonable and informed third party would regard him as a person who is not independent.

The absence of any reference to independence from creditors is a major concern since it is equally important that a business rescue practitioner should not act merely in the interests of a particular creditor or group of creditors.

#### *3.7.1.2.5 Not related to person with compromising relationship*

This requirement is linked to the previous one in that a person who is related to a person who has such a compromising relationship will also be disqualified from appointment as the company's business rescue practitioner.<sup>518</sup> The effect of this requirement will depend on whether the word "relationship" is to be given its defined meaning or not, and it is therefore impossible to evaluate.

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<sup>514</sup> See part 3.7.1.3 below.

<sup>515</sup> See part 3.5.1.2 above on their importance to business rescue.

<sup>516</sup> See *TMA Comments* at 35 and 41.

<sup>517</sup> Section 140(2).

<sup>518</sup> Section 138(1)(e).

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In terms of the Act,<sup>519</sup> an individual is related to another individual if they are married or living together in a similar relationship, or if they are relatives, whether natural or by adoption, who are not more than two degrees removed from each other.

### 3.7.1.3 Vacation of or removal from office

In terms of section 139(3), if a practitioner dies, resigns or is removed from office, the directors or the creditor who nominated that practitioner must appoint a new one. Although the Act does not contain any provision specifically allowing a practitioner to resign, it must be assumed that, since provision is made for the appointment of a practitioner to replace one who has resigned, a practitioner has the right to resign from office, apparently also at any time and for any reason.<sup>520</sup> This unlimited right to resign is perhaps not in the best interests of a company whose continued existence is hanging in the balance and where continuity and consistency are required to bring much-needed stability. It will now be left to the Regulatory Board to draft a code of conduct providing guidelines on when it will be appropriate or compulsory for a practitioner to resign.

A business rescue practitioner can be removed from office only by an order of court, in terms of either section 130(1)(b)<sup>521</sup> or section 139. If the practitioner is removed in terms of section 139, the directors or the creditor who nominated the practitioner who has been removed must appoint a new one.<sup>522</sup>

The court may remove any practitioner in terms of section 139 on application by an affected person or on its own initiative, on any of the following six grounds stipulated in section 139(2). In spite of the fact that some of these grounds refer to inappropriate behaviour on the part of a business rescue practitioner, the court has not been given the authority to declare such a person unfit or ineligible for appointment as a business rescue practitioner in future, unlike section 373 of the Companies Act of 1973 which allows the court to remove a liquidator from office and simultaneously declare him incapable for life or a specific period of being appointed

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<sup>519</sup> In s 2(1)(a).

<sup>520</sup> This is not as obvious a right as may appear, since in some jurisdictions he has no, or only a limited right to resign: see part 2.7.1.3 above.

<sup>521</sup> This applies only to a business rescue practitioner who was appointed by a resolution of the board of directors: see part 3.5.1.3.2 above.

<sup>522</sup> Section 139(3). See my comments on this provision in parts 3.5.1.3 and 3.7.1.1 above.

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as a liquidator. I regard this as a regrettable oversight since it will now be left to the Regulatory Board to suspend or withdraw his accreditation. Whether such action will be taken will depend on whether the matter is brought to the Board's attention and will also take some time before it is dealt with.<sup>523</sup> In the interim such an individual will still be eligible for appointment.

The problems that would be caused by the appointment of a partnership or juristic person as business rescue practitioner are also prominent here. Apart from the fact that many of these grounds would be difficult to apply to a juristic person, the question is whether the removal of a business rescue practitioner would entail removing the juristic person, or merely an order that the nomination of the responsible individual who was guilty of inappropriate behaviour or actions should be recalled by the juristic person.

#### *3.7.1.3.1 Incompetence or failure to perform his duties*<sup>524</sup>

Once again, the question must be asked why competence or the ability to perform the functions and duties required by the circumstances of the specific case is not also one of the requirements for appointment as practitioner.<sup>525</sup> Another question is: whose incompetence is relevant here, that of the juristic person or partnership, or the designated individual?

#### *3.7.1.3.2 Failure to perform his functions with the proper degree of care*<sup>526</sup>

In terms of section 140(3)(b), during the business rescue proceedings the business rescue practitioner has all the duties, responsibilities and liabilities of a director contained in sections 75 to 77. He will also be liable for a breach of any of these duties in the same way as a director, but may not otherwise be held liable for any act or omission in good faith in the exercise of his functions and powers as business rescue practitioner, unless the act or omission amounted to gross negligence.<sup>527</sup>

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<sup>523</sup> It is not required that the Board must meet at specified intervals or a certain number of times per year. Regulation 131(1)(a) merely provides that the chairperson of the Board may determine the date, time and place of meetings.

<sup>524</sup> Section 139(2)(a).

<sup>525</sup> See the discussion on s 130(1)(b) in part 3.5.1.3.2 above.

<sup>526</sup> Section 139(2)(b). The relevant duty of a director to which this presumably refers is to act with the expected degree of care, skill and diligence: s 76(3)(c).

<sup>527</sup> Section 140(3)(c).

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Sections 75 to 77 represent the legislature's attempts to (partly) codify the common-law fiduciary duties and duty of care and skill of directors, and contain most of the basic principles of these duties. Directors are prohibited from approving or entering into contracts in which they or a related person has a personal financial interest, without the required disclosure and approval,<sup>528</sup> and from using their position or information obtained as director to gain a personal advantage or to knowingly cause harm to the company or its subsidiary.<sup>529</sup> Section 76(3) provides that a director must exercise his powers and functions "in good faith and for a proper purpose",<sup>530</sup> "in the best interests of the company",<sup>531</sup> and "with the degree of care, skill and diligence that may reasonably be expected" from a person with the same knowledge, skill and experience and carrying out the same functions in the company as the particular director.<sup>532</sup> Section 77 deals mainly with the liability of a director<sup>533</sup> to the company for a breach of any of his duties stipulated above, and specifically states that this liability will be in accordance with the principles of the common law relating to a breach of fiduciary duties<sup>534</sup> or delict.<sup>535</sup> However, the section also provides that a director may be held liable for any loss or damages sustained by the company as a result of a number of specific actions by a director.<sup>536</sup> One of the stipulated grounds for liability<sup>537</sup> is if the director knowingly acquiesced in the company carrying on its business in contravention of section 22(1) that prohibits both reckless or fraudulent trading by a company and trading under insolvent circumstances. Considering the fact that a company must be imminently insolvent or unable to pay its debts to qualify for the commencement of business rescue proceedings,<sup>538</sup> it is difficult to see how any practitioner will be able to avoid contravening the prohibition against insolvent trading, particularly in the early stages of the process. It would have been of great assistance if here, as well, we had the benefit of a document

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<sup>528</sup> Section 75.

<sup>529</sup> Section 76(2)(a).

<sup>530</sup> Section 76(3)(a).

<sup>531</sup> Section 76(3)(b).

<sup>532</sup> Section 76(3)(c).

<sup>533</sup> And some other officials performing similar functions in the company: s 77(1). These persons are not important for the purposes of this discussion.

<sup>534</sup> In respect of the duties contained in ss 75, 76(2) and (3)(a) and (b).

<sup>535</sup> For a breach of the duty described in s 76(3)(c) (the duty of care and skill) or any other provision of the Act or the company's Memorandum of Incorporation.

<sup>536</sup> Listed in s 77(3).

<sup>537</sup> In s 77(3)(b).

<sup>538</sup> See part 3.4 above.

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explaining the reasoning behind the provision, since it would then have been possible to ascertain whether the drafters realised that they were burdening the rescue practitioner with a duty that was impossible not to breach.<sup>539</sup>

Even more confusing is the fact that only a breach of his duty to act with the required degree of care is mentioned as grounds for the removal from office of a rescue practitioner. It is abundantly clear that the duties described in sections 75 to 77 and which are explicitly made applicable to the practitioner refer to both fiduciary duties and the duty of care and skill. It is difficult to believe that the drafters intended that a breach of his fiduciary duties by a practitioner would not constitute grounds for removal, especially in view of the element of fraudulent abuse of his position that is found in many of these duties. However, unless it is assumed that the drafters intended to include both groups of duties in the word “care”, although making a clear distinction between them in the statutory provisions regulating these duties, or that they believed that a breach of any fiduciary duties were covered by the grounds of a conflict of interest,<sup>540</sup> a practitioner may not be removed from office because of a breach of any of his fiduciary duties.

#### *3.7.1.3.3 Engaging in illegal acts or conduct*<sup>541</sup>

Since this conduct is not required to be in connection with the performance of his duties as a practitioner, he may theoretically be removed for failing to stop at a stop sign or exceeding the speed limit. It is also not required that he should have been found guilty in a court of law, and the question arises what degree of proof, if any, of this conduct is required. I believe that a strong argument could be advanced for striking this requirement on the grounds of vagueness.

#### *3.7.1.3.4 No longer meeting the requirements contained in s 138(1)*<sup>542</sup>

All the uncertainties regarding the proper meaning and interpretation of section 138(1) will once again arise here.<sup>543</sup> Furthermore, the fact that this constitutes

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<sup>539</sup> In terms of regulation 21(1) of the draft Regulations, the practitioner would have to file a Form CoR 21.1 with the Commission to inform it of the fact that the company's liabilities exceed its assets.

<sup>540</sup> Discussed in part 3.7.1.3.5 below. In my view this would not be the case: a breach of the duty to act for a proper purpose, for example, does not necessarily imply a conflict of interest.

<sup>541</sup> Section 139(2)(c).

<sup>542</sup> Section 139(2)(d).

<sup>543</sup> See part 3.7.1.2 above.



separate grounds for removal also emphasises that a practitioner may be removed from office for failing to meet a requirement that is not stipulated in section 138 and, strictly speaking, is not a requirement for appointment.

#### *3.7.1.3.5 Conflict of interest or lack of independence*<sup>544</sup>

This provision seems to indicate that the drafters of the Act intended to require that a person must be independent and without any possible conflict of interests to qualify for appointment as a business rescue practitioner. It would have been a good idea to use the same wording to phrase the requirement for appointment in section 138(1)(d).<sup>545</sup>

#### *3.7.1.3.6 Incapacity and inability to perform his duties*

The court may also remove a business rescue practitioner from office if the practitioner becomes incapacitated and unable to perform his functions, and it is unlikely that he will regain this capacity within a reasonable time.<sup>546</sup>

There is no indication as to what could be regarded as a reasonable time, neither does the provision contain any guidance on who should be managing the business rescue proceedings during this time. It is unthinkable that a company should be left without a capable and functioning practitioner for an indeterminate period during business rescue proceedings, and this would probably prove to be catastrophic for the rescue attempt. The regulatory body will also have to fill this gap by including in their regulations or code of conduct an obligation on a practitioner to resign if he is likely to be incapacitated for more than a few days.

### **3.7.2 Powers and duties of directors**

According to the *Memorandum on the Objects of the Companies Bill, 2008* that accompanied the Companies Bill, 2008<sup>547</sup> the new business rescue proceedings are “largely self-administered by the company” within the constraints set out in the Act and under the independent supervision of the business rescue practitioner.<sup>548</sup> The

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<sup>544</sup> Section 139(2)(e).

<sup>545</sup> See part 3.7.1.2.4 above.

<sup>546</sup> Section 139(2)(f).

<sup>547</sup> B 61D – 2008.

<sup>548</sup> Paragraph 10, page 192 under the heading “Business Rescue”.

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implication of this statement is that directors are not automatically removed from office by the commencement of business rescue proceedings but in fact retain some of their managing powers and duties. This is also reflected in the definition of business rescue, which refers to the “temporary supervision of the company, and of<sup>549</sup> the management” of the company’s affairs, business and property.<sup>550</sup>

The intention thus seems to be that the supervisor will not take over the management of the company completely but that the directors of the company will continue to fulfil their management functions, albeit under the supervision of the practitioner. This view is also confirmed by section 137(2)(a), which provides that each director “must continue to exercise the functions of director, subject to the authority of the [business rescue] practitioner”. However, the use of the word “authority” rather than “supervision” is the first indication that more than mere supervision by the practitioner is envisaged, since this means that they derive their powers from the practitioner and may perform only those management functions that the business rescue practitioner has expressly authorised them to do.

Indeed, several provisions dealing with the respective powers of the practitioner and directors convey the message that the business rescue practitioner takes over full responsibility for the management of the company while directors are not allowed to do more than follow his orders. The first of these provisions is found in section 140(1)(a), which states that during a company’s business rescue proceedings, the practitioner “has full management control of the company *in substitution for its board and pre-existing management*”.<sup>551</sup> However, the practitioner may delegate any of his powers or functions to a person who was<sup>552</sup> part of the board or pre-existing management.<sup>553</sup> The practitioner may obviously not delegate any of his powers connected to the rescue of the company, such as the drafting and implementation of the rescue plan, and the only functions that could be delegated would thus be the functions relating to the management of the company. This implies that the directors do not automatically retain any management powers, but have only the powers specifically delegated to them by the business rescue practitioner.

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<sup>549</sup> My emphasis.

<sup>550</sup> Section 128(1).

<sup>551</sup> My emphasis.

<sup>552</sup> For some reason the past tense is used as if there is no longer a board or management.

<sup>553</sup> Section 140(1)(b).

This view is supported by section 137(2)(b), which imposes a duty on each director to exercise any management function in the company in accordance with the express instructions or direction of the business rescue practitioner in so far as it is reasonable to do so. Directors are also instructed to cooperate with and assist the business rescue practitioner by delivering books and records of the company to him and by providing him, within five business days after the beginning of business rescue proceedings, with a statement of the company's affairs containing at least the prescribed information.<sup>554</sup> Furthermore, a director is relieved from most of his statutory duties and liability for breach of any of these duties<sup>555</sup> as long as he acts according to the express instructions and directions of the practitioner.<sup>556</sup> Clearly, therefore, a director should not act without specific instructions from the business rescue practitioner since he would otherwise risk personal liability for damages suffered by the company as a result of his actions.

The practitioner, on the other hand, "has the responsibilities, duties and liabilities of a director of the company, as set out in sections 75 to 77".<sup>557</sup> This goes much further than merely supervising the directors in the exercise of their functions, and implies that the supervisor takes over all their responsibilities and duties.

Another important clue is found in the power given to a business rescue practitioner to apply to court for the removal from office of a director on one of two specified grounds. The first is that the director has failed to comply with a requirement of Chapter 6 of the Companies Act of 2008.<sup>558</sup> The second one applies where the director has by any act or omission impeded or is impeding the practitioner in the performance of his powers and duties as practitioner (including the development and implementation of a business rescue plan), as well as, quite significantly, if the

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<sup>554</sup> Section 142.

<sup>555</sup> With the exception of his liability for loss or damages sustained by the company because the director acted in the name of the company while knowing that he lacked the necessary authority (s 77(3)(a)), knowingly acquiesced in the company's business being carried on for fraudulent purposes or while insolvent, in contravention of s 22(1) (s 77(3)(b)), or was party to an act or omission of the company despite knowing that it was calculated to defraud a creditor, employee or shareholder or for another fraudulent purpose (s 77(3)(c)). He also remains bound by the provisions of s 75 regarding disclosure of personal financial interests (s 137(2)(c)).

<sup>556</sup> Section 137(2)(d).

<sup>557</sup> Section 140(3)(b). See part 3.7.1.3.2 above for a discussion of these duties and particularly the inevitable breach by the practitioner of the duty not to trade in insolvent circumstances.

<sup>558</sup> Section 137(5)(a).

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director has impeded the *management of the company by*<sup>559</sup> the business rescue practitioner.<sup>560</sup> Strangely enough, although the practitioner is instructed to forward to the relevant prosecuting authority any evidence of reckless trading, fraud or other contravention of any law relating to the company before business rescue proceedings began, he may not rely on any of these as grounds for an application to remove a director.<sup>561</sup> The practitioner is also not included in the list of persons who may apply for an order declaring a director delinquent or under probation.<sup>562</sup>

The practitioner has the right to remove from office any other person who was part of the pre-existing management of the company, without having to approach the court.<sup>563</sup> Since this is usually part of the management duties of the directors, it serves as one more reason to believe that the practitioner effectively replaces the board of directors as the managing organ of the company during business rescue proceedings.

I believe that the contradictory provisions in the Companies Act of 2008 on the division of powers between the business rescue practitioner and the board of directors are the result of an attempt by the drafters of the legislation to incorporate the principle of the debtor in possession of the Chapter 11 reorganisation procedure contained in the United States Bankruptcy Code.<sup>564</sup> This principle is a distinguishing feature of the

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<sup>559</sup> My emphasis.

<sup>560</sup> Section 137(5)(b).

<sup>561</sup> Section 141(2)(c)(ii). There is only a rather puzzling instruction that he must direct management to rectify the matter, just as in the case of finding evidence of voidable transactions or failure by a director to perform any material obligation (s 141(2)(c)(i)). It is unclear what is meant by “rectify” (without reference to any specific powers such as the power to apply to court for dispositions to be set aside) and whether “management” here includes the directors. It is even more incomprehensible why management, whose members are almost certainly the ones who were responsible for these actions, should be chosen to rectify them, rather than being placed under an obligation to assist the practitioner in rectifying these matters, for example by providing all relevant information. By contrast, the judicial manager has specific powers to apply to court for the setting aside of voidable and undue preferences: s 436 of the Companies Act of 1973. I suspect that the answer, at least as regards the provision on “voidable transactions”, is to be found in the fact that the main drafter of the Act is not familiar with South African law and is thus unaware of the special meaning attached to the words “voidable transactions”. The reference in s 141(2)(c)(i) is probably to transactions that are voidable because they do not comply with requirements of the Act such as approval by shareholders etcetera.

<sup>562</sup> In terms of s 162.

<sup>563</sup> In terms of s 140(1)(c), which does not stipulate any specific grounds for the removal from office. Such a person will be an employee of the company, and the apparent contradiction between this provision and s 136(1)(a), which compels the company to continue employing all its employees after business rescue proceedings have started, not to mention the resulting unequal treatment of and unfair discrimination against employees who were part of the company’s pre-existing management, brings the validity of this provision into question.

<sup>564</sup> Title 11, United States Code.

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Chapter 11 procedure and means that, except in those cases where a trustee is appointed (which is the exception rather than the rule),<sup>565</sup> the debtor is left in control of his or its business and affairs<sup>566</sup> with all the rights and powers of a trustee.<sup>567</sup> The directors and management of the company will therefore remain in control of the company's usual business although the debtor in possession is conceptually regarded as an entity separate from the debtor company. The shareholders of the company also retain their usual powers and role.<sup>568</sup>

Their intention to consider the American procedure when designing a new South African business rescue regime was specifically expressed in the policy document issued by the Department of Trade and Industry in 2004.<sup>569</sup> However, in the American procedure the appointment of a person to supervise or oversee the reorganisation is rare and not part of the usual course of events. If a trustee is appointed by the court, management loses its right to manage the company and this power is vested in the trustee. One would therefore find either a debtor in possession or a trustee in a particular case, but not both, as is being attempted in the provisions of the Companies Act of 2008. The fact that a business rescue practitioner must be appointed in all instances thus excludes the possibility of allowing the board to retain its management powers, and it should be clarified in the Companies Act of 2008 that the business rescue practitioner is in charge of the company during business rescue proceedings.

The Companies Act of 2008 does not stipulate who is responsible for those management duties that are not related to the business rescue proceedings, such as convening the annual general meeting, since it does not contain anything similar to the detailed list of duties of a judicial manager set out in the Companies Act of 1973.<sup>570</sup> As a result of the uncertainty over whether the practitioner takes over all

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<sup>565</sup> A trustee is appointed only if so ordered by the court after notice and a hearing, and on stipulated grounds mainly relating to fraud, dishonesty, incompetence or gross mismanagement of the company's affairs by the current management: s 1104(a).

<sup>566</sup> Section 1101(1) of the Bankruptcy Code.

<sup>567</sup> Section 1107(a) of the Bankruptcy Code only excludes a small number of rights and duties: the right to compensation and the duty to file certain documents and statements and to investigate the affairs of the debtor in terms of s 1106(a)(2)-(4). The court may also prescribe limitations or conditions.

<sup>568</sup> Treister et al *Fundamentals* at 393.

<sup>569</sup> *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Reform* (May 2004) at 45, available at <<http://www.thedti.gov.za/ccrd/companies/Guidelines04.pdf>> accessed on 3 March 2009.

<sup>570</sup> In s 433, and including the duties for which directors are normally responsible, such as to keep accounting records, prepare financial statements and convene annual general meetings and other meetings of members.

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management functions, it is also unclear whether these routine tasks also form part of his duties.

### **3.8 The business rescue plan**

One of the major innovations of the new rescue proceedings is the requirement that a rescue plan must be drawn up to show how the rescue of the company will be achieved. As pointed out before, the lack of a requirement that a proper rescue plan must be prepared and approved has been identified as one of the reasons why judicial management has rarely led to a successful rescue.<sup>571</sup>

#### **3.8.1 Power to submit a business rescue plan**

The business rescue practitioner is responsible for the development and implementation of a business rescue plan if approved in terms of the Act.<sup>572</sup> However, although he has to prepare the plan, he must consult the creditors, other affected persons and the management<sup>573</sup> of the company before doing so.<sup>574</sup>

#### **3.8.2 Prescribed contents of a rescue plan**

Section 150(2) prescribes that a rescue plan must contain all the information reasonably required to assist affected persons<sup>575</sup> in deciding whether they should accept or reject the plan. The rescue plan must furthermore be divided into three parts:

##### **3.8.2.1 Part A – Background<sup>576</sup>**

This part must contain at least the following:

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<sup>571</sup> Part 2.8 above.

<sup>572</sup> Section 140(1)(d).

<sup>573</sup> Although the word “management” is used elsewhere to denote persons other than the directors, for example in s 140(1)(c)(i) on the removal of such persons from office, it appears to include both directors and other members of management here, as it is unlikely that the practitioner will be required to consult other persons involved in the management of the company, but not the directors. Consistency in terminology is, once again, shown not to be a strength of this Act.

<sup>574</sup> Section 150(1).

<sup>575</sup> Since only the creditors and shareholders whose rights will be affected have the right to vote on the rescue plan, the question here is whether the words “affected persons” refer to persons who will be affected by the plan or the legally defined group of affected persons (s 128(1)(a)) who form a substantially larger group.

<sup>576</sup> Prescribed in s 150(2)(a).

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- (i) A complete list of all the material<sup>577</sup> assets of the company, indicating which assets were held as security by creditors at the start of business rescue proceedings. Strangely enough, the Act does not specifically require a valuation of these assets, but it must be assumed that a valuation should be included since it would otherwise be impossible to judge the company's chances of survival.
  - (ii) A complete list of creditors of the company when proceedings began, as well as an indication which creditors qualify in terms of insolvency law as secured, statutory preferent or concurrent creditors and which ones have proved their claims.<sup>578</sup> The reference to the laws of insolvency raises some doubts about the exact position of employees who are owed money relating to their employment before the start of business rescue proceedings. These employees are classified as preferred unsecured creditors for the purposes of Chapter 6 by section 144(2), without any limitation as to the amount or employment period of the claim. However, in terms of the Insolvency Act, claims relating to employment prior to insolvency only enjoy preference for a specific period and up to a specific amount.<sup>579</sup>
  - (iii) The dividend that creditors in each class will probably receive should the company be liquidated. To avoid claims from creditors that they have been misled, practitioners would have to be very careful in their estimates since there may be a number of factors that cannot be predicted with any degree of accuracy and that may influence these figures, such as whether purchasers for all the assets will be found and whether all creditors have proved their claims. The calculation of this probable dividend (and other projections and estimates

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<sup>577</sup> When used as an adjective, the word is defined by s 1 to mean significant in the circumstances to a degree that is "of consequence in determining the matter", or "might reasonably affect a person's judgement". The last-mentioned meaning is clearly not applicable here, and it must be assumed to mean that only important assets must be listed. There is no indication what the test is to establish whether an asset is important: is it purely based on its value or on its importance to the company's business? There is also no explanation why some assets should be excluded. Unless, of course, the drafters forgot that they had defined this word in the Act, and merely intended to indicate the opposite of immaterial assets, for which the correct term in our law is corporeal assets. It is impossible to answer these questions with any certainty, because of the regrettable lack of a proper explanatory document.

<sup>578</sup> The practitioner must convene a first meeting of creditors within ten days after being appointed to inform them whether he believes that the company has a reasonable prospect of being rescued, and where creditors may prove their claims: s 147(1). It is at this meeting that creditors decide whether to appoint a committee of creditors to represent their interests as set out in s 149.

<sup>579</sup> Section 98A(1) of the Insolvency Act 24 of 1936.

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required by the Act) will in all probability require the services of an expert such as an accountant or auditor, thereby adding to the costs of what is increasingly developing into a very expensive procedure.

- (iv) A complete list of holders of issued securities of the company. As a result of the inconsistent use of the word “securities” sometimes to denote only shareholders,<sup>580</sup> and not all holders of securities<sup>581</sup> which would include, for example, the holders of derivative instruments, bonds and debentures, it is unclear who should be included in this list. Whatever the answer to that question may be, it is obvious that this list will in some cases contain thousands, if not millions of names. The costs and time involved in preparing this list will be substantial, while it is difficult to find any real purpose of requiring a list with each person’s name, especially if their rights will not be affected by the plan, as would usually be the case with shareholders. Surely a summary indicating the numbers of persons holding each type of share or security would have been more than sufficient, if at all necessary.<sup>582</sup>
- (v) A copy of the written agreement concerning the business rescue practitioner’s remuneration. The practitioner is entitled to charge fees and expenses in accordance with a tariff that the Minister may prescribe by regulation,<sup>583</sup> but this is presumably not what this item is about since no agreement, whether oral or written, is required.<sup>584</sup> The requirement refers to the agreement that a practitioner may propose to the company for the payment of additional remuneration if he succeeds in having a rescue plan approved at all, or within a particular time, or achieves any specified result or results relating to the business rescue

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<sup>580</sup> See, for example, s 137, which refers to shareholders in its heading, but to issued securities in subsection (1); s 152(3)(c), which refers to approval by holders of securities, while s 152(6)(b) refers to approval by shareholders in terms of subsection (3)(c): see further part 3.8.4 below.

<sup>581</sup> As defined in s 1 of the Companies Act of 2008 with reference to s 1 of the Securities Services Act 36 of 2004.

<sup>582</sup> See Loubser “Shareholders” at 379-390 where it is pointed out that shareholders play virtually no role in business rescue proceedings nor are their interests given much attention, and consequently it does not make sense to require this list.

<sup>583</sup> Sections 143(1) and (6).

<sup>584</sup> This situation may be changed as a result of draft regulation 135(1), which requires that the basic remuneration of the practitioner in terms of s 143(1) must be determined at the time of appointment by the board or the court, subject to the maximum amounts stipulated in the regulations. Some agreement on this fee will thus have to be in place before the appointment. The agreement on additional remuneration is not included here and will be in a second agreement since it must be proposed by the practitioner, that is, after his appointment.



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proceedings.<sup>585</sup> The agreement becomes final and binding only if approved by the majority in value of secured and unsecured independent<sup>586</sup> creditors<sup>587</sup> present and voting at a meeting called for this purpose,<sup>588</sup> as well as by the majority of shareholders who are entitled to share in the residual value of the company on winding up, present and voting at a meeting called for this purpose.<sup>589</sup> Even after its approval, a creditor or shareholder who voted against the agreement may apply to court within ten business days after the date of voting<sup>590</sup> for an order setting aside the agreement.<sup>591</sup> The grounds for setting aside the agreement are that it is not just and equitable or that the remuneration in terms of his agreement is unreasonably excessive<sup>592</sup> in relation to the company's financial circumstances. Our courts will, it is hoped, use their powers to set aside such an agreement on the grounds of its not being just and equitable, to prevent the obvious possibilities of abuse by practitioners who attempt to increase their remuneration by demanding extra payment for simply fulfilling the functions and duties that they were appointed to fulfil. I regard this provision as highly undesirable and as constituting obvious possibilities for abuse.

- (vi) A statement whether the plan includes any proposal made informally by a creditor of the company. The right to participate informally in the business rescue proceedings by making proposals for a business rescue plan to the practitioner

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<sup>585</sup> See s 143(2).

<sup>586</sup> In terms of s 147(3), a decision taken at any meeting of creditors, except for the meeting held in terms of s 151 to vote on the rescue plan, must be supported by the holders of a simple majority of independent creditors' voting interests to be valid. An independent creditor is one who is not related (as defined in s 2(1)) to the company, a director or the practitioner: s 128(1)(g).

<sup>587</sup> Creditors' voting interests must be determined according to s 143(4)-(6): see my comments on these provisions in fn 343.

<sup>588</sup> The Act does not specify by whom the meeting should be called, but it will presumably be by the practitioner.

<sup>589</sup> Section 143(3).

<sup>590</sup> Section 143(3) does not require that the two meetings must be held on the same day, and this means that if they are not, a person whose meeting happened first and who waited for the second meeting to establish whether they would also approve the agreement may be close to expiry of his ten days before he knows that an application to court is required to annul the agreement. Therefore, it would have been preferable if the period of ten days always started after the second meeting.

<sup>591</sup> Section 143(4).

<sup>592</sup> Section 143(4)(b) uses the words "egregiously unreasonable" which appear to set the test very high. The remuneration should surely not be so much that it is repugnant, gross or repulsive before it can be set aside! Interestingly enough, the official Afrikaans translation of the Act uses the far milder and, I submit, more appropriate words "uiters onredelik".

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is specifically given to every creditor.<sup>593</sup> This obviously refers to proposals that must be made before or while the plan is being drafted, since a creditor may also propose an amended or alternative plan if the original one is rejected by the creditors.<sup>594</sup> The reason for this requirement is rather obscure since the practitioner is specifically instructed by the Act to consult the creditors before he prepares a business rescue plan and it must be expected that they will make several proposals.<sup>595</sup>

### 3.8.2.2 Part B – Proposals<sup>596</sup>

This part of the plan explains all the proposed measures to assist the company in overcoming its problems and managing its debts. It must therefore contain at least the following information:

- (i) The nature and duration of any moratorium for which the plan provides. This will provide additional breathing space for the company to recover financially and will make the plan more attractive to creditors than one providing for a partial discharge of debts. If the sale of the business is envisaged, such a moratorium will obviously not be required.
- (ii) The extent to which the company will be released from payment of its debts, or debts will be converted to equity in the company or another company. In terms of section 154(1), a rescue plan may provide that if it is implemented according to its terms and conditions, a creditor who acceded to the discharge of the whole or part of a debt owing to him will lose the right to enforce that debt or part of it. The use of the word “acceded” is problematic since its more usual meaning is that of agreement or consent.<sup>597</sup> However, even if a creditor votes against approval of the plan, he will still be bound if it is approved by the required majority.<sup>598</sup> It would have been preferable to state simply that a plan may provide for the discharge or partial discharge of a debt on condition that it is implemented

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<sup>593</sup> Section 145(1)(d).

<sup>594</sup> Section 145(2).

<sup>595</sup> Section 150(1).

<sup>596</sup> Section 150(2)(b).

<sup>597</sup> The *Oxford Study Dictionary* at 4 explains “accede” as “to agree to what is proposed”. In the official Afrikaans version of s 154(1) of the Act, “accede” has also been translated as “aanvaar”.

<sup>598</sup> See part 3.8.4 below on the approval of the plan.

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according to its terms and conditions. It is unnecessary to state that a creditor will lose his right to enforce such a debt, since section 154(2) already provides that a creditor may not enforce a debt owed by the company before business rescue proceedings began, except to the extent provided for in the business rescue plan that has been approved and implemented. It is also slightly worrying that there is no stipulation that all creditors of the same class should be treated equally. Strictly speaking, a rescue plan could thus differentiate between creditors as to which part or percentage of each creditor's claim would be discharged, although it must probably be assumed that, in spite of the absence of any such provision in the Act, each class of creditors must be treated equally. This is one more principle that the courts would have to enunciate.

- (iii) The “ongoing role<sup>599</sup> of the company, and the treatment of any existing agreements”. Since the practitioner has been given the power to cancel or suspend agreements wholly or partially during business rescue proceedings, without any reference to this being subject to approval by the creditors,<sup>600</sup> it must be assumed that the requirement refers to the treatment of contracts after approval of the plan.
- (iv) The “property of the company that is to be available to pay creditors’ claims” in terms of the plan. This provision should probably be interpreted to mean that the assets that will be used to pay creditors must be listed, rather than assets that are merely available and could possibly be used. This provision does not, however, cover the possibility of claims being paid by future earnings.
- (v) The order of preference in which creditors will be paid from the proceeds of the company’s property if the plan is adopted. The lack of any indication here of a specific order of preference that must be followed in the payment of creditors may create the impression that the practitioner is free to draft a plan that provides for any order of payments which he believes the creditors may approve. This is most probably not true, and although the order of preference in terms of

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<sup>599</sup> A rather strange choice of words which could simply mean an indication of how the company’s business will be run to return it to financial health, or whether the company will play a role in the rescue of the business, that is, whether the company will continue to exist or only the business. Presumably the first-mentioned interpretation is meant since there is no other item requiring details of the company’s future plans for the business.

<sup>600</sup> Section 136(2); see part 3.6.2 above.

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insolvency law must be explained in Part A of the plan, it is also unlikely to be the order that must be followed for payments in terms of the rescue plan, because the provisions respectively dealing with post-commencement finance<sup>601</sup> and the rights of employees<sup>602</sup> effect substantial changes to the law in this respect. Therefore, it must be assumed that the business rescue plan will have to provide for payments in the order of preference created by the last-mentioned provisions, even though they do not specifically refer to the rescue plan.<sup>603</sup> This is unfortunate, as major creditors often agree to consolidate a company's debts by paying minor, and usually concurrent debtors first. I submit that this provision could be a major obstacle to a successful rescue and should be removed.

- (vi) A comparison between the benefits for creditors if the plan is adopted and the benefits they would receive if the company were to be placed in liquidation. For creditors this is obviously the crucial point since they are unlikely to approve a plan that will leave them worse off than liquidation would. However, this comparison will be based on a substantial amount of speculation and assumptions, and practitioners should be allowed to include only information that they regard as necessary and fairly reliable. It is also partly a duplication of the information required in Part A (iii) of the plan.
- (vii) The "effect that the business rescue plan will have on the holders of each class of the company's issued securities". This is another example of the drafters' loosely using the word "securities" when they are in fact referring to shares. It is obvious that the effect on the different classes of shareholders must be indicated in the plan, as those shareholders whose rights will be affected also have to approve the business rescue plan by majority vote.<sup>604</sup> The holders of some other

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<sup>601</sup> Section 135 stipulates that after payment of the remuneration and costs of the practitioner and costs of the business rescue proceedings, any remuneration or other employment-related payments that became due to employees during the proceedings will be regarded as post-commencement financing and have preference over all other claims for post-commencement financing, even secured ones. All these claims will have preference over all unsecured claims.

<sup>602</sup> Section 144(2) classifies all employment-related claims of employees dating from before the start of rescue proceedings as preferred unsecured claims, without any limit to the amount or period, for the purposes of Chapter 6: see part 3.8.2.1 above.

<sup>603</sup> On this aspect, judicial management is better regulated because s 434(3) of the Companies Act of 1973 specifies that creditors' claims should be paid *mutatis mutandis* in accordance with the law relating to insolvency as if these claim were claims against an insolvent estate.

<sup>604</sup> Sections 146(d) and 152(3)(c).

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securities, such as debentures, are creditors, and their claims must be treated as such. The intention could surely not have been to give them a double vote: once as a creditor and again as holder of securities. Proof that the drafters intended to include only shareholders is also found in section 10(2)(f) that refers to the rights of *shareholders*<sup>605</sup> to approve a rescue plan in terms of sections 146(d) and 152(3)(c).

It is significant that, although the definition of business rescue<sup>606</sup> very specifically refers to a better return for the company's shareholders as an acceptable outcome of the rescue plan, it is not required here or in any other provisions prescribing the minimum contents of the plan that an indication should be given of the benefits the plan would have for shareholders, let alone a comparison between the benefits of a plan and liquidation for them. It is obvious that liquidation would almost never benefit shareholders in any way, while a successful rescue would always do so. The reference to a better return for shareholders in the definition of business rescue is therefore essentially meaningless because there is no attempt to accommodate this possibility in the provisions, and this part of the definition should be deleted since it is superfluous and misleading.

### 3.8.2.3 Part C – Assumptions and Conditions

This part of the plan must contain at least the following:

- (i) Any conditions that must be satisfied before the rescue plan can come into operation and be fully implemented. No further details are provided, and a rescue plan could presumably be made subject to any condition, for example that the company obtains the necessary financing.
- (ii) An explanation of the plan's effect, if any, on the number of employees and their conditions and terms of employment. In probably the majority of business rescue cases, some retrenchments to limit the running costs of the company are unavoidable: some jobs have to be sacrificed to retain others. Although this is clearly foreseen in this provision, there is no attempt to assist the practitioner in the process. If a business rescue practitioner wants to retrench employees or

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<sup>605</sup> My emphasis.

<sup>606</sup> Section 128(1)(b)(iii): see part 3.1 above.

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change their conditions of service, he has to follow the full procedure prescribed by the Labour Relations Act<sup>607</sup> that a solvent and healthy company has to follow – even if these retrenchments are in terms of the rescue plan. Although I am not arguing for the same situation as in liquidation, I believe that at least if the retrenchments are part of a rescue plan, some attempt should have been made to facilitate unavoidable retrenchments.<sup>608</sup> Just as in the case of judicial management, liquidation now remains the easier option if retrenchments are inevitable.<sup>609</sup>

- (iii) The circumstances under which the rescue plan will end. The need for this provision is not immediately obvious since the Act prescribes the specific circumstances in which the proceedings will end and the procedure that must be followed.<sup>610</sup> If it was envisaged that the rescue plan may alter those provisions and stipulate its own conditions for termination, it should have been made clear in the relevant provisions. The intention of the drafters may have been to allow the plan to specify the requirements that must be satisfied or the targets reached before a practitioner may file a notice of substantial implementation of the plan or notice of termination.
- (iv) A projected balance sheet and statement of income and expenses for the next three years based on the assumption that the plan is adopted. The projected balance sheet and statement “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>611</sup> To fulfil this requirement the practitioner will obviously have to employ the services of an accountant, which will add to the costs of the proceedings. It will also require a substantial amount of guesswork since there could be many unpredictable factors that would influence the

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<sup>607</sup> Act 66 of 1995. In terms of s 136(1)(b) of the Companies Act of 2008, any retrenchment of employees is subject to the Labour Relations Act of 1995 and other applicable employment-related legislation.

<sup>608</sup> Section 144(3)(d) specifically gives every trade union representing employees, and every employee who is not so represented, the right to be consulted by the practitioner during the development of the rescue plan and to be given the opportunity to review and comment on the plan; while s 148 gives them the right to form an employees’ committee to represent their interests. These provisions will ensure that employees are not treated unfairly.

<sup>609</sup> See Loubser “Corporate Rescue and Labour Legislation” at 64-67.

<sup>610</sup> See part 3.9 below on the termination of business rescue proceedings.

<sup>611</sup> Section 150(3).

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income and expenditure of the company. This requirement was clearly not drafted with any consideration of the possible provision in a rescue plan for the immediate sale of the business and liquidation of the company.

The very specific information on the future of the company that is required under this item is reminiscent of two requirements that have both proved to be a serious impediment to rescue procedures: firstly, it shows a definite resemblance to the independent and very costly report on a company's affairs that was initially required when applying for an administration order in England and that was identified as one of the reasons why administration was not used extensively before this requirement was removed by legislation.<sup>612</sup> Secondly, it also reminds one of the heavy burden of proof on an applicant for judicial management who must provide evidence that the company will probably become a successful concern and be able to pay its debts if placed under judicial management. The practitioner is now required to provide enough detailed information to prove that the company will probably make a certain amount of profit.

The last-mentioned requirement is symptomatic of the general weakness of the prescribed contents of the plan, which is to focus on small, sometimes irrelevant and sometimes unreliable detail, rather than on the holistic view. There is, for example, no requirement that the reasons for the company's failure should be explained, and how these problems will be addressed, nor whether financing for the company's continued operation has been or can be obtained. There is also no provision for pre-packaged rescue plans in spite of their increasing importance as evidenced by developments in England in particular.<sup>613</sup>

Depending on the specific requirements regarding training and qualifications, the business rescue practitioner will, it is hoped, be an experienced and properly qualified professional who will know what information to provide to convince creditors that they should approve the rescue plan. The Act should have strived for requiring only the really important minimum information, leaving the rest up to the good sense, experience and knowledge of the rescue practitioner.<sup>614</sup> In time, a fairly standard form

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<sup>612</sup> See Chapter 3, part 1.

<sup>613</sup> See Chapter 3, part 2.8.2.

<sup>614</sup> This is also the view expressed by Burdette "Business Rescue Model (Part 2)" at 439 and 441 who states that the content of the plan "should be left as open-ended as possible". The UNCITRAL *Legislative Guide* at 215 (par 20) also recommends that the minimum information should be specified, focussing on the key objectives and procedures for implementation of the plan, rather than requiring

of agreement will in any event develop once practitioners acquire more experience in drafting these plans, to contain all the information creditors and other persons who may vote on the plan seek.

#### 3.8.2.4 Certificate

The business rescue plan must conclude with a certificate by the business rescue practitioner in which he states that any actual information provided in the plan appears to be accurate, complete and up to date, and that the projections are estimates made in good faith and based on the factual information and assumptions contained in the statement.<sup>615</sup>

### 3.8.3 Approval of the plan

#### 3.8.3.1 Publication of the plan

The business rescue plan must be published by the company<sup>616</sup> within 25 business days after the date of the appointment of the business rescue practitioner unless additional time is allowed by the court on application by the company, or the holders of the majority of creditors' voting rights consent to a longer period.<sup>617</sup> There is no mention of a meeting being held for this purpose, but it could possibly be decided at the first meeting of creditors that must be held within ten business days after the appointment of the practitioner.<sup>618</sup>

The period of 25 days seems quite short,<sup>619</sup> especially in a case involving a large company, unless the directors consulted the practitioner beforehand and the plan was

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a wide range of detailed information.

<sup>615</sup> Section 150(4).

<sup>616</sup> Although the Act states that the company must publish the business rescue plan, draft regulation 134(7) provides that the business rescue practitioner must publish the proposed plan by delivering a notice of the availability of the plan to every affected person, by displaying a copy of this notice at the company's registered offices and principal business place, on its website (if any), on SENS if it is a registered company, and by providing a copy of the plan free of charge to any affected person who requests it.

<sup>617</sup> Section 150(5).

<sup>618</sup> Section 147(1). It could make a difference whether this decision is or must be taken at a meeting, since s 147(3) stipulates that any decision taken at a meeting must be supported by the majority in value of independent creditors. Section 150(5) refers merely to the majority of creditors, which could be interpreted to mean that all creditors' votes will be taken into account if no meeting is held.

<sup>619</sup> In England the administrator is required to publish the plan as soon as possible but not more than eight weeks after his appointment: see Chapter 3, part 2.8.3. Although this is only one week more than the period allowed for the business rescue practitioner, the fact is that in many administrations pre-packs are used and the plan is thus virtually already in place before the administrator is appointed.



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drafted before business rescue proceedings formally commenced (the so-called pre-packaged plans or pre-packs). However, this course of action is fraught with danger because any prior consultations or other action by the board of directors exposes the company to the risk that the employees or their trade unions could take the initiative (and thereby also control over the process) away from them by applying to court for a business rescue order.<sup>620</sup> In addition to that, practitioners are still not sure whether any prior involvement in the preparations for rescue proceedings would make them unsuitable for appointment as business rescue practitioner for the company because of a lack of independence.<sup>621</sup>

### 3.8.3.2 Meeting of creditors and shareholders

Within ten business days after publication of the business rescue plan, the business rescue practitioner must convene and preside over a meeting of the company's creditors and "any other holders of a voting interest" to consider the rescue plan and vote on its approval.<sup>622</sup> Since only a creditor can have a voting interest,<sup>623</sup> it is unclear who the other holders of a voting interest could be. Shareholders whose rights will be affected are referred to as having voting rights.<sup>624</sup> However, judging from other provisions in respect of the meeting, it must be a reference to shareholders with voting rights because only one meeting is convened for creditors and shareholders with voting rights, where creditors get the first opportunity to vote and then shareholders who have voting rights.<sup>625</sup>

The practitioner must deliver a notice of the meeting to all affected persons at least five business days before it is due to take place, setting out the date, time and place of the meeting, the agenda and a summary of the rights of affected persons to participate in and vote at the meeting.<sup>626</sup> Once again, the question needs to be asked why each and every affected person should be notified in person even though in most cases many of them, particularly the shareholders, will not even be allowed to attend,

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<sup>620</sup> In terms of s 131(1), they may do so until a rescue resolution has formally been taken by the board.

<sup>621</sup> See par 3.7.1.2.4 above.

<sup>622</sup> Section 151(1).

<sup>623</sup> As defined in s 128(1)(j) read with s 145(4)-(6).

<sup>624</sup> Section 152(3)(c)(ii).

<sup>625</sup> Section 152(1)(a), for example, provides that at this meeting, the practitioner must introduce the plan for consideration by the creditors and, if applicable, by "the shareholders".

<sup>626</sup> Section 151(2).

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let alone vote at the meeting because their rights will not be directly affected by the plan.

At this meeting the business rescue practitioner must introduce the plan for consideration by the creditors and, if applicable, by the shareholders.<sup>627</sup> He must also inform the meeting whether he continues<sup>628</sup> to believe that there is a reasonable prospect that the company can be rescued. This provision assumes that the practitioner had expressed a positive view on the company's prospects of being rescued when reporting to the first meeting of creditors, and that, if he did not hold that view, he would have terminated the procedure and applied for an order placing the company in liquidation.<sup>629</sup> However, the Act is silent on what the practitioner should do if, in spite of his negative views on the company's future, the creditors vote in favour of continuing the rescue proceedings at their first meeting because they do not agree with his view. It must be remembered that in terms of the Act, a better return for creditors (or shareholders) is also regarded as rescuing the company and the creditors may have reason to believe that rescue proceedings will achieve that.<sup>630</sup> Terminating the rescue attempt at such an early stage and against the wishes of the majority of creditors seems inappropriate and overhasty, but may be inevitable because of the failure of the legislature to provide for this contingency. Although a provisional judicial manager is also required to include his opinion on the prospects of the company becoming a successful concern in his report to creditors, the important difference is that it is intended only to advise the creditors and eventually the court.<sup>631</sup> The final decision whether to continue the judicial management of the company still rests with the court at that stage, because the court has to decide on the return day whether to issue a final judicial management order. Furthermore, the duty to apply to court for an order terminating judicial management if he believes that

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<sup>627</sup> Section 152(1)(a). This seems to imply that creditors and shareholders vote at the same meeting – an impression that is further strengthened by s 152(3)(c)(i), which provides that the practitioner must immediately hold (not call) a meeting of shareholders whose rights will be affected, if the creditors approve the plan.

<sup>628</sup> The first occasion at which he has to report on his opinion regarding the prospect of rescuing the company is to creditors at their first meeting which has to take place within ten days after his appointment: s 147(1)(a)(i).

<sup>629</sup> As he is compelled to do in terms of s 141(2)(a): see part 3.9 below on termination of the business rescue proceedings.

<sup>630</sup> According to the definition of "rescuing the company" in s 128(1)(h): see part 3.1 above.

<sup>631</sup> See s 430(c)(vi) of the Companies Act of 1973 and part 2.5.1 above.

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it will not succeed rests only on the final judicial manager, and therefore arises at a much later stage in the process.<sup>632</sup>

Employees have been given the right to be present at, and make submissions to this meeting before a vote is taken on the plan, but this right must be exercised through their trade union(s), except for employees who are not represented by a trade union, who may personally exercise their rights.<sup>633</sup> In an apparent contradiction of this provision, section 152(1)(c) requires that an opportunity to address the meeting must be provided to the “representatives” of the employees. This could be interpreted as a reference to the committee of employees’ representatives that may be formed,<sup>634</sup> or to the trade unions and representatives of employees who do not belong to a trade union. If the last-mentioned interpretation is correct, it could lead to a long and chaotic meeting where numerous people may insist on exercising their right to address the meeting. Here again, inconsistent and careless phrasing of the provisions have led to uncertainty and lack of clarity.

The practitioner must allow a discussion of the plan and, if any creditors with voting interests<sup>635</sup> propose and second amendments to the plan, or propose that the practitioner should adjourn the meeting to revise the plan, conduct a vote on such motions.<sup>636</sup>

### 3.8.3.3 Approval by creditors

Unless an adjournment has been approved by the required majority of creditors,<sup>637</sup> the practitioner must then call for a vote by the creditors for the preliminary approval of the proposed plan, as amended in terms of any approved motion.<sup>638</sup> If the business rescue plan is supported by creditors holding more than 75 per cent in value of all the creditors who voted, and at least 50 per cent in value of independent creditors, if any, who voted,<sup>639</sup> and no rights of shareholders of any class are altered, this constitutes the final adoption of the plan.<sup>640</sup>

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<sup>632</sup> See s 433(l) of the Companies Act of 1973 and part 2.9 above.

<sup>633</sup> Section 144(3)(e) of the Companies Act of 2008.

<sup>634</sup> In terms of s 144(3)(c).

<sup>635</sup> No provision has been made here or elsewhere for shareholders who have voting rights in respect of the plan, to propose amendments.

<sup>636</sup> Section 152(1)(d).

<sup>637</sup> A simple majority in value of secured and unsecured independent creditors: ss 145(4) and 147(3).

<sup>638</sup> Section 152(1)(e).

<sup>639</sup> Section 152(2).

<sup>640</sup> Section 152(3)(b).

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Although an approval rate of 75 per cent is higher than the norm, it is probably preferable since secured creditors have a vote for the full amount of their respective claims and not only on the unsecured part. This differs from the principles of South African insolvency law where secured creditors are usually given a vote based only on the value of the unsecured part of their claims.<sup>641</sup> The position in company administration under English law is also the more conventional one: a majority of creditors in value present and voting must approve the plan, but the votes of secured creditors are limited to the unsecured parts of their claims. However, secured creditors are protected in that the right of a secured creditor to enforce his security may not be affected by the administrator's proposals unless the secured creditor specifically consents thereto.<sup>642</sup> This solution appears to be far more preferable since it is undesirable to interfere with the rights of a secured creditor without his consent, but also unfair to allow him to vote on a plan to which he will not be bound. Even if secured creditors are bound (which is not absolutely clear from the current provisions of the Act), there would be no reason for them to vote in favour of a plan that postpones payment of their secured claims or converts it into equity or releases the company from payment of the debt or part of it. The company's major creditors will in most cases hold security for their claims and will therefore almost always be in a position to prevent approval of the rescue plan to the detriment of unsecured creditors who will probably be much worse off in a liquidation of the company.

The proviso in section 152(3)(b) that the approval is subject to any conditions on which the plan is contingent is nonsensical. The Act does not provide for conditional approval by the creditors, and if this is a reference to the conditions that must be satisfied before the plan may come into operation,<sup>643</sup> the fact is that these conditions are part of the plan itself and thus also subject to the approval. It is only after the plan

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<sup>641</sup> A secured creditor may vote on the full amount of his claim only in the election of a trustee or when his security is affected: Bertelsmann et al *Mars* at 381-382.

<sup>642</sup> See Chapter 3, part 2.8.3. In Germany as well, secured creditors may only vote if their secured rights will be affected, and then they vote in a separate group: see Chapter 4, part 2.8.3.3. In his proposals for a new South African corporate rescue procedure and based on a comparative study of the law of the United States, Australia, France and Germany, Smits "Corporate Administration" at 104 recommended essentially the same provisions, namely that only unsecured creditors would be able to vote on a rescue plan and that secured creditors could not be forced to give up their security or reduce their claims without their consent.

<sup>643</sup> As allowed by s 150(2)(c)(i) as Part C of the rescue plan: see part 3.8.2.3 above.

has been approved that these conditions, if any, must be fulfilled. Therefore it is not the approval, but the implementation of the approved plan that is contingent on fulfilment of the conditions.

#### 3.8.3.4 Approval by shareholders

If the rights of any shareholders<sup>644</sup> are altered by the plan, the approval by creditors is only a preliminary approval, and the rescue plan must also be approved by the class or classes of shareholders whose rights will be altered.<sup>645</sup> The practitioner must immediately hold a meeting of the holders of these shares and call for a vote to approve the adoption of the proposed rescue plan.<sup>646</sup> The plan will have been finally adopted if the majority of the votes that are exercised at this meeting are in favour of adopting the plan.<sup>647</sup>

If either the creditors or affected shareholders reject the rescue plan, it must be dealt with as stipulated in section 153.<sup>648</sup>

#### 3.8.4 Effects of approval of the business rescue plan

Approval of the rescue plan binds the company, every one of its creditors and each shareholder to the plan, irrespective of whether such a person voted for or against the plan, or even attended the meeting where the plan was considered or, in the case of a creditor, had proved his claim against the company.<sup>649</sup> A creditor is consequently prevented from escaping the effects of the plan on his claim by not taking part in the procedure, and once a rescue plan has been approved and implemented, any creditor to whom the company owed a debt immediately before business rescue

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<sup>644</sup> Section 152(3) again uses the words "holders of the company's securities" although almost certainly intended to refer to shareholders only. The holders of debentures, for example, would have votes as creditors, and it is unlikely that the drafters intended them to have double votes as creditors and as holders of securities.

<sup>645</sup> In terms of s 137(1), no alteration in the classification or status of any issued securities of the company, except by way of a transfer in the ordinary course of business, is allowed during business rescue proceedings, unless authorised by the court or contained in an approved business rescue plan.

<sup>646</sup> Section 152(3)(c)(i).

<sup>647</sup> Section 152(3)(c)(ii)(aa). The same meaningless proviso regarding the satisfaction of any conditions on which the plan is contingent, which is found in the provision dealing with approval by creditors, is also present here: see the discussion of s 152(3)(b) above.

<sup>648</sup> See part 3.8.5 below.

<sup>649</sup> Once again s 152(4) refers to the holder of the company's securities, although obviously meaning its shareholders.

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proceedings started may enforce payment of the debt only to the extent provided for in the rescue plan.<sup>650</sup> Although section 152(4) provides that every creditor will be bound by the adopted business rescue plan, it is unclear to what extent the rights of secured creditors may be altered. It is difficult to believe that a rescue plan could reduce the amount of a secured claim or place any restriction on the enforcement of this security without the specific consent of the relevant creditor. Again, the question then has to be asked whether secured creditors have full voting powers on a plan to which they are not bound in spite of this being patently unfair.

The company, under the direction of the business rescue practitioner, must take all the necessary steps to fulfil any conditions to which implementation of the plan may be subject, and to implement the plan itself.<sup>651</sup> The reference to the company taking the necessary steps is essentially meaningless, since the business rescue practitioner needs neither the cooperation nor the approval of the directors or the shareholders to implement the plan. In so far as it may be necessary to implement an adopted plan, then, if done in accordance with the plan, the practitioner is specifically empowered to issue authorised shares and determine the consideration to be paid therefor.<sup>652</sup> If the shareholders have approved a business rescue plan that provides for the alteration of their rights, the practitioner may also amend the company's Memorandum of Incorporation to authorise the issue of shares not previously authorised, and to determine the preferences, rights, limitations and other terms of such shares.<sup>653</sup> The pre-emptive right to any new issue of shares that an existing shareholder in a private company may have<sup>654</sup> is excluded in respect of shares issued in terms of a business rescue plan unless provided otherwise by the plan.<sup>655</sup> Furthermore, the provisions of sections 112 and 115 which require approval

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<sup>650</sup> Section 154(2). As explained earlier (in part 3.8.2.2), s 154(1), in what can only be described as legislative overkill, provides that a creditor may not enforce payment of that part of his claim that has been discharged in terms of an approved and implemented plan.

<sup>651</sup> Section 152(5) again refers to conditions on which the business rescue plan is contingent although it is obviously the implementation of the plan that would be subject to such conditions.

<sup>652</sup> Section 152(6)(a). The provisions of ss 38 and 40, dealing with the rights of the board to issue authorised shares and determine the issue price, are specifically excluded.

<sup>653</sup> Section 152(6)(b). The subsection also specifically overrides the provisions of ss 16, 36 and 37 that regulate the amendment of the Memorandum, the authorisation for shares in the Memorandum and the determination of rights, preferences, limitations and other terms on which shares may be issued.

<sup>654</sup> In terms of s 39.

<sup>655</sup> Section 152(7).

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by a special resolution of the shareholders for a disposal of all or the greater part of the assets or undertaking of a company, or to implement an amalgamation or merger or scheme of arrangement, have also been excluded if the disposal is in terms of or “contemplated in” an adopted business rescue plan.<sup>656</sup>

The authority given to the business rescue practitioner to issue shares in terms of the plan at least ensures that shareholders will not be able to obstruct the implementation of a plan by refusing to amend the Memorandum or to allow an increase in the number of authorised shares,<sup>657</sup> but also protects their interests by requiring their approval of a plan providing for the authorisation and issue of additional shares which will inevitably dilute their shareholdings. The effectiveness of this protection will, however, depend on how readily the courts will be prepared to set aside their rejection of such a plan.<sup>658</sup>

When the business rescue plan has been substantially implemented, the business rescue practitioner must file a notice to that effect.<sup>659</sup> The Act gives no indication of what would or should be regarded as substantial implementation, and it would therefore be advisable for creditors to stipulate in the plan at what stage it will be regarded as substantially implemented, in order to prevent the business rescue practitioner from abandoning the process before it is completed or nearly completed.<sup>660</sup>

### **3.8.5 Effects of rejection of the business rescue plan**

#### **3.8.5.1 Powers of the rescue practitioner**

##### *3.8.5.1.1 Preparation of a revised rescue plan*

If the plan is rejected by the creditors or, where applicable, by the shareholders, the business rescue practitioner has two options, the first of which is to “seek a vote of approval from the holders of voting interests to prepare and publish a revised plan”.<sup>661</sup>

In this instance, the reference to the holders of voting interests is apparently intended to include only the creditors,<sup>662</sup> because the second option specifically

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<sup>656</sup> Sections 112(1)(a) and 115(1)(a)(ii). Section 118(3) also excludes the provisions in respect of affected transactions if these transactions are in terms of an approved business rescue plan.

<sup>657</sup> As is the case in Germany: see Chapter 3, part 2.8.1.

<sup>658</sup> See part 3.8.5 below on a court’s power to do so.

<sup>659</sup> Section 152(8).

<sup>660</sup> See part 3.8.2.3 above.

<sup>661</sup> Section 153(1)(a)(i).

<sup>662</sup> Contrary to s 151(1) where it also included shareholders: see part 3.8.3.2 above.

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distinguishes between the votes of the holders of voting interests and those of shareholders.<sup>663</sup> This seems to indicate that the practitioner only needs the consent of the creditors to prepare a new plan, even if the plan was rejected by the shareholders. The result of this provision will be that if the creditors vote in favour of the original plan and refuse to approve the development of a new plan, which is almost guaranteed to happen in most of these cases, the practitioner will have to use the second option in respect of the rejection by the shareholders.

If the business rescue practitioner is authorised by the meeting of creditors to prepare and publish a revised plan, the meeting must be concluded immediately after the vote of approval has been given.<sup>664</sup> The practitioner then has ten business days in which to prepare and publish a new or revised plan, and the new plan must again be put through the process prescribed by the Act for publication and consideration of a business rescue plan.<sup>665</sup>

There is no limit on the number of times the meeting of creditors may authorise the practitioner to prepare a revised or new plan, and the court or Commission, as the case may be, to which the practitioner must deliver a monthly report if the proceedings have not ended within three months after being started,<sup>666</sup> does not seem to have the authority to terminate the proceedings *mero motu*. However, it must be assumed that the creditors will not allow the process to continue indefinitely, while the practitioner is also under a duty to take the prescribed steps to terminate the business rescue proceedings if there are no reasonable prospects that the company will be rescued.<sup>667</sup>

#### 3.8.5.1.2 *Application to court to set aside the votes*

The second option available to a practitioner if the rescue plan is rejected is to inform the meeting that “the company”<sup>668</sup> will apply to court to have the result of the vote by the holders of voting interests (the creditors, in other words) or the shareholders, as the

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<sup>663</sup> In s 153(1)(a)(ii).

<sup>664</sup> Section 153(3)(a)(i).

<sup>665</sup> Section 153(3)(a)(ii).

<sup>666</sup> In terms of s 132(3).

<sup>667</sup> Section 141(2). See part 3.9 below on the termination of business rescue proceedings.

<sup>668</sup> Since the responsibility for development, approval and implementation rests squarely on the shoulders of the rescue practitioner (s 140(1)(d)), the application will obviously be brought by the practitioner and on his authority, albeit in the name of the company.



case may be, set aside on the grounds that the decision was inappropriate.<sup>669</sup> Although it is not stated specifically that the application to court will seek to have the votes rejecting the plan set aside, it may be assumed that this is the intention. There are no guidelines on the circumstances in which rejection of the plan will be regarded as inappropriate, and it will be interesting to see how our courts interpret this provision. In most cases these applications would probably be in respect of a rejection of the plan by shareholders, and the question is whether the shareholders' rejection of a plan that was approved by the creditors would automatically be regarded as inappropriate. This would obviously be undesirable because shareholders will lose the little power they have been given to influence the outcome of the business rescue proceedings.

If an application to court is to be made, the meeting must be adjourned for five business days, unless the application to court is made during that time, or until the court has disposed of the application.<sup>670</sup> This provision is anything but clear, but seems to require that the application to court must be brought within five business days. If it is not, the next meeting must take place after the five-day period, but if it is, then the meeting is adjourned until the court has ruled on the matter. Apart from the fact that five days are almost certainly not enough to prepare the documents for the application and file them with the court, the practitioner will presumably have to inform every affected person who is entitled to attend the meeting that it will not take place within five days. It would have been much simpler and more cost-effective to provide that the practitioner must file the application to court within a reasonable time, whether stipulated or not, and that he must call a meeting within a stipulated period after the court has ruled on the application or if he decides to abandon the application.

There is furthermore no indication of the purpose of the meeting: if the court grants the order sought, the plan would presumably be regarded as approved because the votes of the group who rejected it will be nullified. No further voting or other steps are required, and the plan may be implemented. A simple notification to affected persons would surely have been sufficient. If the court dismisses the

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<sup>669</sup> Section 153(1)(a)(ii).

<sup>670</sup> Section 153(2).

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application, it is not clear whether all the other options become available again,<sup>671</sup> or whether the practitioner must merely call for another vote. If none of these apply, the rescue proceedings must be terminated and there is again no need for anything more than a notification to affected persons.

### 3.8.5.2 Powers of affected persons

#### 3.8.5.2.1 *Demanding a revised plan from the practitioner*

The Act offers three possible courses of action if the business rescue practitioner fails to use either of the above options. Firstly, any affected person present at the meeting may put forward a proposal requiring the business rescue practitioner to prepare and publish a revised plan. Once again, this proposal only needs approval by the creditors (“the holders of voting interests”).<sup>672</sup>

The right given to “each holder of any issued security of the company”<sup>673</sup> to propose the development of an alternative plan in accordance with section 153<sup>674</sup> is far more limited than would appear at first sight. Firstly, only an affected person who is present at the meeting may make such a proposal. Since only those shareholders whose rights will be directly affected by the plan may attend the meeting, it is misleading to phrase this provision as if each shareholder would be entitled to make such a proposal. Secondly, the right to propose an alternative plan is limited to exactly that, in other words, to propose an alternative plan. It remains the sole right of creditors to vote on the proposal. If the creditors have voted in favour of the original plan, they will simply reject the proposal for an alternative plan put forward by a shareholder, so that in reality this provision is meaningless and provides only the illusion that shareholders can influence the rescue plan in any way.

Contrary to the almost powerless situation of shareholders, including those whose rights may be directly affected by the plan, trade unions and unrepresented

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<sup>671</sup> Section 153(1)(b), which sets out the powers of affected persons (see part 3.8.5.2 below), specifically provides that these options apply if the practitioner takes no action. In this case he has, although unsuccessfully. Furthermore, s 153(4) specifically provides that in the case of an acquisition of voting rights by others (discussed in part 3.8.5.2.3 below), voting must again take place and all the options in s 153 become available again, while in this instance the Act is silent on this matter.

<sup>672</sup> Section 153(1)(b)(i)(aa).

<sup>673</sup> Again, the drafters probably only intended to include shareholders, and not, for example, debenture holders who would have the substantially stronger rights afforded to creditors.

<sup>674</sup> Section 146(e)(i).

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employees have specifically been given the right to be present at the meeting.<sup>675</sup> They will therefore always be in a position to propose an alternative plan, in addition to any rights they may have as creditors of the company.

The same provisions apply as in the case of the practitioner being the one who requested the drafting of a revised plan, which means that he has ten business days in which to prepare and publish the new plan and this plan must be taken through the whole prescribed process for approval again.<sup>676</sup> Here as well, no limit has been set on the number of times that such a proposal for the drafting of a new plan may be approved.

#### *3.8.5.2.2 Application to court to set aside the votes*

The second possible course of action for affected persons if the practitioner fails to take any action after the plan has been rejected, but again restricted to those who were present at the meeting, is to apply to court for an order setting aside the result of the vote of either the creditors or shareholders on the grounds that it was inappropriate.<sup>677</sup> Theoretically speaking, a shareholder whose rights will be directly affected by the plan and who was thus present at the meeting could rely on this provision to apply to court for the approval of the plan by the creditors to be set aside. There is nothing in the provision itself which excludes this possibility, but such an application is unlikely to succeed. The fact that every trade union and unrepresented employee also have this right could prove to be much more dangerous. Any rescue plan could be delayed and even ruined by trade unions and employees if they are not properly consulted and their cooperation and approval secured before the plan is finalised. In effect, all employees, even those who are not creditors of the company, have been given the right, albeit indirectly, to veto or approve a business rescue plan.

The provisions applicable in the case where the practitioner brings the application to court also apply here. The affected person who intends applying to court must inform the meeting, and the practitioner must adjourn the meeting for five business days or until the court has ruled on the application.<sup>678</sup> In this case the period of five

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<sup>675</sup> Section 144(3)(e).

<sup>676</sup> Section 153(3)(a).

<sup>677</sup> Section 153(1)(b)(i)(bb).

<sup>678</sup> Section 153(2).

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business days is even more unreasonable and all the problems raised above regarding this provision also arise.<sup>679</sup>

#### 3.8.5.2.3 *Acquisition of voting interests*

The third option is open to all affected persons, not only to those who were present at the meeting. If the practitioner does not take any action he is allowed to take after the business rescue plan has been rejected, any affected person or persons acting together “may make a binding offer to purchase the voting interests” of any persons who opposed the adoption of the plan.<sup>680</sup>

Several serious questions and doubts are raised by this provision. The first question that needs to be answered is whether the reference to the acquisition of “voting interests” means that only the votes of dissenting creditors may be acquired, not the votes of shareholders, or whether in this particular case, the voting rights of shareholders are included in “voting interests”. The words “voting interest” are defined in s 128(1)(j) as being the votes to which creditors are entitled on the basis of their claims against the company as determined in terms of s 145(4) to (6).<sup>681</sup> On the face of it this means that the votes of shareholders whose rights will be affected are not included in this option. However, one cannot be certain that this was the intention since section 151(1) refers to “creditors and any other holders of a voting interest” who must be called to the meeting to consider the proposed rescue plan. The answer is found in section 146(e)(ii), which deals with the rights of the company’s shareholders<sup>682</sup> to participate in the business rescue proceedings. This subsection states that each of them is entitled to make “an offer to acquire the interests of any or all of the creditors or other holders of the company’s securities” in terms of section 153. The voting rights of shareholders who oppose the plan may thus also be acquired, but since these rights are attached to the shares, it will in fact be the shares that will be acquired and not merely their voting rights. This makes the rest of this provision discussed below even more ominous.

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<sup>679</sup> See part 3.8.5.1.2 above.

<sup>680</sup> Section 153(1)(b)(ii).

<sup>681</sup> The words “voting rights” are used to denote the rights of holders of the company’s securities to vote on any matter: s 1.

<sup>682</sup> Although the section refers to the holders of the company’s “securities”, this is patently incorrect since many of them would be creditors whose rights to participation are regulated in section 145.

The word “binding” seems to imply that the offer, once made, cannot be retracted or changed, although it is far from clear why this should be the case. An explanatory memorandum or report by the drafters to explain the reason behind this condition would, once again, have been of invaluable help.

Then follows an even more curious condition: the payment offered to purchase the voting interests must be equal to the independently and expertly determined, fair and reasonable estimate of what the holder of the voting interests would receive if the company were to be liquidated. The task of obtaining this valuation is specifically given to the practitioner.<sup>683</sup> The valuation is subject to review, reappraisal and revaluation by the court on application by the holder of the voting interest or the person acquiring it.<sup>684</sup>

This provision can best be described as alarming. The question needs to be asked why the offeror is not allowed to offer more than the liquidation value of the voting interest to make the offer more attractive to the offeree. The liquidation value of a concurrent creditor’s claim, for example, would be close to nil and a share in a company unable to pay its debts would definitely be worthless on liquidation. Such a creditor or shareholder would almost certainly rather attempt to have an amended plan prepared than virtually donating his votes to another person, since there would be no advantage for him in such a transaction. This inexplicable condition now raises the fear that the words “binding offer” referred to above do not apply to the offeror only, but in fact also bind the offeree to the offer. The right of the offeree to apply to court for a review of the valuation would be explained by this interpretation, as he would otherwise simply refuse the offer. It is to be hoped that this is not the intended result of the provision, since the possibilities for abuse and exploitation are endless, but it is almost impossible to say with any certainty what this provision is supposed to achieve.

If such an offer is made, the practitioner must adjourn the meeting for no more than five business days during which period he must amend the plan to reflect the results of the offer.<sup>685</sup> It is not clear what is meant by “the results” of the offer, because all the provisions of sections 152 and 153 will apply afresh at the next

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<sup>683</sup> Ibid.

<sup>684</sup> Section 153(6).

<sup>685</sup> Section 153(4)(a).

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meeting.<sup>686</sup> This means that the plan must be published and voted on as was done previously, although obviously the balance of votes will be different as a result of the acquisition of votes by some affected persons. It is therefore misleading to refer to the results of the offer, as these results will become obvious only after voting has taken place. I would suggest that the provision should merely require the amended plan to reflect details of the offer, the number of votes that have been acquired and by whom. If the plan is rejected again, all the options available in case of rejection as discussed here<sup>687</sup> become available once more.<sup>688</sup>

#### 3.8.5.3 No action taken by either the practitioner or affected persons

If no decision is taken that a revised plan must be prepared, no application is made to court for the setting aside of opposing votes, either at the initiative of the practitioner or an affected person, and no offer for the acquisition of voting interests is made, the business rescue practitioner must without delay file a notice of termination of the business rescue proceedings with the Commission.<sup>689</sup>

### 3.9 Termination of business rescue proceedings

In terms of section 132(2), business rescue proceedings are terminated in one of three ways: by an order of court, by the filing of a notice of termination by the business rescue practitioner, or by the rejection or substantial implementation of a business rescue plan. Although the wording of section 132(2)(a) creates the impression that the court order can either set aside the order or resolution that initiated the proceedings, or convert the proceedings to liquidation proceedings, this is incorrect and misleading. As will appear from the discussion below, an order placing the company in liquidation is always combined with an order setting aside the rescue proceedings. There is no provision for converting these proceedings into liquidation.

No provision has been made for the automatic or compulsory termination of business rescue proceedings after a specified period, but the legislature clearly intended

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<sup>686</sup> Section 153(4)(b).

<sup>687</sup> In part 3.8.5.

<sup>688</sup> In terms of s 153(4)(b), which provides for the application of s 153 at the meeting that must be held to vote on the plan again after an offer for the acquisition of voting interests has been made.

<sup>689</sup> Section 153(5).

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and expected the proceedings to take little more, or maybe even less, than three months in total. As a result, section 132(3) provides that if the proceedings have not ended within three months after commencement, or within a longer period allowed by the court on application by the practitioner, the practitioner must write a report on the progress of the business rescue proceedings and update it on a monthly basis until the rescue proceedings have ended.<sup>690</sup> This report, as well as the monthly updates, must be delivered<sup>691</sup> to each affected person and, if the proceedings have been the subject of a court order, to the court as well.<sup>692</sup> If the last-mentioned condition does not apply, the report and updates must be delivered to the Commission.<sup>693</sup>

The period of three months is fairly unrealistic and would be quite insufficient in most cases, which will result in either a substantial administrative burden for the practitioner, with added costs for the company as a result of this duty, or the costs of applying to court for an extension in order to avoid having to prepare and deliver the monthly updates. A period of 12 to 18 months would have been far more realistic to allow sufficient time for amendments to the rescue plan that may be necessary, as well as for proper implementation of the plan.<sup>694</sup> This provision also creates the risk that the business rescue practitioner will prematurely end his participation in the implementation of the plan to avoid the substantial administrative burden.

The need for stipulating a period at all must also be questioned, since termination never takes place automatically but requires a prescribed action under prescribed circumstances. Unless and until these circumstances are present, it serves no real purpose to attempt to accelerate the procedure. Both the creditors<sup>695</sup> and the employees<sup>696</sup> are entitled to form committees to represent their interests and they would surely be able to monitor the actions of the practitioner to establish whether he

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<sup>690</sup> Section 132(3)(a).

<sup>691</sup> Section 6(11) prescribes the procedure for delivery of documents and allows electronic communication of the document itself or of a notice of the availability of the document. Although the possibility of electronic communication will slightly ease the administrative burden, it still seems to be an unnecessary and costly exercise that will not bring any real advantage to the affected persons.

<sup>692</sup> Section 132(3)(b)(i). The wording creates the impression that reporting to the court will be required if any order of court has been issued in respect of these proceedings, even one as unrelated as an order for the practitioner to provide security, although it is possible that the intention was merely to make it applicable where the actual commencement of the proceedings was as a result of a court order.

<sup>693</sup> Section 132(3)(b)(ii).

<sup>694</sup> In England the period is one year: see Chapter 3, part 2.9.1.

<sup>695</sup> In terms of s 145(3).

<sup>696</sup> In terms of s 144(3)(c).

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is making progress and taking the appropriate action to terminate or finalise the proceedings when required.

### **3.9.1 Termination by order of court**

#### **3.9.1.1 Rescue proceedings started by a board resolution**

The first instance where a court may terminate these business rescue proceedings is when an application is made by an affected person for the business rescue resolution of the board of directors to be set aside.<sup>697</sup> The court may set aside the resolution on any of the stipulated grounds<sup>698</sup> and, where appropriate, may also make an order placing the company under liquidation.<sup>699</sup>

As was explained before, it also appears to be possible for a court to terminate business rescue proceedings that were commenced by a board resolution if an application for the replacement of the business rescue practitioner has been made and not for the setting aside of the resolution to commence business rescue proceedings.<sup>700</sup> If so, an affected person who considers applying for the replacement of the business rescue practitioner would have to carefully consider the unintended consequences that the application may have.

Company directors who started business rescue proceedings by a resolution of the board are not themselves authorised to terminate these proceedings. Only the business rescue practitioner may, and indeed must, apply to court for termination of these rescue proceedings and placing the company in liquidation if, after investigating the company's affairs, business, property and financial situation,<sup>701</sup> or at any time during the business rescue proceedings, he comes to the conclusion that there is no reasonable prospect for the company to be rescued.<sup>702</sup> The court, the company and all affected persons must be informed of this situation, presumably before applying to court, although this is not specifically stated by the applicable provision.<sup>703</sup>

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<sup>697</sup> In terms of s 130(1)(a).

<sup>698</sup> Set out in s 130(5)(a). See the discussion in part 3.5.1.3.1.

<sup>699</sup> Section 130(5)(c)(i).

<sup>700</sup> In terms of s 130(1)(b). See the discussion on s 130(6)(b) in part 3.5.1.3.2.

<sup>701</sup> As he is obliged to do as soon as possible after his appointment: s 141(1).

<sup>702</sup> Section 141(2)(a)(ii).

<sup>703</sup> Section 141(2)(a)(i).



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For some unknown reason, the drafters of the Act deemed it necessary to restate the power of the court to order the liquidation of a company if a reasonable prospect of rescuing the company no longer exists. In spite of section 141(2)(a)(ii) clearly conferring this power and creating a duty on the practitioner to apply for such an order, section 81(1)(b), which deals with the liquidation of solvent companies, provides that a court may order a solvent company to be wound up if the practitioner has applied for liquidation in terms of section 141(2)(a) on the grounds that there is no reasonable prospect of the company being rescued. Apart from being completely unnecessary, section 81(1)(b) also creates substantial confusion, as it is difficult to believe that a company with no reasonable prospects of being rescued could still be solvent. The next logical question raised by this inexplicable provision is whether, and if so, why the power to liquidate insolvent companies is conferred on the courts by section 141(2)(a), but not to liquidate solvent ones, although it contains no requirement that the company must be insolvent.

The business rescue practitioner may not be appointed as the liquidator of the company if the company is liquidated when the business rescue ends.<sup>704</sup>

### 3.9.1.2 Rescue proceedings started or confirmed by an order of court

Unless a business rescue plan has been rejected, or adopted and implemented,<sup>705</sup> business rescue proceedings that were commenced by an order of court<sup>706</sup> can be terminated only by an order of court.<sup>707</sup>

Just as in the case of business rescue proceedings started by a board resolution, the business rescue practitioner must apply to court for an order discontinuing the proceedings and placing the company in liquidation if, after investigating the company's affairs, business, property and financial situation,<sup>708</sup> or at any time during the business rescue proceedings, he comes to the conclusion that there is no reasonable prospect for the company to be rescued.<sup>709</sup> The impression created by section 132(2)(a) that setting aside the business rescue order or converting the

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<sup>704</sup> Section 140(4).

<sup>705</sup> See part 3.9.3 below.

<sup>706</sup> In terms of s 131, discussed in part 3.5.2 above.

<sup>707</sup> In terms of s 132(2)(a)(i).

<sup>708</sup> As he is obliged to do as soon as possible after his appointment: s 141(1).

<sup>709</sup> Section 141(2)(a).

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proceedings to a winding up are alternatives is not correct since in all instances where a court may order liquidation, the Act clearly states that the business rescue proceedings must first be terminated or discontinued.

The practitioner must also apply for an order terminating business rescue proceedings that were started or confirmed by an order of court,<sup>710</sup> if at any time he comes to the conclusion that reasonable grounds to believe that the company is financially distressed no longer exist.<sup>711</sup>

### **3.9.2 Termination by filing a notice**

A business rescue practitioner may also terminate business rescue proceedings by simply filing a notice to that effect with the Companies and Intellectual Property Commission.<sup>712</sup> There are two instances in which a practitioner may file such a notice.

The first one is where the business rescue proceedings were initiated by a resolution of the board of directors and the practitioner concludes that there no longer are reasonable grounds to believe that the company is financially distressed.<sup>713</sup> Since the Act is silent on what will or should happen after such a notice has been filed, it must be assumed that the company will return to its pre-business rescue situation without any further formalities.

The second possibility applies to all business rescue proceedings if a business rescue plan has been rejected by the creditors or shareholders, where applicable, and none of the possible actions provided by section 153(1) have been taken by either the business rescue practitioner or any affected person. In such a case the practitioner must promptly file a notice of termination of the business rescue proceedings with the Commission.<sup>714</sup> However, section 132(2)(c)(i) also provides for this possibility by stating that rejection of the plan and failure by any affected person to use the options provided by section 153 will terminate business rescue proceedings. These two provisions not only regulate exactly the same situation, but contradict each other: according to section 132(2)(b), the business rescue proceedings are terminated by the filing of the notice of

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<sup>710</sup> In terms of ss 131 and 130 respectively.

<sup>711</sup> In terms of s 141(2)(b)(i). See part 3.9.2 below for the procedure where proceedings were started by a board resolution.

<sup>712</sup> As provided for in s 132(2)(b).

<sup>713</sup> Section 141(2)(b)(ii).

<sup>714</sup> Section 153(5).

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termination, while in terms of section 132(2)(c)(i), they are terminated by the mere inaction of the affected persons.

The situation is further complicated unnecessarily by section 81(1)(c)(i), which provides for the liquidation of a (solvent) company by the court on application by one or more of the company's creditors. The grounds stipulated in this subsection for the order are that business rescue proceedings have been terminated in terms of section 132(2)(b) or (c)(i), which refer to the above two instances where a practitioner may file a notice of termination, and it appears to the court that it is just and equitable in the circumstances for the company to be wound up.

It is understandable that provision should be made for the liquidation of a company if the business rescue plan has been rejected and nobody has taken any steps to resolve the deadlock. The company is most probably already insolvent and/or unable to pay its debts or will soon be, and allowing the creditors to have it liquidated without the need to prove any of the usual grounds for insolvent liquidation provides a quick and effective solution to the problem. The reference in section 81(1)(c)(i) to section 132(2)(c)(i) is thus correct. What is not clear, however, is why the termination of business rescue proceedings because the company is no longer in financial distress should also expose the company to the risk of being liquidated on the application of creditors. The additional requirement that it must appear just and equitable to the court for the company to be wound up may act as some safeguard, but considering the historical approach of the courts in favouring creditors, it is uncertain to what extent a company will be protected. The reference to section 132(2)(b) is thus not only unnecessary but could result in unfair and quite possibly unintended consequences for the company.

### **3.9.3 Termination as a result of rejection or implementation of a business rescue plan**

Although the rejection of a rescue plan and failure by any affected person to extend the proceedings in terms of any of the options provided by section 153 is stated as one of the ways in which business rescue proceedings are terminated,<sup>715</sup> this is not

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<sup>715</sup> In s 132(2)(c)(i).

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correct in terms of other provisions of the Act. As explained above,<sup>716</sup> the mere rejection and inaction by affected persons do not terminate the proceedings. They are terminated by the notice of termination of business rescue proceedings that must be filed by the practitioner.<sup>717</sup> This possibility is already covered by the provisions of section 132(2)(b).<sup>718</sup>

However, the second possibility mentioned in this subsection does terminate business rescue proceedings. This is when a business rescue plan has been adopted as prescribed by the Act,<sup>719</sup> and the practitioner has filed a notice of substantial implementation of the plan.<sup>720</sup> There is no indication of what would objectively be regarded as substantial implementation, neither is there any provision for some form of control over this decision by the practitioner. The sole decision on whether the rescue plan has been substantially implemented thus lies with the business rescue practitioner. It would have been preferable to require full implementation or at least that the plan must specify the test for substantial implementation.

### **3.10 Evaluation of business rescue proceedings**

The new business rescue proceedings presented the legislature with an opportunity to design a rescue procedure that would avoid all the pitfalls and weaknesses that had been identified not only in judicial management, but also in comparable procedures such as administration in England. It is clear that this is an attempt to move away from judicial management, but in the process many new problems and uncertainties have been created. Suggestions and recommendations to rectify at least some of them are made in Chapter 5.

The possibility for a company board to commence a formal rescue procedure by simply filing a resolution to that effect and without having to obtain a court order is completely new to South Africa and a major improvement as it will save considerable time and costs. Another improvement is that the required circumstances in which such a resolution may be taken are not as onerous as those for judicial management:

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<sup>716</sup> In part 3.9.2.

<sup>717</sup> In terms of s 153(5).

<sup>718</sup> Discussed in part 3.9.2 above.

<sup>719</sup> Discussed in part 3.8.3 above.

<sup>720</sup> Section 132(2)(c)(ii).

the test throughout is one of a reasonable belief or reasonable likelihood, rather than a probability. The board can also appoint a business rescue practitioner in whom they have confidence and are not compelled to accept one nominated by creditors as would be the case in proceedings commenced by an order of court as well as currently in judicial management.

However, there are many unclear provisions and a lot of unnecessary administrative duties, such as notification to all affected persons of every development. The preference rights given to employees may also present problems and it remains to be seen whether company boards will embrace the new procedure or choose other options, such as informal arrangements or even liquidation, exactly as they have done before.

Creating a successful and acceptable business rescue procedure in a creditor-friendly system, which South Africa most certainly is, is always difficult<sup>721</sup> and this has been proved by our history with judicial management. It is therefore regrettable that the drafters of the provisions regulating the new rescue proceedings did not exercise more care in constructing the new procedure to avoid introducing principles and provisions that are completely foreign and indeed in conflict with our established common law.

Frisby<sup>722</sup> argues convincingly that an insolvency system arises out of existing cultural conditions and attitudes, and how debt and debt forgiveness is viewed in a specific country. It should reflect the legal, historical, political and cultural context of the country that has developed it. In so far as business rescue proceedings also deal with unpaid debts and discharge of debts, the same principles apply here and the danger exists that the business rescue proceedings, in spite of the legislature's best intentions, will not find acceptance because of the many new and foreign principles introduced. The new procedure has many positive aspects, but these may be overshadowed by the negative ones unless they are rectified in time.

## **4 COMPROMISE WITH CREDITORS**

### **4.1 Introduction**

Section 311 of the Companies Act of 1973 provides for a compromise or arrangement

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<sup>721</sup> Finch *Corporate Insolvency* at 245.

<sup>722</sup> "History and Culture in Bankruptcy" at 4.

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between a company and its creditors or members or any class of them. Although this section does not apply only in instances of insolvency or financial difficulties, it is often used as a way to rescue a company in financial distress by reaching a compromise with creditors and, where necessary, with members of the company.<sup>723</sup>

The procedure entails an application to the High Court by the company, a creditor, a member, the (provisional) liquidator if the company is being wound up or the (provisional) judicial manager if the company is under judicial management, for an order directing that a meeting of the creditors or members (or class of creditors or members) of the company be summoned to consider a proposed compromise.<sup>724</sup>

If the court grants the order, a notice summoning the meeting must be sent to the creditors or members concerned, accompanied by a statement explaining the effect of the compromise, stating all relevant information regarding the value of debentures concerned in any arrangement and stating any material interests of directors of the company, whether as directors, members or creditors of the company and the effect thereon of the compromise if it differs from the effect on similar interests of other persons.<sup>725</sup> These are the only prescribed contents for the proposal of a compromise or arrangement, leaving a substantial degree of freedom to the persons making the proposal to design a proposal according to the relevant circumstances. Generally speaking, the proposal must contain sufficient information to enable those persons entitled to vote on it to exercise informed votes, taking into consideration their alternative options, but this information will vary according to the circumstances of each case and the availability of information.<sup>726</sup> The notice summoning the meeting must also be advertised and if the statement is not included, the advertisement must indicate where and how copies may be obtained by creditors.<sup>727</sup>

If the compromise is agreed to by a majority in number and three-fourths in value of the creditors or class of creditors, or a majority representing three-fourths of the votes exercisable by the members or class of members, present and voting in person or by proxy at the meeting convened for this purpose,<sup>728</sup> the applicant must approach the court

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<sup>723</sup> Kloppers "Judicial Management" at 428; Smits "Corporate Administration" at 86.

<sup>724</sup> Section 311(1).

<sup>725</sup> Section 312(1)(a).

<sup>726</sup> Blackman et al *Companies Act* at 12-60 - 12-61.

<sup>727</sup> Section 312(1)(b).

<sup>728</sup> Section 311(2)(a) and (b).

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again to sanction the compromise. The court has a discretion whether to sanction the compromise, even if the required majority has voted in its favour,<sup>729</sup> but once the compromise has been sanctioned by the court, it will be binding on all creditors or class of creditors (or members) and also on the company or, if applicable, the liquidator or judicial manager.<sup>730</sup> A compromise or arrangement in respect of a company that is being wound up may also provide for the discharge of the winding-up order,<sup>731</sup> which is one of the ways in which a section 311 compromise can be used to rescue a company in distress.

The advantages of this compromise procedure are that it may be used outside of any formal insolvency procedure, thus avoiding the stigma of insolvency, and that the unanimous agreement of all the creditors or members concerned is not required to make it binding on them all, although they are adequately protected by the requirement of sanctioning by the court. Even dissenting creditors or members are thus bound to the compromise if the required majority have voted in its favour and the court has given its approval. Another advantage, at least from the perspective of the board, is that the current management of the company is not displaced but remains in control of the company.

The disadvantages are that it is a costly and onerous process because of the involvement of the High Court<sup>732</sup> and, unless it takes place while the company is in liquidation or under judicial management, there is no moratorium in place to protect the company against enforcement actions by creditors or even an application for winding up, until the compromise is approved by the court. As a result of the strictly prescribed procedure and the involvement of the court on two occasions, the period of the company's vulnerability could last several weeks.

## **4.2 Compromise between a company and its creditors under the Companies Act of 2008**

A new compromise procedure has now been created by section 155(2) of the

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<sup>729</sup> Meskin et al *Henochsberg* at 623.

<sup>730</sup> Section 311(2). Strictly speaking this section is not correct, since the sanctioning order will have no effect until it has been registered by the Registrar of Companies: s 311(6)(a).

<sup>731</sup> Section 311(4). See Meskin et al *Henochsberg* at 606(1) for a discussion of the controversy that existed in this regard on whether a court could sanction such a scheme involving the termination of the winding up if the company would remain insolvent after such termination.

<sup>732</sup> Burdette "Business Rescue Model (Part 1)" at 251 also points out that the substantial body of case law on s 311 compromises is an indication of its complexity.

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Companies Act of 2008, which provides that the board of a company or the liquidator of a company being wound up may propose an arrangement or a compromise of the company's financial obligations to all its creditors or to all the members of any class of its creditors. Although section 155(2) refers to both a compromise and an arrangement, the drafters of these provisions do not seem to have appreciated the fact that there is a difference between a compromise and an arrangement.<sup>733</sup> The word "arrangement" appears to have been regarded as merely an alternative term for a compromise. This impression is reinforced by the fact that the headings to both this part of Chapter 6 and section 155 itself refer only to a compromise, and the word "arrangement" is used only in section 155(2) and again in section 155(9), the very last subsection in this part of the Act, which refers to the liability of a surety of the company and does not in any way regulate the compromise or arrangement itself. This discussion will therefore follow the wording of the legislation and also refer only to a compromise.

A major difference between the current section 311 compromise and the new compromise procedure is that the current compromise with creditors and members has been split into two completely separate procedures in the Companies Act of 2008. Provision is made in section 114 of the Act for a scheme of arrangement between a company that is not in liquidation or business rescue, and the holders of its securities or any class of them. This section is found in Chapter 5 dealing with fundamental transactions, takeovers and offers, while the new procedure for a compromise between a company and its creditors is found in Chapter 6, following immediately after the provisions regulating business rescue proceedings.<sup>734</sup> The last-mentioned procedure is thus clearly intended as an alternative to business rescue proceedings and is therefore comparable to the procedure of company voluntary arrangements in England.<sup>735</sup>

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<sup>733</sup> Apart from the fact that an arrangement is more usually between a company and its members, while a compromise is usually between a company and its creditors (see Meskin et al *Henochsberg* at 604), arrangements are much wider and include any arrangement (that could be done by agreement between the company and each individual creditor or member) affecting the rights between the company and its members (or creditors) that is not ultra vires the company or contrary to the law: Meskin et al *Henochsberg* at 603; Blackman et al *Companies Act* at 12–5 -12–6. As a result of the strict prescriptions regarding the contents of the proposals (see part 4.4 below), this is not possible under the new provisions.

<sup>734</sup> In s 155.

<sup>735</sup> The company voluntary arrangement (or CVA) is also a dedicated corporate rescue procedure and therefore regulated by the Insolvency Act 1986: see further Chapter 3, part 3. The current procedure



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By excluding the participation of shareholders from this new procedure, any part of the proposal that requires the consent of shareholders will have to be obtained by a separate process, either by using the procedure of a scheme of arrangement with shareholders (which will not be possible if the company is in liquidation),<sup>736</sup> or by calling a general meeting and obtaining the required consent as prescribed by the Act. Although section 155 specifically provides for the possibility of a proposal that debt will be converted to equity, the drafters do not seem to have foreseen the possibility that the cooperation or approval of shareholders may be required in some cases.<sup>737</sup>

Another important difference is that the new compromise procedure requires only one application to court, namely to approve the compromise once the proposal has been adopted by the required majority of creditors.<sup>738</sup> It will therefore no longer be necessary to seek the court's permission to arrange the meeting where the proposed compromise will be discussed and voted on. This may render the procedure slightly less expensive than the one required by section 311 of the Companies Act of 1973.

Although there are some similarities between the new compromise procedure and company voluntary arrangements in England, it does not appear as if the drafters of the South African legislation took note of the more than 20 years of experience gained in England with company voluntary administrations. The South African procedure does not provide for a moratorium against enforcement actions by creditors in the period between the delivery of a proposal and its approval by the court, even though the lack of a moratorium was identified as a major weakness in company voluntary administrations and subsequently rectified by amending legislation.<sup>739</sup> The requirement that a proposal approved by the affected creditors should be sanctioned by the court to make it binding is also not found in company voluntary arrangements and is probably a remnant from the section 311 procedure. The additional costs resulting from this requirement will contribute to making the procedure too costly for small companies and seem unnecessary considering the high percentage of votes required for approval by

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in terms of s 311 of the Companies Act of 1973, on the other hand, closely resembles the scheme of arrangement between a company and its creditors or members in terms of s 895 of the English Companies Act 2006, which also does not require an impending insolvency: Finch *Corporate Insolvency* at 479ff.

<sup>736</sup> Section 114(1).

<sup>737</sup> See part 4.4.2 below.

<sup>738</sup> See part 4.5.3 below.

<sup>739</sup> See Chapter 3, part 1.

creditors.<sup>740</sup> However, the compromise with creditors has one advantage over company voluntary arrangements, namely that the board of directors are in charge of the whole procedure and not an outsider<sup>741</sup> whose fees and expenses invariably add to the costs of the procedure.

### **4.3 Entities to which a compromise applies**

In terms of section 155(1) of the Companies Act of 2008, the compromise provisions apply to any company, irrespective of whether the company is financially distressed<sup>742</sup> or not, unless the company is engaged in business rescue proceedings in terms of Chapter 6. Companies engaged in business rescue proceedings are excluded for the obvious reason that any compromise reached during this procedure must be part of the business rescue plan which, as indicated below, is very similar in form as prescribed by the Act.<sup>743</sup> Although not specifically stated here, it can be deduced from other subsections that the compromise procedure is available to a company that is in liquidation.

The specific provision that a company need not already be in financial distress to make use of this procedure must be taken to indicate an intention on the part of the legislature to provide a solution which can be used by companies before their financial difficulties have reached the point of actual financial distress. This is probably an acknowledgement of the fact that the existing section 311 compromise has been used more extensively and successfully as a corporate rescue measure than judicial management has. Unfortunately, however, as will be shown in the discussion below, it is questionable whether this new compromise procedure will prove to be a popular successor to the section 311 compromise.

### **4.4 Prescribed contents of a proposal**

The prescribed minimum contents that a compromise proposal must contain are almost identical to those for a business rescue plan. This means that almost all the

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<sup>740</sup> See part 4.5.2 below.

<sup>741</sup> In company voluntary arrangements a nominee is initially appointed, and may be replaced by another person as supervisor to supervise the execution of an approved arrangement: Chapter 3, parts 3.5.1 to 3.5.4.

<sup>742</sup> As defined in s 128(1)(f).

<sup>743</sup> See parts 3.8.2 above and 4.4 below.

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problematic, ambiguous and baffling provisions identified in respect of the prescribed contents of a business rescue plan are repeated here. It also causes a number of unnecessary complications to a procedure that should ideally be straightforward, informal and flexible.

The proposal for a compromise must contain all information reasonably required to assist creditors in deciding whether or not to accept or reject the proposal.<sup>744</sup> The proposal must also be divided into three parts similar to those prescribed for a rescue plan:

#### **4.4.1 Part A - Background**

In terms of section 155(3)(a), this part must contain at least the following information:

- (i) A “complete list of all the material assets of the company” and “an indication as to which assets are held as security by creditors” on the date of the proposal.<sup>745</sup> As was mentioned in the discussion of this item in a rescue plan, it is unclear whether the word “material” refers to important or valuable assets only, without any indication of what the threshold value should be, or whether it was intended to include only corporeal assets. Once again, although no valuation of these assets is required, it must be assumed that a valuation should be included.<sup>746</sup>
- (ii) A complete list of the creditors of the company as on the date of the proposal and an indication which creditors would qualify as secured, statutory preferent and concurrent in terms of insolvency law. It must also indicate which creditors have proved their claims.<sup>747</sup> By all appearances this provision, also found in the requirements for a business rescue plan, was simply repeated without giving any thought to the different circumstances prevailing in a compromise. If the company is not in liquidation, there would not as yet have been any meetings of creditors or proof of claims at this stage, and it is thus unclear whether in such a case all claims must automatically be regarded as proven, or creditors should be required to prove or confirm their claims by some process, or whether this part of the

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<sup>744</sup> Section 155(3).

<sup>745</sup> Section 155(3)(a)(i).

<sup>746</sup> The word “list” does not usually automatically include valuations as well, unlike the word “inventory” which, at least in legal terminology, does, and would thus have been a better choice: see, for example, ss 9 and 27 of the Administration of Estates Act 66 of 1965.

<sup>747</sup> Section 155(3)(a)(ii).

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provision must simply be ignored.<sup>748</sup> It seems an unnecessary complication of the procedure, apart from the fact that, if creditors have to prove their claims by some prior process, they will be alerted to the company's financial difficulties before the compromise is ready for their consideration. Since the company need not necessarily be in liquidation or financial distress to enter into a compromise, the reference to rules of insolvency seems inappropriate and unnecessary.

- (iii) The probable dividend that creditors would receive in their specific classes if the company were placed in liquidation.<sup>749</sup> Since a compromise may also be proposed by the liquidator of a company that is already in liquidation,<sup>750</sup> the wording of this provision has clearly not been given any serious thought. A fairly small change in the wording would cover both possibilities. The estimated dividend will obviously be more accurate in the case of a company that is already in liquidation. Although only the probable dividend has to be provided, the possibility that it may be impossible to do so, particularly if the company is not yet in liquidation, has obviously not been considered. This is unfortunate, and may lead to "rash prophesies, misleading creditors by their unwarranted optimism or pessimism, or stand in the way of an unduly high proportion of proposals."<sup>751</sup>
- (iv) A complete list of the holders of the securities issued by the company, and the effect, if any, that the proposal would have on them.<sup>752</sup> Apart from being extremely impractical and costly, as was pointed out in the discussion of the business rescue plan,<sup>753</sup> this provision is even more unnecessary and meaningless than in a rescue plan. In most cases a compromise would not affect the shareholders<sup>754</sup> at all, as it usually provides for a moratorium on payments, partial discharge of claims and other purely creditor-related issues. In those cases where shareholders will be

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<sup>748</sup> See Chapter 3, part 3.5.4 regarding the CVA procedure in England where every creditor who has notice of the meeting is entitled to vote according to the amount of his debt, subject to the right of the chairman of the meeting to accept or reject a claim (Insolvency Rule 1.17). No formal proof of claims is required.

<sup>749</sup> Section 155(3)(a)(iii).

<sup>750</sup> Section 155(2).

<sup>751</sup> Per Didcott J in *Ensor NO v South Pine Properties (Pty) Ltd* 1978 (2) SA 755 (N) at 761 explaining why it could not be an absolute requirement that a company should in all cases supply this information in a proposed compromise in terms of s 311, since it would often be too soon to predict the outcome of a winding up with much confidence, even if the company is already in provisional liquidation.

<sup>752</sup> Section 155(3)(a)(iv).

<sup>753</sup> See part 3.8.2.1 above.

<sup>754</sup> "Holders of securities" in this instance is logically taken to mean only shareholders.

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affected, for example where shares will be issued to creditors in payment of their claims, this has to be specifically set out in Part B of the proposal.<sup>755</sup> The shareholders are not involved in the compromise: they do not vote on it, even if their rights are affected, and it is not binding on them after approval by the creditors and confirmation by the court.<sup>756</sup> Should their approval or cooperation be required for any part of the compromise, this will have to be stipulated as a condition for the proposal to come into operation or be implemented, which has to be set out in Part C of the proposal.<sup>757</sup>

- (v) “[W]hether the proposal includes a proposal made informally by a creditor of the company”.<sup>758</sup> This is another example of the mindless repetition of a requirement for the business rescue plan. Whereas the right to participate in the business rescue proceedings informally by making proposals for a business rescue plan to the practitioner is specifically given to every creditor,<sup>759</sup> there is no such provision in relation to a compromise. It is difficult to imagine any situation where a creditor will make a proposal for a compromise, but even in the unlikely event that this should happen, there does not seem to be any good reason why this should be specifically mentioned in the proposal. If the proposal is acceptable to the required majority of creditors, it surely makes no difference who the originator of the proposal was, and may merely cause other creditors to be suspicious about a proposal that is inherently sound.

The general impression of Part A is that there is again a tendency by the drafters to over-regulate, to include provisions without any discernible reason and to complicate unnecessarily what could and should have been a procedure designed to assist companies in coming to a quick and cost-effective solution to their financial difficulties.

#### **4.4.2 Part B - Proposals**

In terms of section 155(3)(b), Part B must include at least the following:

- (i) The “nature and duration of any proposed debt moratorium”. This is one of the

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<sup>755</sup> Section 155(3)(b)(ii) discussed in part 4.4.2 below.

<sup>756</sup> See part 4.5 below.

<sup>757</sup> See part 4.4.3 below.

<sup>758</sup> Section 155(3)(a)(v).

<sup>759</sup> Section 145(1)(d).

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important ways in which a compromise can assist in giving a company some time to overcome its difficulties. In most cases, however, this would probably have to be combined with at least a partial discharge of debts.

- (ii) The “extent to which the company is to be released from the payment of its debts, and the extent to which any debt is proposed to be converted to equity in the company, or another company”. In most compromises at least one of these two measures will be found but since this compromise, unlike the section 311 compromise of the Companies Act of 1973, does not provide for the possible inclusion of shareholders in the process, any proposal for the conversion of debt to equity will have to be made subject to the condition that the requirements for the issue of these shares can be fulfilled.<sup>760</sup> It is regrettable that the drafters of this provision, when deciding to exclude shareholders from the procedure, did not consider the difficulties it may present if shareholders are not bound. The scheme of arrangement with shareholders created in section 114 is not applicable to a company in liquidation.<sup>761</sup> Since the scheme of arrangement with shareholders also requires approval by a special resolution,<sup>762</sup> there does not appear to be any advantage in following this procedure, even if it were possible, to obtain the necessary approval of shareholders in cases where it is required for a compromise to become effective.
- (iii) The “treatment of contracts and [the] ongoing role of the company”. The reason for the first part of this item is impossible to explain. Firstly, it is unclear why contracts should be separated from other liabilities of the company. If the company is unable to effect payment or any other performance in full, the compromise offer should

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<sup>760</sup> The board may take a resolution to issue authorised shares without having to obtain the approval of shareholders (s 38(1)), unless the shares are issued to a current or future director or prescribed officer of the company, to a person related to the company, a director or prescribed officer of the company, or to a nominee of any of these persons, in which case approval by special resolution of the shareholders is required (s 41(1)). This approval is also required if shares will be issued that carry voting powers equal to or exceeding 30 per cent of the voting powers of existing shareholders of that class (s 41(3)). The exclusion of shareholders from the insolvency plan in German law has been identified as one of its major weaknesses, since they are not bound by the plan and their refusal to give their consent where required could undermine the process: see Chapter 4, part 2.8.1. In England, by contrast, provision is made for the approval of a company voluntary arrangement by creditors and members, irrespective of whether the rights of members will be directly affected, and members are bound by any voluntary arrangement approved by creditors: see Chapter 3, part 3.5.4.

<sup>761</sup> Section 114(1).

<sup>762</sup> Section 115(2)(a).

surely include some provision such as the partial discharge or moratorium in respect of this obligation just like any other liability. If the company is in liquidation, the compromise will almost certainly provide for the discharge of the winding-up order if the compromise is approved. In such a case, the company will continue to be bound to perform in terms of uncompleted contracts except to the extent that the compromise specifically provides for a moratorium or a discharge of part of the payment or performance by the company. Neither the liquidator nor, after discharge of the winding-up order, the directors, have the right to cancel or suspend any contracts, and the company will be liable for damages for breach of contract if it does. If the company is not in liquidation, the same principles apply. It would therefore be extremely shortsighted not to include the liabilities or obligations under uncompleted contracts in any proposal for a discharge or moratorium.

The requirement that the ongoing role of the company must be explained, presumably applies to a company that is in liquidation and whether it intends applying for a discharge of the winding-up order, although this is not specifically allowed as is presently done by section 311(4) of the Companies Act of 1973. It is unclear what could be intended in the case of a company that is not in liquidation and probably enters into a compromise in order to continue trading. The future of the company will surely become clear from the important part of the proposal dealing with obligations to the creditors and how these will be met.

- (iv) The property of the company that will be made available for the payment of creditors' claims. Considering the fact that the compromise will usually contain a proposal for the payment of a specified portion or percentage of each claim, it seems unnecessary to list specific assets that will be used. Furthermore, the proposal may be to pay from future income of the company. If specific assets are indicated, the question arises whether the company could be forced to use additional assets that were not listed, if the proceeds of the assets chosen for this purpose prove not to be sufficient.
- (v) The "order of preference in which the proceeds of property of the company will be applied to pay creditors if the proposal is adopted". Since the proposal must already contain details of any debt moratorium, as well as what part of each claim will be paid, this seems an unnecessary duplication.

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- (vi) The benefits (for creditors) of adopting the proposal as opposed to the benefits that creditors would receive if the company were placed in liquidation. As pointed out before, however, the company may already be in liquidation, and the wording should reflect this possibility.

#### **4.4.3 Part C - Assumptions and conditions**

In terms of section 155(3)(c), Part C must include at least the following:

- (i) A statement of any conditions that must be satisfied for the proposal to come into operation and be fully implemented.<sup>763</sup> This is where any approval of shareholders, if required, for the issue of authorised shares or for the sale of their shares would have to be stipulated. Should the proposal provide for a sale by the company of all or the greater part of its assets or undertaking, the approval of shareholders by a special resolution will also be required and will have to be mentioned here.<sup>764</sup> The question could of course be asked whether creditors will approve a compromise if it is subject to conditions that may not be fulfilled. The board would probably have to ensure that these conditions will be fulfilled before approaching the creditors with their proposals.
- (ii) Any effect that the plan<sup>765</sup> may have on the number of employees, as well as on their terms and conditions of employment. The reason for this requirement is almost impossible to establish. It is difficult to see how a compromise or agreement between the company and its creditors would be able to influence the number of employees or alter their terms and conditions of employment. Any retrenchments or transfer of employment contracts resulting from a sale of the business or its assets will be determined by the provisions of labour legislation, and most certainly not by the compromise. Furthermore, no compromise could have any direct effect on the terms or conditions of employment of employees, since negotiations and agreement to any such amendments would also have to be conducted in terms of labour legislation. This provision is not only completely

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<sup>763</sup> Section 155(3)(c)(i).

<sup>764</sup> Section 112(2)(a). The provisions of the Act in this regard are not excluded by ss 112(1) and 115(1)(a)(ii) as in the case of a business rescue plan.

<sup>765</sup> Section 155(3)(c)(ii) uses the word “plan”, clearly illustrating that the drafters simply carried over this provision from those regulating the contents of the business rescue plan without much thought going into whether it was appropriate or not.



unnecessary but also displays a lack of any real consideration of or attention to the effect that a compromise could possibly have on employees.

- (iii) A “projected balance sheet for the company ... and a statement of income and expenses for the [next] three years, prepared on the assumption that the proposal is accepted”. Both these documents “must include a notice of any significant assumptions on which the projections are based” and “may include alternative projections based on varying assumptions and contingencies”.<sup>766</sup> In the absence of a proper explanatory report, this requirement seems to be completely unnecessary and all the objections raised in respect of this requirement for a business rescue plan<sup>767</sup> apply with even more force in this instance. Apart from the guesswork and expenses required to compile these documents, the inevitable question is why creditors should be interested in these fairly unreliable figures, for a period of three years in the future, when they agree to accept a reduced or late payment of their claims which, once paid, would terminate their relationship with the company.

#### **4.4.4 Certificate**

A proposal for a compromise “must conclude with a certificate by an authorised director or prescribed officer of the company stating that any ... factual information provided [in the proposal] appears to be accurate, complete, and up to date, [while] projections provided are estimates made in good faith on the basis of factual information and assumptions as set out in the statement”.<sup>768</sup> In the case of a company that is being wound up, it must be assumed that the liquidator will be the appropriate person to sign the certificate, although it is not mentioned in this provision.

### **4.5 Procedure**

#### **4.5.1 Notice of proposal**

A copy of the proposal and notice of a meeting to consider the proposal must be delivered by the liquidator or board of directors proposing the arrangement or

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<sup>766</sup> Section 155(4).

<sup>767</sup> See part 3.8.2.3 above.

<sup>768</sup> Section 155(5).

compromise, to every creditor of the company or every member of the relevant class of creditors whose name or<sup>769</sup> address is known to, or can reasonably be obtained by, the company and to the Commission.<sup>770</sup> There is no indication of how long before the meeting this notice should be delivered, and it remains to be seen whether some courts will refuse to sanction the proposal because creditors were not given sufficient prior notice.

#### **4.5.2 Adoption of the proposal**

A proposal will have been validly adopted by the creditors of the company or the members of the relevant class of creditors, if it is approved by a majority in number, representing at least 75 per cent in value of the creditors or class of creditors, present and voting in person or by proxy at the meeting called for that purpose.<sup>771</sup>

No distinction is made here between secured, preferent and concurrent creditors. This means that all creditors have the right to vote on the full value of their claims, including the secured parts of their claims.<sup>772</sup> However, it is not clear whether this means that the rights of secured and preferent creditors may also be amended by a general compromise applicable to all creditors. Since section 155(2) provides for a proposal to all the creditors of the company, it must be assumed that it is indeed possible. This raises the question whether voting must take place separately in each class of creditors where secured and unsecured creditors are involved. There is nothing in the relevant provisions that indicates such a requirement, because the references to meetings of a class of creditors appear to refer to instances where the proposal is made only to a class of creditors and not to all creditors.<sup>773</sup> This is a most unsatisfactory situation since it is an accepted principle that the rights of secured

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<sup>769</sup> Although it is more usual to include only creditors whose names and addresses are known (as in s 147(2) in respect of business rescue proceedings), s 155(2) specifically uses the word “or” and it must be assumed that it will be the duty of the person making the proposal to trace a creditor of whom only the name or address is known; unless, of course, this is merely a negligent drafting error.

<sup>770</sup> Section 155(2).

<sup>771</sup> Section 155(6).

<sup>772</sup> This inference is supported by s 145(4)(a), which applies to the whole of Chapter 6 of the Act (in terms of s 128(1)(j)) and in terms of which secured and unsecured creditors have voting rights based on the full value of their claim.

<sup>773</sup> Section 155(7) provides that the court may take into consideration the number of creditors “of any affected class” who voted in favour of the proposal.

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creditors may not be amended without their specific consent.<sup>774</sup> On the other hand, it is also patently unfair that a creditor whose claim is largely secured should be able to vote on the full amount of this claim, and not only on the unsecured part, for a substantial discharge of all unsecured claims.

#### **4.5.3 Approval by the court**

If the proposal has been adopted by the creditors as required by section 155(6), the company may apply to the High Court for an order approving the proposal.<sup>775</sup> The use of the word “may” in this provision is misleading since, judging by the stipulated effects of sanctioning by the court,<sup>776</sup> the proposal will not be binding on the creditors or class of creditors, as the case may be, in spite of their formal approval by the meeting of creditors, unless and until the proposal has been sanctioned by the court. The company must therefore apply to court and it is unclear why the provision does not set it out as a requirement that the company must apply to court to bind the creditors concerned.

The court has a discretion whether to sanction the compromise contained in the adopted proposal.<sup>777</sup> The court may do so if it considers it just and equitable, having regard to, firstly, “the number of creditors of any affected class of creditors, who were present or represented at the meeting, and who voted in favour of the proposal”.<sup>778</sup> Since no provision is made for voting by creditors in their different classes, it is unclear whether the requirement of considering the number of creditors in an affected class refers to those instances where only one class of creditors will be affected, or whether this fairly vague provision should be interpreted to mean that separate voting must take place if more than one class of creditors is involved.

The second factor to be taken into account by the court applies only to a compromise in respect of a company being wound up. In such a case, the court must also consider the report of the Master which is required by the provisions regulating the liquidation of companies.<sup>779</sup> This provision refers to the report that the Master may

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<sup>774</sup> See Chapter 3, part 3.8 regarding the situation in England where secured creditors are expressly excluded from voting with other creditors on a company voluntary arrangement, but their rights may only be affected by the company voluntary arrangement if they consent individually.

<sup>775</sup> Section 155(7)(a).

<sup>776</sup> See part 4.5.4 below.

<sup>777</sup> Section 155(7)(b).

<sup>778</sup> Section 155(7)(b)(i).

<sup>779</sup> Section 155(7)(b)(ii).

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file with the court after being notified of the application for liquidation, in which any facts of which he has become aware and which may justify the postponement of the hearing or dismissal of the application by the court are disclosed.<sup>780</sup> Exactly what it is that the court should look for in this report that would render the proposal just and equitable (or not), remains a mystery.

It is regrettable that the legislature found it necessary to retain the requirement of approval by the court, as it will not only add unnecessary costs and time to the procedure, but will almost certainly lead to complications as courts attach differing interpretations to the very vague requirement of just and equitable. The history of the complications and problems caused in the section 311 procedure as a result of courts differing in their interpretation of what the procedure entailed and required is well known and could now repeat itself.<sup>781</sup> Since the court is no longer approached before a meeting is held, the directors or liquidator will find out whether the proposals are acceptable to the court only after the relevant meeting for approval has been held and substantial costs have been incurred. It will also be too late to amend the proposals to make them acceptable to the court. The whole process would have to be started afresh while, as already stated, the company is not protected by any moratorium against enforcement action by creditors who are now fully aware of the company's financial difficulties.

It is not clear why the sanction of the court should be required to make an agreement reached between a substantial majority of affected creditors and the company, binding on the parties. The publicity caused by the application will also be detrimental to the reputation and creditworthiness of the company, and what could have been an informal, inexpensive and fast out-of-court settlement between the company and its creditors, or some of them, has now been turned into an onerous and cumbersome procedure which will probably be inaccessible to smaller companies.

The legislature would have been well advised to follow the example of the English legislation in respect of company voluntary arrangements, where the court becomes involved only if the approval by creditors is challenged on one of the specified grounds.<sup>782</sup>

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<sup>780</sup> In terms of s 346(4)(b) of the Companies Act of 1973, which will, in terms of item 9 of Schedule 5 to the Companies Act of 2008, continue to apply to insolvent liquidations after the last-mentioned Act comes into force.

<sup>781</sup> See Meskin et al *Henochsberg* at 603-605 and the cases referred to there; Blackman et al *Companies Act* at 12-18 -12-30; and generally, Delpont "Section 311"; Delpont "Insolvente Maatskappye".

<sup>782</sup> See Chapter 3, part 3.5.5.

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#### 4.5.4 Effects of approval

If the compromise is sanctioned by the court, the company must file a copy of the order with the Commission within five business days.<sup>783</sup> A copy of the order must also be attached to each copy of the company's Memorandum of Incorporation that is kept at the company's registered office or at another location where the company's records are kept if not at its registered office.<sup>784</sup> Although it is the contents of the compromise that are of importance, these requirements refer to a copy of the order sanctioning the compromise that must be filed and attached to the Memorandum of Incorporation. It is unlikely that the compromise will be included in the order, and in most cases it will be referred to as an annexure to the order. It would have been preferable for these provisions to have made it clear that both a copy of the compromise and of the sanctioning order are included.

Section 155(8)(c) repeats this mistake by providing that the order of court sanctioning a compromise is final and binding on all the company's creditors or all members of the relevant class of creditors, as the case may be, from the date on which the copy of the order is filed. In reality it is the compromise that is binding after sanctioning by the court, and not the order itself, which is meaningless without reference to the compromise. Although the meaning of the provision is clear, that does not detract from the fact that the wording is patently incorrect.

The liability of any person who is a surety of<sup>785</sup> the company is not affected by a compromise approved and sanctioned in terms of section 155.<sup>786</sup>

## 4.6 Evaluation of compromise in the Companies Act of 2008

Whatever the intention behind the drafting of the new compromise provisions may have been – whether to merely simplify the existing procedure in terms of section 311 of the Companies Act of 1973, or to create a new and more informal procedure as an alternative to the formal business rescue proceedings – the final result is not impressive.

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<sup>783</sup> Section 155(8)(a).

<sup>784</sup> Section 155(8)(b) read with ss 24 and 25.

<sup>785</sup> The use of the word "of" is slightly misleading, since it could also mean a surety who guaranteed payment by a debtor to the company. The word "for", as presently used in s 311(3) of the Companies Act of 1973, would have made the meaning clearer.

<sup>786</sup> Section 155(9).

The new provisions perpetuate the weaknesses of section 311 by failing to provide for any moratorium and continuing to require involvement by the court. Instead of creating an improvement on the current procedure, the new compromise achieves the opposite by an almost mindless copying of most of the requirements for a business rescue plan, without any clear basis for setting these detailed requirements. The very specific and detailed information required will almost certainly make the procedure costly. On the other hand, important information such as whether the compromise is (or is even allowed to be) made subject to the condition that an existing provisional winding-up order will be discharged, or how and when the procedure will end, the circumstances that make it necessary to enter into a compromise or the real advantages for creditors, is not required. In spite of having the company voluntary arrangement in England as an example of what is necessary and what should be avoided in the provisions regulating such a procedure, the drafters seemingly chose not to make use of this opportunity.

It is unlikely that the new compromise will be as popular as its predecessor, particularly since its contents are so strictly prescribed that it will not be as adaptable or flexible as the section 311 compromise. The many uncertainties, particularly those pertaining to the rights of secured creditors, and the exclusion of shareholders, will also prevent the compromise from finding general acceptance. We are effectively left worse off than before because we now have two procedures, one for effecting a scheme of arrangement with creditors, and another for a compromise with shareholders, which are both deficient. The compromise with creditors is not quite an out-of-court procedure as it should ideally have been, and excludes shareholders whose cooperation may be essential in some cases, while the scheme of arrangement with shareholders excludes creditors but does not require approval by the court except on application by a person who voted against it.<sup>787</sup> The last-mentioned option is what should have been provided in the procedure for a compromise with creditors since it would have granted an adequate remedy for any creditor who felt aggrieved by the majority decision of the other creditors.

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<sup>787</sup> Sections 114-115.

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## CHAPTER 3

### ENGLAND

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#### 1 INTRODUCTION

The Insolvency Act 1986 (c 45) presently regulating insolvency law in England came into effect on 29 December 1986.<sup>1</sup> This Act was the result of an in-depth investigation into insolvency law that began in 1977 with the appointment of a committee to undertake a complete review of insolvency law, including corporate insolvency law.<sup>2</sup> The Insolvency Law Review Committee under the chairmanship of Sir Kenneth Cork submitted its report containing recommendations for many radical changes in English insolvency law to Parliament in 1982.<sup>3</sup>

The *Cork Report* expressed the opinion that in many cases insolvent companies that could have been rescued had been forced into liquidation because no proper rescue procedure was available to them,<sup>4</sup> particularly where such companies had no floating charges and the appointment of a receiver and manager was thus not an option.<sup>5</sup> In the *Cork Report* one of the main objects of their proposals that the Committee identified was to encourage the continuation and disposal of a debtor's business as a going concern,

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<sup>1</sup> This was the date on which the Insolvency Act 1985 (c 65) was to have been fully brought into force by the Insolvency Act 1985 (Commencement No 5) Order 1986 (SI 1986/1924). However, the Insolvency Act 1986 replaced the Insolvency Act 1985 before the latter fully came into effect. The Insolvency Act 1986 consolidated most of the provisions of the Insolvency Act 1985 with the provisions relating to corporate insolvency contained in the Companies Act 1985, giving effect to the recommendation of the *Cork Report* that there should be a consolidated Act regulating both individual and corporate insolvency: Fletcher *Insolvency* at 19-21. However, as Fletcher points out (at 22), the traditional distinction between corporate insolvency law and personal insolvency law remains.

<sup>2</sup> The history and terms of reference of this Committee are discussed in detail in Fletcher *Insolvency* at 16-19.

<sup>3</sup> *Report of the Review Committee on Insolvency Law and Practice* Cmnd 8558 (1982), hereafter referred to as the *Cork Report* as it is commonly known.

<sup>4</sup> Paragraph 496.

<sup>5</sup> The appointment of a receiver or receiver and manager is a remedy available to a company's debenture holder or mortgagee whose loan is secured by either a fixed charge over specific assets of the company or by floating charge over fluctuating assets such as goodwill and cash: Fletcher *Insolvency* at 417-419; *Palmer* par 14.101ff. In an effort to clarify the many obscurities in this area of the law, s 29(2) of the Insolvency Act 1986 also created a special category of receiver, the administrative receiver, defined in the Act as a receiver or manager of all (or substantially all) the property of a company who is appointed by or on behalf of the holders of any debentures of the company secured by a floating charge. Receivers who did not fall under this definition were largely unaffected by the Insolvency Act 1986 but had far less powers than administrative receivers. However, see footnotes 17 and 64 below for the effects of the Enterprise Act 2002 (c 40) on the power to appoint administrative receivers.

as well as the preservation of at least some of the jobs in such a business.<sup>6</sup> The report therefore proposed the introduction of a new procedure to assist companies<sup>7</sup> experiencing financial difficulties by the appointment of an administrator who would have the wide powers normally conferred upon a receiver and manager appointed under a floating charge.<sup>8</sup> These powers would have to include the power to carry on the business of the company and to borrow funds for that purpose.

This recommendation resulted in the introduction of a new formal rescue procedure, the administration order procedure regulated by Part II of the Insolvency Act 1986, into English law.

Although administration was used successfully in a limited number of cases,<sup>9</sup> it did not achieve its intended purpose of providing a practical and widely-used company rescue procedure that would be appropriate in the various circumstances where intervention was needed.<sup>10</sup> This was partly due to the fact that administration was a new and unfamiliar procedure and thus regarded with some scepticism<sup>11</sup> but also because the procedure itself had certain weaknesses, such as the requirement of a detailed independent (and costly) report on the company's affairs that had to accompany an application for administration<sup>12</sup> and the very fact that an application

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<sup>6</sup> Paragraph 1980(2) of the *Cork Report*.

<sup>7</sup> Paragraph 499 stated that although these proposals were primarily designed for corporate debtors, the intention was not to limit the procedure to companies. The Insolvency Act 1986, however, only refers to a "company" in the sections dealing with administration: see the discussion under part 2.2. below.

<sup>8</sup> Paragraph 497.

<sup>9</sup> Fletcher *Insolvency* at 515; *Palmer* par 14.004.

<sup>10</sup> Fletcher *Insolvency* at 22; *Palmer* par 14.004. Statistics for the period 1996 to 2002 indicate that liquidation was used in the vast majority of corporate insolvency cases and administration was used the least: Parry "Administrative Receivership and Administration" at 148-149.

<sup>11</sup> Fletcher *Insolvency* at 515; *Palmer* par 14.003. Bailey and Groves *Corporate Insolvency* at 341 point out that although many commentators were pessimistic about administration's chances of being effective before the administration procedure was brought into force, many administration orders were actually made every year from the time the Insolvency Act 1986 came into operation in December 1986.

<sup>12</sup> In terms of the original Rule 2.2 of the Insolvency Rules 1986 (SI 1986/1925), and preferably prepared by a qualified insolvency practitioner. Although such a report was not compulsory, the original Rule 2.3(6) required an explanation should a report not be available. In *Re Newport County Association Football Club Ltd* [1987] 3 BCC 635 Harman J stressed the importance of such a report and the influence it had on the court's decision whether to grant an administration order or not, while in *Re W F Fearman Ltd* [1988] 4 BCC 139 the application was denied because of the absence of an independent report. The reports became so elaborate and thus expensive that on 17 January 1994 the Chancery Division issued the *Practice Note (Administration order applications: content of independent reports)* [1994] 1 WLR 160; [1994] BCC 35) in which it was stressed that it was important not to allow high costs to frustrate the primary aim of administration orders, namely the rescue and rehabilitation of insolvent companies. The *Practice Note* therefore stated that the content of the independent report should not be unnecessarily elaborate and detailed but should be a concise assessment of the company's situation and its future prospects. It went on to state that in straightforward cases a report may even be unnecessary and that in all cases



to court was the only way to have an administrator appointed.<sup>13</sup> The administration order procedure was thus criticised for being cumbersome and expensive, the latter in particular making it unsuitable for small to medium-sized companies.<sup>14</sup>

In July 2001, the Insolvency Service<sup>15</sup> published a White Paper<sup>16</sup> setting out the need for some reforms to the administration procedure.<sup>17</sup> This was followed by the Enterprise Act 2002 (c 40), which, with effect from 15 September 2003, substantially replaced those provisions of the Insolvency Act 1986 regulating the administration procedure. Administration is now regulated by the provisions contained in Schedule B1 to the Insolvency Act 1986 as inserted by the Enterprise Act 2002.<sup>18</sup> Although

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“disproportionate investigation and expense” should be avoided. See also *Palmer* par 14.006 where this problem is confirmed. However, Frisby “Rescue Regime” at 259 avers that the costs of the report as a deterrent to administration have been overrated, since it has become common practice for floating charge holders to commission a so-called “Independent Business Review” by an insolvency practitioner when a borrower shows signs of financial difficulties; the costs would thus already have been incurred by the time an application for administration was made.

<sup>13</sup> Goode *Corporate Insolvency Law* at 323 refers to this as a “major impediment” not only because it made the procedure expensive but also because it took too long to appoint an administrator, making it unsuitable for cases where it was necessary for someone urgently to take control of the assets.

<sup>14</sup> Parry “Administrative Receivership and Administration” at 146; Fletcher *Insolvency* at 516; Grier and Floyd *Corporate Recovery* at 6. This is also one of the main criticisms against judicial management: see Chapter 2, part 2.1.

<sup>15</sup> The Executive Agency of the Department of Trade and Industry (now the Department for Business, Enterprise and Regulatory Reform) is responsible for the administration of insolvency law in England (and Wales). A full explanation of the purpose and role of the Insolvency Service can be found on its website at <<http://www.insolvency.gov.uk/aboutus/aboutusmenu.htm>> accessed on 17 February 2010.

<sup>16</sup> Insolvency Service *Productivity and Enterprise: Insolvency – A Second Chance* Cm 5234 (July 2001). In an earlier Consultative Document (*Company Voluntary Arrangements and Administration Orders*) published in 1993, the Insolvency Service identified five reasons for the failure of administration to become widely used, namely time and costs, secured creditors’ right of veto, administrator’s power to remove directors, obligatory report on directors’ conduct and concern by unsecured creditors that they are being ignored: Grier and Floyd *Corporate Recovery* at 213.

<sup>17</sup> The rectification of some weaknesses in the administration procedure itself, particularly the high costs involved, was only part of the reason for the reforms. Interestingly enough, the reforms were also necessary to limit the power of the holders of floating charges to appoint receivers – the very procedure on which administration had been based – because the appointment of an administrative receiver (see fn 5 above) precluded a company from being placed in administration and thus became a major inhibiting factor preventing administration from becoming the popular and successful corporate rescue regime that the government had hoped for: Parry “Administrative Receivership and Administration” at 145-147. In the first 12 years, the number of administrative receiverships per year far outnumbered that of administration orders, with an average of 172 administration orders per year in the first ten years (the highest number reached was 211 in 1990 compared to 4,318 administrative receiverships in the same year), only marginally increasing to 440 in 1999 and 438 in 2000: *Palmer* par 14.004. Receiverships totalled 1,618 and 1,595 respectively in those years: Parry “Administration Orders” at 59. There was also a general perception that secured creditors, more specifically the banks, too easily put troubled companies into receivership, to the detriment of unsecured creditors and enterprise in general: Finch “Corporate Rescue” at 527. See further fn 65 below on the effect of the reforms on administrative receivership.

<sup>18</sup> Section 248(1) of the Enterprise Act 2002 substituted Part II of the Insolvency Act 1986 for a new Part II. Section 8 in the new Part II provides that Schedule B1 which was inserted into the Insolvency Act 1986 by s 248(2) of the Enterprise Act 2002, shall regulate administration orders. However, the previous provisions

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some of the more radical recommendations contained in the White Paper had to be abandoned after strong opposition from some sectors, the Enterprise Act 2002 effectively relaunched the administration procedure.<sup>19</sup>

The *Cork Report* further drew attention to the lack of a procedure whereby a company could effect an out-of-court, formal and binding composition with its creditors, and the fact that the available procedures, particularly the court-sanctioned arrangement between a company and its creditors, were lengthy, involved and costly.<sup>20</sup> The Committee could see no reason why a procedure similar to the one it proposed for an individual insolvent debtor to enter into a voluntary arrangement with his creditors,<sup>21</sup> should not be available to companies as well. The Committee believed that the speed and simplicity of such a procedure, as well as the fact that there was no obligation to go to court, would prove to be of great value to small companies in particular.<sup>22</sup> The result of this recommendation was the new company voluntary arrangement procedure regulated by Part I of the Insolvency Act 1986.<sup>23</sup>

Once again, although on paper it appeared to be an attractive proposition,<sup>24</sup> the new procedure did not prove to be as popular as had been hoped or anticipated, not even during the severe recession in the British economy between 1989 and 1993 when there was a sharp increase in the number of company failures. Statistically, company voluntary arrangements were shown to be even less attractive in practice than administration.<sup>25</sup> This could be ascribed primarily to one reason: there was no provision in the Act for a moratorium to prevent creditors from enforcing their claims while the proposal was still

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regulating administration orders (including the original version of Part 2 of the Insolvency Rules 1986) still apply to petitions for administration orders presented to court before 15 September 2003 (the date on which the Enterprise Act 2002 came into effect) as well as some entities to which the new procedure does not apply. These provisions will thus be referred to as the "original" provisions where it is necessary to refer to them. References to the Insolvency Rules must be taken to refer to the Insolvency Rules 1986 as amended by the Insolvency (Amendment) Rules 2003 (SI 2003/1730) and several other subsequent statutory instruments, unless otherwise stated.

<sup>19</sup> Lightman and Moss *Administrators* par 1-017; *Palmer* par 14.008.

<sup>20</sup> Paragraph 400ff.

<sup>21</sup> In par 366ff.

<sup>22</sup> Paragraph 430.

<sup>23</sup> Containing ss 1-7, which replaced ss 20-26 of the Insolvency Act 1985.

<sup>24</sup> Rutstein "Corporate Failure" at 72 based this view on the fact that a voluntary arrangement allows a company to propose what is essentially a commercial deal to its creditors to pay them later or less or both.

<sup>25</sup> Fletcher *Insolvency* at 516; *Palmer* par 14.403; Broc "Company Voluntary Arrangements" at 177.

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being prepared and considered.<sup>26</sup> In most cases, a voluntary arrangement was thus combined with an administration order that supplied the required moratorium, but this inevitably increased the costs of the procedure.<sup>27</sup> Particularly in the case of smaller companies, this was not a viable option because the full process of administration was too expensive and onerous in relation to the problems that needed to be solved.<sup>28</sup> Even in those cases where a company considered being placed in administration with the ultimate purpose of entering into a company voluntary arrangement, the banks often prevented this by using their power as debenture holders to appoint an administrative receiver – a procedure they obviously preferred.<sup>29</sup> In reaction to these deficiencies in the company voluntary arrangement procedure, the Insolvency Act 2000 (c 39) that came into force on 1 January 2003 included several provisions<sup>30</sup> aimed at removing some of the obstacles that prevented voluntary arrangement from becoming an acceptable alternative to administration, particularly for smaller companies.

Another factor contributing to the limited use of company voluntary arrangements still remains, however, namely the fact that secured and preferential creditors cannot be bound without their individual consent.<sup>31</sup>

The Insolvency Service is currently undertaking a major project aimed at modernising and consolidating insolvency legislation.<sup>32</sup> The purpose of this project is to modernise terminology, remove unnecessary costs particularly in respect of publication of notices, provide flexibility of communication by allowing delivery of

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<sup>26</sup> Broc “Company Voluntary Arrangements” at 183; Fletcher *Insolvency* at 517; Palmer par 14.404; Sealy and Milman *Insolvency Legislation* at 19; Grier and Floyd *Corporate Recovery* at 155.

<sup>27</sup> Stevens “Report for England” at 203.

<sup>28</sup> Apparently some practitioners suggested that a petition for administration should be filed in such a case to create the automatic moratorium under s 10 of the original provisions and the hearing then be postponed until after the creditors had met to consider the voluntary arrangement proposal. If the proposal was adopted, the court could then be requested to dismiss the application: Grier and Floyd *Corporate Recovery* at 156. This would obviously have amounted to an abuse of the process, a view shared by Sealy and Milman *Insolvency Legislation* (2004) at 20 that labelled such a petition “probably ... improper” and “unwise”.

<sup>29</sup> Bailey and Groves *Corporate Insolvency* at 191.

<sup>30</sup> Sections 1 and 2 and Schedules 1 and 2. These provisions were based on proposals contained in a Consultative Document issued by the Insolvency Service in April 1995 entitled *Revised Proposals for a New Company Voluntary Arrangement Procedure*: Fletcher *Insolvency* at 480. After the Labour Government came into power in 1997 a decisive policy of promoting a rescue culture was followed, resulting in a Consultation Document: *A Review of Company Rescue and Business Reconstruction Mechanisms* in September 1999. See further parts 3.1 and 3.6 below.

<sup>31</sup> Sealy and Milman *Insolvency Legislation* at 19. See part 3.6.1 below on renewed efforts to increase the use of company voluntary arrangements by extending the option of a moratorium to all companies.

<sup>32</sup> Regular updates on the progress made in the modernisation and consolidation project are posted on the official Insolvency Service website at <<http://www.insolvency.gov.uk>>.

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notices by email and the use of websites for notices to creditors, and to consolidate much of the secondary legislation relating to insolvency.

The first step in this project was the amendment of the Insolvency Rules 1986 by the Insolvency (Amendment) Rules 2009<sup>33</sup> with effect from 6 April 2009. In terms of the new Rules, notices must be advertised in the *Gazette* but any further advertising of the notices is left in the discretion of the relevant insolvency practitioner. Furthermore, the word “forthwith” wherever it appeared in the Rules, has been replaced with the words “as soon as reasonably practicable”.<sup>34</sup>

The second stage of the project will be completed with the coming into force (probably on 6 April 2010) of the Legislative Reform (Insolvency) (Miscellaneous Provisions) Order 2010<sup>35</sup> and the draft Insolvency (Amendment) Rules 2010.<sup>36</sup> The first important change affecting company voluntary arrangements and administrations which the Legislative Reform (Insolvency) (Miscellaneous Provisions) Order 2010 will make to the Insolvency Act 1986, is the introduction<sup>37</sup> of section 246A (“Remote attendance at meetings”), which will allow a person to attend meetings in any corporate insolvency proceedings by using any form of technology permitting such a person to be heard and to vote at the meeting without having to physically attend the meeting. Another amendment will be the introduction of section 246B (“Use of websites”) that will allow an office-holder in corporate insolvency proceedings to use a website to send documents and information during the proceedings. It is regrettable that the drafters of the regulations in terms of the South African Companies Act of 2008 did not take cognisance of the last-mentioned development, and still insist on delivery of the many prescribed notices during business rescue proceedings by way of email, registered post or fax to each person individually.<sup>38</sup>

A new section 436B will also be inserted<sup>39</sup> into the Insolvency Act 1986 to make it clear that any reference to documents “in writing” will include the electronic form. Finally, all requirements in the Insolvency Act 1986 that a document must be sworn

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<sup>33</sup> SI 2009/642.

<sup>34</sup> Rule 5 of the Insolvency (Amendment) Rules 2009.

<sup>35</sup> SI 2010/18 made on 6 January 2010.

<sup>36</sup> Both the Order and the draft Insolvency (Amendment) Rules are available on the Insolvency Service website at <<http://www.insolvency.gov.uk>> accessed on 22 January 2010.

<sup>37</sup> By article 3(1) of the Order.

<sup>38</sup> See Chapter 2, part 3.5.2.6.

<sup>39</sup> By article 4 of the Order.

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to by affidavit will be replaced with a requirement that the document must be verified by a statement of truth.<sup>40</sup>

The draft Insolvency (Amendment) Rules 2010 will harmonise the Insolvency Rules 1986 with the amendments effected by the draft Order, and will modernise the Rules by making numerous amendments to eliminate unnecessary Rules and clarify any uncertainties.<sup>41</sup> Examples include the replacement of the word “immediately” with “as soon as reasonably practicable”,<sup>42</sup> replacing “affidavit” with “witness statement”<sup>43</sup> and the amendment of some requirements that notices must be sent to all the relevant persons of which the insolvency practitioner is aware, to all those of whose claim and address he is aware.<sup>44</sup>

The final phase of the project to modernise and consolidate insolvency legislation will be to consolidate the Insolvency Rules by the publication of a completely new set of Insolvency Rules together with several smaller insolvency statutory instruments.<sup>45</sup> A draft version of the consolidated Rules has been made available by the Insolvency Service to illustrate the end result of what they hope to achieve with this consolidation.<sup>46</sup>

## 2 ADMINISTRATION

### 2.1 Definition and purpose

For purposes of the Insolvency Act 1986, an administrator of a company is defined in paragraph 1<sup>47</sup> as a person appointed under Schedule B1 of the Act to manage the affairs, business and property of the company. A company is thus “in administration” while the appointment of an administrator is in force<sup>48</sup> but does not cease to be so

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<sup>40</sup> Article 5 of the Order.

<sup>41</sup> Some of the intended amendments are referred to in the discussion of the applicable Rules in this Chapter.

<sup>42</sup> In Rule 1.24(4).

<sup>43</sup> For example in Rule 1.32.

<sup>44</sup> For example in Rule 1.9(2).

<sup>45</sup> See Chapter 1, part 4 on the problems created by the many different sources of insolvency legislation in England.

<sup>46</sup> The document is entitled *Draft Modernisation Rules Nov09* and is available at <<http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/consolidation/updateNov09.htm>> accessed on 22 January 2010. Also see part 3.6.1 below on another project of the Insolvency Service to encourage the use of company voluntary arrangements by extending the moratorium option to all companies.

<sup>47</sup> Schedule B1 to the Insolvency Act 1986 inserted by the Enterprise Act 2002. As the provisions are now contained in a Schedule to the Insolvency Act 1986 rather than in the main body of the Act, they are referred to as “paragraphs” and not “sections”.

<sup>48</sup> Paragraph 1(2)(a) of Schedule B1.

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because of the vacation of his office by an administrator as a result of death, resignation or otherwise or if the administrator is removed from office.<sup>49</sup>

Administration must have one of three purposes stipulated in the Act and these are discussed below<sup>50</sup> as part of the requirements that must be met for the appointment of an administrator.

## 2.2 Entities to which administration applies

Although contained in the Insolvency Act 1986 that regulates both individual and corporate insolvency, the wording of the provisions dealing with administration makes it clear that this procedure is available to companies only.<sup>51</sup> Section 8 states that Schedule B1 to the Insolvency Act 1986 provides for “the administration of companies” and Schedule B1 throughout refers only to companies. This is in spite of the fact that, as was mentioned above,<sup>52</sup> the proposals for administration in the *Cork Report* did not limit the procedure to companies, although the proposals were primarily designed for corporate debtors. The *Cork Report* specifically mentioned that the appointment of an administrator could be “advantageous where a substantial business [was] being carried on by a sole trader or in partnership”.<sup>53</sup> The size of the business, rather than its form, seemed to be

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<sup>49</sup> Paragraph 1(2)(d) of Schedule B1.

<sup>50</sup> In part 2.4.2.

<sup>51</sup> Paragraph 111 of Schedule B1 to the Insolvency Act 1986 was amended by the Insolvency Act 1986 (Amendment) Regulations 2005 (SI 2005/879) to clarify the situation even further. Paragraph 111(1A) was inserted containing a provision interpreting any reference to a “company” in Schedule B1 to mean (a) a company within the meaning of s 735(1) of the Companies Act 1985; (b) a company incorporated in another EEA State; or (c) a company not incorporated in an EEA State but having its centre of main interests (COMI) in a member State other than Denmark. Although par 111(1A)(a) has not been amended to reflect this change, the reference to s 735(1) should now be read as a reference to ss 1(1) and 1171 of the Companies Act 2006 (c 46) which replaced s 735(1) from 1 October 2009: Fletcher *Insolvency* at 482 and 656. In terms of s 1(1), any company formed and registered under the Companies Act 2006 or the Companies Act 1985 (c 6) would be included, as well as any company registered under the former Companies Acts and recognised as an existing company under the Companies Act of 1985. The former Companies Acts are listed in s 1171 and include the Companies Acts dating from the Joint Stock Companies Act 1856. The inclusion in par 111(1A) of companies in the EEA or having their COMI in a member state was a result of EC Council Regulation No 1346/2000 [2000] OJ L160/1 as amended, to ensure the application of uniform rules on jurisdiction, applicable law, recognition and enforcement in the member states of the EU.

<sup>52</sup> Footnote 7.

<sup>53</sup> Paragraph 499. The administration procedure was eventually also made applicable to partnerships by par 6(1) of the Insolvent Partnerships Order 1994 (SI 2421 of 1994) with the relevant provisions modified as set out in Schedule 2 to the Order, as amended by the Insolvent Partnerships (Amendment) Order 2005 (SI2005/1516). The Limited Liability Partnership Regulations 2001 (SI 2001/1090) and subsequently the Limited Liability Partnerships (Amendment) Regulations 2005 (SI 2005/1989) also made administration, with the necessary modifications, applicable to limited liability partnerships as from 6 April 2001. Partnerships will not be discussed here, since there are important

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the determining factor in the proposals of the Cork Committee. However, English insolvency law has historically developed into two very distinct and substantially different branches: corporate insolvency and individual insolvency law, and this distinction will not be changed easily.<sup>54</sup> The existence of separate processes (such as winding up) for insolvent companies, although now contained in one consolidated Insolvency Act, thus remains a distinctive feature not only of English company law but also of the company law of other countries that closely followed England in their company law.<sup>55</sup> South Africa is one of these countries,<sup>56</sup> and although in more recent times there has been some divergence, the basic principles are still similar. This aspect should be kept in mind when considering the development in South African law of a consolidated Insolvency Act that would apply both to individuals and corporations.<sup>57</sup>

Six types of (mainly utility) companies are specifically excluded from the provisions regulating the administration procedure.<sup>58</sup> An administrator may furthermore not be appointed for a company that is already in administration,<sup>59</sup> in liquidation,<sup>60</sup> effects or carries out contracts of insurance<sup>61</sup> or is subject to a liability for a deposit accepted in accordance with the Banking Act 1979 but is not an authorised deposit taker.<sup>62</sup>

### 2.3 Power to initiate administration

The administration procedure commences with the appointment of an administrator for the particular company.<sup>63</sup> There are now three ways in which a person may be appointed as administrator of a company: by an administration order of the court

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basic differences between the South African and English law regulating partnerships.

<sup>54</sup> Stevens "Report for England" at 228.

<sup>55</sup> Fletcher *Insolvency* at 12-15 and 22.

<sup>56</sup> Cilliers, Benade et al *Corporate Law* par 2.03.

<sup>57</sup> See Chapter 1, part 3; Chapter 2, part 3.2.

<sup>58</sup> Section 249(1) of the Enterprise Act 2002. These are companies established and governed by the following statutes which provide their own special administration regimes: the Water Industry Act 1991 (c 56); the Railways Act 1993 (c 43); the Channel Tunnel Rail Link Act 1996 (c 61); the Transport Act 2000 (c 38); the Greater London Authority Act 1999 (c 29) and the Building Societies Act 1986 (c 53).

<sup>59</sup> Paragraph 7. This does not apply to the appointment of replacement or additional administrators in terms of pars 90-97 and 100-103, respectively, of Schedule B1.

<sup>60</sup> Paragraph 8(1). This is subject to the power of the liquidator of a company in terms of par 38 to apply to court for administration of the company, discussed in part 2.3.2 below. In the case of a voluntary winding up, certain holders of a floating charge may also apply for administration (par 8(3), read with pars 14 and 37).

<sup>61</sup> Paragraph 9(2), subject to specific exemptions not relevant to this discussion (par 9(3)).

<sup>62</sup> Paragraph 9(1).

<sup>63</sup> Paragraph 1(2)(b) of Schedule B1.

under paragraph 10,<sup>64</sup> by the holder of a floating charge under paragraph 14<sup>65</sup> or by the company or its directors under paragraph 22.<sup>66</sup>

### 2.3.1 Appointment by the company or its directors

The power to appoint an administrator without having to obtain an order of court is given both to a company and the directors of a company by paragraph 22 of Schedule B1 to the Insolvency Act 1986. This constitutes a major amendment to the original provisions regulating administration in the Insolvency Act 1986 which, in all instances, required an order of court to appoint an administrator. As explained above,<sup>67</sup> these reforms to the administration procedure were made in an effort to render administration more popular and effective by reducing the costs and simplifying the process.

In my view, *Palmer*<sup>68</sup> is correct in pointing out that unless the articles allow the directors to take the decision in the name of the company, an appointment by the company will require a resolution taken at the company's general meeting.<sup>69</sup> The inevitable effects of the publicity resulting from such a meeting and the time and costs involved will be seriously detrimental to a rescue attempt and this route is therefore unlikely to be used very often.<sup>70</sup> In most cases the directors will therefore take such a decision.<sup>71</sup>

<sup>64</sup> Schedule B1 to the Insolvency Act 1986.

<sup>65</sup> Schedule B1. Special provisions for the appointment of an administrator by the holder of a floating charge over the whole or substantially the whole of the company's property were necessitated by the fact that the administrative receivership procedure, to which these creditors had access before, has been abolished (with only a few very specific exceptions) by s 72A of the Enterprise Act 2002. Although this procedure had also sometimes resulted in the rescue of a company, its main object remained to protect the interests of one creditor – the holder of the floating charge: Parry "Administrative Receivership and Administration" at 152-153. This specific type of secured creditor is unknown in South African law and his power to appoint an administrator will therefore not be included in further discussions. This decision is vindicated by Stevens "Report for England" at 228, who believes the power of the floating charge holder to appoint an administrator to be the result of an historical accident and doubts whether any other system of law would want to adopt this procedure.

<sup>66</sup> Of Schedule B1 to the Insolvency Act 1986.

<sup>67</sup> In part 1.

<sup>68</sup> Paragraph 14.034.

<sup>69</sup> This is also the view held by Fletcher *Insolvency* at 536. An informal unanimous assent by all the shareholders will also be acceptable (Bailey and Groves *Corporate Insolvency* at 372), but will obviously be possible only in the case of smaller companies with relatively few shareholders. According to Lightman and Moss *Administrators* par 5-047, an ordinary resolution taken at a meeting or a written resolution signed by all shareholders is required. However, considering that an extraordinary general meeting will have to be called at short notice, this will require consent by 95 per cent of the shareholders.

<sup>70</sup> The decision by the South African legislature to grant the power to appoint a business rescue practitioner only to the board of directors seems sensible and practical in the light of this comment: see Chapter 2, part 3.3.1.

<sup>71</sup> No formal resolution at a board meeting is required, on condition that the majority are in favour of the decision: par 105 of Schedule B1; Bailey and Groves *Corporate Insolvency* at 372.



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To offset the obvious risks of abuse of the process as a result of the relative ease with which it can be initiated, an administrator may not be appointed in terms of paragraph 22 within a period of twelve months starting on the day on which the appointment of a previous administrator of the company ceased, if the previous appointment had been made under this paragraph or in terms of an administration order on application by the company or its directors.<sup>72</sup> A similar restriction regarding the appointment of an administrator and the period applies from the date on which a moratorium under Schedule A1<sup>73</sup> to the Insolvency Act 1986 ends without a voluntary arrangement being in place or where it has ended prematurely.<sup>74</sup>

### 2.3.2 Appointment by order of court

An administration order is defined in paragraph 10<sup>75</sup> as “an order appointing a person as the administrator of a company”. In terms of paragraph 12<sup>76</sup> the application to court<sup>77</sup> for an administration order may be made by the company in terms of a resolution taken at a general meeting,<sup>78</sup> by the directors of the company,<sup>79</sup> by one or

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<sup>72</sup> Paragraph 23 of Schedule B1 to the Insolvency Act 1986. *Palmer* par 14.036 refers to the necessity of measures to prevent “serial filings” by directors who merely want to use the moratorium without any real intention to continue the process to its intended conclusion. It is noticeable that there is no such limitation on how often a board may appoint a business rescue practitioner in the new South African proceedings.

<sup>73</sup> Discussed in part 3 below.

<sup>74</sup> Paragraph 24 of Schedule B1 to the Insolvency Act 1986.

<sup>75</sup> Of Schedule B1 to the Insolvency Act 1986.

<sup>76</sup> Of Schedule B1 to the Insolvency Act 1986.

<sup>77</sup> In terms of ss 117 and 251 of the Insolvency Act 1986 and s 1156 of the Companies Act 2006, jurisdiction vests in the court that has jurisdiction to wind up the company, ie the High Court and, in the case of a company whose paid-up share capital does not exceed £120,000, in the county courts.

<sup>78</sup> Although the relevant provision does not specify this, *Pennington Corporate Insolvency* at 336 submits that the same reasoning would apply as in cases dealing with applications for winding up where it was held that an application in the name of the company could be presented only if a resolution to this effect had been taken by the general meeting or if the articles contained an express delegation of power to the board to apply in the name of the company. This is confirmed by *Bailey and Groves Corporate Insolvency* at 352-353 referring to the case of *Smith v Duke of Manchester* (1883) 24 Ch D 611.

<sup>79</sup> In *Re Equiticorp International Plc* [1989] BCLC 597; 5 BCC 599 it was held that all the directors must apply or the application must be by virtue of a board resolution which would be binding on all directors. The decision was on the original provisions which did not make this clear. The current par 12(b) of Schedule B1 to the Insolvency Act 1986 also merely refers to the power of “the directors” to apply for administration, but par 105 now contains a provision that a reference in Schedule B1 to something done by the directors of a company includes the same act done by a majority of the directors. This need not even be pursuant to a formal resolution but can also be decided informally: *Bailey and Groves Corporate Insolvency* at 352.

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more creditors<sup>80</sup> of the company,<sup>81</sup> by the designated officer exercising the power conferred by section 87A of the Magistrates' Court Act<sup>82</sup> or a combination of these persons. By making it clear that both the company itself and the directors may apply, any uncertainty regarding the power of directors to apply without authorisation by a general meeting, as experienced in South African law with regard to applications for judicial management or liquidation,<sup>83</sup> has been avoided.<sup>84</sup>

The Cork Committee felt very strongly that the directors of a company should have an unfettered right to apply for an administration order.<sup>85</sup> This should be seen in the light of their potential liability for wrongful trading, a new concept that was also introduced into the Insolvency Act 1986<sup>86</sup> on the recommendation of the *Cork Report*.<sup>87</sup> Placing the company in administration would be one of the obvious ways

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<sup>80</sup> If the creditor's claim is disputed, the court will not make an administration order on the basis of that claim unless there are special circumstances: *Palmer* par 14.026.

<sup>81</sup> No minimum amount is required for the debt on which the application is based, and both contingent and prospective creditors are expressly included by par 12(4) of Schedule B1 to the Insolvency Act 1986. Since it would in most cases be very difficult for a creditor to prove the company's actual inability to pay its debts, a creditor will have to rely on deemed inability based on a statutory demand that remains unpaid; in effect it means that the claim of the creditor will have to be for at least £750: see further part 2.4.1 below.

<sup>82</sup> Section 87A of the Magistrates' Courts Act 1980 (c 43) applies under specified circumstances where a fine was imposed on a company.

<sup>83</sup> Discussed in Chapter 2, part 2.3.

<sup>84</sup> This was also true of the original s 9(1) of the Insolvency Act 1986, which expressly authorised both the company and the directors to apply for an administration order.

<sup>85</sup> Paragraph 501 of the *Cork Report*.

<sup>86</sup> In s 214. In terms of this section any person who is or has been a director or shadow director of a company that is being wound up may on the application of the liquidator be declared liable by the court to make such contribution to the company's assets as the court thinks proper. This section only applies if the company has gone into insolvent liquidation and if, at some time before the liquidation, while he was a director or shadow director, the person knew or ought to have known that there was no reasonable prospect of the company avoiding going into insolvent liquidation and omitted to take every reasonable and practicable step to minimise the potential loss to the company's creditors. For determining the last-mentioned requirement, the general knowledge, skill and experience of the specific director as well as that which can reasonably be expected of a person carrying out the same functions in a company are taken into account: s 214(4). The test is therefore both objective and subjective: Sealy and Milman *Insolvency Legislation* at 231. In South Africa, whereas s 424 of the Companies Act of 1973 contains a similar provision for personal liability for debts of the company based on reckless or fraudulent trading, the equivalent s 77(3)(b) of the Companies Act of 2008 provides only for the directors' liability to the company (not to creditors) for actual loss, damages or costs sustained by the company as a result of insolvent trading, which is prohibited by s 22(1)(b). Section 218(2), however, provides that any person who contravenes any provision of this Act is liable to any person who suffered any loss or damage as a result of the contravention.

<sup>87</sup> Chapter 44 of the Report. The Committee felt that it was necessary to create a liability for wrongful trading because the previous Act only provided for liability based on fraudulent trading which required proof of intention and was thus rarely successful (par 1776). Liability for fraudulent trading is now regulated by s 213 of the Insolvency Act 1986.

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to avoid liability for wrongful trading.<sup>88</sup> Another measure that resulted from recommendations contained in the *Cork Report*<sup>89</sup> and that should encourage directors to take all possible steps to rescue their company, is the Company Directors Disqualification Act 1986 (c 46) in terms of which the director of a company that has become insolvent can be disqualified from acting as an insolvency practitioner or director.<sup>90</sup>

Although the directors of a company will obviously prefer to use the faster and easier procedure for an out-of-court appointment of an administrator, an application to court is the only way in which the company may be placed in administration after a petition for winding up the company has been presented to court but not yet disposed of.<sup>91</sup> The power of a company or its directors to apply to court for an administration order therefore still has a definite and important role.<sup>92</sup>

An application for an administration order in respect of a company that is in liquidation may only be made by the company's liquidator.<sup>93</sup> Although it would be unusual for such an application to be made, it could be appropriate if a liquidator wants to continue trading and obtain new business for the company in the interests of the creditors: the power of a liquidator to carry on the business of a company<sup>94</sup> is limited to what may be necessary for its beneficial winding up, and does not include seeking new business.<sup>95</sup> If the administration order is granted, any winding-up order

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<sup>88</sup> *Palmer* par 14.014 believes that if the company was not placed in administration directors should be required to show that they at least considered the possibility of administration as a way to minimise the loss to creditors. If the courts consistently follow this approach when deciding on a director's personal liability for wrongful trading, this will "generate an important incentive for directors to consider administration" or other options, such as a voluntary arrangement, before an insolvent liquidation becomes inevitable. Bailey and Groves *Corporate Insolvency* at 341 declare that administration should be considered as one of the normal measures to be taken by directors in an effort to minimise loss to the company's creditors and should provide directors who have done so with at least a partial defence to a claim of wrongful trading.

<sup>89</sup> In Chapter 45 of the Report.

<sup>90</sup> See part 2.7.1.2 below. Also see Chapter 2, parts 3.7.1.2.2 and 3.7.1.2.3 on similar provisions in the Companies Act of 2008 which do not, however, provide for any order directly disqualifying the individual from acting as a business rescue practitioner, but only from acting as a director.

<sup>91</sup> See part 2.3.1 above.

<sup>92</sup> Bailey and Groves *Corporate Insolvency* at 342. Although a similar prohibition against out-of-court commencement of business rescue proceedings is found in the South African Companies Act of 2008, neither the company nor the directors may apply to court for a business rescue order: see Chapter 2, part 3.5.1.

<sup>93</sup> Paragraph 38(1) of Schedule B1 to the Insolvency Act 1986.

<sup>94</sup> With the approval of the court in a winding up by the court, without any approval required in a voluntary winding up: Schedule 4, par 5 of the Insolvency Act 1986.

<sup>95</sup> Bailey and Groves *Corporate Insolvency* at 339-340.

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in respect of the company must be discharged by the court.<sup>96</sup> The supervisor of a company voluntary arrangement in respect of the company may also apply for an administration order.<sup>97</sup>

In contrast to judicial management and the new business rescue procedures in South Africa, there are no circumstances under which one or more individual members or shareholders of a company may apply for an administration order.<sup>98</sup>

## 2.4 Requirements for administration

### 2.4.1 Inability to pay debts

The first requirement for the appointment of an administrator, whether by an order of court or by the company or its directors, is that the company is or is likely to become unable to pay its debts.<sup>99</sup>

In the case of an application for an administration order, the applicant must state in his application that he believes the company to be, or likely to become, unable to pay its debts.<sup>100</sup> The affidavit supporting the application must contain a statement of the financial position of the company in which the applicant specifies, to the best of his knowledge, the assets and liabilities of the company and details of any security known or believed to be held by creditors, as well as details of any insolvency proceedings in relation to the company of which the applicant is aware and any other information which the applicant believes will assist the court in making its decision.<sup>101</sup>

Where the appointment of an administrator is to be made by the company or its directors without the intervention of the court,<sup>102</sup> the statutory declaration accompanying the notice of intention to appoint an administrator that is filed with the court, must contain a specific declaration that the company is or is likely to become unable to pay its debts.<sup>103</sup>

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<sup>96</sup> Paragraph 38(2)(a) of Schedule B1 to the Insolvency Act 1986.

<sup>97</sup> Paragraph 12(5) read with s 7(4)(b). See part 3.5.3 below regarding the supervisor.

<sup>98</sup> This was also the case under the original provisions of the Insolvency Act 1986. The proposal contained in par 500 of the *Cork Report* that an individual shareholder (or director) should have the right to apply to court for leave to make an application for the appointment of an administrator if the assets of the company are in jeopardy was never implemented.

<sup>99</sup> Paragraphs 11(a) and 27(2)(a) respectively of Schedule B1 to the Insolvency Act 1986.

<sup>100</sup> Rule 2.4(1) of the Insolvency Rules.

<sup>101</sup> Rule 2.4(2)(a) to (c) of the Insolvency Rules. The required affidavit will be replaced by a witness statement once the Draft Insolvency (Amendment) Rules 2010 referred to in part 1 above come into effect.

<sup>102</sup> Under par 22 of Schedule B1 to the Insolvency Act 1986.

<sup>103</sup> Or, where no prior notice is required, the notice of appointment must contain this statement: see part 2.5.1 below.

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By contrast with the uncertainty on the same issue in the case of judicial management,<sup>104</sup> paragraph 111(1) of Schedule B1 provides that the phrase “unable to pay its debts” in this Schedule has the same meaning as in section 123 of the Insolvency Act 1986 where the phrase is defined for the purposes of an application for the winding up of a company. Section 123(1) of the Act provides that a company is deemed to be unable to pay its debts if it fails to pay or secure a debt of at least £750 within three weeks after delivery of a written demand at its registered offices, or if execution on a judgement in favour of a creditor of the company is returned unsatisfied or if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.<sup>105</sup>

Apart from the above circumstances, a company is also deemed to be unable to pay its debts 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 (including prospective and contingent liabilities) – also referred to as balance-sheet deficiency.<sup>106</sup> This ground is important in a company rescue attempt because it allows an application for an administration order to be presented while the company is still able to pay its debts as they fall due but its contingent and prospective liabilities are such that at some stage the company’s assets will clearly be exhausted before all creditors have been paid. Goode<sup>107</sup> points out that in most cases it would be clear that the company’s assets are insufficient to meet all its liabilities, but in marginal cases this test would require some measure of judgment to estimate the amount that a purchaser would be prepared to pay for a particular asset or assets.

There is no provision explaining the circumstances under which a company will be regarded as likely to become unable to pay its debts. According to Pennington,<sup>108</sup>

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<sup>104</sup> Chapter 2, part 2.4.1. In respect of an application for business rescue proceedings, see Chapter 2, part 3.4.2 where two very problematic alternatives for “financial distress” which could be regarded as deeming provisions are discussed. Again, no real deeming provisions have been introduced as grounds for the commencement of business rescue proceedings.

<sup>105</sup> The last-mentioned test is referred to as the cash flow or commercial insolvency test where the courts will look at the factual situation, that is, whether the company is actually not paying its (undisputed) debts as they fall due: Goode *Corporate Insolvency Law* at 87 and 95-101. A company that is still solvent but cannot pay its debts because of a cash-flow problem thus qualifies for administration: Bailey and Groves *Corporate Insolvency* at 361.

<sup>106</sup> Section 123(2) of the Insolvency Act 1986; Fletcher *Insolvency* at 660; Goode *Corporate Insolvency Law* at 88 and 101-109.

<sup>107</sup> *Corporate Insolvency Law* at 88.

<sup>108</sup> *Corporate Insolvency* at 338.

it would be necessary to prove a continuing deterioration in the company's financial situation which will result in the company's insolvency in the not too distant future. In *Re COLT Telecom Group Plc (No 2)*<sup>109</sup> it was held that the court had to be satisfied that it was more probable than not that the company would become unable to pay its debts, and not merely that there was a real prospect of this happening. In comparison to the wording used for the second requirement,<sup>110</sup> it seems that a slightly heavier burden of proof applies to this requirement in that the court must be satisfied on a balance of probabilities that insolvency will occur. In spite of this, the requirement still allows the appointment of an administrator before a company is already commercially or factually insolvent and probably beyond rescue<sup>111</sup> – another major point of criticism raised against judicial management where actual and present inability of the company to pay its debts must be proved to obtain the order.<sup>112</sup>

#### **2.4.2 Achieving the purpose of administration**

The second requirement for administration, irrespective of the procedure by which the administrator is appointed, is derived from paragraph 3 of Schedule B1 to the Insolvency Act 1986, which imposes a duty on the administrator to perform his functions with the objective of achieving the purpose of administration as stipulated in this paragraph, subject to the interests of the company's creditors as a whole.<sup>113</sup>

Paragraph 11(b) repeats this requirement by stipulating, as the second condition for making an administration order, that the court must be satisfied that the administration order is reasonably likely to achieve the purpose of administration. The affidavit filed in support of an application for an administration order will therefore

<sup>109</sup> [2002] EWHC 2815 (Ch); [2003] BPIR 324.

<sup>110</sup> Discussed in part 2.4.2 below.

<sup>111</sup> It may thus increase the possibility of achieving the main object of administration which is to rescue the company as a going concern: see part 2.4.2 below.

<sup>112</sup> Chapter 2, part 2.4.1. The equivalent provision in the Companies Act of 2008 is a major improvement in this respect because the company's future insolvency, albeit subject to a limited period, constitutes grounds for commencement of business rescue proceedings: see Chapter 2, part 3.4.1.1.

<sup>113</sup> Finch "Corporate Rescue" at 548 argues that in reality administrators will aim to satisfy the banks rather than achieve a rescue because the banks are potential sources of future work for insolvency practitioners and the providers of funding without which no rescue will be possible. As a result, administrations will become more like receiverships in that they will primarily serve the interests of the major creditors. Frisby "Rescue Regime" at 262 believes that the duty imposed on administrators may encourage insolvency practitioners to move out of their alleged "institutional inertia" that has perhaps prevented corporate rescue from flourishing. Creditors may enforce this duty by means of par 74 of Schedule B1 (discussed in part 2.7.2 below).

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have to contain enough information to satisfy the court on this requirement.<sup>114</sup> Where an administrator is appointed by the company or its directors, the prescribed administrator's statement that must accompany the notice of appointment contains a statement that in the opinion of the administrator the purpose of administration is reasonably likely to be achieved.<sup>115</sup> This unfortunately adds to the costs of the out-of-court procedure since a thorough and detailed investigation of the company's affairs is necessary before the administrator is able to form such an opinion.<sup>116</sup>

The use of the phrase "reasonably likely to achieve" in the new provisions is intended to resolve the judicial controversy that arose in regard to the burden of proof required for an administration order under the original provisions. The original section 8(1)(b) contained a requirement that the court had to consider the making of the administration order as "likely to achieve" one or more of the stipulated purposes. In some judgments this was interpreted to mean "on a balance of probabilities" or "more likely than not", while in others it was held to require the lesser burden of proof of "reasonably likely" or merely "a real prospect".<sup>117</sup> Although the new wording still requires more than the mere possibility that administration will achieve its intended purpose, the requirement is not as onerous as the heavy burden of proof that an applicant for judicial management has to discharge in proving a reasonable probability that it will be successful.<sup>118</sup> In *Auto Management Services Ltd v Oracle Fleet UK Ltd*<sup>119</sup> the Chancery Division once again explained that the court did not have to be satisfied that on a balance of probabilities the purpose would be achieved, but only that there was a reasonable prospect.

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<sup>114</sup> In terms of Rule 2.4(2)(e) of the Insolvency Rules, which requires any information which "will assist the court in deciding whether to make such an order". The statement by the administrator (Form 2.2B) consenting to his appointment must also state that in his opinion it is reasonably likely that the purpose of administration will be achieved.

<sup>115</sup> Paragraph 29(3)(b) of Schedule B1 to the Insolvency Act 1986.

<sup>116</sup> *Palmer* par 14.034.

<sup>117</sup> The last-mentioned meaning was eventually accepted by the courts as the correct one: *Sealy and Milman Insolvency Legislation* at 43; *Pennington Corporate Insolvency* at 342; and *Farrar's Company Law* at 688. The observation by Vinelott J in preferring the test of "a real prospect", that a too strict burden of proof would "stultify the Act and achieve no useful purpose", is of particular relevance in the context of judicial management where this is exactly what has happened: *Re Primlaks (UK) Ltd* [1989] BCLC 734; (1989) 5 BCC 710.

<sup>118</sup> Chapter 2, part 2.4.3. The equivalent requirement for business rescue proceedings is far less onerous and also closer to the one for administration: see Chapter 2, part 3.4.1.2.

<sup>119</sup> [2008] BCC 761.

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By contrast with the original provisions which contained four purposes of an administration order that were placed on an equal footing and from which one or more had to be selected by the applicant,<sup>120</sup> paragraph 3(1)<sup>121</sup> sets out three objectives in a clear hierarchy, although all under the heading to paragraph 3: “Purpose of administration”.<sup>122</sup> The choice of which purpose to pursue rests solely with the administrator and it is unlikely that a court would interfere with his decision unless it can be proved that the decision was made in bad faith or irrationally.<sup>123</sup>

#### 2.4.2.1 Rescue of the company as going concern

The first and main objective of administration that an administrator must pursue is to rescue the company as a going concern.<sup>124</sup> From the wording it is clear that the survival of the company entity is envisaged, and not just the business or part of it. The criticism levelled against judicial management because it does not provide for the rescue of a company’s business or a viable part of its business only, but requires a rescue of the corporate entity as well,<sup>125</sup> would thus also apply here and the change has in fact been criticised.<sup>126</sup> However, it is important to note that although statistics in England indicated that it was more usual for the business of a company to be

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<sup>120</sup> The purposes as set out in the original s 8(3) of the Insolvency Act 1986 were (i) the survival of the company and the whole or any part of its undertaking as a going concern, (ii) the approval of a voluntary arrangement under the Act, (iii) the sanctioning of a compromise or arrangement under s 425 of the Companies Act 1985 (now s 895 of the Companies Act 2006) and (iv) a more advantageous realisation of the company’s assets than would be effected on a winding up. The Cork Committee recommended another purpose – carrying on business for the public interest (par 498) – but this was never included in the Act.

<sup>121</sup> Schedule B1 to the Insolvency Act 1986.

<sup>122</sup> Paragraph 111(1) of Schedule B1 provides that any reference in this Schedule to the purpose of administration means an objective specified in par 3. It is submitted that whenever there is a reference to the “purpose” of administration, all or any of the three stated objectives are thus included. Under the original s 8(3) of the Insolvency Act 1986 the specific purpose or purposes for which it was made had to be disclosed in the administration order.

<sup>123</sup> Bailey and Groves *Corporate Insolvency* at 345.

<sup>124</sup> Paragraph 3(1)(a).

<sup>125</sup> Chapter 2, part 2.4.3.

<sup>126</sup> Stevens “Report for England” at 206 refers to this change as “regrettable”. Sealy and Milman *Insolvency Legislation* at 504 holds a contrary view, namely that the insistence on a rescue of the company and not just its business could make it easier for an administrator to conclude that this objective is not reasonably practicable and to pursue the second statutory objective (a better result for creditors, discussed in part 2.4.2.2 below).



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saved than the company itself,<sup>127</sup> the wording of this provision was deliberate.<sup>128</sup> It was argued that there would be little incentive for directors to initiate a rescue by way of administration if the rescue of the business and not the company itself was the objective, and the purpose of the Act would thus be defeated.<sup>129</sup> However, the addition of the words “as a going concern” was intended to make it clear that it is the business that is of value and should be saved where possible, even if it means stripping the company to an empty shell.<sup>130</sup> This is made possible by the power of the administrator, among other things, to sell or otherwise dispose of the property of the company.<sup>131</sup> A judicial manager, on the other hand, is specifically prohibited from selling or otherwise disposing of any of the company’s assets without the leave of the court unless it is in the ordinary course of the company’s business.<sup>132</sup>

#### 2.4.2.2 Better result for creditors

Contrary to the situation in judicial management, the rescue of the company is not the only objective that the administrator is allowed to pursue. If the administrator thinks<sup>133</sup> either that it is not reasonably practicable to rescue the company as a going concern or that the second objective of administration would achieve a better result for the company’s creditors as a whole, he may perform his functions with that

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<sup>127</sup> Statistics released by the R3 Association of Business Recovery Professionals in their report for the period January 2002 to June 2003 *Corporate Insolvency in the UK – 12<sup>th</sup> Survey* indicated that in 59 per cent of rescue procedures the entire business of the company was saved through a sale as a going concern.

<sup>128</sup> Lightman and Moss *Administrators* par 5-012 (fn 18) refers to the fact that the government was not prepared to amend the provision to focus on the rescue of the underlying business rather than the company, in spite of intensive lobbying by the Association of Business Recovery Professionals and others.

<sup>129</sup> Parry *Corporate Rescue* at 38.

<sup>130</sup> Parry “Administrative Receivership and Administration” at 163. Goode *Corporate Insolvency Law* at 335-336 puts it somewhat differently: confirming that the phrase “as a going concern” was added at a later stage to make the government’s policy clear, he interprets it to mean that it was not the empty shell of the company that should be rescued but the company with at least a substantial part of its business intact.

<sup>131</sup> Paragraph 60 of Schedule B1 and Schedule 1 to the Insolvency Act 1986.

<sup>132</sup> Section 434(1) of the Companies Act of 1973. The Companies Act of 2008 has widened this power by authorising the company (not the business rescue practitioner) to dispose of company assets in the ordinary course of its business, or in a bona fide transaction with the prior approval of the business rescue practitioner, or as part of an approved business rescue plan (s 134(1)(a)). A disposal of all or the greater part of the company’s assets will also not require the approval of the shareholders if it is done in terms of a business rescue plan: s 112(1)(a).

<sup>133</sup> Frisby “Rescue Regime” at 264-265 draws attention to the importance of the use of the word “thinks” that emphasises the administrator’s subjective and thus almost unassailable opinion in this regard, possibly even irrespective of whether he has reasonable grounds for this belief. *Palmer* par 14.021 also expresses the opinion that the use of such “inexact” expressions as “thinks” and “reasonably practicable” is likely to become grounds for future challenges of an administrator’s choice of an alternative objective.

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second objective, namely to achieve a better result for the company's creditors than would be likely if the company were wound up without first being in administration.<sup>134</sup> There can be no doubt that this provision firmly places the interests of creditors first, even before those of employees or shareholders who would benefit more from a rescue of the company itself, in that a rescue of the corporate entity need not be pursued if it would be to the detriment of the creditors.<sup>135</sup> By contrast, the South African courts have emphatically rejected a better result for creditors as a ground for judicial management.<sup>136</sup>

Under the original administration provisions, the viable part of a company's business had in practice often been transferred to a new company, and the court was then approached for a termination of the administration order, replacing it with a liquidation order to realise any remaining assets and pay outstanding debts. In many cases the application for an administration order therefore provided for the rescue of the company or the more advantageous eventual winding up of the company as alternative objectives.<sup>137</sup> As neither the administration application nor the statement of the proposed administrator now requires an indication of the specific objective<sup>138</sup> that will be pursued during administration, the administrator may under the new provisions apparently decide to pursue the second objective even though this was not originally intended, if at any stage during the administration he comes to the conclusion that the second objective would be the better or more practicable option.<sup>139</sup> This would address another problem encountered in judicial management where the courts have refused to issue even a provisional judicial management order to enable a judicial manager to ascertain whether the company could be successfully rescued.<sup>140</sup>

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<sup>134</sup> Paragraphs 3(1)(b) and 3(3)(a) and (b). According to Goode *Corporate Insolvency Law* at 327, the vast majority of administrations have in practice achieved this purpose.

<sup>135</sup> *Gower* at 848; *Palmer* par 14.021, who regards it as significant that there is no reference to the interests of shareholders or employees. According to Parry "Administrative Receivership and Administration" at 162, this provision also ensures that an administrator will not be obliged to attempt a rescue of a company that is beyond salvage.

<sup>136</sup> Chapter 2, part 2.4.3. However, see Chapter 2, part 3.1 regarding the inclusion of a better return for creditors (and shareholders!) as a secondary purpose in the definition of "business rescue" in s 128(1)(b) of the Companies Act of 2008.

<sup>137</sup> Pennington *Corporate Insolvency* at 306-307.

<sup>138</sup> Of the three objectives listed under the purpose of administration in par 3(1) of Schedule B1 to the Insolvency Act 1986.

<sup>139</sup> The administrator would, however, require the approval of a creditors' meeting should he decide to pursue another objective after his proposals have already been approved: see part 2.8.3 below.

<sup>140</sup> *Kotzé v Tulryk Bpk en Andere* 1977 (3) SA 118 (T) referred to in Chapter 2, part 2.4.3.

### 2.4.2.3 Distribution to secured or preferential creditors

The third and last objective listed under the purpose of administration is that of realising property in order to make a distribution to one or more secured or preferential creditors. This objective may, however, only be pursued by the administrator if he thinks that it is not reasonably practicable to achieve either of the other two objectives and he does not unnecessarily harm the interests of the company's creditors.<sup>141</sup> This objective can be seen as part of the trade-off to compensate creditors holding a floating charge over the company's assets for depriving them of their traditional remedy of appointing a receiver or administrative receiver. However, the pursuit of this objective is more regulated than the others since, where applicable, the administrator is required to explain in his administration proposals<sup>142</sup> why he believes that the other objectives cannot be achieved.<sup>143</sup>

## 2.5 Procedure to commence administration

### 2.5.1 By the company or its directors

A person who intends appointing an administrator under paragraph 22 must give at least five business days' prior written notice to any person entitled to appoint an administrative receiver of the company and to any holder of a floating charge who is or may be entitled to appoint an administrator under paragraph 14.<sup>144</sup> This notice of intention to appoint has to identify the proposed administrator and be in the prescribed form.<sup>145</sup> A copy of the company's resolution to appoint an administrator or a record of the decision of the directors to make such an appointment must accompany the notice.<sup>146</sup> If there are no such persons

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<sup>141</sup> Paragraph 3(4) of Schedule B1 to the Insolvency Act 1986. Bailey and Groves *Corporate Insolvency* at 345 (fn 6) refers to this duty to creditors as "window-dressing" to appease ordinary creditors and wonders quite what practical effect it will have.

<sup>142</sup> Discussed in part 2.8.2 below.

<sup>143</sup> Paragraph 49(2)(b) of Schedule B1 to the Insolvency Act 1986.

<sup>144</sup> Paragraph 26(1) of Schedule B1 to the Insolvency Act 1986. This will give the holder of the floating charge an opportunity to appoint an administrator of his choice, but will not allow him to block administration as before: Parry "Administrative Receiverships and Administration" at 161. Rule 2.20(2) of the Insolvency Rules also requires notice to the company if the directors are making the appointment, to the supervisor of a voluntary arrangement under Part 1 of the Insolvency Act 1986, any sheriff known to be executing a legal process against the company and any person known to have distrained against the company or its property.

<sup>145</sup> Paragraph 26(3) of Schedule B1 to the Insolvency Act 1986 and Form 2.8B.

<sup>146</sup> Rule 2.22 of the Insolvency Rules. An ordinary resolution by the company (or an informal unanimous consent) seems to be all that is required: Sealy and Milman *Insolvency Legislation* at 516. Where the directors intend making the appointment, the use of the word "decision" rather than the more formal "resolution" indicates that they need not even hold a formal meeting: par 105 of Schedule B1 and Sealy and Milman *Insolvency Legislation* at 516 and 563.

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entitled to prior notice, the notice of appointment (discussed below) will include the statements and declarations prescribed for the notice of intention to appoint and will be accompanied by a copy of the company's resolution or record of the directors' decision.<sup>147</sup>

A copy of the notice of intention to appoint and its accompanying document must also be filed with the court as soon as is reasonably practicable.<sup>148</sup> The prescribed notice contains a mandatory statutory declaration to be made by or on behalf of the person who proposes to make the appointment in which it is declared that the company is or is likely to become unable to pay its debts,<sup>149</sup> that, so far as the person making the statement is able to ascertain, the appointment is not prevented by paragraphs 23 to 25<sup>150</sup> and that the company is not in liquidation.<sup>151</sup>

The actual appointment of an administrator, which also signals the official commencement of administration,<sup>152</sup> is done by filing the prescribed notice of appointment and other prescribed documents with the court<sup>153</sup> at least five business days after the required written notice of intention to appoint has been given<sup>154</sup> but not more than ten business days after a copy of this notice was filed with the court.<sup>155</sup> The notice of appointment must include a statutory declaration<sup>156</sup> by or on behalf of the person making the appointment stating that

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<sup>147</sup> Rule 2.25 of the Insolvency Rules.

<sup>148</sup> Paragraph 27(1) of Schedule B1 to the Insolvency Act 1986. If there are no persons to whom notice has to be given, no such notice is filed with the court either.

<sup>149</sup> Discussed in part 2.4.1 above.

<sup>150</sup> These refer to the restrictions on the appointment of an administrator within 12 months after the previous appointment of an administrator or an arrangement under Schedule A1 (discussed in part 2.3.1 above) and those in terms of par 25 discussed below in this part.

<sup>151</sup> Paragraph 27(2) and (3) of Schedule B1 to the Insolvency Act 1986 requires that this declaration must accompany the copy of the notice filed with the court, but it actually forms part of the notice itself as prescribed in Form 2.8B. In terms of Rule 2.21 of the Insolvency Rules this statutory declaration may not be made more than five business days before the notice is filed with the court.

<sup>152</sup> Paragraph 1(2)(b) of Schedule B1 to the Insolvency Act 1986 provides that a company enters administration when the appointment of an administrator takes effect. Paragraph 31, in turn, provides that the appointment of an administrator under par 22 takes effect when the requirements of par 29 are satisfied.

<sup>153</sup> Paragraph 29 of Schedule B1 to the Insolvency Act 1986. Form 2.9B is prescribed if a notice of intention to appoint has been issued, and Form 2.10B if it has not because there are no persons entitled to notice in terms of the relevant provisions. Apart from the administrator's statement discussed below, the other prescribed documents are a statement on their division of functions if more than one administrator is to be appointed (in terms of par 100(2)) and the written consent of all the persons to whom notice of the intention to appoint was given if the notice of appointment is filed less than the prescribed five business days afterwards: Rule 2.23 of the Insolvency Rules.

<sup>154</sup> Unless each person who was notified consents in writing to the making of the appointment: par 28(1)(b) of Schedule B1 to the Insolvency Act 1986.

<sup>155</sup> Paragraph 28(2) of Schedule B1 to the Insolvency Act 1986.

<sup>156</sup> On Form 2.8B and made not more than five business days before filing with the court: Rule 2.21 of the Insolvency Rules.

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he is entitled to make an appointment under paragraph 22 and that the appointment is in accordance with Schedule B1 to the Insolvency Act 1986, and further confirming the accuracy, as far as he is able to ascertain, of the statements and information contained in the declaration filed with the notice of intention to appoint.<sup>157</sup> The administrator, who must be identified in the notice of appointment, has to provide an accompanying statement in which he consents to his appointment, provides details of any prior professional relationship he has had with this company and expresses his opinion that the purpose of administration is reasonably likely to be achieved.<sup>158</sup> Paragraph 29(4)<sup>159</sup> makes it clear that the administrator is entitled to rely on information supplied by directors of the company for his statement, unless he has reason to doubt the accuracy of this information.

As soon as is reasonably practicable after the notice of appointment and other prescribed documents have been filed in accordance with paragraph 29<sup>160</sup> the person appointing the administrator must notify him and the same persons who had to be notified of the intention to appoint an administrator. Failure to do so without a reasonable excuse constitutes a criminal offence.<sup>161</sup> The administrator then has to notify the company, its creditors and the registrar of companies of his appointment, in the same manner as required after an administration order has been issued.<sup>162</sup>

Paragraph 25 of Schedule B1 prohibits the appointment of an administrator under paragraph 22 if an administrative receiver of the company is in office or if a petition for the winding up of the company has been presented<sup>163</sup> and not yet disposed of.<sup>164</sup> For obvious

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<sup>157</sup> Paragraph 29(2) of Schedule B1 to the Insolvency Act 1986. It is an offence to make a false statement under this provision without reasonably believing it to be true (par 29(7)).

<sup>158</sup> Paragraph 29(3) of Schedule B1 to the Insolvency Act 1986 read with Rule 2.3(5) of the Insolvency Rules. The purpose of administration is discussed in part 2.4.2 below.

<sup>159</sup> Schedule B1 to the Insolvency Act 1986.

<sup>160</sup> Of Schedule B1 to the Insolvency Act 1986.

<sup>161</sup> Paragraph 32 of Schedule B1 to the Insolvency Act 1986.

<sup>162</sup> Paragraph 46 of Schedule B1 to the Insolvency Act 1986 and Rule 2.27(2) of the Insolvency Rules, discussed in part 2.5.2 below. He also has to gazette the notice of his appointment and advertise it in any other manner he deems fit: Rule 2.27(1).

<sup>163</sup> In *Re Blights Builders Ltd* [2006] EWHC 3549(Ch); [2007] BCC 712 the uncertainty as to exactly at what point this is, was resolved when it was held that a petition for winding up is presented when it is delivered to the court for issue, and not later when it is actually issued by the court. See Chapter 2, part 3.5.1.1 where a similar uncertainty in respect of the new rescue proceedings in South African law has been created because of unclear wording.

<sup>164</sup> This is contrary to the position in an application for an administration order where it is merely required that the administrative receiver and the person who appointed him, or the petitioner for winding up (and the provisional liquidator if one has been appointed), as the case may be, should be notified of the application (discussed in part 2.5.2 below). As explained in part 2.3.2 below, an administrator may not be appointed for a company already in (final) liquidation, except by virtue of an order of court

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reasons it also prohibits the appointment of an administrator if an application for an administration order has been made and not yet disposed of.

## **2.5.2 By order of court**

### **2.5.2.1 Application and supporting documents**

The application for an administration order must be in the prescribed form and accompanied by an affidavit containing the prescribed information.<sup>165</sup> The Rules are very specific about the persons who must make the affidavit supporting the application in each case. If the application is to be made by the company or by the directors, the affidavit must be made by one of the directors or the secretary of the company.<sup>166</sup> If the application is to be made by creditors, they must authorise one person (who need not be one of them) to make the affidavit on their behalf.<sup>167</sup>

The application must also be accompanied by a written statement by each of the persons proposed to be appointed as administrator. It must contain each candidate's consent to the appointment, details of any prior professional relationship with the company and his opinion that it is reasonably likely that the purpose of administration will be achieved.<sup>168</sup> The last requirement was inserted to avoid the problem experienced under the original provisions where it became accepted practice to file a statement of the company's affairs prepared by another insolvency practitioner (because of the requirement of a report prepared by an independent person), adding to the costs and time spent on an administration application.<sup>169</sup> It is, however, still required that the proposed administrator should be objective in his assessment of the situation.<sup>170</sup> The courts largely rely on the evidence supplied by the prospective administrator and his statement should contain enough information to show why other options are not appropriate and how the administration process will be funded and managed.<sup>171</sup>

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on the application of the liquidator.

<sup>165</sup> Rules 2.2(1), 2.3 and 2.4 of the Insolvency Rules. The form prescribed for the application is Form 2.1B. The prescribed contents of both the application and the affidavit (soon to be replaced by a witness statement as explained above) are discussed in part 2.4 above.

<sup>166</sup> Rule 2.2(2) of the Insolvency Rules.

<sup>167</sup> Rule 2.2(3) of the Insolvency Rules.

<sup>168</sup> Rule 2.3(5) of the Insolvency Rules.

<sup>169</sup> Discussed in part 1 and fn 12 above.

<sup>170</sup> Lightman and Moss *Administrators* par 5-017.

<sup>171</sup> Bailey and Groves *Corporate Insolvency* at 357.

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The application and all supporting documents must be filed with the court which will then determine a date for the hearing.<sup>172</sup> An application for administration may not be withdrawn without the permission of the court after it has been presented.<sup>173</sup> This is intended to discourage frivolous applications or abuse of the process<sup>174</sup> to obtain the advantage of the interim moratorium that operates from the presentation of the petition to court.<sup>175</sup>

#### 2.5.2.2 Notification of application

The applicant must give notice of the application as soon as is reasonably practicable after filing the application but not less than five days<sup>176</sup> before the date of the hearing.<sup>177</sup> The detailed and very specific list of parties to whom notice should be given does not include the general body of creditors nor does it include employees, but is restricted to the company itself (if it is not the applicant), the person proposed as administrator, the petitioner in any pending petition for winding up of the company (and the provisional liquidator, if any), any supervisor of a voluntary arrangement under Part I of the Insolvency Act 1986 and any person who, being the holder of a qualifying floating charge in respect of a company's property, is or may be entitled to appoint an administrator of the company in terms of paragraph 14 of Schedule B1 of the Insolvency Act 1986.<sup>178</sup>

As a result of the very limited notification required by the Act,<sup>179</sup> it is possible that a creditor who is unaware of the pending administration application may apply for

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<sup>172</sup> Rule 2.5 of the Insolvency Rules.

<sup>173</sup> Paragraph 12(3) of Schedule B1.

<sup>174</sup> Bailey and Groves *Corporate Insolvency* at 347 (fn 1) refers to the prevention of a “knee-jerk” reaction to pressure from creditors by applying for administration merely to buy time.

<sup>175</sup> See part 2.6.1 below.

<sup>176</sup> These are stipulated as business days by the draft Insolvency (Amendment) Rules 2010.

<sup>177</sup> Paragraph 12(2) of Schedule B1 to the Insolvency Act 1986, read with Rule 2.8(1) of the Insolvency Rules.

<sup>178</sup> Paragraph 12(2) of Schedule B1 to the Insolvency Act 1986 and Rule 2.6 of the Insolvency Rules. Also on the list prescribed by par 12(2) and Rule 2.6 are any administrative receiver who has been appointed, the person who appointed him and any person who is entitled to appoint an administrative receiver. As the power to appoint an administrative receiver is now severely limited by the Insolvency Act 1986 to only a few very special cases (mostly where administration is not applicable), they are not important to this discussion.

<sup>179</sup> The *Cork Report* (in par 502) specifically recommended that “an application for the appointment of an administrator should not be advertised”. This is understandable when one takes into account the serious and damaging consequences that prior notification would probably have on the company's ability to continue doing business. Unfortunately, the drafters of South Africa's business rescue provisions in the Companies Act of 2008 do not seem to have considered this at all: see Chapter 2, part 3.5.2.1.

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winding up of the company after an application for administration has been presented. In such a case the court will hear the administration application first so as not to damage the company while this petition is pending, and will lean towards granting the administration order if it has a chance of succeeding, especially as it will become clear very early on in the administration process whether it should be allowed to continue.<sup>180</sup>

Although this will only be allowed in very exceptional circumstances, the courts have on occasion granted an administration order without any prior notice being given, for example to avoid a run on a bank that was the subject of the administration order.<sup>181</sup> In view of the comprehensive notification required by the provisions regulating business rescue proceedings in the Companies Act of 2008 it seems unlikely that any South African court will believe itself to have a similar discretion, even if it is clear that irreparable damage will be caused by the compulsory notices.<sup>182</sup>

### 2.5.2.3 Persons who may participate in the hearing

Rule 2.12(1)<sup>183</sup> contains a limited list of persons who may appear or be represented at the hearing, including the applicant, the company and one or more of the directors.<sup>184</sup> Persons who are not included in this list – such as members and some secured and all unsecured creditors – may appear or be represented only with the permission of the court if they appear to have an interest justifying their appearance.<sup>185</sup> Under the previous, identically-worded provision,<sup>186</sup> members were not regarded as automatically having such an interest, particularly if the company was already in, or on the verge of, insolvency, in spite of having a real interest in a successful rescue of the company.<sup>187</sup> However, Bailey and Groves<sup>188</sup> state that it is

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<sup>180</sup> Bailey and Groves *Corporate Insolvency* at 351.

<sup>181</sup> Parry *Corporate Rescue* at 34-35.

<sup>182</sup> See Chapter 2, part 3.5.2.1.

<sup>183</sup> Of the Insolvency Rules 1986.

<sup>184</sup> The other persons on the list are an administrative receiver (if one has been appointed), any person who has presented a petition for the winding up of the company, the person proposed for appointment as administrator, any holder of a floating charge who qualifies in terms of par 14 of Schedule B1 to appoint an administrator and any supervisor of a voluntary arrangement under part I of the Insolvency Act 1986 (discussed in part 3 below).

<sup>185</sup> Rule 2.12(1)(k) of the Insolvency Rules.

<sup>186</sup> Rule 2.9(1)(g) of the Insolvency Rules.

<sup>187</sup> *Re Chelmsford City Football Club (1980) Ltd* [1991] BCC 133; Sealy and Milman *Insolvency Legislation* at 45 and 721. The court did, however, allow members to appear in *Re Farnborough-*



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normally fairly easy to convince the court to hear an interested party and an applicant would have serious problems trying to convince the court that an interested creditor should not be heard.

#### 2.5.2.4 Powers of the court

Apart from granting the administration order or dismissing the application, the court may also adjourn the hearing, make an interim order (that may restrict the exercise of a power of the company or directors and may confer a discretion on the court or a person qualified to act as an insolvency practitioner)<sup>189</sup> or make any other order which the court thinks appropriate.<sup>190</sup> The court does not have the power to appoint an interim administrator but may appoint an insolvency practitioner to take control of and manage the company's property if necessary.<sup>191</sup> However, in the Practice Note issued in January 1994<sup>192</sup> it was mentioned that in suitable cases the court could appoint an administrator but require him to report back to court within a short period so that the court could decide whether to allow the administration to continue or terminate it.<sup>193</sup> There is thus no provision for a provisional administration order as in the case of judicial management where such an order is obligatory.<sup>194</sup> No provision exists in the Companies Act of 2008 for a provisional order in respect of the new business rescue proceedings, and the power of the court to make "any further necessary and appropriate order" only applies if the application for business rescue proceedings is dismissed.<sup>195</sup> It will therefore not include the power to make a provisional order either.

The court is furthermore given the express power to treat an administration application as a winding-up petition and make any order it has the power to make when

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*Aircraft.com Ltd* [2002] EWHC 1224 (Ch); [2002] 2 BCLC 641.

<sup>188</sup> *Corporate Insolvency* at 362, also citing *Re Farnborough-Aircraft.com Ltd* [2002] EWHC 1224 (Ch); [2002] 2 BCLC 641 as an example.

<sup>189</sup> Paragraph 13(3) of Schedule B1 to the Insolvency Act 1986.

<sup>190</sup> Paragraph 13(1)(a), (b), (c), (d) and (f) respectively of Schedule B1 to the Insolvency Act 1986.

<sup>191</sup> Sealy and Milman *Insolvency Legislation* at 48; Grier and Floyd *Corporate Recovery* at 24-25 and cases mentioned there; Parry *Corporate Rescue* at 42.

<sup>192</sup> Referred to in fn 12 above.

<sup>193</sup> Sealy and Milman *Insolvency Legislation* at 717.

<sup>194</sup> However, the courts in South Africa emphatically rejected the use of a provisional judicial management order to determine whether judicial management was appropriate: Chapter 2, part 2.5.1.

<sup>195</sup> Section 131(4)(b): see Chapter 2, part 3.5.2.5.

hearing a petition for winding up, obviously including an order for winding up.<sup>196</sup> This is an exception to the general rule that a winding-up order may be made only after a petition for winding up has been presented under section 124 of the Insolvency Act 1986.<sup>197</sup> However, in spite of a recommendation in the *Cork Report*<sup>198</sup> that the converse should also be made possible, this has not happened: the court may not issue an administration order when hearing a winding-up petition because the Insolvency Act 1986 makes it clear that an administrator may be appointed only under its Schedule B1.<sup>199</sup> This is the exact opposite of the situation in judicial management where the court is granted the express power to issue a judicial management order where an application for winding up is before the court.<sup>200</sup> On the other hand, South African courts are not authorised under the Companies Act of 1973 to issue a winding-up order when hearing an application for judicial management, unless a proper application for the winding up of the company is before the court.<sup>201</sup> The Companies Act of 2008 now allows a court to order, under appropriate circumstances, the commencement of business rescue proceedings when hearing an application for winding up of the company and, conversely, to order the liquidation of the company when an application for the commencement of business rescue proceedings is before the court.<sup>202</sup>

If an administration order is made by the court, the applicant must notify the person appointed as administrator as soon as reasonably practicable by sending him a sealed copy of the order.<sup>203</sup> The administrator is responsible for sending a notice of his appointment to the company, all its creditors (or at least those whose claims

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<sup>196</sup> Paragraph 13(1)(e) of Schedule B1 to the Insolvency Act 1986 which had no predecessor in the legislation before the Enterprise Act of 2002. Section 125(1) of the Insolvency Act 1986 provides that on hearing a winding-up petition, the court may dismiss it, adjourn the hearing, make an interim order or make any other order that it thinks fit, thereby giving the court the widest possible discretion. The court used its power under par 13(1)(e) to issue a winding-up order in *Re Ci4net.com Inc* [2004] EWHC 1941 (Ch); [2005] BCC 277.

<sup>197</sup> *Re Brooke Marine Ltd* [1988] BCLC 546; Sealy and Milman *Insolvency Legislation* at 150-151. This rule is also discussed in part 2.9 dealing with the termination of administration.

<sup>198</sup> Paragraph 510 of the *Cork Report* recommended that the court should have jurisdiction to appoint an administrator if appropriate, even if there was no specific application for such an appointment.

<sup>199</sup> Paragraph 1 of Schedule B1 states that for the purposes of the Insolvency Act 1986 an administrator of a company means a person "appointed under this Schedule". The same principle applied to the original provisions of the Insolvency Act 1986, although they did not contain a provision similar to par 1: Sealy and Milman *Insolvency Legislation* at 45.

<sup>200</sup> Section 427(3) of the Companies Act of 1973 discussed in Chapter 2, part 2.4.5.

<sup>201</sup> Such an application may, for example, be brought by an intervening creditor or the provisional judicial manager: Chapter 2, part 2.5.2.

<sup>202</sup> See Chapter 2, parts 3.5.2.4 and 3.5.2.5 respectively.

<sup>203</sup> Rule 2.14 of the Insolvency Rules.

and addresses appear on the list he must obtain from the company) and the registrar of companies.<sup>204</sup> The administrator is also required to advertise his appointment in the *Gazette* and may advertise it in any other way as he thinks fit.<sup>205</sup>

Administration officially commences at the time stipulated in the order of court appointing the administrator or, if no such time is specified, when the order for the appointment of the administrator is made.<sup>206</sup> This is in sharp contrast to the rather confusing situation regarding the commencement of business rescue proceedings in terms of the Companies Act of 2008.<sup>207</sup>

An appeal against an administration order may be lodged by any party aggrieved at the making of the order.<sup>208</sup>

## 2.6 The moratorium

Whereas the original section 10 of the Insolvency Act 1986 provided for an automatic moratorium on most legal processes that commenced or continued against the company as soon as an administration order was presented to the court,<sup>209</sup> the moratorium on insolvency proceedings and other legal processes against the company now only commences once the company is in administration, that is, from the moment when an administrator is appointed.<sup>210</sup> Lightman and Moss<sup>211</sup> express the opinion that although it is convenient to describe it as a moratorium, the breathing space that the company is allowed is not an authorisation to the company to postpone the payment of its debts<sup>212</sup> but merely a limited immunity against enforcement of some legal rights. It would appear as though the drafters of the provisions regulating the new business rescue proceedings in South Africa have

<sup>204</sup> Paragraph 46 of Schedule B1 to the Insolvency Act 1986.

<sup>205</sup> Rule 2.27 of the Insolvency Rules.

<sup>206</sup> Paragraph 13(2).

<sup>207</sup> See Chapter 2, part 3.5.2.6.

<sup>208</sup> In terms of Rule 7.47. Aggrieved persons include the company, the administrator and a creditor who can prove that the order is oppressive in respect of himself: *Palmer* par 14.029.

<sup>209</sup> This moratorium lasted until the order was granted or the application dismissed. In the former case the moratorium was extended in terms of s 11.

<sup>210</sup> See part 2.6.2 below.

<sup>211</sup> *Administrators* par 2-040.

<sup>212</sup> The administrator has not been given any specific power to repudiate a contract but should this be necessary to promote the purpose of administration, it would be advisable to apply to court for directions in terms of par 63: Bailey and Groves *Corporate Insolvency* at 398. Sections 238 and 239 of the Insolvency Act 1986, on the other hand, provide for applications to court by the administrator to set aside transactions at an undervalue and (undue) preferences respectively.

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confused these two issues by allowing a company to suspend existing contracts or some provisions thereof, which could effectively be used as a moratorium on the payment of debts.<sup>213</sup>

### 2.6.1 Interim moratorium

The fact that the moratorium commences only on the granting of an administration order or the appointment of an administrator would, in the period immediately after the first steps towards administration have been taken, leave the company vulnerable to actions by creditors hoping to enforce their claims before the moratorium takes effect. To fill this gap, provision is made for an interim moratorium in the period between the making of an application for administration and the granting or dismissal of an administration order, as well as between filing an intention to appoint an administrator with the court<sup>214</sup> and the moment the actual appointment takes effect or the specified period of ten business days expires without any appointment being made.<sup>215</sup> The scope of the interim moratorium is almost exactly the same as that of the final one, because the provisions of paragraphs 42 and 43 (except for references to the consent of the administrator) are made applicable to the interim moratorium.<sup>216</sup> As Sealy and Milman<sup>217</sup> correctly point out, no interim moratorium will come into effect if there are no persons to whom notice of the intention to appoint an administrator must be given, because no notice of intention to appoint an administrator is filed with the court in such a case. The effect of this omission is that the company will be left vulnerable while the documents for appointment of an administrator are being prepared.

In his discussion of the moratorium under the original provisions, Pennington<sup>218</sup> pointed out that there was no moratorium on the actions of directors of a company

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<sup>213</sup> See Chapter 2, part 3.6 and Chapter 4, part 2.6.

<sup>214</sup> In terms of par 27(1) of Schedule B1 to the Insolvency Act 1986.

<sup>215</sup> Paragraph 44 of Schedule B1 to the Insolvency Act 1986.

<sup>216</sup> Paragraph 44(5) of Schedule B1 to the Insolvency Act 1986. There is another notable difference in that, during the interim moratorium, the permission of the court is not required for the appointment of, or carrying out of his functions by, an administrative receiver or the appointment of an administrator in terms of par 14 of Schedule B1: par 44(7). Although the appointment of administrative receivers has been virtually abolished by s 72A of the Insolvency Act 1986 as inserted by the Enterprise Act 2002, this applies only to floating charges created after its enactment, and administrative receivers will still be around for a long time.

<sup>217</sup> *Insolvency Legislation* at 517 and 528.

<sup>218</sup> *Corporate Insolvency* at 361-362.

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until the administration order was issued because the directors remained in office in the period between the filing of the first documents and the time when the appointment of an administrator takes effect. Directors were thus free to exercise their powers, including the power to dispose of company property by selling, leasing, mortgaging or charging it and they could also continue to draw on the company's bank account.<sup>219</sup> Although paragraph 13(3)(a)<sup>220</sup> now authorises the court to make an order restricting the exercise of a power of the directors of a company, this is still only possible when the application for administration is heard and if the application is not immediately granted or dismissed.<sup>221</sup> The weakness that was identified in the original provisions has therefore continued to exist in the amended procedure. However, the possibility of being reported to the Secretary of State and consequently being disqualified from acting as an insolvency practitioner or being involved in the promotion, formation or management of a company without the permission of the court,<sup>222</sup> should act as a strong deterrent from taking any improper actions. The situation is only marginally better in the case of judicial management where all the property of the company is automatically vested in the Master of the High Court as soon as a provisional judicial management order is issued.<sup>223</sup>

### 2.6.2 Final moratorium

In terms of paragraph 42,<sup>224</sup> there is an absolute moratorium on the winding up of the company while in administration, whether by way of a company resolution or order of court.<sup>225</sup> By contrast, the position under the new business rescue proceedings in

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<sup>219</sup> Pennington *Corporate Insolvency* at 362 stated that the court apparently had no authority to prevent directors from exercising their normal powers unless it would amount to a breach of fiduciary or other duties.

<sup>220</sup> Of Schedule B1 to the Insolvency Act 1986.

<sup>221</sup> Paragraph 13 of Schedule B1 discussed in part 2.5.2 above.

<sup>222</sup> In terms of the Company Directors Disqualification Act 1986 (c 46): see part 2.7.1.3 below.

<sup>223</sup> Chapter 2, part 2.5.1. The Companies Act of 2008 makes no provision for an interim moratorium before the commencement of business rescue proceedings, in spite of requiring wide notification of an intended application for a business rescue order, thereby leaving a company completely exposed to actions by creditors and directors: see Chapter 2, part 3.6.1.1.

<sup>224</sup> Of Schedule B1 to the Insolvency Act 1986. The two very specific exceptions concern state authorities acting in the public interest and are not relevant to this discussion.

<sup>225</sup> In spite of this, however, one of the powers of an administrator as contained in Schedule 1 to the Insolvency Act 1986 is to present a petition for the winding up of the company (par 21). In such a case the administrator will simultaneously have to apply to court in terms of par 79 for his appointment to be terminated.

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South Africa is far from clear because winding up is not specifically mentioned in the provisions regulating the moratorium. It must be assumed that an application to court for the winding up of the company is possible with the consent of the business rescue practitioner or the court.<sup>226</sup>

The moratorium on other legal processes prohibits, except with the consent of the administrator or the permission of the court, any steps to enforce security over the company's property, repossess goods under a hire-purchase agreement, exercise a landlord's right of forfeiture and any other legal process against the company<sup>227</sup> or its property while the company is in administration.<sup>228</sup> The moratorium is thus automatic and wide and in force for the duration of administration but, with the exception of any process to wind up the company, it is not absolute, since both the administrator and the court have the power to allow a specific legal process against the company to be instituted or continued.

In *Re Atlantic Computer Systems Plc*<sup>229</sup> the Court of Appeal set out the principles which should be applied in deciding whether to grant leave to an applicant to exercise existing proprietary rights (including security rights). Among these is the duty of the court to balance the interests of the applicant with those of other creditors where giving leave would hinder the achievement of the administration's purpose.<sup>230</sup> In general, administration should not be conducted for the benefit of unsecured creditors at the expense of secured creditors or owners/lessors, unless this is unavoidable, and leave should normally be granted if a lessor or secured creditor will suffer significant loss if leave is refused.<sup>231</sup> A court

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<sup>226</sup> See Chapter 2, part 3.6.1.2.

<sup>227</sup> In terms of a decision of the Court of Appeal (although on the previous provisions) this also applies to criminal proceedings against the company: see *Environment Agency v Clark (Administrator of Rhondda Waste Disposal Ltd)* [2000] BCC 653 (CA).

<sup>228</sup> Paragraph 43 of Schedule B1 to the Insolvency Act 1986.

<sup>229</sup> [1992] Ch. 505; [1990] BCC 859. See Fletcher *Insolvency* at 544-546; *Farrar's Company Law* at 691-694; *Palmer* par 14.045 and Sealy and Milman *Insolvency Legislation* at 53-54 for a discussion of the moratorium and in particular this decision. Although this case and many other authorities mentioned in the discussions deal with the moratorium under the original provisions, the basic principles still apply.

<sup>230</sup> This aspect was again emphasised by the Court of Appeal in *Innovate Logistics Ltd v Sunberry Properties Ltd* [2008] EWCA Civ 1321; [2009] BCC 164 where permission was refused because the intended proceedings would prejudice the achievement of the purpose of the administration by resulting in a lower realisation of the company's estate. See Frisby "Pre-packs" at 1-4 where this judgment is discussed in detail.

<sup>231</sup> This does not follow automatically, however; each case must be considered individually, including the behaviour of the applicant, and whether the application is opposed by the administrator: Bailey and Groves *Corporate Insolvency* at 381-382.

may grant permission for a process to be instituted or continued against the company subject to a condition or a requirement.<sup>232</sup> These principles should also guide an administrator in deciding whether to allow a legal process.

## 2.7 Managing the procedure

### 2.7.1 The administrator

#### 2.7.1.1 Appointment

It has already become clear from the discussions above that an outsider (the administrator or administrators, as more than one may be appointed) is appointed to manage the company's affairs during administration.<sup>233</sup> The administrator is appointed either by the court as part of the administration order or by the company or its directors.<sup>234</sup> Only a person who is qualified to act as an insolvency practitioner in relation to the company may be appointed.<sup>235</sup> The phrase "in relation to the company" refers to a possible prior professional relationship with the company which would disqualify an insolvency practitioner from appointment for that particular company. The Act does not describe the circumstances under which this would be the case,<sup>236</sup> but details of any such prior relationship must be disclosed.<sup>237</sup>

Where an administration order is made by the court and different administrators are nominated by the company and another party respectively, the court has a discretion whom to appoint without having to give preference to the nominee of any particular party, such as the company or the creditors.<sup>238</sup>

<sup>232</sup> Paragraph 43(7) of Schedule B1 to the Insolvency Act 1986.

<sup>233</sup> Paragraph 100 of Schedule B1.

<sup>234</sup> Paragraph 2 of Schedule B1 to the Insolvency Act 1986. As explained in part 2.3 above, the third possibility of appointment by the holder of a floating charge is not relevant for our purposes, as South African law does not recognise this special type of company creditor.

<sup>235</sup> Paragraph 6 of Schedule B1 to the Insolvency Act 1986.

<sup>236</sup> All the professional bodies concerned publish guides to professional conduct and ethics that explain the principles to be considered when deciding whether to accept an appointment or not: Sealy and Milman *Insolvency Legislation* at 426.

<sup>237</sup> In Form 2.2B: Statement of proposed administrator, as prescribed by Rule 2(23)(2)(a) of the Insolvency Rules.

<sup>238</sup> But the court may be persuaded to appoint a specific candidate if creditors overwhelmingly support his appointment rather than the other: Bailey and Groves *Corporate Insolvency* at 364. Otherwise each nominee's knowledge of the company's affairs and the amount of investigative work he has already done are some of the factors the court will take into consideration. However, according to Milman "Overview" at 2, referring to the decision in *The Oracle (North West) Ltd v Pinnacle Financial Services (UK) Ltd* [2008] EWHC 1920 (Ch); [2009] BCC 159, the court will usually choose the person nominated by the leading creditors rather than the one nominated by the company.

### 2.7.1.2 Qualifications

The strictly regulated system of appointment and supervision of insolvency practitioners is an important feature of current English insolvency law. These requirements were introduced as a result of proposals put forward by the *Cork Report*<sup>239</sup> which stressed that the success of any insolvency system depended largely on those who administered it: if they did not have the respect and confidence of the courts, the creditors, the debtors and the general public, the insolvency system would fall into disrepute and disuse.<sup>240</sup> The *Cork Report* thus recommended that some minimum professional qualification as well as control was required to ensure a high standard of competence and integrity and to prevent abuse.<sup>241</sup>

A person is disqualified from acting as insolvency practitioner if at the time he is an undischarged bankrupt, or disqualified from being an insolvency practitioner or a director of a company,<sup>242</sup> is a mental patient or lacks capacity.<sup>243</sup> Acting as an insolvency practitioner without being qualified to do so is an offence for which the offender can be imprisoned or fined or both.<sup>244</sup> Unfortunately, no such provision is found in the South African Companies Act of 2008 and the only sanction seems to be the possible withdrawal of the accreditation of such a person by the regulatory authority.<sup>245</sup>

In terms of section 390 of the Insolvency Act 1986, only an individual<sup>246</sup> who has been authorised to act as an insolvency practitioner is qualified so to act. Section 390(2) prescribes the two ways in which a person may be authorised to act as an insolvency practitioner, namely by virtue of membership of a recognised professional

<sup>239</sup> Paragraphs 758–774.

<sup>240</sup> Paragraph 732.

<sup>241</sup> Although at the time there were no statutory requirements regarding the qualifications or experience of persons appointed in any insolvency proceedings (eg liquidators, receivers etc), the courts would only appoint solicitors or registered accountants with several years of experience in their profession, as liquidators: Pennington *Corporate Insolvency* at 4.

<sup>242</sup> In terms of the Company Directors Disqualification Act 1986, a person may be disqualified by an order of court for a specified period from being an insolvency practitioner or director or in any way taking part in the promotion, formation or management of a company without the permission of the court (s 1(1)). The order may be based on the person's conviction of an indictable offence (s 2), persistent breaches of company legislation (s 3), fraud or fraudulent trading of a company that has been wound up (s 4), summary conviction of contravention of company legislation (s 5) or unfitness (s 6).

<sup>243</sup> Section 390(4) of the Insolvency Act 1986.

<sup>244</sup> Section 389(1).

<sup>245</sup> See Chapter 2, part 3.7.1.2.

<sup>246</sup> Section 390(1) excludes "a person who is not an individual", and corporate bodies are thus disqualified. This provision is preferable to the one in South Africa which allows the appointment of a juristic person or partnership as a business rescue practitioner, thereby creating innumerable problems: see Chapter 2, part 3.7.1.2.



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body and permitted to act as such by its rules<sup>247</sup> or, alternatively, in terms of an authorisation by a competent authority.<sup>248</sup>

#### *2.7.1.2.1 Membership of a recognised professional body*

As far as the first option is concerned, the Secretary of State has the power to issue or revoke an order recognising a professional body for this purpose. However, only a professional body that regulates the practice of a profession and maintains and enforces rules ensuring that members who act as insolvency practitioners are fit and proper persons and meet acceptable requirements in education, practical training and experience, may be recognised.<sup>249</sup> At present there are seven such recognised bodies of which all but one represent either the legal profession or accountants.<sup>250</sup>

Mere membership of a recognised professional body does not, however, automatically qualify the relevant member to act as an insolvency practitioner. The member must also be permitted to act as an insolvency practitioner in terms of the rules of his professional body.<sup>251</sup> This part of the provision allows a recognised professional body to set minimum requirements and standards for its members with regard to qualifications, training and experience before allowing them to act as insolvency practitioners.

Sealy and Milman<sup>252</sup> point out that although the Secretary of State does not have the power to exercise direct control over the way a recognised professional body conducts its affairs, his power to revoke his authorisation from such a body allows him to ensure adherence to acceptable standards and control of members.

#### *2.7.1.2.2 Authorisation by the Secretary of State*

The second option is available for individuals who are not members of one of the recognised professional bodies. Such individuals may on application be authorised by the

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<sup>247</sup> Section 390(2)(a). In terms of s 391(3), persons who are not members of a recognised professional body but who are subject to its rules in the practice of the profession in question may also be authorised.

<sup>248</sup> In terms of s 390(2)(b).

<sup>249</sup> Section 391.

<sup>250</sup> These recognised professional bodies are the Association of Chartered Certified Accountants; the Institute of Chartered Accountants in England and Wales; the Institute of Chartered Accountants in Ireland; the Institute of Chartered Accountants in Scotland; the Law Society; the Law Society of Scotland, and the Insolvency Practitioners Association: Insolvency Practitioners (Recognised Professional Bodies) Order 1986 (SI 1986/1764).

<sup>251</sup> Section 390(2)(a).

<sup>252</sup> *Insolvency Legislation* at 428.

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Secretary of State to act as insolvency practitioners.<sup>253</sup> Section 393 of the Insolvency Act 1986 provides that authorisation may be granted to an applicant who appears to be a fit and proper person to act as an insolvency practitioner and who meets the prescribed requirements with respect to education, practical training and experience. This authorisation is given for one year<sup>254</sup> but must be automatically renewed by the competent authority unless it appears to the authority that the practitioner no longer complies with the requirements<sup>255</sup> of being a fit and proper person to act as an insolvency practitioner and those regarding education, practical training and expertise.<sup>256</sup> The authorisation may be withdrawn earlier if the holder appears no longer to be a fit and proper person or fails to comply with any applicable provisions of the Insolvency Act 1986.<sup>257</sup>

To ensure that the same standards of competence will be maintained by all the various authorising professional bodies and the Secretary of State, all applicants have since 1990 been required to pass a centrally organised examination set by the Joint Insolvency Examining Board.<sup>258</sup>

In spite of the strict controls already in place, many insolvency practitioners in England were not complying with their statutory duties and the system was thus regarded as being inadequate.<sup>259</sup> As a result, the Insolvency Practitioners Regulations 2005<sup>260</sup> which came into effect on 1 April 2005, inter alia replaced the previous regulations relating to the grant and refusal of authorisation by the Secretary of State. The new regulations provide a list of six specific issues that must be included in the matters to be taken into account in deciding whether any applicant is a fit and proper person to act as an insolvency practitioner.<sup>261</sup> Consideration of these issues is clearly

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<sup>253</sup> The Secretary of State is the competent authority unless he has designated another body or person for cases of a certain type (s 392(2)). No such designation has as yet been made: Sealy and Milman *Insolvency Legislation* at 429.

<sup>254</sup> In terms of s 393(3) of the Insolvency Act 1986. The period was reduced from the previous period of three years by the Provision of Services (Insolvency Practitioners) Regulations 2009 (SI 2009/3081).

<sup>255</sup> Stipulated in s 393(2).

<sup>256</sup> Section 393(3A). Regulation 8A was inserted into the Insolvency Practitioners Regulations 2005 (SI 2005/524) to stipulate the requirements for further authorisation of an insolvency practitioner in respect of education, practical training and experience.

<sup>257</sup> Section 393(4). In such a case no automatic authorisation is granted in terms of s 393(3A) and if already granted, is withdrawn: s 393(6).

<sup>258</sup> Finch "Insolvency Practitioners" at 336.

<sup>259</sup> Finch "Insolvency Practitioners" at 342.

<sup>260</sup> Statutory Instrument 2005/524.

<sup>261</sup> In regulation 6(a) to (f). Briefly stated, they are whether the applicant has been convicted of an offence involving fraud or dishonesty, has contravened any provision of insolvency legislation, has engaged in deceitful, unfair or improper behaviour (whether unlawful or not) in his profession or

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intended to ensure that only those applicants who will conduct their practices as insolvency practitioners with honesty, integrity, fairness and the appropriate professional skills will be authorised. The regulations also contain specific requirements to ascertain whether an applicant who has never previously been authorised to act as insolvency practitioner meets the requirements with respect to education, practical training and experience as prescribed by section 393(2)(b). Apart from having to have passed the Joint Insolvency Examination Board examination referred to above, the applicant must also have acquired the necessary experience as set out in provisions detailing the prescribed minimum number of cases or hours of insolvency work in a specific period of time.<sup>262</sup> Although contained in a separate provision, the same requirements in respect of previous experience that are set for first-time applicants are made applicable to applicants who have previously been authorised to act as insolvency practitioners.<sup>263</sup> In addition, these applicants are also required to have completed a specified minimum number of hours of continuing professional development.<sup>264</sup>

In an evaluation of the present system of regulation of insolvency practitioners, Finch<sup>265</sup> states that using several recognised professional bodies as well as the Secretary of State (through the Insolvency Service) to execute this regulation has the advantage of a wide regulation of all the activities of insolvency practitioners, such as their conduct as accountants and lawyers, as well as their activities as insolvency practitioners. Although a single regulator could perhaps lead to more consistency and

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employment, has failed to make full disclosure of a conflict of interest when acting as insolvency practitioner, whether he had adequate systems of control and accounting in place in any insolvency practice he carried on and whether his insolvency practice is or will be carried on with independence, integrity and appropriate professional skills.

<sup>262</sup> Regulation 7(1)-(6). To summarise: the applicant must have held office as insolvency practitioner (or in certain other prescribed capacities) in at least 30 cases during the immediately preceding ten years, or acquired at least 2000 hours of insolvency work (at least 1400 hours thereof in the immediately preceding two years). In the last-mentioned instance, the applicant must also either have acted in one of the prescribed offices in at least five cases in the preceding five years or acquired so-called "higher insolvency work experience" (as defined) of at least 1000 hours, or in specified combinations of numbers of cases and hours.

<sup>263</sup> Regulation 8(2).

<sup>264</sup> Regulation 8(2). Activities regarded as continuing professional development include attendance at courses, seminars or conferences (or viewing a recording thereof), giving lectures, reading books or periodical publications and writing for publication, all of these obviously on insolvency law or insolvency practitioners (reg 8(3)). Practitioners authorised by the Secretary of State are required to keep records of these activities (reg 9) and must also submit annual reports to him containing details of such activities as well as of cases in which they acted as insolvency practitioners in the period covered by the report (reg 11).

<sup>265</sup> *Corporate Insolvency* at 202-203.

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transparency, and provide a single body to which the public could address complaints, the existing system was still preferable because of the dual scrutiny to which it subjected most insolvency practitioners.

### 2.7.1.3 Vacation of or removal from office

The Insolvency Act 1986 provides for various situations that may cause the administrator of a company to cease holding office before the administration procedure ends and that will result in the administrator having to be replaced. Paragraph 90<sup>266</sup> contains four of these reasons: if the administrator dies, resigns,<sup>267</sup> is removed by order of court<sup>268</sup> or vacates his office because he is no longer qualified to act as an insolvency practitioner in relation to the company.<sup>269</sup> In addition, where an administrator was appointed by the company or its directors, the person who made the appointment is also entitled to remove and replace the administrator.<sup>270</sup> This ensures that an administrator who is failing to fulfil his duties properly can be removed without the expense and delay which would inevitably result if the court had to be approached for the removal of an administrator. It should also remove one of the possible obstacles to implementation of formal corporate rescue measures, namely the fear of directors of an ailing company that they may be handing over the management of the company to someone who is not capable of rescuing the company but can only be removed at great expense and with great difficulty. This fear is certainly justified in South Africa where the current Companies Act of 1973 provides neither for any qualifications, experience nor training for judicial managers, nor a procedure or grounds to remove a judicial manager.<sup>271</sup>

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<sup>266</sup> Of Schedule B1 to the Insolvency Act 1986.

<sup>267</sup> In terms of par 87 of Schedule B1 to the Insolvency Act 1986. He may only do so on the grounds of ill-health, intention to cease practising as insolvency practitioner, conflict of interest, change in personal circumstances making it impossible or impracticable to discharge his duties or, if on grounds other than these specified ones, with permission of the court: Rule 2.119 of the Insolvency Rules.

<sup>268</sup> In terms of par 88 of Schedule B1 to the Insolvency Act 1986.

<sup>269</sup> Paragraph 89 of Schedule B1 to the Insolvency Act 1986. The Secretary of State may withdraw his authorisation on the grounds that the authorised person is no longer a fit and proper person, has failed to comply with his statutory duties or has furnished the Secretary of State with false, misleading or inaccurate information (s 393(4)). A professional body will follow its own rules in deciding whether to withdraw its authority in respect of a particular member.

<sup>270</sup> Paragraphs 93 and 94 of Schedule B1 to the Insolvency Act 1986. The consent of every holder of a qualifying floating charge (ie who is authorised in terms of par 14 to appoint an administrator for the company) is required, but if this consent is withheld, the court may give the required permission.

<sup>271</sup> Chapter 2, part 2.7.1. Unfortunately, although the profession of business rescue practitioner is now regulated in terms of the Companies Act of 2008, the Act provides for the removal of the practitioner only by an order of court: Chapter 2, part 3.7.1.3.

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An important power is given to the creditors' meeting in that they are also allowed to replace the administrator in those cases where the company or its directors appointed him.<sup>272</sup> This is another safeguard to prevent abuse of the procedure by the directors or members of a company appointing an insolvency practitioner who will act according to their wishes and to the detriment of the creditors. The risk, however, is that this may deter the directors from putting the company into administration, as they have no guarantee that the administrator appointed by them will not be removed and replaced by the creditors.

The power of the court to remove an administrator is limited by allowing only a few specified persons to apply for such an order<sup>273</sup> and, in those cases where the administrator was not appointed by an administration order, also limiting the circumstances under which the court may replace the administrator.<sup>274</sup> However, an application to court by a creditor or member challenging the administrator's conduct<sup>275</sup> may also lead to his removal from office.<sup>276</sup> The Act does not specify the grounds on which an administrator should be removed by the court but if the administrator has been guilty of misfeasance<sup>277</sup> the courts will probably remove him because it is one of the mainstays of the insolvency legislation that only those who are ethically and educationally qualified should be allowed to act as insolvency practitioners.<sup>278</sup>

To counterbalance the powers of the administrator, paragraphs 74 and 75 respectively provide for a challenge to and examination of the administrator's conduct in respect of the company. In terms of paragraph 74, a creditor or member may apply to court for relief on the grounds that the administrator has unfairly harmed<sup>279</sup> the

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<sup>272</sup> Paragraph 97. This is subject to the conditions that there is no holder of a qualifying floating charge and that the new administrator's written consent to act is presented to the meeting before the replacement is made.

<sup>273</sup> In terms of par 91 the creditors' committee, the company, its directors, one or more creditors or a remaining co-administrator is authorised to make the application. However, if the administrator was appointed by administration order, only the creditors' committee may apply unless there is no such committee or the court is satisfied that the committee is not taking reasonable steps to appoint a replacement or the court is satisfied by another reason for the application.

<sup>274</sup> Paragraph 95 allows the court to replace an administrator only if the person entitled to replace him is not taking reasonable steps to do so or there is another acceptable reason for the court to make the replacement.

<sup>275</sup> In terms of par 74, discussed below.

<sup>276</sup> Paragraph 74(4)(d).

<sup>277</sup> In terms of par 75 discussed below.

<sup>278</sup> Bailey and Groves *Corporate Insolvency* at 391.

<sup>279</sup> The original provision (s 27) used the more familiar "unfairly prejudicial to the interests" and it is unclear whether a difference in meaning was intended, as the new provision could require proof of

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interests of the applicant or proposes to do so or is not performing his functions as quickly or efficiently as is reasonably practicable. Although this power may conceivably be abused by some creditors for tactical reasons,<sup>280</sup> the more general view seems to be that the courts would be slow to interfere with the professional and commercial judgment of insolvency practitioners.<sup>281</sup> A director is not authorised to bring the application in his capacity as such. The court has a wide discretion regarding the relief it may grant and may in particular regulate the administrator's exercise of his functions or order that his appointment will cease to have effect, subject to the condition that the court may not make an order that will prevent or impede a voluntary arrangement or compromise with members and creditors sanctioned under section 425 of the Companies Act 1985.<sup>282</sup>

Paragraph 75 provides for an examination of the conduct of an administrator or past administrator (or someone who purports or purported to be one) on the application of a creditor, member, liquidator or administrator of a company or the official receiver. Such an application must be based on an allegation that the administrator has misapplied or retained or become accountable for any money or other property of the company, has breached a fiduciary or other duty to the company, or has been guilty of misfeasance.<sup>283</sup> It is important to note that this action is based on the misconduct of the administrator towards the company and not against the applicant.<sup>284</sup> If any of these grounds are established, the court may order the administrator to repay or restore money or other property to the company, pay

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actual harm rather than mere potential harm: *Palmer* par 14.073; Sealy and Milman *Insolvency Legislation* at 545.

<sup>280</sup> Finch "Corporate Rescue" at 548 raises this possibility and suggests that it would result in reducing the effectiveness of the rescue because the process would become highly contested and thus slowed down.

<sup>281</sup> Frisby "Rescue Regime" at 264-265. *Palmer* par 14.075 is of the opinion that, unless the applicant has a strong case, the court would rather adopt a "wait and see" attitude, relying on the potential liability of an administrator for wrongdoing because it would be detrimental to the process if an administrator's commercial judgment could be too easily questioned. However, Finch "Corporate Rescue" at 555 warns that this attitude could change if the courts lost confidence in the way administrators and others operated during the process. Milman "Overview" at 3 refers to the refusal of the court to make an order under par 74 in *Re Lehman Brothers International (Europe) (In Administration)* [2008] EWHC 2869 (Ch); [2009] BCC 632 as an indication that the approach taken by the courts still points towards non-intervention.

<sup>282</sup> Now ss 895-899 of the Companies Act 2006.

<sup>283</sup> Paragraph 75(3). As agent of the company (par 69) the administrator is in a fiduciary position as regards the company: Bailey and Groves *Corporate Insolvency* at 388. Finch *Corporate Insolvency* at 444 (fn 365) notes that there has not been any case law to date in respect of administrators being sued for breach of duty but expects this to change as administrations take over from administrative receiverships.

<sup>284</sup> *Palmer* par 14.077.

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interest or pay compensation, but may not terminate his appointment under this paragraph. A successful action thus benefits the company in the first place and any creditor who succeeds in his action will derive only an indirect benefit.

In my view these provisions are preferable to those found in the Companies Act of 2008 which simply make the business rescue practitioner subject to the same duties as a director: a business rescue practitioner operates under completely different circumstances and with objectives different from those of a director, rendering several of a director's duties inappropriate.<sup>285</sup>

### **2.7.2 Powers and duties of directors**

The administrator is given extremely wide powers by the Act in that he has all the powers that may be necessary or expedient to manage the affairs, business and property of the company.<sup>286</sup> This, however, does not mean that the directors are automatically removed from office when the company is in administration: both the board of directors and the members in general meeting retain their powers as organs of the company,<sup>287</sup> but their powers are severely restricted by paragraph 64(1), which forbids a company or any of its officers from exercising a management power without the consent of the administrator. For the purposes of this provision, a management power is defined as any power, irrespective of whether it is conferred by legislation or an instrument, that could interfere with the exercise of the administrator's powers.<sup>288</sup> The management powers of the directors are thus effectively suspended for the duration of administration although they remain liable to perform their statutory duties such as the proper filing of annual returns and holding of annual meetings.<sup>289</sup> In the absence of clear provisions on this aspect in the South African business rescue proceedings, and since the directors seem to lose only their management powers, the position must be assumed to be the same as in England.<sup>290</sup>

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<sup>285</sup> See Chapter 2, part 3.7.1.3.2.

<sup>286</sup> Paragraph 59(1). Some specific powers are listed in Schedule 1 to the Act, such as the power to continue the company's business and raise or borrow money, but are not limited to them (par 59(2)). As a result of the very extensive powers given to the administrator, it should only in very special circumstances be necessary to make use of par 63 to apply to court for directions in connection with his functions.

<sup>287</sup> This of course means that their usual statutory and common law duties, including fiduciary duties, will still apply. See Sealy and Milman *Insolvency Legislation* at 57 and 539; *Farrar's Company Law* at 689.

<sup>288</sup> Paragraph 64(2) of Schedule B1 to the Insolvency Act 1986.

<sup>289</sup> Bailey and Groves *Corporate Insolvency* at 393; *Fletcher Insolvency* at 549; *Palmer* par 14.053.

<sup>290</sup> See Chapter 2, part 3.7.2.

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The administrator is also very specifically authorised to remove any director of the company and to appoint a person as director, whether or not to fill a vacancy.<sup>291</sup> In making these decisions the administrator will be led by the needs of the company “and the best way in which to achieve the purpose of administration”.<sup>292</sup>

The administrator is furthermore one of the office-holders who are compelled to submit a report to the Secretary of State if they find that the conduct of a director or past director of a company that has become insolvent makes him unfit to be concerned in the management of a company.<sup>293</sup> This report could result in the director being disqualified from acting as an insolvency practitioner or, unless he has the permission of the court, taking part in the formation, promotion or management of a company for a period of between two and fifteen years.<sup>294</sup> Disqualification is achieved by an order of court on application by the Secretary of State<sup>295</sup> or the acceptance by the Secretary of State of a disqualification undertaking by a person who meets the requirements for a disqualification order.<sup>296</sup>

In his discussion of the (then merely proposed) amendments, Fletcher<sup>297</sup> expressed some doubts as to whether they would really solve the problem of under-utilisation of administration since the main problem lay in the “inbuilt aversion” of directors to relinquish their power to an independent official who furthermore had the power to dismiss them. He saw the answer in more compelling inducement for directors to take action at an early stage when rescue is still a realistic possibility, in particular by not requiring administrators to report on directors’ conduct if administration results in the survival of the company. Conversely, in those cases where a company was liquidated, the failure of its directors to take timely and genuine steps to initiate administration could be taken as an indication of unfitness to be involved in the management of a company. He also suggested that the power of an administrator to remove a director should be made subject to approval by the

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<sup>291</sup> Paragraph 61 of Schedule B1 to the Insolvency Act 1986.

<sup>292</sup> Fletcher *Insolvency* at 549.

<sup>293</sup> Section 7(3) of the Company Directors Disqualification Act 1986 (c 46). In terms of s 6(2)(b) of this Act a company is automatically regarded as having become insolvent by the mere fact that an administration order has been made in relation to it.

<sup>294</sup> Sections 1 and 6 of the Company Directors Disqualification Act 1986.

<sup>295</sup> In terms of ss 6 and 7 of the Company Directors Disqualification Act 1986.

<sup>296</sup> In terms of a new s 1A of the Company Directors Disqualification Act 1986 inserted by the Insolvency Act 2000 (c 39).

<sup>297</sup> *Insolvency* (2002) at 516. The law in this book was as at December 2001.



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court, thereby affording the affected director an opportunity to challenge the administrator's reasons for removing him.<sup>298</sup>

Although none of these proposals have found their way into the new provisions regulating administration, Fletcher points to the role that section 214 of the Insolvency Act 1986 and sections 6 and 7 of the Company Directors Disqualification Act 1986<sup>299</sup> can play in discouraging directors from allowing a company to “decline into a state of insolvency” without taking any active steps to at least attempt to rescue it.<sup>300</sup> In terms of section 214(1), the directors of a company which has gone into insolvent liquidation may incur personal liability for wrongful trading through an order of court issued on application by the liquidator of the company and ordering a director to make such a contribution to the company's assets as the court deems appropriate.<sup>301</sup> However, section 214(3) provides a statutory defence to any director who can satisfy the court that he took every reasonable and practicable step he should have taken, to minimise the potential loss to creditors of the company as soon as he had actual or constructive knowledge that the company had no reasonable prospect of avoiding insolvent liquidation. If the courts emphasise administration and company voluntary arrangements as such reasonable and practicable steps which could result in a director being saved from personal liability, it would encourage directors to consider these measures at an early stage when it may still be possible to rescue the company. The courts and the Insolvency Service should also apply the same considerations when exercising their powers in respect of the disqualification of directors under the Company Directors Disqualification Act 1986.<sup>302</sup>

## **2.8 The rescue plan**

### **2.8.1 Power to submit a statement of proposals**

The most important duty of the administrator is to prepare a statement setting out his proposals for achieving the purpose of administration.<sup>303</sup> The administrator is also the

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<sup>298</sup> Fletcher *Insolvency* (2002) at 518.

<sup>299</sup> Discussed above. See Fletcher *Insolvency* at 869-884 for a full discussion of the provisions of the Act.

<sup>300</sup> *Insolvency* at 522-523. This is in the later (2009) edition in which he again confirms his original view (at 516-517) that the relaxation of some procedural aspects alone would not have solved the problem of under-usage because of the reluctance of directors to relinquish their power to an administrator.

<sup>301</sup> See Fletcher *Insolvency* at 857.

<sup>302</sup> Fletcher *Insolvency* at 523.

<sup>303</sup> Prescribed by par 49 of Schedule B1 to the Insolvency Act 1986 and Rule 2.33 of the Insolvency Rules. The proposals must be attached to the prescribed Form 2.17B.

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only person who may submit a rescue plan. Although he is not obliged to do so, it would be advisable for the administrator to consult the major creditors on any proposals involving “significant action” such as a sale of substantial assets of the company or a compromise.<sup>304</sup> By contrast, the business rescue practitioner in South Africa is specifically ordered by section 150(1) of the Companies Act of 2008 to consult the creditors, other affected persons and the management of the company before preparing a business rescue plan.<sup>305</sup> This seems to be a more realistic approach since no plan can succeed without the support of the major creditors, while the management of the company may have the experience and expert knowledge required to compile a feasible plan for the rescue of the company.

### **2.8.2 Contents of the statement of proposals**

Apart from the prescribed formal information (details of company, administrator, directors, etcetera) that it must contain, the statement must explain the circumstances that led to the appointment of the administrator, the company’s financial position<sup>306</sup> and, most importantly, how the administrator intends achieving the purpose of administration and how it should end.<sup>307</sup> If he is of the opinion that the objective of a rescue of the company as a going concern or a better result for the company’s creditors cannot be achieved, he has to explain the reasons for this belief.<sup>308</sup>

Paragraph 49(3) specifically permits the proposals for achieving the purpose of administration to include a proposal for a voluntary arrangement under part I of the Insolvency Act 1986<sup>309</sup> or a court-sanctioned compromise or arrangement with creditors or members.<sup>310</sup> Again, this is in clear contrast to the rather confusing position in South Africa where the applicant for a judicial management order must

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<sup>304</sup> Goode *Corporate Insolvency Law* at 382.

<sup>305</sup> See Chapter 2, part 3.8.1.

<sup>306</sup> To obtain this information, the administrator may in terms of pars 47-48 of Schedule B1 to the Insolvency Act 1986 require a statement of the affairs of the company from any relevant person who will then be compelled to supply it.

<sup>307</sup> Rule 2.33(2)(m). In terms of the draft Insolvency (Amendment) Rules 2010 a new paragraph (2C) will be added to Rule 2.33(2) requiring additional information if it is proposed that the company will move into a company voluntary arrangement.

<sup>308</sup> Paragraph 49(2)(b) of Schedule B1 to the Insolvency Act 1986.

<sup>309</sup> Discussed in part 3 below.

<sup>310</sup> In terms of s 425 of the Companies Act 1985 (now ss 895-899 of the Companies Act 2006) and very similar to the South African scheme of arrangement in terms of s 311 of the Companies Act 1973.

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prove a reasonable probability that the company will be able to pay all its debts in full in spite of the fact that a judicial manager is one of the persons authorised to apply to court for an order summoning a meeting of creditors to approve a compromise.<sup>311</sup> On the other hand, the Companies Act of 2008 has now created a strict division between business rescue proceedings and a compromise with creditors by excluding a company engaged in business rescue proceedings from the procedure for a compromise between a company and its creditors.<sup>312</sup>

The further requirement that the statement must include details on how the company has been managed and financed since the administrator's appointment, and will continue to be managed and financed if his proposals are approved<sup>313</sup> is important because it is generally agreed that the availability of working capital is essential for a successful rescue.<sup>314</sup> In spite of listing detailed information that must be included in a business rescue plan, the South African Companies Act of 2008 does not require the plan to explain the future or current financing of the company or how it will be managed.<sup>315</sup>

Another important set of requirements regarding the information to be disclosed was recently added in respect of so-called "pre-packaged sales" (or "pre-packs").<sup>316</sup> For purposes of these requirements a pre-pack is defined as an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser before an administrator is appointed and the administrator effects this sale immediately or shortly after his appointment.<sup>317</sup> In several cases the courts have held that an administrator has the power to sell assets without prior approval of the court or creditors

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<sup>311</sup> Section 311(1) of the Companies Act of 1973.

<sup>312</sup> Section 155(1): see Chapter 2, part 4.3.

<sup>313</sup> Rule 2.33(2)(o) of the Insolvency Rules.

<sup>314</sup> In Chapter 2, part 3.4 two South African cases are mentioned where the courts refused to grant a judicial management order because the companies would not have had access to adequate capital.

<sup>315</sup> See Chapter 2, part 3.8.2.

<sup>316</sup> Joint Insolvency Committee *Statement of Insolvency Practice 16 (E and W)* with effect from 1 January 2009 available at <<http://www.sra.org.uk/documents/solicitors/accreditation/insolvency-practitioners-statement-16.pdf>> accessed on 8 February 2010. The rules contained in the *Statement* have been adopted by all the regulatory bodies of insolvency practitioners and a departure from these standards could lead to disciplinary action being taken against an insolvency practitioner by his regulatory authority.

<sup>317</sup> According to Bailey and Groves *Corporate Insolvency* at 347 (fn 5), administration is increasingly being used to effect pre-packed sales of businesses which are arranged some time before the (usually out-of-court) appointment of an administrator and then completed on the day of or soon after the appointment.

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if justified by the circumstances of the case and in genuine furtherance of the purpose of administration.<sup>318</sup> A pre-packaged sale of the company's business has been accepted by the courts as a legitimate purpose of administration and administration orders are often granted by the courts where such a pre-pack sale is given as one of the purposes of the administration.<sup>319</sup> Although pre-packaged sales can have many benefits, such as preserving more jobs, providing a better return for creditors and preserving the value of the business,<sup>320</sup> concurrent creditors will not be informed about the sale before it takes place and will not have the opportunity to consider whether it will be to their advantage. As a result, these creditors are often suspicious as to whether the sale was in their best interests, particularly in the 59 per cent of cases where the business is sold back to connected parties, such as directors of the company.<sup>321</sup> *Statement of Insolvency Practice 16* was therefore developed to address these concerns of creditors by requiring the administrator to disclose all the details regarding a pre-packaged sale, including his pre-administration involvement, efforts to consult with major creditors, details of assets involved, consideration, terms of payment, identity of the purchaser,<sup>322</sup> names of directors or previous directors connected to the purchaser and a detailed explanation and justification of his decision.<sup>323</sup>

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<sup>318</sup> See *Re T&D Industries Plc* [2000] 1 WLR 646; [2000] 1 All ER 333; *Re Transbus International Ltd (In Liquidation)* [2004] EWHC 932 (Ch), [2004] 2 All ER 911; *DKLL Solicitors v HM Revenue & Customs* [2007] EWHC 2067 (Ch); [2007] BCC 908.

<sup>319</sup> Frisby "Pre-packs" at 3. Finch *Corporate Insolvency* at 456 refers to estimates that between 35.5 per cent and 50 (or even 80) per cent of sales of businesses during an administration were done by way of pre-packs.

<sup>320</sup> R3-Association of Business Recovery Professionals *Press Briefing: the use of 'pre-pack' administrations* 22 January 2009 available at <<https://www.r3.org.uk/newsandpress/>> accessed on 17 March 2009. Hyde and White "Pre-pack administrations" at 135 mention the preservation of goodwill as a major advantage of pre-packs because of the swift and seamless transfer to a purchaser, thereby improving returns to creditors. See Finch *Corporate Insolvency* at 456-457 for a discussion of the potential advantages of pre-packs, including a substantial saving in costs, but also (at 460-463) the disadvantages and potential for abuse. Parry *Corporate Rescue* at 16-17 notes that although pre-packs do not appear anywhere in the insolvency legislation, which may create the impression that they are illegitimate, pre-packaged sales are often used for sound commercial reasons and should be accepted as fulfilling a need, on condition that the administrator observes his duties and acts according to the hierarchy of objectives contained in the Insolvency Act 1986.

<sup>321</sup> These are generally referred to as "phoenix" pre-packs: Frisby "Pre-packs" at 1; Hyde and White "Pre-pack administrations" at 137.

<sup>322</sup> In a 2007 study, it was found that the most common omission in the reports of administrators was the identity of the purchaser: Finch *Corporate Insolvency* at 463. It is hard to believe that this was merely coincidence rather than an effort by administrators to conceal the fact that these were sales to management.

<sup>323</sup> *Statement of Insolvency Practice 16* par 9. In a detailed discussion of pre-packs in administration in *Kayley Vending Limited, Re Insolvency Act 1986* [2009] EWHC 904 (Ch); [2009] BCC 578 it was held that the court must be alert to obvious abuses of the pre-pack when exercising its discretion to

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This information should preferably be provided with the first notification of administration to creditors.<sup>324</sup> However, if no initial meeting of creditors is to be held<sup>325</sup> and it is impracticable to provide the information in the first notification, the information must be provided in the proposals of the administrator which he should send out as soon as possible after his appointment.<sup>326</sup>

### 2.8.3 Approval of the plan

Within eight weeks after his appointment<sup>327</sup> the administrator must send a copy of his statement of proposals to the Registrar of Companies and to every known creditor and member of the company.<sup>328</sup> Each copy of the statement sent to a creditor must be accompanied by an invitation to an initial creditors' meeting that must take place within ten weeks after the date on which the company entered administration.<sup>329</sup> There is no provision for approval or veto of the proposals by members because the approach is that although a rescue of the company is the ideal outcome, the emphasis is on a rescue of the business rather than keeping a damaged and essentially unrecoverable company alive.<sup>330</sup> The argument seems to be that since a liquidation of the company is the most probable outcome of the process and the company is already insolvent or nearly so, the shares in the company no longer have any real value and therefore shareholders do not have any residual interest in the company or its fate.<sup>331</sup> In spite of the many references to shareholders in various provisions regulating business rescue proceedings in South Africa, the position is

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make an administration order, and should refuse the order if it appeared to be inappropriate even if it is not being opposed.

<sup>324</sup> See part 2.5.2 above.

<sup>325</sup> See part 2.8.3 below.

<sup>326</sup> *Statement of Insolvency Practice 16* par 11.

<sup>327</sup> Paragraph 49(5) of Schedule B1 to the Insolvency Act 1986.

<sup>328</sup> Paragraph 49(4) of Schedule B1 to the Insolvency Act 1986. In terms of par 49(6), the administrator need not notify every member individually but may simply publish a notice that he will furnish any member who applies in writing, with a copy of the statement of proposals. Rule 2.33(7) and (7A) leaves the manner in which the notice will be published entirely in his discretion. This is in stark contrast to the costly and unnecessary notifications that must be sent to all the members of a company in business rescue proceedings even if they have no right to attend or vote at the meeting convened for approval of the rescue plan: see Chapter 2, part 3.8.3.1.

<sup>329</sup> Paragraph 51 of Schedule B1. Rule 2.34(1) also requires that the administrator gazette details of the meeting as soon as practicable after the invitation to creditors has been sent, and in terms of Rule 2.34(1A), he may also advertise this information in any other manner he thinks fit.

<sup>330</sup> *Goode Corporate Insolvency Law* at 330-332.

<sup>331</sup> But see *Finch Corporate Insolvency* at 379-380, who disagrees with this view and believes that shareholders clearly have an interest if there is a possibility that the company may survive.

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essentially the same since shareholders have no vote unless their rights will be affected directly by the business rescue plan.<sup>332</sup>

If the administrator thinks that the company has enough assets to pay all its creditors in full, or not even enough assets to make any distribution to unsecured creditors, or that administration will achieve neither a rescue of the company nor a better return for creditors, the statement of proposals must contain a statement to this effect.<sup>333</sup> In such a case the administrator need not convene a creditors' meeting as it would not serve any purpose and be a waste of money. However, creditors holding at least 10 per cent of the company's debts may requisition a meeting for which they will have to bear the costs.<sup>334</sup>

The administrator's proposals are considered by the creditors at their meeting and may be approved without modifications or with amendments to which the administrator has consented.<sup>335</sup> To approve the proposals, a majority in value of creditors present and voting at the meeting must vote in favour of the proposals.<sup>336</sup> The Insolvency Act 1986 makes provision for the procedure to be followed by the administrator to summon a creditors' meeting for the purpose of obtaining the creditors' approval should he want to substantially amend his original proposals after they have been approved.<sup>337</sup> At a creditors' meeting the creditors may establish a creditors' committee to protect their interests through regular communication with the administrator.<sup>338</sup>

The administrator is required to report the result of this meeting to the court, the registrar of companies and such other persons as may be prescribed.<sup>339</sup>

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<sup>332</sup> See Chapter 2, part 3.8.3.2. See also generally Loubser "Shareholders".

<sup>333</sup> Paragraph 52(1).

<sup>334</sup> Paragraph 52(2); *Palmer* par 14.062.

<sup>335</sup> Paragraph 53(1) of Schedule B1 to the Insolvency Act 1986.

<sup>336</sup> Rule 2.38(4). A secured creditor only has a vote for the unsecured balance of his claim (Rule 2.40(1)) but is protected by par 73(1) and (2) which prohibits any proposal that would affect his right to enforce his security unless he specifically consents to such a proposal.

<sup>337</sup> Paragraph 54 of Schedule B1 to the Insolvency Act 1986. This implies that the administrator may make insubstantial deviations from the approved plan of action although it may not always be easy to distinguish between substantial and insubstantial changes: *Pennington Corporate Insolvency* at 388; *Sealy and Milman Insolvency Legislation* at 536 and 542. The court may also authorise the administrator to deviate from the approved proposals if necessary as a result of a subsequent change in circumstances or misunderstanding about the proposals: par 68(3)(c) and (d).

<sup>338</sup> Paragraph 57 of Schedule B1 to the Insolvency Act 1986.

<sup>339</sup> Paragraph 53(2) of Schedule B1 to the Insolvency Act 1986.

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#### 2.8.4 Effects of approval of the plan

Once the proposals have been approved, the administrator has to act in terms of these proposals.<sup>340</sup> There are various mechanisms to ensure that the administrator fulfils his functions according to the approved proposals, such as the power given to creditors and members to challenge his conduct and actions in court<sup>341</sup> and the authority of the creditors' committee to obtain information from the administrator.

#### 2.8.5 Effects of rejection of the plan

If the administrator reports to the court that the meeting of creditors has refused to approve his proposals or a revision of his proposals, the court may order that his appointment will cease from a specified date, thereby effectively terminating the administration, or make any order it regards as appropriate.<sup>342</sup> The power of the court to make any other appropriate order could be interpreted to mean that the court could approve those proposals despite their rejection by the creditors.<sup>343</sup>

### 2.9 Termination of administration

#### 2.9.1 Automatic termination

The appointment of an administrator and, consequently, the administration of a company are automatically terminated one year after the appointment became effective.<sup>344</sup> According to the Insolvency Service,<sup>345</sup> this period was decided on after

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<sup>340</sup> Paragraph 68(1) of Schedule B1 to the Insolvency Act 1986. Paragraph 65 now expressly grants him the power to make a distribution to preferent and secured creditors without the permission of the court.

<sup>341</sup> In terms of pars 74 and 75 of Schedule B1 to the Insolvency Act 1986 discussed in part 2.7.2 above.

<sup>342</sup> Paragraph 55 of Schedule B1 to the Insolvency Act 1986.

<sup>343</sup> *Palmer* par 14.080 confirms that these wide powers enable a court to react in a flexible way if the creditors refuse to approve the administrator's proposals, but believes that unless strong evidence exists that the purpose of administration could still be achieved by, for example, the appointment of a new or additional administrator, a court would be more likely to make an order for the transition to winding up. Sealy and Milman *Insolvency Legislation* at 537 do not, however, seem to share this view: they merely state that, despite the wide wording of par 55(2)(e) authorising the court to make any order it thinks appropriate, the court's powers are limited and they could not impose on the creditors any proposals to which they have not agreed.

<sup>344</sup> Paragraph 76(1) of Schedule B1 to the Insolvency Act 1986. The original sections of the Act did not provide for automatic termination or for a specified period for administration, but the custom developed to grant it for only three months, which was generally regarded as too short. The original version of this clause in the Enterprise Act 2002 also limited the period to three months, but was changed because it would have caused inconvenience and unnecessary costs as a result of repeated applications for extensions: *Palmer* par 14.099.25. This is another aspect of which the drafters of the Companies Act of 2008 should have taken notice before deciding on the obviously insufficient period of three months

consultation with a wide range of interested parties but may be amended in future if shown by experience to be necessary.

The administrator is also instructed to perform his functions “as quickly and efficiently as is reasonably practicable”.<sup>346</sup> He may, however, apply to court to extend his term of office for a specified period or it may be extended for up to six months by consent of all the secured creditors and of unsecured creditors holding more than 50 per cent of the unsecured debts of the company.<sup>347</sup> The reason for the fairly short period of administration is that, unlike judicial management, administration is not seen as an end in itself, but a facilitative procedure to give the company some protection while it devises a solution to its problems, such as a voluntary arrangement or compromise with its creditors or even its liquidation.<sup>348</sup> In essence, therefore, administration is a temporary measure that grants the company a period of relief during which the foundations for its actual rescue are laid, rather than being the rescue measure itself.<sup>349</sup>

### 2.9.2 By order of court

The administrator of a company may apply to court for his appointment to cease before it expires automatically. He is compelled to do so if it appears to him that the purpose of administration cannot be achieved, or he thinks that the company should not have entered administration in the first place or if he is required to make such an application by a meeting of the company’s creditors.<sup>350</sup>

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for completion of business rescue proceedings: see Chapter 2, part 3.9.

<sup>345</sup> Item 11, “Frequently Asked Questions about the Enterprise Act: Company” available at <<http://www.insolvency.gov.uk/faq/faqeactc.htm#11>> accessed on 14 February 2010.

<sup>346</sup> Paragraph 4 of Schedule B1 to the Insolvency Act 1986. Frisby “Rescue Regime” at 268 believes that this provision renders the imposition of a time limit of one year unnecessary and unwise, since a rescue attempt of the whole company as a going concern should not be hastily undertaken for fear of running out of time. Sealy and Milman *Insolvency Legislation* at 505, on the other hand, remark that this provision may be too vague to establish a positive legal duty that can be enforced, although par 74(2) provides a remedy by allowing a creditor or member to apply to court claiming that the administrator is not performing his functions as quickly or efficiently as reasonably practicable.

<sup>347</sup> Paragraph 76(2). However, the debts of those unsecured creditors who did not respond to the invitation to give or withhold their consent must be disregarded in the calculation of the total unsecured debts: par 78 of Schedule B1 to the Insolvency Act 1986.

<sup>348</sup> Lightman and Moss *Administrators* par 2-040.

<sup>349</sup> Keay and Walton *Insolvency Law* at 95. The same could probably be said of business rescue proceedings since the procedure is expected to be completed within an even shorter period of three months and comes to an end when the business rescue practitioner is able to file a notice of substantial implementation of the rescue plan: see Chapter 2, part 3.9.3.

<sup>350</sup> Paragraph 79(1) and (2) of Schedule B1 to the Insolvency Act 1986.



Most applications for discharge under the original provisions were made because the purpose or purposes of the administration order could not be achieved or the creditors refused to approve the administrator's proposals.<sup>351</sup> Although winding up the company often appeared to be an unavoidable result, the courts did not (and still do not) have any specific power to order the winding up of a company on an application for the discharge of an administration order: as a general rule a winding up order may only be made on a petition lodged in terms of section 124 of the Insolvency Act 1986.<sup>352</sup> An administrator has specifically been given the power to apply for the winding up of the company<sup>353</sup> but if he fails to do so the courts may, where necessary, direct the administrator to exercise this statutory power.<sup>354</sup> However, if it is necessary for the company to move into a compulsory liquidation in order to deal with the claims of creditors, the administrator will usually present a petition for winding up rather than depend on the court to make the required order.<sup>355</sup> The court may appoint the administrator as liquidator of the company if a winding up order is made immediately after the discharge of an administration order.<sup>356</sup>

Where the administrator was appointed by order of court, he is also compelled to apply to court if he thinks that the purpose of administration has been sufficiently achieved before the period of one year has expired.<sup>357</sup>

The Act also provides for the termination of administration on application by a creditor in those cases where the appointment was made for an improper motive.<sup>358</sup>

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<sup>351</sup> Pennington *Corporate Insolvency* at 355 and 356.

<sup>352</sup> *Re Brooke Marine Ltd* [1988] BCLC 546. In *Lancefield v Lancefield* [2002] BPIR 1108, however, it was held that a court may in an appropriate case and under exceptional circumstances issue a winding-up order *mero motu*. See also Sealy and Milman *Insolvency Legislation* at 62; Pennington *Corporate Insolvency* at 401-402. In those cases where par 83 applies (discussed in part 2.9.3 below), the problem will be solved by the company moving into a voluntary liquidation.

<sup>353</sup> Schedule 1, par 21.

<sup>354</sup> An example of such a case is found in *Re Brooke Marine Ltd* [1988] BCLC 546.

<sup>355</sup> Bailey and Groves *Corporate Insolvency* at 427. The writers believe that the court has the authority to issue a winding-up order in terms of the "catch-all" provision in par 79(4)(d) authorising the court to make any order "it thinks appropriate" when the administrator applies for his appointment to be terminated. In *Re J Smith Haulage Ltd* [2007] BCC 135 where a petition for the winding up of the company had been suspended by the administration order, the court used this power to order winding up the company to take effect immediately after termination of the administration. However, Rule 2.114(4) refers specifically to an application by an administrator in terms of par 79 for an order ending administration, in conjunction with a winding-up petition under s 124 for an order to wind up the company, which clearly requires a petition for the winding-up order.

<sup>356</sup> Section 140(1) of the Insolvency Act 1986.

<sup>357</sup> Paragraph 79(3) of Schedule B1 to the Insolvency Act 1986.

<sup>358</sup> Paragraph 81 of Schedule B1 to the Insolvency Act 1986.

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Although the provision does not explain what would be regarded as an improper motive, nor within what period such an application should be made, *Palmer*<sup>359</sup> believes that the court's discretion is sufficiently wide to allow an administration to continue if it is in the best interests of the company and its creditors.<sup>360</sup>

### 2.9.3 By filing of a notice

In those cases where the administrator was appointed by the company or its directors, he may file a prescribed notice with the court and the registrar of companies if he thinks that the purpose of administration has been sufficiently achieved. This will terminate his appointment from the date of proper filing of the notice.<sup>361</sup>

The administrator<sup>362</sup> may furthermore turn the administration into a creditors' voluntary winding up if he believes that the total amount payable to all secured creditors has been paid or set aside and a distribution will be made to unsecured creditors. The procedure he has to follow is to file a notice with the registrar of companies and the court that paragraph 83<sup>363</sup> applies, and send a copy of this notice to every known creditor. On registration of this notice by the registrar of companies, the appointment of the administrator ceases and the company is wound up as if a resolution for voluntary winding up was passed on that day. The creditors may appoint a liquidator of their choice but it would obviously save time and costs if they choose the administrator.<sup>364</sup>

If the abovementioned procedure is not applicable because there are no assets to permit a distribution to creditors, the administrator can effect the dissolution of the company by sending a notice to that effect to the registrar of companies.<sup>365</sup> He must

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<sup>359</sup> Paragraph 14.099.28.

<sup>360</sup> Bailey and Groves *Corporate Insolvency* at 428 states that if administration is found to be in the best interests of the creditors, the court is unlikely to order rescission of the administration order, but may make an order replacing the administrator.

<sup>361</sup> Paragraph 80 of Schedule B1 to the Insolvency Act 1986. Although par 80(4) requires that a copy of this notice must be sent to every creditor of whose claim and address he is aware, the administrator is regarded as having complied with this provision if he merely gazettes within five business days after filing, a notice undertaking to provide a copy to any creditor: Rule 2.113(6). This Rule also allows any further advertising of the notice which he may regard as necessary.

<sup>362</sup> As only the administrator, and not a former administrator has this power, it must be done before his appointment automatically expires after one year: Bailey and Groves *Corporate Insolvency* at 430.

<sup>363</sup> Paragraph 83 of Schedule B1 to the Insolvency Act 1986 which contains detailed provisions on the procedure that has to be followed.

<sup>364</sup> *Palmer* par 14.099.31.

<sup>365</sup> In terms of par 84(1) of Schedule B1 to the Insolvency Act 1986.

also as soon as possible thereafter file a copy of the notice with the court and send it to every known creditor.<sup>366</sup> Three months after receipt and registration of this notice by the registrar the company is deemed to be dissolved.<sup>367</sup> This procedure may be used irrespective of the manner in which the company was placed in administration.

## 2.10 Evaluation of administration

The introduction of the process of administration was greeted with a certain degree of scepticism in England while some commentators also drew attention to its similarities with judicial management in South Africa and the fact that the last-mentioned was not generally regarded as being a very effective rescue procedure.<sup>368</sup> That scepticism seemed to be well-founded when the procedure failed to achieve general acceptance and popularity and the number of administration orders remained more or less static.<sup>369</sup> The amendments effected by the Enterprise Act 2002 have undoubtedly removed certain weaknesses, some of which administration shared with judicial management. The remaining similarities as well as the differences between these two procedures are therefore important for the development of South African law in this area.

Although some doubts were initially expressed by commentators on the ability of administration to become more effective in spite of the reforms effected by the Enterprise Act 2002<sup>370</sup> others believed that it was at least a possibility.<sup>371</sup> Indications

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<sup>366</sup> Paragraph 84(5). In practice this procedure is also used where all available assets have been distributed by the administrator. Although this is not strictly in accordance with the wording of par 84, the Insolvency Service has given its approval to the wide interpretation of this provision and the courts have also applied it: *Palmer* par 14.099.33; Sealy and Milman *Insolvency Legislation* at 553.

<sup>367</sup> Paragraph 84(6).

<sup>368</sup> This was mentioned in Sealy and Milman *Insolvency Legislation* (2004) at 40 but was not repeated in later editions. Bailey and Groves *Corporate Insolvency* at 340 also refers to judicial management as a similar rehabilitation procedure and comments that it proved to be unsuitable as a result of the extensive involvement of the court. *Palmer* par 14.002 merely states that administration is comparable to procedures that are available under foreign insolvency law systems but specifically mentions Chapter 11 of the US Bankruptcy Reform Act (11 USC) as one possible model, albeit without its foremost characteristic – the debtor in possession system where the directors remain in control of the company.

<sup>369</sup> Fletcher *Insolvency* at 515 refers to a “sustained vote of ‘no confidence’”.

<sup>370</sup> Finch “Corporate Rescue” at 557. Frisby “Rescue Regime” at 262 concluded that the new regime did not provide administrators with any new apparatus to achieve a rescue.

<sup>371</sup> Several commentators have remarked that the reforms will succeed only if approached in a positive manner by creditors (particularly the banks), insolvency practitioners and judges: Finch “Corporate Rescue” at 528. At least as far the judges are concerned, Finch has since reached the conclusion that “they are sympathetic to the development of administration as a streamlined tool of rescue” and will not easily interfere with the business judgments of the administrator: *Corporate Insolvency* at 452.

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are that the power given to directors to directly appoint an administrator without involvement by the courts, has resulted in administration becoming a user-friendly and affordable way of rescuing a company.<sup>372</sup> The automatic moratorium that allows the administrator to prepare proposals for the creditors without the pressure of threatening enforcement actions, and to continue running the business while the creditors consider these proposals, is also a major advantage of administration.<sup>373</sup> However, Finch still expresses many reservations about administration and particularly its attraction for banks as the major creditors.<sup>374</sup> The legal uncertainties for major creditors created by, among other things, the duty of the administrator to act in the best interests of all the creditors may result in banks using various methods of security for their claims, leading to a fragmentation of the secured assets.<sup>375</sup> The general uncertainty of banks about their role in the rescue of companies may eventually cause the banks to lose patience with troubled companies and opt for direct enforcement action at an early stage rather than attempting a rescue.<sup>376</sup> Parry also points out that the increase in the number of administrations may “superficially” be regarded as an indication of its “resounding success”, but in actual terms it is more expensive, complex and slower than administrative receivership, and creditors are not in a significantly better position than before the changes effected by the Enterprise Act 2002.<sup>377</sup>

The most important similarity between administration and judicial management is the fact that both apply to companies only.<sup>378</sup> This has not been changed by the new provisions and, it is submitted, supports the view that it is undesirable (if not impossible) to design a rescue procedure that would be equally suitable for large companies and small businesses. Furthermore, just like judicial management,

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<sup>372</sup> Statistics show that the out-of-court procedure for the appointment of an administrator was an immediate success after the Enterprise Act 2002 came into effect. In the period of 2003-2004 this procedure was used in 65.5 per cent of companies entering administration: Finch *Corporate Insolvency* at 393.

<sup>373</sup> Bailey and Groves *Corporate Insolvency* at 385.

<sup>374</sup> *Corporate Insolvency* at 402.

<sup>375</sup> Finch *Corporate Insolvency* at 403.

<sup>376</sup> Finch *Corporate Insolvency* at 404.

<sup>377</sup> *Corporate Rescue* at 24-25. She believes that the increase in administrations could also be partly ascribed to its use as an alternative liquidation procedure.

<sup>378</sup> This is also true of the new business rescue proceedings in South Africa, except for the – in my view misguided – decision to make it applicable to close corporations as well: see Chapter 2, part 3.2.

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administration could formerly also be initiated only by an order of court. The introduction of a less formal procedure for the company and its directors to commence administration is therefore of particular importance to South Africa to establish whether it has had the intended result of encouraging directors to act at an early stage when a rescue of the company is still possible.<sup>379</sup>

Even in those cases where an administrator is appointed by an order of court, it is not required (or even allowed) that a provisional administrator should first be appointed. This has the advantage that if all the requirements for the appointment of an administrator are met, the court has to be approached only once and the costs of a second court appearance, as required for a final judicial management order, are saved. In South Africa, the procedure for the commencement of business rescue proceedings by an order of court now also includes only one approach to the court, but has had the unfortunate result that the interests of affected persons are protected by a requirement of prior notification to all of them which will undoubtedly have serious detrimental consequences for the company.<sup>380</sup>

Whereas the original provisions on administration provided for the alternative objective of a more advantageous realisation of the company's assets than on winding up, on an equal footing with a rescue of the company, it is interesting to note that in the amended provisions the rescue of the company as a going concern is now very firmly positioned as the first and primary objective of administration. Achieving a better result for creditors may only be the objective if the administrator believes that administration is not practicable or would not achieve a better result for the company's creditors. In this respect administration has moved closer to judicial management. It is important, however, that advantage to creditors in a subsequent winding up of the company is acceptable as the purpose of administration and constitutes a vast difference from judicial management.<sup>381</sup>

Another important difference between administration and judicial management is that the company is protected by a moratorium from the moment that the first steps

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<sup>379</sup> Parry "Administrative Receivership and Administration" at 172. The introduction of a similar procedure for the commencement of business rescue proceedings was probably influenced by administration: see Chapter 2, part 3.3.1.

<sup>380</sup> See Chapter 2, part 3.5.2.1.

<sup>381</sup> See Chapter 2, part 3.1 on the inclusion of this purpose in the definition of business rescue proceedings.

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are taken to place the company in administration.<sup>382</sup> Furthermore both the interim and final moratoria come into effect automatically. In judicial management the moratorium has to be specifically applied for and ordered by the court. This means that a judicial management order could conceivably be granted without a moratorium, either because it was not included in the application as a result of an oversight by the applicant, or because a court may decide not to grant it. This would undoubtedly make any rescue attempt extremely difficult, if not impossible. Although this problem has now been addressed by the provisions regulating business rescue proceedings through the introduction of an automatic moratorium, the unclear wording of these provisions has created new problems.<sup>383</sup>

Both in administration and judicial management an outsider is appointed to take control of the company and the rescue process. This is cited as one of the disadvantages of administration as creditors may generally feel uncomfortable about such an outsider running the business and also having the power to remove the directors.<sup>384</sup> However, there is a vast difference between the stringent requirements set for appointment as an administrator and the practically non-existent ones for a judicial manager. It is clear that the success of administration depends largely on the expertise and irreproachable conduct of the insolvency practitioner<sup>385</sup> to the same extent that judicial management has probably often failed because of a lack of it.<sup>386</sup> The intended regulation of the profession of business rescue practitioner by the Companies Act of 2008 in South Africa is thus a welcome innovation although a number of problems are foreseen in the application of these provisions.<sup>387</sup>

Apart from the control exercised over an administrator by his professional body or the Secretary of State, the actions of a particular administrator may be challenged in court by a creditor or member of the company.<sup>388</sup> This may even result in his removal from office. By contrast with all the above measures designed to control and

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<sup>382</sup> Part 2.6 above.

<sup>383</sup> See Chapter 2, part 3.6.

<sup>384</sup> Bailey and Groves *Corporate Insolvency* at 387.

<sup>385</sup> Sealy and Milman *Insolvency Legislation* at 421 point out that the introduction of professional standards for insolvency practitioners has, for example, made it possible to allow them to perform certain functions without the consent of the court, thereby saving time and costs.

<sup>386</sup> See Chapter 2, part 2.7.1.2.

<sup>387</sup> See Chapter 2, part 3.7.1.2.

<sup>388</sup> Part 2.7.2 above.

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supervise the actions of an administrator and remove him from office if necessary, there is no express provision in the Companies Act 1973 for the removal of a judicial manager on any grounds, and a degree of uncertainty regarding the inherent power of the court to do so remains.<sup>389</sup> Furthermore, only the Master, the final judicial manager himself or a duly authorised representative of the creditors may apply to court for a variation of the judicial management order which does not include removal from office of the judicial manager.<sup>390</sup> A business rescue practitioner in South Africa may be removed from office by an order of court on application by any affected person or on the court's own initiative on a (possibly too) wide array of grounds.<sup>391</sup> However, there seems to be little else an affected person can do to control the actions of a particular practitioner except to have him removed by an order of court or possibly reporting him to the intended regulating authority.<sup>392</sup>

Whereas a judicial manager is more or less left to his own devices during the rescue attempt, an administrator has to prepare definite proposals for achieving the purpose of administration and obtain the creditors' approval. Once his proposals have been approved, he is obliged to act in terms thereof.<sup>393</sup> The business rescue practitioner is now under a similar duty to draft a business rescue plan for approval by (mainly) the creditors.<sup>394</sup>

Administration automatically terminates after one year and, in those cases where the administrator has been appointed by the company or directors, may be terminated even sooner and without intervention by the court, if the purpose has been achieved.<sup>395</sup> Whereas judicial management lasts for an indefinite period and can be terminated only by an application to court,<sup>396</sup> the provisions regulating business rescue proceedings fall somewhere between the two possibilities: it is supposed to last only three months but does not end automatically after this period. Depending on how the proceedings were commenced and why they are being terminated, an application to court or the filing of a notice by the practitioner is

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<sup>389</sup> Chapter 2, part 2.7.1.3.

<sup>390</sup> Chapter 2, part 2.7.1.3.

<sup>391</sup> See Chapter 2, part 3.7.1.3.

<sup>392</sup> Chapter 2, part 3.7.1.2.1.

<sup>393</sup> Part 2.8 above.

<sup>394</sup> Chapter 2, part 3.8.

<sup>395</sup> See part 2.9.3 above.

<sup>396</sup> Chapter 2, part 2.9.

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required to terminate the business rescue proceedings.<sup>397</sup> In keeping with most of the provisions regulating business rescue proceedings, the provisions determining the procedure for termination of the proceedings are noticeably more complicated and unclear than those applicable to administration and could have benefited quite substantially from following the examples found in the Insolvency Act 1986.

In spite of all the attempts at improving, adapting and modernising administration, some doubts about its potential success remain. Fletcher mentions two major problems that England has to overcome in attempting to develop a rescue culture and a successful company rescue regime.<sup>398</sup> These are, first, the characteristic feature of English insolvency law of bias towards the protection of (particularly secured) creditors' interests resulting in a conflict with the aims of a rescue culture. The second problem is the "deep-seated mistrust of the concept of 'debtor-in-possession'" which allows the existing management to retain their management powers during a rescue attempt. As a result of the uncertainty of their position and combined with the risks of personal liability, directors tend to postpone the decision to commence administration until the only possible outcome is the distribution of the company's assets to its creditors. His conclusion is that a true rescue culture will remain an "elusive quest" and beyond the reach of English insolvency law while it remains in its present form. This is probably equally true of South African law.

### **3 COMPANY VOLUNTARY ARRANGEMENTS<sup>399</sup>**

#### **3.1 Definition and purpose**

Section 1(1) of the Insolvency Act 1986 provides for a proposal that is made to a company and to its creditors<sup>400</sup> for a voluntary arrangement between the company and its creditors within the framework provided by Part I of the Act. A proposal is

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<sup>397</sup> See Chapter 2, part 3.9.

<sup>398</sup> *Insolvency* at 605-607.

<sup>399</sup> This procedure is often referred to by the abbreviated term "CVA".

<sup>400</sup> Although contingent and prospective creditors are not expressly included here whereas in other sections of the Insolvency Act 1986 they are (eg, par 12(4), which defines creditors for the purposes of an application for an administration order to include contingent and prospective creditors), the question whether they are included has been settled by the courts to the effect that such creditors are indeed included: *Doorbar v Alltime Securities Ltd* [1996] 1 WLR 456; [1995] BCC 1149; *Re Cancol Ltd* [1996] 1 All ER 37; [1995] BCC 1133; *Re Sweatfield Ltd* [1997] BCC 744. However, there is nothing to prevent a scheme of arrangement from containing terms excluding future or contingent creditors from its operation: Sealy and Milman *Insolvency Legislation* at 21-22.



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defined in the Act as being one which provides for a person (the so-called nominee), who must be qualified to act as an insolvency practitioner or authorised to act as nominee, to act either as trustee or otherwise to supervise the implementation of the voluntary arrangement.<sup>401</sup>

A voluntary arrangement can be in the form of either a composition in satisfaction of a company's debts<sup>402</sup> or a scheme of arrangement<sup>403</sup> of its affairs.<sup>404</sup> It is generally accepted that a voluntary arrangement created in terms of the relevant statutory provisions is thereafter governed by contractual principles, which means that a court cannot give orders for the amendment of a company voluntary arrangement after it has been concluded.<sup>405</sup>

The Insolvency Act 2000 introduced a new Schedule 1A into the Insolvency Act 1986 in terms of which a company voluntary arrangement can be combined with a moratorium in certain cases.<sup>406</sup> However, the original company voluntary arrangement without moratorium continues to exist for companies that do not qualify for the moratorium procedure.<sup>407</sup> It is also used by companies that are eligible but prefer to

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<sup>401</sup> Section 1(2). See part 3.7.1 below for a discussion of the qualifications required for appointment as nominee (and supervisor).

<sup>402</sup> Described by Goode *Corporate Insolvency Law* at 26 as an agreement by the company's creditors to accept, either in one sum or by instalments, an amount less than the amount due to them, without involving a transfer of assets or change in the structure of the company or rights of its members. It is essential, however, that the company must make a payment of money or other consideration: a proposal providing for a nil dividend to unsecured creditors, for example, would not qualify as a composition but as a scheme of arrangement: Bailey and Groves *Corporate Insolvency* at 197.

<sup>403</sup> A scheme of arrangement involves an element of give and take and includes a wide array of schemes such as conversion of debt into equity or secured into unsecured debt and vice versa and subordination of debt: Goode *Corporate Insolvency Law* at 26. It involves something less than the release or discharge of the company's debts, eg a moratorium, which would not qualify as a composition but would be acceptable as a scheme of arrangement: Sealy and Milman *Insolvency Legislation* at 22. It may also involve a third party who will supply financing or other benefits: Bailey and Groves *Corporate Insolvency* at 199. This scheme of arrangement must not be confused with the scheme of arrangement in terms of ss 895-899 of the Companies Act 2006 (previously s 425 of the Companies Act 1985) that requires approval by the court and closely resembles the scheme of arrangement in South African law in terms of s 311 of the Companies Act 61 of 1973 (discussed in Chapter 2, part 4.1).

<sup>404</sup> Picarda *Receivers, Managers and Administrators* at 581; Grier and Floyd *Corporate Recovery* at 155.

<sup>405</sup> Broc "Company Voluntary Arrangements" at 179-180; Sealy and Milman *Insolvency Legislation* at 35; Goode *Corporate Insolvency Law* at 388. This was confirmed by the judgment of the Court of Appeal in *Re NT Gallagher and Son Ltd* [2002] EWCA Civ 404; [2002] 1 WLR 2380.

<sup>406</sup> By inserting s 1A into the Insolvency Act 1986, which provides that Schedule 1A will determine which companies are eligible for the moratorium, the procedure for obtaining, and effects of such a moratorium, and the procedure for the approval and implementation of a voluntary arrangement where a moratorium is or has been in force. The procedure and requirements for obtaining the moratorium are discussed in part 3.6 below.

<sup>407</sup> Consequently, there are two sets of provisions in the Insolvency Act and two sets of Rules in the Insolvency Rules for company voluntary arrangements, being one each for arrangements with and

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avoid the inevitable publicity that accompanies the moratorium because it could result in destabilising the company's business to such an extent that it cannot survive.<sup>408</sup>

### **3.2 Entities to which a company voluntary arrangement applies**

Company voluntary arrangements, as the name implies, apply to companies as defined for this purpose in section 1(4) of the Insolvency Act 1986. This means that it applies primarily<sup>409</sup> to companies within the meaning of the Companies Act 2006.<sup>410</sup>

### **3.3 Power to initiate a company voluntary arrangement**

A proposal for a composition in satisfaction of the company's debts or for a scheme of arrangement of its affairs (both referred to in the Act as a voluntary arrangement) may be made to a company and its creditors by the directors of the company on condition that the company is not in administration or being wound up.<sup>411</sup> If the company is in administration or being wound up the administrator and the liquidator respectively have the power to make such a proposal.<sup>412</sup> Neither the members nor the creditors of a company may propose a voluntary arrangement.

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those without a moratorium, respectively. However, except for those specifically dealing with the moratorium itself (discussed in part 3.6 below), the provisions and Rules are essentially the same, particularly those regarding the consideration and implementation of the voluntary arrangement: *Palmer* par 14.449. Bailey and Groves *Corporate Insolvency* at 194 (fn 12) remarks that the Insolvency Rules Committee seems to have lost enthusiasm for the totally unnecessary task of maintaining two separate sets of provisions by simply making many of the Rules for a CVA without moratorium applicable to the CVA with moratorium by direct reference to the former. The provisions regulating the CVA with a moratorium will therefore only be referred to where they differ from the standard ones.

<sup>408</sup> *Palmer* par 14.406.

<sup>409</sup> Section 1(4) also includes companies incorporated in an EEA State other than the UK or a company not so incorporated but having its centre of main interests in a member State other than Denmark. These will not be considered, as they are not relevant to this discussion.

<sup>410</sup> These would be companies formed and registered under s 1(1) of the Companies Act 2006 (c 46) (previously s 735(1) of the Companies Act 1985) or the former Companies Acts excepting the Joint Stock Companies Acts, the Companies Act 1862 and the Companies (Consolidation) Act 1908: see fn 51 above. Voluntary arrangements based on company voluntary arrangements were also made available to partnerships by the Insolvent Partnerships Order 1994 (SI 1994/2421), as amended by the Insolvent Partnerships (Amendment) Order 2005 (SI2005/1516), and to limited liability partnerships by the Limited Liability Partnership Regulations 2001 (SI 2001/1090) as amended by the Limited Liability Partnerships (Amendment) Regulations 2005 (SI 2005/1989). Partnerships will not be discussed here, since there are important basic differences between the South African and English law regulating partnerships. In terms of s 90A of the Building Societies Act 1986 (c 53), the company voluntary arrangement procedure may also be used by building societies.

<sup>411</sup> Section 1(1) of the Insolvency Act 1986.

<sup>412</sup> Section 1(3) of the Insolvency Act 1986. Such companies are excluded from the procedure involving a moratorium: see part 3.6 below.

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### 3.4 Requirements for a company voluntary arrangement

There are no specific requirements for a company to be eligible for a voluntary arrangement – it need not be insolvent, unable to pay its debts or likely to become so as defined by the statutory definitions.<sup>413</sup> If the company is already in liquidation or administration, it would of course have had to comply with the requirements for those procedures and will thus in most cases be insolvent or likely to become insolvent or unable to pay its debts.

Although it is not specifically required that the company must be insolvent or likely to become so as defined by statute,<sup>414</sup> it is unlikely that the directors of a company will propose a voluntary arrangement if the company is not in some sort of financial distress, and even more unlikely that creditors will accept their proposal, since it usually provides for late payment or only partial payment of the company's debts. The absence of formal requirements regarding insolvency does have the advantage that directors are able to act as soon as the first signs of serious financial problems appear,<sup>415</sup> particularly in the case of smaller companies where it is now possible to do so without exposing the company to the risk of creditors making a run on the company to obtain payment before a voluntary arrangement comes into effect.

### 3.5 Procedure for a company voluntary arrangement

If a company is in administration or liquidation, the administrator or liquidator will normally appoint himself as nominee, and the procedure prescribed by the Act therefore differs according to whether the nominee is the liquidator (or administrator) or another person.<sup>416</sup>

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<sup>413</sup> Fletcher *Insolvency* at 483-484; Grier and Floyd *Corporate Recovery* at 9; Pennington *Corporate Insolvency* at 409; Goode *Corporate Insolvency Law* at 387. It is, however, clearly assumed to be in financial distress: Rule 1.6(1) authorises the nominee to ask the directors to provide him with further and better particulars of the circumstances and reasons why the company is insolvent or threatened with insolvency.

<sup>414</sup> Sealy and Milman *Insolvency Legislation* at 20.

<sup>415</sup> Fletcher *Insolvency* at 483-484 explains that a company voluntary arrangement can therefore be used "in an attempt to avoid a threatened, or predictable, insolvency before it actually occurs".

<sup>416</sup> Section 2 of the Insolvency Act 1986 prescribes the procedure where the nominee is another person. This part of the procedure is omitted if the nominee is the liquidator or administrator.

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### 3.5.1 Notice of proposal

The directors must give written notice of their proposal to the intended nominee by delivering the notice, accompanied by a copy of the proposal,<sup>417</sup> to the nominee himself or a person authorised to accept delivery on his behalf. If he agrees to act, the nominee must endorse the date on which he receives the notice on a copy thereof and immediately return this endorsed copy to the directors.<sup>418</sup>

The directors must also within seven days after delivery of the proposal deliver to the nominee a statement of the company's affairs, certified as correct by at least two directors (or one director and the company secretary) in which the prescribed information regarding the company's assets, liabilities, secured, unsecured, preferential and connected creditors is disclosed, as well as the names, addresses and respective shareholdings of the company's members, and any other information required in writing by the nominee.<sup>419</sup>

If the nominee is not the liquidator or administrator of the company, the directors<sup>420</sup> will in practice consult the intended nominee beforehand and he would usually assist in drawing up the proposal.<sup>421</sup> The prescribed procedure up to the point where meetings of the company's members and creditors are held to consider the proposal is thus to a large extent a mere formality.

If the liquidator or administrator is the nominee, this part of the procedure is omitted<sup>422</sup> and he immediately proceeds to summon the required meetings.<sup>423</sup> From that point onwards the procedure is the same for both situations.

### 3.5.2 Report by nominee

Within 28 days (or a longer period allowed by the court) after the recorded date of

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<sup>417</sup> See part 3.8 below for a discussion of the contents of the proposal.

<sup>418</sup> Rule 1.4 of the Insolvency Rules 1986.

<sup>419</sup> Rule 1.5 of the Insolvency Rules 1986. After amendment by the Insolvency (Amendment) Rules 2010, the statement of affairs will have to be delivered at the same time as the proposal, and verified by a statement of truth by at least one director.

<sup>420</sup> It will be assumed for the purposes of this discussion that the proposal has been made by the directors when the nominee is not the administrator or liquidator of the company, although there is nothing to prevent an administrator or liquidator from designating another person as nominee.

<sup>421</sup> Fletcher *Insolvency* at 487; *Palmer* par 14.415; Sealy and Milman *Insolvency Legislation* at 21.

<sup>422</sup> Section 3(2) of the Insolvency Act 1986. The reason behind this is that an administrator or liquidator is always an insolvency practitioner and may thus be assumed to have already made a professional judgment on the viability and terms of his proposal: Fletcher *Insolvency* at 487.

<sup>423</sup> See part 3.5.3 below.

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receiving notice of the proposal for a voluntary arrangement, the nominee must submit a report to the court in which he expresses his opinion on whether the proposed voluntary arrangement has a reasonable prospect of being approved and implemented and whether meetings of the company and its creditors should be summoned to consider the proposal.<sup>424</sup> If he believes that these meetings should be summoned, he must also indicate when and where he proposes that they should be held.<sup>425</sup> A copy of the proposal<sup>426</sup> and a copy or summary of the company's statement of affairs must accompany the nominee's report.<sup>427</sup>

If the nominee expresses the opinion that the directors' proposal has a reasonable prospect of being approved and implemented and that meetings of the company and its creditors should be summoned, he must attach his comments on the proposal to his report to court. If he believes otherwise, he must give reasons for his opinion.<sup>428</sup> The date on which the nominee's report is filed in court must be endorsed on the report and any director, member or creditor of the company is entitled to inspect the file at all reasonable times on a business day.<sup>429</sup> The court does not play an active role in this regard, but merely an administrative one, as it does not give any order for meetings to be held. In spite of this, the nominee is not allowed to convene the meetings before he has filed his report.<sup>430</sup> The nominee must also send a copy of his report and any comments to the company.<sup>431</sup>

Although he need not personally verify every minute detail, the nominee may not merely accept the information supplied in the proposal and statement of affairs without query, especially not if there is reason to doubt whether the information supplied by the directors is complete or truthful.<sup>432</sup> In such a case he is expected to

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<sup>424</sup> Section 2(2)(a) of the Insolvency Act 1986 as amended by Schedule 2 to the Insolvency Act 2000.

<sup>425</sup> Section 2(2)(b) of the Insolvency Act 1986. In terms of Rule 1.9(1) of the Insolvency Rules of 1986, the meetings must be held in the period between 14 and 28 days after the filing of the report in court.

<sup>426</sup> Which may be amended by the directors with the written consent of the nominee until just before this point: Rule 1.3(3) of the Insolvency Rules.

<sup>427</sup> Rule 1.7(1) of the Insolvency Rules.

<sup>428</sup> Rule 1.7(2) of the Insolvency Rules 1986. There is no provision prohibiting the company's directors from seeking out another nominee for a second opinion: Sealy and Milman *Insolvency Legislation* at 24.

<sup>429</sup> Rule 1.7(3) of the Insolvency Rules 1986.

<sup>430</sup> Section 3(1) of the Insolvency Act 1986; *Palmer* par 14.414.

<sup>431</sup> Rule 1.7(4) of the Insolvency Rules 1986.

<sup>432</sup> In terms of s 6A of the Insolvency Act 1986 it is a criminal offence for an officer of the company to make any false representation or fraudulently do or omit to do anything for the purpose of obtaining the approval of members or creditors to a proposal for a voluntary arrangement.

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take at least reasonable steps to satisfy himself on three aspects in particular:

- (a) that the company's substantially real financial situation is represented to the creditors;
- (b) that the proposal has a real prospect of being implemented in the way it is presented to the creditors' meeting; and
- (c) that the information he has does not indicate an unavoidable prospective unfairness in his functions.<sup>433</sup>

The nominee may also request further information from the directors if he cannot properly prepare his report on the information that he already has.<sup>434</sup> This would include more information on the circumstances of and reasons for the company's insolvency or threatened insolvency and particulars of previous proposals for a voluntary arrangement.

If the nominee fails to submit his report or has died (presumably before submitting the report), the directors may apply to court for the appointment of another person to replace the nominee. The directors or the nominee may also bring such an application if it is impracticable or inappropriate for the nominee to continue acting as such.<sup>435</sup> As Sealy and Milman<sup>436</sup> point out, there does not seem to be any reason why the procedure could not simply be aborted under these circumstances without approaching the court, because no creditor would as yet have been approached or even be aware of the intended proposal. However, they believe that the consent of the nominee would be required, as ethical rules might prevent a colleague from replacing him against his wishes. If this consent is refused, the court would have to become involved.

### **3.5.3 Meetings of creditors and members**

If the report of the nominee states that meetings of the company and its creditors should be held, they must be summoned by the nominee for the date, time and place as specified in the report.<sup>437</sup> Where the nominee is the liquidator or administrator he

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<sup>433</sup> Picarda *Receivers, Managers and Administrators* at 588 in his discussion of the judgment in *Re a Debtor (No 140 IO of 1995)* [1996] 2 BCLC 429. Although this case dealt with an individual voluntary arrangement, Picarda submits that the same principles would apply to a company voluntary arrangement.

<sup>434</sup> Rule 1.6 of the Insolvency Rules 1986.

<sup>435</sup> Section 2(4) of the Insolvency Act 1986 as amended by par 3 of Schedule 2 to the Insolvency Act 2000.

<sup>436</sup> *Insolvency Legislation* at 25.

<sup>437</sup> Section 3(1) of the Insolvency Act 1986.

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decides on the date and place of the meetings.<sup>438</sup> The meeting of creditors must always be held before that of the members, and if not held on the same day, the members' meeting must take place within seven days after the meeting of creditors. If the meetings for the company's members and creditors are held on the same date, they must be held in the same place and then the convenience of the creditors is the deciding factor when choosing a venue for the meetings.<sup>439</sup> It is not required that separate meetings must be held for the different classes of creditors.

The meetings are summoned by sending a notice to every known creditor and member of the company at least 14 days before the meeting.<sup>440</sup> The notice must contain an explanation of the requisite majority votes of creditors required for approval and be accompanied by copies of the proposal, the statement of affairs and, where applicable, the nominee's comments on the proposal.<sup>441</sup> Notice must also be given to directors and other officers of the company whose presence is required, but they may be excluded from attendance at a meeting, even if they have been notified.<sup>442</sup>

### **3.5.4 Approval of company voluntary arrangement**

The procedure to be followed at these meetings is prescribed in detail, including the voting rights of creditors and members.<sup>443</sup> For the voluntary arrangement to be binding, it must be approved (with or without modifications) by a majority of creditors in excess<sup>444</sup> of three-quarters in value (excluding secured or unproved claims) of creditors present in person or by proxy and voting.<sup>445</sup> However, if more than half in value of the creditors to whom notice of the meeting was sent,<sup>446</sup> whose votes are not

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<sup>438</sup> Section 3(2) of the Insolvency Act 1986.

<sup>439</sup> Rule 1.13 of the Insolvency Rules. The reference to seven days will be amended to clarify that it means "business days" once the amendments to the Rules come into operation in 2010.

<sup>440</sup> Rules 1.9(2) and 1.11(1) respectively of the Insolvency Rules.

<sup>441</sup> Rules 1.9(3) and 1.11(2) respectively of the Insolvency Rules.

<sup>442</sup> Insolvency Rule 1.16.

<sup>443</sup> Insolvency Rules Part 1, Chapter 5 (Rules 1.13-1.21).

<sup>444</sup> This differs from the more usual requirement of just 75 per cent voting in favour of a resolution. However, Rule 1.19(1) will be replaced by Rule 1.19(2) of the draft Insolvency (Amendment) Rules 2010 which stipulates "three-quarters or more (in value)".

<sup>445</sup> Insolvency Rule 1.19. Rule 1.17(3) allows a creditor whose claim is for an unliquidated amount or a debt whose value is not ascertained, to vote but for this purpose his vote is valued at £1 unless the chairman agrees to put a higher value on it. The creditor's acceptance of this value is not necessary: *Palmer* par 14.422.

<sup>446</sup> Bailey and Groves *Corporate Insolvency* at 272 state that it is unclear why importance is attached to notice of the meeting having been sent. Strictly speaking, the vote of a creditor who did not receive notice but somehow learns of the meeting, attends and votes against the proposal, should then not be

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to be left out of account<sup>447</sup> and who are not, to the best of the chairman's belief, connected with the company,<sup>448</sup> vote against approval of the proposal, the resolution approving the proposal is invalid.<sup>449</sup> This double requirement is intended to prevent minority creditors being forced into an arrangement by majority creditors who are closely connected to the company.<sup>450</sup>

As far as approval by members is concerned, more than half in value of the votes (determined by the number of voting rights conferred by the articles of association) of members present in person or by proxy and voting is required.<sup>451</sup>

However, an important amendment was made to the Act by the introduction of section 4A by the Insolvency Act 2000. Although section 4A(2)(a) repeats the general principle that a decision regarding the approval of a voluntary arrangement has effect if taken by the meetings of both the creditors and the members,<sup>452</sup> section 4A(2)(b) provides an alternative by stating that such a decision will also have effect if taken by the creditors' meeting only. If a different decision than the one taken by creditors is taken by the members, a member of the company may within 28 days after the later of the two decisions was taken apply to court for relief.<sup>453</sup> The court may order that the decision taken by the members, and not the one taken by the creditors, should have effect or make any other order it deems fit.<sup>454</sup>

It is clearly almost entirely up to the creditors of a company whether a voluntary arrangement will be implemented or not, irrespective of the wishes of the members, as it seems unlikely that a court would readily interfere with the decision taken in this

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taken into consideration, but they believe that the courts will in such a case deem the creditor to have been given notice.

<sup>447</sup> Insolvency Rule 1.19(3) stipulates which votes are to be left out of account, such as those in respect of secured claims (because secured creditors are not bound unless they consent: see part 3.8 below) or where written notice of the claim was not given at or before the meeting.

<sup>448</sup> Defined in s 249 as a director or shadow director, or associate of such persons or associate of the company. Section 435 of the Insolvency Act contains a complete list of who will be regarded as an associate, and includes the husband, wife or civil partner of an individual or a relative of one of them, a partner, employer or employee of the individual or a person who controls a company.

<sup>449</sup> Insolvency Rule 1.19(4).

<sup>450</sup> Bailey and Groves *Corporate Insolvency* at 271.

<sup>451</sup> Insolvency Rule 1.20.

<sup>452</sup> Previously stated in s 5(1) of the Insolvency Act 1986. This section has now been amended by the Insolvency Act 2000 to reflect the new situation.

<sup>453</sup> Section 4A(3) and (4). In spite of this provision, a voluntary arrangement takes effect from the date of the creditors' meeting, although this could be up to seven days before the meeting of members is being held (s 5(2)(a)).

<sup>454</sup> Section 4A(6).



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regard by the creditors. In effect the members of a company have been left powerless in spite of the very obvious interest they have in rescuing the company although their rights may not be affected by a voluntary arrangement. This once again illustrates the point that although a company rescue can benefit various interested parties, the emphasis here remains on the best interests of the creditors. However, the inclusion of members in the process, although subject to severe limitations on their rights, ensures that the arrangement will be binding on them, which is a substantial advantage compared to the new compromise procedure created by the Companies Act of 2008 in South Africa, where shareholders are not involved and their consent, if necessary, will have to be obtained in a separate process.<sup>455</sup>

One of the modifications expressly allowed by the Insolvency Act 1986 is a decision to replace the nominee by another person on whom the relevant functions are then conferred to supervise the execution of the voluntary arrangement.<sup>456</sup> Although the nominee is usually appointed as supervisor, major creditors sometimes approve an arrangement subject to the condition that their choice of supervisor is appointed.<sup>457</sup>

### **3.5.5 Effects of approval**

If the proposal for a voluntary arrangement is approved in terms of section 4A of the Act it binds every person who was entitled to vote at the meeting (irrespective of whether he was present or represented at the meeting) or who would have been entitled to vote if he had notice of the meeting.<sup>458</sup> Thus even a creditor (or member) who did not receive notice of the meeting would be bound.<sup>459</sup> Fletcher<sup>460</sup> explains that this change in the law was effected to prevent creditors that escaped being bound

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<sup>455</sup> See Chapter 2, part 4.2. Although no similar procedure exists in Germany, the exclusion of members from the insolvency plan, which can also contain a compromise, has led to a situation where shareholders can undermine the plan by withholding their consent which also has to be obtained in a separate process: see Chapter 4, part 2.8.1.

<sup>456</sup> Section 4(2) of the Insolvency Act 1986.

<sup>457</sup> Bailey and Groves *Corporate Insolvency* at 278.

<sup>458</sup> Section 5(2)(b) as substituted by the Insolvency Act 2000. Previously, only persons who had received notice of the meeting were bound.

<sup>459</sup> Bailey and Groves *Corporate Insolvency* at 192 allege that creditors are sometimes deliberately omitted from the statement of affairs.

<sup>460</sup> *Insolvency* at 497.

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from undermining an otherwise acceptable voluntary arrangement, and although he acknowledges that this is “a suppression of a customary principle of natural justice”, he refers to the remedy provided by section 6 of the Insolvency Act to challenge a decision taken at the meeting.<sup>461</sup> Broc<sup>462</sup> makes a valid point when she submits that under the previous dispensation a voluntary arrangement was weakened by the existence of creditors who were not bound by it, thereby putting the procedure at a disadvantage compared to the more expensive and cumbersome scheme of arrangement under section 425 of the Companies Act 1985.<sup>463</sup> However, these creditors are now accorded special protection by section 5(2A),<sup>464</sup> which makes the company liable for payment to such persons of any amount payable under the arrangement but not yet paid when the arrangement comes to an end.<sup>465</sup>

If a voluntary arrangement takes effect in terms of section 4A, the nominee or other person who has been given the task of executing the voluntary arrangement in terms of the approval is now referred to as the supervisor of the voluntary arrangement.<sup>466</sup> In most cases the nominee appointed in the proposal also continues to act as the supervisor<sup>467</sup> who administers the voluntary arrangement after it has been approved, and the Act seems to assume that this will be so in its description of the nominee.<sup>468</sup> If the company is being wound up or an administration order is in force, the court may stay all proceedings in the winding up or discharge the administration order<sup>469</sup> once a period of 28 days has expired after the approval of the meetings has been reported to the court<sup>470</sup> – the period within which the decisions of the meetings may be challenged in court by a person entitled to vote at one of the meetings, or by the nominee, the liquidator or administrator.

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<sup>461</sup> Section 6 is discussed below in this part.

<sup>462</sup> “Company Voluntary Arrangements” at 181.

<sup>463</sup> Now ss 895-899 of the Companies Act 2006.

<sup>464</sup> Inserted into the Insolvency Act 1986 by the Insolvency Act 2000.

<sup>465</sup> Unless the arrangement ends prematurely. Section 6, discussed in the next paragraph, also provides a right to challenge the arrangement or its approval in court.

<sup>466</sup> Section 7(2) of the Insolvency Act 1986.

<sup>467</sup> Discussed in part 3.5.5 below.

<sup>468</sup> Section 1(2); Sealy and Milman *Insolvency Legislation* at 22.

<sup>469</sup> Section 5(3). Alternatively, the court may give such directions regarding the administration or winding up as it thinks appropriate for facilitating the implementation of the voluntary arrangement.

<sup>470</sup> The chairman of each meeting, and not the nominee/supervisor, has to report the outcome of the meeting to the court and prescribed persons: s 4(6) of the Insolvency Act 1986. In terms of Rule 1.24 of the Insolvency Rules 1986, the report must be filed in court within four days after the meeting and immediately after that, sent to every person who was notified of the meeting.

The grounds on which the application to court may be made are that the arrangement unfairly prejudices the interests of a member or creditor or that there has been some material irregularity in relation to either of the two meetings.<sup>471</sup> The court may revoke or suspend any approval given at one or both of the meetings and may give directions for further meetings to be summoned to consider a revised proposal put forward by the same person who made the original one.<sup>472</sup>

The supervisor has to act in terms of the approved voluntary arrangement and the Rules issued in terms of the Insolvency Act 1986 but the court has also been given almost unlimited powers to oversee his conduct. Any creditor or other person<sup>473</sup> dissatisfied by any act, omission or decision of the supervisor may apply to court for an order to reverse or modify such act or decision or to give directions to the supervisor or make any other order the court considers appropriate.<sup>474</sup> The supervisor may also apply to court for directions in relation to any matter arising under the voluntary arrangement<sup>475</sup> and may apply for the winding up of the company or an administration order.<sup>476</sup> The decisions of the courts in cases involving company voluntary arrangements have thus far proved to be supportive and helpful in finding practical solutions to contentious questions, thereby avoiding delays and unnecessary litigation that could have undermined this rescue procedure.<sup>477</sup>

### 3.6 The moratorium

As was mentioned before, the company voluntary arrangement procedure did not originally make any provision for a moratorium.<sup>478</sup> As a result the procedure was mainly

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<sup>471</sup> Section 6. A person who was not notified of the meeting must apply to court within 28 days from the day on which he first became aware that the meeting had taken place.

<sup>472</sup> Section 6(4) of the Insolvency Act 1986. The court does not have the power to make its own amendments or make a proposal for consideration by the meetings: Sealy and Milman *Insolvency Legislation* at 32. However, the writers (at 34) refer to the decision in *Re FMS Financial Management Services Ltd* (1989) 5 BCC 191 that a certain group should be treated as creditors and included in the voluntary arrangement already agreed to by other creditors, although this resulted in the other creditors getting a substantially smaller dividend.

<sup>473</sup> Although the Act places no limitation on persons that may apply, an applicant will presumably have to show some interest in the matter: Sealy and Milman *Insolvency Legislation* at 34.

<sup>474</sup> Section 7(3) of the Insolvency Act 1986.

<sup>475</sup> Section 7(4)(a) of the Insolvency Act 1986.

<sup>476</sup> Section 7(4)(b) of the Insolvency Act 1986.

<sup>477</sup> Broc "Company Voluntary Arrangements" at 182-183.

<sup>478</sup> With the exception of s 233 of the Insolvency Act, which prohibits a supplier of gas, electricity, water or communications services from making the giving of any further supplies subject to the condition that

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used in combination with administration, which defeated the purpose of creating an inexpensive procedure as envisaged by the *Cork Report*. An attempt has now been made to rectify this problem, although only in respect of certain companies, by the introduction of section 1A of and Schedule A1 to the Insolvency Act 1986.<sup>479</sup>

### 3.6.1 Eligibility for moratorium

Section 1A states that the directors of an eligible company may take steps as prescribed in Schedule A1 to obtain a moratorium when they intend to make a proposal for a voluntary arrangement. An eligible company is defined as a company that satisfies at least two of the three requirements for being a small company as specified in section 382(3) of the Companies Act 2006 in the year ending with the date of filing of the documents for obtaining the moratorium or in the immediately preceding financial year.<sup>480</sup> The three requirements for a small company are that its annual turnover may not exceed £6.5 million, its balance sheet total may not be more than £3.26 million and the number of employees may not exceed 50.<sup>481</sup>

Finch remarks that companies meeting these requirements are “very small companies indeed” and endorses the view that there is no good reason for restricting the moratorium to small companies instead of making it available to all companies.<sup>482</sup> This is obviously a widely-held view, and the Insolvency Service is consequently considering the extension of the moratorium to all companies. A discussion document entitled *Encouraging Company Rescue - a consultation*, was issued by the Insolvency Service in June 2009.<sup>483</sup> Comments were invited on two proposals for extending the moratorium in company voluntary arrangements: Proposal A was to extend the current moratorium of Schedule A1 to the Insolvency Act 1986 to medium and large-sized companies as well, thereby allowing all companies to benefit from this option, while Proposal B was to create an additional new procedure for a court-sanctioned moratorium of up to three months which would be

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payment must first be made for supplies given to the company before the date on which a voluntary arrangement (or other insolvency processes) came into effect.

<sup>479</sup> By way of the Insolvency Act 2000 with effect from 1 January 2003.

<sup>480</sup> Paragraph 3 of Schedule A1.

<sup>481</sup> Section 382(3)-(6) of the Companies Act 2006.

<sup>482</sup> *Corporate Insolvency* at 491. She agrees with the view expressed by Fletcher that the chief reason seemed to be “the desire to channel all rescue proceedings involving larger companies through the new, streamlined administration procedure” (fn 59).

<sup>483</sup> Available on the Insolvency Service website at <<http://www.insolvency.gov.uk/index.htm>> accessed on 22 January 2010.

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available to all companies. The majority of the respondents expressed support for the new proposals and the Insolvency Service will now develop more detailed proposals.<sup>484</sup>

Certain specific types of companies are excluded<sup>485</sup> as well as companies that already are in some insolvency or rescue procedure.<sup>486</sup> To prevent directors from abusing the procedure, there is a further exclusion of any company that was in administration in the immediately preceding twelve months, or that had a moratorium in force at any time in the preceding twelve months where no voluntary arrangement had been in force when the moratorium ended or the voluntary arrangement ended prematurely.<sup>487</sup>

### 3.6.2 Procedure

The procedure for obtaining the moratorium and subsequent consideration and implementation of a voluntary arrangement is very similar to that described above for a voluntary arrangement without a moratorium. The directors are required to furnish the nominee with a written statement of the terms of the proposed voluntary arrangement and prescribed information on the company's assets, debts and liabilities and any other information required by the nominee to form a professional opinion on the prospects of the voluntary arrangement.<sup>488</sup>

An important difference is that the nominee does not submit his report on the directors' proposals to the court but to the directors. This report must state whether, in the opinion of the nominee, "the proposed voluntary arrangement has a reasonable prospect of being approved and implemented, the company is likely to have sufficient funds available to it during the proposed moratorium to enable it to carry on its business, and meetings of the company and its creditors should be summoned".<sup>489</sup>

If the nominee's report is favourable, the directors may then file with the court the document setting out the terms of the proposed voluntary arrangement, the nominee's

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<sup>484</sup> Ministerial Statement *Insolvency Service Consultation on Encouraging Company Rescue* available at <<http://www.insolvency.gov.uk/index.htm>> accessed on 22 January 2010.

<sup>485</sup> Such as insurance companies, banks, companies operating in the financial market and other institutions protected by the Banking Act 1987: par 2(2) of Schedule A1 to the Insolvency Act 1986.

<sup>486</sup> Such as a company in administration or liquidation or where a provisional liquidator or administrative receiver has been appointed or a voluntary arrangement is already in effect: par 4(1).

<sup>487</sup> Paragraph 4(1)(f) of Schedule A1 to the Insolvency Act 1986.

<sup>488</sup> Paragraph 6(1) of Schedule A1.

<sup>489</sup> Paragraph 6(2)(b) of Schedule A1. The directors have to supply the nominee with the information he needs to meet this requirement: par 6(1)(c).

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statement and his consent to act, a statement of the company's affairs and a statement that the company is eligible for a moratorium.<sup>490</sup> The professional opinion of the nominee is the deciding factor as to whether a company is able to obtain a moratorium, and the nominee thus has the responsibility to prevent abuse or exploitation of the procedure by the directors of a company that is doomed to fail.<sup>491</sup> This aspect was criticised by Steiner<sup>492</sup> on the grounds that it was not clear whether the nominee was merely required to exercise professional judgment or whether he was required to approach the major creditors, which could be fatal because the creditors would then have due warning of the intended moratorium. It is submitted that the last-mentioned interpretation is unlikely to have been the intention of the legislation and, as a result, there is a considerable responsibility resting on the shoulders of the nominee. Finch<sup>493</sup> refers to the "difficult" role of the nominee in this respect because he has to rely heavily on the information supplied to him by the directors and does not have the time or the power to personally conduct a thorough investigation of the company's affairs. She agrees with Brown<sup>494</sup> that if too much reliance is placed on the nominee acting as a "filter" for unviable cases, it will inevitably lead to a procedure that was intended to be fast and inexpensive becoming "prohibitively expensive and slow" since the nominee will try to protect himself by a "due diligence" investigation resulting in increased costs and delays. If, as discussed above, the moratorium is extended to medium and large companies as well, this will become an even greater problem for nominees since the affairs of the company will be even more complicated and difficult to assess.<sup>495</sup>

The moratorium comes into force when the above documents are filed with the court.<sup>496</sup> The nominee must "as soon as reasonably practicable"<sup>497</sup> advertise the

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<sup>490</sup> Paragraph 7 of Schedule A1.

<sup>491</sup> Brown *Corporate Rescue* at 663; *Palmer* par 14.444.

<sup>492</sup> "Insolvency Bill" at 63.

<sup>493</sup> *Corporate Insolvency* at 501-502.

<sup>494</sup> *Corporate Rescue* at 663-664.

<sup>495</sup> This point was in fact raised by respondents to the proposals of the Insolvency Service in this regard. It was pointed out that the perceived risk to a nominee when expressing an opinion on the viability of a company voluntary arrangement was already proving to be one of the main obstacles to a wider use of the Schedule A1 moratorium and would therefore have to be addressed if the proposals for a wider application of the moratorium were adopted: The Insolvency Service *Encouraging Company Rescue Summary of Responses* (Nov 2009) par 17.

<sup>496</sup> Paragraph 8(1) of Schedule A1.

<sup>497</sup> In terms of Rule 5 of the Insolvency (Amendment) Rules 2009 (SI 2009/642), the word "forthwith" was replaced with the words "as soon as reasonably practicable" wherever it appeared in the Insolvency Rules 1986.

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coming into force of the moratorium in the *Gazette*, but may exercise his own discretion as to whether any further publication is necessary and if so, what form it will take.<sup>498</sup> As a result of this notice, the financial problems of the company will become known to its creditors at an earlier stage than in the case of a CVA without a moratorium, where creditors are informed about the proposed arrangement for the first time when they are called to the meeting to consider the proposal.<sup>499</sup>

### 3.6.3 Effect of moratorium

The moratorium is wide in its application and forbids any steps to enforce security over the company's property as well as any other proceedings, execution or other legal process against the company or its property, without the leave of the court. During the period that the moratorium is in force, no petition for the winding up of the company or for an administration order may be presented, no meeting of the company may be held without the consent of the nominee or the court, no resolution may be passed or order made for the winding up of the company and no administrative receiver may be appointed.<sup>500</sup>

The activities of the company are strictly controlled and monitored during the period of the moratorium and even limited in some aspects to avoid any possible abuse.<sup>501</sup> Any creditor or member of the company may furthermore apply to court for an appropriate order that could include ending the moratorium, on the grounds that the directors are or have been managing the company's affairs, business and property in an unfairly prejudicial way to the interests of its creditors or members in general or some part of them.<sup>502</sup> Officers of the company are held accountable for

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<sup>498</sup> Rule 1.40(2). Before its amendment by the Insolvency (Amendment) Rules 2009 which apply to all company voluntary arrangements commencing on or after 6 April 2009, the Rule required that the notice should also be published in a newspaper. This is one example of the modernisation and consolidation project of the Insolvency Service referred to in part 1 above to, among other things, remove unnecessary costs in the administration of insolvency processes.

<sup>499</sup> See part 3.5.3 above.

<sup>500</sup> Paragraph 12(1) of Schedule A1.

<sup>501</sup> Paragraphs 9 and 10 provide for notification of the beginning and end of the moratorium, pars 16 and 17 ensure that anyone doing business with the company will be informed of the moratorium and par 18 regulates disposals and payments by the company. The nominee is also specifically instructed to monitor the company's affairs during a moratorium to ensure that the proposed arrangement still has a reasonable prospect of being approved and implemented and that the company is likely to have sufficient funds available to continue carrying on its business until the moratorium comes to an end: par 24(1) of Schedule A1 to the Insolvency Act 1986.

<sup>502</sup> Paragraph 40 of Schedule A1. See further part 3.6.4 below.

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their actions not only during the moratorium but also during the twelve months immediately preceding the moratorium: any officer (including a shadow director) who during this period did one of a list of prohibited things or knew about others doing some specified ones is regarded as having committed an offence and liable to imprisonment and/or a fine.<sup>503</sup>

The process is so heavily regulated that *Palmer*<sup>504</sup> describes it as “exacting” but concedes that the threshold requirements in particular have to prevent exploitation of the procedure by directors who may use the moratorium as a delaying tactic when the company in reality has no chance of survival. However, as a result of these onerous requirements as opposed to the relative simplicity of the original procedure and the possibility of avoiding too much publicity during a financially sensitive period, some companies that do qualify for the moratorium choose the original and riskier voluntary arrangement over the new procedure.<sup>505</sup>

This illustrates the dilemma associated with any rescue procedure that, in an effort to make it fairly simple and not too expensive, is informal and unregulated and thus open to abuse. As a result there has to be considerable supervision that inevitably raises the costs of the procedure and renders the procedure too difficult and demanding to become widely used or popular. There is also a fear that nominees may insist on even closer supervision than intended by the legislation because of the heavy responsibility they bear during the moratorium to monitor the company’s activities closely<sup>506</sup> and the possibility of being held personally liable for losses suffered by the company as a result of their acts, omissions or decisions.<sup>507</sup> This will again have the result that the costs of the moratorium will be higher than intended.<sup>508</sup>

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<sup>503</sup> Paragraph 41 of Schedule A1 to the Insolvency Act 1986. These acts include removing or concealing company property worth more than £500 and concealing, destroying or falsifying company documents or book entries or disposing, pledging or pawning property of the company obtained on credit and not yet paid for.

<sup>504</sup> Paragraph 14.444.

<sup>505</sup> Paragraph 14.406. This view is shared by Fletcher *Insolvency* at 481, who believes that if there is no danger of disruption of the procedure by a non-assenting creditor, the benefits of the original procedure – simplicity and the avoidance of excessive publicity – may outweigh those of the new procedure.

<sup>506</sup> In terms of par 24 of Schedule A1.

<sup>507</sup> In terms of par 27 of Schedule A1.

<sup>508</sup> Steiner “Insolvency Bill” at 64.



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### 3.6.4 Termination of moratorium

A moratorium ends on the day on which the meetings of creditors and members summoned to approve or reject the proposed voluntary arrangement<sup>509</sup> take place (or the later of the two if held on different days), or 28 days after coming into force, whichever is the first.<sup>510</sup> This period may be extended by a meeting of creditors or members if they decide to adjourn their meeting, but the extended period may not exceed a period of two months after the first meeting was held.<sup>511</sup>

The moratorium will come to a premature end if the nominee withdraws his consent to act, which he is compelled to do if at any time he comes to the conclusion that the proposed voluntary arrangement no longer has a reasonable prospect of being approved or implemented, or the company will not have sufficient funds to continue its business, or the company was not eligible for the moratorium in the first place or the directors fail to provide him with any information he needs to monitor the company's affairs during the moratorium.<sup>512</sup>

The moratorium may also be terminated by an order of court on the application of a creditor, director or member of the company or any other person affected by it if they are dissatisfied with any action taken or omitted by the nominee.<sup>513</sup> A moratorium that comes to an end without any voluntary arrangement having been approved constitutes one of the specific grounds on which a company may be wound up by the court.<sup>514</sup> The nominee must gazette a notice of the moratorium coming to its end as soon as reasonably practicable after it has ended, and may further advertise the notice as he thinks is appropriate.<sup>515</sup>

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<sup>509</sup> In terms of par 29 the nominee must summon meetings of the company and every known creditor of the company.

<sup>510</sup> Paragraph 8(2) of Schedule A1. The strict limitation on the duration of the moratorium is one of the measures intended to prevent abuse of the procedure: *Palmer* par 14.404.

<sup>511</sup> Paragraph 32.

<sup>512</sup> Paragraph 25 of Schedule A1.

<sup>513</sup> Paragraph 26 of Schedule A1.

<sup>514</sup> Section 122(1)(fa) of the Insolvency Act 1986.

<sup>515</sup> Rule 1.42(1). In terms of a new Rule 1.42(1A) to be introduced by the draft Insolvency (Amendment) Rules 2010 the notice will, apart from the standard contents (to be prescribed by a new Rule 12A.32), also have to state the nature of the company's business, that the moratorium has come to an end and the date on which it ended.

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## 3.7 Managing the procedure

### 3.7.1 Nominee and supervisor

The appointment of the nominee and supervisor takes place as explained above and is an integral part of the voluntary arrangement procedure. Before the enactment of the Insolvency Act 2000, the Insolvency Act 1986 provided that both the nominee and supervisor must be qualified insolvency practitioners meeting the same requirements as an administrator. However, as part of the effort to reduce the costs associated with the voluntary administration procedure, this is no longer required. It is now also possible for a person who is not authorised to act as an insolvency practitioner to act as nominee or supervisor of a voluntary arrangement, provided that he is authorised to act as such in terms of section 389A of the Insolvency Act 1986.<sup>516</sup> The intention behind this amendment was to enable individuals with business rescue experience rather than accountants, to assist small companies in particular and prevent them from entering insolvency.<sup>517</sup>

A person may be authorised to act as nominee or supervisor of a voluntary arrangement if he is a member (and/or subject to the rules) of a body recognised for this purpose by the Secretary of State and has given security for the proper performance of his functions.<sup>518</sup> A body may be recognised for this purpose if it maintains and enforces rules to ensure that its members are fit and proper persons to act as nominees or supervisors and meet acceptable requirements regarding education, practical training and experience.<sup>519</sup> However, to date no such bodies have been recognised.

The recognition of a body may be revoked by the Secretary of State if it appears to him that it no longer complies with the requirements.<sup>520</sup> No provision has been made for direct authorisation by the Secretary of State to act as nominee or supervisor as in the case of insolvency practitioners.

A person is disqualified from acting as nominee or supervisor if at the time he is an undischarged bankrupt, subject to a disqualification order or disqualification

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<sup>516</sup> Inserted by the Insolvency Act 2000.

<sup>517</sup> Bailey and Groves *Corporate Insolvency* at 201.

<sup>518</sup> Section 389A(2) and (6).

<sup>519</sup> Section 389A(5).

<sup>520</sup> Section 389A(7).

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undertaking in terms of the Company Directors Disqualification Act 1986, is a mental patient or lacks capacity.<sup>521</sup> Acting as a nominee or supervisor without proper authorisation is an offence for which the offender can be imprisoned or fined or both.<sup>522</sup>

### 3.7.2 Powers and duties of directors

The supervisor of a voluntary arrangement takes possession and control of only those assets that are included in the arrangement and must deal with them according to the terms as agreed in the voluntary arrangement.<sup>523</sup> This could mean carrying on the business of the company, realising assets or otherwise administering or disposing of company funds.<sup>524</sup>

The supervisor does not have the powers given to an administrator and the management of the company therefore remains in the hands of the directors. The supervisor has only those powers given to him in terms of the voluntary arrangement or flowing from his appointment as administrator or liquidator.<sup>525</sup> The fact that management is not replaced may be an advantage from the point of view of the directors and may encourage them to put forward proposals at an early stage that will satisfy the creditors without having to subject themselves to the level of control that an administrator will exercise if the company enters administration.<sup>526</sup>

In the past, some directors might also have preferred to make use of the voluntary arrangement procedure rather than administration because, unlike an administrator, the nominee or supervisor of a voluntary arrangement was not compelled to report a director to the Secretary of State where the director's conduct as director of a company that had become insolvent,<sup>527</sup> made him unfit to be concerned in the management of

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<sup>521</sup> Section 389A(3).

<sup>522</sup> Section 389(1) read with s 389A(3).

<sup>523</sup> Rule 1.23(1) of the Insolvency Rules.

<sup>524</sup> Rule 1.26(1) of the Insolvency Rules.

<sup>525</sup> Sealy and Milman *Insolvency Legislation* at 22. The writers believe that it would have been preferable for the supervisor to have been given specific statutory powers and authority because it would have avoided uncertainty regarding the extent to which the terms of the voluntary arrangement may override the articles of the company in granting authority to the supervisor.

<sup>526</sup> Grier and Floyd *Corporate Recovery* at 10. Rutstein "Corporate Failure" at 72 refers to the fact that directors are often reluctant to hand over management of their companies to insolvency practitioners because insolvency practitioners are regarded as "financial undertakers" rather than rescuers.

<sup>527</sup> In terms of s 6(2) of the Company Directors Disqualification Act 1986 a company is automatically regarded as "becoming insolvent" when it enters administration.

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a company.<sup>528</sup> This was an important issue to consider because such a report may result in the disqualification, for a specified period, of such director from being a director of a company or in any way taking part in or being involved with the promotion, formation or management of a company without the leave of the court, or from acting as an insolvency practitioner.<sup>529</sup> However, section 7A of the Insolvency Act 1986<sup>530</sup> now provides for an almost similar duty on the supervisor or nominee to report to the Secretary of State any past or present officer of the company who appears to have been guilty of any offence in connection with the moratorium or voluntary arrangement, for which he is criminally liable.

The limitation on the powers of the supervisor does not mean that the directors have a completely free hand in managing the company during the voluntary arrangement. Specifically in those cases where a moratorium is or was effected, a creditor or member of the company may challenge any act or omission of the directors in court. Such an application may be made on the grounds that the company's affairs, business and property are being or have been managed in a way that is unfairly prejudicial to the interests of the creditors or members generally or any part of them, or that any actual or proposed act or omission of the directors would be prejudicial to them.<sup>531</sup> The application may be brought during or after the moratorium and the court may make any order it deems fit.<sup>532</sup> Such an order may in particular regulate the way in which the directors manage the company during the remainder of the moratorium, order them to call a meeting of creditors or terminate the moratorium.<sup>533</sup>

### 3.8 The proposal

In the proposal it must be explained why a voluntary arrangement is desirable as well as why the creditors would be willing to agree to such an arrangement.<sup>534</sup> Other

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<sup>528</sup> Sections 6 and 7 of the Company Directors Disqualification Act 1986.

<sup>529</sup> Section 1(1) of the Company Directors Disqualification Act 1986. The stipulated period may be anything from two to 15 years. Sealy and Milman *Insolvency Legislation* at 37 believe that the absence of the duty to report any such offence could have been one of the attractions of company voluntary arrangements for directors.

<sup>530</sup> Introduced by the Insolvency Act 2000.

<sup>531</sup> Paragraph 40(2) of Schedule A1.

<sup>532</sup> Paragraph 40(3)-(4) of Schedule A1.

<sup>533</sup> Paragraph 40(5) of Schedule A1.

<sup>534</sup> Rule 1.3(1) of the Insolvency Rules.

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prescribed information that must be contained in the proposal includes details of the company's assets with the estimated value of each asset and the extent to which any asset is subject to security in favour of creditors, an indication which particular assets are to be excluded from the voluntary arrangement, particulars of property which is not part of the assets of the company but will be included in the arrangement, liabilities of the company and how it is intended to deal with the various types of claims, how the business of the company is to be conducted during the course of the arrangement and what further credit facilities are to be arranged for the company.<sup>535</sup> The proposed duration of the arrangement and proposed dates on which distributions to creditors will be made, as well as the estimated amounts of such payments, must also be disclosed. Details of the person proposed as supervisor of the voluntary arrangement, payment of his remuneration and expenses and his functions must also be included.<sup>536</sup>

Although the Rules are quite specific about the formal matters that must be dealt with in the proposal, section 1 of the Insolvency Act 1986 contains almost no prescriptions regarding the terms and substance of the proposal for a voluntary arrangement except to state that the proposal must be for a composition in satisfaction of the company's debts or a scheme of arrangement of its affairs. As a result there is considerable flexibility regarding the type of arrangement and the terms that may be proposed, subject only to the question whether they will be acceptable to the required majority of creditors.<sup>537</sup> Examples of the terms that an arrangement could validly contain include a term that unsecured creditors are to receive a different payment from what they would have received in a liquidation, or that smaller claims are to be paid before large ones or even that non-preferential, unsecured creditors will receive no payment.<sup>538</sup> Broc<sup>539</sup> also suggests the company voluntary arrangement as an appropriate way to sell company assets or the business as a going concern, or to facilitate the reorganisation of a company, which would be followed by an

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<sup>535</sup> Rule 1.3(2) of the Insolvency Rules 1986. The draft Insolvency (Amendment) Rules 2010 will also add a general par (2)(r) requiring that the proposal must disclose any other information that is regarded as appropriate to ensure that the members and creditors are able to reach an informed decision on the proposal.

<sup>536</sup> Rule 1.3(2)(h), (o) and (p) of the Insolvency Rules 1986.

<sup>537</sup> *Palmer* par 14.412. Fletcher *Insolvency* at 496 refers to the fact that although the basic requirement remains the acceptance of the proposal by creditors and members, s 4A(2) of the Insolvency Act 1986 (discussed in part 3.5.4 above) enables a proposal to take effect with the approval of only the creditors.

<sup>538</sup> Fletcher *Insolvency* at 485; *Palmer* par 14.412.

<sup>539</sup> "Company Voluntary Arrangements" at 180.

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administration order to exit from the reorganisation.<sup>540</sup> As mentioned above,<sup>541</sup> a company voluntary arrangement may also follow an administration order as the means to accomplish the purpose of administration. The proposal should therefore include as much information as possible to assist (and persuade) creditors in making their decision whether to accept the proposal. Provision should also be made for a moratorium that would prevent any creditor bound by the arrangement from instituting an action to pursue his claim outside the arrangement.<sup>542</sup>

Secured and preferential creditors are expressly protected by the Act<sup>543</sup> in that no proposal affecting their rights may be approved without the consent of each such affected creditor.<sup>544</sup> However, the fact remains that their rights may be modified with their concurrence, and the overall policy in this regard is referred to by Fletcher as one of “laissez-faire”.<sup>545</sup>

There is no provision in the Act for variation of the arrangement after it has been approved, and so the terms of the arrangement should preferably include an express power of variation or modification. If it does not, an amendment to address unexpected problems would be possible only if all interested parties agreed to it or an application was made to court, the last-mentioned resulting in added costs and other complications.<sup>546</sup>

### **3.9 Termination of voluntary arrangement**

A voluntary arrangement that has not been terminated prematurely in one of the ways described above<sup>547</sup> is completed once the supervisor has fully implemented the proposal as approved by the meetings. Within 28 days after its final completion the supervisor must send a notice to all the members and creditors of the company bound by the voluntary arrangement to the effect that it has been fully implemented.

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<sup>540</sup> Sealy and Milman in *Insolvency Legislation* (2004) at 20 suggested that, where administration and a voluntary arrangement were combined, it would be more practical to obtain the administration order first, after which the administrator himself could act as nominee and supervisor of the scheme.

<sup>541</sup> Part 2.8.2 above.

<sup>542</sup> Goode *Corporate Insolvency Law* at 403-404. If there is no express provision preventing creditors from enforcing their claims while the company is still in the process of complying or has already complied with its obligations in terms of the scheme of arrangement, the court may, depending on the terms of the arrangement, imply such a provision: Bailey and Groves *Corporate Insolvency* at 198.

<sup>543</sup> Section 4(3) and (4).

<sup>544</sup> Finch *Corporate Insolvency* at 490.

<sup>545</sup> *Insolvency* at 484.

<sup>546</sup> Fletcher *Insolvency* at 503.

<sup>547</sup> In parts 3.6.4 and 3.7.2.

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This notice must be accompanied by a report of the supervisor setting out all receipts and payments made by him in terms of the arrangement and explaining any differences between the actual implementation of the voluntary arrangement and the proposal as originally approved.<sup>548</sup> Within the same period, a copy of the notice and report must also be sent to the registrar of companies and the court.<sup>549</sup> No other formalities are required to terminate the voluntary arrangement officially.

### **3.10 Evaluation of company voluntary arrangements**

Before the introduction of the moratorium for smaller companies in a voluntary arrangement by the Insolvency Act 2000, the procedure was not popular in spite of having all the characteristics that many commentators regard as the most important for a successful rescue procedure: it is easy and relatively inexpensive to commence, the creditors have control over the way in which the rescue will be effected, the procedure is fairly informal and involvement by the courts is limited. The new provisions that should have popularised voluntary arrangements, particularly for smaller companies that had the most to benefit from these amendments, unfortunately do not seem to have had much of an impact.<sup>550</sup> This is probably as a result of the amendments made to the administration procedure by the Enterprise Act 2002 which came into effect on 15 September 2003, a mere nine months after the introduction of the moratorium, and which made administration more accessible.<sup>551</sup>

For medium-sized and large companies, administration will remain the better option as long as they cannot make use of the moratorium although, as indicated above, there is now a real possibility of its extension to all companies.<sup>552</sup> This possibility was foreseen at the initial introduction of the moratorium by commentators who believed that, depending on how effective and popular it turned out to be, it might eventually be widened to include bigger companies.<sup>553</sup> As Rutstein<sup>554</sup> points out, however, it must be remembered that even after the amendments company voluntary arrangements are not

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<sup>548</sup> Rule 1.29(1)-(2) of the Insolvency Rules.

<sup>549</sup> Rule 1.29(3) of the Insolvency Rules.

<sup>550</sup> Lightman and Moss *Administrators* par 2-017.

<sup>551</sup> Bailey and Groves *Corporate Insolvency* at 193.

<sup>552</sup> See part 3.6.1.

<sup>553</sup> Broc "Company Voluntary Arrangements" at 188; Steiner "Insolvency Bill" at 62.

<sup>554</sup> "Corporate Failure" at 74.

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free from criticism: they are often seen as a stalling tactic delaying the inevitable failure of the company and could be a means by which incompetent or dishonest management keep themselves in office. On the other hand, the exacting but unavoidable regulation of the moratorium procedure, which is designed to prevent abuse, may discourage eligible companies from using it; preferring, instead, to enter administration by way of the new and fairly simple process.<sup>555</sup>

In favour of the company voluntary arrangement it must be said, however, that it is extremely flexible, that it is less costly than other insolvency procedures, and that it may be structured to avoid capital gains tax<sup>556</sup> and may effect the rescue of a small company without its having to enter an insolvency procedure such as administration or liquidation with the resulting damage to its reputation. None of these advantages are visible in the newly created compromise with creditors introduced into South African law by the Companies Act of 2008,<sup>557</sup> and with the added disadvantage that no moratorium is available during this procedure, I see very little reason to believe that it will be successful in the rescue of any South African company, big or small.

Some of the disadvantages of company voluntary arrangements are that there is no provision for detrimental transactions to be set aside and claims for wrongful trading or malfeasance may not be made against directors or other officers.<sup>558</sup>

#### **4 CONCLUSION**

Apart from the historical link between the corporate laws of England and South Africa, there are definite and clear similarities between the corporate rescue procedures as well. These similarities have become even more as a result of the new procedures introduced into South African law by the Companies Act of 2008 and include the fact that both administration and business rescue proceedings may be commenced without

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<sup>555</sup> Milman "Opinion" at 2 refers to a "sneaking suspicion" that the moratorium will not be widely used because it is over-regulated and because of the reforms to the administration procedure. This is confirmed by the statistics quoted by Broc "Impact" at 105 of the number of annual company voluntary arrangements from 1992 to 2005 indicating only a moderate impact of the moratorium and also by Sealy and Milman *Insolvency Legislation* at 23. However, in a discussion of the official insolvency statistics for the period from October 2008 to September 2009, Milman "Overview" at 2 points out that company voluntary arrangements had increased by about 16 per cent in this period, and ascribes it to the media prominence given to company voluntary arrangements of large retail chains in England.

<sup>556</sup> Bailey and Groves *Corporate Insolvency* at 202.

<sup>557</sup> See Chapter 2, part 4.6.

<sup>558</sup> Bailey and Groves *Corporate Insolvency* at 202.



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approaching the court, that both apply primarily to companies and were thus designed with companies in mind, and that both involve the appointment of an outsider to take over the management of the company during the rescue process.

The new compromise procedure introduced by the Companies Act of 2008 differs from the company voluntary arrangement in several respects, but the experience in England with the CVA procedure should provide South Africa with an indication of where problems may be expected. Unfortunately, the South African drafters do not seem to have heeded these potential problems, as appears from the absence of a moratorium in the South African procedure, although this has proved to be the single most problematic aspect of company voluntary arrangements. In addition, the South African provisions are extremely formalistic and prescriptive with regard to the contents of the proposal, requiring detailed information that often seems completely unnecessary. The requirement in South Africa that a court must approve the proposal after its adoption by the required majority of creditors is also an unnecessary feature since a compromise or arrangement is contractual in nature and the role of the court should have been limited, as in England, to instances where serious objections are raised against the approved proposal on grounds of unfair prejudice or irregularities.<sup>559</sup>

In spite of the South African Department of Trade and Industry's original intention to look at the American Chapter 11 procedure, it is clear that the culture and attitudes which influence our corporate insolvency law are far closer to those prevailing in England than in America.

Perhaps the most important lesson that South Africa can learn from England is that corporate rescue is not a static area of law which, once established, can be left unchanged for decades as happened in the case of judicial management. It needs to be streamlined, adapted and modernised all the time to keep up with the ever-changing circumstances under which it operates. If the South African legislation regulating judicial management had been subjected to regular assessment, evaluation and improvement, it would not have been necessary to replace judicial management with completely new proceedings that will require some time for practitioners and company directors to familiarise themselves with all their intricacies and implications before those practitioners and directors will be prepared to make use of them.

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<sup>559</sup> See part 3.5.5 above.

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## CHAPTER 4

### GERMANY

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#### 1 INTRODUCTION

The Insolvenzordnung (InsO)<sup>1</sup> or Insolvency Code of 5 October 1994<sup>2</sup> came into force on 1 January 1999 and replaced all existing insolvency and business rescue legislation and proceedings in the old East and West Germany respectively. Up to that date, the Konkursordnung<sup>3</sup> of 10 February 1877 and the Vergleichsordnung<sup>4</sup> of 26 February 1935 had respectively regulated liquidation and composition proceedings in the old West Germany. In the old East Germany the Gesamtvollstreckungsordnung<sup>5</sup> of 1990, enacted as a provisional measure after the reunification of Germany, substantially kept the previous insolvency legislation dating from just after the Second World War, in force in the former East German states.<sup>6</sup>

The process of extensive reform to the insolvency law started in West Germany in 1978<sup>7</sup> with the appointment of a commission of insolvency experts to make recommendations on a fundamental reform of the insolvency law.<sup>8</sup> The Commission delivered its reports in 1985 and 1986<sup>9</sup> but the proposed new insolvency legislation

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<sup>1</sup> In keeping with the German legislative tradition of referring to statutes and codes by their abbreviations, the abbreviated form of the name is normally used when referring to the Insolvenzordnung: Flessner “Germany” at 313. The abbreviation will be used throughout this Chapter when referring to the Insolvenzordnung, and all references to sections or provisions or “the Code” will be to the Insolvenzordnung unless specifically stated otherwise.

<sup>2</sup> BGBl. I S 2866.

<sup>3</sup> Reichgesetzblatt (RGBl. S 351). In English this is usually referred to as the Bankruptcy Act: Remmert “Introduction” at 427.

<sup>4</sup> Composition Act (RGBl. I S 321). This statute was enacted during the Nazi regime and therefore, rather than promoting reorganisation of all potentially successful businesses, it reflected the national-socialist views on public welfare and reserved this benefit for “deserving” and “respectable” businesses. Debtors who had become insolvent through “dishonesty, price cutting or imprudence” were not allowed to use this procedure: Schiessl “Comparative Analysis” at 237-238; also Flessner *Sanierung* at 17.

<sup>5</sup> Collective Enforcement Act; Gesetzblatt der DDR (Gbl. I 32, 285).

<sup>6</sup> Flessner “Germany” at 313.

<sup>7</sup> According to Ehlers “Statutory Corporate Rescue” at 155, it was no mere coincidence that this was also the year in which the United States Bankruptcy Code (Title 11, United States Code) was passed – 1978 marked a new era of insolvency law globally.

<sup>8</sup> The Kommission für Insolvenzrecht (Commission for Insolvency Law), which consisted of academics, practitioners, insolvency judges, trustees and representatives from trade unions and business: Schiessl “Comparative Analysis” at 234.

<sup>9</sup> Bundesministerium der Justiz *Erster Bericht der Kommission für Insolvenzrecht*, Köln, 1985; *Zweiter Bericht der Kommission für Insolvenzrecht*, Köln, 1986.

detailed in these reports was greeted with widespread disapproval.<sup>10</sup> There was also substantial support for the retention, with some amendments, of the 1877 legislation,<sup>11</sup> but after drastic amendments by the Bundestag to the two successive ministerial drafts<sup>12</sup> that had also been heavily criticised,<sup>13</sup> the new *Insolvenzordnung* was enacted in 1994.<sup>14</sup>

Whereas the recommendations of the Commission had been heavily influenced by the reorganisation procedure under Chapter 11 of the American Bankruptcy Code,<sup>15</sup> the final version of the *InsO* differed from the American proceedings in several important ways.<sup>16</sup> Two basic principles of the American reorganisation procedure were rejected by the German legislature: firstly, the rule of debtor in possession that in most cases allows the debtor to remain in control of and continue to operate the business,<sup>17</sup> and secondly, the priority and independence that reorganisation in terms of Chapter 11 enjoys.<sup>18</sup> According to the German rule, the rescue of a business should not in itself be the purpose of insolvency proceedings, but should be an option only if it is clear that the value of the business as a going concern (the continuation value) is higher than its liquidation value.<sup>19</sup> However, the introduction of the option of an insolvency plan to restructure the debts of the debtor and allow its business to survive was one of the

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<sup>10</sup> Balz and Landfermann *Insolvenzgesetze* at XXXIV-XXXV; Flessner "Germany" at 314; Schiessl "Comparative Analysis" at 259.

<sup>11</sup> Ehlers "Statutory Corporate Rescue" at 155; Henckel "Einleitung" at 2-3. See also generally Binz and Hess *Konkurs*, which is a publication specifically aimed at proving that a total reform of insolvency law was unnecessary (see in particular the summary at 45); Gravenbrucher Kreis "Alternativentwurf", which proposed minor amendments to the *Konkursordnung* that they believed would be sufficient.

<sup>12</sup> The first was a draft Bill, the *Regierungs-Entwurf einer Insolvenzordnung* in 1991. After some amendments by the Legal Committee of the Lower House of Parliament (Rechtsausschusses des Deutschen Bundestages, which is more or less the equivalent of the parliamentary portfolio committees in South Africa), the final draft was accepted in April 1994: Stewart *Insolvency Code* at 10.

<sup>13</sup> See, for example, Grub "Sanierungsfeindlich" at 397, who argued that the new draft legislation would make business rescues more difficult; Grub and Rinn "Freifahrtschein" at 1587, who concluded that the legislation was too debtor friendly and would result in more debtors defaulting on their payments. Balz and Landfermann *Insolvenzgesetze* at XLII-XLIII give an overview of the objections.

<sup>14</sup> Flessner "Germany" at 313. Several critics remained opposed to the final version, however, and the Gravenbrucher Kreis sent a document to every member of the Bundestag in an attempt to convince them not to pass the legislation: see "Appell gegen die Verabschiedung".

<sup>15</sup> Title 11, United States Code.

<sup>16</sup> The Parliamentary Secretary of State declared that consultations with practitioners and economists during an information visit to the United States in 1992 had confirmed that the German legislation had adopted the successful principles of the American Bankruptcy Code but had omitted the problematic ones: Funke "Stand der Diskussion" at 447.

<sup>17</sup> See, however, part 2.7.2.2 regarding the possibility of self-administration.

<sup>18</sup> Ehlers "Statutory Corporate Rescue" at 162.

<sup>19</sup> Balz "Logik und Grenzen" at 1440.

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principles taken over from the American system.<sup>20</sup> Further examples of such principles are the requirement that the insolvency plan must disclose all the information that creditors may need to assess the plan,<sup>21</sup> as well as the classification of creditors into groups according to the similarity of their claims<sup>22</sup> and the provisions binding dissenting minorities of creditors to the plan (the so-called cram down provisions).<sup>23</sup>

One of the many grounds on which the InsO has been criticised is that it adopted the American model without taking into account the differences between European and American culture and practices, particularly the German belief that the American system is too debtor friendly.<sup>24</sup>

The InsO has been amended on several occasions since coming into force. Of these, the two most important amending Acts are the Gesetz zur Änderung der Insolvenzordnung und anderer Gesetze v 26.10.2001,<sup>25</sup> which dealt mainly with consumer insolvency,<sup>26</sup> while the Gesetz zur Vereinfachung des Insolvenzverfahrens v 13.4.2007,<sup>27</sup> which came into force on 1 July 2007, addressed the need to improve some aspects of the standard (that is, business) insolvency proceedings.<sup>28</sup>

## 2 INSOLVENCY PROCEEDINGS

### 2.1 Definition and purpose

§ 1 of the InsO defines the insolvency proceedings by reference to their objective, namely the satisfaction of the debtor's creditors either by the liquidation of the debtor's assets and distribution of the proceeds, or by way of an arrangement contained in an insolvency plan<sup>29</sup> intended to keep the enterprise going. The German insolvency procedure is therefore a unitary one in that, at least initially, there is no difference in the procedure, irrespective of whether liquidation or a rescue of the

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<sup>20</sup> Ehlers "Statutory Corporate Rescue" at 161.

<sup>21</sup> See part 2.8.2.1 below on the plan's required disclosure.

<sup>22</sup> See part 2.8.2.2 below.

<sup>23</sup> See part 2.8.3.3 below.

<sup>24</sup> Kamlah "German Insolvency Act" at 422-423.

<sup>25</sup> InsOÄndG 2001 (Insolvency Code Amendment Act) (BGBl. I S 2710), which came into effect on 1 December 2001.

<sup>26</sup> Braun *Commentary* at 61 par 19. See part 2.2.1 below regarding consumer insolvencies.

<sup>27</sup> Act for the Simplification of Insolvency Proceedings (BGBl. I S 509).

<sup>28</sup> Henckel "Einleitung" at 19; Schmidt and Ahrendt *Hamburger Kommentar* at 6.

<sup>29</sup> Discussed in part 2.8 below.

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business is envisaged.<sup>30</sup> This explains why the general term “insolvency proceedings” is used for all procedures under the Code rather than any specific terminology distinguishing between the liquidation and rescue procedures as found in many other systems.<sup>31</sup> It is also noteworthy that the purpose of the proceedings is expressly stated to be the satisfaction of creditors’ claims, irrespective of whether this happens by way of liquidation or reorganisation.

The procedure contains no bias or built-in preference for rescue or liquidation.<sup>32</sup> However, as explained later in this Chapter, the close association and equalisation of business rescue with liquidation has resulted in insolvency practitioners continuing to favour liquidation, with which they were familiar before the introduction of the new legislation, over an insolvency plan to rescue the business.<sup>33</sup> Of course, this approach is strengthened by the legislation, which makes it clear that the main purpose of the insolvency proceedings remains the most advantageous realisation of the debtor’s assets and satisfaction of creditors’ claims.<sup>34</sup>

## 2.2 Entities to which insolvency proceedings apply

§ 11(1) provides that insolvency proceedings may be instituted in respect of the assets owned by or the estate of any individual, corporation<sup>35</sup> or unincorporated association. This is amplified by § 11(2), which specifically includes any “company without legal personality”,<sup>36</sup> and deceased or joint estates. Even a company or unincorporated association that has already been liquidated or dissolved may be the subject of insolvency proceedings if the assets have not yet been distributed.<sup>37</sup>

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<sup>30</sup> Flessner “Germany” at 314. See part 2.2.2 below.

<sup>31</sup> For example, in England where the terms insolvency, winding up, administration and company voluntary arrangement indicate the type of debtor and procedure.

<sup>32</sup> Balz “Market Conformity” at 168; Braun *Commentary* at 71 pars 63-64 and at 72 par 65.

<sup>33</sup> See part 3 below. See also Loubser “Business Rescue” at 161-162 for a discussion of the negative impact that the close association of judicial management with insolvency probably had on judicial management.

<sup>34</sup> Braun *Commentary* at 58 par 8 and at 71 par 61; Remmert “Introduction” at 427; Wimmer and Ahrens *Frankfurter Kommentar* at 8.

<sup>35</sup> Insurance companies and financial institutions are not excluded but in terms of the *Versicherungsaufsichtsgesetz* (Insurance Supervision Act) and *Gesetz über das Kreditwesen* (Credit Industry Act) respectively, only the regulating authorities are authorised to initiate their insolvency proceedings: Flessner “Germany” at 317.

<sup>36</sup> These are listed in § 11(2)(1) as a general commercial company, limited partnership, professional partnership, company under the Civil Code, shipping company or EEIG.

<sup>37</sup> § 11(3).

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The general application of the Code to all debtors is qualified by the special simplified provisions for consumers contained in Part Nine of the InsO.<sup>38</sup> These provisions apply to all individuals who do not currently and have not previously pursued independent economic activities (that is, natural persons without a business or professional practice owned by them)<sup>39</sup> as well as to individuals who in the past pursued independent economic activities but who have fewer than 20 creditors at the time of applying for relief and who have no claims arising out of employment relationships against them.<sup>40</sup>

The special insolvency procedure for consumers differs considerably from the standard procedure, and the two are mutually exclusive. Furthermore, the court determines the applicable procedure, and the debtor is not allowed any choice in the matter.<sup>41</sup>

Government institutions and assets are specifically excluded from insolvency proceedings in terms of the Code.<sup>42</sup>

### **2.3 Power to initiate insolvency proceedings**

Insolvency proceedings must be commenced by way of an application to the insolvency court<sup>43</sup> made by the debtor or his creditors.<sup>44</sup>

Any creditor may apply if he has a legal interest in commencing insolvency proceedings and is able to provide prima facie proof of both his claim and the necessary grounds for initiating the proceedings.<sup>45</sup> The requirement of a legal interest is intended to prevent malicious, frivolous or vexatious applications by creditors, and means that it must not be possible for the creditor to obtain payment of his claim by

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<sup>38</sup> §§ 304-314.

<sup>39</sup> Flessner "Germany" at 316.

<sup>40</sup> § 304. This section was substantially amended by the InsOÄndG 2001 to exclude all individuals who are still pursuing independent economic activities when insolvency intervenes.

<sup>41</sup> Braun *Commentary* at 524.

<sup>42</sup> § 12.

<sup>43</sup> In terms of § 3 the insolvency court in whose district the debtor has his main business activity has jurisdiction. The Local Court (Amtsgericht) has exclusive jurisdiction as insolvency court: § 2; Braun *Commentary* at 73 par 72. This is a local court of first instance that also has jurisdiction in other non-litigation matters such as adoptions, deceased estates and enforcement of judgments. The insolvency court has at least one judge assisted by an administrative staff of semi-judicial officers (Rechtspfleger): Flessner "Germany" at 329-330. Appeals from the insolvency court are decided by the Regional Court (Landgericht) or if so provided, by the Higher Regional Court (Oberlandesgericht) and from there, although very rarely, to the Federal Supreme Court (Bundesgerichtshof): Flessner "Germany" at 331-332.

<sup>44</sup> § 13(1).

<sup>45</sup> § 14(1). The grounds on which insolvency proceedings may be commenced are discussed in 2.4 below.

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means of another procedure that is faster, simpler or cheaper: insolvency proceedings must serve the general satisfaction of all the creditors, not just the applicant who could just as easily use ordinary execution procedures to obtain payment.<sup>46</sup> However, this does not mean that the applicant must first exhaust all other means of execution to obtain payment: if he can prove one of the grounds for an insolvency order, it will normally be sufficient.<sup>47</sup>

A creditor whose claim is fully secured will not have the required legal interest,<sup>48</sup> and neither will a lower-ranking creditor except for the rare instances where it can be proved that such creditors will receive at least partial payment of their claims.<sup>49</sup> The test here is thus an objective one: no legal interest exists where the commencement of insolvency proceedings will serve no purpose for a particular creditor.<sup>50</sup>

A creditor must also not have ulterior motives that are unrelated to the objectives of the insolvency proceedings, for example to eliminate a competitor<sup>51</sup> or to put pressure on a still solvent but unwilling debtor to pay his claim or at least part of it.<sup>52</sup> Neither the size of the claim nor its ranking plays a role in establishing whether the creditor has the required interest in insolvency proceedings being commenced,<sup>53</sup> and it is generally accepted that if one of the grounds for insolvency proceedings is proved to be present, the creditor has such a legal interest except under very special circumstances.<sup>54</sup> However, the debtor must be given an opportunity to be heard to

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<sup>46</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 190. This requirement shows a strong similarity to the South African requirement of advantage to creditors in applications for sequestration of an individual's estate (Bertelsmann et al *Mars* at 72 and 123), and seems rather misplaced in the context of a corporate insolvency, not to mention a business rescue procedure.

<sup>47</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 123.

<sup>48</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 190 with reference to a decision of the Oberlandesgericht Brandenburg ZInsO 2001, 1153-1154.

<sup>49</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 190-191. See part 2.8.2.2 regarding these creditors who are normally not involved in the insolvency proceedings or plan.

<sup>50</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 123.

<sup>51</sup> Braun *Commentary* at 93 par 163 and at 94 par 173; Flessner "Germany" at 318; Oberlandesgericht Köln ZInsO 2002, 728 and 730.

<sup>52</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 191 referring to two decisions where this was confirmed: Amtsgericht Duisburg NZI 2003, 161; Amtsgericht Hamburg ZInsO 2001, 1121. See also Eickmann, Flessner et al *Heidelberger Kommentar* at 124-125 and Bertram and Gottwald *Insolvenzrechtshandbuch* at 220 for confirmation of these and other examples of abuse of the process by creditors.

<sup>53</sup> Flessner "Germany" at 318. This is another point on which the German procedure differs from the American Chapter 11 reorganisation, as the InsO requires neither a minimum number of creditors nor a minimum value of their claims to apply for insolvency proceedings to commence: Schiessl "Comparative Analysis" at 246.

<sup>54</sup> Braun *Commentary* at 93 par 163; Eickmann, Flessner et al *Heidelberger Kommentar* at 123.

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rebut the evidence of the applicant.<sup>55</sup> This is a right accorded to the debtor for which the consent of the court is not required, but which the debtor is also not compelled to exercise nor can he be forced to do so.<sup>56</sup>

Although these measures are aimed at protecting the debtor and preventing an abuse of insolvency proceedings, they may have the unintended consequence that a creditor who is a major supplier of the company and launches an application with the aim of rescuing the company to preserve his market may find his application being refused by the court because he would be able to obtain payment of his claim by other means. It is clear that although the procedure is theoretically intended for both liquidation and business rescue, very little attention has been paid to the actual aim of business rescue.

In the case of a corporate debtor, any individual director may apply for insolvency proceedings on behalf of the company<sup>57</sup> if he is able to satisfy the court that the required grounds for such an application exist.<sup>58</sup> This provision constitutes an unusual exception to the generally accepted rule that boards govern by majority decision and that single directors do not have any powers to act on behalf of the company unless specifically authorised.<sup>59</sup>

The reason why individual directors have been given the right to initiate insolvency proceedings is to be found in the concomitant statutory obligation which compels the board of directors of a company to bring such an application without culpable delay and, at the latest, within three weeks<sup>60</sup> after the company becomes insolvent or unable to pay its debts.<sup>61</sup> If the board fails to file such an application, or even causes an unnecessary

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<sup>55</sup> § 14(2); Braun *Commentary* at 94 par 173.

<sup>56</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 192.

<sup>57</sup> The application must be brought on behalf of the company and not in the name of the individual director: Eickmann, Flessner et al *Heidelberger Kommentar* at 135.

<sup>58</sup> § 15(1). However, such an application may be brought only on the grounds of illiquidity or insolvency, and not impending illiquidity: see part 2.4 below. This subsection also authorises any partner of an unincorporated association or partnership to apply for insolvency in respect of its business. Furthermore, if a company has no managing organ at the time, every member of the company and every member of the supervisory board have the same right to apply.

<sup>59</sup> Blackman et al *Companies Act* Vol 1 at 4–29; Davies et al *Gower* pars 7-18 to 7-20; Schmidt *Gesellschaftsrecht* at 806-807; Jäger *Aktiengesellschaft* at 386.

<sup>60</sup> Schiessl “Comparative Analysis” at 239 explains that the very short period of three weeks, which makes successful negotiations with creditors almost impossible, is the result of the legislature’s being “very suspicious” of an insolvent debtor attempting to retain some assets at the expense of the creditors.

<sup>61</sup> § 15a(1) of the InsO. § 15a was inserted by the Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG) of 23.10.2008 (BGBl I S 2026) with effect from 1 November 2008. At the same time this Act scrapped the almost identical provisions (to those in §



delay in doing so,<sup>62</sup> every individual member of the board<sup>63</sup> has a duty to file the application to avoid both criminal<sup>64</sup> and civil personal liability for damages to the company.<sup>65</sup> The three-week period may be used by the board to investigate alternative ways of rescuing or reorganising the company<sup>66</sup> but if it is clear that an insolvency plan procedure has the same or even a better chance of success than an out-of-court rescue attempt, especially where creditors' interests are at risk, an insolvency application must be brought immediately.<sup>67</sup> Furthermore, if it is clear at the outset that there is no real possibility of a rescue, the directors may not wait for three weeks before applying but must do so immediately after becoming aware of the situation.<sup>68</sup> Another aim of this provision is to ensure that a lack of consensus among the directors over the existence of grounds for an insolvency application will not cause an unnecessary delay in bringing the application.<sup>69</sup> If the application is brought by a single director, the court must afford other members of the board the opportunity to be heard.<sup>70</sup>

Braun<sup>71</sup> states that the duty to apply for the opening of insolvency proceedings is often breached by company boards that are either reluctant to admit that the company is in trouble or seem unaware of their duty to file for insolvency. Not even the provision that directors who, in contravention of corporate or insolvency law, and

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15a(1)) contained in § 92(2) of the AktienGesetz (AktG) (the Stock Corporation Act regulating public companies) and § 64(1) of the Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG) (the Private Limited Companies Act regulating private companies): see Schmidt *Gesellschaftsrecht* at 816-818; Bertram and Gottwald *Insolvenzrechtshandbuch* at 155-158. As the wording of the new provision is very similar to the previous ones, commentaries and judgments on the repealed provisions will also apply to the new § 15a(1).

<sup>62</sup> In terms of a decision of the Federal High Court of Justice for Civil Matters in the case of the Herstatt Bank (BGHZ 75, 96), it will not be regarded as an unnecessary or negligent delay if the three-week period is used by the managing organ of the company to investigate the possibility of other less drastic measures to solve the company's financial problems: see further Baur and Stürner *Insolvenzrecht* at 388-90; Kühn and Uhlenbruck *Konkursordnung* at 1995 par IV.

<sup>63</sup> If there is no management organ in place at the time, every member of a private company (GmbH) and every member of the supervisory board of a public company (Aktiengesellschaft) is obliged to bring such an application, unless they had no knowledge of the illiquidity or insolvency of the company: § 15a(3).

<sup>64</sup> In terms of § 15a(4), any person who was compelled to bring an insolvency application in terms of this section but failed to do so or to do it in good time may be sentenced to imprisonment of up to three years or a fine. However, if such a person was merely negligent, the maximum period of imprisonment is limited to one year: § 15a(5).

<sup>65</sup> Schmidt and Lutter *Aktiengesetz* Band I at 1046-1047. Directors may also be liable in delict to individuals who contracted with the company without knowing that it was insolvent: Flessner "Germany" at 357.

<sup>66</sup> § 401 AktG and § 84 GmbHG.

<sup>67</sup> Müller "Antragsrecht" at 434.

<sup>68</sup> Jäger *Aktiengesellschaft* at 2207 par 32.

<sup>69</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 198.

<sup>70</sup> § 15(2).

<sup>71</sup> *Commentary* at 613 par 2847.

in culpable breach of their duties fail to apply for insolvency, may be held personally liable to refund a creditor who advances money to cover the costs of the proceedings, has had the desired effect of encouraging directors to apply before the company is hopelessly insolvent.<sup>72</sup> The South African authorities should take note of this observation in light of the obligation that is now placed on company boards to inform all affected persons if the company is in financial distress but the board has not resolved to commence business rescue proceedings: if not even the very real risk of specific criminal and personal liability is sufficient to force directors to act, it is highly unlikely that South African boards will generally comply with this provision.<sup>73</sup>

Members of the company, as well as the supervisory board,<sup>74</sup> whether individually or collectively, are not authorised to bring an application for insolvency proceedings in respect of a company.<sup>75</sup> Since members have the most to gain by a rescue attempt and could have influenced the administrator and creditors to attempt a rescue, their omission as authorised applicants is regrettable. This is particularly important in Germany where very few corporate rescues are attempted as a result of an historical and cultural mistrust of bankrupts.

## 2.4 Requirements for opening of insolvency proceedings

In terms of the InsO it is an absolute requirement for the opening of insolvency proceedings that one of the grounds specified in the Code must exist at the time when the court decides whether to grant such an application.<sup>76</sup> In sizeable business insolvencies the court usually appoints an expert to establish whether the requirements are present.<sup>77</sup> Since these grounds have been defined precisely in the InsO, very little room has been left for interpretation or adaptation of the requirements.<sup>78</sup> Any other considerations, such as general political, social, economic and even labour issues, may

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<sup>72</sup> § 26(3); Schmidt and Ahrendt *Hamburger Kommentar* at 13. See further part 2.5.2 on this aspect.

<sup>73</sup> See further Chapter 2, part 3.5.1.2.

<sup>74</sup> The supervisory board (Aufsichtsrat) is the second tier of the German two-tier system of corporate governance, with the board of directors (Vorstand) being the other: see generally Du Plessis et al *German Corporate Governance* at 65ff.

<sup>75</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 199. This is subject to the exceptions stipulated in § 15a(3) discussed above.

<sup>76</sup> § 16.

<sup>77</sup> Flessner "Germany" at 319.

<sup>78</sup> Braun *Commentary* at 61 par 20.

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not influence the court's decision.<sup>79</sup> This illustrates a major disadvantage of the unitary proceedings, as the prevention of job losses is invariably advanced as one of the reasons for the existence of business rescue procedures, but this obviously plays no part in the decision to wind up an insolvent company. As the requirements stipulated in the InsO have to apply to both situations, the discussion below will show that these requirements are geared almost solely towards insolvency and liquidation.

The strict condition that one of the stipulated grounds must be present is intended to protect the debtor, the creditors and the shareholders against an abuse of the insolvency proceedings, but means that relief can be granted by the court under only very limited circumstances and at a fairly late stage in the deterioration of a company's financial situation when the chances of a successful rescue are substantially diminished. The Insolvency Commission rejected proposals that would have given debtors access to a rescue procedure at the first signs of financial problems and before insolvency or illiquidity was imminent. The Commission's view was that until actual financial distress occurred, it was preferable for a debtor to negotiate with his creditors outside of formal court proceedings.<sup>80</sup> This view is not without merit, as the commencement of formal insolvency or rescue proceedings negatively affects the reputation and creditworthiness of a debtor and could be harmful to the business and therefore debtors would probably have hesitated to use such a pre-insolvency procedure.<sup>81</sup> On the other hand, the safeguards of formal proceedings, notably a stay of execution, are not present in an out-of-court rescue attempt, and debtors are therefore exposed to enforcement actions by creditors of their claims.

#### **2.4.1 Illiquidity<sup>82</sup>**

The first and most usual ground on which insolvency proceedings may be initiated is the illiquidity of the debtor.<sup>83</sup> A debtor is deemed to be illiquid if he is unable to pay his debts

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<sup>79</sup> Braun *Commentary* at 95 par 176.

<sup>80</sup> Schiessl "Comparative Analysis" at 247.

<sup>81</sup> See Chapter 2, part 3.2 on this issue.

<sup>82</sup> "Zahlungsunfähigkeit". Although the direct translation of this term is "inability to pay", most English texts use the word "illiquidity" to denote the true nature of the requirement and to distinguish it from the requirement of factual insolvency that could also result in an inability to pay debts. Schmidt *Gesellschaftsrecht* at 322 even uses the German term "Illiquidität" for this requirement.

<sup>83</sup> § 17(1). Wimmer and Ahrens *Frankfurter Kommentar* at 247 declare that the other two grounds for an insolvency order are not of fundamental importance when compared to illiquidity because technical

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as and when they become due.<sup>84</sup> Furthermore, as a rule, a debtor is presumed to be unable to pay if he has stopped payment of his debts.<sup>85</sup> Although this is interpreted to mean that it should have become clear to others in the debtor's business circle that he does not have the necessary funds to pay a substantial part of his debts,<sup>86</sup> even non-payment of one important debt can indicate that the debtor has ceased payment of his debts, in spite of payment of some other debts.<sup>87</sup> The debtor may rebut this presumption of inability to pay if the application is brought by a creditor.<sup>88</sup> As a rule, in practice this will be possible only if the debtor was mistaken or misled others about his inability to pay, or if his unwillingness to pay was mistaken for inability.<sup>89</sup>

Illiquidity in this respect must be taken to mean a lack of cash or money with which to pay, whether as cash in hand, credit in a bank account or in the form of available credit.<sup>90</sup> Only the debtor's monetary debts are therefore taken into consideration, and not other obligations such as an obligation to deliver an object; such an obligation becomes relevant only after changing into a claim for damages.<sup>91</sup> Illiquidity can also be proved by circumstantial evidence such as when a debtor closes his business, insists on cash payment on delivery or fails to pay taxes and social security contributions.<sup>92</sup> The test is one of liquidity, not solvency, although proof of the last-mentioned could, but does not necessarily always indicate illiquidity.<sup>93</sup>

In cases where an application based on illiquidity is made by a creditor, the court has to guard against an abuse of the process by the creditor who may be attempting to achieve other non-insolvency objectives such as forcing the debtor to pay.<sup>94</sup>

Illiquidity was also recognised as a ground for insolvency proceedings under the previous insolvency legislation, and specific criteria regarding duration, importance

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insolvency (see part 2.4.3 below) can be "calculated away" while imminent illiquidity does not give rise to a duty to apply (see part 2.4.2 below).

<sup>84</sup> § 17(2).

<sup>85</sup> § 17(2).

<sup>86</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 148.

<sup>87</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 220.

<sup>88</sup> Braun *Commentary* at 96 par 188.

<sup>89</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 153.

<sup>90</sup> Braun *Commentary* at 96 par 185; Schmidt and Ahrendt *Hamburger Kommentar* at 216.

<sup>91</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 213.

<sup>92</sup> Braun *Commentary* at 96 par 186. See also Eickmann, Flessner et al *Heidelberger Kommentar* at 149-151 for further examples of such circumstantial evidence, including non-payment for essential services such as electricity and rent for the business premises.

<sup>93</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 148.

<sup>94</sup> Braun *Commentary* at 96 par 187.

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and seriousness of the creditors' claim were created by the legislation and the literature to determine the exact circumstances under which illiquidity would be sufficiently substantial and permanent to constitute the required ground.<sup>95</sup> However, the legislature decided to ignore these criteria in drafting the InsO, and opted for a legal definition of illiquidity which has been criticised as being insufficient and unclear. The official drafters defended their decision by pointing out that, firstly, it was unnecessary to state the obvious fact that a temporary cashflow problem that would soon be solved did not qualify as illiquidity; secondly, requiring the illiquidity to be continuous or lasting could be interpreted to mean that the debtor had to cease payment of his debts over a period of weeks or even months to fulfil this requirement, thereby defeating the purpose of encouraging applications to be made as soon as possible; and thirdly, a requirement that the debtor had to be unable to pay a substantial part of his debts was not only unnecessary in so far as a very small cash shortfall would obviously not be considered as illiquidity, but could also strengthen the undesirable tendency to limit the meaning of illiquidity by restricting it to an inability to pay a specified minimum percentage of total debts – a limitation that the drafters regarded as excessive and unjustified.<sup>96</sup>

Braun<sup>97</sup> does not agree with these arguments and mentions the following four particular problems in this regard:

- (i) The duration or size that would distinguish a merely temporary cashflow problem (or payment bottleneck, as he refers to it) from illiquidity or inability to pay as required by the InsO has not been defined.
- (ii) There is no indication of the specific point in time at which illiquidity should be present to distinguish it from imminent liquidity, which is an alternative ground for insolvency proceedings.<sup>98</sup>
- (iii) Failure to pay could be due to the debtor's being unable or unwilling to pay in spite of having adequate liquid funds.

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<sup>95</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 212.

<sup>96</sup> *Begründung RegE* Zu §20 und §21: Balz and Landfermann *Insolvenzgesetze* at 90; Wimmer and Ahrens *Frankfurter Kommentar* at 234.

<sup>97</sup> *Commentary* at 96 pars 182-188. Häsemeyer *Insolvenzrecht* at 137 also believes that the legislature erred in not being more precise in its definition of illiquidity, particularly in respect of the importance and duration of the inability to pay.

<sup>98</sup> See part 2.4.2 below.

(iv) Mere factual stopping of payments by a debtor is regarded as evidence of illiquidity although the debtor may refute the presumption. However, discontinuation of payments as an indication of illiquidity means more than simple non-payment by a debtor and should include an obvious inability of the debtor to pay his liabilities when due.

Not all of these points of criticism can be accepted as valid, however, as there is sufficient authority to emphasise the fairly obvious fact that a debtor will not be regarded as unable to pay when, although he has the necessary funds, he is unwilling to pay, or forgot to do so or believes, rightly or wrongly, that the claim is unfounded.<sup>99</sup> It is also clear from the discussion above that irrespective of the size or number of unpaid claims, the court will look at the reason for the non-payment. What the court will not take into consideration is whether the debtor knew the legal consequences that his non-payment could have or whether he intended to indicate his inability to pay.<sup>100</sup>

However, in spite of the legislature's intentional omission of specific criteria, the Federal High Court<sup>101</sup> has now laid down the principle that illiquidity in the judicial sense is most probably present when a debtor has been unable to pay 10 per cent or more of his total due and payable debts for more than three weeks<sup>102</sup> unless it is almost certain that the shortfall will soon be completely or almost completely eliminated. In cases where the shortfall is less than 10 per cent, illiquidity will be assumed only if it is already foreseeable that this percentage will in the near future exceed 10 per cent. As a result of this decision, a cash shortfall of less than 10 per cent must now be regarded as too small to constitute illiquidity, while one exceeding 10 per cent will create a rebuttable presumption of illiquidity.<sup>103</sup>

#### **2.4.2 Imminent illiquidity**

An alternative ground on which an insolvency application may be granted is the imminent or threatening illiquidity of the debtor. However, this ground is available only

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<sup>99</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 144-145. See Chapter 2, part 3 where it is shown that the Companies Act 2008 has not excluded this danger.

<sup>100</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 149.

<sup>101</sup> Bundesgerichtshof decision of 24.05.2005 (BGHZ 163,134): ZInsO 2005, 807.

<sup>102</sup> The courts had previously set the period at one month: Eickmann, Flessner et al *Heidelberger Kommentar* at 146. However, commentators had recommended periods varying from a few days to three months: Wimmer and Ahrens *Frankfurter Kommentar* at 234.

<sup>103</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 217. See also Eickmann, Flessner et al *Heidelberger Kommentar* at 147, who agree with this interpretation.

in cases where the debtor is the applicant.<sup>104</sup> Contrary to the original proposal by the Insolvency Commission, the legislature specifically decided on this limitation to prevent creditors from exercising undue pressure on a debtor and hindering any rescue attempt before actual insolvency sets in.<sup>105</sup>

In the case of a company, the application must be brought by all the directors together unless the applicant is authorised to represent the company.<sup>106</sup> Therefore, it may not be brought by a single director without the necessary authority to act on behalf of the company. This is the case not only because the legislature intended to prevent abuse of the new insolvency ground<sup>107</sup> but also because imminent insolvency does not impose an obligation on the directors to apply for insolvency proceedings with the accompanying risk of personal liability if they fail to do so.<sup>108</sup> At this stage, the directors are still free to attempt an informal or extra-judicial compromise with debtors, but, as is the case in most systems, the safeguards afforded by statutory liquidation or rescue procedures are absent while these attempts are underway. Hence there is no stay of execution, and debts have to be paid when they become due.<sup>109</sup>

In terms of the InsO a debtor meets the requirement of imminent insolvency if it is likely that he will be unable to pay his existing debts when they fall due.<sup>110</sup> As was the case in England before amending legislation brought clarity,<sup>111</sup> the exact degree of probability or possibility required by the term “likely” is unclear. Commentators generally seem to interpret it as requiring proof that illiquidity is more probable than not, that is, there has to be more than a 50 per cent probability that it will happen.<sup>112</sup> As it is almost impossible to predict future illiquidity with any mathematical precision,

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<sup>104</sup> § 18(1).

<sup>105</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 243. See Chapter 2, part 3.3.2.3 where ample opportunity for abuse has been created by the wide array of persons who may apply on any of the prescribed grounds for the new rescue proceedings in South Africa.

<sup>106</sup> § 18(3). The articles of association may provide that a single director has authority to apply for insolvency proceedings but may also require the opposite, namely that all directors, or a minimum number of directors must apply together: Müller “Zahlungsunfähigkeit” at 459.

<sup>107</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 132.

<sup>108</sup> *Ausschussbericht* Zu § 22 Abs 3: Balz and Landfermann *Insolvenzgesetze* at 92; Wimmer and Ahrens *Frankfurter Kommentar* at 242. See part 2.3 above regarding the obligation of directors to apply if one of the other two grounds for insolvency proceedings are present.

<sup>109</sup> Braun *Commentary* at 97 par 192.

<sup>110</sup> § 18(2).

<sup>111</sup> See Chapter 3, part 2.4.2 on the problems created in England regarding the interpretation of the requirement of “likely to achieve”.

<sup>112</sup> Spliedt “Schulnerberatung” at 41; Müller “Zahlungsunfähigkeit” at 458.

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the general rule is that the further into the future the illiquidity is expected to occur, the more pronounced the indications of impending illiquidity will have to be.<sup>113</sup>

The practice is to prepare a projective financial statement covering a specific future period, showing payments that will be due, in the sequence that they will be payable.<sup>114</sup> In spite of the fact that the wording of this subsection clearly refers to existing<sup>115</sup> debts, all debts that may arise in the near future must be included in the calculation of imminent illiquidity.<sup>116</sup> These would include expenses that are unavoidable in the running of a business such as salaries, taxes, electricity costs and rent.<sup>117</sup> Temporary cashflow problems and minor shortfalls will obviously not constitute this ground.

The reference to existing debts payable at some future date but without any limitation as to how far into the future they must be payable has made it difficult to establish the period over which the imminent illiquidity should be measured. Some commentators believe that the period must extend until the date on which the last existing debt is payable, but as this could stretch over several years, with possibly only one debt payable far later than all the others, this period is regarded as potentially too long.<sup>118</sup> The suggested solution to this problem is that the management of a company use their financial and liquidity planning to establish whether there is a threat of future illiquidity, and since the planning period usually stretches over the next (financial) year, this is also the period that should be used for determining imminent illiquidity.<sup>119</sup> The courts are not, however, bound to the period chosen by the debtor and may use any other period they deem appropriate.<sup>120</sup>

Since none of the previous insolvency legislation contained a similar provision, imminent insolvency as a ground for the opening of insolvency proceedings was introduced into German insolvency law for the first time by the InsO. This

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<sup>113</sup> Müller "Zahlungsunfähigkeit" at 458.

<sup>114</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 156.

<sup>115</sup> "Bestehenden".

<sup>116</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 130; Braun *Commentary* at 97 par 189. Spliedt "Schuldnerberatung" at 40 confirms this view and points out that if the business will soon have insufficient liquid funds, it makes no difference whether it will be due to existing debts or unavoidable future debts.

<sup>117</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 156; Häsemeyer *Insolvenzrecht* at 140.

<sup>118</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 131; Spliedt "Schuldnerberatung" at 40.

<sup>119</sup> Spliedt "Schuldnerberatung" at 41. However, he also believes that if a debtor will be unable to obtain the necessary cash within six months by selling some of its assets, it is probably already insolvent. Eickmann, Flessner et al *Heidelberger Kommentar* at 155 and Bertram and Gottwald *Insolvenzrechtshandbuch* at 131 also limit the acceptable period to two years.

<sup>120</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 157.



development is the Code's first acknowledgement of the business rescue aspect of insolvency proceedings, in that it is intended to come to the assistance of a debtor at an early stage when a rescue or restructuring of his business has a better chance of succeeding.<sup>121</sup> This also explains why only the debtor may base an application on this ground, apart from the fact that it requires information that mostly only the debtor would have. It would also be open to abuse if available to creditors.<sup>122</sup>

The general consensus in Germany is that under the previous legislation most insolvency proceedings were instituted far too late when there were almost no assets left,<sup>123</sup> and the legislature regarded it as one of the major aims of the insolvency law reform to solve this problem and to give a business in financial distress the opportunity to be rescued while enjoying the protection of the insolvency procedure.<sup>124</sup> However, in spite of the legislature's good intentions in introducing the ground of imminent illiquidity to enable a debtor to act at an early stage when faced with financial crisis, it has not had the desired effect and plays almost no role as a ground for the commencement of insolvency proceedings.<sup>125</sup> Although many applications are now based on the imminent inability of the debtor to pay his debts, it appears that in the vast majority of these cases the debtor is in fact already insolvent or unable to pay his debts.<sup>126</sup> Even in those few cases where the debtor is not already unable to pay his debts, it is an almost unavoidable consequence of the application that the debtor becomes illiquid soon afterwards because banks usually then cancel the debtor's credit and demand immediate payment of their claims.<sup>127</sup>

Schmidt and Ahrendt<sup>128</sup> point out that both the introduction of imminent illiquidity as a ground for an insolvency order and the concomitant potential liability of directors

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<sup>121</sup> According to Eickmann, Flessner et al *Heidelberger Kommentar* at 154, it was also intended to assist natural persons who may not base an insolvency application on overindebtedness (that is, insolvency) (see part 2.4.3 below).

<sup>122</sup> Braun *Commentary* at 97 par 190.

<sup>123</sup> According to Remmert "Introduction" at 427, 84 per cent of applications for commencement of insolvency proceedings under the *Konkursordnung* were refused because of a lack of sufficient assets (even to cover the costs).

<sup>124</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 128-129.

<sup>125</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 226; Eickmann, Flessner et al *Heidelberger Kommentar* at 154; Bertram and Gottwald *Insolvenzrechtshandbuch* at 129.

<sup>126</sup> Braun *Commentary* at 61 par 23; Ehlers "Statutory Corporate Rescue" at 173. Wimmer and Ahrens *Frankfurter Kommentar* at 244 estimate that, at least during the first years after the *InsO* came into effect, only in 1 to 2 per cent of these applications had illiquidity not already set in.

<sup>127</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 226.

<sup>128</sup> *Hamburger Kommentar* at 13.

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for the costs of the proceedings if they have not applied in good time in breach of their statutory and other duties<sup>129</sup> have failed to achieve the aim of putting pressure on directors to apply for the commencement of insolvency proceedings before actual insolvency sets in. This can be ascribed to the view still widely held that insolvency is a sign of shameful commercial failure, resulting in insolvency applications being brought too late. In spite of several provisions specifically aimed at encouraging voluntary and thus early applications, most debtors delay applying for as long as possible until all resources have been exhausted and the possibility of a rescue is lost.<sup>130</sup> There has not yet been the required acceptance of the InsO as a modern business rescue statute,<sup>131</sup> and the anticipated interest of creditors in these proceedings has also not materialised. It is only in rare cases, mostly in the case of large companies, that an insolvent company applies for insolvency proceedings with the specific intention of achieving a successful corporate rescue.<sup>132</sup>

There are also other reasons for the failure of company boards to use imminent illiquidity to apply for an insolvency order early enough to rescue the company or business. These include the fact that, contrary to the intentions of the directors, the creditors may decide against a rescue and in favour of liquidation after the insolvency order has been granted,<sup>133</sup> or the fact that the court may find that the company is already unable to pay its debts, in which case the directors are criminally liable for breach of their duty to apply for insolvency.<sup>134</sup>

### **2.4.3 Overindebtedness<sup>135</sup>**

The third ground on which an application to initiate insolvency proceedings may be granted is overindebtedness, which is defined in § 19(2) as the situation that exists if the assets of the debtor are no longer sufficient to cover its existing liabilities. This is what

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<sup>129</sup> See further parts 2.3 and 2.5.2 regarding this liability.

<sup>130</sup> Müller "Zahlungsunfähigkeit" at 461. The writer explains that the perception that insolvency is a sign of financial and personal failure first needs to be overcome, and that this will take time but may be achieved by positive reports of successful rescues taking hold in the minds of the general public.

<sup>131</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 244 state that a change in legislation and policy is not sufficient to change ingrained behaviour automatically.

<sup>132</sup> Braun *Commentary* at 59 pars 10-11.

<sup>133</sup> At the report meeting held in terms of § 157: see part 2.5.2 below regarding this meeting.

<sup>134</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 130. See part 2.3 above regarding this duty.

<sup>135</sup> "Überschuldung".

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most legal systems refer to as actual or technical insolvency, as opposed to commercial insolvency.<sup>136</sup> However, this ground is available only in those instances where the debtor is a legal person<sup>137</sup> and is specifically intended to prevent companies that often have nothing but their limited share capital to pay their debts, from continuing to operate in the marketplace once their liabilities exceed their assets.<sup>138</sup>

To prove that a company is insolvent, an account must be prepared showing all the assets of the company, including immaterial property such as special expertise, together with their realisable value, as well as all liabilities.<sup>139</sup>

§ 19(2) specifically provides that for the purposes of this provision the valuation of the debtor's assets must be done on the basis of a going concern if, in the circumstances, it seems highly probable that the business will continue to operate.<sup>140</sup> This part of the provision was added to the draft legislation by the parliamentary committee in spite of the government draft expressly excluding it on the grounds that it was an unnecessary complication of the test for insolvency.<sup>141</sup> The parliamentary committee believed that it was necessary to add this sentence because a practice had developed that was supported by decisions of the Federal High Court,<sup>142</sup> to exclude overindebtedness as grounds for an insolvency order if the prognosis for survival of the business was positive, even if the liabilities exceeded the assets at liquidation values.<sup>143</sup> The parliamentary committee was of the view that a favourable prognosis for the business should not automatically exclude insolvency – only a valuation based on this positive prognosis that resulted in the value of assets exceeding total liabilities should have that effect. Otherwise it could lead to a company continuing to conduct its business without the necessary capital, leading to creditors suffering considerable prejudice if the positive prognosis turned out to be wrong.<sup>144</sup>

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<sup>136</sup> See Bertelsmann et al *Mars* at 2.

<sup>137</sup> § 19(1).

<sup>138</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 159.

<sup>139</sup> Braun *Commentary* at 99 pars 200-201.

<sup>140</sup> However, see the discussion below on the temporary amendment of this provision.

<sup>141</sup> See Landfermann "Insolvency Code" at 36, who expressed relief that it had been omitted, not realising that the final version would include this provision.

<sup>142</sup> Entscheidungen des Bundesgerichtshofes in Zivilsachen (BGHZ) 119, 201: NJW 1992, 2891. Schmidt *Gesellschaftsrecht* at 322-323 mentions further cases and expresses serious doubts whether the legislation will be successful in changing the existing practice.

<sup>143</sup> *Ausschussbericht* Zu § 23 Abs 2: Balz and Landfermann *Insolvenzgesetze* at 93.

<sup>144</sup> *Ausschussbericht* Zu § 23 Abs 2: Balz and Landfermann *Insolvenzgesetze* at 93. See Müller "Überschuldung" at 467-470 for a discussion of the history and the reaction to the inclusion of this sentence.

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A valuation founded on the basis of a going concern will mean that assets will be valued at their maximum value, as they invariably have a higher value when part of a going concern rather than when broken up into separate items.<sup>145</sup> The valuation of the company's assets therefore entails two elements or steps: firstly, a prediction must be made, based on the company's current financial situation, whether the continuation of the business is more likely than not.<sup>146</sup> This is referred to as a company's insolvency status, as opposed to its insolvency balance.<sup>147</sup> A prognosis that the business will probably be carried on further can be made only if the debtor is determined that it will continue, even if it requires a sale of the business as a running concern, and if, seen objectively, it will be possible to continue running the business.<sup>148</sup>

The second part of the test is a financial balance sheet calculation where, depending on the outcome of the first step, assets will be valued as part of either a continuing business or a liquidation.<sup>149</sup> The provision does not stipulate the period over which the company's future continuation should be calculated, which allows the courts to consider the merits of each case according to its own individual circumstances.<sup>150</sup> However, many commentators seem to agree that the period should be at least one year but should not exceed two years.<sup>151</sup> Therefore, overindebtedness (or insolvency) in the legal sense that constitutes grounds for an insolvency order can be determined only after both steps have been completed.<sup>152</sup>

Some commentators believe this test to involve three steps: firstly, a determination of the company's insolvency by using liquidation values; secondly, if the company is already insolvent, ascertaining whether the business is likely to be continued; and thirdly, if the last-mentioned result is positive, doing a new calculation based on going concern values which may, or may not, still result in an outcome of

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<sup>145</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 161.

<sup>146</sup> According to Eickmann, Flessner et al *Heidelberger Kommentar* at 160, the test is whether the probability that the business will be continued is more than 50 per cent.

<sup>147</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 246.

<sup>148</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 160 describe the test as being whether an effective and knowledgeable business manager would decide to continue the business after considering all the relevant circumstances.

<sup>149</sup> Braun *Commentary* at 98 par 196; Schmidt and Ahrendt *Hamburger Kommentar* at 232.

<sup>150</sup> Braun *Commentary* at 99 par 199.

<sup>151</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 134.

<sup>152</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 133-134.

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insolvency.<sup>153</sup> Although some commentators firmly believe that it is wrong to begin with the prognosis on the future existence of the business, it does not seem to make any difference to the final result which of the two tests is used. Doing a calculation based on liquidation values when a company is clearly able to survive is superfluous and unnecessary and not required by the InsO.<sup>154</sup>

The intention behind this ground is to encourage the management of a company to apply for insolvency before the company reaches the stage where it can no longer pay its debts as they become due.<sup>155</sup> The Code therefore recognises the fact that a company may be technically insolvent but still able, at least for the moment, to pay its debts as they become due.<sup>156</sup> However, overindebtedness also gives rise to the statutory duty on directors to file for insolvency as soon as it occurs.<sup>157</sup> It has therefore been described as one of the “Ten Commandments for Business Managers” to check the company’s liquidity and financial situation continuously and to ensure that the insolvency of the company will be detected immediately.<sup>158</sup>

This insolvency ground is not of major importance in practice, as it is very difficult for a creditor to prove that a company is insolvent, while in the case of an application by the debtor, imminent illiquidity is usually also already present, at the very least.<sup>159</sup> The main importance of this ground lies in the fact that it results in the duty of directors to apply for liquidation, while imminent illiquidity does not.<sup>160</sup>

As part of its efforts to deal with the global financial crisis, the German government passed legislation in 2008 to stabilise the financial markets and to limit corporate insolvencies.<sup>161</sup> In terms of this Act<sup>162</sup> the wording of § 19(2) was amended for a limited period stretching from 18 October 2008 (the date on which the Act came into force) until 31 December 2010. The original intention was that from 1 January

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<sup>153</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 247.

<sup>154</sup> Müller “Überschuldung” at 470-471.

<sup>155</sup> See part 2.4.1 above.

<sup>156</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 142 states that illiquidity almost always occurs only after insolvency.

<sup>157</sup> See part 2.3 above.

<sup>158</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 137. See also Müller “Überschuldung” at 465 and sources referred to there (in fn 2).

<sup>159</sup> Wimmer and Ahrendt *Frankfurter Kommentar* at 245.

<sup>160</sup> Wimmer and Ahrendt *Frankfurter Kommentar* at 246.

<sup>161</sup> Gesetz zur Umsetzung eines Maßnahmenpakets zur Stabilisierung des Finanzmarktes (FMStG) vom 17.10.2008 (BGBl. I S 1982) with effect from 18 October 2008.

<sup>162</sup> §§ 6(3) and 7(2).

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2011, when the financial crisis was expected to be over the worst, the wording will revert to the position as discussed above. However, new legislation was approved in 2009 to extend the original period by another three years to 31 December 2013.<sup>163</sup>

The temporary § 19(2) now provides that overindebtedness is present when the assets of the debtor no longer cover its existing debts *unless, in the circumstances, it is highly probable that the business will continue to operate*.<sup>164</sup> This definition reflects the views of the Federal High Court referred to above that the mere existence of a positive prognosis for the continuation of the business automatically excludes overindebtedness as grounds for an insolvency order. It may be assumed that this amendment also relieves the directors of their duty to apply for an insolvency order as soon as the company's liabilities exceed its assets, on condition that in spite of the company's insolvency, there is a strong probability that the company will be able to continue operating its business.<sup>165</sup> This provision is a clear acknowledgement by the legislature (although it needed a global financial crisis to get it to that point) that an insolvent company with the potential to survive should sometimes be allowed to trade itself out of insolvency without any intervention by the courts and outside of the formal insolvency process. This should be noted by the South African legislature, which has placed a total and unconditional ban on insolvent trading in the Companies Act of 2008 without considering the possibility that insolvent companies can, and in practice often do, trade themselves out of temporary insolvency.<sup>166</sup>

## **2.5 Procedure to commence insolvency proceedings**

### **2.5.1 Provisional order**

Although it is not explicitly termed as such in the InsO, insolvency proceedings are divided into provisional and final proceedings.<sup>167</sup> As soon as the application for an insolvency order has been filed, the court must be satisfied that the application is

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<sup>163</sup> By the Gesetz zur Erleichterung der Sanierung von Unternehmen vom 18.9.2009.

<sup>164</sup> My emphasis.

<sup>165</sup> However, directors can still be held liable for any payments made by the company after it has become overindebted (or illiquid) unless these payments were made with the care that one would expect of a skilled businessman: § 64 GmbHG and § 92(2) AktG.

<sup>166</sup> Section 22(1)(b): see Chapter 2, part 3.5.1.2. However, Regulation 21(3) of the draft Companies Regulations, 2010 does seem to provide for this possibility.

<sup>167</sup> Braun *Commentary* at 191 par 657.

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admissible, which requires the applicant to prove his locus standi to bring the application<sup>168</sup> and provide at least prima facie evidence of one of the grounds for the opening of insolvency proceedings.<sup>169</sup> This is an important safeguard to prevent an unfounded application from causing the irreparable damage to a debtor that unavoidably follows once the court orders any of the protective measures discussed below and the publicity that it requires.<sup>170</sup>

If the court finds the application prima facie admissible,<sup>171</sup> it must take all necessary and reasonable steps to preserve the estate and to prevent any change in the assets of the debtor that may prejudice the creditors, until a decision is made whether to grant the insolvency order.<sup>172</sup> These provisions are also intended to increase the chances of a successful rescue as much as possible by keeping the debtor's assets together for the duration of the opening stages and allowing the provisional administrator to use these assets to continue carrying on the business.<sup>173</sup> This provision is an indication that, contrary to the previous position, the legislature now recognises the fact that closing down a business prematurely must be avoided because reviving it later will be a very costly exercise.<sup>174</sup>

The provisional order is not therefore a provisional *insolvency* order as such but entails measures to safeguard the debtor's assets against diminution by creditors or by the debtor in the period between the hearing of the application and the final order by the court.<sup>175</sup> However, as will be seen in the ensuing discussion, the effects can be very similar to those of a provisional insolvency order. These measures are regarded as necessary because it often takes several months before the court has completed its investigations into the existence of a valid ground for an insolvency order and the general financial situation of the debtor, after which it is able to rule on

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<sup>168</sup> As stipulated in § 14(1): see the discussion above.

<sup>169</sup> Prima facie evidence is provided by affidavit and supporting documents. However, conclusive proof of his claim must be supplied by a creditor whose application is based solely on this claim: Braun *Commentary* at 94 par 172.

<sup>170</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 165.

<sup>171</sup> According to Hess *Insolvenzrecht* at 637, these measures may be ordered even before the court decides on the preliminary question of whether the application is admissible.

<sup>172</sup> § 21(1). The debtor may immediately file an objection to the order.

<sup>173</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 7.

<sup>174</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 285.

<sup>175</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 271.

the insolvency application itself.<sup>176</sup> It is noteworthy, however, that these far-reaching interventions may be ordered in spite of the fact that no insolvency order, not even a provisional one, has been issued as yet and may never be issued if the court eventually refuses the application for commencement of insolvency proceedings. The legal status of the debtor therefore has not yet been changed to that of an insolvent with the usual resulting limits on his legal capacity.

Apart from the general enabling provision in § 21(1) referred to in the previous paragraphs, five radical measures that the court may order at this preliminary stage are specified in § 21(2).

The most drastic measure of these is the appointment of a provisional insolvency administrator to take control of and manage the debtor's assets.<sup>177</sup> This is the option usually chosen by the court in business insolvencies to allow the provisional administrator to run the business of the debtor.<sup>178</sup> This may be combined with a general prohibition on any disposition<sup>179</sup> or transfer by the debtor<sup>180</sup> or, alternatively, ordering that dispositions by the debtor will be subject to the consent of the provisional administrator.<sup>181</sup> An overall ban on any transactions by the debtor in respect of his assets does not require the appointment of a provisional administrator if the business has already stopped trading<sup>182</sup> but would under other circumstances be senseless although not prohibited by law because the debtor would still have the assets under his (physical) control.<sup>183</sup> Such appointment is, however, recommended where the debtor applies for an insolvency order based on imminent illiquidity.<sup>184</sup> Whereas it is usually essential to appoint a provisional administrator in cases where the complete financial situation of the debtor cannot easily be assessed, or where the reliability or trustworthiness of the debtor

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<sup>176</sup> Braun *Commentary* at 102 par 214; Flessner "Germany" at 322.

<sup>177</sup> § 21(2)1. The qualifications, powers and duties of the provisional administrator are discussed in part 2.7.1 below from which the far-reaching effects of these measures will become clear.

<sup>178</sup> Flessner "Germany" at 322; Schmidt and Ahrendt *Hamburger Kommentar* at 270.

<sup>179</sup> The term must be understood in the wide sense of any juristic act in respect of the debtor's corporeal and incorporeal assets: Eickmann, Flessner et al *Heidelberger Kommentar* at 178.

<sup>180</sup> A so-called "strong" provisional insolvency administration: Schmidt and Ahrendt *Hamburger Kommentar* at 271. See part 2.7.1.1 below on the difference between a strong and a weak insolvency administrator.

<sup>181</sup> § 21(2)2. This constitutes the so-called "weak provisional insolvency administration": Schmidt and Ahrendt *Hamburger Kommentar* at 271.

<sup>182</sup> Braun *Commentary* at 103 par 217.

<sup>183</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 274.

<sup>184</sup> Braun *Commentary* at 103 par 222. See part 2.3.2 above on imminent liquidity as a ground for insolvency proceedings.



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is in doubt,<sup>185</sup> such an appointment can also be necessary simply because there are substantial assets that need to be protected, and even a trustworthy debtor often does not have sufficient knowledge of insolvency law to do so.<sup>186</sup>

An order in terms of § 21(2) prohibiting or limiting the power of the debtor to deal with his assets, or appointing a provisional administrator, must be published and served on the debtor personally as well as on the provisional insolvency administrator and any person who owes any obligation to the debtor. All obligations to the debtor must then be met in accordance with the court order.<sup>187</sup> If the debtor is a company, such an order must also be entered in the Commercial Register.<sup>188</sup>

Although not specifically mentioned in the Code, the court may also order more limited restrictions on dispositions by the debtor, such as prohibiting the debtor from surrendering movable goods to a secured creditor or collecting outstanding debts from the debtor's own creditors, or making only specific dispositions, such as loan agreements, subject to the approval of the provisional administrator.<sup>189</sup> However, specified prohibitions, as opposed to general ones, have the disadvantage that bona fide acquiring parties are protected in the case of a disposition and transfer by the debtor in contravention of the prohibition.<sup>190</sup> As a result, these provisions are hardly ever used in practice.<sup>191</sup>

Another important possible measure stipulated in the Code is an order to stay or temporarily stay all executions against the debtor because such a stay does not follow automatically as a result of either the insolvency application or the appointment of a provisional administrator.<sup>192</sup> Even execution by individual creditors who hold security for their claims against the debtor is included in the stay.<sup>193</sup> The provision

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<sup>185</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 175.

<sup>186</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 272.

<sup>187</sup> § 23(1). However, performance to the debtor by a person who was unaware of the order will discharge the obligation.

<sup>188</sup> § 23(2). The Commercial Register is the equivalent of the Companies Register in South Africa. Where applicable, restrictions on property transfers must also be entered in the land register, registers of ships and ships under construction and the register of liens on aircraft: § 23(3).

<sup>189</sup> Braun *Commentary* at 103 par 220.

<sup>190</sup> § 135(1) of the Bürgerliches Gesetzbuch (Civil Code); Braun *Commentary* at 103 par 221. § 24(1) read with § 81 clearly provides that only a transfer of property in contravention of a general prohibition or of the condition that all transfers must be approved by the provisional administrator will be invalid.

<sup>191</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 274.

<sup>192</sup> § 21(2)3; Schmidt and Ahrendt *Hamburger Kommentar* at 277.

<sup>193</sup> Braun *Commentary* at 104 par 226.

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does, however, specifically exclude individual executions involving immovable property from the stay. Such measures can be included in a temporary stay only by an order of the court of execution on application by the provisional administrator.<sup>194</sup>

The fourth possibility specified in the InsO provides for an order that the mail of the debtor may be temporarily intercepted.<sup>195</sup> Electronic messages such as emails and text messages are included in mail that may be intercepted,<sup>196</sup> and, in the case of a corporate debtor, also the mail of every director.<sup>197</sup> The intention is to obtain information about the debtor's assets and to prevent detrimental actions. This type of order becomes necessary if the debtor obstructs the work of the provisional administrator or fails to give full information about his assets and liabilities.<sup>198</sup> Such an order will necessitate the appointment of a provisional administrator, as the mail will be redirected to him.<sup>199</sup>

The last measure was only recently added<sup>200</sup> and provides for an order that all or some specific movables which are not in the possession of creditors but are subject to security rights in their favour may not be realised or seized by them and may be used for the continued running of the debtor's business in so far as these assets may be of substantial importance to the business.<sup>201</sup> However, creditors must be compensated on an ongoing basis for losses in the value of their security resulting from the use of these assets.<sup>202</sup>

The protection of the interests of creditors is regarded as so important that the courts do not recognise an automatic right of the debtor to be heard before ordering these protective measures.<sup>203</sup> However, the debtor has an immediate right of appeal against the order.<sup>204</sup> If these measures are revoked by the court, this must be

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<sup>194</sup> § 30d of the *Zwangversteigerungsgesetz* (Act on the Compulsory Auction of Immovable Property) inserted by § 20(4) of the *Einführungsgesetz zur Insolvenzordnung* of 5 October 1994; Bertram and Gottwald *Insolvenzrechtshandbuch* at 258-259; Braun *Commentary* at 104 par 227.

<sup>195</sup> § 21(2)4 read with §§ 99 and 101(1).

<sup>196</sup> Braun *Commentary* at 105 par 230.

<sup>197</sup> § 101(1).

<sup>198</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 176.

<sup>199</sup> § 99, which provides for such an order after insolvency proceedings have commenced, specifically states that mail must be redirected to the insolvency administrator who will be entitled to open and read it to ascertain whether it is related to the assets of the debtor.

<sup>200</sup> By the *Gesetz zur Vereinfachung des Insolvenzverfahrens*, 2007: see part 1 above.

<sup>201</sup> § 21(2)5. The assets are identified as those which could be subject to § 166 if insolvency proceedings are opened. § 166 allows the insolvency administrator to sell such movables although subject to the creditors' preferential rights to payment.

<sup>202</sup> § 21(2)5.

<sup>203</sup> Braun *Commentary* at 105 par 234.

<sup>204</sup> § 21(1); Braun *Commentary* at 105 par 234.

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published *mutatis mutandis* in the manner prescribed by § 23(1) for the publication of an order imposing any restrictions on transfer of assets by the debtor or appointment of a provisional insolvency administrator.<sup>205</sup>

If the measures taken by the court prove inadequate to prevent the dissipation of the debtor's assets, the debtor, or in the case of a company, its directors may be summoned to appear before the court and may then, as a last resort, be arrested and detained after being heard.<sup>206</sup> This measure is intended to force the debtor to cooperate but is also helpful in preventing a debtor from harming the estate, for example by removing assets to another country.<sup>207</sup> As soon as the reasons for ordering the detention cease to exist, the order must be rescinded.<sup>208</sup> An immediate appeal is available against both the detention order and a refusal by the court to revoke the order when the reasons for it have disappeared.<sup>209</sup>

As soon as the court finds that the application for insolvency proceedings is admissible, there is a duty on the directors and employees of the company, as well as on anyone who had been a director or employee of the company in the two years before the application was made, to supply the court with all such information that may be necessary for the court to come to a decision whether to grant the insolvency order.<sup>210</sup> The court may order that this information be supplied by way of an affidavit to ensure that it is truthful.<sup>211</sup> The reasoning behind these provisions is that the debtor's intimate knowledge of the business will facilitate and speed up the proceedings.<sup>212</sup>

### **2.5.2 Final order commencing insolvency proceedings**

An application for the commencement of insolvency proceedings is heard in chambers, and opens with a formal decision signed by the judge.<sup>213</sup> The application may be withdrawn until such time as the court grants or refuses the application.<sup>214</sup>

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<sup>205</sup> § 25(1).

<sup>206</sup> § 21(3).

<sup>207</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 179.

<sup>208</sup> § 21(3) read with § 98(3).

<sup>209</sup> § 98(3).

<sup>210</sup> § 20, read with §§ 97, 98 and 101. This duty continues to exist for the duration of the insolvency proceedings.

<sup>211</sup> § 20(1) read with § 98(1). An uncooperative debtor may also be arrested and detained (§ 98(2)).

<sup>212</sup> Braun *Commentary* at 100 par 203.

<sup>213</sup> Flessner "Germany" at 320.

<sup>214</sup> § 13(2).

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The decision whether insolvency proceedings should be opened is made by a judge because it entails the review and evaluation of evidence to decide whether the requirements for starting insolvency proceedings are present. However, once the application for the opening of these proceedings is granted, most of the subsequent judicial duties are executed by the insolvency court's administrative officials<sup>215</sup> under the supervision of the judge, whose involvement is thereby kept to a minimum.<sup>216</sup>

It is the duty of the court to determine whether there are sufficient assets to pay the costs of the insolvency proceedings as listed in § 54, namely court fees as well as the remuneration earned and expenses incurred by the provisional insolvency administrator, the insolvency administrator and the creditors' committee.<sup>217</sup> Even if the other requirements regarding the locus standi of the applicant and the grounds for an order to commence insolvency proceedings are met, the court must refuse to grant the order if the debtor's assets will probably not be sufficient to cover the costs of the proceedings. The only exception to this strict rule is if a sufficient amount of money is advanced (for example, by a creditor who is the applicant) to cover all the costs.<sup>218</sup> The person making such an advance may claim it from any person who, contrary to the provisions of insolvency or company law, wrongfully and in breach of his duties, failed to apply for insolvency proceedings.<sup>219</sup> In the case of a company, this liability would usually attach to the individual directors. If such a director disputes that he acted unlawfully and in breach of his duties by not applying, the onus is on him to prove this defence.<sup>220</sup>

The refusal of a court to grant an insolvency order on the grounds of insufficient assets is fatal to a company because it results in the dissolution of the company.<sup>221</sup>

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<sup>215</sup> Their role can therefore be compared with that played by officials in the office of the Master of the High Court in judicial management: see Chapter 2, parts 2.5 and 2.7. It is not clear who will fulfil this role in the new business rescue proceedings: see Chapter 2, parts 3.5 and 3.7.

<sup>216</sup> Braun *Commentary* at 63 par 29.

<sup>217</sup> Braun *Commentary* at 111 par 254. If a provisional administrator is appointed, he may be tasked with investigating whether the debtor's property will cover these costs: see part 2.5.1.1 below. The court and subsequently the meeting of creditors may decide to establish a creditors' committee to represent secured, major and small creditors as well as employees if they hold substantial claims, to assist and supervise the administrator: §§ 67-79.

<sup>218</sup> § 26(1). The Insolvenzordnungsänderungsgesetz, 2001 inserted §§ 4a-4d into the InsO to assist individual debtors in cases of insufficient assets.

<sup>219</sup> § 26(3).

<sup>220</sup> § 26(3).

<sup>221</sup> § 69(1)5. of the GmbHG (for private limited companies) and § 262(1)4. of the AktG (for public companies).

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Once again, the disadvantages of a unitary procedure and an emphasis on the protection of creditors' interests are clearly shown, since it is the interests of creditors that underpin this prescriptive provision.<sup>222</sup> A court is thus not permitted to take into consideration the future prospects of the company to pay the costs if it is allowed to continue trading as part of a rescue attempt.

If an insolvency order is granted by the court, the order must contain the name, registration number, type and place of business of the debtor company, the name and address of the insolvency administrator (who is simultaneously appointed by the court)<sup>223</sup> and the exact moment when the insolvency proceedings commence.<sup>224</sup> If no exact time is provided in the order, insolvency proceedings will be deemed to have commenced at noon of the day on which the order was issued.<sup>225</sup>

The insolvency order also contains the specific period (not less than two weeks or more than three months) within which creditors are required to file their claims with the insolvency administrator.<sup>226</sup> Furthermore, creditors are ordered to furnish the insolvency administrator with full details of any security they may be holding over movable assets of the debtor, without delay.<sup>227</sup> Should a creditor fail to furnish this information or disclose it too late through his own fault, he will be liable for any consequent damages.<sup>228</sup> The order commencing insolvency proceedings also directs persons who have obligations towards the insolvent debtor to render performance to the insolvency administrator and not to the insolvent.<sup>229</sup>

As part of the order opening insolvency proceedings and after considering the specific circumstances of the case, the court determines the dates on which two important meetings of creditors<sup>230</sup> will be held. At the first meeting (the report meeting),<sup>231</sup>

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<sup>222</sup> Braun *Commentary* at 111 par 254.

<sup>223</sup> § 27(1). See further part 2.7.1.1 below. A trustee (Sachwalter) instead of an insolvency administrator will be appointed if the court grants the debtor's application for self-administration: see part 2.7.2 below.

<sup>224</sup> § 27(2).

<sup>225</sup> § 27(3).

<sup>226</sup> § 28(1). The procedure for filing of claims as prescribed by § 174 requires that claims and supporting documents must be filed with the insolvency administrator – a measure designed to lessen the administrative burden on the insolvency courts and their officials.

<sup>227</sup> § 28(2).

<sup>228</sup> § 28(2).

<sup>229</sup> § 28(3).

<sup>230</sup> In terms of § 38 all creditors who had claims against the debtor on the date that insolvency proceedings were opened will be recognised as creditors of the insolvency proceedings.

<sup>231</sup> § 156(1) prescribes the topics on which the administrator must report at this meeting, namely the financial situation of the debtor and the reasons for these problems, the chances of keeping the

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which should preferably take place within six weeks but may not be held more than three months after the insolvency order,<sup>232</sup> the creditors decide,<sup>233</sup> on the basis of a report by the insolvency administrator, on the continuation of the insolvency proceedings, whether the debtor's business should be closed down or continued and whether an insolvency plan<sup>234</sup> should be drawn up.<sup>235</sup> This absolute right of veto that creditors have over whether the business will be allowed to continue trading, irrespective of the intentions of management when applying for the commencement of insolvency proceedings, has been given as one of the reasons why company boards have been reluctant to apply at an early stage in the company's financial distress: although they may believe that the company can still be rescued, the creditors have the power to force the company into regular liquidation. Therefore, even if initiated by the debtor with the specific aim of rescuing the business, the outcome of insolvency proceedings is impossible to predict because of the creditors' autonomy over the insolvency plan procedure.<sup>236</sup>

The second meeting (the verification meeting) must be set down for a date not less than one week and not more than two months after the expiry of the period for filing claims against the insolvent debtor, and is intended for the verification of filed claims.<sup>237</sup> In fairly uncomplicated cases the meetings may take place simultaneously.<sup>238</sup>

The insolvency order must be published by the Registrar of the insolvency court<sup>239</sup> and served individually on the insolvent, his debtors and creditors.<sup>240</sup> The Registrar has to send to the authority responsible for the Commercial Register, a copy of an order opening insolvency proceedings as well as of an order refusing the

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debtor's business or part of it, possibilities for an insolvency plan and the present outlook for payment of creditors' claims. The debtor, creditors, works council and the representatives of management must be given an opportunity at this meeting to comment on the administrator's report: § 156(2).

<sup>232</sup> § 29(1)1. This meeting is referred to in the InsO as the report meeting.

<sup>233</sup> In terms of §§ 76-77 every creditor who has reported his claim to the insolvency administrator (except for lower-ranking claims) and whose claim is not disputed has a vote based on the value of his claim, including a secured creditor who has a vote for the full amount of his secured claim. A resolution is valid if taken by the majority in value of creditors present and voting at the meeting.

<sup>234</sup> Discussed in part 2.8 below.

<sup>235</sup> § 157. Schmidt and Ahrendt *Hamburger Kommentar* at 16 explain that in practice the decision to close down the business is usually already taken during the opening proceedings and would therefore effectively have been taken long before this meeting.

<sup>236</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 1365.

<sup>237</sup> § 29(1)2.

<sup>238</sup> § 29(2).

<sup>239</sup> § 30(1). § 9 allows publication by electronic means but § 30(1) specifically also requires publication in the official Federal Gazette (*Bundesanzeiger*).

<sup>240</sup> § 30(2). § 8 allows service by ordinary mail but the court may order formal service if it is deemed necessary: Braun *Commentary* at 86 par 137.

application because of insufficient assets and liquidating the company.<sup>241</sup> The opening of insolvency proceedings is also entered into the Land Register against any land or rights to land owned by the debtor,<sup>242</sup> and into the registers for ships, ships under construction and liens on aircraft where applicable.<sup>243</sup> The aim is to prevent the insolvent from disposing of assets to bona fide purchasers, as no transfer of ownership can be registered once these entries have been made.<sup>244</sup> The registers are open for inspection to the public, and a potential purchaser may use these registers to ascertain whether the seller is entitled to sell the asset.

An immediate appeal against the court's refusal to grant an order for the commencement of insolvency proceedings is available to the applicant and also to the debtor if the order is refused because of insufficient assets.<sup>245</sup> For a debtor company the latter is particularly important, as it leads to automatic liquidation of the company if the order of the court stands. The debtor also has the right to an immediate appeal if the insolvency order is granted.<sup>246</sup>

## 2.6 The moratorium

Unlike the situation in South Africa where a general moratorium on all summonses, actions and legal proceedings (including enforcement measures) against the company during judicial management may be ordered by the court, and will follow automatically on the commencement of business rescue proceedings,<sup>247</sup> the InsO differentiates in its provisions between a stay on the enforcement of claims against the insolvent debtor on the one hand, and on the other, a moratorium on other legal proceedings or actions in general.

### 2.6.1 Civil legal proceedings

As soon as insolvency proceedings are instituted, any pending civil case to which the

<sup>241</sup> § 31. In a South African situation this would be the Registrar of Companies.

<sup>242</sup> § 32.

<sup>243</sup> § 33.

<sup>244</sup> Braun *Commentary* at 114 par 265.

<sup>245</sup> § 34(1).

<sup>246</sup> § 34(2). A successful appeal and resultant repeal of the insolvency order must also be published *mutatis mutandis* as prescribed by § 200 regulating the publication of an order terminating the insolvency proceedings after completion of the process: § 34(3).

<sup>247</sup> See Chapter 2, parts 2.6 and 3.6 respectively.

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debtor is a party and which involves assets that will form part of the insolvent estate is automatically suspended until the court issues an insolvency order or the case is otherwise closed.<sup>248</sup> However, once insolvency proceedings have commenced, the administrator may decide whether he wants to join and continue on behalf of the estate any civil case in which the debtor is the plaintiff and which affects the assets of the estate.<sup>249</sup> If he decides not to do so, the debtor and the defendant may continue the case.<sup>250</sup>

The insolvency administrator or the plaintiff may also continue with a pending civil case in which the debtor is the defendant and in which the plaintiff claims specific movable or immovable property from the estate,<sup>251</sup> or payment of a claim payable in full as part of the administration costs.<sup>252</sup> Only these specified actions are regulated by § 86 and all of them concern claims that, if the plaintiff is successful, will have the effect of reducing the size of the estate available for distribution.<sup>253</sup>

All other creditors who have claims against the insolvent estate may enforce their claims only in accordance with the provisions of the InsO.<sup>254</sup> This means that ordinary creditors for whom no special provision has been made can only institute their claims against the estate by filing these claims with the administrator in accordance with the prescribed procedure.<sup>255</sup>

Legal proceedings that are instituted after commencement of insolvency proceedings are not specifically regulated by the InsO. This is not deemed necessary as a result of § 80(1), which provides for vesting the debtor's right to manage and transfer the assets of the insolvent estate in the administrator, as well as the prescribed procedures in the InsO for dealing with claims and liabilities of the estate.<sup>256</sup>

## 2.6.2 Stay of executions

The InsO provides for several different stays of execution in the course of insolvency

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<sup>248</sup> § 240 of the Civil Procedure Code.

<sup>249</sup> § 85(1) of the InsO.

<sup>250</sup> § 85(2).

<sup>251</sup> As regulated by §§ 47-52, such as claims in terms of a reservation of ownership, pledge or lien.

<sup>252</sup> § 86(1). The claims payable as administration costs are set out in § 55 and include liabilities under mutual contracts that the administrator has chosen to continue in terms of § 103 (referred to below).

<sup>253</sup> The so-called "Teilungsmassegegenstreit": Braun *Commentary* at 203 par 715.

<sup>254</sup> § 87.

<sup>255</sup> The filing of claims against the insolvent estate is regulated by §§ 174-187.

<sup>256</sup> Braun *Commentary* at 199 par 696.



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proceedings. The first one is the stay or temporary stay on any measures of execution against the debtor that may be ordered by the court during the provisional period after an application for the commencement of insolvency proceedings has been made and until the court decides whether to grant the order.<sup>257</sup>

Another measure that could be regarded as creating a limited stay in the initial stages of the insolvency application is found in the provision that as soon as an application for commencement of insolvency proceedings has been filed, no contract of rent or lease over movable or immovable property may be cancelled by the lessor because of non-payment of the rent<sup>258</sup> or the worsening financial position of the lessee.<sup>259</sup>

Once an order for commencement of insolvency proceedings has been issued by the court, and for the duration of these proceedings, no executions by individual insolvency creditors<sup>260</sup> are allowed on any assets of the debtor, irrespective of whether these assets form part of the insolvent estate or not.<sup>261</sup> Not only executions commencing after the opening of the insolvency proceedings are prohibited, but also those that were commenced but not completed before the start of the proceedings.<sup>262</sup> Furthermore, any security obtained by an insolvency creditor through execution against the assets of the insolvent estate within one month before the insolvency application was brought, or after it was brought, will become void on the commencement of the insolvency proceedings.<sup>263</sup> Payments as a result of execution are not covered by this provision, but in most cases will be subject to an action to be set aside as impeachable dispositions.<sup>264</sup> This stay will obviously facilitate any effort by the administrator to continue the business of the debtor since assets that are important for the continuation of the business will be retained. Both civil claims and official ones are included in the stay.<sup>265</sup>

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<sup>257</sup> Authorised by § 21(2)3. This moratorium is discussed in part 2.5.1 above.

<sup>258</sup> § 112(1). In terms of §§ 543(2) and 569(2) of the Bürgerliches Gesetzbuch (the Civil Code, hereafter referred to as the BGB), a lessor would normally have this right after a tenant or lessee has missed two payments.

<sup>259</sup> § 112(2).

<sup>260</sup> Insolvency creditors are creditors as described in §§ 38 and 39, being those who had established claims against the debtor at the time of commencement of the insolvency proceedings and subordinate creditors as listed in § 39. Secured creditors are thus excluded.

<sup>261</sup> § 89(1).

<sup>262</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 530; Braun *Insolvenzordnung* at 623.

<sup>263</sup> § 88.

<sup>264</sup> In terms of § 131: Braun *Insolvenzordnung* at 619.

<sup>265</sup> Braun *Insolvenzordnung* at 623.

A special stay of execution effective for a period of six months from the commencement of insolvency proceedings applies to claims classified as costs of the estate<sup>266</sup> but which did not arise as a result of any juristic act by the administrator.<sup>267</sup> The legislature intended this provision to protect the insolvency administrator, at least during the initial phase of the insolvency procedure, from claims that he had neither incurred by any of his actions nor been able to prevent but that would break up the insolvent estate and hamper or even prevent any rescue attempt.<sup>268</sup> Most importantly, this provision prevents the immediate withdrawal of cash assets that are critical to enabling a debt-ridden business to survive in the early stages.<sup>269</sup>

However, three types of liabilities that enjoy preference as administration costs are specifically excluded from the abovementioned stay of six months.<sup>270</sup> The first are those liabilities that arise from an uncompleted mutual<sup>271</sup> contract that the administrator has chosen to continue.

The general principle applicable to uncompleted contracts is contained in § 103, which provides the insolvency administrator<sup>272</sup> with an express choice whether or not to fulfil a wholly or partially uncompleted contract.<sup>273</sup> The administrator may ensure the continuation of the contract, even against the will of the other contracting party, and in spite of the debtor's having been in breach of the agreement before insolvency.<sup>274</sup>

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<sup>266</sup> In terms of § 53 the costs of the insolvency proceedings (being court costs and remuneration of the provisional and final insolvency administrators and members of the creditors' committee: § 54), as well as costs arising from the administration of the estate as set out in § 55, are classified as estate liabilities and as such must be paid first and in full from estate assets. I will hereafter refer to them all collectively as administration costs.

<sup>267</sup> § 90(1).

<sup>268</sup> Braun *Insolvenzordnung* at 628. These claims are referred to as imposed or inherited ("oktroierte") debts, as opposed to those debts voluntarily incurred by the administrator ("gewillkürten Masseverbindlichkeiten"): *Begründung RegE* Zu § 101: Balz and Landfermann *Insolvenzgesetze* at 170.

<sup>269</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 538.

<sup>270</sup> In terms of § 90(2).

<sup>271</sup> This must be interpreted to mean that both parties have to perform in terms of the contract, although the value of their obligations need not be equal: Braun *Insolvenzordnung* at 696.

<sup>272</sup> According to § 279, the insolvent debtor will have this right in the case of self-administration (ordered in terms of § 98 and loosely based on the principle of debtor in possession found in Chapter 11 reorganisations in the USA), although he should exercise his choice in consultation with the appointed trustee.

<sup>273</sup> This was taken over from § 17 of the *Konkursordnung* (KO) (repealed and substituted by the *InsO*) although this particular provision had been one of the most controversial provisions when part of the previous legislation: Wagner "Vertragsverhältnisse" at 338. Contracts regulated specifically by another provision are excluded, such as fixed date transactions with a market or stock exchange price (§ 104); sale by the debtor of a movable article subject to a retention of title (§ 107); contracts for the lease of immovable property (§§ 109-111) and employment contracts (§ 113).

<sup>274</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 592.

Should an administrator choose to perform under an uncompleted contract, he steps into the shoes of the debtor and must therefore deliver full performance on behalf of the estate exactly as the debtor would have had to do.<sup>275</sup> Obligations arising from uncompleted contracts that the insolvency administrator chooses to complete are specifically classified as costs of the insolvent estate<sup>276</sup> and enjoy a preferent right to payment from the insolvent estate.<sup>277</sup>

The other contracting party has been given the right to demand that the insolvency administrator immediately exercise his right to choose between performance and repudiation to end the uncertainty regarding the fate of the contract.<sup>278</sup> After receiving such a demand, the administrator must declare without delay whether he wishes to claim performance of the contract. The words “without delay” should be interpreted with reference to the Civil Code where they are defined to mean that there may not be any culpable delay.<sup>279</sup> The length of the period that the insolvency administrator may use to make his decision will depend on how much time he needs to assess the advantages and disadvantages for the insolvent estate of fulfilling the contract, which will often include forming an opinion on whether to continue the business of the insolvent temporarily.<sup>280</sup> Failure by an insolvency administrator to make his choice known to the other party after being called upon to do so is regarded as a refusal to perform, and the administrator loses the right to demand performance of the contract.<sup>281</sup>

These very clear and unambiguous provisions regulating uncompleted contracts are in stark contrast to the unclear and controversial provisions on this issue in the South African business rescue proceedings.<sup>282</sup>

<sup>275</sup> Braun *Commentary* at 226-227 par 842. In terms of the decision of the Federal Supreme Court of 25.04.2002 (BGH NZI 2002, 375) insolvency proceedings do not terminate the mutual claims of the contracting parties, but merely their enforceability which is revived, although now against the estate, by the administrator's choice to continue the contract.

<sup>276</sup> § 55(1)2. The application of § 103 is qualified by a special provision in respect of divisible contracts: in terms of § 105 any claim by the other contracting party for counter performance based on that party's partial performance before insolvency will only be an ordinary claim against the insolvent estate, in spite of the administrator's demand for performance of the outstanding obligations. This means that § 103 will apply only to that part of a divisible contract that is uncompleted on the date of insolvency.

<sup>277</sup> § 53.

<sup>278</sup> § 103(2).

<sup>279</sup> § 121(1) BGB.

<sup>280</sup> Hess *Insolvenzrecht* Band I at 1732-1723.

<sup>281</sup> § 103(2). Braun *Insolvenzordnung* at 706-707. If the insolvency administrator decides not to perform the insolvent debtor's obligations under the contract, the other contracting party may prove a concurrent claim against the estate for damages suffered as a result of non-performance of the contract: § 103(2).

<sup>282</sup> Section 136(2) of the Companies Act 2008 discussed in Chapter 2, part 3.6.

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The second type of administration costs excluded from the six-months' stay are those from long-term contracts of lease over immovable property and contracts of employment after the first date on which the administrator could have legally terminated these contracts but failed to do so.<sup>283</sup>

The third group of administration costs exempted from the stay are those emanating from a long-term contractual relationship where the administrator has claimed performance from the other party in favour of the insolvent estate.<sup>284</sup> This provision is particularly important in respect of a claim for remuneration where the administrator has terminated an employee's contract but has continued to use his services.<sup>285</sup>

## **2.7 Managing the procedure**

### **2.7.1 The provisional insolvency administrator and the insolvency administrator**

#### **2.7.1.1 Appointment**

##### *2.7.1.1.1 The provisional insolvency administrator*

As previously discussed in this Chapter,<sup>286</sup> an insolvency court may appoint a provisional insolvency administrator as one of the measures to preserve the estate pending the court's decision whether to open insolvency proceedings.<sup>287</sup> This is the codification of a practice that was developed during the previous legislative dispensation although it lacked any statutory foundation.<sup>288</sup> Although the court has a discretion whether to appoint a provisional administrator, such appointment will

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<sup>283</sup> § 90(2)2. In terms of § 108(1), rental and lease agreements of the debtor as lessor or lessee over immovable property or premises, as well as employment contracts, irrespective of whether the debtor is the employer or employee, will continue after commencement of insolvency proceedings and must be paid as administration costs. The administrator has not been given any choice in the matter but may terminate the contract on any of the normal grounds for dismissal. If no shorter period has been agreed on, § 113 requires notice of three months for termination of a service contract by either the administrator or the other party. If the contract is ended prematurely by the administrator, the other party has an ordinary claim for damages against the insolvent estate.

<sup>284</sup> § 90(2)3.

<sup>285</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 539.

<sup>286</sup> See part 2.5.1 above.

<sup>287</sup> A provisional insolvency administrator is subject to the same provisions of the InsO as the final administrator regarding supervision of his activities by the insolvency court (§ 58), dismissal (§ 59), personal liability for breach of his duties (§ 60), liability to creditors (§ 61), prescription of liabilities (§ 62) and remuneration and expenses (§§ 63-66). Where relevant, these provisions will be discussed below with reference to the final insolvency administrator.

<sup>288</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 190.

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obviously be unavoidable if the court orders that all dispositions of his assets by the debtor will be subject to the consent of a provisional administrator.<sup>289</sup> The appointment of a provisional administrator is also advisable where the debtor applies for an insolvency order on the grounds of imminent illiquidity,<sup>290</sup> presumably to guard against further mismanagement and depletion of his assets by the debtor. A provisional administrator will usually also be appointed by the court where it is intended to continue the business of the debtor, even if there are no grounds for doubting the trustworthiness or honesty of the debtor.

Although not found in the InsO itself, the terms “strong” (“starker”) or “weak” (“schwacher”) insolvency administrator are used in practice to denote the powers given to the provisional insolvency administrator by the court.<sup>291</sup>

A strong provisional insolvency administrator is one who is given the sole authority to dispose of the debtor’s assets while the debtor is deprived of all powers to deal with his assets. This type of provisional administrator is usually appointed where the court has evidence of fraud or other special circumstances that require stringent security measures, and therefore it is not the standard procedure.<sup>292</sup> As a result, the powers and duties of a provisional administrator whose appointment is combined with a general prohibition on dealings by the debtor are set out very precisely in the InsO. It is firstly stated as his general duty to take over the management and right of disposal over the debtor’s property.<sup>293</sup> This means that in the case of a corporate debtor, the provisional administrator will take over all the management duties of the board of directors. He will effectively be running the company and may even continue pending legal actions on behalf of the company as plaintiff or defendant.<sup>294</sup>

The InsO divides this general duty of a provisional administrator into three detailed sets of duties. He must:

(i) safeguard and preserve the debtor’s property. Although he may use assets of the

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<sup>289</sup> In terms of § 21(2)2. See part 2.5.1 and Braun *Commentary* at 103 par 222.

<sup>290</sup> Braun *Commentary* at 103 par 222.

<sup>291</sup> Braun *Commentary* at 107 par 241; Eickmann, Flessner et al *Heidelberger Kommentar* at 191; Remmert “Introduction” at 428.

<sup>292</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 191.

<sup>293</sup> § 22(1).

<sup>294</sup> § 24(2) read with §§ 85(1) and 86.

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debtor as security if necessary for the continuation of the business, he is not normally entitled to realise the assets.<sup>295</sup>

(ii) continue carrying on the business of the debtor until the court decides whether to open insolvency proceedings. This is unless the court consents to the closure of the business to avoid a significant diminution of assets because, for example, the business is running at a loss.<sup>296</sup> Here the provisional administrator's authority is limited to performing transactions in the ordinary course of business in order to keep the business functioning as a going concern. However, Braun points out that the provisional administrator's duty to keep the business running may conflict with his duty to preserve the debtor's property, since it may be necessary for the success of the business over the long term to be run at a loss for a short period.<sup>297</sup> If major losses are foreseen, the court will use its discretion to close the business wholly or partially after it has been provided with all the necessary information.<sup>298</sup>

(iii) ascertain whether the debtor's assets will be sufficient to cover the costs of the insolvency proceedings. This will also entail investigating whether there are voidable transactions that could increase the estate's ability to cover the insolvency costs.<sup>299</sup> The court may furthermore also instruct the provisional administrator to provide an expert opinion on the existence of a valid ground for the commencement of insolvency proceedings as well as on the future prospects of the debtor's business.<sup>300</sup> If no provisional administrator is appointed, the court may request an independent expert to provide his opinion on these matters.<sup>301</sup>

In practice, the appointment of a strong provisional administrator is rare for various reasons including the fact that such an appointment would mean that the insolvent estate would have to incur additional costs.<sup>302</sup> Braun<sup>303</sup> also points out that although the legislature originally intended it to be the standard procedure, the appointment of a strong provisional insolvency administrator creates a legal problem

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<sup>295</sup> Braun *Commentary* at 107 par 243.

<sup>296</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 197.

<sup>297</sup> *Commentary* at 107 par 244.

<sup>298</sup> Braun *Commentary* at 107 par 244.

<sup>299</sup> Braun *Commentary* at 108 par 247.

<sup>300</sup> § 22(1)1-3.

<sup>301</sup> Braun *Commentary* at 108 par 247.

<sup>302</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 267; Braun *Commentary* at 104 par 224; Eickmann, Flessner et al *Heidelberger Kommentar* at 203.

<sup>303</sup> *Commentary* at 63 par 32.

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regarding liabilities that arise during the period that he is in charge: whereas a weak administrator does not have the authority to incur liabilities on behalf of the debtor but only to approve those incurred by the debtor, all such liabilities become valid claims against the insolvent estate because no insolvency proceedings have yet been opened at the time they are incurred. However, the liabilities incurred by the strong provisional administrator are also pre-insolvency debts but they have not been incurred by the debtor, and are therefore more difficult to classify. In spite of this difficulty, the claims are generally accepted to be valid against the insolvent estate.

Most provisional insolvency administrators, however, are so-called weak administrators where the debtor retains the power to dispose of his property but requires the consent of the provisional administrator to give effect to such dispositions.<sup>304</sup> This type of provisional administrator has only those duties specifically determined by the court in its order. The court may deprive the debtor of the power to enter into certain types of transactions, such as loan agreements or other specified dispositions, and these powers will then be transferred to the insolvency administrator. His powers may also include the running of the debtor's business, particularly if it is a small to medium-sized business.<sup>305</sup> The duties assigned by the court to the weak provisional administrator may not, however, exceed the statutory duties imposed on the strong insolvency administrator.<sup>306</sup>

Every provisional insolvency administrator has the right to enter the business premises of the debtor and to conduct investigations there. The debtor is compelled to allow the provisional administrator to inspect his books and business papers, to provide that administrator with all necessary information and to assist him in the performance of his duties.<sup>307</sup> Where the debtor is a company, these obligations rest on the current directors and previous directors who vacated their office within the preceding two years, as well as on current employees and previous employees who left within the last two years.<sup>308</sup>

If the appointment of a provisional insolvency administrator is revoked (usually together with the other precautionary measures originally imposed by the court), he

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<sup>304</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 203.

<sup>305</sup> Braun *Commentary* at 108 par 246.

<sup>306</sup> § 22(2).

<sup>307</sup> § 22(3). §§ 97, 98 and 101, dealing with the debtor's duties of co-operation and providing information after insolvency proceedings have started apply *mutatis mutandis*.

<sup>308</sup> § 22(3) read with § 101(1) and (2).

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must use the property administered by him to pay all costs and liabilities incurred by him in the exercise of his duties before he vacates his office.<sup>309</sup>

#### 2.7.1.1.2 *The (final) insolvency administrator*

The insolvency court appoints the final<sup>310</sup> insolvency administrator as part of the order opening insolvency proceedings.<sup>311</sup> The insolvency administrator plays a pivotal role in the insolvency proceedings, and if a provisional insolvency administrator had previously been appointed, he is usually subsequently appointed by the court to act as the final insolvency administrator.<sup>312</sup> This practice ensures continuity and is greatly facilitated by the fact that the same requirements and qualifications for appointment apply to both officials.<sup>313</sup> For the same reasons, if no provisional administrator had been appointed but the court had requested an insolvency expert's opinion,<sup>314</sup> the court would inevitably appoint this expert as insolvency administrator.<sup>315</sup>

The choice of insolvency administrator by the court takes place in two stages: the insolvency judge first compiles a preselection list of qualified and willing candidates<sup>316</sup> from which the actual appointment is then made, which is the second stage.<sup>317</sup> In an important decision by the German Constitutional Court<sup>318</sup> it was held that each insolvency judge has the duty to compile a preselection list, using his own tried and tested criteria to determine who qualifies for appointment, but has a wide discretion in his final choice of an insolvency administrator and need not regularly or automatically appoint everybody on the list. Therefore, an unsuccessful candidate cannot appeal against his omission from the preselection list or demand his appointment to replace the appointed administrator.<sup>319</sup>

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<sup>309</sup> § 25(2). Although the subsection refers specifically to the provisional insolvency administrator who has been vested with the right to deal with all the debtor's property (that is, a strong provisional administrator), Braun *Commentary* at 110 par 253 believes that for practical reasons it will also apply to weak provisional administrators who have been vested with the right to effect specific dispositions.

<sup>310</sup> Although he is merely referred to as the insolvency administrator in the InsO, many commentators refer to him as the final insolvency administrator to differentiate him clearly from the provisional administrator.

<sup>311</sup> § 27(1).

<sup>312</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 695.

<sup>313</sup> §§ 21(2)1 and 56. See part 2.7.1.2 below for a discussion of these requirements.

<sup>314</sup> See part 2.7.1.1 above.

<sup>315</sup> Braun *Commentary* at 63 par 31.

<sup>316</sup> See part 2.7.1.2 below regarding these qualifications.

<sup>317</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 696.

<sup>318</sup> Judgment of 23.05.2006 ZInsO 2006, 765, discussed in detail in Schmidt and Ahrendt *Hamburger Kommentar* at 699-701, including later judgments of the court confirming this decision.

<sup>319</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 352; Schmidt and Ahrendt *Hamburger Kommentar* at 707.



The administrator must be given an official letter of appointment that he must return to the insolvency court on termination of his office for whatever reason.<sup>320</sup>

As a result of the priority given to the rights of creditors in insolvency proceedings, irrespective of whether liquidation or rescue is envisaged, the creditors are given the right to choose another insolvency administrator to replace the one appointed by the court.<sup>321</sup> The creditors' co-operation with and confidence in the insolvency administrator is regarded as an absolute requirement for the smooth running of the insolvency process, as it is largely steered by them.<sup>322</sup> As a result, they are not required to justify their decision in choosing a replacement.<sup>323</sup> In most cases, however, the creditors accept the administrator appointed by the court,<sup>324</sup> and it is only in major insolvencies where creditors play a more active role than usual that the court's appointment of an insolvency administrator is sometimes challenged.<sup>325</sup>

The creditors have this opportunity only once in respect of each administrator, which is at the first meeting of creditors that takes place after the appointment of the administrator by the court.<sup>326</sup> The reason for this limitation is to avoid a situation where the insolvency administrator's independence and ability to carry out his duties properly could be undermined by a creditor or creditors threatening to replace him if they do not agree with him.<sup>327</sup>

The new administrator must be chosen by the majority of the creditors in value and number<sup>328</sup> who voted, and the court may refuse to confirm his appointment only if he is not suitable to take over the office.<sup>329</sup> Even so, any creditor has an immediate

<sup>320</sup> § 56(2).

<sup>321</sup> § 57.

<sup>322</sup> Braun *Commentary* at 161 par 491. The administrator must, for example, obtain the consent of the creditors' committee (or creditors, if no committee has been appointed) to all "particularly important" legal acts such as the sale of the business or part of it, or onerous loan contracts: § 160.

<sup>323</sup> Braun *Commentary* at 161 par 493.

<sup>324</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 268.

<sup>325</sup> Flessner "Germany" at 325.

<sup>326</sup> § 57. This also applies to a new administrator appointed by the court after the previous one has died or been dismissed: Braun *Commentary* at 161 par 492.

<sup>327</sup> Braun *Commentary* at 161 par 494. The InsO provides for dismissal of the insolvency administrator in § 59: see part 2.7.1.3 below.

<sup>328</sup> The additional requirement of a majority in number was introduced by the amending legislation of 2001 (see part 1 above) and is intended to prevent secured creditors with large claims (who have voting rights for the total amount of their claims and not just for the unsecured part: § 76(2)) as well as any other major creditors from imposing their will on the majority of creditors and abusing the process: Braun *Commentary* at 161 par 492; Wimmer and Ahrens *Frankfurter Kommentar* at 8.

<sup>329</sup> § 57. This decision is actually taken by the Registrar of the insolvency court: Braun *Commentary* at 161 par 495.

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right of appeal against the court's refusal to confirm the appointment.<sup>330</sup>

The insolvency administrator (both provisional and final) is subject to the supervision of the insolvency court for the duration of the insolvency proceedings, that is, also during the implementation of an insolvency plan if there is one.<sup>331</sup> Thus the court may order him to furnish information on a specific issue or on his management of the business and the insolvency proceedings at any time.<sup>332</sup> Although the duty of the court is mainly restricted to ensuring that the administrator fully complies with the law, and not whether he is taking the correct business decisions,<sup>333</sup> the court may intervene if, considered objectively, any measure causes losses to the insolvent estate or the actions of the administrator are contrary to the purpose of the insolvency proceedings.<sup>334</sup>

Should the court find a dereliction of duty on the part of the administrator it may, after a prior warning, impose a fine not exceeding € 25,000 on him, against which he may immediately appeal.<sup>335</sup>

#### 2.7.1.2 Qualifications

The qualifications for appointment as an insolvency administrator are set out in § 56(1) and show some similarity to the requirements for appointment as trustee, liquidator or judicial manager in South Africa in so far as no formal academic or professional qualifications are required.<sup>336</sup>

Although contained in one subsection, there are in fact four requirements that a person has to meet to qualify for appointment as insolvency administrator, which will be discussed hereunder.

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<sup>330</sup> § 57. Full reasons must therefore be provided for a rejection because of the immediate right of appeal of the creditors: Braun *Commentary* at 162 par 496.

<sup>331</sup> See part 2.8 below regarding the insolvency plan. The degree of supervision is determined by the court but is not affected by whether a creditors' committee, which also exercises a supervisory function has been appointed: Braun *Commentary* at 162 par 499.

<sup>332</sup> § 58(1). Normally the administrator will submit a report every six to twelve months: Braun *Commentary* at 163 par 503.

<sup>333</sup> Flessner "Germany" at 328.

<sup>334</sup> Braun *Commentary* at 163 pars 501-502. Specific exceptions where the court may interfere with a business decision have also been created in the InsO, for example a decision by the insolvency administrator to close the business which may be suspended at the request of the debtor until creditors have had an opportunity to decide whether to give or withhold their consent: § 158(2).

<sup>335</sup> § 58(2). An administrator who has been dismissed may also be fined in the same way if he fails to return assets of the insolvent estate: § 28(3).

<sup>336</sup> See Chapter 2, part 2.5.1.

### 2.7.1.2.1 *Natural person*

The InsO stipulates that only a<sup>337</sup> natural person can be appointed. Therefore, it is not possible to appoint a company or even a firm that will nominate an individual to act. The parliamentary committee amended the original draft legislation that provided for the appointment of firms, because they foresaw difficulties in respect of conflicts of interest and the personal liability of the insolvency administrator for damages caused by a breach of his duties.<sup>338</sup> The personal liability of the administrator is an important feature of the insolvency procedure and is widely regarded as the most effective measure to ensure that he exercises his duties properly and carefully.<sup>339</sup> The specific individual must therefore be appointed directly.

This decision has been criticised on the basis that an individual can also experience a conflict of interests, especially when working as a partner in a firm (as most do). On the other hand, there is nothing to prevent the members of a juristic person from being held personally liable, and the argument that a firm may not be able to pay damages because of solvency problems applies equally – if not more so – to natural persons.<sup>340</sup> In practice, the reality is that an insolvency administrator will not do everything personally but will be assisted by others in the firm.<sup>341</sup> Furthermore, some doubt has been expressed about the constitutionality of this clause, as the rights of juristic persons are also protected by the constitution.<sup>342</sup>

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<sup>337</sup> The word “a” (“eine”) is generally understood to mean that only one administrator may be appointed at a time: Flessner “Germany” at 326; Wimmer and Ahrens *Frankfurter Kommentar* at 518. The final government draft explained that the appointment of more than one administrator had proved to be unnecessary in practice because he could employ other professionals to assist him. It would also avoid the problem of having to demarcate the responsibilities of each administrator: *Begründung RegE Zu § 65*: Balz and Landfermann *Insolvenzgesetze* at 134.

<sup>338</sup> Braun *Commentary* at 158 par 479. In terms of § 60 an insolvency administrator is personally liable to all parties to the proceedings (such as the debtor, creditors and reversionary heirs) for damages caused by a culpable breach of any of his statutory duties or his failure to act with the care of a proper and conscientious insolvency administrator. See further Braun *Commentary* at 166 par 520ff.

<sup>339</sup> Flessner “Germany” at 328.

<sup>340</sup> Braun *Insolvenzordnung* at 445.

<sup>341</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 512 point out that the firm that dealt with the most insolvency cases in 2000 only had two insolvency administrators, which clearly shows that they did not attend to every matter themselves.

<sup>342</sup> Braun *Insolvenzordnung* at 445 with reference to Art. 12, 3 Grundgesetz für die Bundesrepublik Deutschland. This view is shared by Wimmer and Ahrens *Frankfurter Kommentar* at 512 and others referred to there.

### 2.7.1.2.2 *Suitable for the specific case*

The person must be a suitable candidate for appointment in the specific case. This means that his experience and expertise must be sufficient for him to cope with the particular intricacies and problems of the case, whether in respect of the law, business or accounting, although he does not have to be a specific professional such as an attorney, accountant or business manager.<sup>343</sup> For example, only a highly experienced and senior insolvency practitioner will be considered for appointment in a case involving a large corporate debtor.<sup>344</sup> However, it is accepted that new entrants to the profession have to gain their experience in small and uncomplicated cases, and experience as an insolvency administrator is thus not essential in all cases.<sup>345</sup>

As a result of the fact that the office of insolvency administrator is not an officially regulated profession as in England, for example,<sup>346</sup> the criteria for meeting this requirement have largely been set by legal commentators and the courts, as well as by various professional organisations to which many insolvency administrators belong.<sup>347</sup> Thus in 2001, the insolvency court in Hamburg held that the code of conduct accepted by the Verband der Insolvenzverwalter Deutschlands e.V. (VID),<sup>348</sup> a voluntary professional organisation for insolvency administrators, could be used as a concrete reflection of this requirement in the InsO.<sup>349</sup> The decision was severely criticised by some because it placed too much emphasis on the value of the code of conduct, thereby raising mere “banalities” almost to the level of legislation, while others, although recognising this danger, concluded that the end result of the court’s use of the code was correct.<sup>350</sup> As a result of the criticism against their code of conduct, members of the VID approved a new set of professional rules for administrators.<sup>351</sup> The organised attorneys’ profession also attempted to set criteria

<sup>343</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 349.

<sup>344</sup> Flessner “Germany” at 326 notes that there are a number of insolvency experts with a countrywide reputation who are normally appointed by the courts in cases of large corporate insolvencies.

<sup>345</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 349.

<sup>346</sup> See Chapter 3, part 2.5.1.2 on the highly regulated profession of insolvency practitioner.

<sup>347</sup> Braun *Insolvenzordnung* at 446.

<sup>348</sup> Previously known as the Arbeitskreis der Insolvenzverwalter Deutschland e.V. : Wimmer and Ahrens *Frankfurter Kommentar* at 517.

<sup>349</sup> AG Hamburg, ZIP (2001) at 2147.

<sup>350</sup> Braun *Insolvenzordnung* at 446-447 refers to several commentators who held this view, and so do Wimmer and Ahrens *Frankfurter Kommentar* at 517.

<sup>351</sup> “VID – Berufsgrundsätze der Insolvenzverwalter” published in *Zeitschrift für Wirtschaftsrecht* (2006) at 2147.

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for the appointment of attorneys as insolvency administrators by the creation of a specialised profession for attorneys who are experts in insolvency law.<sup>352</sup>

Thus, although at first sight it would seem that, as in the present situation of insolvency practitioners in South Africa, the office of insolvency administrator is also not limited to specific professionals such as accountants or lawyers, nothing could be further from the truth. The German Constitutional Court has confirmed that acting as an insolvency administrator is a separate and recognised profession in its own right and therefore is not limited to lawyers or any other professionals,<sup>353</sup> but the fact is that almost 90 per cent of all appointed insolvency practitioners are lawyers, while the rest are mainly tax advisers and auditors.<sup>354</sup> The simple reason for this is that the members of these professions who specialise in insolvency administrations are the only persons who are able to meet all the requirements for appointment in most cases. Professional organisations such as the Verband der Insolvenzverwalter Deutschlands e.V. referred to above, and other interest groups of insolvency administrators, for example the Gravenbrucher Kreis,<sup>355</sup> were started by and consist almost entirely of members of the legal profession.<sup>356</sup> Therefore, although membership of these organisations or of any professional organisation is not required by the Code, the courts are unlikely to appoint a person with no such affiliation, and in practice, lawyers who are specialised insolvency administrators are usually appointed, especially in corporate insolvencies.<sup>357</sup> Several commentators have therefore expressed serious doubts about the correctness of the Constitutional Court's opinion, especially since many insolvency administrators, in addition to being practising lawyers or accountants, are also involved in business rescues outside the formal insolvency proceedings.<sup>358</sup> Once again this demonstrates the importance of

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<sup>352</sup> Fachanwalt für Insolvenzrecht: Braun *Insolvenzordnung* at 447. Nothing similar has been done by the professional bodies for chartered accountants or tax advisors from whose ranks appointments are also made.

<sup>353</sup> BverfG v 9.2.2005 – 1 BvR 2719/04; Köhler-Ma "Administrator Selection" at 1.

<sup>354</sup> Braun *Commentary* at 160 par 489; Flessner "Germany" at 326; Wimmer and Ahrens *Frankfurter Kommentar* at 513.

<sup>355</sup> See Braun *Insolvenzordnung* at 447 regarding the rules for the admission and appointment of insolvency administrators drafted by them and their subsequent demand (later abandoned) for legislative recognition of the profession of insolvency administrator.

<sup>356</sup> Balz and Landfermann *Insolvenzgesetze* at XXXIV; Braun *Commentary* at 158-159 pars 481-482.

<sup>357</sup> Braun *Commentary* at 160 par 489.

<sup>358</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 698.

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properly drafted regulations, and the recognition of an official regulator by the South African Department of Trade and Industry for the profession of business rescue practitioner.<sup>359</sup>

#### 2.7.1.2.3 *Business experience*

An insolvency administrator is specifically required to have business experience, particularly in the type of business involved in the case for which he seeks appointment.<sup>360</sup> This will enable him to manage the business if necessary and also to establish whether criminal activities or bad management caused the company's downfall. It has been suggested that when deciding on the business knowledge required of an administrator in a particular case, the court should determine whether this is a matter where the business should be liquidated and closed by an insolvency lawyer, or whether it should be continued and needs economic and managerial skills or whether there have been criminal activities requiring special knowledge.<sup>361</sup> Braun<sup>362</sup> laments the fact that no special provisions exist for the appointment of one administrator where several independent but connected companies are concerned, as money may have been unlawfully circulated among the companies.<sup>363</sup>

#### 2.7.1.2.4 *Independent from creditors and the debtor*

An insolvency administrator is required to be independent from the creditors as well as from the debtor. This refers to financial independence from both the debtor and the assets of the insolvent estate,<sup>364</sup> and, for example, disqualifies a major creditor or shareholder of the debtor as well as the debtor's legal representative. It is important that the insolvency administrator's decisions should not be influenced by any personal financial interests or effects.

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<sup>359</sup> See Chapter 2, part 3.7.1.2.

<sup>360</sup> Braun *Commentary* at 159 par 483.

<sup>361</sup> Braun *Insolvenzordnung* at 448.

<sup>362</sup> *Commentary* at 159 par 484.

<sup>363</sup> See Katz "Developments" at 39 who also pointed out this weakness in South African insolvency law where groups of companies are not treated as single entities in insolvency and where it is sometimes mere coincidence which company happens to be the owner of the assets at the insolvency of one or more of them.

<sup>364</sup> Braun *Commentary* at 160 par 490.

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The independence of an individual is not, however, in doubt simply because he is nominated by a creditor,<sup>365</sup> and neither is that of the drafter of an insolvency plan filed simultaneously with the debtor's application for the opening of insolvency proceedings or a potential insolvency administrator who has held preparatory consultations with the debtor.<sup>366</sup>

In November 2002, in an effort to clarify all the requirements, but with more focus on independence, the Arbeitskreis der Insolvenzverwalter Deutschlands e.V.,<sup>367</sup> a voluntary association of attorneys who act as insolvency administrators, decided on a code of conduct that provided detailed guidelines on this requirement.<sup>368</sup> Although the code is not legally binding, it is valuable in interpreting the legislation and in time could encompass the generally accepted principles. Attorneys in particular have to guard against a conflict of interests when they have acted for the insolvent debtor before insolvency because appointment as insolvency administrator requires objectivity and the duty to investigate and report on the debtor's transactions before insolvency, while as attorney he is bound to a professional duty not to disclose his client's affairs.<sup>369</sup>

All the guidelines that have developed in respect of this requirement may be of assistance to South African lawyers in judging the independence of a business rescue practitioner as required by the Companies Act of 2008, a provision that, because of its lack of specifics, may be open to widely divergent interpretations and, strangely enough, does not even require the practitioner to be independent from a creditor or creditors.<sup>370</sup>

#### 2.7.1.2.5 *Any willing individual*

The fifth aspect is not so much a requirement for the individual administrator but rather a directive to the insolvency court which was added to § 56(1) with effect from 1 July 2007.<sup>371</sup> This was as a result of the practice of the courts of making

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<sup>365</sup> This was expressly stated by the drafters of the government draft in their explanatory notes: *Begründung RegE Zu § 65: Balz and Landfermann Insolvenzgesetze* at 134.

<sup>366</sup> Braun *Insolvenzordnung* at 446; Eickmann, Flessner et al *Heidelberger Kommentar* at 348.

<sup>367</sup> Now known as the Verband der Insolvenzverwalter Deutschlands e.V. (VID); Wimmer and Ahrens *Frankfurter Kommentar* at 517.

<sup>368</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 349. The complete code of conduct is reproduced on pages 354-356 of this textbook.

<sup>369</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 514-515.

<sup>370</sup> See Chapter 2, part 3.7.1.2.4 on the potential problems of interpreting the South African provision.

<sup>371</sup> By the Gesetz zur Vereinfachung des Insolvenzverfahrens (Act for the Simplification of Insolvency Proceedings) of 2007: see fn 27 above.

appointments from closed lists that they had compiled of (mostly local)<sup>372</sup> insolvency practitioners with whose work they were familiar. After two insolvency administrators took the matter to the Federal Constitutional Court, this practice was declared unconstitutional.<sup>373</sup> The court held that the insolvency court should at least give every potential candidate a fair chance to be considered for the specific case, although it does not mean that he can demand to be appointed as insolvency administrator.<sup>374</sup>

The subsection now specifically states that appointments must be made from all persons who are willing to take on insolvency administrations. It is also possible for an individual to limit his availability for appointment as insolvency administrator to certain proceedings.<sup>375</sup> This allows an insolvency administrator to specialise in consumer insolvencies, for example, and declare this to the insolvency court.<sup>376</sup> Selection of insolvency administrators is now made from open lists (which each judge must compile independently),<sup>377</sup> and the judges look further than local candidates, especially where more complicated cases are involved which require special business or international expertise.<sup>378</sup> Some insolvency judges also determine and disclose the criteria they will use for selection in a specific case.<sup>379</sup>

However, the fundamental problem, which is a serious shortage of experienced insolvency administrators and the absence of appropriate and clear criteria for inclusion in the list of potential candidates that should ideally be uniformly applied by all insolvency courts in Germany, has not been addressed either by the Constitutional Court or the amending legislation.<sup>380</sup> Schmidt and Ahrendt<sup>381</sup> point out that the insolvency courts do not have the capacity to develop such national uniform

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<sup>372</sup> The principle of regionality – that an insolvency administrator whose place of business is situated in the court's district should be appointed – was the subject of heated debates in the period before 2007, and it is still accepted that, in spite of modern communication technology, it may sometimes be preferable to appoint a local person: Eickmann, Flessner et al *Heidelberger Kommentar* at 349.

<sup>373</sup> BverfG v 3.8.2004 – 1 BvR 135/00, NZI 2004, 574; ZInsO 2004, 913; Braun *Insolvenzordnung* at 444-5. See Hess *Insolvenzrecht* at 100-101 on the history and legal problems in this matter. See also Loubser "Shareholders" at 375 where a similar practice of the Master of the High Court in South Africa to only appoint insolvency practitioners from "panels" is questioned as being probably unconstitutional.

<sup>374</sup> Runkel "Gläubiger" at 439.

<sup>375</sup> § 56(1).

<sup>376</sup> Braun *Insolvenzordnung* at 445.

<sup>377</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 701.

<sup>378</sup> Braun *Commentary* at 160 par 486.

<sup>379</sup> Braun *Commentary* at 159 par 482 and at 160 par 486.

<sup>380</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 6.

<sup>381</sup> *Hamburger Kommentar* at 6-7.



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standards, and as a result there is a real danger of inconsistency in the approach of different courts. This has become visible primarily in two different approaches: some courts have made a concerted effort to include as many names as possible in their lists of candidates, while others are still using procedures that come very close to creating a “closed shop”. Clearly, more specific regulation of the profession is required to bring certainty to the matter, and this supports the decision of the South African legislature to opt for regulation of the profession of business rescue practitioner. It also emphasises the need for detailed and specific legislative requirements for appointment as a business rescue practitioner to avoid the confusion created by leaving these requirements too open or general in nature.

The working group responsible for this amendment to the InsO<sup>382</sup> also expressed their support for a system similar to the one introduced in Austria in 2002,<sup>383</sup> which created an Internet-based list of potential insolvency administrators that was created and administered by the private sector. The working group believed that such a list could be of great value to the courts by providing information about and assisting in the choice of an appropriate insolvency administrator.<sup>384</sup> This view was not shared by all, however, as some commentators believed it to be a failure: firstly, because it was impossible to verify the information supplied by the aspirant administrators about themselves and, secondly, because it created such a huge oversupply of possible candidates that it was impossible for the courts to consider their choices from the whole group.<sup>385</sup>

### 2.7.1.3 Vacation of or removal from office

The insolvency administrator’s office is terminated by his death or by order of the court or when the insolvency proceedings come to an end.<sup>386</sup> The insolvency administrator may be removed from office on any serious grounds by the insolvency court, either *mero motu* or on application by the administrator himself, the creditors’ committee or the creditors’ meeting.<sup>387</sup> Individual creditors, the debtor or any other

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<sup>382</sup> The Bund-Länder-Arbeitsgruppe “Insolvenzrecht”: Braun *Insolvenzordnung* at 447.

<sup>383</sup> By the Insolvenzrechts-Novelle of 2002: see Braun *Insolvenzordnung* at 448.

<sup>384</sup> *Abschlussbericht der Bund-Länder-Arbeitsgruppe “Insolvenzrecht”* at 21, available at <<http://www.jm.nrw.de/JM/justizpolitik/schwerpunkte/insolvenzrecht/abschlussbericht.pdf>> accessed on 2 February 2010.

<sup>385</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 707.

<sup>386</sup> See part 2.9 regarding the end of insolvency proceedings.

<sup>387</sup> § 59(1).

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parties are not entitled to bring such an application.<sup>388</sup> The court has a duty to investigate whether to remove an insolvency administrator *mero motu* as soon as it becomes aware of any serious grounds, but it is often at the instigation of the debtor or individual creditors who do not have the authority to apply to court for removal that the court launches an investigation. In the last-mentioned case the court must proceed with caution because individual debtors who were unsuccessful in their efforts to have the administrator dismissed by the meeting or committee of creditors are often only pursuing their selfish personal interests.<sup>389</sup>

No specific grounds for dismissal are provided, and it is left to the court's discretion whether there are reasons serious enough for dismissal. These could vary from the permanent disability or illness of the insolvency administrator to the breach of his statutory duties.<sup>390</sup> Even where the administrator himself brings the application for removal, he has to provide proper reasons. However, it may rightly be questioned whether there is any advantage for the proceedings in forcing an unwilling administrator to remain in office, particularly as he cannot resign.<sup>391</sup>

Dismissal is regarded as a last resort and appropriate only if the administrator is suspected of committing serious offences such as embezzlement, fraud or bribery.<sup>392</sup> Insolvency administrators have also been dismissed for continuing the debtor's business in direct contravention of a resolution of creditors, displaying a lack of objectivity and independence, breaching the duty to report to creditors,<sup>393</sup> mixing money belonging to the insolvent estate with their own, and failure to draft an insolvency plan 18 months after being ordered to do so by the creditors' meeting.<sup>394</sup>

The administrator and the creditors' representatives must be heard before a decision is taken by the court whether to dismiss the insolvency administrator.<sup>395</sup> The

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<sup>388</sup> Braun *Commentary* at 165 par 512.

<sup>389</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 362-363.

<sup>390</sup> Braun *Commentary* at 165 par 514. In the case of the temporary disability of the insolvency administrator, it is preferable to appoint an administrator to take over his duties temporarily until he has recovered, rather than permanently replacing him. Eickmann, Flessner et al *Heidelberger Kommentar* at 362 also mention other serious grounds, such as negligent financial administration by the administrator, inadequate management and personal problems that are not of a temporary nature.

<sup>391</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 362.

<sup>392</sup> Braun *Commentary* at 165 par 515.

<sup>393</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 531.

<sup>394</sup> Runkel "Gläubiger" at 455.

<sup>395</sup> § 59(1). An immediate appeal by the administrator against his dismissal is allowed, as well as an immediate appeal by the applicant(s) against the court's refusal to dismiss: § 59(2).

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insolvency court must provide reasons for its decision because the administrator has an immediate right of appeal against a decision to dismiss, while the creditors' committee or any individual creditor may appeal against a decision not to do so, the last-mentioned only in cases where the application to dismiss was brought by the creditors' meeting.<sup>396</sup>

## **2.7.2 Powers and duties of directors**

### **2.7.2.1 Standard cases**

It is apparent from the discussion of the provisional order and appointment of a provisional insolvency administrator that the directors of a debtor company may be divested of some or all their management powers before the insolvency proceedings have even started.<sup>397</sup>

As soon as the commencement of insolvency proceedings has been ordered by the court, the right to manage and deal with property forming part of the insolvent estate is automatically transferred to the insolvency administrator.<sup>398</sup> This means that, although they are not removed from office, the directors of an insolvent company will no longer have any right to manage the company's business or dispose of any assets.<sup>399</sup> Any disposition in contravention of this prohibition will be invalid.<sup>400</sup> Furthermore, the office of insolvency administrator is of a highly personal nature, and as a result, he may not delegate his functions to the directors (or to any other person) except for purely administrative functions that are not related to the insolvency proceedings.<sup>401</sup>

Every director has a duty to disclose all relevant information (including incriminating information that could cause criminal or administrative action to be taken against him),<sup>402</sup> to support the administrator and to be available at all times, while the duty of disclosure also applies to every past director who vacated his office

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<sup>396</sup> § 59(2); Wimmer and Ahrens *Frankfurter Kommentar* at 532.

<sup>397</sup> See parts 2.2.2 and 2.5.1.1 above.

<sup>398</sup> § 80(1). § 148(1) also orders the insolvency administrator to immediately take possession of all property forming part of the assets subject to the insolvency proceedings.

<sup>399</sup> Flessner "Germany" at 323.

<sup>400</sup> § 81.

<sup>401</sup> Braun *Commentary* at 191 par 657.

<sup>402</sup> However, § 97(1) does offer some protection, as it prohibits the use of such incriminating information against him without his consent in a subsequent criminal trial or proceedings for an administrative offence.

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within two years before commencement of the insolvency proceedings.<sup>403</sup> If any of these persons refuse to co-operate, the court may order their detention until they comply with the court's request.<sup>404</sup>

#### 2.7.2.2 Self-administration

The InsO provides for an exception to the above standard procedure of the company being managed by an insolvency administrator. This exception, referred to as self-administration, appears to be a remnant of the initial intention to model the InsO on the United States Bankruptcy Code<sup>405</sup> and is loosely based on the principle of debtor in possession,<sup>406</sup> which is a distinctive feature of American insolvency law.<sup>407</sup> However, unlike the American system where the appointment of a trustee to take over the management of the debtor's business is an extraordinary measure<sup>408</sup> that the court will order only under very specific and exceptional circumstances,<sup>409</sup> self-administration is an exceptional procedure under German insolvency law and the debtor remains subject to supervision, albeit to a slightly lesser degree.

Self-administration must be ordered by the insolvency court at the same time that the order commencing insolvency proceedings is issued.<sup>410</sup> A self-administration order allows the debtor to manage and dispose of the assets that are subject to the insolvency proceedings, but under the supervision of a trustee<sup>411</sup> who is appointed instead of an insolvency administrator.<sup>412</sup> Therefore, the debtor is not given total control over his assets and affairs, and in reality self-administration is a highly watered-down version<sup>413</sup> of the American system of debtor in possession where the

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<sup>403</sup> § 97 read with § 101(1).

<sup>404</sup> § 98.

<sup>405</sup> Title 11, United States Code.

<sup>406</sup> Braun *Commentary* at 483 par 2230.

<sup>407</sup> The principle of debtor in possession means that the debtor (or its management) will ordinarily remain in possession and control of the estate and management of the business: Cowans *Bankruptcy Law* at 134-135.

<sup>408</sup> Epstein, Nickles and White *Bankruptcy* at 738 and 745.

<sup>409</sup> The grounds are set out in detail in s 1104 of the United States Bankruptcy Code and mainly refer to instances of fraud and mismanagement by the debtor.

<sup>410</sup> § 270(1).

<sup>411</sup> § 270(1).

<sup>412</sup> § 270(3).

<sup>413</sup> Ehlers "Statutory Corporate Rescue" at 154.

debtor has all the powers of a trustee.<sup>414</sup> According to Braun,<sup>415</sup> the system is based on the principle that the debtor may manage his current business while the trustee controls the management; Braun believes the position of the trustee to be much weaker than that of the administrator.

There is almost no difference, however, between the legal position of the trustee and that of the administrator.<sup>416</sup> The trustee is also appointed by the insolvency court and must meet the same requirements set for appointment as an insolvency administrator.<sup>417</sup> As in the case of an insolvency administrator, the first meeting of creditors may also elect another trustee to replace the one appointed by the court.<sup>418</sup>

§ 274(2) entrusts the trustee with the duty to verify the debtor's economic situation and monitor the management of his business to prevent mismanagement or transactions that could prejudice the creditors.<sup>419</sup> For this purpose he has the same rights of entry and inspection as a provisional administrator.<sup>420</sup> Should he find any evidence suggesting disadvantage to creditors as a result of self-administration, he must immediately inform the court and the creditors.<sup>421</sup> The trustee does not have the power to apply for cancellation of the self-administration order, but it is assumed that the creditors will do so once they have been informed of (potential) disadvantages.<sup>422</sup>

In spite of being nominally authorised to manage his own business, the debtor must obtain the consent of the trustee to incur any liabilities that are not in the ordinary course of his business.<sup>423</sup> The trustee may even object to transactions that are in the ordinary course of the business, in which case the debtor will also need his consent to those

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<sup>414</sup> The United States Bankruptcy Code explicitly gives the debtor in possession all the powers that a trustee would have if appointed: s 1107(a) of the Bankruptcy Code.

<sup>415</sup> *Commentary* at 485 par 2243 and at 487 par 2251.

<sup>416</sup> *Braun Commentary* at 487 par 2251.

<sup>417</sup> § 274(1) read with § 56: see part 2.5.1.2 above. All the other provisions applicable to the insolvency administrator regarding supervision by the court, dismissal, personal liability for damages caused by a wrongful breach of his duties, prescription of claims against him and remuneration have also been made applicable to the trustee: § 274(1) read with §§ 58-60 and 62-65.

<sup>418</sup> § 274(1) read with § 57: see part 2.7.1.1 above.

<sup>419</sup> *Braun Commentary* at 488 par 2254.

<sup>420</sup> § 274(2) read with § 22(3).

<sup>421</sup> § 274(3).

<sup>422</sup> § 272 regulating the revocation of the order is discussed below.

<sup>423</sup> § 275(1). According to *Braun Commentary* at 489 par 2256, the description of business operations contained in § 343 of the Handelsgesetzbuch (Commercial Code), namely that it includes all business that enables, promotes or maintains trade, should be used to ascertain what could be regarded as in the course of business. It should then be divided into ordinary and non-ordinary business, based on the articles of association or past business operations of the debtor company (par 2257).

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transactions.<sup>424</sup> Furthermore, the trustee may insist that all payments should be made only to and by him.<sup>425</sup> Contravention by the debtor of any of these provisions does not affect the validity of the transactions, even if the other contracting party knew that the trustee's consent was lacking, but it will expose the debtor to the risk of having the order authorising self-administration revoked by the court.<sup>426</sup>

In addition to requiring the approval of the trustee for some transactions, the debtor must also obtain the consent of the creditors' committee, if one has been appointed (which is not compulsory), to transactions that are of particular importance to the insolvency proceedings.<sup>427</sup> Some examples of such transactions are provided in the InsO<sup>428</sup> and include the sale of the business or its entire stock, immovable property to be sold by private sale, a loan agreement that will be secured by a considerable burden on the assets in the insolvent estate, and bringing, joining or avoiding a court action involving a considerable amount. Again, a transaction in contravention of these provisions will not affect the validity of the contracts concerned.<sup>429</sup> As a group, the creditors may also apply to court for an order that the consent of the trustee must be obtained for certain transactions, and the court will be compelled to grant the order without any reasons having to be advanced by the creditors. Any such transaction entered into without the required consent will be null and void.<sup>430</sup> The court may<sup>431</sup> grant a similar order on application by a single creditor, but the creditor must prove that the order is urgently required to prevent prejudice to the creditors.<sup>432</sup>

Unless the InsO provides otherwise, all the general provisions of the Code will apply to self-administration proceedings.<sup>433</sup> Creditors must file their claims with the trustee, but no endorsements in respect of the insolvency proceedings are made in the Land Register, ship or aircraft registers.<sup>434</sup>

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<sup>424</sup> § 275(1).

<sup>425</sup> § 275(2).

<sup>426</sup> Braun *Commentary* at 489 par 2258. See below for the discussion on § 274(3) regarding the trustee's duty to report any potential disadvantages to creditors and § 272(1) on their right to demand termination of self-administration.

<sup>427</sup> § 276.

<sup>428</sup> In § 160(2).

<sup>429</sup> § 276 read with § 164.

<sup>430</sup> § 277(1). The order must be published (§ 277(3)) to make it known as widely as possible.

<sup>431</sup> In this case the court has a discretion: Braun *Commentary* at 491 par 2266.

<sup>432</sup> § 277(2).

<sup>433</sup> § 270(1). These would include the provisions regarding the first meeting of creditors and the appointment of a creditors' committee: Braun *Commentary* at 484 par 2233.

<sup>434</sup> § 270(3). See fn 242 and fn 243 regarding the endorsement of registers.

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The general provisions regarding uncompleted contracts<sup>435</sup> also apply, except that the debtor now has the same choice that the insolvency administrator usually has, which is whether to perform or to repudiate the contract.<sup>436</sup> The debtor is supposed to exercise this right with the approval of the trustee, but failure to obtain such approval will not affect the validity of the debtor's actions.<sup>437</sup> However, the termination or amendment of an agreement with the works council<sup>438</sup> regulating employment conditions for employees and a decision to approach the Labour Court for termination of specific employment contracts, will be legal and binding only if the trustee has consented thereto.<sup>439</sup> However, only the trustee, and not the debtor, has the power to dispute the validity of transactions entered into by the debtor before insolvency.<sup>440</sup>

Should the creditors decide that an insolvency plan must be put in place, they have a choice whether to instruct the trustee or the debtor to do so.<sup>441</sup> If the instructions are directed to the debtor, the trustee must act as advisor.<sup>442</sup> The trustee must supervise the implementation of the insolvency plan in all cases.<sup>443</sup>

Only the debtor is entitled to apply for self-administration and particularly where the debtor is a company, this provision ensures that the directors and other managing organs of the company are prepared to take responsibility for the continued running of the business, as the proceedings would otherwise be doomed to failure.<sup>444</sup> Should the applicant for commencement of insolvency proceedings be a creditor, his consent (but not that of the other creditors) to self-administration by the debtor is an absolute requirement for such an order.<sup>445</sup>

A further requirement is that the court must be satisfied that an order of self-administration will not delay the process or cause any other disadvantages to the

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<sup>435</sup> Contained in §§ 103-128 of the Code.

<sup>436</sup> § 279.

<sup>437</sup> Braun *Commentary* at 492 par 2273.

<sup>438</sup> The system of a works council (Betriebsrat) that every company employing five or more people must establish allows ordinary workers to be actively involved in structuring their personal and social environment at plant level: see generally Du Plessis et al *German Corporate Governance* at 112-113 regarding the establishment and functions of the works councils.

<sup>439</sup> § 279 read with §§ 120, 122 and 126.

<sup>440</sup> § 280 read with §§ 129-147. The latter sections regulate what we know in South African insolvency law as voidable or impeachable dispositions: see Bertelsmann et al *Mars* at 248ff.

<sup>441</sup> § 284(1).

<sup>442</sup> § 284(1).

<sup>443</sup> § 284(2).

<sup>444</sup> Braun *Commentary* at 484 par 2235.

<sup>445</sup> § 270(2)1-2.

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creditors.<sup>446</sup> To establish whether this requirement has been met, a comparison must be made between the expected course of self-administration and that of standard proceedings, to establish whether any disadvantages for creditors can be foreseen should self-administration be ordered by the court.<sup>447</sup> Circumstances that indicate the possibility of such disadvantages are where the debtor is unwilling to co-operate with creditors, has contravened provisions of the insolvency legislation or appears to be inexperienced or unreliable.<sup>448</sup> The onus is on the debtor to prove the absence of any foreseeable disadvantages to creditors and not on the court to establish whether such circumstances exist.<sup>449</sup> However, this does not mean that the debtor has to show any particular advantages of self-administration over the standard procedure.<sup>450</sup>

In an effort to fulfil this condition, a corporate debtor that intends applying for self-administration will usually (partially or completely) replace its board of directors and managing director with insolvency and corporate rescue experts before the insolvency application is heard by the court. This step is intended to convince uneasy creditors that the necessary expertise to ensure the proper progress of self-administration is already present.<sup>451</sup> However, doubts have been raised about the independence of these experts in managing the company and protecting the interests of the body of creditors because they are often also involved as insolvency administrators in other cases. Supporters of such a management change point out that the directors of a company will seldom have the required knowledge of insolvency law to guarantee the proper running of the proceedings, and an insolvent company will furthermore only be able to continue operating in the market if a homogeneous management is in place.<sup>452</sup> Critics of this practice believe that there is a real risk of the new management only advancing the interests of and being unduly influenced by the major creditors, such as banks, to whom they owe their appointment in the first place.<sup>453</sup> A further valid criticism is that in some

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<sup>446</sup> § 270(2)3. See below for the negative influence this very onerous requirement has had on orders for self-administration.

<sup>447</sup> Braun *Commentary* at 484 par 2237.

<sup>448</sup> Braun *Commentary* at 484 par 2237. Schmidt and Ahrendt *Hamburger Kommentar* at 2136-2137 also list other indications that self-administration is not appropriate, such as failure by the company to compile financial statements over several years, fruitless rescue attempts by the debtor's management and obvious procrastination in bringing an insolvency application.

<sup>449</sup> Braun *Commentary* at 485 par 2239.

<sup>450</sup> Braun *Commentary* at 485 par 2239.

<sup>451</sup> Braun *Commentary* at 483 par 2232; Eickmann, Flessner et al *Heidelberger Kommentar* at 1165.

<sup>452</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 2137.

<sup>453</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 2137-2138.



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cases an insolvency expert who may not qualify for appointment as insolvency administrator, for instance because of a lack of independence because of previous services to the company, can be brought into the insolvency proceedings in this way.<sup>454</sup>

In practice an application for self-administration is often preceded by a visit of the debtor to the insolvency court to obtain the court's prior agreement to the order. If the application enjoys the support of the main creditors, their attendance at this meeting will almost guarantee that the court will agree to self-administration.<sup>455</sup> The reason for this is found in § 271, which entitles the creditors to apply for self-administration by the debtor if the debtor's application has been refused by the insolvency court. The decision to bring the application must be taken at the first meeting of creditors and the court is compelled to order self-administration if requested by the creditors. The insolvency administrator already appointed may be appointed as the trustee.<sup>456</sup>

The insolvency court must revoke the order allowing self-administration on application by the creditors on the strength of a majority decision taken at any creditors' meeting and without their having to supply reasons for this decision.<sup>457</sup> A single secured or unsecured creditor may also apply but must prove that self-administration can no longer be expected not to cause a delay or other disadvantage to creditors, before the court will cancel the self-administration order.<sup>458</sup> Where the application is brought by a single creditor, the debtor has the right to be heard before the court rules on the application and both the creditor and the debtor have an immediate right of appeal against the decision of the court.<sup>459</sup> The court must also cancel the order on application by the debtor, and again the Code does not require the debtor to provide any grounds for his application,<sup>460</sup> because self-administration clearly cannot be successful without the debtor's support and commitment.<sup>461</sup> If the court revokes the self-administration order, the former trustee may be appointed as insolvency administrator.<sup>462</sup>

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<sup>454</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 2139.

<sup>455</sup> Braun *Commentary* at 485 par 2241.

<sup>456</sup> § 271. An order for self-administration issued after commencement of insolvency proceedings must be published, as must the cancellation of such an order: § 273.

<sup>457</sup> § 272(1)1.

<sup>458</sup> § 272(1)2 read with § 270(2)3.

<sup>459</sup> § 272(2).

<sup>460</sup> § 272(1)3.

<sup>461</sup> Braun *Commentary* at 487 par 2248.

<sup>462</sup> § 272(3).

By allowing company boards to retain their management positions, the introduction of self-administration was intended to encourage them to file for insolvency at an early stage while the company still had sufficient liquidity to continue the business and a successful rescue was still possible.<sup>463</sup> Coupled with the simultaneous filing of a pre-packaged plan,<sup>464</sup> it offers the possibility of retaining the expertise of the current management and effecting an outcome similar to an informal out-of-court compromise but within the protection and structure of a formal insolvency procedure which binds dissenting minority creditors.<sup>465</sup>

Unfortunately, and not quite unexpectedly, self-administration has rarely been granted by the courts so far<sup>466</sup> and then mostly in very large corporate insolvencies<sup>467</sup> such as Kirch Media, Herlitz and Babcock Borsig.<sup>468</sup> Braun<sup>469</sup> ascribes the readiness of the courts to grant the order in these cases to the international nature of their businesses and to the fact that they had already appointed insolvency and reorganisation experts to their management before applying for an insolvency order. This step in particular was severely criticised by some commentators, who described it as a form of “self-selection of the insolvency administrator”.<sup>470</sup> However, self-administration has been allowed more frequently in recent years, also in smaller cases.<sup>471</sup> It is ironic that whereas self-administration is supposed to allow the present management to remain in place, their best chance of succeeding in an application for self-administration is actually to replace themselves with insolvency administrators before an insolvency order has even been issued.

The failure of self-administration to become more widely accepted in insolvency proceedings has been partly due to the fact that it was a new and unknown procedure<sup>472</sup>

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<sup>463</sup> Ehlers “Statutory Corporate Rescue” at 174; Flessner “Germany” at 316.

<sup>464</sup> See part 2.8.1 below.

<sup>465</sup> Ehlers “Statutory Corporate Rescue” at 174-175.

<sup>466</sup> Häsemeyer *Insolvenzrecht* at 188. In 2002 self-administration was ordered in 235 cases, in 2003 only 185 and in 2004 it dropped to 173: Eickmann, Flessner et al *Heidelberger Kommentar* at 1167.

<sup>467</sup> The legislature mainly intended self-administration to be available for smaller businesses, but in practice the exact opposite has happened, with most self-administration orders made in respect of big corporations: Wimmer and Ahrens *Frankfurter Kommentar* at 1376.

<sup>468</sup> Ehlers “Statutory Corporate Rescue” at 175-176.

<sup>469</sup> *Commentary* at 483 par 2232.

<sup>470</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 1167.

<sup>471</sup> Braun *Insolvenzordnung* at 1308.

<sup>472</sup> See, however, Flessner “Germany” at 325, who believes that it should not be unfamiliar to insolvency practitioners, as it contains some elements of the previous compromise in terms of the Vergleichsordnung: see part 1 above.

and was consequently treated by both the courts and commentators with some suspicion and misgivings<sup>473</sup> – this is, after all, the country where a substantial group of prominent insolvency lawyers strongly canvassed for the retention of the Bankruptcy Act<sup>474</sup> that was more than 100 years old, rather than the introduction of a new Insolvency Code.<sup>475</sup> Indeed, during the reform process that preceded the introduction of the InsO a fierce debate raged on whether it was appropriate or harmful to introduce self-administration.<sup>476</sup> Debtors have also been to blame for the reluctance of the courts to order self-administration: in spite of the possibility of applying for an insolvency order based on imminent illiquidity, most debtors are already unable to pay their debts when they apply, which results in a total loss of confidence in management, thereby effectively excluding self-administration from even being considered.<sup>477</sup>

Another reason already mentioned above for the small number of self-administration orders is that the courts are reluctant to accept that such an order will not prejudice the creditors in any way.<sup>478</sup> This requirement is reminiscent of the prerequisite that a court in South Africa may grant a judicial management order only if satisfied that, *inter alia*, it would be just and equitable.<sup>479</sup> Both requirements are onerous, vague and thus open to wide interpretation, and almost impossible to prove at an early stage, with the result that in Germany, as in South Africa, the courts are generally unwilling to accept that this requirement has been met. Here again one sees evidence that the InsO is primarily geared towards liquidation for the benefit of creditors, and the aspect of business rescue appears to be an uncomfortable appendage that does not fit in with the overall scheme of the Code.

Therefore, in spite of the legislature's best intentions to create a modern system based on the liberal American model, self-administration has remained mostly a

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<sup>473</sup> Ehlers "Statutory Corporate Rescue" at 154; Schmidt and Ahrendt *Hamburger Kommentar* at 2138. This shows a strong similarity to the extremely conservative, almost hostile treatment by the courts of judicial management when first introduced into South African law – one of the main reasons why judicial management never became a widely accepted rescue measure: see Chapter 2, part 2.4.4.

<sup>474</sup> Konkursordnung of 10 February 1877, Reichgesetzblatt (RGBl S. 351).

<sup>475</sup> See part 1 (Introduction) above. The Gravenbrucher Kreis (referred to in part 2.7.1.2.2 above) was specifically formed by successful insolvency administrators to oppose the recommendations of the Insolvency Committee: see Balz and Landfermann *Insolvenzgesetze* at XXXIV. See also part 1, fn 11 above.

<sup>476</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 1163; Kamlah "German Insolvency Act" at 433.

<sup>477</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 13.

<sup>478</sup> As required by § 270(2)3. See Braun *Commentary* at 483 par 2232.

<sup>479</sup> See Chapter 2, part 2.3.4.

theoretical option that is tolerated in only a very limited number of highly exceptional cases.<sup>480</sup> Flessner<sup>481</sup> maintains that the drafters of the Insolvency Code intended self-administration to be an exceptional procedure, although they refrained from including a stipulation to that effect in the Code.

The decision by the German legislature not to favour rescue over liquidation but to treat business rescue as merely an optional step in the insolvency proceedings with the concomitant priority given to the creditors and their interests, as well as the reluctance of the courts to allow self-administration, have also had another unforeseen consequence: recently, several large German companies operating internationally have chosen to move their headquarters to England when they experience financial distress, in order to make use of the administration procedure and the company voluntary arrangement to attempt a rescue of the company itself.<sup>482</sup> This is surely an indication that there is a need for specific and dedicated corporate rescue procedures that, while protecting the interests of creditors, have the rescue of the business or corporation as their first priority.

## 2.8 The insolvency plan

Before the enactment of the InsO, insolvency lawyers in Germany had developed the system of “übertragende Sanierung” (reorganisation by transfer), which constituted the only realistic option to rescue a debtor’s business but was not formally regulated in insolvency law.<sup>483</sup> This procedure involved the sale of all the assets required to continue the debtor’s business (or part thereof) to a new entity specifically incorporated or acquired for this purpose, and the consequent liquidation and dissolution of the debtor company. The disadvantage of this procedure was that

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<sup>480</sup> Braun *Commentary* at 59 par 9. However, see Hess *Insolvenzrecht* at 3571-3572 on the view now widely held that it has many advantages and thus the potential to become an important procedure, in spite of the risks involved for creditors and the business of the debtor as a result of the obvious possibilities for abuse.

<sup>481</sup> “Germany” at 325; also Eickmann, Flessner et al *Heidelberger Kommentar* at 1165.

<sup>482</sup> 18 July 2007 *Business Report* at 22; Tashiro and Beissenhirtz “German Companies”. This is made possible by the wide interpretation of “centre of main interests” (COMI) of a company by the English courts who look at the location where management decisions are taken (where the mind of management is) rather than the visible commercial activities of the company: Ehlers “Statutory Corporate Rescue” at 179. The COMI originates from the European Insolvency Code 1346/2000 of 29 May 2000, which has been introduced into the English Insolvency Act of 1986 as s 1(4): see Chapter 3, part 2.2 fn 36.

<sup>483</sup> Ehlers “Statutory Corporate Rescue” at 154.

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some assets, particularly incorporeal assets such as official permits or long-term contracts, could not be transferred to the new entity.<sup>484</sup> Another major disadvantage was that the transfer of a business or part thereof to a purchaser resulted in all employment contracts, as well as claims of employees against the previous employer, being transferred to the purchaser as well.<sup>485</sup>

However, this disadvantage now substantially applies to a business or asset transfer within insolvency proceedings as well, because Germany decided to exercise the choice allowed by the EC Directive, in favour of also making these provisions applicable to transfers after the commencement of insolvency proceedings.<sup>486</sup> This decision was taken in spite of strong lobbying during the reform process to exclude operation of the rule during insolvency in order to facilitate the rescue of businesses. The government based its decision on the belief that a business rescue attempted during insolvency proceedings should not be given this advantage over a rescue attempt outside insolvency.<sup>487</sup> The decision by the German legislature is regrettable and difficult to explain since some form of relief from this rule, especially if included in an insolvency plan, would have made the option of a plan far more attractive. It is also in direct contrast to the express desire of the legislature to encourage business owners to apply for an insolvency order as soon as possible, and preferably before actual insolvency or illiquidity occurs.<sup>488</sup> There can be no doubt that any attempted rescue of a business will invariably require retrenchments to save costs, and making them just as difficult to effect inside insolvency, whether with or without an insolvency plan, as outside insolvency, will not change this fact but merely add to the factors working against attempting any rescue.<sup>489</sup> Wimmer and Ahrens<sup>490</sup> believe that the emphasis that has been placed on the retention of jobs has had the effect that the public measures the success of an insolvency plan process purely on whether jobs

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<sup>484</sup> Braun *Commentary* at 423 par 1798. But see part 3 below where it is also identified as a potential problem in the implementation of an insolvency plan.

<sup>485</sup> § 613a of the Civil Code, which is the implementation of EC Directive 77/187/EEC, [1977] OJ L 61/26.

<sup>486</sup> Ehlers "Statutory Corporate Rescue" at 159 fn 32.

<sup>487</sup> Flessner "Germany" at 348.

<sup>488</sup> See in particular the discussion in part 2.4.2 on the reasons for the introduction of imminent illiquidity as a ground for an insolvency order.

<sup>489</sup> See Flessner "Germany" at 349 regarding the potential financial burden of employee claims on an insolvent estate and the limits placed on them by the InsO.

<sup>490</sup> *Frankfurter Kommentar* at 1361.

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were saved, even if only over the short term, as is often the case. As a result, more economically sound practices that should be part of an insolvency plan often have to yield to the strong public pressure that the plan must primarily save jobs.

Although a compromise was possible in terms of both the *Konkursordnung* and the *Vergleichsordnung*, the high percentage of votes required by both pieces of legislation for approval of the compromise was rarely reached and ensured that composition did not present a viable alternative.<sup>491</sup>

The InsO therefore specifically addresses this deficiency by providing for the option of an insolvency plan that may alter the normal course of events prescribed by the Code for the payment of creditors' secured<sup>492</sup> and unsecured claims, the liquidation and distribution of the debtor's assets, and the liabilities of the debtor after termination of the insolvency proceedings.<sup>493</sup> Claims that are payable as costs of the insolvency proceedings<sup>494</sup> are not included in the plan.<sup>495</sup>

Although Chapter 11 of the American Bankruptcy Code<sup>496</sup> served as a model for the insolvency plan contained in the InsO, there are several differences between the provisions regulating the respective plans. One of the fundamental differences is that, whereas a Chapter 11 plan provides specifically for the reorganisation and thus rescue of the corporate entity, the InsO allows almost complete freedom in the contents and envisaged outcome of the plan, including liquidation, a sale of assets, restructuring of the business or merely deferring payment of creditors' claims, or any combination of them.<sup>497</sup>

The submission of an insolvency plan is not compulsory, and if no plan is submitted, the regular procedure of liquidation and dissolution of the company will be followed. However, an insolvency plan may also provide for liquidation, particularly in the context of an "übertragende Sanierung".<sup>498</sup> As mentioned before,<sup>499</sup> the InsO does not favour either straightforward liquidation or the submission of an insolvency

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<sup>491</sup> Braun *Commentary* at 423 par 1800.

<sup>492</sup> The provision that secured creditors may also be included in the plan and bound by it is one of the major innovations of the InsO: Flessner "Germany" at 359.

<sup>493</sup> § 217.

<sup>494</sup> In terms of §§ 53-55.

<sup>495</sup> Braun *Commentary* at 425 par 1816; Eickmann, Flessner et al *Heidelberger Kommentar* at 1053.

<sup>496</sup> Title 11, United States Code.

<sup>497</sup> Braun *Commentary* at 424 pars 1804-1811; Ehlers "Statutory Corporate Rescue" at 162-163.

<sup>498</sup> Braun *Insolvenzordnung* at 1184.

<sup>499</sup> See part 2.1 above.

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plan, and it is left to the debtor and the insolvency administrator to decide on the most appropriate course. The aim of the InsO is thus to give total autonomy to the persons involved to decide on the best possible way deal with the debtor's insolvency.<sup>500</sup> None the less, Braun<sup>501</sup> classifies insolvency plans into the following six main groups:

- (i) liquidation plans where assets are sold separately and the proceeds distributed to creditors. This type of plan changes the normal procedure for the sale of assets by, for example, providing for a longer period over which assets will be sold or the way in which secured assets will be dealt with.<sup>502</sup> The end result remains the destruction and dissolution of the company as in a liquidation without an insolvency plan;<sup>503</sup>
- (ii) rescue plans where the aim is the survival of the corporate entity and continuation of the business by the same entity. These plans would normally include a reduction in or postponement of the payment of debts;<sup>504</sup>
- (iii) transfer plans where the debtor's assets are also sold, not individually as in a liquidation plan, but as a unit to enable the new owner to continue the business or part of it;
- (iv) mixed plans, such as one providing for liquidation of part of the business that has been suffering heavy losses but rescuing the viable part of the business;
- (v) other plans that do not regulate the way in which the assets should be dealt with, but rather change the normal payments to creditors as regulated by statute by, for example, exchanging monetary payments for other benefits; and
- (vi) procedural plans amending the prescribed procedure or course of the insolvency process, for example by providing that the business will be continued for a limited period to complete a profitable contract and then liquidated, thereby increasing the eventual payment to creditors.

In the first few years after the enactment of the InsO, very few insolvency plans were filed.<sup>505</sup> The reason for this low rate is partly explained by the lack of a rescue

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<sup>500</sup> Braun *Insolvenzordnung* at 1183; Eickmann, Flessner et al *Heidelberger Kommentar* at 1048.

<sup>501</sup> *Insolvenzordnung* at 1186-1188. Eickmann, Flessner et al *Heidelberger Kommentar* at 1053 follow more or less the same classification system, but point out that in practice a plan rarely falls into just one of the specific categories and is thus usually a combination or mixed plan.

<sup>502</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 1053.

<sup>503</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 1367.

<sup>504</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 1049.

<sup>505</sup> Only in 539 cases in the first five years: Ehlers "Statutory Corporate Rescue" at 184.

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culture in German insolvency law, where insolvency is still widely regarded as shameful and an insolvent debtor treated with mistrust.<sup>506</sup> Therefore, the main purpose of insolvency proceedings has always been to ensure that the debtor pays as much as possible to satisfy his liabilities and not to provide a way out for a company in distress.<sup>507</sup> Another explanation is the simple fact that this was a new procedure and it was to be expected that it would take time to become a significant feature of insolvency law in Germany.<sup>508</sup> However, in more recent times there has been a discernible change in this attitude,<sup>509</sup> and the provision of more than one option in the InsO to deal with a business in distress must in itself be regarded as substantial progress.<sup>510</sup>

It should come as no surprise that liquidation and the subsequent disposal of a business as a going concern (often as part of an “übertragende Sanierung”), rather than its reorganisation by way of an insolvency plan, continue to be the proceeding favoured by insolvency practitioners in Germany.<sup>511</sup> Practitioners see little reason to choose reorganisation over liquidation, the procedure with which they are more familiar, especially as there is very little incentive to choose the more complicated and lengthy procedure required for an insolvency plan when the outcome is going to be virtually the same in most cases.

An interesting comment on the German insolvency plan procedure was made during its early stages and it is one that is also relevant to the South African situation where there seems to be a great deal of optimism about the new business rescue proceedings. This comment almost served as a warning that an insolvency plan providing for the rescue of a business should be an instrument to intervene extensively in the dysfunctional financial and managerial structure of the business

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<sup>506</sup> Ehlers “Statutory Corporate Rescue” at 153-154.

<sup>507</sup> The general attitude to business rescues was described by Schmidt “Insolvenzrechtsreform” at 624, who declared that the best rescues took place silently and quickly, in other words, outside insolvency proceedings.

<sup>508</sup> Braun *Insolvenzordnung* at 1188; Bertram and Gottwald *Insolvenzrechtshandbuch* at 22 state that it will presumably take some time before everybody is comfortable with this new insolvency instrument.

<sup>509</sup> When the model train manufacturer, Märklin, recently filed for insolvency, its directors declared that they intended to restructure their business by using the instruments provided by German insolvency law and to permanently establish the company in the market: 5 February 2009 *Spiegel Online International* <<http://www.spiegel.de/international/business>> accessed on 5 February 2009.

<sup>510</sup> Ehlers “Statutory Corporate Rescue” at 184-185.

<sup>511</sup> Aleth “Germany” at 134; Braun *Commentary* at 62 par 27; Ehlers “Statutory Corporate Rescue” at 153 and 184; Häsemeyer *Insolvenzrecht* at 689-690.



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and to improve and rectify it. It should not merely be the result of a rescue euphoria that ignores the obstacles and insists on reviving a business that will soon become insolvent again.<sup>512</sup> Almost the same sentiments were expressed by Schmidt,<sup>513</sup> who referred to some commentators' mistaken belief that the *Konkursordnung* had been a bad piece of legislation and that the legislative change introduced by the *InsO* could guarantee that many insolvent businesses would be rescued.

### 2.8.1 Power to submit an insolvency plan

Only the insolvency administrator or the debtor may submit an insolvency plan to the insolvency court.<sup>514</sup> Although the legislature initially also considered allowing shareholders holding at least 20 per cent of the company's share capital as well as creditors to submit an insolvency plan, the idea was abandoned in an effort to simplify the procedure and to avoid the possibility of conflicting insolvency plans being submitted by different groups of creditors.<sup>515</sup>

However, although the shareholders of a company are not included in the plan procedure, their co-operation will become unavoidable if the plan provides for the company to remain in existence and continue its business: the legislation regulating the various forms of corporate entities all require a resolution to continue the business by a prescribed majority of the shareholders.<sup>516</sup> A plan that involves any change in ownership of the company, for example by raising new share capital, or any matter that requires a change in the constitution of the company, will also be doomed if the shareholders do not agree, and in such a case the plan would have to be made conditional on the necessary approval being given by shareholders. Ehlers<sup>517</sup> regards this exclusion of shareholders as one of the obstacles to making the choice and implementation of an insolvency plan an attractive option because uncooperative shareholders can obstruct a plan for quite irrational reasons by, for example, refusing their consent to the cession of important contracts and licenses to a new entity in the case of a restructuring by transfer.<sup>518</sup>

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<sup>512</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 1361.

<sup>513</sup> *Gesellschaftsrecht* at 320.

<sup>514</sup> § 218(1).

<sup>515</sup> *Ausschussbericht* Zu den §§ 254, 255: Balz and Landfermann *Insolvenzgesetze* at 328.

<sup>516</sup> Braun *Commentary* at 428 par 1837; Flessner "Germany" at 362; Frank "Insolvenzplan" at 1192.

<sup>517</sup> "Statutory Corporate Rescue" at 171-172.

<sup>518</sup> See part 2.8 above where this is also mentioned as one of the disadvantages of a reorganisation by transfer ("übertragende Sanierung").

Flessner<sup>519</sup> points out that the decision to keep the shareholders out of the plan – a decision that he believes has never been adequately explained by the legislature – will in many instances give those shareholders a veto over the insolvency plan, in direct conflict with the principle that shareholders' rights are the first to be eliminated once a company is placed in insolvent liquidation and unable to pay all its debts.<sup>520</sup> He finds it regrettable that this is one of the points on which the German system differs noticeably from the Chapter 11 procedure in America.

I submit that this issue reveals another major disadvantage of a rescue procedure that is part of or linked to insolvency: in a dedicated and independent rescue procedure the shareholders have a real interest in the outcome because a successful rescue will prevent liquidation and the resultant complete eradication of their investment. Thus they can (and should) be fully participating parties in the rescue proceedings, with the necessary voting rights to approve or reject a rescue plan.<sup>521</sup>

The debtor may submit an insolvency plan simultaneously when filing the application for an insolvency order: the so-called pre-packaged plan that can substantially shorten the duration of the insolvency proceedings to as little as five or six weeks<sup>522</sup> and presents the debtor with a unique opportunity to steer the statutory insolvency process away from liquidation.<sup>523</sup> Another advantage of submitting such a plan is that the intended results of the insolvency proceedings – particularly the reorganisation and continued existence of the company and its business – are made clear to all interested parties at an early stage.<sup>524</sup> This could limit some of the damage that a company's reputation and future business prospects usually suffer when its financial problems are made public. In this respect the procedure has a significant advantage over business rescue proceedings in South Africa where no provision has been made for pre-packaged plans while several provisions will actively discourage companies from attempting this measure, as it may trigger hostile actions by other affected parties.<sup>525</sup>

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<sup>519</sup> "Germany" at 362.

<sup>520</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 1370 also believe that the matter should have been regulated in the InsO.

<sup>521</sup> See further Loubser "Shareholders" at 372-373 and 389-390. Unfortunately, the South African legislature did not use the advantage of rescue proceedings being separated from insolvency proceedings to include shareholders in the rescue procedure: see Chapter 2, part 3.8.3.

<sup>522</sup> Braun *Commentary* at 426 par 1823; Ehlers "Statutory Corporate Rescue" at 174.

<sup>523</sup> Frank "Insolvenzplan" at 1154.

<sup>524</sup> Braun *Commentary* at 426 par 1822.

<sup>525</sup> Particularly the trade unions and employees: see Chapter 2, parts 3.3.2.3 and 3.5.1.2.

The insolvency administrator (but not the provisional administrator)<sup>526</sup> may also submit a plan, either on his own initiative or on the instructions of the creditors' meeting. The administrator is obliged to give a full report to the first meeting of creditors on the economic situation of the company, the reasons for its failure and his assessment of the prospects of the company's business (or part of it) being continued, including the possibilities presented by an insolvency plan.<sup>527</sup> If the meeting instructs the administrator to draft an insolvency plan, he must do so within a reasonable time,<sup>528</sup> which is not fixed by the legislation but must be determined according to the facts and complexity of the specific case.<sup>529</sup>

There is some controversy over the extent to which the creditors' meeting may prescribe the contents of the plan to be drafted by the insolvency administrator, with some commentators believing that the creditors may present the administrator with a complete plan that he must submit.<sup>530</sup> The administrator retains his right to submit his own plan, however, and as a result, three competing insolvency plans may be submitted: one by the debtor, another by the administrator and yet another by the administrator but drafted according to the instructions of the meeting of creditors.<sup>531</sup> The legislature seems to have assumed that where more than one plan has been submitted, all but one will be abandoned or rejected in the course of the process.<sup>532</sup>

The insolvency administrator is in any event obliged to consult the creditors' committee (if one has been appointed), the works council (Betriebsrat), a representative of the company's managing officers and the debtor on any plan drafted by the administrator.<sup>533</sup>

An insolvency plan submitted after the final meeting of creditors has been held to approve the final distribution account of the administrator<sup>534</sup> will be ignored.<sup>535</sup> Therefore, by implication a plan may be submitted at a fairly late stage in the

<sup>526</sup> Braun *Commentary* at 427 par 1825.

<sup>527</sup> § 156(1). The court determines the date of this meeting as part of the insolvency order: see part 2.5.2 above.

<sup>528</sup> § 218(2).

<sup>529</sup> Braun *Commentary* at 427 par 1827. In a fairly straightforward case, up to four weeks could be reasonable: Frank "Insolvenzplan" at 1171.

<sup>530</sup> Braun *Commentary* at 427 par 1828.

<sup>531</sup> Braun *Commentary* at 427 par 1830; Frank "Insolvenzplan" at 1173.

<sup>532</sup> Flessner "Germany" at 359.

<sup>533</sup> § 218(3).

<sup>534</sup> The meeting is called by the insolvency court before it consents to the final distribution: § 197.

<sup>535</sup> § 218(1).

proceedings when realisation of the insolvent estate has already started. To increase the chances of a successful business rescue as envisaged in the plan, which requires that assets should be retained by the estate, the debtor or administrator may apply to the insolvency court for an order suspending any further disposition and distribution of assets from the estate in so far as it may jeopardise the execution of an insolvency plan that has been submitted.<sup>536</sup> The court must, however, refuse or cancel such a suspension order if it will cause substantial disadvantage to the assets in the estate<sup>537</sup> or if, with the consent of the creditors, the administrator requests that the disposition and distribution of assets be continued.<sup>538</sup> If the creditors want the realisation and distribution to continue, however, the court must refuse or rescind the order without further investigation.<sup>539</sup>

### 2.8.2 Contents of the plan

Although the details of the plan itself are not prescribed and the drafter of the plan is free to design whatever plan seems appropriate, the InsO does prescribe that every insolvency plan must consist of a descriptive or declaratory part and a constructive part, and be accompanied by the attachments stipulated in §§ 229 and 230.<sup>540</sup>

#### 2.8.2.1 The descriptive part<sup>541</sup>

The descriptive part of the plan must explain the measures taken or still to be taken after commencement of the insolvency proceedings to lay the groundwork for the intended reorganisation of the parties' rights.<sup>542</sup> It must also contain all other information regarding the basis and effects of the plan that creditors may require to decide whether to approve the plan and that the court may need for confirmation

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<sup>536</sup> § 233. Frank "Insolvenzplan" at 1228 points out that, contrary to the wording of this provision, the application should be made before the realisation of assets has begun or the plan has been jeopardised, otherwise it is probably too late to be effective.

<sup>537</sup> The prime example of such disadvantage mentioned in the explanatory notes to the draft legislation is where a sale of the business that would be to the advantage of the creditors would be blocked and consequently fall through completely: *Begründung RegE Zu 277*: Balz and Landfermann *Insolvenzgesetze* at 348.

<sup>538</sup> § 233.

<sup>539</sup> Frank "Insolvenzplan" at 1229.

<sup>540</sup> § 219. The attachments are discussed below.

<sup>541</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 1390 explain that this is the equivalent of the disclosure statement required by the American Bankruptcy Code in a Chapter 11 reorganisation plan.

<sup>542</sup> § 220(1).

thereof.<sup>543</sup> In particular it must contain a comparison between the results of a regular liquidation and those of the plan, enabling creditors to determine the extent to which they will be better off as a result of the implementation of the insolvency plan.<sup>544</sup>

This part usually starts with a preamble indicating the main objectives of the insolvency plan, such as the continuation, transfer or breaking up of the business.<sup>545</sup> It is also essential to include a history of the business and the reasons why it failed, as well as detailed information on matters such as products, sales and financial circumstances to demonstrate the viability of the business. This is necessary to convince creditors to whom payment is deferred in terms of the plan that the business has the potential to become successful and eventually pay their claims.<sup>546</sup>

#### 2.8.2.2 The constructive part

The constructive part must explain how the legal position of the parties involved will be altered by the insolvency plan.<sup>547</sup> For the purposes of this part of the plan, the creditors must be classified in different groups according to their legal standing, namely secured creditors<sup>548</sup> (if their rights are to be affected),<sup>549</sup> non-lower-ranking creditors and every class of lower-ranking creditors<sup>550</sup> unless their claims are deemed to be waived in terms of § 225(1).<sup>551</sup> Based on the assumption that there will in most cases not be sufficient assets available to pay the lower-ranking creditors, their claims are deemed waived unless the insolvency plan provides otherwise, and therefore they will normally not be part of the insolvency plan.<sup>552</sup>

The plan may create further subgroups by grouping together creditors with equal rights and the same economic interests on condition that the groups are properly

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<sup>543</sup> § 220(2).

<sup>544</sup> Burger and Schellberg "Insolvency Plan" at 10; Frank "Insolvenzplan" at 1176.

<sup>545</sup> Braun *Commentary* at 429 par 1841.

<sup>546</sup> Braun *Commentary* at 429 par 1842.

<sup>547</sup> § 221.

<sup>548</sup> In German law they are not referred to as secured creditors, but as creditors entitled to separate satisfaction, indicating that they have the right to be paid from the proceeds of the specified asset securing the particular claim.

<sup>549</sup> Unless the insolvency plan provides otherwise, the right of such creditors to the payment of their claims from the assets subject to their security will not be affected: § 223(1).

<sup>550</sup> As defined in § 39, such as interest accrued after commencement of insolvency proceedings, costs of creditors as a result of participating in insolvency proceedings, fines and administrative penalties.

<sup>551</sup> § 222(1).

<sup>552</sup> Lower-ranking creditors may submit their claims against the estate only if expressly invited to do so by the court: § 174(3). Even then, they will not have any voting rights: § 77(1).

separated from each other and the criteria for their classification are indicated in the plan.<sup>553</sup> Employees must be classified as a separate group if they are claiming substantial amounts as creditors of the estate,<sup>554</sup> while separate groups may also be formed for minor creditors.<sup>555</sup>

The insolvency plan must indicate in detail how each group of creditors will be affected: the amount by which their claims will be reduced, the duration of the postponement of payments, the securities they will receive and any other applicable provisions.<sup>556</sup> All members of a group must be offered the same rights unless all members of the group give their written consent to some of them being treated differently.<sup>557</sup>

If the plan provides for deferred payment to creditors from funds generated by continuation of the debtor's business, the constructive part may, and usually would, also contain provisions for surveillance of the implementation of the plan after the insolvency proceedings have formally ended.<sup>558</sup> It could take several years before these creditors are paid in full, and this measure is intended to ensure that the debtor will fulfil his obligations to them. However, the surveillance period is restricted to three years, after which the insolvency court will automatically terminate it if it is still in force.<sup>559</sup> Payment of creditors' claims by a company or other entity that was specifically incorporated to take over or continue the debtor's business or a part of it may also be included in the surveillance by a provision to that effect in the plan.<sup>560</sup> The plan could also provide for surveillance of the debtor's performance of any other

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<sup>553</sup> § 222(2).

<sup>554</sup> The test is whether the claim is substantial for the employees concerned and not in relation to other claims against the estate: Braun *Commentary* at 431 par 1854. Remuneration is not included here, as wage and salary claims for up to three months before insolvency proceedings are not claimed from the insolvent estate but from the Federal Labour Agency: Braun *Commentary* at 431 par 1852. Claims for more than three months' arrear wages are classified as ordinary concurrent claims against the estate: Flessner "Germany" at 346.

<sup>555</sup> § 222(3). This is measured in relation to other claims, and such a group is usually formed if the total of these minor claims does not constitute more than 5 per cent to 10 per cent of all claims: Braun *Commentary* at 431 par 1855.

<sup>556</sup> §§ 223(2) and 224 in respect of secured and non-lower-ranking creditors respectively. If there will be sufficient funds to also pay lower-ranking claims after paying the non-lower-ranking creditors, the same details must also be included in respect of the lower-ranking claims: § 225(2).

<sup>557</sup> § 226.

<sup>558</sup> § 260.

<sup>559</sup> § 268(1). See also the discussion in part 2.9 below.

<sup>560</sup> § 260(3). This would, for example, apply in the case of a so-called "übertragende Sanierung" if it forms part of an insolvency plan.

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obligations under the plan.<sup>561</sup> The surveillance is normally carried out by the insolvency administrator under the supervision of the insolvency court, while the creditors' committee continues to protect the interests of the creditors.<sup>562</sup> During the period of surveillance, the administrator must report annually to the creditors' committee and to the insolvency court on the progress and prospects of implementation of the plan.<sup>563</sup> However, if any due performance is not or cannot be fulfilled, the administrator must immediately inform the insolvency court and the creditors' committee or, if there is none, all the creditors entitled to payment.<sup>564</sup> The creditors must then decide which measures to take.<sup>565</sup>

As an additional precaution, the constructive part of the plan may provide that during the period of surveillance, specific transactions will require the consent of the administrator to be valid and binding.<sup>566</sup> The plan may also provide for preferent status for claims based on loans taken up by the company during surveillance but subject to a maximum amount.<sup>567</sup>

The plan may provide for the appointment of a person other than the administrator to carry out the surveillance, but in such a case the statutory provisions are not applicable and no supervision by the insolvency court takes place.<sup>568</sup>

It must be emphasised that since the surveillance takes place after the formal termination of the insolvency proceedings, it does not form part of such proceedings. For this reason, the costs must be paid by the debtor or the takeover company.<sup>569</sup> Furthermore, it is only the payment of creditors' claims in terms of the insolvency plan that is monitored, and not the running of the debtor's business.<sup>570</sup>

Contrary to the provision in the Companies Act 2008 requiring that the business rescue plan must stipulate the extent to which the company is to be released from

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<sup>561</sup> Braun *Commentary* at 473 par 2169.

<sup>562</sup> § 261(1). For this reason none of these persons are relieved from office on termination of the insolvency proceedings: see further part 2.9 below.

<sup>563</sup> § 261(2).

<sup>564</sup> § 262.

<sup>565</sup> Braun *Commentary* at 476 par 2191. See part 2.8.4 below for the measures available to a creditor in the case of non-fulfilment of an approved and confirmed plan.

<sup>566</sup> § 263.

<sup>567</sup> § 264.

<sup>568</sup> Braun *Commentary* at 475 par 2180.

<sup>569</sup> § 269.

<sup>570</sup> Braun *Commentary* at 474 par 2174.

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payment of its debts,<sup>571</sup> the InsO has simplified the matter by simply providing that unless the plan provides otherwise, the debtor shall be discharged of any residual obligations to creditors after paying them as stipulated in the plan.<sup>572</sup>

### 2.8.2.3 Attachments

The InsO provides for certain attachments that must accompany the insolvency plan where applicable. The first attachment is required if the plan provides for the satisfaction of creditors' claims from the future earnings of the business that is to be continued by the debtor or another person. This document must contain a list of all assets (with their values) and liabilities of the business, as well as the expected income and expenses of the company for the duration of the period until creditors have been paid, and a financial plan showing how liquidity is to be maintained during this period.<sup>573</sup> Although not specifically required by the InsO, a comparative account indicating what the financial situation would be if there were no plan and the business were to be liquidated is also necessary. This is intended to assist both the creditors and the court in deciding whether the insolvency plan would have a better outcome than the ordinary liquidation of the business.<sup>574</sup>

The second type of attachment is required if the insolvency plan provides for creditors to acquire shares, membership or participation rights in a company. In this case, a statement from each such creditor consenting to the transfer of these rights to him must be attached to the insolvency plan.<sup>575</sup> The reason for this requirement is that the legislature wanted to ensure that no creditor would be forced against his will to take up membership or participation rights in a company instead of being paid cash for his claim.<sup>576</sup>

Finally, in the event of a third party's agreeing to take over any obligations to the creditors if the insolvency plan is approved, a statement by such third party in which the details of these obligations are set out must accompany the insolvency plan.<sup>577</sup> The legislature envisaged possibilities such as a holding company being willing to

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<sup>571</sup> Section 150(2)(b)(ii) discussed in Chapter 2, part 3.8.2.2.

<sup>572</sup> § 227.

<sup>573</sup> § 229.

<sup>574</sup> Braun *Commentary* at 437 par 1898.

<sup>575</sup> § 230(2).

<sup>576</sup> *Begründung RegE Zu § 274*: Balz and Landfermann *Insolvenzgesetze* at 344.

<sup>577</sup> § 230(3).



take over some debts of its subsidiary, or that a third party wishing to continue the business would undertake to pay the company's debts. The intention behind this requirement of an explanatory statement is to ensure that creditors can judge the exact extent of the obligations to be undertaken.<sup>578</sup>

### 2.8.3 Approval of the plan

#### 2.8.3.1 Preliminary review

Every plan submitted to the insolvency court is subjected to a preliminary examination by the court to determine whether it meets the fundamental requirements of the InsO. This is clearly aimed at putting a stop to unsuitable or unworkable plans right at the beginning before too much time or money is wasted on them.

In terms of § 231(1), the insolvency court must *mero motu* reject an insolvency plan that falls into one of the following categories:

- (i) A plan that does not comply with the provisions regulating the right to submit a plan or the prescribed contents,<sup>579</sup> if such defect cannot be rectified at all or within a reasonable time. If the defect can be corrected within a reasonable time, the court will give a detailed description of the defect and indicate possible ways in which it could be remedied, as well as set the time within which the plan must be rectified.<sup>580</sup>
- (ii) A plan submitted by the debtor that obviously has no chance of being accepted by the creditors or confirmed by the court. This ground applies only to an insolvency plan submitted by the debtor, and it is clear from the wording that the court must be quite certain that the creditors would not approve the plan.<sup>581</sup> One example of such a situation is where the plan provides for the continuation of the business by the debtor although a large majority at a creditors' meeting have already decided against continuation of the business.<sup>582</sup>
- (iii) A plan submitted by the debtor providing for the payment of claims that obviously cannot be met. The court will interfere with a plan that provides for payment from

<sup>578</sup> Balz and Landfermann *Insolvenzgesetze* at 344.

<sup>579</sup> Among other things, the court will carefully scrutinise the plan for improper or incorrect groupings of creditors that debtors may use to manipulate voting on the plan to ensure approval by the majority in every group: Braun *Commentary* at 440 par 1911.

<sup>580</sup> Braun *Commentary* at 440 par 1910.

<sup>581</sup> Braun *Commentary* at 440 par 1913. In appeals from the insolvency court, the Regional Court (Landgericht) and the Higher Regional Court (Oberlandesgericht) have held that a plan should be rejected on this ground only in extremely exceptional cases: Frank "Insolvenzplan" at 1225 fn 2.

<sup>582</sup> Balz and Landfermann at 346.

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future income only if completely unrealistic assumptions or projections are made, otherwise it will be left to the creditors to decide whether they find the plan acceptable, because it is usually impossible to predict with any certainty whether the debtor will be able to generate the future income stated in the plan.<sup>583</sup>

From the above it is clear that a plan filed by the debtor is examined with far greater care than one filed by the insolvency administrator, because the former is regarded as more likely to be flawed.<sup>584</sup> However, some commentators have expressed doubts whether the insolvency court (officials) have the necessary qualifications and training to judge the feasibility or acceptability to creditors of an insolvency plan or to make any other economic assessment of the plan.<sup>585</sup> The lack of training and expertise of the insolvency court judges and officers is a recurring theme in discussions on the guiding and supervising role they can or should play, particularly when a business rescue is attempted. The general consensus seems to be that there is no proper training and, because of the fairly small number of insolvency cases in several court districts – in some about 20 cases per year, in others less than 10 – specialisation in insolvency cases is almost impossible.<sup>586</sup> In addition, the insolvency courts are not adequately staffed to deal with the increasing numbers of insolvency cases.<sup>587</sup>

A plan submitted by a debtor whose previous plan was rejected by creditors or not confirmed by the court or withdrawn by the debtor after the date for the meeting to discuss the plan had already been published must also be rejected by the court on application by the insolvency administrator.<sup>588</sup> The intention behind this limitation on the right of a debtor to submit a second insolvency plan is to prevent a debtor from abusing the system to delay the process.<sup>589</sup>

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<sup>583</sup> Braun *Commentary* at 440 par 1917.

<sup>584</sup> Ehlers "Statutory Corporate Rescue" at 167.

<sup>585</sup> Flessner "Germany" at 361; Haarmeyer, Wutzke and Förster *Insolvenzordnung* at 141. The last-mentioned writers believe that this may lead to delays, as the court would have to consult experts on the matter. The Insolvency Commission specifically rejected the possibility of the insolvency court deciding on the feasibility of a plan (as required by the American Bankruptcy Code s 1129(a)(11)) because the Commission doubted whether bankruptcy judges would be capable of doing so: Schiessl "Comparative Analysis" at 258.

<sup>586</sup> Schmidt and Ahrendt *Hamburger Kommentar* at 22-23.

<sup>587</sup> Wimmer and Ahrens *Frankfurter Kommentar* at 12-13.

<sup>588</sup> § 231(2). If a creditors' committee has been appointed, their prior consent to such an application must be obtained by the administrator.

<sup>589</sup> Balz and Landfermann at 346.

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An order of court rejecting a plan on any of the above grounds is subject to an immediate appeal by the person who submitted the plan.<sup>590</sup>

### 2.8.3.2 Submission of comments on the insolvency plan

A plan that was not rejected by the court in the initial phase must be forwarded to several stipulated persons or bodies with an accompanying invitation by the insolvency court to submit their comments on the plan within a period determined by the court.<sup>591</sup> The plan must first be sent to the creditors' committee (if one has been appointed), the works council and the representative of the company's managing officers, as well as to the debtor if the plan was submitted by the administrator, and vice versa.<sup>592</sup>

The court may also give an opportunity to submit comments on the plan to the official professional body of the particular industry, trade, craft or agricultural sector to which the debtor belongs, or to any other relevant body of experts.<sup>593</sup>

As soon as the period for submission of comments has expired, the insolvency plan and all comments received must be made available for the inspection of the parties concerned.<sup>594</sup> The phrase "parties concerned" is interpreted very narrowly since the insolvency plan may contain confidential information about the business and its future plans: this group is therefore limited mainly to persons who are entitled to vote because their rights will be affected, being the ordinary creditors.<sup>595</sup>

### 2.8.3.3 Approval of the plan

Every plan submitted to the insolvency court that has not been rejected during the preliminary examination must be considered and voted on by the creditors at a meeting arranged for this purpose by the insolvency court.<sup>596</sup> Individual notices of the

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<sup>590</sup> § 231(3).

<sup>591</sup> § 232. Although the length of the period for commenting is set by the court, it should not exceed two weeks, as it would otherwise delay the proceedings too much: Braun *Commentary* at 441 par 1922.

<sup>592</sup> § 232(1).

<sup>593</sup> § 232(2).

<sup>594</sup> § 234. § 235(2) provides that the official notice publishing the date of the meeting to discuss and decide on approval of the plan must also notify the affected parties that the insolvency plan and comments thereon are available for inspection at the office of the Registrar of the insolvency court.

<sup>595</sup> Braun *Commentary* at 443 par 1935; Frank "Insolvenzplan" at 1230-1231.

<sup>596</sup> § 235(1). The meeting may not take place more than a month after publication of the date thereof. The creditors' voting rights on the insolvency plan are also determined at this meeting according to §§ 237-239 in terms of which secured creditors will only have a vote for the unsecured part of their claims unless they have waived their security (or part of it). If their rights are to be affected by the plan, they will have full voting rights in a separate group.

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meeting, accompanied by a copy or summary of the plan, must be sent to all creditors who have filed claims, as well as to secured creditors, the administrator, the debtor, the works council and the representative of the company's management.<sup>597</sup>

Although all plans may be considered at the same meeting, voting on each plan must take place separately in the sequence determined by the court.<sup>598</sup> Even if a prior plan is approved by creditors, they must still discuss and vote on a later plan, because an approved plan could be set aside later as a result of appeals and other legal remedies.

Voting on the insolvency plan takes place separately in each group of creditors with voting rights as identified in the constructive part of the insolvency plan.<sup>599</sup> One creditor may have a vote as a member of more than one group, for example in the group of secured creditors (if his security rights are to be affected) as well as in the group of ordinary creditors for the part of his claim that is not secured,<sup>600</sup> and need not even vote the same way in each group!<sup>601</sup>

A majority of creditors both in value and in number of creditors voting in each group must vote in favour of a plan to constitute approval.<sup>602</sup> Rejection by the majority in every group will result in termination of the proceedings.<sup>603</sup>

However, if the majority of the groups have voted in favour of the plan, a group without the required majority will be deemed to have consented to the plan on condition that the creditors in this group will probably not be placed in a worse financial position by the insolvency plan than they would be without this plan and they are given reasonable participation in any further advantages flowing from the plan.<sup>604</sup> "Reasonable participation" for the purposes of this provision is defined to mean that no other creditor will receive more than the full amount of his claim in terms of the plan, that neither a lower-ranking creditor nor the debtor or one of its members will

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<sup>597</sup> § 235(3).

<sup>598</sup> Frank "Insolvenzplan" at 1173-1174. However, Braun *Commentary* at 427 par 1831 states that voting should take place in the same order that the plans were submitted: the first plan that was filed must therefore be voted on first.

<sup>599</sup> § 243.

<sup>600</sup> Braun *Commentary* at 452 par 2006.

<sup>601</sup> Eickmann, Flessner et al *Heidelberger Kommentar* at 1110.

<sup>602</sup> § 244. In terms of the repealed laws, a majority of 75 per cent was required for approval of a compromise, but this was reduced to 50 per cent (+ 1) in the InsO, making it easier to obtain approval of a plan: Ehlers "Statutory Corporate Rescue" at 167.

<sup>603</sup> Braun *Commentary* 453 par 2021.

<sup>604</sup> § 245(1).

receive any economic value, and that no creditor who would rank equally with these creditors without a plan is placed in a better position by the plan.<sup>605</sup> The conditions set out in § 245 are both cumulative and absolute,<sup>606</sup> but it requires an economic assessment by the insolvency court which the court is widely believed not to be competent to do.<sup>607</sup> This provision is derived from the American cram-down rules<sup>608</sup> and intended to prevent abusive or arbitrary obstruction of the plan by creditors.<sup>609</sup> It is thus generally referred to as the rule against obstruction.<sup>610</sup>

Where none of the creditors in a specific group have voted, this group is also deemed to have consented to the plan.<sup>611</sup>

If more than one plan is approved, the insolvency court determines which plan is accepted, based on the majority in value and number of creditors who voted in favour of the plan. If one plan is approved by the majority in number, and another by a majority in value, the majority in value is decisive.<sup>612</sup>

If the creditors indicate during the discussions that particular provisions of a plan should be amended, the person who submitted the plan has the right to change the plan accordingly, and creditors may then vote on the amended plan at the same meeting.<sup>613</sup> This measure is intended to prevent unnecessary delays, but as these amendments would not have been published before the meeting, the right to amend is limited to individual provisions while retaining the original core of the plan.<sup>614</sup>

The insolvency court may arrange a separate meeting for voting on the plan within one month after the discussion meeting, but this is an exception to the normal

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<sup>605</sup> § 245(2). Braun *Commentary* at 456 par 2041 points out that there may sometimes be good reasons to give some advantage to a group, such as a higher dividend to minor creditors, but this is prevented by the rule.

<sup>606</sup> In terms of a decision by a Higher Regional Court (Oberlandesgericht): OLG Köln of 5.1.2001 – 2 W 228/00, NZI 2001, 660.

<sup>607</sup> Flessner “Germany” at 361.

<sup>608</sup> Braun *Commentary* at 454 par 2023; Wimmer and Ahrens *Frankfurter Kommentar* at 1364 and 1488. The writers explain that this prohibition is a totally new instrument that will probably cause a debate on the nature of the plan because it differs substantially from an ordinary agreement where the actual consent of all parties is required.

<sup>609</sup> Frank “Insolvenzplan” at 1160.

<sup>610</sup> “Obstruktionsverbot”: Wimmer and Ahrens *Frankfurter Kommentar* at 1364.

<sup>611</sup> § 246. In terms of this provision, lower-ranking creditors whose claims are deemed waived are also deemed to have given their consent, but as they do not form part of the plan anyway, it is not at all clear why the obvious had to be restated.

<sup>612</sup> Braun *Commentary* at 427 par 1833; Frank “Insolvenzplan” at 1174.

<sup>613</sup> § 240.

<sup>614</sup> Braun *Commentary* at 450 pars 1986-1988.

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procedure and should be used sparingly.<sup>615</sup> One instance where a separate meeting may be appropriate is when dealing with a major case that is very complex, and another would be where substantial changes are made to the plan after the discussions.<sup>616</sup>

The debtor's consent to the plan is deemed to have been given unless he files an objection in writing with either the insolvency court or, at the latest, at the creditors' meeting convened for voting on the insolvency plan.<sup>617</sup> Even if the debtor objects in the prescribed manner, his objections may be disregarded if he is not disadvantaged by the plan when compared to his situation without a plan and no creditor is to receive more than the full amount of his claim.<sup>618</sup> In the case of a corporate debtor where the constitution of the company may have to be amended to give effect to a rescue plan, however, the consent of the shareholders will be essential.<sup>619</sup>

#### 2.8.3.4 Confirmation of the plan

The final step after the approval of the plan by the creditors and the debtor is its confirmation by the insolvency court after hearing the insolvency administrator, the creditors' committee (if there is one), and the debtor.<sup>620</sup> The court will first ascertain whether the plan meets all the statutory requirements and whether the creditors and the debtor have consented or are deemed to have consented to the plan as prescribed by the InsO.<sup>621</sup>

Furthermore, there are specific statutory grounds on which the court must refuse confirmation: if preconditions set in the plan for confirmation have not been met;<sup>622</sup> if any essential prescribed requirement regarding the contents and procedure in dealing with the plan has not been adhered to and the defect cannot be rectified;<sup>623</sup> if approval of the plan was effected by improper means, particularly by granting an advantage to one creditor;<sup>624</sup> or if a creditor who filed a written objection to the plan

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<sup>615</sup> § 241. See Braun *Commentary* at 450 par 1992.

<sup>616</sup> Braun *Commentary* at 450 pars 1994-1995.

<sup>617</sup> § 247(1).

<sup>618</sup> § 247(2).

<sup>619</sup> Reinhart "Insolvency Bill" at 39.

<sup>620</sup> § 248.

<sup>621</sup> In §§ 244-247 as discussed above.

<sup>622</sup> § 249.

<sup>623</sup> § 250(1).

<sup>624</sup> § 250(2).

prior to or at the voting meeting applies for the plan to be rejected and can prove to the court that he is likely to be worse off than he would have been without a plan.<sup>625</sup> The last-mentioned provision is intended to protect a creditor who forms part of the minority in a group and was therefore outvoted, but as all the creditors in one group have to be treated the same, it is unlikely to occur very often that the majority would have voted in favour of a plan that is prejudicial to them. The determination by the court of an objecting creditor's situation with and without a plan is the only economic judgment the court is allowed to make on the plan: it may not otherwise pass judgment on whether the plan is economically sensible or feasible.<sup>626</sup>

The decision to confirm or reject the plan, issued in the form of an order of court,<sup>627</sup> must be announced at the voting meeting or at a special meeting convened for this purpose.<sup>628</sup> If the plan is confirmed, secured creditors and those creditors who have filed claims must be notified of the court's decision and furnished with a copy or summary of the essential contents of the plan.<sup>629</sup>

The creditors and debtor may bring an immediate appeal against the court order.<sup>630</sup> Consequently, an insolvency plan, although confirmed by the court, will not come into force before the statutory period for filing an appeal has expired or an appeal has been finalised.<sup>631</sup> This unlimited right of appeal given to any aggrieved creditor, even if he has suffered no actual disadvantage, has been criticised by some commentators because it can be abused to obstruct or undermine the reorganisation process. They are therefore advocating a limited right of appeal available only to creditors who were financially prejudiced by receiving less than they would have, had they been treated correctly.<sup>632</sup>

#### 2.8.4 Effects of confirmation

Final<sup>633</sup> confirmation of the insolvency plan has the immediate effect of binding all parties involved to its constructive part, including creditors who did not file their claims

<sup>625</sup> § 251.

<sup>626</sup> Flessner "Germany" at 361. Obviously unworkable plans would already have been eliminated during the preliminary review by the court: see part 2.8.3.1 above.

<sup>627</sup> Ehlers "Statutory Corporate Rescue" at 168.

<sup>628</sup> § 252(1).

<sup>629</sup> § 252(2).

<sup>630</sup> § 253.

<sup>631</sup> Ehlers "Statutory Corporate Rescue" at 169.

<sup>632</sup> Ehlers "Statutory Corporate Rescue" at 169 fn 62.

<sup>633</sup> If an appeal against the order is filed, the order is suspended and does not become effective until after the appeal has been finalised: Braun *Commentary* at 463 par 2097.

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and any person who opposed the plan.<sup>634</sup> The creation, waiver, amendment or transfer of rights in objects or shares in terms of the insolvency plan automatically take effect once the confirmation order is final, as do any undertakings on which they are based.<sup>635</sup> However, where formal requirements are required for the transfer of rights, such as an entry in the land register for rights to immovable property, these must be met before the rights vest in the transferee.<sup>636</sup>

A slightly curious provision is found in § 254(3) in terms of which a creditor who receives more than he was entitled to in terms of the plan will not be liable for restitution. This provision was explained by the government as being necessary *inter alia* to enable the administrator to make full payment to secured creditors in order to retain assets that are necessary for the continuation of the business.<sup>637</sup> It would seem as though an opportunity has been created by this provision for the unequal treatment of creditors which is not allowed in the insolvency plan itself. I submit that if unequal treatment of some creditors is necessary for the success of a reorganisation in terms of an insolvency plan – something that the legislature obviously anticipated and accepted – it should be possible to provide for this option in the plan itself, because it is subject to approval by the creditors and it should be left to them to decide whether they find this acceptable.

Creditors whose rights were suspended or partly<sup>638</sup> waived in terms of the insolvency plan will no longer be bound to such suspension or waiver if the debtor substantially defaults on his performance of the plan in regard to their claims.<sup>639</sup> The commencement of new insolvency proceedings against the debtor before the plan has been fully performed will have the same effect for all such creditors.<sup>640</sup>

In the case of a substantial default by the debtor to perform as required by the plan, a creditor may also use the confirmed insolvency plan in which his claim has been determined and accepted, to enforce execution against the debtor as if a judgment has been issued against the debtor.<sup>641</sup> The plan may also be used as the

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<sup>634</sup> § 254(1).

<sup>635</sup> § 254(1).

<sup>636</sup> Braun *Commentary* at 464 par 2107 with reference to § 929 of the Civil Code.

<sup>637</sup> Balz and Landfermann *Insolvenzgesetze* at 373.

<sup>638</sup> Claims that were fully waived will remain so: Braun *Commentary* at 466 par 2121.

<sup>639</sup> § 255(1).

<sup>640</sup> § 255(2).

<sup>641</sup> § 257(1).



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basis for execution against a third party who has undertaken in writing to guarantee performance of the debtor's obligations under the plan.<sup>642</sup> For these purposes the insolvency plan is placed on an equal footing with a formal judgment of the court.

## 2.9 Termination of insolvency proceedings

The insolvency court decides on the termination of the insolvency proceedings as soon as the insolvency plan has been finally confirmed.<sup>643</sup> The decision to terminate and the reasons therefor must be published,<sup>644</sup> while the debtor, the insolvency administrator and members of the creditors' committee must receive prior notification of the date on which the termination will become effective.<sup>645</sup>

Before the termination of the proceedings, the administrator must pay claims that have been accepted and provide security for those that are being contested.<sup>646</sup> Where the debtor is continuing the business, new liabilities will arise on a regular basis, but these should not be taken into account when termination of the proceedings is pending. The decision to terminate should thus include the determination of a cut-off date for claims to be paid by the administrator.<sup>647</sup>

Termination of the proceedings has the effect of releasing the administrator and members of the creditors' committee from office and revesting the debtor with the right to freely deal with his assets.<sup>648</sup> However, if the insolvency plan provides for the surveillance of the implementation of the plan,<sup>649</sup> the offices of the administrator, the creditors' committee and the supervision of the insolvency court will continue for the duration of the surveillance period.<sup>650</sup> The surveillance period may not exceed three years, as it will be terminated *mero motu* by the insolvency court after this period if it has not already been terminated because all claims have been met or guaranteed.<sup>651</sup>

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<sup>642</sup> Unless the third party has reserved his rights under the *beneficium excussionis*: § 257(2).

<sup>643</sup> § 258(1).

<sup>644</sup> If the implementation of the plan is to be monitored in terms of § 260, details of such surveillance must also be published at the same time: § 267.

<sup>645</sup> § 258(3).

<sup>646</sup> § 258(2).

<sup>647</sup> Braun *Commentary* at 471 pars 2153-2154.

<sup>648</sup> § 259(1). In the case of a corporate debtor only if an insolvency plan provides for the continued existence of the corporate entity; otherwise the company will be dissolved and deleted from the company register: Commercial Code § 157.

<sup>649</sup> In terms of § 260 discussed in part 2.8.2.2 above.

<sup>650</sup> §§ 259(2) and 261(1).

<sup>651</sup> § 268(1).

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### 3 EVALUATION AND CONCLUSION

It is clear that in the German system the rescue of a company is not regarded as being of prime importance, while the rescue of the business or a viable part thereof, by whatever means this is achieved, is not an end in itself, but a means of obtaining a better return for creditors where appropriate. Liquidation and the rescue of a business are therefore not seen as alternative solutions for a company in financial distress, but merely as two of the possible mechanisms that can be used alone or in any combination to obtain the best results for creditors and conform to market principles.

Any rescue attempt will unavoidably form part of insolvency proceedings, and the interests of the creditors thus remain the main (if not the only) purpose even where a rescue is attempted.<sup>652</sup> As a result, the shareholders are virtually ignored in the process, and no provision for the possible amendment of their rights exists. Ironically, this omission enables shareholders to obstruct the successful implementation of some insolvency plans.

Some commentators believe that the advantages the new legislation should have brought did not materialise, at least not in the early stages after the InsO came into force, and they blame excessive bureaucracy, lack of coordination and information and even selfish personal ambitions of the provincial legal authorities for this fact.<sup>653</sup> This is a potential problem of which the South African authorities should be aware when the new legislation comes into effect, particularly since the business rescue proceedings are also new and the authority to regulate the new procedure is being transferred from the Masters of the High Court in the Department of Justice and Constitutional Development to an as yet undetermined official in the Department of Trade and Industry.

There are, however, some valuable lessons that South Africa can learn from the German experience, perhaps the most important of which is that a new and foreign procedure that is imposed upon another legal system, no matter how successful it may be in its country of origin, will invariably meet with resistance and scepticism if it does not conform to the prevailing legal norms and culture. In spite of the German authorities' hopes that the insolvency plan procedure and possible business rescue

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<sup>652</sup> As noted in part 1 above, this is the only purpose expressly stated in the InsO.

<sup>653</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 19.

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would become a successful alternative to liquidation, as is the case with Chapter 11 reorganisations in America on which they modelled their legislation, this has not materialised, largely because of the suspicion and disapproval with which insolvency has historically been viewed in Germany. Merely replacing one piece of legislation with another will not change the culture and entrenched views of society.

Another extremely important point that we should note is that despite many years of preparatory work and discussions on legal policy, and several drafts of the legislation spanning many years, the new InsO still did not achieve satisfactory solutions to all the challenges presented. Commentators blame this partly on the influence of some interest groups, partly on political and parliamentary interventions in the legislation but also on the fact that the legislation, although effecting major changes to the law, may have been conceptualised and implemented too hastily.<sup>654</sup> Considering the fact that the German reform process stretched over a period of approximately 20 years from the appointment of the Insolvency Commission in 1978 until the InsO came into effect in 1999, this is in sharp contrast to the almost unseemly haste with which the Companies Act of 2008, which introduced the new South African business rescue proceedings, was rushed through Parliament in less than six months after a very short and rather limited public consultation process of just over a year.

There are also some specific aspects that deserve our attention when evaluating the new South African business rescue proceedings. The first of these is that only the debtor may file for insolvency on the grounds of imminent insolvency. This limitation avoids the very real potential for abuse of the proceedings that has been created in the South African legislation by allowing a wide range of individuals to file for business rescue proceedings on any of the grounds.<sup>655</sup>

Another important point is that although the German system provides three different grounds on which to base an application for the commencement of insolvency proceedings, it is really only the inability to pay debts as they become due (or illiquidity) that is generally used for this purpose. Even in applications based on imminent illiquidity, debtors are usually already unable to pay their debts. The present

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<sup>654</sup> Bertram and Gottwald *Insolvenzrechtshandbuch* at 23-24.

<sup>655</sup> See Chapter 2, parts 3.3.2 and 3.4.1.1 respectively on the persons who may apply and the grounds for such an application.

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inability to pay debts does not constitute a ground for the commencement of business rescue proceedings in the South African procedure, and applications to court will have to be based on the future inability of the company to pay its debts in spite of the company clearly being unable to do so already.

The efforts of the German legislature to encourage company boards to apply on the grounds of imminent illiquidity before it is too late to attempt a business rescue have not been successful. This is partly due to the lack of any real incentives or advantages for them to bring an early application, and partly to the fact that complete control of the proceedings is taken over by the creditors.

A big advantage of the German procedure is that the necessary provisions have been included in the legislation to facilitate prepackaged plans, thereby recognising the important role they play in practice and their substantial advantages in facilitating and shortening the duration of the proceedings.

The fact that an order of court is required to commence proceedings, which is unavoidable because these are insolvency proceedings, is an obvious disadvantage and one of the reasons why German companies prefer to use the English corporate rescue procedures because they are faster and allow them more control over the course of the rescue attempt.

Although employees are protected in the case of a sale or transfer of the business, they do not have voting rights in respect of the insolvency plan unless they have substantial claims other than claims for remuneration. As a result, they are not involved in the process except through representation by the works council.

The lack of proper training and qualifications of the officials in insolvency courts in particular is an obstacle, as they are not, for example, qualified to judge insolvency plans and often have to use experts to advise them, which leads to delays and additional costs. The issue of ensuring that officials in the government authority dealing with business rescues are sufficiently qualified and trained to properly fulfil their duties should therefore enjoy as much attention as the qualifications required for a business rescue practitioner.

Creditors have been given almost complete power over the course that the proceedings will take, which is an inevitable result of the fact that these are insolvency proceedings even if an attempt is made to rescue the business. Contrary

to the debtor's wishes or intentions, the creditors may decide that the debtor may not continue trading and that assets may be realised and distributed even while the debtor is attempting to draft a rescue plan which, eventually, they may also reject.

Specific provision has been made for the supervision of the implementation of the insolvency plan up to three years after its approval. This will almost certainly encourage creditors to approve a plan providing for the continued existence and trading of a corporate debtor and the payment of their debts to be made out of future earnings. As added security, in the case of non-performance by the debtor, a creditor may use the confirmed insolvency plan to enforce execution against the debtor.

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# CHAPTER 5

## CONCLUSION

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### 1 INTRODUCTION

In this Chapter I will recommend some legislative changes to Chapter 6 of the Companies Act of 2008 which I believe will make it more acceptable and effective, thereby increasing its chances of becoming the success that many in government, business and practice hope it will be.<sup>1</sup> I will not attempt to address every aspect in Chapter 6 that I consider to be in need of improvement, but only some that I believe to be important. Although this Chapter will thus inevitably focus on the imperfections of Chapter 6, I trust that this will not be interpreted as an indication that there is nothing to recommend the new procedures. They represent a genuine attempt on the part of the government to assist the many struggling and failing companies to survive, and I hope that in my discussions in the preceding chapters I have also indicated the many positive aspects.

In general, Chapter 6 (and probably the rest of the Companies Act of 2008) needs to be scrutinised for incorrect, conflicting and inconsistent terminology. The wording should be improved to ensure that the provisions are clear, correct and formulated in South African legal terminology with established and clear meanings. Some of the general errors in Chapter 6 that need rectification are the often confusing and incorrect reference to holders of securities when only shareholders are meant;<sup>2</sup> not making a clear distinction between resolutions and actions to be taken by the board of directors and those to be taken by the company, that is, the shareholders in general meeting;<sup>3</sup> the inconsistent use of “publish notice to” (an unfamiliar phrase in South African law), “publish” and “notify” when apparently the same procedure is meant;<sup>4</sup> the reference to “holders of the majority of creditors’

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<sup>1</sup> Where a specific provision is quoted, the words that should be removed have been struck through, while new words and phrases are underlined.

<sup>2</sup> See, for example, Chapter 2, parts 3.8.3.4 and 3.8.5.2.1.

<sup>3</sup> See Chapter 2, part 3.3.1.

<sup>4</sup> See, for example, Chapter 2, parts 3.5.1.1, 3.5.2.1 and 3.8.3.1; and part 2.8.3.1 below.

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voting interests” (which has even confused the drafters themselves)<sup>5</sup> rather than the far simpler South African terminology of “the majority in value of creditors”; and the use of the words “debt forgiveness”, which is an American expression, instead of using the entrenched South African legal term of “discharge of a debt”.<sup>6</sup>

It must be clear that weaknesses and problems in the new business rescue proceedings and in the compromise procedure should be identified and corrected as soon as possible to avoid both procedures going the same route as judicial management and being virtually ignored in practice. In the current global economic crisis, it would be nothing short of a tragedy if the opportunity to establish a solid and workable rescue procedure for companies were missed. Unfortunately, the process of developing and drafting the provisions for business rescue proceedings and compromises was completed in a fairly short time and probably much too hastily for a completely new procedure.<sup>7</sup> The time allowed for comments and recommendations was almost certainly not sufficient, and as Keay<sup>8</sup> prophetically pointed out, a new rescue procedure in South Africa will only be successful if the proposals of academics and members of legal and accounting professions are considered carefully and a reasonable amount of time is given to the preparation of the final draft.

## **2 COMMENTS AND RECOMMENDATIONS ON BUSINESS RESCUE PROCEEDINGS**

### **2.1 Definition and purpose**

Although the procedure is termed business rescue, I submit that it is mainly a procedure designed to achieve the rescue of the company itself together with the viable part of its business. This is clear not only from the statutory definition of business rescue proceedings,<sup>9</sup> but also from the requirement of a reasonable prospect for rescuing the company that is set for the commencement of the procedure.<sup>10</sup> The decision by the legislature in favour of a dedicated rescue procedure that is housed in the Companies Act

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<sup>5</sup> See, for example, Chapter 2, parts 3.8.3.2, 3.8.5.1.1 and 3.8.5.2.3.

<sup>6</sup> In the South African creditor-friendly culture where failure to pay a debt is still widely regarded as shameful, discharge of a debt and forgiving the debtor for not paying his debts do not necessarily go together!

<sup>7</sup> See Chapter 1, part 3.

<sup>8</sup> “To Unify” at 70-71.

<sup>9</sup> See Chapter 2, part 3.1.

<sup>10</sup> See Chapter 2, part 3.4.1.2.

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of 2008 and not in an Insolvency Act should be followed through by avoiding any association with insolvency, and should not duplicate the outcomes that can be achieved more quickly and cheaply by liquidation or any other insolvency procedure. The rescue of a business without the rescue of the company itself can be achieved only by the sale of the business, and since eventual liquidation of the company is then unavoidable, this can and should be effected by directly placing the company in liquidation.<sup>11</sup> The only exception to this rule is if a prepackaged sale of the business or a major part of it is negotiated with a purchaser before the commencement of the business rescue procedure, and completed immediately after such commencement before the value or viability of the business is affected by the negative connotations of business rescue. However, since the business rescue practitioner is not given any powers to dispose of all or the greater part of a company's assets or undertaking unless as part of an adopted business rescue plan,<sup>12</sup> this option is unlikely to be used as effectively as in England.<sup>13</sup> To provide for the few cases where it might be used to rescue the business of the company, I have included this as an alternative purpose of the business rescue procedure.

However, the reference to the object of a better return for creditors in the definition of business rescue proceedings is undesirable and not supported by the wording of most of the provisions regulating the procedure.<sup>14</sup> The object of a better return for shareholders in an eventual liquidation is, as I have already pointed out, quite meaningless,<sup>15</sup> and I therefore submit that the definition of this procedure should refer to one main purpose, namely the rescue of the corporate entity, and a secondary one of rescuing the business or a major part of it. If at some later stage this appears to be an unattainable object, in spite of initial indications to the contrary, the procedure should be converted to liquidation. It should not be allowed to become an alternative but more expensive and longer way to wind up a company.

The name of the procedure should also be changed to reflect the fact that its main purpose is not to rescue the business or part of it, and my recommendation is that the procedure should be termed "company supervision", which is far preferable

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<sup>11</sup> See Chapter 2, part 3.1.

<sup>12</sup> See Chapter 2, part 3.8.2.3.

<sup>13</sup> See Chapter 3, part 2.8.2.

<sup>14</sup> See Chapter 2, part 3.1.

<sup>15</sup> See Chapter 2, part 3.1.



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to the current confusing and cumbersome name of “business rescue proceedings”.<sup>16</sup> This would also avoid the very problematic use of the word “proceedings” in the name, and maybe also some of the uncertainty it creates on whether a full procedure or merely court proceedings are meant when the same word is used in another context.<sup>17</sup> However, I will continue to refer to “business rescue proceedings” and “business rescue practitioner” in this Chapter to refer to existing provisions of the Companies Act of 2008 since it can also be used as a generic term for any business rescue procedure, irrespective of the specific name it may be given.

I recommend that section 128(1)(b), which contains the definition and purpose of this procedure, should be amended to read as follows:

**“business rescue company supervision”** means ~~proceedings to facilitate the rehabilitation of a procedure to rescue a company or the business of a company that is financially distressed~~<sup>18</sup> by providing for –

- (i) the temporary supervision of the company, and ~~of~~<sup>19</sup> the management of its affairs, business and property;
- (ii) a temporary moratorium on ~~the rights of claimants~~ legal processes<sup>20</sup> against the company or ~~in respect of property~~ legally 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 as a going concern;<sup>21</sup> ~~on a solvent~~<sup>22</sup> basis or, if it is not possible for the company to so continue in existence, to rescue the business of the company or a major part thereof. ~~results in a better return for the company’s creditors or shareholders than would result from the immediate liquidation of the company.~~

The definition of “rescuing the company”<sup>23</sup> should be amended as follows:

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<sup>16</sup> See Chapter 1, fn 25.

<sup>17</sup> See Chapter 2, parts 3.5.2.3 and 3.5.2.4.

<sup>18</sup> See part 2.4.1 below on the recommendation for amendments to the requirement of “financial distress”.

<sup>19</sup> See part 2.7.2 below on the position of the directors during supervision and why this word should be removed from the definition.

<sup>20</sup> See part 2.6 below on the recommended amendments to the provisions regulating the moratorium.

<sup>21</sup> This is based on the main object of company administration in England: see Chapter 3, part 2.4.2.1.

<sup>22</sup> See Chapter 2, part 3.1 on the reasons for removing this part of the definition.

<sup>23</sup> Section 128(1)(h).

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**“rescuing, or rescue of, the company”** means achieving the goal of the continued existence of the company or, if that is not possible, of a major part of the company’s business as a going concern, set out in paragraph (b)(iii) ~~set out in the definition of “business rescue”~~;

## **2.2 Entities to which business rescue proceedings apply**

The procedure should be strictly limited to companies since its structure and procedure have been specifically designed with companies in mind. The provision that makes this procedure available to close corporations<sup>24</sup> is not only unnecessary in the light of the rescue procedure available in the Close Corporations Act itself,<sup>25</sup> but may lead to extremely inappropriate and costly attempts by ill-advised members of close corporations to use a procedure that is obviously far too onerous, complicated, expensive and formal to be suitable for close corporations.

Experience in England with company administration has shown that merely making a procedure designed for companies applicable to other business forms, such as partnerships, is not sufficient. Each and every provision has to be reworked to adapt it to the particular structure and management of the other business form.<sup>26</sup> This has not been done in the case of close corporations and will undoubtedly lead to uncertainty and confusion regarding the exact meaning of many provisions and requirements when applied to close corporations.

Item 6 of Schedule 3 to the Companies Act of 2008 should therefore be scrapped.

## **2.3 Power to initiate business rescue proceedings**

The power of the board of directors to commence the proceedings by taking a resolution to this effect and without having to approach the court is one of the most important improvements on judicial management.<sup>27</sup> However, the heading of section 129 of the Act which provides for this option should be amended to reflect the fact that it is a board resolution, and not a company resolution, that is, a resolution by

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<sup>24</sup> Item 6 of Schedule 3 to the Companies Act of 2008.

<sup>25</sup> See Chapter 2, part 3.2.

<sup>26</sup> See Chapter 3, part 2.2, fn 39.

<sup>27</sup> See Chapter 2, part 3.3.1.

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shareholders in general meeting, that is required.<sup>28</sup> The exclusion of shareholders from this possibility, contrary to the situation in England,<sup>29</sup> is not, I submit, a major disadvantage and need not be changed.

However, I recommend that the board of directors should also be given the power to apply to court for the commencement of business rescue proceedings, as has been done in England,<sup>30</sup> because this would be the only way for them to initiate the procedure after liquidation proceedings have been started.<sup>31</sup> Since a director can be held personally liable to the company for damages because he “acquiesced” in the company’s trading in insolvent circumstances,<sup>32</sup> the legislature should also consider following the example of Germany by allowing a single director to bring the application in his capacity as such.<sup>33</sup> This would become particularly relevant if a positive duty to act within a specified period after the company becomes insolvent is placed on directors.<sup>34</sup>

On the other hand, the number of persons who have been given the power to apply for a business rescue order seems unduly high.<sup>35</sup> The possibilities for abuse in allowing individual shareholders, and particularly trade unions and employees who are not creditors of the company, to bring such an application are abundantly clear.<sup>36</sup> It is also unheard of in most other comparable systems.<sup>37</sup> Although individual members are also allowed to apply for judicial management,<sup>38</sup> the very onerous requirements for a judicial management order have always ensured that there was very little opportunity for abuse of the procedure. Since almost no prior notification is required,<sup>39</sup> a vexatious or malicious application for judicial management would not be widely publicised before being refused by the court, and would therefore cause limited harm to the reputation of the company.

The situation is completely different in business rescue proceedings where prior notice of an intended application must be given to every affected person, that is, every

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<sup>28</sup> See Chapter 2, part 2.3 on the importance of this distinction.

<sup>29</sup> See Chapter 3, part 2.3.1.

<sup>30</sup> See Chapter 3, part 2.3.2.

<sup>31</sup> See Chapter 2, part 3.3.2.

<sup>32</sup> In terms of ss 22(1)(b) and 77(3)(b); see Chapter 2, parts 3.5.1.2 and 3.7.1.3.2.

<sup>33</sup> See Chapter 4, part 2.3.

<sup>34</sup> See Chapter 2, part 3.5.1.2.

<sup>35</sup> See Chapter 2, part 3.3.2.

<sup>36</sup> See Chapter 2, part 3.3.2.3 in particular.

<sup>37</sup> See Chapter 3, part 2.3.2; Chapter 4, part 2.3.

<sup>38</sup> See Chapter 2, part 2.3.

<sup>39</sup> See Chapter 2, part 2.5.

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shareholder, creditor and trade union or unrepresented employee.<sup>40</sup> In the light of the strong presence and influence of the trade union movement in government, it would be unrealistic to expect the legislature to remove the right of trade unions to apply, but I seriously recommend that the right of individual employees and shareholders to bring the application should be scrapped. Furthermore, the risk of abuse of the procedure should be limited by specifically providing for the liability of such an applicant for payment of damages to the company.<sup>41</sup> For this purpose the wording of a similar provision in the Companies Act of 1973<sup>42</sup> in respect of a winding-up application should be inserted as section 131(4)(c):

Whenever the court is satisfied that an application for an order placing a company under supervision is an abuse of the court's procedure or is malicious or vexatious, the court may allow the company forthwith to prove any damages which it may have sustained by reason of the application and award it such compensation as the court may deem fit.

As a further precautionary measure against abuse, the right of trade unions to demand access to a company's financial statements for purposes of an application to court for the commencement of business rescue proceedings should be limited.<sup>43</sup> Unless section 31(3) is amended to make it clear that only the published financial statements of the company have to be supplied to the trade unions, only one such request per year, in total and not per trade union, should be allowed in respect of a specific company.<sup>44</sup>

## **2.4 Requirements for commencement of business rescue proceedings**

### **2.4.1 Financially distressed**

The future period within which the insolvency or inability of the company to pay its debts is reasonably likely to occur should be increased from six to 12 months in the definition of "financially distressed" to allow company boards in particular to take

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<sup>40</sup> See Chapter 2, part 3.5.2.1.

<sup>41</sup> See Chapter 2, part 3.3.2.3.

<sup>42</sup> Section 347(1A).

<sup>43</sup> See Chapter 2, part 3.3.2.3.

<sup>44</sup> See part 2.4.1 below regarding my recommendation that the period for measuring financial distress should be increased to twelve months.

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remedial action as soon as the first indications of future financial problems appear and while there is still a chance of successfully averting the company's failure.<sup>45</sup>

Furthermore, I submit that the definition of "financially distressed" should be broadened to include a deeming provision, thereby enabling creditors in particular to satisfy the court on this requirement when applying for an order to commence the procedure.<sup>46</sup> The deeming provisions of the Companies Act of 1973,<sup>47</sup> which refer to a company's present inability to pay its debts, can serve as a basis, but will have to be amended since the definition of "financially distressed" in the Companies Act of 2008 refers only to the future inability of the company to pay its debts.

The current two alternatives for the requirement of financial distress when a court orders the commencement of business rescue proceedings should be scrapped.<sup>48</sup> The first alternative, namely the non-payment of liabilities relating to employment matters, will be covered by the deeming provision in subsection (aa) below. The duration of the period in which the company failed to pay these amounts is stipulated as at least three months, to avoid a company being placed under supervision as a result of missing one payment, accidentally or through no fault of its own.

I submit that the other alternative, namely "otherwise just and equitable ... for financial reasons",<sup>49</sup> should be removed because it is vague, unclear and will almost certainly lead to interpretational problems. There is also no discernible reason for this ground, particularly if the definition of "financially distressed" is widened as proposed below.

Therefore, I recommend that the amended definition should read as follows:

**"financially distressed"**, in reference to a particular company at any particular time, means that –

- (i) it appears to be 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~~ 12 months; or
- (ii) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing ~~six~~ 12 months; or

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<sup>45</sup> See Chapter 2, part 3.4.1.1.

<sup>46</sup> See Chapter 2, part 3.4.2; Chapter 3, part 2.4.1; Chapter 4, part 2.4.1.

<sup>47</sup> Section 345.

<sup>48</sup> See Chapter 2, part 3.4.2.

<sup>49</sup> Section 131(4)(a)(iii).

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- (iii) the company is deemed to be financially distressed because
- (aa) ~~the company it~~ has failed, for a period of at least three consecutive months, to pay over any amounts in terms of an obligation under or in terms of a public regulation, or contract, with respect to employment-related matters,<sup>50</sup> or
  - (bb) a creditor, by cession or otherwise, to whom the company is indebted in a sum not less than ~~one hundred~~ ten thousand rand then due has served on the company, by leaving the same at its registered office, a demand requiring the company to pay the sum so due and the company or body corporate has for three weeks thereafter neglected to pay the sum, or to secure or compound for it to the reasonable satisfaction of the creditor;<sup>51</sup> or
  - (cc) any process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned by the sheriff or the messenger with an endorsement that he has not found sufficient disposable property to satisfy the judgment, decree or order or that any disposable property found did not upon sale satisfy such process.<sup>52</sup>

An amended definition of “financially distressed” will make it possible for this requirement to be applied without any changes, irrespective of the way in which the rescue procedure is commenced.

#### **2.4.2 Reasonable prospect of rescuing the company**

To avoid any uncertainty or confusion, the wording of this requirement should be amended to distinguish it very clearly from the onerous requirement of a reasonable probability in judicial management.<sup>53</sup> I would therefore recommend that this requirement for both the commencement of the procedure by a board resolution and by an order of court should use the words “a reasonable possibility of rescuing the company”.<sup>54</sup> Combined with the amended wording for the definition of “rescuing, or rescue of, the company” suggested above,<sup>55</sup> it would be clear that a reasonable

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<sup>50</sup> Based on s 131(4)(a)(ii); see Chapter 2, part 3.4.2.

<sup>51</sup> Based on s 345(1)(a) of the Companies Act of 1973.

<sup>52</sup> Based on s 345(1)(b) of the Companies Act of 1973.

<sup>53</sup> See Chapter 2, part 2.4.3.

<sup>54</sup> See Chapter 2, parts 3.4.1.2 and 3.4.2.

<sup>55</sup> In part 2.1.

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possibility should exist of either the company or a major part of its business continuing in existence.

## **2.5 Procedure to commence business rescue proceedings**

### **2.5.1 Board resolution**

#### 2.5.1.1 Formalities and effects

As stated before, the power given to company boards to commence business rescue proceedings by simply filing a resolution to this effect is a major improvement on judicial management and could do much to encourage boards to use the procedure. However, this is subject to the condition that certain amendments are made to the provisions regulating this procedure.

Firstly, I have already explained that there is no reason why the resolution to place the company under supervision and the appointment of the business rescue practitioner by the board should be separated. It may safely be assumed that in most cases company boards will take both resolutions at the same time.<sup>56</sup> Section 129(1) should therefore be amended by combining it with section 129(3)(b) as follows:

129(1) Subject to subsection (2)(a), the board of a company may ~~resolve~~ take a resolution that the company voluntarily begin business rescue proceedings and be placed the company placing the company under supervision and appointing a business rescue practitioner (supervisor) who satisfies the requirements of section 138 and has consented in writing to accept the appointment, if the board has reasonable grounds to believe that –

In terms of section 129(2)(b) this resolution (including the appointment of the business rescue practitioner) will have no force until it has been filed with the Commission. Consequently, it will also be unnecessary to provide for the effect on the rescue resolution if no practitioner is appointed within a specified time.<sup>57</sup>

The second amendment that should be made is to the wording of section 129(2)(a) prohibiting the taking of such a resolution after liquidation proceedings have

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<sup>56</sup> See Chapter 2, part 3.5.1.1.

<sup>57</sup> As is done by the current s 129(5).

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been “initiated”.<sup>58</sup> To avoid any uncertainty over the exact moment when such a prohibition takes effect, the subsection should be amended as follows:

- (2) A resolution contemplated in subsection (1) –
- (a) may not be adopted if liquidation proceedings winding up of the company by the court have been initiated or the voluntary winding up of the company has commenced;

In respect of the many unnecessary and costly notices to affected persons that are required after the board has taken a rescue resolution,<sup>59</sup> the following recommendations are made. Since the business rescue practitioner has to convene meetings of creditors and employees’ representatives within ten days after his appointment, he would have to give notice of these meetings immediately after his appointment.<sup>60</sup> A substantial saving in costs would be achieved by only requiring one notice informing affected persons of the resolution and also giving notice to creditors and employees of their respective meetings. This could be achieved by amending section 129(3) as follows:

- 129(3) Within five business days after ~~a company~~ the board has ~~adopted and filed a~~ resolution as contemplated in subsection (1), or such longer time as the Commission, on application by the ~~company board or practitioner may allow~~, the ~~company practitioner~~ must ~~(a) publish a notice of the resolution, and its effective date, notify every affected person in the prescribed manner of to–~~
- (a) the contents of the resolution<sup>61</sup> and its effective date, including with the notice a sworn statement of the facts relevant to the grounds on which the board resolution was founded; and
- (b) the date, time and place of, and agenda for the meetings of creditors and representatives of employees to be held in terms of sections 147 and 148 respectively.

Section 129(4) which deals with the appointment of the practitioner and notification thereof to affected persons, will thus fall away.<sup>62</sup> The risk of inadvertently

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<sup>58</sup> See Chapter 2, part 3.5.1.1.

<sup>59</sup> See Chapter 2, part 3.5.1.1.

<sup>60</sup> Sections 147 and 148 respectively: see Chapter 2, parts 3.5.1.1 and 3.5.2.5.

<sup>61</sup> Since the appointment of the practitioner will be part of the resolution, it will automatically be included.

<sup>62</sup> See Chapter 2, part 3.5.1.1.



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failing to comply fully with the formalities will also be greatly reduced by requiring only one notice to affected persons.

Considering the fact that section 129(5)(a) is both extreme and unclear in its possible effects if the company fails to comply with any of the prescribed formalities, I submit that it should be scrapped.<sup>63</sup> In terms of my recommendation the duty would now rest on the practitioner to notify all affected persons, and punitive steps can be taken against him by the professional organisation in the case of culpable failure to comply. The possibility of a court setting aside the board resolution if the formalities of section 129(3) have not been complied with, gives the board the necessary incentive to ensure that the practitioner complies with this duty.<sup>64</sup>

The provision contained in section 129(5)(b) that a company may not take another business rescue resolution within the next three months if it fails to comply with these formalities should also be removed since the period is too short to be of any significance.<sup>65</sup>

Section 129(6) should be amended to make it clear that the company may not take a resolution either to enter voluntary winding up or to apply to court for an order winding up the company, if that is the intended meaning of the subsection.<sup>66</sup>

(4)<sup>67</sup> A company that has adopted a resolution contemplated in this section may not adopt a resolution to begin a voluntary winding up of the company or to apply for winding up of the company by the court ~~liquidation proceedings, unless the resolution has lapsed in terms of subsection (5), or until the business rescue proceedings have ended as determined in accordance with section 132(2).~~

#### 2.5.1.2 Failure to adopt a business rescue resolution.

It is clear that the damage that will almost certainly be caused by the notice that a company is compelled to send in terms of section 129(7) to all affected persons if it

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<sup>63</sup> See Chapter 2, part 3.5.1.1.

<sup>64</sup> See Chapter 2, part 3.5.1.3.1.

<sup>65</sup> In England there is a blanket prohibition on taking a resolution within 12 months after a previous resolution for the appointment of an administrator ceased: see Chapter 3, part 2.3.1. See part 2.5.2.6 below for the resulting amendment to s 132(1) regarding the time of commencement of the procedure by a board resolution.

<sup>66</sup> See Chapter 2, part 3.5.1.1.

<sup>67</sup> As a result of the recommended scrapping of subsections (4) and (5) this will now become subsection (4).

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decides not to take a business rescue resolution, far outweighs any possible benefits that it could have for the company's creditors, shareholders or employees.<sup>68</sup> For this reason it should be scrapped completely.

If the legislature believes that the prohibition against insolvent trading in section 22(1)(b), and the potential civil and criminal liability of directors<sup>69</sup> for contravening this section, are not sufficient incentives, a provision similar to the one in the German Insolvency Code which places a positive duty on the board to act within three weeks after technical or commercial insolvency occurs may be considered.<sup>70</sup> Since financial distress refers to a future situation that may or may not occur in the next twelve months and a director could be held personally liable for voting in favour of this resolution if it later appears to have been unfounded,<sup>71</sup> the obligation to take a business rescue resolution should only arise if there is more than mere reasonable grounds to believe that it would be appropriate. My recommendation for an amended section 129(7) is therefore as follows:

(5)<sup>72</sup> ~~If the board majority of the directors of a company have reasonable grounds to believe and do believe that the company is financially distressed and that there is a reasonable possibility of rescuing the company, but they board has not must adopted a resolution contemplated in this section within three weeks after becoming aware of the situation. the board must deliver a written notice to each affected person, setting out the criteria referred to in section 128(1)(c) that are applicable to the company, and its reasons for not adopting a resolution contemplated in this section.~~

Any breach of this duty by the directors will automatically result in their potential liability for damages to any person who has suffered a loss as a result of their failure to act.<sup>73</sup> The amendment will also ensure that the board will not be forced to commence business rescue proceedings if the company cannot be rescued and liquidation would be more appropriate.<sup>74</sup>

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<sup>68</sup> See Chapter 2, part 3.5.1.2.

<sup>69</sup> In terms of ss 77(3)(b) and 214(1)(c) respectively.

<sup>70</sup> See Chapter 4, part 2.3.

<sup>71</sup> See part 2.5.1.3.1 below.

<sup>72</sup> The number of the subsection will change as a result of the recommended deletion of the current subsections (4) and (5).

<sup>73</sup> In terms of s 218(2).

<sup>74</sup> See Chapter 2, part 3.5.1.2.

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2.5.1.3 Objections to a business rescue resolution

2.5.1.3.1 *Setting aside the business rescue resolution*

In so far as the wording of section 130(1)(a) creates the impression that an application to court for setting aside a business rescue resolution may be based on the current circumstances of the company, and not those prevailing at the time that the resolution was taken, it should be amended.<sup>75</sup> I also believe that such an application to court should only be allowed within a specified period after the applicant has received notice of the resolution. This will prevent a situation where the board and the practitioner are constantly involved in litigation defending the resolution and also remove the permanent threat that the rescue procedure could be terminated at any time by an affected person. It is unnecessary to give affected persons this power for almost the entire duration of the procedure since the business rescue practitioner is under an obligation to terminate the procedure if the circumstances no longer warrant the continuation of the rescue attempt.<sup>76</sup> The following wording is recommended to incorporate all the above suggestions:

- 130(1) Subject to subsection (2), ~~at any time~~ after the adoption of a resolution in terms of section 129 ~~the adoption of a business rescue plan in terms of section 152~~, an affected person may apply to court for an order –
- (a) within three weeks after notice of the resolution has been given in terms of section 129(3), for an order setting aside the resolution on the grounds that at the time when the board took the resolution, –
- (i) there ~~is~~ was no reasonable basis for believing that the company was financially distressed;
  - (ii) there ~~is~~ was no reasonable ~~prospect~~ possibility ~~for~~ of rescuing the company; or
  - (iii) the company has failed to satisfy the procedural requirements set out in section 129;

Section 130(5), dealing with the powers of the court when such an application is before it, should also be amended.<sup>77</sup> It is difficult to imagine the circumstances in which

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<sup>75</sup> See, for example, Chapter 2, parts 3.8.3.4 and 3.8.5.2.1.

<sup>76</sup> See Chapter 2, parts 3.9.1.1 and 3.9.2.

<sup>77</sup> See Chapter 2, part 3.5.1.3.1.

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a court would find it just and equitable to set aside a rescue resolution in spite of finding that there was a reasonable basis for believing that the company was financially distressed, that there was a reasonable possibility of rescuing the company and that all the procedural requirements have been met.<sup>78</sup> The possibility of a court setting aside the resolution because it is regarded as just and equitable creates a substantial degree of uncertainty. Any factor, even one unrelated to the procedure itself, could lead a court to this view. Different courts would be influenced by different aspects, including the court's opinion on the desirability of a business rescue procedure, or sympathy towards creditors or towards employees.<sup>79</sup> I recommend that section 130(5)(a)(ii) should be removed to restrict the court's power to set aside the resolution on application by an affected person to those instances where the resolution was taken improperly because the stipulated requirements for a business rescue resolution were not present or the correct procedure has not been followed. Furthermore, since the practitioner must convene meetings with creditors and employees within ten days after his appointment, where he has to express an opinion on whether there is a reasonable prospect of rescuing the company,<sup>80</sup> it should be left to him to comply with his statutory obligation to apply for the termination of the rescue procedure if he comes to the conclusion that the company cannot be rescued.<sup>81</sup> I submit that it is undesirable for a court to have the power to terminate the rescue proceedings at an early stage, on the application of possibly a single employee, creditor or shareholder, even though the practitioner believes that it may succeed. Should the legislature strongly believe that the practitioner should not be the only person who may decide that the rescue proceedings should be terminated, this should be separated from the application to set aside an improperly taken resolution. One possibility is found in English law where the creditors may take a resolution instructing the administrator to apply for the termination of administration.<sup>82</sup> This would avoid multiple applications brought by persons who want to obstruct the procedure for the wrong reasons.

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<sup>78</sup> The three grounds stipulated in s 130(1) on which an affected person may apply for an order setting aside the resolution: see Chapter 2, part 3.5.1.3.1.

<sup>79</sup> See Chapter 2, part 2.4.4 on the problems created by these words in applications for judicial management.

<sup>80</sup> See Chapter 2, part 3.5.1.3.1.

<sup>81</sup> See Chapter 2, parts 3.9.1.1 and 3.9.1.2.

<sup>82</sup> See Chapter 3, part 2.9.2.

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I propose that section 130(5) should read as follows:

- (5) When considering an application in terms of subsection (1)(a) to set aside the company's resolution, the court may –
- (a) set aside the resolution ~~(i)~~ on any grounds set out in subsection (1); ~~or~~
    - ~~(ii)~~ if, having regard to all of the evidence, the court considers that it is otherwise just and equitable to do so; and
  - ~~(b)~~ afford the practitioner sufficient time to form an opinion whether or not
    - (i) the company appears to be financially distressed; or
    - ~~(ii)~~ there is a reasonable prospect of rescuing the company, and after receiving a report from the practitioner, may set aside the company's resolution if the court concludes that the company is not financially distressed, or there is no reasonable prospect of rescuing the company; and
  - ~~(c)~~ if it makes an order under paragraph (a) ~~or (b)~~ setting aside the company's resolution, make any further necessary and appropriate order, including –
    - (i) an order placing the company under liquidation; or
    - (ii) if the court has found that ~~there were~~ the board did not have no reasonable grounds for believing that the company would be unlikely to pay all of its debts as they became due and payable was financially distressed, an order of costs against any director who voted in favour of the resolution to commence business rescue proceedings, unless the court is satisfied that the director acted in good faith. ~~and on the basis of information that the director was entitled to rely upon in terms of section 76(4) and (5).~~

#### 2.5.1.3.2 *Replacing the business rescue practitioner*

The many problems and uncertainties created by the provisions of section 130(1)(b) and its apparent conflict with several other provisions<sup>83</sup> can quite easily be eliminated by two simple steps. First, all the grounds for removal of a business rescue practitioner contained in section 130(1)(b) should be included as requirements for his appointment in section 138(1).<sup>84</sup> I submit that section 130(1)(b) should then be

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<sup>83</sup> See Chapter 2, part 3.5.1.3.2.

<sup>84</sup> See Chapter 2, part 3.7.1.2 and part 2.7.1.2 below.

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scrapped completely, as there would be no real need for its existence. In terms of section 139(2) every affected person has the power to apply for the removal of the practitioner if, among other things, he does not comply with the requirements of section 138(1).<sup>85</sup> This provision applies to all business rescue practitioners, and there is no discernible reason for duplicating the conferment of this power where the practitioner was appointed by the company's board.

#### *2.5.1.3.3 Requiring the practitioner to provide security*

As has already been explained, it is an entrenched principle of South African law that an individual who is appointed in a position such as that of the business rescue practitioner and who will have control over substantial assets of another person must always provide security for the proper performance of his duties.<sup>86</sup> As a member of a regulated profession it will be fairly easy for him to do so, and it is therefore recommended that section 130(1)(c), which only requires security if so ordered by the court, should be removed. The provision of security should be included in section 138(1) as one of the requirements for appointment.<sup>87</sup>

### **2.5.2 Court order to begin rescue proceedings**

#### **2.5.2.1 Notification of application**

In view of the detrimental effects that the required prior notice of the application to all affected persons will undoubtedly have,<sup>88</sup> my preference would be for only limited notification to be required, similar to the prior notice required for an application for an administration order in England.<sup>89</sup> In such a case, prior notice would only be given to the company (if it is not the applicant), the Commission, the person nominated for appointment as interim business rescue practitioner<sup>90</sup> and the applicant in any pending winding-up application.<sup>91</sup>

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<sup>85</sup> See Chapter 2, part 3.7.1.3.

<sup>86</sup> See Chapter 2, parts 3.5.1.3.3 and 3.7.1.2.

<sup>87</sup> See part 3.7.1.2 below.

<sup>88</sup> See Chapter 2, part 3.5.2.1.

<sup>89</sup> See Chapter 3, part 2.5.2.

<sup>90</sup> See Chapter 2, part 3.5.2.5.

<sup>91</sup> See Chapter 2, part 3.5.2.3 and part 2.5.2.3 below.

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However, considering the determination of the trade union movement that trade unions will be involved in every phase of business rescue proceedings right from the beginning of the procedure, and the support they have from the Department of Trade and Industry,<sup>92</sup> it is unlikely that a requirement of only limited notice will be acceptable to the legislature. Therefore, it is extremely important that the company should be protected by an interim moratorium on any winding-up order, resolution for voluntary winding up and any other legal processes, from the moment that the application is presented to court by filing the papers with the Registrar of the court,<sup>93</sup> until the court grants an order placing the company under supervision or dismisses the application.<sup>94</sup> At the same time, it is also essential that the provision stipulating the moment of commencement of business rescue proceedings by an order of court,<sup>95</sup> and the one regulating an application for a business rescue order after “liquidation proceedings” have commenced,<sup>96</sup> should be properly and clearly formulated as recommended below.<sup>97</sup>

Finally, the wording of section 131(2)(b) should make it clear that notice must be given only after the application has been presented to court. It would also be advisable to stipulate the period within which affected persons should be notified. In this respect the example of English law could be followed by requiring notice to be given as soon as reasonably practicable but not less than five business days before the date of the hearing.<sup>98</sup> It is also hoped that the regulations will provide for a less expensive way of giving notice, even if only to shareholders, by publication of the notice in a daily newspaper or newspapers.<sup>99</sup>

#### 2.5.2.2 Right of affected persons to participate in hearing

To prevent unnecessary costs and a long period of uncertainty, it is essential that the court hearing should be finalised as soon as possible. This will become very difficult if too

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<sup>92</sup> See Chapter 2, part 3.3.2.3.

<sup>93</sup> See Chapter 2, part 3.5.2.6 and part 2.5.2.6 below.

<sup>94</sup> See Chapter 2, part 3.6.1 and part 2.6.1 below regarding the need for and wording of an interim moratorium.

<sup>95</sup> See Chapter 2, part 3.5.2.6.

<sup>96</sup> See Chapter 2, part 3.5.2.3.

<sup>97</sup> See below parts 2.5.2.6 and 2.5.2.3 respectively.

<sup>98</sup> See Chapter 3, part 2.5.2.

<sup>99</sup> See Chapter 2, part 3.5.2.6.

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many litigants participate, filing long and complicated papers.<sup>100</sup> On the other hand, for reasons already stated above, it is highly unlikely that the legislature will be prepared to exclude the trade unions and workers from participation, while creditors must, and shareholders should, be given the opportunity to protect their interests. However, I would recommend a provision similar to that in the company administration application in England, which gives only a few specified persons an automatic right to appear or be represented at the hearing, while all others have to obtain the permission of the court by showing that they have an interest that justifies their participation.<sup>101</sup> Although the English courts are fairly lenient in recognising such an interest, it does at least enable them to limit the number of participants if necessary.

Section 131(3) would then read as follows:

The applicant, the company, one or more of its directors, any registered trade union representing employees of the company, any person who has filed an application for the winding up of the company and, with the permission of the court, any other Each affected person who appears to have an interest justifying his appearance, may ~~has a right to~~ participate in the hearing of an application in terms of this section.

### 2.5.2.3 Application after liquidation has commenced

The provisions regarding the period within which an application for business rescue proceedings may be made after “liquidation proceedings” have been commenced are unsatisfactory and should be rephrased to clearly identify and limit this period.<sup>102</sup> Furthermore, there is no need to suspend the application for winding up if a business rescue order is issued, since the business rescue practitioner will have the duty to apply for liquidation if the company cannot be rescued.<sup>103</sup> The court has the power to order the liquidation of the company if the application for a business rescue order is refused,<sup>104</sup> and it is thus not really necessary for the original winding-up application to be revived. However, this part of the provision is retained to afford the original applicant an opportunity to convince the court that such an order is necessary.

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<sup>100</sup> See Chapter 2, part 3.5.2.2.

<sup>101</sup> See Chapter 3, part 2.5.2.

<sup>102</sup> See Chapter 2, part 3.5.2.3.

<sup>103</sup> See Chapter 2, part 3.9.1.2.

<sup>104</sup> See Chapter 2, part 3.5.2.5.



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Therefore, I suggest that section 131(6) should be amended as follows:

- (6) If an application for winding up of the company has liquidation proceedings have already been presented to the court commenced by or against the company but not yet disposed of at the time an application is made in terms of subsection (1), the application will suspend those liquidation proceedings until the application for winding up will be –
- (a) suspended until the court has adjudicated upon the application for business rescue proceedings; and
  - (b) dismissed if the court makes the order ~~applied~~ for business rescue proceedings.

To avoid any confusion regarding the position of a company that is already in liquidation, the proviso at the beginning of section 131(1) should read as follows:

- (1) Unless a company has adopted and filed a resolution contemplated in section 129, or a court has issued a final order of winding up in respect of the company or the voluntary winding up of the company has commenced, an affected person may apply to a court ~~at any time~~ for an order ...

#### 2.5.2.4 Order during liquidation proceedings

As a result of the inconsistent use of terminology by the drafters of the Act, the word “proceedings” could refer to court proceedings or a procedure such as liquidation or business rescue. Since I regard it as highly undesirable to allow a business rescue order to be made after the winding up of a company has commenced, it should also be made clear in this subsection that a court may only order business rescue proceedings instead of winding up, if winding up has not yet formally commenced.

I propose the following wording for section 131(7) by using section 427(3) of the Companies Act of 1973 as an example:

- (7) ~~In addition to the powers of a court on an application contemplated in this section,~~  
a When an application for the winding up of a company is made to court, or legal proceedings to enforce any security have been instituted against a company, a court may make an order contemplated in subsections (4)(a) or

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~~and (5) if satisfied that the requirements for such an order are met. applicable, at any time during the course of any liquidation proceedings.~~

Such a provision may assist in creating a rescue culture in South Africa if courts take up the challenge not to order the winding up of the company automatically when a creditor applies for it, but to use their discretion and consider whether the company is a good candidate for a rescue attempt. Although the courts also have this power in the case of judicial management, the onerous requirements for a judicial management order and the courts' general disinclination to make such an order prevented them from making use of this option.<sup>105</sup>

In this respect the South African courts have an advantage over their English counterparts, which are not allowed to issue an administration order unless there is a specific application for such an order before them.<sup>106</sup> It seems unnecessarily formalistic to restrict the discretion of the courts in this manner, especially if the legislature is trying to develop a rescue culture, and it is also contrary to the specific recommendations of the Cork Committee. German courts could perhaps be said to have the easiest option since, as a result of their unitary procedure, they do not have to make a decision on the direction the procedure will take.<sup>107</sup> However, this is also seen as a disadvantage because of the uncertainty whether creditors will decide in favour of a rescue or not.<sup>108</sup>

#### 2.5.2.5 Powers of the court

As explained before,<sup>109</sup> the two alternative grounds for financial distress on which a court may order the commencement of business rescue proceedings, are unsatisfactory and should be removed from section 131(4).

The power of the court to order the liquidation of the company if it dismisses the application for the commencement of business rescue proceedings must be welcomed since this was not specifically authorised where an application for judicial management was dismissed, and apparently also not included in the power of the

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<sup>105</sup> See Chapter 2, parts 2.4.4 and 2.4.5.

<sup>106</sup> See Chapter 3, part 2.5.2.

<sup>107</sup> See Chapter 4, part 2.5.2.

<sup>108</sup> Ibid.

<sup>109</sup> See part 2.4.1 above.

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court to make any order it may deem just.<sup>110</sup> Apart from the waste of costs and time caused by requiring a specific application for winding up to be made after dismissal of the judicial management application, it also left the company vulnerable to enforcement action by creditors until such time as an application could be made.

Courts in England also have the power to order the winding up of the company in appropriate circumstances when hearing an application for an administration order.<sup>111</sup>

The power of the court to order business rescue proceedings when an application is made by a director or shareholder in terms of section 163 for relief from oppressive or prejudicial conduct seems quite drastic.<sup>112</sup> However, it is unlikely to be used very often, since not only will the applicant have to prove the prejudicial conduct, but the court will also have to be satisfied that the circumstances for a business rescue order apply. The advantage of this provision is that a court may order the commencement of business rescue proceedings when an inherently sound company is managed in such an oppressive and dictatorial way by one or more influential directors that the company is in financial distress.<sup>113</sup> It could also provide a director who is not an affected person and may therefore not apply directly for business rescue proceedings to commence, with an opportunity to achieve this result if appropriate.<sup>114</sup> However, it does not completely solve the problem for a director who is regularly outvoted by the majority on the board, because there is no guarantee that the court will order business rescue proceedings to commence, even if the circumstances required for such an order apply to the company.

#### 2.5.2.6 Commencement of business rescue proceedings

The uncertainty created by the wording of section 132(1)(b) regarding the specific moment of commencement of business rescue proceedings by an order of court, and the complications that would result if it commences before the relevant court order is issued, have already been explained.<sup>115</sup> The relevant provisions of the English

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<sup>110</sup> See Chapter 2, part 2.5.2.

<sup>111</sup> See Chapter 3, part 2.5.2.

<sup>112</sup> See Chapter 2, part 3.5.2.5.

<sup>113</sup> If my recommendation that financial distress should be measured over the next 12 months (see part 2.4.1 above) is accepted, the court could look at the results that the oppressive conduct is likely to cause in this period, even if the company is still quite healthy at the moment.

<sup>114</sup> See Chapter 2, part 3.3.2.

<sup>115</sup> See Chapter 2, part 3.5.2.6.

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Insolvency Act 1986 could serve as an example because of their clarity and the discretion given to a court to order the commencement of administration at a time different from the date on which the order is made.<sup>116</sup>

Therefore, I recommend that section 132(1) should be amended as follows:<sup>117</sup>

- (1) Business rescue proceedings shall commence ~~begin~~ when –
  - (a) the company –
    - (i) files a resolution ~~to placing~~ itself under supervision and appointing a business rescue practitioner in terms of section 129(3); or
    - (ii) ~~applies to the court for consent to file a resolution in terms of section 129(5)(b);~~
  - (b) ~~a person applies to the court for an~~ makes an order placing the company under supervision in terms of section 131(~~14~~(a)), unless a different time for commencement is stipulated in the order. ; ~~or~~
  - (c) ~~during the course of liquidation proceedings, or proceedings to enforce a security interest, a court makes an order placing the company under supervision.~~

My recommendation that section 131(1)(c) should be scrapped is based on the fact that there will no longer be any difference in the time of the commencement of business rescue proceedings that start as a result of an order of court, irrespective of whether the order results from an application for business rescue, for liquidation, for enforcement action or for relief from oppressive conduct.

The unclear wording of section 131(8)(a) on the prohibition against a company “placing itself in liquidation” during business rescue proceedings commenced by an order of court should be improved by using an adapted version of the recommended wording for section 129(6):<sup>118</sup>

- (8) A company that has been placed under supervision in terms of this section
  - (a) may not adopt a resolution placing itself to begin a voluntary winding up of the company or to apply for winding up of the company by the court in

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<sup>116</sup> See Chapter 3, part 2.5.2.

<sup>117</sup> This recommendation also incorporates the suggestions made in respect of proceedings commenced by a board resolution for the scrapping of s 129(5): see part 2.5.1.1 above.

<sup>118</sup> See part 2.5.1.1 above.

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liquidation until the business rescue proceedings have ended as determined in accordance with section 132(2).<sup>119</sup>

Another example of the multiple and often unnecessary notices to affected persons repeatedly required by the Act is found in section 131(8)(b), which compels the company to inform each affected person of the business rescue order within five business days after it has been issued.<sup>120</sup> Since every affected person has already been notified of the application,<sup>121</sup> and creditors and employees have to be notified by the practitioner of their respective meetings convened within ten days after the order,<sup>122</sup> I submit that it is unnecessary and wasteful to notify every affected person of the order.

I therefore propose that section 131(8)(b) should be scrapped. The notices convening the respective meetings of creditors and employees' representatives will serve as confirmation that the court order has been issued and shareholders, who have already been informed of the application, will be notified of the meeting to approve a rescue plan if their rights will be affected directly.<sup>123</sup>

## **2.6 The moratorium**

### **2.6.1 Moratorium on legal proceedings**

In terms of my recommendations, the business rescue procedure will formally commence when the board resolution is filed or the relevant court order is issued.<sup>124</sup> This is also the obvious moment when a moratorium on legal processes against the company should become effective. However, it is clear that in the case of an application to court for a business rescue order, the company needs protection from enforcement action and other legal processes by creditors from the moment that the intended application is made public (the filing of papers at the court) until the court order is issued. This protection should be in the form of an interim moratorium that protects the company from winding-up applications and other legal processes.

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<sup>119</sup> See below on my recommendation that section 131(8)(b) should be scrapped.

<sup>120</sup> See Chapter 2, part 3.5.2.6.

<sup>121</sup> See part 2.5.2.1 above.

<sup>122</sup> See part 2.5.1.1 above.

<sup>123</sup> See Chapter 2, part 3.5.2.6.

<sup>124</sup> See part 2.5.2.6 above.

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A company that is placed under supervision as a result of a board resolution will not need this protection, as no prior notice to any person is required.<sup>125</sup> In the absence of any provision requiring the registration of the resolution before it becomes effective or any power granted to the Commission to refuse the filing of the resolution, it may be assumed that the resolution becomes effective the moment the resolution is filed at the Commission and the final moratorium then takes effect. However, in the interests of clarity, I believe that the wording of the final moratorium should also be improved and that winding-up orders should be specifically and absolutely excluded.<sup>126</sup> An application for winding up while the company is under supervision should not even be possible with the consent of the business rescue practitioner or the court. It should be allowed only after the business rescue proceedings have been set aside or terminated as provided in the Act.

Therefore I recommend the following wording for section 133, based partly on the moratorium that may be ordered in respect of a company under judicial management and partly on the wording of the moratorium applicable to administration in English law:

**133 Interim and general moratorium on legal proceedings against company**

- (1) From the moment that an application for the commencement of business rescue proceedings has been filed with the court, until the business rescue proceedings commence or the court has dismissed the application, no order may be made for the winding up of the company and, except with the permission of the court and subject to any conditions it may impose, no legal proceedings, actions, or the execution of any writs, summonses and other processes against the company may be instituted or proceeded with.
- (2) No order may be made for the winding up of a company that is under supervision.
- (13) ~~During business rescue proceedings, no legal proceeding, including enforcement action, against the company, or in relation to any property belonging to the company, or lawfully in its possession, may be commenced or proceeded with in any forum; While a company is under supervision, no legal proceedings, actions, or the execution of any writs, summonses and other processes against the company may be instituted or proceeded with except –~~
- (a) with the written consent of the practitioner;
  - (b) with the leave of the court and ~~in accordance with any terms~~ subject to any

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<sup>125</sup> See Chapter 2, part 3.5.1.1.

<sup>126</sup> Similar to the situation in England: see Chapter 3, part 2.6.2.

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- condition or requirement that the court considers suitable may impose;
- (c) as a set-off against any claim made by the company in any legal proceedings, irrespective whether those proceedings commenced before or after the business rescue proceedings began;
  - (d) criminal proceedings against the company; ~~or any of its directors or officers;~~ or
  - (e) proceedings concerning any property or right over which the company exercises the powers of a trustee.
- (24) During business rescue proceedings, a guarantee or surety by a 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 in the circumstances.
- (35) ~~If any right to commence proceedings or otherwise assert a claim against a company is subject to a time limit, the measurement of that time must be suspended during the company's business rescue proceedings. Prescription will not run on any claim or right against a company while the company is under supervision or protected by an interim moratorium.~~

### 2.6.2 Uncompleted contracts

The provision apparently giving a business rescue practitioner the right unilaterally to amend, suspend or cancel a (presumably uncompleted) agreement is objectionable in so many respects that it should be deleted almost entirely.<sup>127</sup>

Based on the provisions of the German InsO<sup>128</sup> and the common law principles regulating this issue in South African insolvency law, sections 136(2) and (3) should be amended as follows:

- (2) If, at the commencement of business rescue proceedings, the obligations in terms of a contract to which the company is a party have not been performed in full by the company or the other contracting party, except for obligations arising out of a contract as described in Subject to sections 35A and 35B of the Insolvency Act, 1936 (Act No. 24 of 1936) and a contract during business rescue proceedings, the practitioner may cancel or suspend entirely, partially or

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<sup>127</sup> See Chapter 2, part 3.6.2.

<sup>128</sup> Paragraph 103(1) of the German InsO: see Chapter 4, part 2.6.2.

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~~conditionally any provision of an agreement to which the company is a party at the commencement of the business rescue period, other than an agreement of employment, the business rescue practitioner may, despite any provision of the agreement to the contrary, choose –~~

~~(a) to perform the company's unfulfilled obligations and claim the same from the other contracting party; or~~

~~(b) to refuse to fulfil the contract;~~

~~by informing the other contracting party in writing of his decision within a reasonable time after his appointment.~~

- (3) ~~Any The other party to an agreement that has been suspended or cancelled, or any provision which has been suspended or cancelled, repudiated by the business rescue practitioner in terms of subsection (2)(a) may assert a will have a claim for damages against the company for breach of contract but may not claim specific performance from the company.~~

If the business rescue practitioner chooses to continue the contract, this will form part of the costs of the business rescue proceedings, but if he decides to repudiate the contract, the claim for damages will not enjoy any preference. The amended version of the two subsections at least makes it clear that no vested rights will be affected and that the rightful owner of property in the possession of the company, for example as a result of a contract of lease or a sale subject to retention of title by the seller, will have the right to demand its return if the business rescue practitioner repudiates the contract. It will also make it clear that no business rescue practitioner may unilaterally change the provisions of a contract: he must either bind himself to the full contract or repudiate it.

## **2.7 Managing the procedure**

### **2.7.1 The business rescue practitioner**

#### **2.7.1.1 Appointment**

As explained above, the appointment of a business rescue practitioner by the board should be combined with the resolution to place the company under supervision to save time and costs and generally simplify the procedure.<sup>129</sup>

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<sup>129</sup> Part 2.5.1.1.



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The apparent discretion given to the court whether to appoint an interim practitioner when ordering the commencement of rescue proceedings is misleading and should be rectified since the rescue cannot proceed without a practitioner.<sup>130</sup> The first part of section 131(5) should therefore be amended as follows:

- (5) If the court makes an order in terms of subsection (4)(a), the court ~~may~~ must make a further order appointing as interim practitioner a person who satisfies the requirements of section 138, and who has been nominated by the affected person who applied in terms of subsection (1), subject to ratification by the ~~holders of a majority in value~~ in value of the independent creditors' ~~voting interests~~ at the first meeting of creditors, as contemplated in section 147.

Regarding the replacement of a practitioner who has been removed by an order of court,<sup>131</sup> I propose that the right to nominate a practitioner should properly be given to the person who applied for the order where applicable. Section 139(3) should thus be amended as follows:

- (3) The company, or the creditor who nominated the practitioner, as the case may be, must appoint a new practitioner if a practitioner dies or resigns. If a practitioner ~~or~~ is removed from office by an order of court, the court ~~may~~ must make a further order appointing ~~as interim practitioner a person~~ as interim practitioner a person who satisfies the requirements of section 138, and who has been nominated by the affected person who applied in terms of subsection (1). ~~subject to the right of an affected person to bring a fresh application in terms of section 130(1)(b) to set aside that new appointment.~~

Since this order may be issued when the business rescue proceedings are at an advanced stage, I do not recommend an interim appointment that must first be ratified by the creditors. Any affected person who has objections to the new business rescue practitioner has the same right to apply for his removal.<sup>132</sup>

#### 2.7.1.2 Qualifications

The first issue that should be clarified in this respect is whether only individuals can

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<sup>130</sup> See Chapter 2, part 3.7.1.1.

<sup>131</sup> See Chapter 2, part 3.7.1.1 and in this Chapter, parts 2.5.1.3.2 above and 2.7.1.3 below.

<sup>132</sup> See part 2.7.1.3 below.

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be appointed as business rescue practitioners or whether juristic persons and partnerships will be included as well.<sup>133</sup> I believe that all the other provisions in this regard favour the appointment of individuals only. The word “person” in section 138(1)<sup>134</sup> should therefore be replaced by “individual”.<sup>135</sup>

Furthermore I regard it as important that every practitioner should be required to provide security for the proper performance of his duties.<sup>136</sup> This is a standard requirement not only for similar appointments in South African law but also in other legal systems. It should therefore be added to section 138(1) as a requirement for appointment.

As explained before, the requirements for appointment as a business rescue practitioner should as far as possible be aligned with the grounds for his removal. This will not only bring clarity to the situation but also prevent requirements for appointment being set indirectly by introducing them for the first time as grounds for removal.<sup>137</sup>

#### *2.7.1.2.1 Membership of a regulatory body*

As indicated before, the present wording of this requirement merely refers to membership of the profession (or, by implication, the professional body).<sup>138</sup> I submit that it should be made clear that it is not membership that is required but, like the requirement set in England for insolvency practitioners and in accordance with the wording of the draft regulations, the authority or accreditation to act as business rescue practitioner which must be given by the regulatory body.<sup>139</sup> This is particularly important since the Act itself does not stipulate any requirements regarding qualifications, training or experience, and it will be up to the regulatory authority to ensure that only properly skilled practitioners are permitted to act. The accreditation can then be revoked in appropriate circumstances where a business rescue practitioner has been guilty of objectionable behaviour. This is of particular importance since there is no provision for an order of court disqualifying a person from acting as a business rescue practitioner.

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<sup>133</sup> See Chapter 2, part 3.7.1.2.

<sup>134</sup> Regulations 132 to 133 should also be amended to reflect this restriction.

<sup>135</sup> For the sake of cohesion, the full wording of s 138(1) with all proposed amendments will be quoted at the end of part 2.7.1.2.

<sup>136</sup> See Chapter 2, parts 3.5.1.3.3 and 3.7.1.2.

<sup>137</sup> See Chapter 2, parts 3.5.1.3.2 and 3.7.1.3.1 and this Chapter, part 2.5.1.3.2 above.

<sup>138</sup> See Chapter 2, part 3.7.1.2.1.

<sup>139</sup> See Chapter 3, part 2.7.1.2.

*2.7.1.2.2 Not subject to order of probation*

This requirement is welcomed since any inappropriate behaviour as a director, even if it is not sufficient to completely disqualify the individual from appointment as director, would prevent his appointment as business rescue practitioner.<sup>140</sup>

*2.7.1.2.3 Not disqualified from acting as director*

I agree that it would be highly undesirable to appoint an individual who is disqualified from managing a company as director, to manage the business as business rescue practitioner. However, it is difficult to understand why firstly, there is no provision for a court to specifically disqualify a person from acting as business rescue practitioner and secondly, why inappropriate behaviour as a director should not also lead directly to disqualification from appointment as business rescue practitioner, as is the case in English law.<sup>141</sup> Unfortunately, the wording of the English provisions differs substantially from that of the Companies Act of 2008 and cannot be used as a model for amendments to the South African legislation.<sup>142</sup>

The linking of the qualifications for appointment as a business rescue practitioner to the disqualifications relating to a director has created unnecessary confusion and uncertainty.<sup>143</sup> I submit that this requirement will be improved by specifically listing all the disqualifications for business rescue practitioners.

*2.7.1.2.4 No compromising relationship with company*

In spite of its complicated wording,<sup>144</sup> this qualification requires nothing more than independence and the absence of any potential conflict of interests from the business rescue practitioner. The requirement should be amended to correspond to the much simpler wording of essentially the same requirement where it is listed among the grounds for removal of the business rescue practitioner.<sup>145</sup> The amended wording should also make it clear that independence from the creditors is just as

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<sup>140</sup> See Chapter 2, part 3.7.1.2.2.

<sup>141</sup> See Chapter 3, part 2.7.1.2.

<sup>142</sup> See part 3.7.1.3 below for the proposed amendments that will link such power to the removal of a business rescue practitioner from office.

<sup>143</sup> See Chapter 2, part 3.7.1.2.3.

<sup>144</sup> See Chapter 2, part 3.7.1.2.4.

<sup>145</sup> See Chapter 2, part 3.7.1.2.4 and in this Chapter, part 3.7.1.3.5 below.

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important as independence from the company itself. A less convoluted description will also leave room for the circumstances of each case to be considered when deciding whether there is a conflict of interests, and would also allow the professional organisation to draft guidelines on how possible conflicts of interest should be identified and handled.<sup>146</sup>

#### *2.7.1.2.5 Not related to person with compromising relationship*

If the last-mentioned requirement is rephrased to cover any situation that could lead to a conflict of interests or lack of independence, this requirement will become unnecessary.<sup>147</sup> It will then be obvious that, for example, the spouse of a major shareholder or creditor of the company could probably not be regarded as independent.

In view of all my above-mentioned recommendations regarding the requirements for appointment as a business rescue practitioner, I propose that section 138(1) should be amended as follows:

#### **138 Qualifications of practitioners**

- (1) ~~An individual person~~ may be appointed as the practitioner of a company only if ~~such individual person—~~
- (a) ~~is a member in good standing of, accredited to act as a business rescue practitioner by a profession subject to regulation by a~~ the regulatory authority designated by the Minister for the a regulatory authority regulation of the profession in terms of subsection (2);
  - (b) has the necessary skills and competencies required by the specific circumstances of the company;
  - (c) has given security to the satisfaction of the Commission for the proper performance of his duties as business rescue practitioner;
  - (d) is independent of the company and its creditors and free from any potential conflict of interests; does not have any other relationship with the company such as would lead a reasonable and informed third party to conclude that the integrity, impartiality or objectivity of that person is compromised by that relationship; and

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<sup>146</sup> As has been done in England (see Chapter 3, part 2.7.1.1) and in Germany (see Chapter 4, part 2.7.1.2.4).

<sup>147</sup> See Chapter 2, part 3.7.1.2.5.

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- ~~(e) is not related to a person who has a relationship contemplated in paragraph (d)~~
  - (e) has not been declared to be disqualified from being appointed as a business rescue practitioner in terms of section 139(2);<sup>148</sup>
  - (f) is not subject to an order of probation in terms of section 162(7);
  - (g) is not subject to an order declaring him a delinquent director in terms of section 162(5);
  - ~~(e) would not be disqualified from acting as a director of the company in terms of section 69(8);~~
  - (h) is not an insolvent;
  - (i) is not a minor or an individual under any other legal disability;
  - (j) has not been removed from an office of trust on the grounds of misconduct involving dishonesty;
  - (k) has not been convicted, in the Republic or elsewhere, and imprisoned without the option of a fine, or fined more than the prescribed amount, for theft, fraud, forgery, perjury or an offence –
    - (i) involving fraud, misrepresentation or dishonesty;
    - (ii) in connection with the promotion, formation or management of a company, or in connection with any act contemplated in section 69(2) or (5); or
    - (iii) under this Act, the Insolvency Act 24 of 1936 (Act 24 of 1936), the Close Corporations Act 69 of 1984, the Competition Act 89 of 1998, the Financial Intelligence Centre Act 38 of 2001 (Act No. 38 of 2001), the Securities Services Act 36 of 2004 (Act No. 36 of 2004), or Chapter 2 of the Prevention and Combating of Corruption Activities Act 12 of 2004 (Act No. 12 of 2004).

Although sections 138(1)(f) to (k) should automatically lead to the cancellation of an individual's authority to act as a business rescue practitioner by the professional organisation, the present uncertainty over the identity, exact powers and competency of the body still to be appointed requires that the disqualifications should be stipulated in the Act itself.<sup>149</sup>

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<sup>148</sup> See part 2.7.1.3 below.

<sup>149</sup> If anything, the fact that draft Regulation 129(1) establishes a Regulatory Board which will function as an organ of state, and that in terms of draft Regulation 130(1), the Minister will appoint more than

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### 2.7.1.3 Vacation of or removal from office

In terms of my recommendations, section 139 will be the only provision regulating the removal of a practitioner by an order of court.<sup>150</sup> Although at least two of the grounds for removal reflect clearly objectionable and even criminal acts by a practitioner, the court ordering his removal does not have the power to order that such an individual is disqualified from future appointments. Therefore I propose that this power should be added to the wording of section 129(2). The full text of section 129(1) and (2) with the recommended amendments will be quoted after the discussion of the grounds for removal.

#### 2.7.1.3.1 *Incompetence or failure to perform his duties*

Since possession of the necessary skills and competence for the particular case is now a requirement in terms of my proposed section 138(1)(b),<sup>151</sup> a lack of such skills or competence that is only discovered after the appointment of a particular practitioner, will be covered by the grounds of a person no longer meeting the requirements of section 138(1).<sup>152</sup> However, the failure to perform his duties at all will not necessarily be as a result of incompetence, and I submit that the second part of this provision should be retained to allow the removal of a practitioner who fails to perform his duties for any reason. It could be argued that the failure to perform his duties is included in the next provision, namely the failure to perform his functions with the proper degree of care and skill.<sup>153</sup> However, since I propose that the last-mentioned provision should be amended to refer to any breach of his fiduciary duties or duties of care and skill,<sup>154</sup> it may be wiser to retain the failure to act at all, as separate grounds for removal of a business rescue practitioner.

#### 2.7.1.3.2 *Failure to perform his functions with the proper degree of care*

In my view, the fact that the full spectrum of directors' duties has been made applicable to business rescue practitioners indicates that the drafters of this provision intended to

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half of the members of the Board, confirms this view.

<sup>150</sup> See part 2.5.1.3.2 above.

<sup>151</sup> See part 2.7.1.2 above.

<sup>152</sup> See part 2.7.1.3.4 below.

<sup>153</sup> See part 2.7.1.3.2 below.

<sup>154</sup> See part 2.7.1.3.2 below.

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constitute a breach of any of those duties, including his fiduciary duties and the full duty of care, skill and diligence as it is formulated in the relevant section describing directors' duties, as grounds for his removal.<sup>155</sup> Furthermore, merely providing for possible personal liability for breach of his duties does not, I submit, offer sufficient protection to the company and the affected persons; such a business rescue practitioner should not be allowed to continue in office if the rescue procedure is still continuing.

A degree of overlapping exists between these and the last-mentioned grounds for removal, since a lack of skill appears to be the same as incompetence. I submit that it would have been preferable not to choose the shortcut by simply referring to the duties of directors, but rather to list the relevant and specifically adapted duties as they would apply to a business rescue practitioner. However, without any explanatory document from the legislature it is difficult, if not impossible, to tell exactly which duties were regarded as applicable and important for a business rescue practitioner to adhere to. Under the circumstances I would strongly recommend that at least the liability for insolvent trading should be specifically excluded by section 140(3)(b). In its amended form the subsection should thus read as follows:

- (3) During a company's business rescue proceedings, the practitioner –
  - (a) is an officer of the court, and must report to the court in accordance with any applicable rules of, or orders made by, the court;
  - (b) has the responsibilities, duties and liabilities of a director of the company, as set out in sections 75 to 77, with the exception of section 77(3)(b);

Furthermore, the grounds for removal of a business rescue practitioner should be reworded to make it clear that a breach of either his fiduciary duties or his duties of care and skill could lead to his removal by the court.

### 2.7.1.3.3 *Engaging in illegal acts or conduct*

Once again it has to be said that it is impossible to tell whether the drafters were specifically referring to illegal conduct by the business rescue practitioner which

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<sup>155</sup> See Chapter 2, part 3.7.1.3.2.

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related to his office or were performed in the exercise of his duties.<sup>156</sup> I submit that this provision is too vague to be of any value and is covered by the previous grounds of a breach of fiduciary duties. If found guilty of a serious and relevant illegal act or conduct, which should at least have been a requirement for removal under this heading, a business rescue practitioner will probably not meet the requirements of section 138(1) any longer,<sup>157</sup> or his authority to act will, it is hoped, be removed by the regulatory authority.<sup>158</sup>

Therefore I believe this provision should be removed.

#### *2.7.1.3.4 No longer meeting the requirements contained in section 138(1)*

The numerous specific requirements stated in section 138(1) should go a long way to ensuring that a business rescue practitioner can be removed on these grounds if he is found to be unwilling, unable or unsuitable to remain in office.<sup>159</sup> However, probably the most important aspect in this regard is that, in terms of my recommendations, section 138(1) must specifically require that a member of the professional organisation must be accredited to act as a business rescue practitioner. It will thus be possible for the organisation to remove an individual from the profession for any unethical or inappropriate behaviour, irrespective of whether it amounts to an illegal act. Once accreditation to act as a business rescue practitioner has been revoked, he will automatically no longer meet the requirements of section 138(1).

#### *2.7.1.3.5 Conflict of interest or lack of independence*

This aspect is covered by two other grounds for the removal of a business rescue practitioner. Firstly, a business rescue practitioner's independence and the absence of any conflict of interests are requirements for appointment in terms of section 138(1), both in the original wording and in my recommended version.<sup>160</sup> Should the situation change, the business rescue practitioner will no longer meet the requirements of section 138(1) and may be removed on those grounds. Secondly,

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<sup>156</sup> See Chapter 2, part 3.7.1.3.3.

<sup>157</sup> See part 2.7.1.3.4 below.

<sup>158</sup> See part 2.7.1.2 above.

<sup>159</sup> See part 2.7.1.2 above.

<sup>160</sup> See parts 2.7.1.2 and 2.7.1.3.4 above.



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acting as business rescue practitioner while his interests are in conflict with those of the company is a clear breach of his fiduciary duties and also constitutes grounds for his removal.<sup>161</sup>

#### *2.7.1.3.6 Incapacity and inability to perform his duties*

I submit that a business rescue practitioner who becomes incapacitated to such an extent that he is unable to perform his duties should be removed immediately if he cannot or will not resign.<sup>162</sup> It would be unreasonable to expect the affected company to wait for any period of time while the rescue proceedings and the financial situation of the company become more precarious with every passing day. The uncertainties surrounding the exact meaning of a “reasonable time” and when it can be said that he is “unlikely” to regain his capacity make this part of the provision extremely undesirable.

In conclusion, I recommend that section 139(1) and (2) should be amended as follows:<sup>163</sup>

#### **139 Removal and replacement of practitioner**

- (1) A practitioner may be removed only
  - ~~(a)~~ by a court order in terms of section 130; or
  - ~~(b)~~ as provided for in this section.
- (2) ~~Upon request of~~ On application by an affected person, or on its own motion, the court may remove a practitioner from office on any of the following grounds, and may at the same time declare such practitioner to be incapable of being appointed as a business rescue practitioner under this Act for life or for such period as the court may determine:
  - ~~(a)~~ ~~Incompetence or~~ failure to perform his duties;
  - ~~(b)~~ breach of his fiduciary duties or failure to exercise the proper degree of care, skill and diligence in the performance of the practitioner’s functions;
  - ~~(c)~~ ~~engaging in illegal acts or~~ conduct;
  - ~~(d)~~ if the practitioner no longer satisfies the requirements set out in section 138(1); or
  - ~~(e)~~ ~~conflict of interest or lack of independence; or~~

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<sup>161</sup> See part 2.7.1.2.3 above.

<sup>162</sup> See Chapter 2, part 3.7.1.3.6.

<sup>163</sup> See part 2.7.1.1 above for the amended version of s 139(3).

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- (d) if the practitioner is incapacitated and unable to perform the functions of that office., ~~and is unlikely to regain that capacity within a reasonable time.~~

### **2.7.2 Powers and duties of directors**

The retention in office of the directors may assist the practitioner in identifying the company's problems and devising an appropriate rescue plan by using their experience and knowledge of the company.<sup>164</sup> This will obviously depend on the extent to which the directors were part of the company's problems and contributed to its precarious situation. However, the current uncertainty created by contradictory provisions in regard to the powers of the directors during business rescue proceedings will almost certainly give rise to a power struggle between the directors and the business rescue practitioner, particularly if the business rescue practitioner was not appointed by the board, or will result in directors' hesitating to exercise even their most routine duties.<sup>165</sup>

The appointment of a business rescue practitioner in all cases indicates a decision by the legislature to retain the present principle in judicial management that an outsider will be put in charge of the company during rescue proceedings, and it should be clearly reflected in the relevant provisions. This is similar to the position of the administrator in England<sup>166</sup> and the insolvency administrator in Germany<sup>167</sup> where the directors also remain in office but lose any powers that may conflict or interfere with the task of the insolvency practitioner. The experience in Germany with the mostly unsuccessful introduction of self-administration<sup>168</sup> proves that any attempt to introduce something similar to the debtor in possession procedure of the United States which is completely alien to our legal culture and traditions, will almost certainly fail.<sup>169</sup>

The directors are clearly absolved from liability for the breach of most of their statutory fiduciary duties or duties of care and skill if they act according to the express instructions of the business rescue practitioner and disclose any personal

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<sup>164</sup> See Chapter 2, parts 3.7.2 and 3.8.1.

<sup>165</sup> See Chapter 2, part 3.7.2.

<sup>166</sup> See Chapter 3, part 2.7.2.

<sup>167</sup> See Chapter 4, part 2.7.2.1.

<sup>168</sup> See Chapter 4, part 2.7.2.2.

<sup>169</sup> See Chapter 2, parts 3.7.2 and 3.10.

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financial interests.<sup>170</sup> Their position is thus closer to that of directors in Germany who lose all powers to manage the company's business or deal with its assets,<sup>171</sup> than to that of directors in England whose powers of management are restricted but who retain their general powers as organs of the company and are consequently still subject to their statutory and common-law duties.<sup>172</sup>

Most provisions relating to the powers of the directors during business rescue proceedings clearly point towards the overall authority of the business rescue practitioner to manage the company and its property and towards the limitation of directors' powers to those functions that are specifically delegated to them or authorised by the business rescue practitioner, or that will not interfere with the duties of the practitioner.

However, the following provisions seem to contradict this situation and should be amended. In section 128(1)(b)(i) where the procedure is defined, the word "of" should be removed as indicated above in order to clarify that the proceedings provide for the management of the company's affairs, and not for the supervision of its management.<sup>173</sup>

Since a director may be removed from office by the court because he has obstructed the business rescue practitioner in the performance of his duties or management of the company,<sup>174</sup> the duty not to do so should also be included in the list of conditions to which he is subject in the exercise of his duties and functions in terms of section 137(2).<sup>175</sup>

As in the case of the business rescue practitioner,<sup>176</sup> I submit that it is unreasonable to hold directors liable for insolvent trading during business rescue proceedings, especially since they were possibly the ones who acted by commencing business rescue proceedings. I thus propose that the reference to section 77(3)(b) in section 137(2)(d) should be removed.

Section 137(2) should consequently read as follows:

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<sup>170</sup> See Chapter 2, part 3.7.2.

<sup>171</sup> See Chapter 4, part 2.7.2.1.

<sup>172</sup> See Chapter 3, part 2.7.2.

<sup>173</sup> See part 2.1 above.

<sup>174</sup> See Chapter 2, part 3.7.2.

<sup>175</sup> See Chapter 3, part 2.7.2 where this is stated as a limitation on the powers of directors.

<sup>176</sup> See Chapter 2, part 3.7.1.3.2; and part 2.7.1.3.2 above.

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- (2) During a company's business rescue proceedings, each director of the company –
- (a) must continue to exercise the functions of director, subject to the authority of the practitioner and without impeding the practitioner in the performance of his powers and functions and the management of the company;
  - (b) 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;
  - (c) remains bound by the requirements of section 75 concerning personal financial interests of the director or a related person; and
  - (d) to the extent that the director acts in accordance with paragraphs (b) and (c), is relieved from the duties of a director as set out in section 76, and the liabilities set out in section 77, other than section 77(3)(a), ~~(b)~~ and (c).

## **2.8 The business rescue plan<sup>177</sup>**

### **2.8.1 Power to submit a rescue plan**

Although only the business rescue practitioner is allowed to submit a rescue plan, the statutory duty placed on him to consult the management of the company and affected persons compensates for the fact that the company or its management may not submit a rescue plan.<sup>178</sup> However, it is not clear what remedy would be available to any of these parties if the business rescue practitioner does not consult them.

### **2.8.2 Prescribed contents of a rescue plan**

In general it must be said that the long lists of specific and often unnecessary minimum information that must be included in a business rescue plan will add to the costs of the procedure and will raise questions about the applicability or not of insolvency law principles.<sup>179</sup> Since the plan may not, as it may in Germany,<sup>180</sup> provide for liquidation of the company, the many references to liquidation and insolvency law

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<sup>177</sup> In England under the administration procedure, it is referred to as a "rescue plan" to indicate that it could also be a plan to save the company and not just its business: see Chapter 3, part 2.8.

<sup>178</sup> See Chapter 4, part 2.8.1 regarding the right of the debtor to also submit a plan in Germany. The situation in England is the same as in South Africa: see Chapter 3, part 2.8.1.

<sup>179</sup> See Chapter 2, part 3.8.2.

<sup>180</sup> See Chapter 4, part 2.8.2.

are, I submit, inappropriate. Furthermore, and in spite of requiring a substantial amount of information, section 150(2) of the Companies Act of 2008 fails to require other information that may be quite important for creditors to know, such as how the rescue plan will be financed.

Any business rescue practitioner will know that he must provide sufficient information to convince the affected persons whose approval of the plan is required, to vote in favour of the plan. The details should be left for the business rescue practitioner to decide in each appropriate case, depending on variables such as the size of the company's business, the number and total of creditors' claims, the value of the company's assets and, quite importantly, whether the company can afford to pay the various professionals whose services would have to be used to provide some of the (often unnecessary) information.

In this respect the prescribed information that the proposals of a company administrator in England must contain can be used as an example.<sup>181</sup> In addition to the obvious details about the company, such as its name, address, registration number and names of its directors and company secretary (not required by the current provisions of the Companies Act of 2008), just a few basic items need be prescribed as necessary for all rescue plans. Essentially, there must be a statement of the company's affairs, listing its assets and their value, and a list of creditors, indicating the amount of each debt and any security held for this claim. Furthermore, an explanation of the circumstances that caused the company's financial problems is necessary, as well as an indication of how these problems can be surmounted and the company's rescue be achieved.<sup>182</sup> As part of the last-mentioned explanation, the rescue plan will have to provide details on how the company's rescue will be financed and whether the financing is already in place. Where applicable, the full details of a pre-packaged sale of the business should be disclosed.<sup>183</sup> Any other information should depend on the circumstances of each case and should not be prescribed or compulsory because there is a big difference between the information that would be

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<sup>181</sup> See Chapter 3 (England), in part 2.8.2.

<sup>182</sup> Even in judicial management where no rescue plan is required, the courts require an explanation of the circumstances that caused the company's problems, in order to decide whether the company can be rescued: see Chapter 2, part 2.4.

<sup>183</sup> See Chapter 3, part 2.8.2.

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required in the case of a sale of the business of the company, and that of a merger or the continued trading of the company.

The only other prescribed requirement that I recommend should be retained is a slightly amended version of the certificate by the business rescue practitioner at the end of the rescue plan as required by section 150(4):

- (4) A proposed business rescue plan must conclude with a certificate by the practitioner stating that any –
  - (a) actual information provided ~~appears to be~~ is, to the best of his knowledge and belief, accurate, complete, and up to date; and
  - (b) any projections or estimates provided are ~~estimates~~ made in good faith on the basis of factual information and assumptions as set out in the statement.

### 2.8.3 Approval of the plan

#### 2.8.3.1 Publication of the plan

Since it is now clear that the odd expression of “publish to” requires that a notice of availability of the plan must be sent by the practitioner to all affected persons, and not only to those who may vote on the plan, there is substantial room for improvement in this requirement.<sup>184</sup> The usual objection of unnecessary duplication of notices and thus waste of costs can also be raised against this provision and the one discussed under the next heading,<sup>185</sup> and it would seem only common sense to combine these two notices as it is done in England and Germany.<sup>186</sup>

I would therefore recommend that section 150(5) be scrapped and the following wording be used to combine the provisions of section 150(5) with sections 151(1) to (3):

#### **151 Meeting to consider rescue plan ~~determine future of company~~**

- (1) ~~The business rescue plan must be published by the company w~~ Within 25 business days after the date on which the practitioner was appointed, or such longer time as may be allowed by ~~(a)~~ the court on application by the ~~company~~ practitioner, or ~~(b)~~ by the holders of a majority in value of the creditors ~~voting~~

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<sup>184</sup> See Chapter 2, part 3.8.3.1.

<sup>185</sup> See Chapter 2, part 3.8.3.2.

<sup>186</sup> See Chapter 3 (England), part 2.8.3 and Chapter 4 (Germany), part 2.8.3.3.

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interests, the practitioner must send a copy of the proposed rescue plan to every affected person.

- (2) Each copy of the rescue plan must be accompanied by notice of a meeting to be held not less than five and not more than ten business days after the date of such notification, for the purpose of consideration of the proposed rescue plan by creditors and, if applicable, by shareholders.
- (3) The notice of the meeting must set out –
- (a) the date, time and place of the meeting;
  - (b) the agenda of the meeting; and
  - (c) a summary of the rights of affected persons to participate in and vote at the meeting.
- (4) The meeting contemplated in this section may be adjourned from time to time, as necessary or expedient, until a decision regarding the company's future has been taken in accordance with sections 152 and 153.

#### 2.8.3.2 Meeting of creditors and shareholders

One aspect, caused by careless and inconsistent drafting, needs to be clarified in relation to the meeting. This is the question as to exactly who may address the meeting on behalf of employees. Since the words “the employees’ representatives” in section 152(1)(c) apparently refer to the trade unions representing employees, as well as to the representatives of employees who are not represented by a trade union, I believe that it will be necessary to limit the number of representatives who may speak on behalf of employees.<sup>187</sup> I submit that this subsection should be amended to provide for “an opportunity for the employees’ representatives one representative from each registered trade union to which employees of the company belong, and one representative on behalf of all employees who are not members of a trade union, to address the meeting”.

#### 2.8.3.3 Approval by creditors

The requirement that more than 75 per cent in value of creditors who vote must vote in favour of the plan may present a major obstacle to the adoption of business rescue

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<sup>187</sup> See Chapter 2, part 3.8.3.2.

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plans in practice. The majority of creditors will in most cases hold at least some security for their claims and will consequently hold the bulk of the votes since they may vote on the full value of their claims, including the secured portions.<sup>188</sup> There would be little advantage for them in approving a plan postponing payment of their claims, and in many cases it will become impossible to obtain the support of 75 per cent in value of creditors. Since the Act is anything but clear on this aspect, it is even possible that secured creditors will be able to vote on a plan without being bound in any way by its provisions. Therefore, it is essential that the relevant provisions should be amended either to exclude the votes of creditors on any secured portions of their claims, or to make it clear to what extent secured creditors are bound by the plan.<sup>189</sup> If they are bound, it may also be necessary to provide for voting by creditors in their different groups, that is, secured, preferent or concurrent.

The additional requirement that 50 per cent in value of independent creditors must vote in favour of the plan is unnecessary.<sup>190</sup> There is no requirement that they must at least hold a specified minimum percentage of total claims, and this provision could result in a small number of creditors, holding an even smaller percentage of the claims against the company, being able to undermine the rescue attempt. This is a particular risk for smaller family-owned companies and would be another deterring factor when the board has to decide between liquidation and business rescue. Section 152(2)(b) which contains this requirement, should, in my view, be scrapped, and section 152(2)(a) should, I submit, be amended to require the approval of only a simple majority in value of creditors based on the value of the unsecured part of their claims.

Furthermore, the references to the final adoption of the plan being dependent on the satisfaction of any conditions after the required majorities have voted in its favour must be removed from section 152(3)(b) and (c)(ii)(aa). Any conditions that have to be fulfilled before the plan can be fully implemented, such as procuring post-commencement finance, are part of the adopted plan and are the first steps to be

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<sup>188</sup> See Chapter 2, part 3.8.3.3.

<sup>189</sup> English law provides us with a perfect example of how this situation should be approached: see Chapter 3, part 2.8.3.

<sup>190</sup> See Chapter 2, part 3.8.3.3. See also Chapter 3, part 2.8.3 for the requirement that only a simple majority of creditors in value is necessary.



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taken by the practitioner in implementing the plan. The plan itself is either adopted or not, but cannot be conditionally approved.

#### 2.8.3.4 Approval by shareholders

Since the Act clearly envisages that only one meeting for both creditors and shareholders will be convened on the same date and at the same place,<sup>191</sup> section 152(3)(c) should be amended to provide that the practitioner must, immediately after approval by the creditors, call for a vote by the shareholders whose rights will be altered by the plan.<sup>192</sup>

The subsection should thus read as follows:

- (3) If a proposed business rescue plan –
  - (a) ...
  - (b) ...
  - (c) does alter the rights of any class of holders of the company's shares ~~securities~~ –
    - (i) the practitioner must immediately ~~hold a meeting of and~~ call for a vote by the holders of the class, or classes of ~~securities~~ shares whose rights would be altered by the plan, ~~them~~ to approve the adoption of the proposed ~~business~~ rescue plan;

#### 2.8.4 Effects of approval of the business rescue plan

I submit that, for the reasons already explained,<sup>193</sup> the plan itself cannot be conditional, but may contain some conditions that have to be fulfilled before the rest of the plan can be implemented. Section 152(5)(a) is thus misleading by requiring the fulfilment of “any conditions on which the business rescue plan is contingent” as if it is separate from the implementation of the plan itself and not part of the plan. This part of section 152(5) should thus be scrapped. Section 152(5)(b) should be reworded to place a positive duty on the practitioner to implement the plan and not merely to direct its implementation. However, the company should still be mentioned

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<sup>191</sup> See Chapter 2, part 3.8.3.2 and part 2.8.3.1 above.

<sup>192</sup> See Chapter 2, part 3.8.3.4.

<sup>193</sup> In part 2.8.33 above. See also Chapter 2, part 3.8.3.3.

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in order to provide for instances where the cooperation of shareholders or the board is required or part of the plan can only be implemented after business rescue proceedings have ended. This subsection should thus read as follows:

- (5) The company, under the direction of the practitioner and the company must take all necessary steps to
  - ~~(a) attempt to satisfy any conditions on which the business rescue plan is contingent; and~~
  - ~~(b) implement the plan as adopted.~~

### **2.8.5 Effects of rejection of the business rescue plan**

#### 2.8.5.1 Powers of the rescue practitioner

Since it seems to be the intention that only the creditors should have the power to approve the preparation of a revised plan,<sup>194</sup> section 153(1)(a)(i) should be amended to refer to “a vote of approval from the creditors of the company to prepare and publish a revised plan”.

Although the practitioner is instructed to adjourn the meeting if he or an affected person intends applying to court to have the result of the vote set aside, there is no provision compelling them to bring the application within a reasonable time or at all.<sup>195</sup> It is possible that the duty to call a meeting within five days unless an application has been made to court in that time is an attempt to restart the procedure if no application is to be made after all, but this is not clear.

Assuming that all the options become available again if the court dismisses the application or no application is made, it will be necessary to convene a meeting of creditors and shareholders again. I propose that section 153(2) should be amended in the following way to clarify the situation and to avoid an unnecessary meeting being convened if the court does grant the order, resulting in the plan being approved.

- (2) If the practitioner, acting in terms of subsection (1)(a)(ii), or an affected person, acting in terms of subsection (1)(b)(i)(bb), informs the meeting that an application will be made to the court as contemplated in those provisions, the practitioner

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<sup>194</sup> See Chapter 2, part 3.8.5.1.1.

<sup>195</sup> See Chapter 2, part 3.8.5.1.2.

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must adjourn the meeting –

~~(a) for five business days, unless the contemplated application is made to the court during that time; or~~

~~(ba) until the court has disposed of dismissed the contemplated application; or~~

~~(b) until a reasonable time has elapsed without the application having been presented to court.~~

#### 2.8.5.2 Powers of affected persons

Firstly, section 153(1)(b)(i)(aa) should be amended in the same way as section 153(1)(a)(i)<sup>196</sup> to make it clear that a vote of approval from only the creditors is necessary to require the practitioner to prepare a revised plan.<sup>197</sup>

I submit that trade unions and employees who do not have voting rights as creditors or shareholders of the company to approve or reject a rescue plan should not be given this right through the backdoor by allowing them to apply for the setting aside of votes of creditors or shareholders. This will effectively give them more rights than shareholders who may lose more as a result of a failed rescue attempt than employees would.

Section 153(1)(b)(ii), which allows any affected person to acquire the votes of creditors and (possibly) shareholders, is one of the most disturbing and startling provisions regulating business rescue proceedings.<sup>198</sup> As a result of the lack of any explanation or clarification of this provision, it could possibly enable the expropriation without any compensation of a concurrent creditor's claim or a shareholder's shares. I strongly recommend that this provision should be drastically amended to ensure that its effects are fair, transparent and not in conflict with any acceptable and entrenched principles of our law.

Therefore, I believe that the following amendment to section 153(1)(b) should be made:

- (b) If the practitioner does not take any action contemplated in paragraph (a) –
- (i) any affected person present at the meeting and entitled to vote on the

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<sup>196</sup> See part 2.8.5.1.1 above.

<sup>197</sup> See Chapter 2, part 3.8.5.2.1.

<sup>198</sup> See Chapter 2, part 3.8.5.2.3.

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approval or rejection of the rescue plan, may –

- (aa) call for a vote of approval from the creditors of the company ~~holders of voting interests~~ requiring the practitioner to prepare and publish a revised plan; or
- (bb) apply to the court to set aside the result of the vote by the holders of voting interests or shareholders, as the case may be, on the grounds that it was inappropriate; or
- (ii) any affected person, or combination of affected persons, may ~~make a binding~~ offer to purchase the voting interests of one or more creditors or the shares of one or more shareholders who opposed adoption of the business rescue plan. ~~at a value independently and expertly determined, on the request of the practitioner, to be a fair and reasonable estimate of the return to that person, or those persons, if the company were to be liquidated.~~

Section 153(6) which provides for an application to court to review the determination of the value of the votes to be bought in terms of this provision, should accordingly be scrapped completely.

I specifically make no reference to any formula or procedure to determine the price to be offered, as the offeror should be free to offer the amount that he is prepared to pay, while the offeree should be free to refuse an offer that he believes to be inadequate.

#### 2.8.5.3 No action taken by either the practitioner or affected persons

I submit that if no action is taken after a rescue plan has been rejected, it is obvious that there is no reasonable prospect for the company to be rescued. In such a case the business rescue practitioner is surely still under the obligation to apply to court for an order discontinuing the rescue proceedings and placing the company into liquidation.<sup>199</sup> The requirement that the business rescue practitioner must merely file a notice of termination in these circumstances is in conflict with this obligation and it should be removed. If the legislature considers it necessary to make it clear that the

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<sup>199</sup> See Chapter 2, parts 3.9.1.1 and 3.9.1.2.

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business rescue practitioner is still under a duty to apply for liquidation in this case, section 153(5) should be amended as follows:

- (5) If no person takes any action contemplated in subsection (1), the practitioner must ~~promptly file a notice of the termination of the business rescue proceedings~~ act according to the provisions of section 141(2)(a).

## **2.9 Termination of business rescue proceedings**

### **2.9.1 Termination by order of court**

The setting aside of a board resolution to commence rescue proceedings has already been dealt with.<sup>200</sup> Section 81(1)(b), which authorises the court to liquidate a solvent company on application by the practitioner if there is no reasonable prospect of a rescue, is not only unnecessary but also creates confusion. Therefore, I propose that it should be deleted.<sup>201</sup> Section 141(2)(a) places a very clear duty on a practitioner to apply to court to terminate the business rescue proceedings and to issue an order for the winding up the company if there is no reasonable prospect that the company will be rescued.<sup>202</sup> I submit that this is sufficient to clarify the court's powers in this regard, and since there is no reference to whether the company must be solvent or insolvent, it is unnecessary to stipulate that elsewhere.

### **2.9.2 Termination by filing a notice**

As explained above,<sup>203</sup> there is no reason why a business rescue practitioner should be absolved from his duty in terms of section 141(2)(a) to apply for an order discontinuing the business rescue proceedings and placing the company into liquidation if a rescue plan is rejected and no further action is taken.<sup>204</sup> It may safely be assumed that in such a case the company has no reasonable chances of being rescued and liquidation is the only viable option. In this case I submit that merely filing a notice of termination and leaving the company hanging is inappropriate.

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<sup>200</sup> See part 2.5.1.3 above.

<sup>201</sup> See Chapter 2, part 3.9.1.1.

<sup>202</sup> See Chapter 2, parts 3.9.1.1 and 3.9.1.2.

<sup>203</sup> In part 2.8.5.3.

<sup>204</sup> See Chapter 2, part 3.9.2.

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Although I believe that the practitioner should be obliged to apply for liquidation, the power created in section 81(1)(c)(i) for a creditor to apply for liquidation in these circumstances should be retained to provide for those instances where a business rescue practitioner fails to do so or is not convinced that a rescue of the company is no longer reasonably possible.<sup>205</sup> However, the reference in section 81(1)(c)(i) to section 132(2)(b) should be deleted, since a notice of termination will now only be filed if the company is no longer in financial distress. Allowing a creditor to base his application for liquidation of the company on this situation seems unduly harsh, since it only applies to rescue proceedings that were commenced by a resolution of the board. Considering the pressure on boards to take such a resolution at the first signs of potential problems, it is extremely unfair, I submit, to punish them for taking the resolution if they manage to avert the expected financial disaster or in hindsight prove to have been too pessimistic about the company's future.

### **2.9.3 Termination as a result of rejection or implementation of a business rescue plan**

The misleading provision in section 132(2)(c)(i) that creates the impression that the mere inaction of affected persons after rejection of a rescue plan will terminate business rescue proceedings must be deleted.<sup>206</sup> This situation is now covered by section 132(2)(a)(ii), in terms of which business rescue proceedings are terminated by an order of court "converting" them into liquidation proceedings.<sup>207</sup> Strictly speaking, the court does not order a conversion of the proceedings, but, in accordance with the application by the business rescue practitioner, will order the discontinuing of the business rescue proceedings and then order the liquidation of the company.<sup>208</sup>

Section 132(2)(c)(ii) will remain intact since business rescue proceedings do indeed end when the practitioner files a notice of substantial implementation of the plan in terms of section 152(8).<sup>209</sup>

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<sup>205</sup> See Chapter 2, part 3.9.2.

<sup>206</sup> See Chapter 2, part 3.9.3.

<sup>207</sup> See Chapter 2, part 3.9.1.2 regarding the misleading use of the word "converting".

<sup>208</sup> See part 2.8.5.3 above.

<sup>209</sup> See Chapter 2, part 3.8.4.

## **2.10 Final analysis of business rescue proceedings**

South African company law has a long history of business rescue, dating back to the first Companies Act of 1926 when the legislature displayed an insight far ahead of its time by recognising the need for a formal statutory procedure to allow distressed but deserving companies some breathing space to overcome their problems. However, the fact that the new business rescue procedure introduced by the Companies Act of 2008 was not the first attempt at a statutory corporate rescue procedure in South Africa and that it will succeed judicial management, was both an advantage and a disadvantage for the new procedure.

It was an advantage because after many years of experience with judicial management, we knew exactly what its weaknesses were and where judicial management got it wrong. We were thus in a position to avoid these pitfalls in designing a new business rescue procedure and rectify previous mistakes. Another advantage, although not readily acknowledged by most critics of judicial management, is that in spite of its shortcomings, judicial management is in many ways a well-constructed procedure regulated by clear, detailed and mostly unambiguous provisions in the Companies Act of 1973. Therefore, the possibility also existed for the drafters of the provisions regulating the new procedure to identify and take over some important provisions from judicial management, or at least to be made aware of what needed to be regulated. Unfortunately, however, the Department of Trade and Industry to a large extent neutralised these advantages by choosing to use the services of foreign consultants, who lacked any real knowledge of or insight into judicial management, to draft this legislation.

The disadvantage of succeeding judicial management is that, because judicial management was widely perceived to be a failure, no rescue culture has developed in South Africa, and informal workouts or liquidation is still the automatic choice in most cases of financial distress of a company. The attitudes to judicial management will invariably affect any new business rescue procedure and cause it to be viewed with some scepticism. It will require a concerted effort by the courts and major creditors such as banks, to be supportive and sympathetic in their treatment of the new procedure, in order to convince company boards to accept and use it. A

substantial success rate of rescue attempts, driven by properly qualified, ethical and expert business rescue practitioners, will also help to change the present culture of liquidation being the statutory procedure of choice.

Another problem faced by the Department of Trade and Industry, which was clearly illustrated by the submissions to the Portfolio Committee, was that each of the various interest groups focussed only on their own interests. COSATU, for example, insisted on more rights for employees of companies in financial distress, while other groups saw this as a major impediment to a successful rescue procedure. There is thus a real risk that we may lose sight of the bigger picture by trying to establish whether a particular provision is better for employees, creditors, directors or shareholders. There should be only one test, and that is whether a particular provision or measure would increase the chances of a successful rescue of a company, because that will ultimately be to the advantage of everybody.

Unfortunately, one cannot escape the impression that the new business rescue proceedings are often characterised by an unsympathetic attitude to shareholders and a distrust of company management. Many provisions seem to be based on the assumption that shareholders are rich capitalists who do not need any assistance or support when trying to rescue the company and that only the employees need protection. While this may have been true when judicial management was introduced into South African law for the first time, it is not a true reflection of the current situation. It is a widely accepted fact that the major providers of capital to South African companies are the institutional investors who are investing the pension fund contributions and savings of ordinary workers. If a company fails, many more workers than those who were actively employed by the company could thus lose their livelihood.

The legislature also seems to have forgotten that this is not a liquidation of the company and that the company is quite possibly not insolvent or unable to pay its debts, and may not even become so. There is a disturbing and inappropriate confusion and mixing of principles of corporate and contractual law, on the one hand, and insolvency law, on the other. The legislature decided to separate corporate rescue from insolvency law and should remain consistent and true to this principle in the provisions regulating corporate rescue proceedings. If the legislature does not have sufficient confidence in the possibility of successful company or business



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rescues, then business rescue proceedings should be removed from the Companies Act of 2008 and become part of a future consolidated Insolvency Act.

The first bold steps have been taken to provide the framework for a new and more successful rescue procedure for viable companies and their businesses. It will require good faith and trust from all stakeholders, including the legislature, to make this work in practice.

### **3 COMMENTS AND RECOMMENDATIONS ON THE COMPROMISE WITH CREDITORS**

#### **3.1 General comments**

Considering the successful use of the present section 311 compromise procedure as a corporate or business rescue measure,<sup>210</sup> the decision by the legislature to provide for a compromise specifically intended for this purpose is a welcome addition. Unfortunately, however, the legislature failed to incorporate the biggest potential advantage of this type of procedure for a company that is not yet financially distressed but approaching that point. This advantage is to address the problem in a fast, effective and fairly confidential procedure which will bind all the affected creditors once the required majority has approved the compromise, without the costs or the stigma attached to a formal insolvency or rescue procedure. Instead, the legislature could once again not resist the temptation to regulate the procedure down to the finest detail.<sup>211</sup>

Furthermore, the new compromise procedure also perpetuates two major disadvantages of the section 311 compromise of the Companies Act of 1973, namely the lack of a moratorium to protect the company<sup>212</sup> and the requirement that an adopted proposal will be subject to the approval of the court.<sup>213</sup>

#### **3.2 The moratorium**

The failure to provide for any form of moratorium to protect a company that is not in liquidation, from enforcement by creditors of their claims in the period between

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<sup>210</sup> See Chapter 2, part 4.1.

<sup>211</sup> See Chapter 2, parts 4.4 and 4.5.3.

<sup>212</sup> See Chapter 2, part 4.1 and part 3.2 below.

<sup>213</sup> See part 3.5 below.

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informing them of the proposed compromise (and thus of the company's precarious financial situation) until the compromise becomes binding on them, is a serious weakness of the new procedure and removes one of its main advantages over an unregulated common-law compromise with creditors.<sup>214</sup> This omission is surprising in the light of the well-documented initial failure of company voluntary arrangements in England as a result of the lack of a moratorium and the resulting amendments made to the procedure to remedy this shortcoming.<sup>215</sup>

The Companies Act of 2008 does not require that the proposal for a compromise must be filed with any authority or office as required by the provisions regulating the company voluntary arrangement in England and which marks the commencement of the moratorium.<sup>216</sup> Therefore, the obvious moment for a moratorium to begin in the South African compromise procedure is when a copy of the proposal and notice of the meeting are delivered to creditors.<sup>217</sup> I do not recommend that the moratorium should be limited to a specific type or size of company as it presently is in England,<sup>218</sup> but should be the automatic result of any proposal for a compromise. The moratorium should provide the same protection as in the case of business rescue proceedings, and I therefore propose the introduction of the following subsection in section 155 based on the recommended wording for the interim moratorium in business rescue proceedings.<sup>219</sup>

From the moment that the notice and a copy of the proposal have been sent to creditors in terms of subsection (2) above, until the proposal has been adopted or rejected by the creditors or relevant class of creditors, no application or order may be made for the winding up of the company and, except with the permission of the court and subject to any conditions it may impose, no legal proceedings, actions, or the execution of any writs, summonses and other processes against the company may be instituted or proceeded with.

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<sup>214</sup> See Chapter 2, part 4.5.3.

<sup>215</sup> See Chapter 2, part 4.2 and Chapter 3, part 3.6.

<sup>216</sup> See Chapter 3, part 3.6.2.

<sup>217</sup> See Chapter 2, part 4.5.1.

<sup>218</sup> See Chapter 3, part 3.6.1.

<sup>219</sup> See part 2.6.1 above.

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### 3.3 Prescribed contents of a proposal

The almost identical requirements set for the contents of a compromise proposal as for a business rescue plan are clearly inappropriate since a compromise is not a formal rescue procedure and is specifically intended to be flexible, informal and fast.<sup>220</sup>

In this respect I submit that the required contents for a company voluntary arrangement in English law are far more realistic and practical, providing as much flexibility as possible while ensuring that creditors have all the important information they require in deciding whether to adopt a proposal or not.<sup>221</sup>

Therefore, I recommend that the currently prescribed contents of a proposal in section 155(3) should be scrapped and replaced by a shorter and less complicated set of requirements. I submit that no more than the following information needs to be prescribed in relation to the contents of a proposal:

- (a) Why a compromise is being proposed and what the advantages for creditors would be.
- (b) A list of assets and their respective values, indicating which assets are subject to security rights held by creditors, and which assets are to be excluded from the compromise.
- (c) A list of liabilities, indicating the amount and nature of each claim, and how they will be met, modified, postponed or otherwise dealt with in terms of the compromise. This will include details on any proposed moratorium as well as any proposed discharge of debts and a conversion of debt to equity.<sup>222</sup> It will also, where applicable, indicate whether additional financing must or has been arranged.
- (d) The intended duration of the compromise, explaining how and when it will end.
- (e) The proposed dates of payments to creditors and the estimated amounts of such payments.
- (f) The manner in which the company's business will be conducted during the course of the compromise.

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<sup>220</sup> See Chapter 2, part 4.4.

<sup>221</sup> See Chapter 3, part 3.8.

<sup>222</sup> This is a far more logical and cohesive way of dealing with creditors' claims than the fragmented provisions scattered over the relevant prescribed parts of the current provisions: see Chapter 2, parts 4.4.1, 4.4.2 and 4.4.3.

(g) Any conditions that must be satisfied before the proposal can come into operation or be fully implemented.

Any other necessary information will be dictated by the circumstances of each case and the nature of the proposals. I submit that, ideally, the directors should be able to provide most of the information that the creditors need since the directors themselves will be responsible for the implementation of the compromise. This will also save time and costs and prevent too much prior publication of the company's financial problems and plans.

### **3.4 Adoption of a compromise proposal**

Section 155(6), which regulates the adoption of a proposal by the creditors is, I submit, deficient in many respects and should be redrafted to clarify the many uncertainties. Unfortunately, however, it is impossible to state with any certainty what the legislature's intention was and it is therefore also impossible to propose any specific amendments.

If it is assumed that the legislature intended to bind the secured creditors to any adopted and confirmed compromise with the general body of creditors and for that reason included them in the voting process, this should be specifically stated. This is necessary because it is an entrenched principle of our law that the security rights of a creditor may not be affected without his specific and individual consent.<sup>223</sup> It will also be necessary to state whether the statutory preference rights of a creditor may be changed by a compromise. Furthermore, the legislature will have to decide whether creditors should vote in different groups, depending on whether their claims are secured, preferential or concurrent, and whether each group must approve the plan to make it binding on that specific group, if at all.

However, if the intention was that the rights of secured creditors should remain unaffected by a compromise, it is difficult to explain why secured creditors, who would often hold the majority of the votes, should be allowed to vote on a proposal that will not affect them in any way. In this case it is imperative that secured creditors should only be allowed to vote on the unsecured part of their claim.

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<sup>223</sup> See Chapter 2, part 4.5.2.

Since a compromise is not heavily regulated, and the directors control the whole procedure, it is surprising that the Act does not in this instance contain an additional requirement that at least 50 per cent in value of independent creditors should have voted in favour of the proposals.<sup>224</sup> I believe that it will provide at least some protection to creditors who may otherwise be forced by creditors connected to the company into accepting extremely unfavourable conditions of payment.

### **3.5 Approval of a compromise proposal**

I submit that it is an unnecessary and costly burden to require approval of a compromise proposal by the court.<sup>225</sup> It will also introduce an element of uncertainty into the process, since there is little indication of the grounds on which a court may refuse to approve a proposal. If the necessary percentage of votes of creditors has been obtained, there appears to be little advantage in involving the court, and this will merely lead to delays and extra costs. I submit that sufficient protection against an unfair or prejudicial compromise will be provided if a subsection is introduced into section 155 allowing a creditor who was entitled to vote at the meeting, to apply to court for the revocation or suspension of any decision taken at the meeting.<sup>226</sup> Such an application will have to be based on either the unfair prejudice of the applicant's interests by an adopted compromise, or a material irregularity at or in relation to the meeting. The period within which such an application must be presented to court must be limited to a specified number of days after the compromise was adopted or the applicant became aware of the fact that a meeting had been held of which he not been given notice.

After acceptance of the compromise proposal by the creditors, nothing more should be required than the filing of the compromise by the board with the Commission within five business days, as is presently the case.<sup>227</sup> The requirement that a copy of the compromise should be attached to every copy of the Memorandum of Incorporation of the company held at its registered office may be retained.<sup>228</sup>

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<sup>224</sup> See part 2.8.3.3 above where, in my view quite unnecessarily, this is required for a rescue plan.

<sup>225</sup> See Chapter 2, part 4.5.3.

<sup>226</sup> See Chapter 3, part 3.5.3 in respect of such an application in England.

<sup>227</sup> See Chapter 2, part 4.5.4.

<sup>228</sup> See Chapter 2, part 4.5.4.

### **3.6 Final analysis of the compromise procedure**

The decision to introduce a procedure allowing a company that is not necessarily financially distressed to enter into a compromise with its creditors, thereby replacing the more costly and onerous, but widely-used compromise in terms of section 311 of the Companies Act of 1973, must be welcomed.

Unfortunately, however, the new compromise procedure shares many of the weaknesses identified in business rescue proceedings, and it appears as though the legislature could not quite bring itself to move away from the formal procedure of the current section 311 compromise. The new compromise with creditors in its present form contains too many uncertainties and is too over-regulated to be regarded as a major improvement on the current situation under the Companies Act of 1973. I submit that the absence of any provision for a moratorium to protect the company while it is negotiating a compromise, as well as the rigidity and formality of the prescribed contents and procedure of a compromise, constitute major stumbling blocks that will almost certainly prevent the successful implementation of this procedure.

Apart from the specific amendments that are necessary, a major reconsideration is required on exactly what the procedure is meant to achieve and how best to do this. The new compromise procedure cannot fulfil its potential role as either a pre-emptive move against a company's possible collapse or a faster and less onerous way out of liquidation, until a firm official policy is determined on exactly what this role is supposed to be.

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