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CHAPTER 5
LITERATURE REVIEW OF TURNAROUND LEGISLATIVE MEASURES

"… a business rescue regime has a far better chance of succeeding if the insolvency system in which it is applied is debtor-friendly, as opposed to a creditor-friendly system of insolvency where business rescue regimes are not applied successfully."

Hamer (in Burdette, 2004:4)

5.1 INTRODUCTION TO A LITERATURE REVIEW OF LEGISLATION

This chapter deals with international trends in business rescue legislation. Discussions include the old and new South African legislation, with the rescue requirements of Chapter 6 of the new Companies Act, Act 71 of 2008, being discussed. The literature researched in this chapter is not an attempt to justify statutory rules, nor is it meant to be a legal discussion or an attempt to arrive at a legal solution, or an attempt to rewrite or criticise current, and very soon, historic legislation (owing to the implementation of a new companies act during in 2011), it merely attempts to give the reader a critical overview of South African legislation in a turnaround context. The overview focuses on existing South African legislation and various sources of data regarding company, insolvency and labour law are investigated. In addition, the implications and possible constraints that this legislation may have are investigated and discussed. In the South African context, auditing and law businesss will, no doubt, play an important role in the execution of Chapter 6 of the Act. The larger international businesss, such as Price Waterhouse Coopers, KPMG and Deloitte and Touche, as well as various local legal businesss and private practitioners, are currently in the process of positioning themselves to capitalise on the potential opportunities that will be created by Chapter 6 of the new Act.

The uncertainty in the appointment of a regulatory body has contributed to competition between various disciplines in the professional and business arena for this important position. The discussion in this chapter will deal with the turnaround event and the methodology to be adopted by the turnaround practitioner.

Part one of the literature research began with the current juncture in South African law, using the old Companies Act No. 61 of 1973, which was recently amended, as a point of departure.

Part two reflects on international bankruptcy legislation research from similar debtor-friendly regimes to obtain an understanding of global trends. Part three will deal with the seminal work of South African authors and researchers, carried out against the backdrop of development of a new South African bankruptcy process. In part four, Chapter 6 of the new Companies Act, Act 71 of 2008 is investigated and commented on. The research aims to identify possible associations between the practitioner's liabilities and the Act, as turnaround plans can be faced with various opportunities and/or obstacles that facilitate or obstruct their effective execution. Part five reviews the rescue plan as contained in Section 150 of Chapter 6 of the new Companies Act (Act 71 of 2008).

As Chapter 6 of the new Act is a new law and is, to date, unchallenged, it opens up a new management science in South Africa. This research included international insolvency, bankruptcy and liquidations laws and common law. It goes without saying that the legislation contained in Chapter 6 will, if required, be legally tested in our courts. In terms of the new Act, closed corporations will be phased out as the Act divides all companies into profit and non-profit companies, hence new closed corporations will be incorporated (Brewis, 2009:3). This study therefore refrained from referring to the rule of precedent or to any case law (except where applicable and then specifically indicated), but attempted to analyse all applicable Acts.

Pretorius and Holtzhauzen (2008:93) argue that the word "turnaround" implies that a declining business can be rescued, whilst a business that has actually failed cannot. However, a turnaround manager will still be appointed, which creates an agency relationship.

According to Combs, Michael and Castrogiovanni (2004:910), an agency relationship is formed when the principal (as one party) delegates authority to the agent (the other party). The turnaround manager assumes six liabilities, which are identified by Pretorius and Holtzhauzen (2008:94). These liabilities are the following: legitimacy; resource scarcity; leadership capacity; strategy options; data integrity; and integration (see table 5.1).

The turnaround practitioner must be able to address and resolve the various liabilities; for this reason the education, knowledge and skills required of the practitioner should be on a very senior and advanced level. In terms of the legislation, the minister still has to appoint the regulatory body for turnaround practitioners, but it is clear from deliberations with interested parties that the general view is that superior quality management is required.

To be able to understand the liability burden fully, Pretorius and Holtzhauzen (2008:103) have drawn up a matrix indicating the requirements with regard to each liability identified. The prerequisite of employing a multi-skilled, educated professional to discharge the turnaround practitioner's responsibilities is emphasised by the variables under the headings "Liability, "Knowledge" and "Skills" requirements. In no particular order these are listed in table 5.1

5.2 CURRENT (HISTORIC) SOUTH AFRICAN COMPANIES ACT, ACT 61 OF 1973

5.2.1 INTRODUCTION

Currently, the South African government is revisiting consumer and business legislation as part of law reform to cater for job creation and job retention and a more coherent society. Accordingly, the National Credit Act, Act No. 34 of 2005, protects consumer rights. As the South African Insolvency Act, Act no 24 of 1936, is the only Act dealing with bankruptcy.

Roestoff and Renke (2005:96) argue that the main aim of the current Insolvency Act is not to provide debtors with debt relief, but they are of the opinion that the consumer law reform commission has adopted the United States' approach of "a new beginning".

Table 5.1 Liability, knowledge and skills requirements (Pretorius & Holtzhauzen, 2008:103)

Liability	Knowledge requirements	Skills requirements
Legitimacy	Legal framework of relevant acts Financial	Personal credibility Interpersonal skills Reputational slack Mustering support
Resource scarcity	Sales and markets Operations/logistics Human resources Management Efficiencies/effectiveness Environmental munificence	Diagnostic skills Analysing skills Conceptualising preconditions Learning from experience Ability to read preconditions Strategic formulation
Leadership capacity	Situational leadership Experience in leading people	Influencing capability Vision/direction Seeing the big picture Problem-solving skills Style (severity dependent) Creating a new culture
Strategy options	Strategic management Industry knowledge Environmental interactivity Cause-effect relationships	Innovative thinking Advanced strategic management skills Entrepreneurial thinking
Data integrity	Basic financial knowledge Taxation implications Financial ratios Causes, signs and flags	Basic financial skills Use of financial information

Integration	Wide understanding of general business principles Sales, marketing, operations and strategy interactions	Ability to integrate Ability to implement

The main aim of the consumer law reform is to combat over-indebtedness, but Renke, Roestoff and Bekink (2006:91) are of the opinion that the National Credit Act, will, apart from rendering consumer protection, also provide consumers with much-needed credit education and adequate information to allow consumers to make informed decisions.

The business rescue legislation contained in the new Companies Act is not dissimilar to that contained in the National Credit Act (Act 34 of 2005). Current regulatory pressures imposed by South African business legislation are described by Hall (1980:75) as part of the hostile environment in which entrepreneurs operate. South Africa is identified as a country with the most cumbersome labour laws.

Consequently, under normal circumstances it is difficult for a business to entertain an informal turnaround process, as there is currently no legal avenue; fortunately this situation will largely be rectified by the new Companies Act. As previously mentioned, formal turnaround strategies are not part of current legislation and the only option currently available is contained in Sections 311 and 427 of the old South African Companies Act, Act 61 of 1973.

In terms of Section 311 (old Companies Act, Act 61 of 1973), a compromise is often proposed to entrepreneurs as an alternative source of turnaround and (in terms of Section 311, old Companies Act, Act 61 of 1973) a company may enter into a compromise with its creditors to arrange debt restructuring. This is a court-driven process where both the creditors and the court must sanction the eventual compromise. Burdette (2004a:14) argues that this process is an expensive procedure to implement.

5.2.2 SECTION 311 COMPROMISE

The huge array of case law regarding these compromises is a clear indication that it is not always a simple undertaking. An application for a Section 311 (Companies Act, Act 61 of 1973) compromise relates to the distressed state that a company finds itself in. In the event that a court does not grant an order for a Section 311 compromise, the creditors are not bound to enter into any other arrangement and can file for liquidation.

Section 311 compromises are not uncommon practice in South Africa after liquidation (see also acts of insolvency later on in this chapter).

Section: 311. *Compromise and arrangement between company, its members and creditors.*

(1) Where any compromise or arrangement is proposed between a company and its creditors or any class of them or between a company and its members or any class of them, the Court may, on the application of the company or any creditor or member of the company or, in the case of a company being wound up, of the liquidator, or if the company is subject to a judicial management order, of the judicial manager, order a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be), to be summoned in such manner as the Court may direct.

(2) If the compromise or arrangement is agreed to by-

(a) a majority in number representing three-fourths in value of the creditors or class of creditors; or

(b) a majority representing three-fourths of the votes exercisable by the members or class of members,

At the present juncture, the only legal pre-liquidation "turnaround" option/alternative available for the debtor is judicial management, as described in Section 427 (Companies Act, Act 61 of 1973).

5.2.3 SECTION 427 JUDICIAL MANAGEMENT

The conditions under which a court of law will consider placing a company under judicial management are described by Section 427(1) (old Companies Act, Act 61 of 1973) which reads as follows:

Section 427. *Circumstances in which company may be placed under judicial management.*

(1) When any company by reason of mismanagement or for any other cause-

(a) is unable to pay its debts or is probably unable to meet its obligations; and

(b) has not become or is prevented from becoming a successful concern, and there is a reasonable probability that, if it is placed under judicial management, it will be enabled to pay its debts or to meet its obligations and become a successful concern, the Court may, if it appears just and equitable, grant a judicial management order in respect of that company.

(2) An application to Court for a judicial management order in respect of any company may be made by any of the persons who are entitled under Section 346 to make an application to Court for the winding-up of a company, and the provisions of Section 346(4)(a) as to the application for winding-up shall mutatis mutandis apply to an application for a judicial management order.

(3) When an application for the winding-up of a company is made to Court under this Act and it appears to the Court that if the company is placed under judicial management the grounds for its winding-up may be removed and that it will

become a successful concern and that the granting of a judicial management order would be just and equitable, the Court may grant such an order in respect of that company".

The critical measure of whether a company can pay its debt, or is probably unable to meet its debt repayments and thereby fails to become a successful business, is dominant in the qualification for Section 427.

Courts can conclude that a debtor's liabilities exceed the true value of its assets if evidence of commercial insolvency can be found. Such a company will then be factually insolvent. This phenomenon is referred to as the "insolvency rule" (Smart, 2006:17).

The main aim of judicial management is to restore the business to a position where it is able to service its debt obligations. These formal measures do not have any benefits for the entrepreneur but rather they favour the creditors. Nevertheless, creditors place little reliance on these formal measures. Accordingly, Loubser (2005:1) concludes that judicial management has, in general, not been accepted as an effective corporate turnaround procedure, which attributes largely to the stringent requirements (insolvency rule) evident in the old Companies Act (Act 61 of 1973).

From the aforementioned it can be deducted that technical or factual insolvency occurs when the debtor's liabilities in fact exceed the value of its assets (Meskin 1990:2–17). It can be thus be deduced that directors/entrepreneurs are at risk of acquiring personal liabilities if they trade under conditions of insolvency and incur additional debt. Meskin (2004:911) indicates the conditions under which a court of law will consider action against director/s described in Section 424(1) and (3). (Companies Act, Act 61 of 1973), which will be discussed in the next section.

5.2.4 RECKLESS TRADING

Trading under insolvent conditions is regarded as trading recklessly. Section 339 of the Companies Act (Act 61 of 1973) describes conditions of insolvency.

Meskin (2004:666) states, that, if a company is unable to pay its debt, the laws of insolvency will apply. Commercial insolvency occurs when an individual or company is unable to pay its debts when they are due and payable. This is one of the four instances where, according to section 424 (Companies Act, Act 61 of 1973), a director can be held personally liable. Winer, Levestein and Gewer (2005) argue that it is becoming increasingly clear that directors/entrepreneurs need to understand the subtle difference between factual (technical) and commercial insolvency when conducting business.

Section 427(1) states the following: When it appears, whether it be in a winding-up, judicial management or otherwise, that "[w]here any business of the company was or is being carried on recklessly …" the court decides on application of the master, the appointed liquidator, or, any of the creditors of the company, whether any person who was knowingly a party to the carrying on of the business in aforesaid fashion, could be held responsible in their personal capacity.

Section 427(3): "… where any business of a company is carried on recklessly …" with the intent or for the purpose as mentioned in section (1) above, everybody who was knowingly party to the conducting the business in this manner will be guilty of an offence. Obviously it is for the courts to decide whether the director or person is guilty and liable for reckless trading under circumstances of insolvency. It is important to note that proof of a causal link between the relevant conduct and such debts or liabilities is not required.

In the case of *Ozinsky NO v Lloyd* 1992 (3) SA 396 (C) at 413–414, the court (Van Deventer J) stated (at 414): *"… If a company continues to carry on business and to incur debts when, in the opinion of reasonable businessmen, standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business is being carried on recklessly …."*

The dilemma facing entrepreneurs who are experiencing cash flow distress in their business is how they will obtain additional debt (whether from normal creditors or financial institutions).

Australia has similarly styled legislation with regards to reckless trading under Section 588G of the Australian Corporations Act. The aim of this legislation is to protect creditors from directors' and shareholders' actions that were taken to reduce the probability of them being paid. James, Ramsay and Siva (2004:12) argue that shareholders and directors will be reluctant to perform certain actions that will ultimately harm their reputations. If found guilty of reckless trading, the entrepreneur, as a director, incurs considerable personal liability.

In the case of *Philotex (Propriety) Limited & Others v J R Snyman & Others* 1998 (334/93), the court stated: that *"… when the business of the company has been carried on recklessly, or with the intent to defraud creditors or for any fraudulent purpose, any person who was knowingly a party to such conduct may be held personally liable for the debts of the company…".*

It is therefore very risky to assume (when a business is having cash flow problems) that there is a reasonable prospect that creditors will receive future payments. Attempts by debtors (entrepreneurs) to steer their distressed businesses out of trouble are often regarded by aggressive creditors (usually smaller creditors) as an act of insolvency. The measure mentioned under informal turnarounds above is of interest here, as creditors are quite successful when they approach our courts with an application for liquidation and they can prove acts of insolvency. Entrepreneurs can obviously seek permission to appeal and defend the attack against them, but litigation is a costly exercise to enter into especially where signs of distress are already in evidence.

Section 8 of the Insolvency Act (Act 24 of 1936) describes the eight acts of insolvency. For the purposes of the discussion only the acts of insolvency relevant to turnaround situations will be addressed.

Section 8(c) of the Insolvency Act (Act 24 of 1936) states that if a debtor makes or attempts to make any disposition of any of his property which has or would have the effect of creating prejudice or preference to one creditor above another, he commits an act of insolvency.

Thus, when an entrepreneur (debtor) disposes of any of his property, that is, selling so-called unproductive assets, he may effectively be committing two acts of insolvency. The first is the actual or attempted disposition of any property, which has the effect of preferring/prejudicing creditor/s above another. The second is the actual or attempted disposal of property. Had the attempt been successful, it would have had the effect of preference. Entrepreneurs embarking on this avenue must be aware that the intention with which the disposal was made, or attempted, is of no consequence to the court.

Disposition of assets can be open to attack by the liquidator in a liquidation scenario. Under Sections 26 to 33 of the Insolvency Act Act 24 iof 1936), disposition without value, voidable preferences, undue preferences and collusive dealings are remedies available to creditors.

In addition, Section 8(e) of the Insolvency Act (Act 24 of 1936) states that if a debtor makes, or offers to make, any arrangement with any of his creditors for releasing him wholly or partially from his debts he commits an act of insolvency.

Thus, when an entrepreneur (debtor) enters into an arrangement, which entails the creditors releasing him wholly, or partially, from his debts, it is an act of insolvency. The mere offering to make such an arrangement is also regarded as an act of insolvency. The courts can treat such an arrangement or attempt as an acknowledgement by the debtor that he is unable to pay his debts when they are in fact due and payable.

Section 8(g) of the Insolvency Act (Act 24 of 1936) states that a debtor commits an act of insolvency when he gives notice to any of his creditors that he is unable to pay any of his debts. The written notice to creditors is a practice fairly commonly used by businesses that are unaware of the dire consequences. Meskin (1990:5–99) states that this act is committed when a debtor notifies his creditor in writing that he is unable to pay all, or any one, of his debts. Entrepreneurs asking for time to pay a debt, which is due and payable, need to be aware that this action will give rise to an inference that he is unable to pay the debt.

Section 8 of the Insolvency Act (Act 24 of 1936) states that a debtor commits an act of insolvency as a trader if he gives notice in the *Government Gazette,* in terms of sub-section (1) of Section 34, that he intends selling his business and will thereafter be unable to pay all his debts. Any of the above actions, outside the current legislative provisions, may thus lead to the formal processes of insolvency being implemented. Informal turnarounds are less costly and do not require formal contracts, proceedings or direct compliance.

Creditors, such as banks, can initiate it and, if successfully executed, restore creditor faith in the entrepreneur and business. Trade creditors and financial institutions will, however, be reluctant to extend any form of credit to businesses that are experiencing the above-mentioned distress, purely as a result of the obvious risks involved but also because of the lack of a proper turnaround plan.

Informal turnarounds could benefit the business with immediate cash, but a longer-term solution would be more prudent. Moreover, downsizing the workforce is often contemplated to enable the business to continue. However, this option brings its own problems, as South Africa has some of the most stringent labour laws in the world. Jacobs (2004:125) encourages entrepreneurs to become members of the Confederation of Employers of South Africa (COFESA) in order to obtain support with “legal jargon”.

The Labour Relations Act, Act 66 of 1995, contains very strict procedures that need to be followed before retrenchments can be contemplated. Reducing the workforce can be a costly exercise as the law dictates that severance packages must to be paid. Marè (2004), commenting on Labour Law case law, addresses the issue of retrenchments and concludes that “fair reasons” could exist that justify retrenchments.

The preceding discussion alluded to the more obvious and crucial legislation. Cognisance should, however, be taken of other legislation that will impact on effective turnaround. Other legislation includes the National Credit Act, Act 34 of 2005, the Competition Board rules and corporate governance compliance (King II, and III reports).

Non-enumerable information such as credit information is important, but Altman (1984:180) indicates that for information to be dependable more than one credit source needs to be investigated. The treatment of credit information is addressed in the new National Credit Act, Act 34 of 2005.

Lee (1998:640), in discussing the Korean Crisis, indicates that two elements have contributed significantly to business sector failure: they are the lack of mechanisms to manage corporate governance, and secondly, a too lenient government-led credit allocation policy. The constraints and opportunities clearly suggest that turnaround should be attempted in a period of decline rather than in a period of distress. Chapter 11 of the United States of America's insolvency law provides for a more debtor-friendly approach. It is worth noting that the Canadian Bankruptcy and Insolvency Act (s 50.4(8) 1992) allows for a stay of (moratorium on) proceedings which, in turn, allows the de facto insolvent party to apply to the courts for a stay or extension for the duration of the moratorium.

Rajak and Henning (1999:286*)* observe that

> "… all modern corporate rescues are united on one matter, the absence which, possibly more than anything else, has helped to bring South Africa's judicial management to its present perceived impotence. This is the recognition that the agreed plan by which the future relations between the debtor and its creditors will be governed may well include the reduction of the debtors' overall indebtedness. To insist, as the South African rescue provision does, that a protective moratorium is available only where "there is a reasonable probability that if [the debtor] is placed under judicial management, it will be unable to pay its debts or to meet its obligations" is to ignore the well-nigh universal reality of creditors being prepared, for their own benefit to forgive part of the debt. It is frequently the case that a creditor will benefit far more from having the debtor back in the marketplace than from suing the debtor into extinction. A radically new rescue provision should provide a mechanism under which a specified majority of creditors can approve a plan under which the debtor may emerge from protection and resume normal commercial dealings."

Members of the South African government task team for corporate reform (2004), such as Daly and Burdette, have indicated that the new legislation should demand the removal of the entrepreneur and/or management from the business, as they are perceived as the root cause for the business failure.

This anticipated removal of the current management/entrepreneur highlights the importance for an entrepreneur to be equipped with a turnaround model. Nevertheless, the entrepreneur must understand what events turned prior success into distress and failure. Pretorius (2004:265) points out that the perseverance characteristic must not lead to the entrepreneur being stubborn about his situation.

Under current legislation, entrepreneurs will have to be cognisant of the increased risk when contemplating “informal” turnarounds. Burdette (2004a:20) argues that informal turnarounds are risky by their very nature because no moratorium is granted, and other (normally smaller) creditors cannot be bound by the informal arrangements. Informal agreements or arrangements, which can, in turn, lead to the implementation of formal insolvency proceedings by such creditors, accentuates the need for a change in current legislation that will allow such entrepreneurs adequate leeway to design proper turnaround plans.

Entrepreneurs need to be equipped with extensive, integrated and applied knowledge of early warning signal “verifier determinants” that will enable them to spot the danger signs and empower them to design turnaround plans to save their businesses.

5.3 INTERNATIONAL LEGISLATION

5.3.1 INTRODUCTION

Altman and Hotchkiss (2006:58–78) have done seminal work in comparing the bankruptcy regimens of ten different countries with the United Kingdom and the United States of America. In addition,

Rajak and Henning (1999:262–287) have done substantial work in Australia and Canada which has contributed to the background study in formulating South African business rescue law. Franks, Nyborg and Torous (1996:91) compared the United States, the United Kingdom and German insolvency codes and Omar (2006) carried out substantial research with regard to European insolvency laws, specifically Germany, England and Wales, Spain and France. Omar (2006:2) refers to the rescue proceedings of Australia, Canada, France, Singapore, the United States and South Africa as "modern" rescue processes and argues that many other jurisdictions are in the process adapting similar processes. Although

Franks, *et al.* work is dated, it adds to a better understanding of the development of rescue law. In a report on entrepreneurial re-starters, the Boston Consulting Group (2002:16) investigated and commented on re-starter-friendly insolvency regimes. Countries listed were the United States of America, the United Kingdom, France and the Netherlands. These authors identified three factors of influence for recognising a country as re-starter friendly:

- A legislative framework dictating the ease of the entrepreneur's re-entry, manoeuvrability in decline, exit and re-entering of markets.
- Financial environment that dictates the rules of financing of re-starters.
- The social content reflecting on society attitudes towards risk and failure.

In researching the international rescue arena, it is evident that in some countries, the rescue legislation is incorporated in corporate law as is now proposed with Chapter 6 of the South African Companies Act (Act 71 of 2008). In some countries, such as the United Kingdom, rescue proceedings are incorporated in insolvency law.

The question whether to house rescue proceedings in the Companies Act or in the Insolvency Act was also a very salient issue debated by the Companies Act Law Reform Team.

5.3.2 UNITED STATES OF AMERICA

The form of administration in the United States is the infamous Chapter 11 debtor in possession administration, Altman and Hotchkiss (2006:60), according to which an automatic stay is part of the process. Jostarndt and Sautner (2008:2189) argue that the United States of America has a commercial market that is more shareholder (debtor) friendly with poor creditor protection. Last resort action can include write-down of losses on over-indebted companies. Chapter 11 requires reorganisation plans to be filed with the bankruptcy court and these plans are then available to the public (Hubbard & Stephenson, 1997:548). Bower and Gilson (2003:20) raise the possibility that Chapter 11 procedures can be used as a means to hide fraudulent or reckless actions by management and directors. Subsequently, Chapter 11 was amended to remove this possibility. In discussing turnaround plans, Hubbard and Stephenson (1997:549) state that claimants are provided with sufficient information to make informed decisions to assess the plan. The court will only confirm a plan when all the classes of creditors are in agreement with it.

Reorganisations have a cost consequence in terms of direct costing, as well as a substantial social cost. Chen, Weston and Altman (1995:57) criticise the (high) cost of the bankruptcy reorganisation process, while Bower and Gilson (2003:20) argue that the social cost of bankruptcy is “staggeringly’ high. Thus out-of-court restructurings through debt restructuring are suggested to avoid the high cost of Chapter 11 reorganisations.

Chen *et a.l* (1995:67) and Su (2007:33) argue that rights issue offerings appear to be a popular tool for reorganisations. However, debt equity stock swaps are more frequently used, as creditors are able to obtain shares at substantially discounted rates. In discussing the methodology for identifying the characteristics of a successful turnaround, Hespel and Golzgaker (2005:3) define a successful Chapter 11 reorganisation as follows: a successful reorganisation is “defined as emerging from Chapter 11 protection and not filing for bankruptcy for at least four years”. A subsequent merger or acquisition of the “reorganised “company as a result of the fact that it could not sustain itself, will not contribute to the definition of a successful turnaround.

5.3.3 UNITED KINGDOM

Katz and Mumford (2005:136) are of the opinion that the United Kingdom “has a plethora” of insolvency procedures from which a suitable process to follow must be decided. These authors distinguish between administration and administrative receivership as measures for business rescue vehicles. The forms of administration available in the United Kingdom include a company voluntary arrangement, a scheme of arrangement, an administrative receivership and an administration, (Altman & Hotchkiss, 2006:60; Omar, 2006:9). Company voluntary administration was, according to Omar (2006:9), designed to be “a cheap, quick, efficient method of dealing with financial difficulties”.

In the United Kingdom a stay of proceedings is sanctioned by the court. Franks and Sussman (2005:283) argue that the main focus when constructing a dynamic model of bankruptcy law is the relationship between law and finance. The law should be considered as a mechanism for standardising commercial agreements. Franks and Sussman (2005:284) distinguish between a hard approach “protecting the liquidation rights of the creditors” and a soft one “giving the company a better chance to reorganise”. These authors argue that the court and the legislature will be in a position to solve the problem of under-innovation, but that they are biased towards the protection of private benefits. The treatment of minority creditors when discharging debt by way of a restructuring plan was discussed by Smart (2006:54), who concluded that the interests of minority creditors will have to be protected.

By introducing Chapter 6 of the new Companies Act, the South African legislature has opened the debate on a debtor-friendly versus the historical creditor-friendly regimes.

5.3.4 SWITZERLAND

In Switzerland, the administration takes the form of a composition which is subject to a majority of creditors’ and court approval (Altman & Hotchkiss, 2006:72). The rescue plan is subject to creditor approval and court sanction.

5.3.5 BELGIUM

The Belgian form of administration is a judicial composition where the debtor acts in good faith and applies to the court (Altman & Hotchkiss, 2006:72). A restructuring plan is prepared and the approval of 50% of the creditors in value and number is required.

5.3.6 GERMANY

Germany's *Insolvenzordnung,* which came into effect in 1999, created a uniform insolvency statute for all of Germany (Omar, 2006:5). Germany, like South Africa, has traditionally been considered as a country with weak debtor and strong creditor protection. Jostarndt and Sauter (2008:2189) state, however, that German corporations will be actively engaged in turnaround activities well before actual bankruptcy.

In Germany, an insolvency plan (*Insolvenzplan*) is filed and the court appoints an administrator. Altman and Hotchkiss (2006:64) and Omar (2006:8) confirm that the plan is subject to approval by the creditors. There is no automatic stay of proceedings but courts can grant a stay. Distressed businesses are recapitalised by way of fresh equity capital placed in rights issues or private and public placing.

5.3.7 SPAIN

In Spain, insolvency is a prerequisite for proceedings (Omar, 2006:13) and is similar to the current Section 427 of the South African Companies Act (Act 61 of 1973).

The administration of business rescue in Spain takes the form of a court-appointed insolvency administrator (Altman & Hotchkiss, 2006:77). The administrator will prepare reports and plans and there is an automatic stay of proceedings.

5.3.8 SWEDEN

In Sweden, administration takes the form of business reorganisations, which commence with a board resolution and the filing of the resolution at court (Altman & Hotchkiss, 2006:77). An administrator will draw up a plan, which, through an informal agreement, is sanctioned by both creditors and the court.

5.3.9 FINLAND

Finnish insolvency law has been proven to be closely related to Chapter 6 of the new South African Act.

Bergström, Eisenberg and Sundgren (2002:359–372) have researched the Finish law on reorganisations and conclude that the Finnish insolvency regime is a debtor-friendly regime similar to Chapter 11 of the United States. They further argue that if creditors are well secured they will not be supportive of an attempt to reorganise the business (Bergström *et al,.* 2002:360).

5.3.10 ITALY

In Italy, the form of administration deals with three sets of preconditions: *concordata preventive, amministrazione controltta* and *amminstrazione straordinaria*, (composition, and the extraordinary administrative directors control) (Altman & Hotchkiss, 2006:68).

In all three of the aforementioned conditions, the administrator is appointed by the court and is subjected to a rescue plan and approval from creditors. In the first instance there is no automatic stay, but it can be requested. In the last two instances there is an automatic stay of proceedings.

5.3.11 NETHERLANDS

In the Netherlands proceedings lead to the appointment of an administrator by the court. The focus is on the acceptance of a business rescue plan and a stay of proceedings for two months (Altman & Hotchkiss, 2006:88).

5.3.12 FRANCE

Altman and Hotchkiss (2006:64) state that in France administration takes place through the courts, which appoint an expert who will seek an informal and voluntary arrangement (*mandataire ad hoc*). The French rescue process or *sauvegarde* is conceived as being similar to a debtor in possession (Omar, 2006:20) which will then have the inference that management will stay involved. The expert has limited powers, however, and has to work with management. There is no automatic stay of proceedings but the court can specifically order a stay.

5.3.13 CANADA

Corporate restructurings in Canada are governed by either the Companies' Creditors Arrangement Act (CCAA) or the proposal provisions of the Bankruptcy & Insolvency Act (BIA). Known as "Chapter 11 without rules", the CCAA is only available to debtors with total debts of over $5 million (Canadian dollars). The Canadian Parliament has passed acts to reform its bankruptcy and insolvency legislation on, *inter alia*, commercial issues. In short, as discussed by Yamauchi (2006:179), the amendments cater for a debtor-friendly environment where the distressed business's management retain control over the business.

5.3.14 AUSTRALIA

The Australian insolvency provisions are found in Chapter 5 of the Australian Companies Act. These provisions allow for a practitioner to be appointed after a

creditor "pool" agrees on voluntary arrangements to be confirmed by order of court. A rescue plan is a requirement and has to be accepted by all parties.

Chapman (2003) deduces that reorganisations or rescues of businesses (in Australia) are being complicated by senior creditors (usually secured) who have a conflict of interest as a result of their secured position, and thereby tend to procrastinate turnaround proceedings.

5.4 DEVELOPING A BANKRUPTCY RULE IN SOUTH AFRICA

South Africa's young democracy is challenged by various socioeconomic variables which require frequent attention. Housing poses a serious challenge but the main focus of government is to create and maintain jobs. From a government perspective, Chapter 6 of the Act is a mechanism to ensure the minimisation of job losses. Government is committed to enhancing legislation to achieve these goals and Chapter 6 is an excellent example.

The United Nations Commission on International Trade (UNCITRAL) and the International Bar Association (IBA) (2000:22) have laid down the key elements of draft legislation as a guideline for countries to follow and implement in their corporate law reform efforts. The South African corporate law reform task team has used these guidelines, together with some principles from INSOL, to draft Chapter 6 of the new Companies Act.

Failure of the current judicial management as a turnaround mechanism prompted the legislature to come up with workable alternatives. A system which allows and extends legal protection to participants in an attempted turnaround was previously markedly absent in South African legislation. Up to the present juncture, legislation did not allow for a stay of proceedings or protection of property interests. With the adoption of the King III corporate governance rules, management are obliged to attempt business rescue before filing for winding up and, as such, rescue legislation had to accept a more debtor-friendly approach.

If directors do not consider or commence with a business rescue when in financial distress, it will in general be a proper inference that the business is being carried on recklessly. In the Grant Thornton Catalyst Management Issues (2005b:5), it is concluded that it is the liability of the directors to ensure that they are fully skilled in managing the affairs of a company.

The question, however, is against what standards are these skills to be measured. Coetzee (2009:4) argues that the most important provision in the new Companies Act is Section 76 where the dispensation of directors' statutory fiduciary duties is addressed under the heading "Standard of director's conduct". Consequently, taking into account all the challenges that have been discussed above, the legislature had the mammoth task of satisfying all role players' requirements and complying with UNCITRAL and INSOL guidelines and principles. The usefulness of these guidelines was highlighted by The Honourable Justice Farley at the Multinational Judicial Colloquium held by UNCITRAL and INSOL (1995:3). The biggest challenge, however, is to move and encourage business South Africa to make the paradigm shift from a creditor- to a debtor-friendly bankruptcy regime.

Chapter 6 of the new Companies Act was largely successful in addressing specific issues:

- creating a debtor-friendly environment
- establishing an environment in which all creditors could cooperate
- creating a moratorium on all proceedings
- setting clear timelines for passing resolutions and cut-offs for compliance
- the introducing of a turnaround practitioner ensures proper management and controls actions that could have adversely affected returns
- all affected parties to agree and commit to a rescue plan
- accorded additional funding priority status

In deliberating the judicial management system with the Van Wyk de Vries Commission, the Masters of the Supreme Court called for the abolition of the judicial management system owing to its low success rate (Burdette, 2004:9).

The option of Section 427 proceedings, by its very nature, does not represent a debtor-friendly environment and is for this very reason rarely a route of choice by entrepreneurs. In this regard, Burdette (2004:4) refers to a point that was originally made by Harmer, namely that "a business rescue regime has a far better chance of succeeding if the insolvency system in which it is applied is debtor-friendly, as opposed to a creditor-friendly system of insolvency where business rescue regimes are not applied successfully".

Entrepreneurs perceive compromise and/or judicial management of the business as personal failure. For this very reason entrepreneurs are discouraged from actively participating in turnarounds of this nature. Consequently, judicial management has a negative psychological effect on entrepreneurs.

Burdette (2004:11) submits that the following problems exist with judicial management:

- it is seen as an extraordinary measure
- the reasonable probability that the business will become a successful concern
- reliance placed on court proceedings
- the insolvency requirement
- use of liquidators as judicial managers
- it only applies to companies
- the absence of a timeline benchmark detailing specific performance periods adds to the complexities experienced with judicial management.

Based on the problems stated above and the high cost implications for companies already in distress, it can be concluded that entrepreneurs would rather opt for a less expensive and less cumbersome route and attempt an informal turnaround. Informal turnaround plans in various formats are contemplated by businesses in South Africa; Burdette (2004:20) refers to these as "informal creditor workouts" which are being used increasingly in the business environment.

The entrepreneurs themselves, or the senior creditors (mostly banks) who stand to lose the most, usually contemplate these informal turnarounds. James, Ramsey and Livan (2004:32) report on the type of debt distribution in insolvencies in Australia and indicate that bank- or financier-related debt amounts to 7,8% of the total average debt. Unfortunately, in South Africa, no such statistics are available, but the major banks are more involved in pre-insolvency turnaround attempts. The report on South African insolvency legislation by the United States Agency for International Development (USAID), prepared by Johnson and Meyerman (2011:16), concluded that, according to the stakeholders interviewed, "approximately 75% of all businesses encountering financial distress attempt to resolve the problem by informal workout or a turnaround of the business".

The report further concludes that business or banks, in conducting informal workouts, may adopt methods similar to the London Approach. Bolton (2003:52), discusses the London Approach and states that it has its main application in bank syndicates of informal consortia that attempt to restructure a business's debt.

Although some measures can be attempted formally, that is, by means of a court order, entrepreneurs frequently attempted an informal approach. Sub-section 32 of the United Nations Commission on International Trade, referred to in its abbreviated form, UNCITRAL Guide (2001:12), mentions that the success rate of informal creditor workouts will be determined to a large extent by the insolvency laws and legal framework of a country. The guide identifies the following avenues for turning a business around: debt forgiveness; debt rescheduling; debt equity conversions; and sale of the business or parts of it. The International Association of Restructuring, Insolvency and Bankruptcy Professionals, referred to in its abbreviated form, INSOL, has suggested that turnaround principles are required to effectively and successfully execute a business turnaround (rescue). These proposed principles are the following:

- All creditors must be prepared to cooperate.
- Creditors should refrain from enforcing claims – agree to moratorium (or standstill).

- Debtors should not to take action to adversely affect returns.
- Creditors should coordinate response to debtor.
- Debtor should provide all information – assets, liabilities, business.
- Proposals for resolving financial distress should reflect applicable law and position of creditors.
- Information should be available to all creditors but treated confidentially.
- Additional funding should be accorded priority status.

In the South African context, Loubser (2005:5) has investigated various turnaround plans and proposes the following two measures as key rescue methods:

- downsizing the workforce
- transferring the business or part thereof.

In an attempt to do an informal turnaround, cost-cutting measures are implemented immediately. Pretorius (2004:281) discusses the following actions to improve short-term cash flow:

- lowering of creditor collection days
- stretching debtor payment days
- increase in cash sales
- negotiating better terms with vendors and suppliers
- reducing debt and interest by:
    - selling old inventory
    - selling unproductive assets
    - selling non-core business units.

These measures are short term in nature and a strategic plan needs to be designed to ensure lasting measures are implemented. Short-term measures are often implemented when creditors call for payment and the business's cash flow cannot meet these demands. The effect of this scenario is discussed later and referred to as "constraints to informal turnarounds".

While informal turnarounds are gaining popularity due to low cost, low profile social responsibility and/or other advantages, there are a number of disadvantages when applied under the current South African laws. The following are Acts that have the potential to be construed as disadvantageous:

- Companies Act: Act 71 of 2008, reference to reckless trading
- Insolvency Act: Act 24 of 1936, reference to acts of insolvency
- Labour Acts: (Various Labour Acts relating to restrenchements) reference to downsizing of labour force

The South African concept of limited liability structures, namely closed corporations and companies, are most frequently under attack from a corporate governance scrutiny. Financial institutions demand personal guarantees from shareholders and members if financial assistance is to be considered. Where no direct sureties are provided entrepreneurs or directors are held personally liable if found to be trading in a reckless manner.

5.5 NEW NATIONAL LEGISLATION: COMPANIES ACT, ACT 71 OF 2008

5.5.1 INTRODUCTION

The literature research on Chapter 6 of the new Companies Act is not an attempt to solicit legal argument as various areas of the Chapter are still being debated by individuals in the legal fraternity and input from business is still awaited. In addition, the regulatory aspects have not yet been concluded. It would, at this juncture, be premature to discuss the various sections from a juristic point of view.

The research was therefore limited to the requirements for a literal interpretation of Chapter 6. The research concentrated mainly on salient provisions that have obvious benefits, or disadvantages, for the entrepreneur and his/her business.

Moosa (2009:1) identifies four distinct advantages of this legislation:

Firstly, business rescue is a substantively non-judicial commercial process whereby a board resolution is passed. Franks and Sussman (2005:287) share this view and conclude that "bankruptcy, namely the course of action to be taken following a default, is a commercial affair". The process is formalised through the filing of the resolution at the court.

It remains the responsibility of the persons affected by the bankruptcy (i.e. shareholders, creditors and employees individually or through their representative trade unions) to formulate contributions to a business rescue plan in order to save the company.

Secondly, business rescue is an inclusive and consultative process involving all affected persons as well as a business rescue practitioner (who will be a qualified professional, experienced in turnarounds, as per the regulatory directives of the new Companies Act).

Thirdly, the new Companies Act allows a stay of legal proceedings during business rescue, through the allowance of a limited moratorium period.

Fourthly, the legislation allows for the company to be rescued and the likelihood of the company's continued existence on a solvent basis to be maximised. If the continuation of the company cannot be achieved, it provides a better return for the creditors or shareholders than would result from the liquidation of the company.

In certain respects the structured, formal process proposed in the Act is not dissimilar to the typical negotiated rescue proceedings conducted informally when major creditors of a distressed company act together to reach a commercial solution to rescue the company.

Judging from the above there is clear benefit in the broader notion of business rescue. Unfortunately, as is the case with most new legislation, the devil lies in the details. An assessment of some of these challenges forms the basis of this paper.

5.5.2 FINANCIAL DISTRESS

An understanding of the phrase "financial distress" is of utmost importance in future commercial action. Chapter 6 of the new Companies Act clearly defines two criteria for financial distress, that is, "unable to pay its debts" and "become insolvent", but, most importantly, it adds a six-month period in which these events can most likely take place. This is the opposite of the judicial management requirement, where a business must be insolvent before Section 427 (old Companies Act, Act 61 of 1973) can be applied. A complete copy of Chapter 6 of the new Act is attached under Appendix C. Chapter 6 of the new Companies Act supplies a clear definition of financial distress, which reads as follows:

> **Section 128(1)(j)** *"… financially distressed", in reference to a particular company at any particular time, means that 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; or it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months..."*

Chapter 6 of the new Companies Act is structured into five main sections which guide the reader to a fair understanding of the total intended scope of this chapter of the Act.

They are:

- business rescue proceedings
- the practitioner's functions and terms of appointment
- the rights of affected persons during the rescue proceedings
- the development and approval of the business rescue plan
- compromise between company and creditors.

As each topic has its own measure of importance these aspects are discussed under their own headings.

5.5.3 RECKLESS TRADING UNDER THE NEW COMPANIES ACT

The new Companies Act has adopted the same tough stance on reckless trading as is currently applicable, but has added more regulations which must be adhered to. Various sections of the new Companies Act refer to trading under reckless circumstances and strict adherence to corporate compliance rules is of utmost importance. Section 22 of the Act prohibits reckless trading.

This important section reads as follows:

> **Section 22(1)** *… A company must not— carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose; or b) trade under insolvent circumstances … .*

If the company's board has reasonable grounds to believe that the company is experiencing financial distress as defined by the new Companies Act, it has the responsibility to adopt a resolution to institute rescue proceeding in terms of Section 129(1) of the Act, which reads as follows:

> *Subject to section (2)(a), the board of a company may resolve that the company voluntarily begin business rescue proceedings and place the company under supervision … .*

If the business experiences financial distress or insolvent trading, or is likely to trade under these conditions within the next six months, and the board does not adopt a Section 129(1) resolution, the provisions of Section 129(7) must be introduced. Section 129 (7) reads as follows:

> *… if the board of a company has reasonable grounds to believe that the company is financially distressed, but the board has not adopted a resolution contemplated in this section, the board must deliver a written notice to each*

affected person, setting out the criteria referred to in Section 128(1) (e) that are applicable to the company, and its reasons for not adopting a resolution contemplated in this section … .

A clear distinction must be made between financial distress and reckless trading, as Chapter 6 of the new Companies Act is not an instrument for avoiding the ramifications of reckless, fraudulent or any other misconduct.

The mandate of the turnaround practitioner must include investigating the matters of the business in order to establish the precise conditions under which the business has been conducted. Section 141 reads as follows:

… as soon as practicable after being appointed, a practitioner must investigate the company's affairs, business, property, and financial situation, and after having done so, consider whether there is any reasonable prospect of the company being rescued. And,

… reckless trading, fraud or other contravention of any law relating to the company, the practitioner must- so inform the court, the company, and all affected persons in the prescribed manner, and- forward the evidence to the appropriate authority for further investigation and possible prosecution … .

If any misconduct (excluding conduct of a criminal nature) is evident in the management of a business the court may, in terms of section 164(7)(b)(ii), make an order to place a person under probation.

The exception to this rule is to be found under Section 162(7)(b)(ii), *"… except in terms of—a business rescue plan resulting from a resolution of the board in terms of Section 129; or a compromise with creditors in terms of Section 155 …".*

5.5.4 BEGINNING, DURATION AND ENDING OF BUSINESS RESCUE

Out of court business rescue proceedings start when a company resolution is filed at the court. The company resolution is taken by the board of a company, when the board is of the opinion that the business is experiencing financial distress according to the definition in Chapter 2. Any affected party can apply through the court to commence with business rescue and rescue proceedings will commence when the order is granted.

Section 128 of Chapter 6 of the new Companies Act describes the affected parties as

- shareholder or creditor
- trade union
- employee/s not represented by trade union.

After the adoption and filing of the resolution the company must publish a notice of the resolution and appoint a turnaround practitioner. The qualifications, minimum requirements and regulatory issues are still being debated by both government and business and consequently have been excluded from the literature discussion.

> **Section. 129(3**) … *Within five business days after a company has adopted and filed a resolution, as contemplated in section (1), or such longer time as the Commission, on application by the company, may allow, the company must-publish a notice of the resolution, and its effective date, in the prescribed manner to every affected person, including with the notice a sworn statement of the facts relevant to the grounds on which the board resolution was founded: and*
>
> (c) *appoint a business rescue practitioner who satisfies the requirements of Section 138, and who has consented in writing to accept the appointment… .*

Business rescue proceedings end when the court sets aside the resolution or rescue order and the turnaround practitioner files a notice to the effect that the rescue proceedings have been terminated. However, from the outset the rescue proceedings will not be implemented if it is obvious that the rescue plan will be rejected. The commencement of a business rescue and the timeline that needs to be adhered to is illustrated in figure 5.1. The left-hand side of the figure illustrates the turnaround practitioner's operational and strategic functions, while the second horizontal column relates to a board resolution and the third column to a court order for business rescue commencement. Timelines are indicated in the applicable vertical columns. Strict adherence to the set timelines is vitally important, as non-adherence could jeopardise the entire process and cause unnecessary delays. The success of a turnaround is primarily dependant on the swiftness with which it is executed.

5.6 LIABILITIES OF THE TURNAROUND PRACTITIONER

5.6.1 LIABILITY OF LEGITIMACY

The appointment of a turnaround practitioner and the delegation of powers to the turnaround manager takes place as per Section 129(3)(b), which reads as follows: "*… appoint a business rescue practitioner who satisfies the requirements of Section 138, and who has consented in writing to accept the appointment."*

The above quote refers to Section 138, which stipulates when a practitioner is qualified to act as a practitioner. This section of the new Companies Act is currently being revisited by the Department of Trade and Industry and all interested parties have submitted comments and suggestions. The final requirements will be adopted and published by government in due course.

Section 138 stipulates that a person who may be appointed as a practitioner to a distressed company should be *"… a member in good standing of a profession*

subject to regulation by a regulatory authority …," "… is not subject to an order of probation …" , ".does not have any other relationship with the company …" and is "… not related to a person who has the relationship …" (illustrated in fig. 4.2).

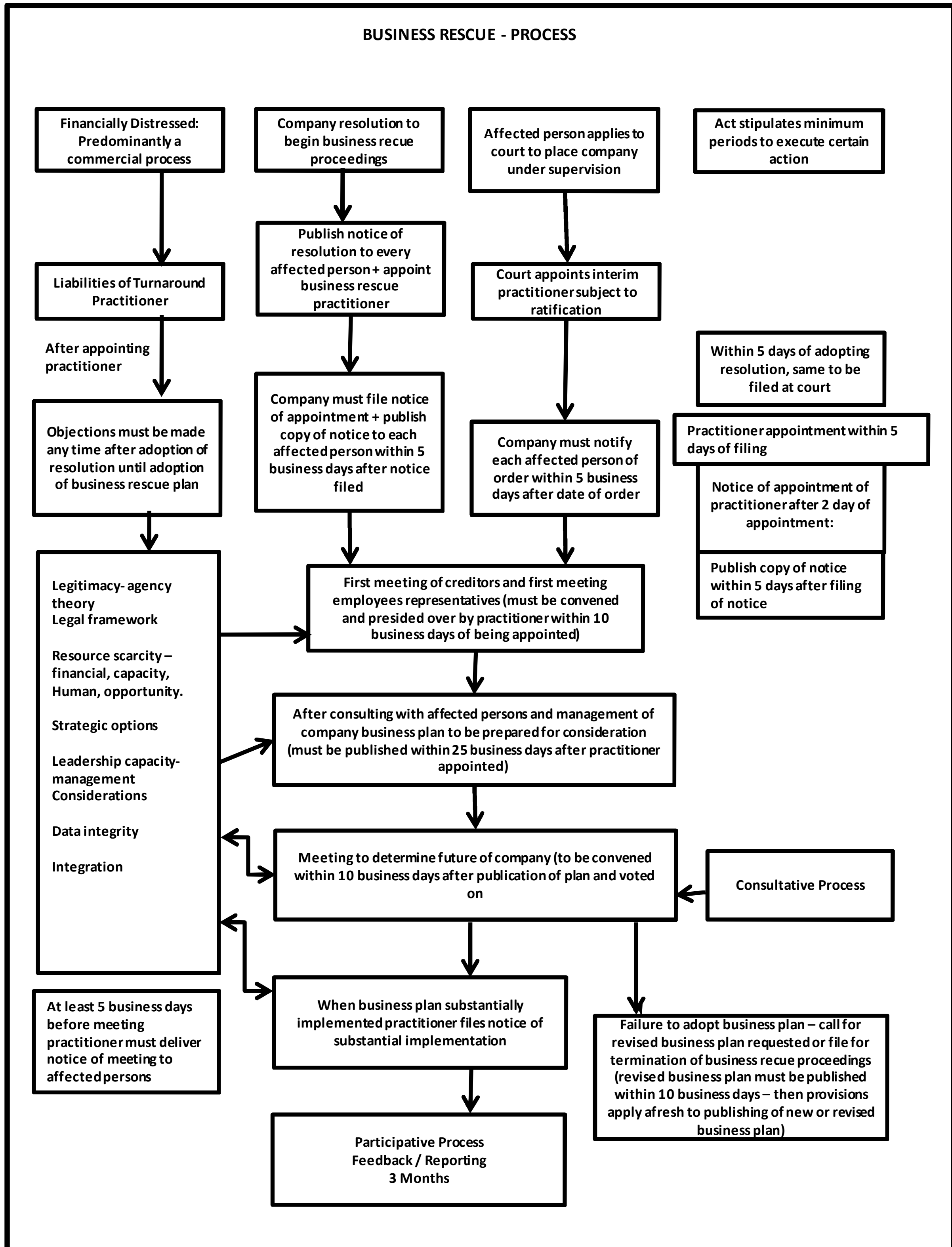

Figure 5.1 Section 129 rescue process timeline (adapted from Samuelson, 2010)

5.6.2 LIABILITY OF LEADERSHIP

According to the principles of the agency theory (Eisenhardt (1989a:58), the agent (practitioner) is conferred with a leadership role by the board (principal). Chapter 6 is unambiguous in terms of the practitioner's leadership liability. This section of the new Companies Act is also an admonition to business concerning the quality and experience required from a practitioner when considering his/her appointment.

> **Section 137(2)** *During a company's business rescue proceedings, each director of the company must continue to exercise the functions of director, subject to the authority of the practitioner;*
>
> *(h) 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;*
>
> **Section 137(3)** *During a company's business rescue proceedings, each director of the company must attend to the requests of the practitioner at all times, and provide the practitioner with any information about the company's affairs as may reasonably be required.*
>
> **Section 137(5)** *At any time during the business rescue proceedings, the practitioner may apply to a court for an order removing a director … .*
>
> **Section 140(1)** *During a company's business rescue proceedings, the practitioner, in addition to any other powers and duties; has full management control of the company in substitution for its board and pre-existing management; may delegate any power or function of the practitioner to a person who was part of the board or pre-existing management of the company; has the responsibilities, duties and liabilities of a director of the company, and, direct the management … .*

At the start and for the duration of a business turnaround, the directors of the company must cooperate with and give assistance to the turnaround practitioner.

5.6.3 LIABILITY OF DATA INTEGRITY

Data integrity is most certainly the most important liability to address in the early stages of a turnaround attempt. Verification and authentication of data is, under any circumstances, a time-consuming process and the strict timelines imposed by Chapter 6 of the new Companies Act do not allow for the investigation process to be procrastinated in a turnaround situation.

The liability of data integrity is highly dependent on the turnaround manager's ability to apply the correct methodology to verify and authenticate data for decision making. The most important decision to make is whether to attempt the rescue/turnaround. This decision should include turnaround activities after the decision to turnaround has been taken.

> **Section 142(1)***… each director of a company must deliver to the practitioner all books and records that relate to the affairs of the company … .*
>
> **Section 142(2***)... any director of a company who knows where other books and records relating to the company are being kept, must inform the practitioner … .*
>
> **Section 141(1)** *...after being appointed, a practitioner must investigate the company's affairs, business, property, and financial situation, and after having done so, consider whether there is any reasonable prospect of the company being rescued.*
>
> **Section 150(3)** *… The projected balance sheet and statement required by sub-section (2)(c)(iv), 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 … and then, the most onerous requirement.*

Section 150(4) *… a proposed business rescue plan must conclude with a certificate by the practitioner stating that (any) actual information provided appears to be accurate, complete, and up to date; and projections provided are estimates made in good faith on the basis of factual information and assumptions as set out in the statement … .*

5.6.4 LIABILITY OF STRATEGY OPTIONS

In order to achieve a successful turnaround, a turnaround practitioner must realign company strategy. Chapter 6 of the new Companies Act incorporates a few demanding prerequisites for the practitioner's strategic abilities.

Section 141 dictates that as soon as the turnaround practitioner has complied with the liability of data integrity, he needs to "… *consider whether there is any reasonable prospect of the company being rescued.*

As part of assessing and realigning the strategic direction of the company, the practitioner is allowed under Section 132(2) of the new Companies Act to either *"… subject to Sections 35A and 35B of the Insolvency Act, 1936 (Act No. 24 of 1936), despite any provision of an agreement to the contrary, during business rescue proceedings, the practitioner may cancel or suspend entirely, partially or conditionally any provision of an agreement to which the company is a party at the commencement of the business rescue period, other than an agreement of employment …".* Or, in terms of Section 137, contemplate as part of the business rescue plan, alterations to the classification or status of securities. Solomon and Boltar (1998:26) argue that Section 136(2) has potentially drastic consequences. The words "cancel" and "suspend" are not explained and reliance has to be placed on their common, literal meaning.

A key part of a strategic approach is the drafting of a business plan. Section 140(1)(d) requires the drafting of a rescue plan and its implementation. Section 150 stipulates the minimum requirements for a business plan.

Most important is that in terms of Section 150(1), *"… the practitioner, after consulting the creditors, other affected persons, and the management of the company, must prepare a business rescue plan for consideration and possible adoption…".*

Once again the liability of data integrity is clearly illustrated by Section 150(2): *"… the business rescue plan must contain all the information reasonably required to facilitate affected persons in deciding whether or not to accept or reject the plan … ."*

The rescue plan therefore has to be considered by all affected persons and, after it has been accepted, the practitioner must see to its implementation.

The practitioner has the responsibility to inform all affected parties in terms of Section 141 that if *"… at any time during business rescue proceedings, the practitioner concludes that— there is no reasonable prospect for the company to be rescued…" and, "… apply to the court for an order discontinuing the business rescue proceedings …".*

5.6.5 LIABILITY OF RESOURCE SCARCITY

Resource slack is arguably the key determinant of both decline severity and the options for turnaround strategies chosen in response. Pretorius and Holtzhauzen (2005:95) conclude that resource munificence refers to the level of resources (scarcity or abundance) required to operate a venture successfully. Castrogiovanni (1991:542), on the other hand, defines resource munificence as the critical resources needed to operate a business. The liability facing the turnaround practitioner in maintaining adequate resources while responding to decline is often problematic as Section 134 imposes restrictions on the disposal of assets. During the period of financial decline assets are "stripped" in order to generate much needed cash and this process destroys the business's resources over time. This phenomenon is confirmed by Barker and Duhaime (1997:20).

Protection of property interests

> **Section 134.** *Subject to sub-sections (2) and (3), during a company's business rescue proceedings—(a) the company may dispose, or agree to dispose., of property only in the ordinary course of its business; in a bona fide transaction at arm's length for fair value approved in advance and in writing by the practitioner; or in a transaction contemplated within, and undertaken as part of the implementation of, a business rescue plan that has been approved in terms of Section 152 … .*

Funding of the turnaround attempt is of the utmost importance. Early detection and engagement will allow the practitioner to align his strategy with resource scarcity. Levinthal (1991) refers to declining organisational capital as the most important determinant of business mortality. Accordingly, turnaround can only be effectively executed if the minimum threshold for organisational working capital is met.

Pretorius and Holtzhauzen (2008:96) conclude that the level of a business's resources at the time of the turnaround attempt will affect the financially distressed business's capacity to "implement strategic change". The dilemma facing entrepreneurs, who are experiencing cash flow distress in their business, is how they will obtain additional debt (normal creditors or financial institutions). As described in Section 135, post-commencement funding may be secured and such funding will be paid in order of preference.

Burdette (2004c:422) argues that a clear distinction needs to be drawn between the cash that will be needed to continue trading until a plan is approved and the cash flow that will be generated out of the operation once the plan is accepted and implemented. It is envisaged that the leading creditor bank will assume the responsibility for funding these interim periods as well as post-commencement finance.

The interim period financing will be included in the securitisation, labelled "post commencement finance", only if it happens after the resolution has been filed.

Section 135(2) … *During its business rescue proceedings, the company may obtain financing other than as contemplated is sub-section (1), and any such financing—(a) may be secured to the tender by utilising any asset of the party to the extent that it is not otherwise encumbered … .*

5.6.6 LIABILITY OF INTEGRATION

To overcome the liability of legitimacy the turnaround practitioner will ensure the integration of the turnaround actions and the support of all stakeholders or affected persons. All the affected persons will have to be included in strategy formulation in order to create some slack to free up working capital for funding the turnaround. Sections 145 and 147 describe the participation process by creditors:

Section 145(3) … *The creditors of a company are entitled to form a creditors' committee, and through that committee are entitled to be consulted by the practitioner during the development of the business rescue plan … .*

Section 147(1) … *Within 10 business days after being appointed, the practitioner must convene, and preside over, a first meeting of creditors, at which-(a) the practitioner must inform the creditors whether the practitioner believes that there is a reasonable prospect of rescuing the company; and (ii) may receive proof of claims by creditors; and (b) the creditors may determine whether or not a committee of creditors should be appointed and, if so, may appoint the members of the committee … .*

The new Companies Act ensures that all affected parties are included and provision is made for shareholders and employees, or their representatives, to attend rescue meetings. Overcoming the liability of integration culminates in the finalisation of the rescue plan as determined under Section 140(1)(d) of the Act: *"… develop a business rescue plan to be considered by affected persons … ."*

Overall knowledge of the proposed cash-generating strategies is essential in determining the future of the business, leading management to implement the rescue plans on a wide set of disciplines suggests overcoming the liability of leadership. Decisions of this nature will depend on the verification and authentication of the data used in the decision-making process, thereby overcoming the liability of data integrity.

The real danger of undetected and/or undisclosed data is that it is an unknown factor which only surfaces after a turnaround has commenced.

Section 151(1) determines that the practitioner must convene a meeting of creditors and other affected persons, as well as holders of voting interests as described by the Act, for the purpose of assessing and considering the proposed rescue plan.

5.7 CONSIDERATION OF A BUSINESS TURNAROUND PLAN.

The aforementioned literature research confirms that in almost any debtor-friendly bankruptcy regime, the prerequisite is the drafting, evaluation and acceptance of a business rescue plan. The UNCITRAL Guide (2005:7) defines the turnaround or reorganisation plan as "a plan by which the financial well-being and viability of the debtor's business can be restored". Under Chapter 6 of the new Companies Act, the business plan is discussed with a clear directive of what issues are to be addressed.

> **Section 152(5)** *the company, under the direction of the practitioner, 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.*

Development and approval of the business rescue plan is the primary task of the practitioner, who, after consulting the creditors, other affected persons and the management of the company, must prepare a business rescue plan for consideration by the stakeholders.

The business turnaround plan must contain all the information required to assist stakeholders in deciding whether or not to accept or reject the plan. Chapter 6 divides the turnaround plan into three distinct sections:

Part A – Background which must include at least a

> *… complete list of all the material assets of the company, as well as an indication as to which assets were held as security by creditors when the business rescue proceedings began; a complete list of the creditors of the company when the business rescue proceedings began, as well as an indication as to which creditors would qualify as secured, statutory preferent and concurrent in terms of the laws of insolvency, and an indication of which of the creditors have proved their claims; the probable dividend that would be received by creditors, in their specific classes, if the company were to be placed in liquidation; a complete list of the holders of the company's issued securities; copy of the written agreement concerning the practitioner's remuneration; and a statement whether the business rescue plan includes a proposal made informally by a creditor of the company … .*

Part B – **Proposals** which must include at least

> *… the nature and duration of any moratorium for which the business rescue plan makes provision; 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: the ongoing role of the company, and the treatment of any existing agreements; the property of the company that is to be available to pay creditors' claims in terms of the business rescue plan; the order of preference in which the proceeds of property will be applied to pay creditors if the business rescue plan is adopted; the benefits of adopting the business rescue plan as opposed to the benefits that would be received by creditors if the company were to be placed in liquidation; and the effect that the business rescue plan will have on the holders of each class the company's issued securities … .*

Part C – Assumptions and conditions, which must include at least

> *… a statement of the conditions that must be satisfied, if any, for the business rescue plan to come into operation; and be fully implemented; the effect, if any, that the business rescue plan contemplates on the number of employees, and their terms and conditions of employment: the circumstances in which the business rescue plan will end: and a projected— balance sheet for the company; and statement of income and expenses for the ensuing three years, prepared on the assumption that the proposed business plan is adopted … .*

Benade, Henning, Du Plessis, Delport, De Koker and Pretorius (2003:4) highlight the importance of all the South African Acts impacting on the entrepreneurial venture. The prerequisites of the following Acts are also of importance when constructing the turnaround plan in terms of Section 140 and are used as a frame of reference:

The Insolvency Act, Act 24 of 1936

The Insolvency Act is in the process of being redrafted to align insolvency law and practice with Chapter 6 of the new Companies Act, Act 71 of 2008.

The Income Tax Act, Act 58 of 1962

Income tax seldom comes into play in a turnaround situation, as assessed losses are a feature of a business experiencing financial distress. The realignment of a business's structure can, however, be tax beneficial. Section 44 to 46 of the tax act addresses unbundling, amalgamations and de-grouping (Fluxman 2009:292–330).

Labour legislation

The various Acts governing labour in South Africa are listed below. These Acts, in one form or another, influence the treatment of labour in a turnaround situation. Labour and organised labour are included in the new Companies Act as affected persons but a good working knowledge of the following Acts is a prerequisite for constructing a rescue paln:.

- Basic Conditions of Employment Act 75 of 1997

- Labour Relations Act 66 of 1995
- Employment Equity Act 55 of 1998
- Skills Development Act 97 of 1998
- South African Qualifications Authority Act 58 of 1995
- Broad-based Black Economic Empowerment Act 53 of 2003

The process for determining the actual state of affairs of the business is not discussed in the new Companies Act and no directive on methods to be used to determine the feasibility of continuing with the business is given.

Various methods for turning a business around are available to turnaround practitioners, but it is suggested that a combination of methods will, depending on the prevailing circumstances, be most effective.

A due diligence process comprises the following:

- feasibility assessment with stress testing
- forecasts
- sustainability after rescue process
- corporate governance
- data integrity
- simulations, such as Monte Carlo simulation.

The various methods are addressed in more detail in chapter 8 (of this study) where turnaround modelling is suggested. Although the new Companies Act is not prescriptive on the method used to ascertain the state of affairs, it is quite clear on the minimum requirements of forecasts required in the rescue plan.

Section 150(2)(c) Part C outlines the financial forecast requirements in the proposed plan and Section 150(1) to (5) dictates the minimum requirements for a business rescue plan. It is submitted that, when constructing the plan, all the affected persons will not be sophisticated or skilled enough to make a workable input. This problem adds to the turnaround practitioner’s liability impediment.

The practitioner, after consulting with the creditors, other affected persons and the management of the company, must prepare a business rescue plan for consideration and possible adoption. The new Companies Act is clear on the content required for the rescue plan and divides the requirements into three parts, namely, background, proposal and assumptions and conditions.

5.8 SUMMARY

It will take the South African courts some time to adjust to the proposed new way of treating bankruptcy. Franks and Sussman (2005:385) tested the levels of innovations in the United Kingdom courts after rescue law reforms and concluded that they have taken a substantial period of time to bed down. The literature review confirmed the following similarities between the various debtor-friendly regimes:

- rescue is seen as part of a business process
- a clear process for commencing with business rescue is evident
- a person is appointed who is responsible for the turnaround process
- a turnaround plan is central to all turnaround options and has to be sanctioned by creditors.

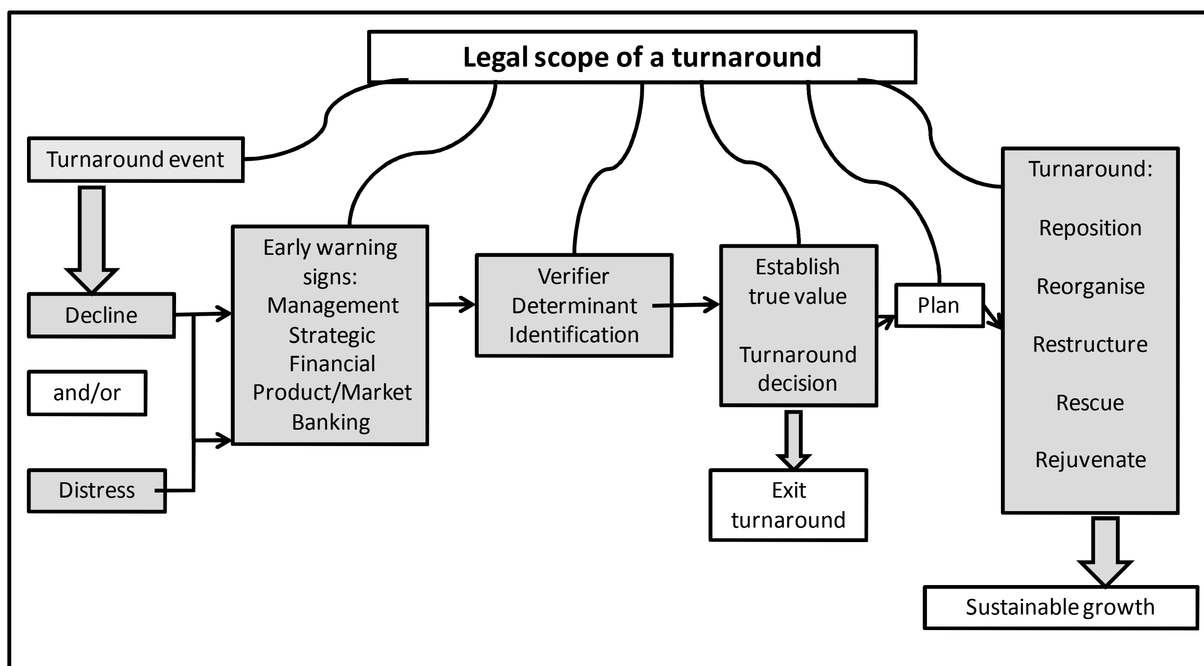

Figure 5.2- Legal impact on turnaround process flow

It is envisaged that the same process will play itself out in South Africa as Chapter 6 of the new Companies Act is tested in our courts. What will be of interest is how business is going to react to the debtor-friendly regime. Figure 5.2 illustrates the overall importance of the legal impact on the turnaround process.

As happens with the introduction of any new legislation, a great deal of speculation has already been reported on by the South African media, with mixed reviews on the viability, potentially problematic areas and the overall probability of success of Chapter 6 of the new Companies Act.