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Impact of Labour Law on South Africa's New Corporate Rescue Mechanism

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South Africa's recently enacted Companies Act *introduces a new business rescue mechanism. Corporate rescue has the aim of resuscitating faltering companies. The legal disciplines of labour, insolvency and corporate law interact during business rescue proceedings. In this contribution the question is posed whether an appropriate balance is being struck between employees' and creditors' interests in this business rescue mechanism. The investigation is done against the background of ILO and EU standards and South Africa's labour and insolvency law frameworks. The conclusion is drawn that the potential success that this rescue mechanism may hold could be eroded due to the over-protection of employees in the model adopted by South Africa.*

1. INTRODUCTION

It is doubtful whether anyone will argue with the fact that corporate rescue[1] has the noble underlying intention of maintaining the life of a business enterprise when it is faced with the prospect of closure. There can also be no doubt that it is almost without exception in the best interest of workers to save the distressed corporate entity by whom they are employed. The same can be said of the shareholders of the distressed entity, who hope to maintain their capital investment in the company and who may still harbour hopes of future dividends. Governments also abhor the demise of corporate taxpayers as it reduces the tax base when companies go into liquidation.

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[1] J. L. Westbrook, C. B. Booth, C. G. Paulus and H. Rajak *A Global View of Business Insolvency Systems*, Washington DC, Martinus Nijhoff Publishers, 2009, p. 122 point out that '[i]nsolvency "rehabilitation", or "reorganization" or "rescue" is everywhere devoted to maintaining all or a major part of a business as a going concern'.

All of these reasons seem to provide ample motivation for the existence of corporate rescue mechanisms, but one should not lose sight of the fact that corporate rescue procedures almost always come into play during a time when a particular business enterprise is faced with harsh economic realities, and when it has its back against the wall. Creditors may have lost faith in a particular ailing business and may not share the same positive sentiments expressed by the remaining stakeholders. Rather than continuing with attempts at resuscitation, it may be in the creditors' best interest to liquidate the assets of the corporate entity and to acquire their fair share of what remains.

It is not novel that particular legal disciplines seek to protect the rights of a particular interest group above others. So, for example, South African insolvency law has as its primary goal the fair distribution of the remaining assets of insolvent individuals and corporate entities amongst their creditors.[2] The South African system is a traditional, creditor-friendly one based on the principles of *pari passu* distribution after the preferential payment of certain classes of creditors.[3] Until approximately 8 years ago, the rights of employees had received very limited protection in terms of the insolvency regime in South Africa.[4] While it is understandable that the insolvency regime strives to protect creditors, it is just as understandable that labour law strives to protect the interests of employees. It has long been recognised that the common-law contract of employment does not adequately regulate the unequal social and bargaining status between employers and employees, and on an international level it has been accepted that if this inequality is not addressed it could lead to the exploitation of employees.[5] However, it is where these two disciplines intersect that brings about some interesting legal, social and moral questions.

The long awaited new South African Companies Act[6] (the Companies Act 2008) was passed by Parliament and signed by the President on 8 April 2009, although it is only expected to come into effect during April 2011. Chapter 6 of the Companies Act 2008 introduces a new corporate rescue regime as well as a new procedure for dealing with a compromise between a company and its creditors. It is an interesting fact that significant new provisions concerning the protection of employee rights have been included in the new corporate rescue procedure contained in Chapter 6. The question the authors consider in this

[2] E. Bertelsmann, R. G. Evans, A. Harris, M. Kelly-Louw, A. Loubser, M. Roestoff, A. Smith, L. Stander and L. Steyn, *Mars The Law of Insolvency in South Africa*, Cape Town, Juta & Co, 2008, p. 2 state that 'the main aim of the sequestration [and liquidation] process is … to provide for a collective debt collecting process that will ensure an orderly and fair distribution of the debtor's assets in circumstances where these assets are insufficient to satisfy all he creditor's claims.'

[3] As pointed out by R. W. Harmer, 'Comparison of Trends in National Law: The Pacific Rim' (1997) vol.13 *Brooklyn Journal of International Law*, p. 147 a corporate rescue regime is far more likely to be successful if the insolvency law framework within which it is applied is debtor-friendly, as opposed to a creditor-friendly system. Measured against this statement it is likely that any corporate rescue regime may find it difficult to succeed in South Africa.

[4] In 2001 N. Smit *Labour Law Implications on the Transfer of an Undertaking* (2001) (LLD thesis RAU), p. 43 mentioned that it 'is submitted that the law of insolvency does not take enough cognisance of the problems and interests of employees' interests in the event of the transfer of insolvent undertakings'. See the discussion in paragraph 3.2 below regarding the amendments that occurred in 2002 and 2003.

[5] M. Brassey, E. Cameron, H. Cheadle and M. Olivier, *The New Labour Law*, Cape Town, Juta & Co, 1987, p. 6 has ascribed this unequal relationship to the simple reason that most employees need a job and wages more than an employer needs the services of an employee. In A. Van Niekerk, M. A. Christianson, M. McGregor, N. Smit and B. P. S. Van Eck, *Law@work*, Durban, LexisNexis, 2008, pp. 3-4 it is mentioned that '[l]egislative intervention in the employment relationship was originally motivated by the recognition that contractual rules ignore the fact that the bargaining power between employer and employee is inherently unequal. Few employees are in a position to bargain on equal terms of the relationship'. It is submitted, however, that despite these sentiments, it should be taken into account that the directors of companies who may also serve as managers and employees of a company often do have the status to take care of their own personal interests.

[6] Act 71 of 2008.

paper is whether the legislator has succeeded in striking an appropriate balance between the protection of the rights of the employees on the one hand, and actually saving the company or its business on the other.

It is our contention that if a corporate rescue procedure goes too far in providing for the protection of the employees of the failed entity, this may ultimately be to the detriment of the employees. This is especially so if the protection granted corresponds with the over-burdening of the new owner (employer), or the excessive erosion of the rights of creditors, such as banks, that hold the key to the company's credit lifeline. If these important stakeholders are deterred from investing by an unbalanced procedure, the corporate rescue legislation could become counter-productive.

In the first part of this article we provide a brief outline of the protection afforded to employees under the broader discipline of employment and labour law in South Africa, as well as a brief exposition of the position relating to employees in terms of insolvency law. Both these aspects will be considered against the background of supra-national principles established by the International Labour Organisation (ILO) and the European Union (EU).

In the second part of the article we delve into the new corporate rescue mechanism established by the Companies Act 2008, namely the 'business rescue' procedure. In the final analysis we draw conclusions regarding the question whether the legislature was successful in establishing an appropriate balance that will serve the best interests of the relevant social and economic partners in the situation of business rescue.

2. PROTECTION AFFORDED BY LABOUR LAW

2.1 International Position

ILO conventions are silent on principles regarding transfers of businesses as going concerns during solvent and insolvent situations.[7] However, the EU has introduced directives in this regard that bind member states. In the 1970s the European Council was concerned about the social consequences that the continued economic integration of the European Community may have on the workers of business enterprises. In order to address these concerns the EU adopted regulations safeguarding employees' rights in the event of transfers of undertakings or parts thereof.[8]

The EC Acquired Rights Directive of 1977 initially did not make any reference to transfers of insolvent businesses.[9] The amendments to the Acquired Rights Directive in 1998 were consolidated and replaced by Directive 2001/23/EC of 12 March 2001[10] and here the situation of the transfer of insolvent businesses was to some extent addressed. In essence, the 2001 directive provides three levels of protection relating to the safeguarding of employees' rights in the event of transfers[11] of undertakings, businesses or parts thereof:

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[7] See N. Smit, *op. cit.*, pp. 52-53.

[8] C. Todd, D. du Toit and C. Bosch, *Business Transfers and Employment Rights in South Africa*, 2004, Durban, LexisNexis, p.13.

[9] D. A. Burdette 'Formalities for the Transfer of Insolvent Businesses: The Obligatory Transfer of Employees in South Africa and the United Kingdom' (2007) Issue No.3 *INSOL International Technical Series* p. 9.

[10] Hereinafter the 2001 directive.

[11] There was some uncertainty about the definition of 'transfer' in terms of the Acquired Rights Directive of 1977. This was addressed in the 2001 directive which provides that 'there is a transfer within the meaning of this Directive where there is a transfer of an economic entity which retains its identity, meaning an organized grouping of recourses which has the objective of pursuing an economic activity, whether or not that activity is central or ancillary.'

- Firstly, it makes provision that when a business or part thereof is transferred as going concern, all contracts of employment must be transferred from the old to the new employer.[12] Member states may elect to provide that after the transfer the old and the new employer shall be jointly and severally liable in respect of obligations which emanate from contracts of employment existing on the date of the transfer.
- Secondly, it provides that employees must be protected against dismissal by the old or new employer on the ground of the transfer of the business in itself. This, however, does not stand in the way of the dismissal of employees on ground of 'economic, technical or organisational reasons' directly before or after the transfer.[13]
- Thirdly, the old and new employers must inform and consult the representatives of the employees affected by the transfer in good time.[14] This must in any event occur before the employees are affected by the transfer as regards their conditions of employment and work.

It may be asked to what extent the regulations were relaxed to make conditions more favourable for buyers of businesses that were either insolvent or already subject to insolvency proceedings? In the context of this discussion, it is significant to note that the 2001 directive provides that unless member countries provide otherwise, the first two categories of protection (namely in respect of the transfer of all contracts of employment and the protection against dismissal on grounds of the transfer) do not automatically apply to any transfer if the old employer is subject to insolvency proceedings.[15] However, if a member country should decide to comply with these protective measures while insolvency proceedings have been instituted, the old employer's debts arising from any contracts of employment and payable before the transfer will not transfer to the new employer.[16] In addition to this, the old employer or the new employer on the one hand, and the representatives of the workers on the other, may agree to amendments to the contracts of employment with a view to ensuring the survival of the undertaking.[17]

In addition to the 2001 directive, another directive was adopted a year later that has had an influence on corporate rescue provisions. Directive 2002/14/EC has the objective that each member state should establish a general framework within which the provision of information to workers and the engagement of consultations between workers and management will be enhanced, especially where the employer's evaluation suggests that employment within the organisation will be under threat.[18] The directive applies to undertakings with more than 50 workers[19] and information to employees and the right to consult is in relation to 'decisions likely to lead to substantial changes in work organisation.' This is especially relevant 'where there is a threat to employment' and it is submitted that the 2002 directive in all likelihood applies to the situation of corporate rescue.

[12] Art 3(1) of the 2001 directive.
[13] Art 4 of the 2001 directive.
[14] Art 7 of the 2001 directive. The old and new employer must inform the representatives of the employees of the date of the transfer, the reasons for the transfer and the legal, economic and social implications of the transfer.
[15] Art 5(1) of the 2001 directive. The article also extends to any analogous proceedings with a view to the liquidation of the assets of the old employer and is under the supervision of a competent public authority or insolvency practitioner authorised by a competent public authority. The directive does not, however, extend to corporate rescue procedures which arguably do not form part of insolvency or liquidation procedures.
[16] Art 5(2)(a) of the 2001 directive.
[17] Art 5(2)(b) of the 2001 directive.
[18] Art 1 of Directive 2002/14/EC of 11 March 2002. Hereinafter the 2002 directive.
[19] Art 3(1) of the 2002 directive.

2.2 Position in South Africa

Employees in South Africa have a distinctive advantage in that the Constitution[20] enshrines a number of workers' rights as fundamental human rights. So, for example, South Africa's supreme law with its horizontal and vertical application provides explicit protection to every employee's right to fair labour practices, the right to organise, the right to strike and the right to be represented by trade unions.[21] Modern South African statutes, such as the Labour Relations Act[22] (the LRA) and the Basic Conditions of Employment Act[23] (the BCEA) give effect to the constitutional promise of fair labour practices. However, creditors, as a specific interest group, are not in the same privileged position[24] and only have indirect protection through the right to equality before the law[25] and their property rights which may be secured.[26]

With the implementation of the LRA of 1995, protective measures regarding the transfer of businesses as going concerns were for the first time introduced by the legislature. Section 197 of the LRA stipulates that whenever a business or any part thereof is transferred as a going concern, and unless an alternative agreement is reached with the employees:

- the new employer must take over all of the employees on the same conditions of service;
- the rights of the employees who are transferred workers (such as unpaid salary) and duties apply to new employer;
- everything done by the old employer (such as unfair dismissal) is transferred to the new employer; and
- the transfer does not interrupt the continuity of service.

It may seem peculiar that even though South Africa did not go through the same process of economic integration as the European Union, South African policy makers were strongly influenced by the EU's directives after the first post-*apartheid* democratic elections.[27] As was the case with the original Acquired Rights Directive of 1977, the LRA initially said nothing about the transfer of a business as going concern under insolvent circumstances. However, in 2002, and in line with the consolidated 2001 directive, section 197A of the LRA introduced protection to employees in the transfer situation when an old employer is insolvent or when a scheme of arrangement or compromise is being entered into to avoid the winding-up of a company for reasons of insolvency. In an attempt to balance the rights of employees in the transfer situation with some of the limitations that are placed on buyers of businesses as going concerns under solvent circumstances, watered-down protection was afforded to employees of insolvent businesses in the transfer situation.[28]

Even though section 197A of the LRA still provides that all employees have the right to be transferred, and that continuity of service is not interrupted, two significant relaxations

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[20] Act 108 of 1996.
[21] S 23(1)-(5) of the Constitution.
[22] Act 66 of 1995.
[23] Act 75 of 1997.
[24] B. P. S. van Eck, A. Boraine and L. Steyn, 'Fair Labour Practices in South African Insolvency Law' (2004) vol 121 *South African Law Journal*, p. 902.
[25] S 9 of the Constitution.
[26] S 25 of the Constitution.
[27] See M. Vranken, 'Transfer of Undertakings in Australia and New Zealand: How Suitable is the European Regulatory Approach for Exportation?'(2005) vol. 21 *IJCLLIR* pp. 227-247 regarding the lessons that can be learnt by non-EU countries in respect of standards adopted by the EU regarding transfers of undertakings.
[28] A. Boraine and B. P. S. Van Eck, 'The New Insolvency and Labour Legislative Package: How Successful was the Integration?' (2003) *Industrial Law Journal (South Africa)* p. 1840.

have been introduced for potential buyers of financially distressed businesses. In line with Article 5 of the 2001 EU directive:

- claims that employees may have had against their old employers in respect of unpaid salary and unpaid leave do not transfer to the new employer; and
- the new employer cannot be held liable for the unfair dismissal of any of the employer's former employees.[29]

As a developing economy, and with an unemployment rate of 25,3%,[30] South Africa has gone quite far in adopting not only some but all of the protective measures that apply to the more sophisticated EU member states in respect of the protection of employee rights in the transfer situation. South Africa has also extended the protection to employees where the transfer of an insolvent business takes place. However, the relaxation that is afforded to buyers of insolvent businesses have also been introduced into the South African provisions, and it is submitted that in this respect the appropriate balance is being struck in respect of the new owners (employers) of distressed companies. It remains to be seen if this is also the case in the new business rescue model that has been developed for South Africa.

3. PROTECTION AFFORDED IN TERMS OF THE INSOLVENCY ACT

3.1 International Position

The South African Insolvency Act, 1936[31] (the Insolvency Act) does not comply with Part III of ILO's Protection of Workers' Claims (Employer's Insolvency) Insolvency Convention of 1992[32] which prescribes that a guarantee fund must be established for unpaid salary in respect of employees of insolvent employers. However, even though South Africa has not ratified the 1992 convention, South Africa does comply with Part II which directs that ratifying countries must provide protection to employees for claims against their insolvent employers by means of a privilege, so that they are paid out of the assets of the insolvent employer before non-privileged creditors can be paid their share.[33] Article 6 of the 1992 convention provides that the privilege shall cover at least:

> '(a) the workers' claims for wages relating to a prescribed period, which shall not be less than three months, prior to the insolvency or prior to the termination of the employment;
> (b) the workers' claims for holiday pay due as a result of work performed during the year in which the insolvency or the termination of the employment occurred, and in the preceding year;
> (c) the workers' claims for amounts due in respect of other types of paid absence relating to a prescribed period, which shall not be less than three months, prior to the insolvency or prior to the termination of the employment;
> (d) severance pay due to workers upon termination of their employment.'[34]

[29] *Ibid.*
[30] Statistics South Africa accessed at http://www.statssa.gov.za/keyindicators/keyindicators.asp on 11 September 2010.
[31] Act 24 of 1936.
[32] ILO Protection of Workers' Claims (Employer's Insolvency) Convention 173 of 1992. Hereinafter the 1992 convention.
[33] Art 5 of the 1992 convention.
[34] Art 7 of the 1992 convention provides that national laws may limit the protection by privilege of workers' claims to a prescribed amount; where the privilege afforded to workers' claims is limited, the prescribed amount

Part III of the 1992 convention makes provision for signatories to this part to establish independent guarantee institutions that would stand in for workers' claims against their insolvent employers.[35] The independent fund, with assets separate from the assets of the employer, would pay out these claims.[36] Article 12 of the 1992 convention provides that the workers' claims protected pursuant to this Part shall include at least:

> ‘(a) the workers' claims for wages relating to a prescribed period, which shall not be less than eight weeks, prior to the insolvency or prior to the termination of the employment;
> (b) the workers' claims for holiday pay due as a result of work performed during a prescribed period, which shall not be less than six months, prior to the insolvency or prior to the termination of the employment;
> (c) the workers' claims for amounts due in respect of other types of paid absence relating to a prescribed period, which shall not be less than eight weeks, prior to the insolvency or prior to the termination of employment;
> (d) severance pay due to workers upon termination of their employment.’

3.2 Position in South Africa

Before 1 January 2003, section 38 of the Insolvency Act had the effect that the formal insolvency of the insolvent employer automatically terminated all the contracts of employment between the insolvent employer and the employees. The result was that when the whole or a part of a liquidated company was transferred, there were no contracts of employment that could be transferred in terms of the LRA. Upon the insistence of the trade union movement, based on the constitutional ‘right to fair labour practices’, the Insolvency Act and the LRA were amended.[37]

In an attempt to save businesses and to align the provisions of the Insolvency Act with the provisions of the LRA, the insolvency provisions were radically changed. After the amendments were affected, contracts of employment were no longer terminated but suspended for a period of 45 days after the final appointment of the officeholder (trustee or liquidator). Although the employees are not required to render their services and do not get paid during this period of suspension, they are entitled to claim unemployment benefits in terms of the Unemployment Insurance Act.[38] In theory this hiatus provides the officeholder with a window of opportunity to find a buyer for the whole of the business or parts thereof.[39]

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shall be adjusted as necessary so as to maintain its value. Art 8 provides that national laws shall give workers' claims a higher rank of privilege than most other privileged claims (in particular those of the State and the social security system). However, where workers' claims are protected by a guarantee institution in accordance with Part III of the Convention, the claims protected may be given a lower privilege than those of the State and the social security system.

[35] Art 9.

[36] Directive 2002/74/EC of 23 September 2002, amending Directive 80/987/EC of 20 October 1980, makes provision that European Union members subscribe to Part III of the ILO Insolvency Convention.

[37] The amendments to the LRA came into effect on 1 August 2002. See the Labour Relations Amendment Act 12 of 2002, GG 23540. The Insolvency Amendment Act 33 of 2003 came into effect on 1 January 2003. See A. Boraine and B. P. S. Van Eck *op.cit.*, p. 1840.

[38] Act 63 of 2001.

[39] A. Boraine and B. P. S. Van Eck *op. cit.*, pp. 1841-1843.

During 2002 and 2003, employees' protection in respect of unpaid salary and severance benefits were also improved. The order of payment of preferential claims from the free residue of an insolvent estate under South African insolvency law is currently as follows:

- funeral expenses (in insolvent deceased estates);[40]
- death bed expenses (in insolvent deceased estates);[41]
- sequestration, administration, and execution costs;[42]
- salary and wages (salary 3months with a maximum of R12,000), leave pay (maximum R4,000) and severance pay (maximum R12,000);[43]
- arrear income tax;[44]
- claims secured by a general mortgage bond;[45]
- concurrent (unsecured) claims.[46]

From the above provisions it is clear that South Africa does comply with part II of the 1992 convention, and at least provides some protection in respect of unpaid salary, leave pay and severance benefits. The concurrent or unsecured creditors, including employees that have claimed over and above their respective preferential portions, will also be treated as concurrent creditors for the balance of their claims. From these provisions it is clear that the legislature has sought to improve the position of employees by striking a balance between the rights of buyers of insolvent businesses and the rights of the employees of these entities by aligning the provisions of the Insolvency Act with the provisions of the LRA.

When dealing with the new corporate rescue procedure known as 'business rescue', the question that arises is to what extent employees as an interest group should play a role in steering the company through the rescue procedure. In addressing this question we look at whether or not there would be any benefit for the employees to influence the corporate rescue procedure in order to improve the claims they may ultimately pursue against the company should the rescue attempt fail, and we look at how effective the new corporate rescue provisions will be in staving off liquidation and ultimately saving jobs.

4. THE NEW CORPORATE RESCUE DISPENSATION IN SOUTH AFRICA

4.1 Introduction to the Companies Act 2008

The Companies Act 2008 was introduced in a constitutional setting which South African corporate and insolvency lawyers may not previously have been used to. It is a milieu with a new social and democratic order in South Africa, which is much more sensitive to the rights of employees. It is one of the clearly stated purposes of the Companies Act 2008 to ensure compliance with the Bill of Rights of the Constitution, which *inter alia* enshrines every employee's right to fair labour practices.[47] The other aims of the Companies Act 2008 include the balancing of the interests of shareholders and directors, the fostering of

[40] S 96 of the Insolvency Act.
[41] S 97 of the Insolvency Act.
[42] S 98 of the Insolvency Act.
[43] S 98A of the Insolvency Act.
[44] S 101 of the Insolvency Act.
[45] S 102 of the Insolvency Act.
[46] S 103 of the Insolvency Act.
[47] S 7(a) of the Companies Act 2008.

responsible management, and to provide for the efficient rescue of financially distressed companies in a manner that balances the interests of all relevant stakeholders.[48]

Although the term 'business rescue' is a generic term used to describe corporate rescue, this is the name that was decided upon for the new procedure. Since we are particularly interested in the provisions of this new procedure that relate to the rights of employees the focus of the discussion will not extend to other elements of the business rescue mechanism. Interestingly, the Companies Act 2008 provides that in instances where there is inconsistency between the provisions of the Act as a whole and any other national legislation, the provisions of the Companies Act 2008 should as far as possible be interpreted concurrently with such other legislation. In those instances where this is not possible and there is conflict between the provisions of the Companies Act 2008 and the LRA, it is stipulated that the provisions of the LRA will prevail over the provisions of the Companies Act 2008.[49]

4.2 Introduction to the Business Rescue Provisions

Chapter 6 of the Companies Act 2008 deals mainly with business rescue, but there are also provisions that regulate a compromise between a company and its creditors.[50] Once it becomes operative, the provisions of Chapter 6 will replace the existing judicial management procedure currently contained in the Companies Act 1973.[51] It is important to note that the idea of rescuing a company that is in financial distress is certainly not new to South Africa,[52] even though the new business rescue procedure is seen as 'radically different' to judicial management.[53] The new business rescue regime was apparently greatly influenced by similar concepts that can be found in jurisdictions such as the United States and the United Kingdom,[54] although this is not always apparent from the provisions themselves.

Judicial management was first introduced as a business rescue procedure in South Africa in the Companies Act 1926.[55] Even though serious doubts were expressed about the success of judicial management as a corporate rescue mechanism,[56] the Companies Act 1973

[48] S 7(i)-(k) of the Companies Act 2008.
[49] S 5(4)(b)(i)(bb) of the Companies Act 2008.
[50] Ss 128 – 155 of the Companies Act 2008.
[51] Act 61 of 1973. This Act remains operative until such time as the 2008 comes into operation. Even then there are still parts of the Companies Act 1973 that will remain operative for some time, eg the winding-up provisions contained in Chapter XIV of the Act. According to the Minister of Trade and Industry in South Africa, Dr Rob Davies, the 2008 Companies Act will come into force on 1 April 2011.
[52] D. M. Davis, F. H. I. Cassim and W. Geach (Eds) *Companies and other Business Structures in South Africa* Oxford University Press, South Africa, 2009, p. 164 (hereinafter D. M. Davis *et al*); J. Rushworth 'A Critical Analysis of the Business Rescue Regime in the Companies Act 71 of 2008' in T. H. Mongalo (ed) *Modern Company Law for a Competitive South African Economy*, Cape Town, Juta & Co, 2010, p. 376.
[53] J. Rushworth *op. cit.*, p. 408.
[54] *Ibid.*, p. 376.
[55] Act 46 of 1926. According to J. L. Westbrook *et al. op. cit.*, p. 122 the 'concept of a formal business rescue regime in modern times can be traced back to at least 1926 when, under the description of Judicial Management, it was introduced in South Africa'. As mentioned by D. A. Burdette 'Some Initial Thoughts of the Development of a Modern and Effective Business Rescue Model for South Africa', (2004), vol. 16, *SA Merc Law Journal* 246 (hereinafter D. A. Burdette *SA Merc Law Journal*) it is, therefore, quite ironic that since the introduction of judicial management South Africa has not really developed it in relation to insolvency law, and has consequently fallen out of step with other modern systems in this regard.
[56] When the Van Wyk de Vries Commission (*Kommissie van ondersoek na die Maatskappywet* main report RP 45/1970) par 51.02 at 147 reviewed the success of judicial management as a corporate rescue mechanism in the early 1970s, the Masters of the Supreme Court called for the abolition of judicial management due to its low

retained it subject to some minor amendments. The most problematic areas of concern regarding judicial management as a corporate rescue mechanism include the fact that:

- the courts view it as an extraordinary procedure and not a viable alternative to liquidation;[57]
- it is a court driven procedure that makes it expensive and inaccessible for especially smaller companies;[58]
- in terms of the Companies Act 1973 the strict requirement of insolvency applies before the courts will make an order for judicial management;[59] and
- liquidators as opposed to properly trained business people are appointed as the judicial manager.[60]

In May 2004 the Department of Trade and Industry published a policy document on the reform of South African company law, the concept of corporate rescue being specifically mentioned as one of the areas that needed attention.[61] As will be seen in the ensuing discussion, a number of the shortcomings of the judicial management procedure have been addressed, but inevitably these have led to new questions and concerns regarding the new procedure.[62] The focus of this discussion will naturally be the provisions of the Companies Act 2008 that deal with employee rights, and the question of whether the process may be abused to the detriment of other stakeholders is considered.

4.3 The Purpose of Business Rescue and the Definition of 'affected persons'

The main purpose of business rescue is to facilitate the rehabilitation of a company in financial distress.[63] The process can be initiated before or during the winding-up process (at any time before the final distribution account has been approved by the court), and if it is initiated after a winding-up application has already been launched it has the effect of placing the liquidation process on hold if the court grants the order.[64] The process has three main features:

- The management, business and property of the company are placed under the temporary supervision of a business rescue practitioner;
- A temporary moratorium is placed on the rights of claimants against the company or in respect of property in its possession;

success rate. In *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* [2001] 1 All SA 223 (C) at 238 Josman J referred to judicial management as 'a system which has barely worked since its initiation in 1926'.

57 See D. A. Burdette *SA Merc Law Journal op. cit.*, p. 247.

58 A. Loubser *Some Comparative Aspects of Corporate Rescue in South African Company Law* (2010) (unpublished LLD Thesis, UNISA), p. 18. Hereinafter A. Loubser LLD Thesis. However, it is to be noted that the Van Wyk de Vries Commission deemed judicial management to be a successful procedure and retained it in the Companies Act of 1973.

59 A. H. Olver 'Judicial Management: A Case for Law Reform' (1986) 49 *THRHR*, p. 48.

60 *Ibid*.

61 *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* RN 1183 in *Government Gazette* No 26493 of 23 June 2004. See also the discussion in A. Loubser LLD Thesis *op. cit.*, p. 3.

62 See the discussion in par 5 below.

63 S 128(1)(b) of the Companies Act 2008. Ss 136(1) and 144(2) of the Companies Act make it clear that the preservation of jobs is central to the process as a whole.

64 Ss 131(6) and (7) read with s 132(1)(c) of the Companies Act 2008.

- If approved, the implementation of a plan aimed at restructuring the company's business, property and debt by maximizing the possibility that the company will continue to do business on a solvent basis, or to effect a better return for the company's creditors or shareholders than would have been the case had the company been liquidated immediately.[65]

So-called 'affected persons' play a significant role in the business rescue procedure as they have various rights in respect of the initiation of the process and decision-making, and they also acquire new, stronger preferential rights should the business rescue fail and the company eventually be wound up.[66]

The Companies Act 2008 defines an 'affected person' as:[67]

- a shareholder or creditor of the company;
- any registered trade union representing employees of the company; and
- if any of the employees of the company are not represented, each of those employees.

By classifying trade unions and employees as 'affected persons' the legislature has provided the employees with a powerful tool, placing at their disposal far-reaching rights and powers that can have a huge impact on the future of the distressed company. These are discussed in more detail below.

4.4 The Process of Business Rescue

The Companies Act 2008 allows for two possible initiation procedures of a business rescue proceeding. In the first instance, the board of directors of a company may pass a resolution for the company to voluntarily begin business rescue proceedings and place the company under supervision. There is an obligation on the company to enter business rescue proceedings when the board has reasonable grounds to believe that the company is financially distressed and that a reasonable prospect of rescuing the company exists.[68] Although the strict requirement of immediate insolvency (as was the case with judicial management) does not apply, an inability by the company to pay debts (cash flow test) or probable insolvency of the company (balance sheet test) within a period of six months is the criteria used to determine whether or not the company is financially distressed. The other benefit (as opposed to judicial management) is that the process is not court-driven. Such a voluntary resolution by the board of directors may not be adopted after liquidation proceedings have been initiated by or against the company. Once the resolution has been filed with the Companies and Intellectual Property Commission (hereinafter the Commission)[69] the resolution, its affected date and a sworn statement containing the facts relevant to the grounds on which the decision was

[65] S 128(1)(b) of the Companies Act 2008.
[66] Part C of Chapter 6 deals with rights of affected persons during these proceedings. S 144 of the Companies Act 2008 deals specifically with the rights of employees, and s 145 of the Companies Act 2008 sets out the possible participation in the process by the creditors.
[67] S 128(1)(a) of the Companies Act 2008.
[68] S 129(1) of the Companies Act 2008.
[69] In terms of s 129(2)(a) of the Companies Act 2008 the resolution only has force once it has been filed with the Commission.

founded, must within five calendar days be published to every affected person[70] and a practitioner must be appointed.[71]

If the company does not meet the rather short prescribed time-limits, the resolution lapses and becomes a nullity.[72] In such a case a new resolution may not be filed by the company within three months of the previous resolution.[73] Should an affected person have an objection against the adoption of a voluntary resolution by the board of directors, such person may apply to court for an order setting the resolution aside.[74] This may be done at any time after the resolution has been passed up to the time when a business rescue plan is adopted.[75]

Besides the voluntary procedure of placing a company under business rescue, a company may also be placed under compulsory business rescue by means of a court order. Such an order may be sought by an affected person.[76] It is significant that trade unions or employees (as categories of affected persons) have the right to initiate this process at any time before or after winding-up proceedings have commenced by or against the company. Where application is made after winding-up proceedings have already commenced, such an application will suspend the liquidation process.[77]

The board of directors may not pass a resolution placing the company under business rescue once a winding-up proceeding has commenced.[78] A copy of the court application must be served on the company and the Commission and each of the affected persons must be notified of the application in the prescribed manner.[79] All affected persons have the right to participate in the hearing when the application is being considered.[80] The court has the power to either grant the order and commence business rescue proceedings or dismiss the application and issue an alternative order which may include an order placing the company under liquidation.[81]

[70] S 129(3)(a) of the Companies Act 2008. The affected persons must be notified within 5 business days of the filing of the resolution with the Commission.

[71] S 129(3)(b) of the Companies Act 2008. The business rescue practitioner must consent to his or her appointment. S 138 of the Companies Act 2008 contains the requirements that must be met for the appointment of a business rescue practitioner. S 129(4) of the Companies Act 2008 provides that two days after the company has appointed the business rescue practitioner the company must file a notice of the appointment with the Commission, and once again publish a copy of the notice of the appointment to all affected persons within 5 days after the filing of the notice.

[72] S 129(5)(a) of the Companies Act 2008.

[73] S 129(b) of the Companies Act 2008. The court may shorten the period for good cause shown.

[74] S 130 of the Companies Act 2008.

[75] S 152 of the Companies Act 2008. The grounds for an objection are stated in s 130(1)(a) of the Companies Act 2008 and includes the following: i) there are no reasonable grounds to believe that the company is financially distressed; ii) there is no reasonable prospect for rescuing the company; or iii) the company has failed to satisfy the procedural requirements in respect of the initiation of the process.

[76] S 131 of the Companies Act 2008.

[77] S 131(6) of the Companies Act 2008.

[78] S 129(2)(a) of the Companies Act 2008.

[79] S 131(2) of the Companies Act 2008.

[80] S 131(3) of the Companies Act 2008. In terms of s 131(4)(a) of the Companies Act 2008 the applicant must prove that the company is financially distressed, that the company has failed to pay over any amount in terms of an obligation in terms of a public regulation, contract or in respect of employment-related matters, or it is otherwise just and equitable to do so for financial reasons and that there is a reasonable prospect for rescuing the company.

[81] S 131(4) of the Companies Act 2008. In terms of s 131(5) of the Companies Act 2008 the court may first appoint a qualified interim business rescue practitioner that has been nominated for that purpose by the affected person bringing the application. The appointment of the interim business rescue practitioner is provisional in so far as it has to be ratified at the first meeting of creditors by the majority of the independent creditors' voting interests. The qualifications for practitioners are regulated in section 138 of the Companies Act 2008. In terms of s 131(8) of the Companies Act 2008 each affected person must be notified of the order within five business days after the date of the order.

4.5 *The Role of the Business Rescue Practitioner and the Business Rescue Plan*

The main duties of the business rescue practitioner are to investigate the affairs of the company, to decide on the future of the company and to take over the full management and control of the company. It entails a substitution of the board of directors and any other pre-existing management structures of the company.[82] The business rescue practitioner assumes the responsibilities, duties and liabilities of a director of the company.[83] If there is a reasonable prospect that the company can be rescued,[84] the business rescue practitioner must prepare a business rescue plan by consulting affected persons in the process.[85] If it forms part of the business rescue plan to sell or close a part of the business, the responsibility will fall on the business rescue practitioner to ensure adherence to the transfer and retrenchment provisions of the LRA in so far as the position of employees may be concerned. The directors of the company must assist the practitioner in the execution of his prescribed duties.[86]

The business rescue practitioner must consult with the creditors, registered trade unions and employees and the management of the company with a view to developing a business rescue plan for consideration and possible adoption.[87] The affected persons must be provided with the relevant information, which could conceivably include information regarding the possible retrenchment of employees, or regarding an envisaged sale of a part or the whole of the business.[88] The plan must contain prescribed information reasonably required to facilitate affected persons in deciding whether or not to accept or reject the plan.[89]

Creditors and employees play a roll when the plan is being finalized. Within 10 days after publication of the plan the practitioner must convene and preside over a meeting of creditors, representatives of the employees and other holders of voting interests to consider the proposed plan.[90] The plan must be placed before a meeting where the employees' representatives are given an opportunity to address the meeting before the plan is subjected to a vote.[91] At least 75% of those with creditors' voting interests must vote in favour of the plan for it to enjoy preliminary approval.[92] Of these votes at least 50% must represent independent creditors' voting interests.[93] It the plan is not approved by the required majority, any of the affected persons are entitled to make a binding offer to buy the voting interests of one or more of the persons opposed to the plan, at a value that is independently and expertly determined by the practitioner.[94] Once the business rescue plan has been substantially

[82] S 140(1)(a) of the Companies Act 2008.
[83] S 140(3)(b) of the Companies Act 2008.
[84] S 141(1) of the Companies Act 2008.
[85] S 150(2) of the Companies Act 2008. Part D of Chapter 6 of the Companies Act 2008 deals with the development and approval of the business rescue plan.
[86] S 142 of the Companies Act 2008. S 142(3) of the Companies Act 2008 provides for certain information that the directors need to make available to the business rescue practitioner.
[87] S 150(1) of the Companies Act 2008.
[88] *Ibid.*
[89] Ss 150(2) and 150(2)(c)(ii) of the Companies Act 2008. In terms of s 150(5) of the Companies Act 2008 the plan must be finalised and published by the company within 25 business days after the time on which the business rescue practitioner was appointed.
[90] S 151(1) of the Companies Act 2008.
[91] S 152(1)(c) of the Companies Act 2008.
[92] S 152(2)(a) of the Companies Act 2008.
[93] S 152(2)(a) of the Companies Act 2008.
[94] S 153(1)(b)(ii) of the Companies Act 2008.

implemented the business rescue practitioner must file a notice of the substantial implementation of the business rescue plan.[95]

It is also only the employees who have the right to propose the development of an alternative plan if the proposed plan is not accepted. Regarding this right employees are in a stronger negotiating position than the shareholders and / or creditors of the company.[96] In addition to any rights that employees may have as creditors of the company, they will always be in a position to propose an alternative plan.[97]

4.6 Unpaid Salary and Post-Commencement Finance

In order for a financially distressed company to continue trading, the business rescue procedure makes provision for post-commencement financing to be obtained by the company after the business rescue procedure has already commenced. Rushworth states the following when describing the importance of the provisions dealing with post-commencement finance:

> 'The ability to raise finance during the proceedings should facilitate the continued operation of the company on a satisfactory basis whilst the rescue plan is prepared, in particular if the lenders to the company before the proceedings commence are not prepared or are unable to provide additional funding to the company once the proceedings have commenced.'[98]

Due to the fact that creditworthiness of the company will be negatively affected by the commencement of business rescue proceedings, it is important to grant the provider of post-commencement finance a preferential right to recoup its money as a super preference before other creditors are paid.[99] However, before the lender (the creditor who has provided the post-commencement financing) is repaid, it is important to note that the business rescue practitioner and the employees will be paid first. Effectively, therefore, any post-commencement financing will be used to bankroll the business rescue practitioner's fees and the employees' salaries during the period the company is under business rescue. Although this section has been clumsily drafted, it does not retract from the rather surprising priorities created by this section.

In respect of salaries due and payable and in respect of finance obtained after the commencement of business rescue proceedings, employees are treated as special category of creditors. The Companies Act 2008 stipulates that to the extent that any remuneration or other amounts of money related to employment becomes due and payable by a company during the process of business rescue and the company is unable to honour its commitments in this regard, the unpaid amounts are regarded as post-commencement finance. A special order of preference is established by the Companies Act 2008 in respect of post-commencement finance that overlaps with and supersedes the provisions of the Insolvency Act. Unpaid moneys to employees are elevated to the rank of a 'super preference' to be taken into account as preferred claims directly after the remuneration of the business rescue

[95] S 152(8) of the Companies Act 2008. If the business rescue practitioner at any stage becomes convinced that there is no reasonable prospect of rescuing the company, there is in terms of s 141(2) of the Companies Act 2008 a duty on him or her to inform all affected persons and to apply to court to discontinue the business rescue proceedings and to liquidate the company.
[96] S 144(3)(e) of the Companies Act 2008.
[97] A. Loubser LLD Thesis *op. cit.*, p. 136.
[98] J. Rushworth *op. cit.*, pp. 385-386. The author does not, unfortunately, state where this funding is to come from if the lenders are unable or unwilling to lend.
[99] S 135 of the Companies Act 2008.

practitioner, irrespective of whether such financing may be secured to the lender by utilising any unencumbered asset of the company to the extent that it may not already serve as security.[100]

Employees who are owed any amount of money relating to employment and which became due and payable by the company before the beginning of business rescue proceedings, and that had not been paid to the employees immediately before the beginning of the proceedings, are regarded as 'preferred unsecured creditors' of the company.[101] Section 144(2) of the 2008 Companies Act does not place any limitation on the claims of employees for arrear salaries and other amounts that may exist at the time the company goes into business rescue. To this extent the business rescue provisions are far more favourable than the provisions of the Insolvency Act, which provide for only three months' arrear salary and a maximum amount of R12,000 for such claims if the company had gone into liquidation.[102]

The preferential provisions included in the new business rescue procedure may create significant problems in practice. Financial institutions that could possibly still have entertained the idea of providing a financial injection to a distressed company, could quite conceivably be deterred from making any finance available due to the reality that the money will first be utilised to pay the arrear salaries of employees and the business rescue practitioner's remuneration before they will stand in line to be paid their secured debt.[103] Another important issue is the fact that the preferences created for employees by the business rescue procedure will remain in force even if the business rescue fails and the company is forced into liquidation.[104]

4.7 Suspension of Contracts and Maintaining Contracts of Employment

Once the business rescue plan has been adopted, the business rescue practitioner may suspend or cancel entirely, partially or conditionally any provision or contract that the company is a party to.[105] Where a claim arises against the company as a result of such suspension or cancellation the prejudiced party will only be entitled to institute a claim for damages.[106] In order to provide clarity and consistency when dealing with uncompleted contracts, Burdette suggests that 'the same rules regarding contracts in insolvency should apply to business rescue proceedings.'[107] This is clearly not the situation under the new business rescue procedure

The situation is quite different in respect of contracts of employment. The Companies Act 2008 provides that contracts of employment that were in place immediately before the beginning of the business rescue proceedings will remain in force on the same terms and conditions.[108] This has the result that all employees must continue to render their services and

[100] S 135(2)(a) of the Companies Act 2008. See A. Loubser LLD Thesis *op. cit.*, p. 47. See also D. Davis *et al op. cit.*, p. 170 where it is noted that 'a new order of preference for the payment of creditors can be created, overriding even the statutory order of preferences set out in the Insolvency Act 24 of 1936.'
[101] S 144(2) of the Companies Act 2008.
[102] S 98A of the Insolvency Act, 1936.
[103] S 135(3)(b) of the Companies Act 2008.
[104] These preferences will, however, be subject to costs arising out of the liquidation process. Therefore, these preferent claims will only be payable after the liquidation costs have been covered.
[105] In terms of s 136(2) of the Companies Act 2008 it is subject only to ss 35A-B of the Insolvency Act (these provisions deal with financial market contracts).
[106] S 136(3) of the Companies Act 2008.
[107] D. A. Burdette *SA Merc Law Journal op. cit.*, p. 425.
[108] S 136(1)(a) of the Companies Act 2008.

will be entitled to their salaries as was the case before the commencement of business rescue. The employees and the company may agree on different terms and conditions, but such agreements are subject to the applicable prevailing labour law principles.[109] This does not preclude the business rescue practitioner from including as part of the plan the condition to retrench some of the employees but the proper consultation processes which include attempts at reaching consensus on aspects such as the appropriate measures to limit the number of employees that will be affected by the retrenchment, fair selection criteria, severance pay and the timing of the termination of the contracts of employment, will have to be adhered to in line with the protective measures of the LRA.[110] The same applies in respect of the transfer of a part of the business as going concern.[111]

It is important to note that the employees of a company under business rescue (and their representatives) will receive additional protection afforded as part of the retrenchment process when compared to the retrenchment of employees when the company is not subject to a business rescue procedure. For example, the employees will have a say in respect of the appointment of the business rescue practitioner if they initiate the process, they will have to be consulted during the development of the plan and they have voting powers before the plan is finally accepted. They are also allowed to address the meeting when a business rescue plan is being voted upon. It is debatable whether the courts will accept a company's argument that the consultations in terms the business rescue provisions of the Companies Act 2008 and those in terms of the LRA serve the same purpose, and that one of the two parallel processes can be dispensed with.

5. COMPARISON OF THE BENEFITS DUE TO EMPLOYEES UNDER THE BUSINESS RESCUE PROCEDURE AND WINDING-UP

5.1 Introduction

The Insolvency Act 1936 and the LRA regulate the position of employees when a company is wound up, and the Companies Act 2008 and the LRA protect employees when a company enters the business rescue procedure. The question is to what extent employees are better off, if at all, under either process. If one is to be preferred above the other, and this is of course assuming that one procedure contains benefits that the other does not, one may find the more beneficial procedure being abused at the expense of the less beneficial procedure.

5.2 Involvement in the Decision-Making Process

Trade unions and employees play an important role in the initial stages of the business rescue procedure in South Africa, whether the procedure is voluntary or compulsory. They have the right to receive notification of the resolution and the founding affidavit describing the reasons behind the factual situation of the company in distress. They can also assume the role of watchdog concerning the process as a whole, and in some cases even become joint decision-makers in the business rescue procedure. Employees may also play a direct role in the appointment of a business rescue practitioner.

Research conducted by Loubser suggests that there is no equivalent in any other comparable jurisdiction as regards the rights given to employees in the corporate rescue

[109] S 135(1)(a)(ii) of the Companies Act 2008.
[110] Ss 189 and 189A of the LRA.
[111] Ss 197 and 197A of the LRA.

procedure, and states that these rights may be 'excessive'.[112] For example, she compares the position in South Africa to the situation in England and Germany where only the company, the directors and creditors may initiate a corporate rescue procedure.[113] In South Africa this right does not only befall registered trade unions, but also individual employees.[114] Loubser also submits that trade unions may use the threat of an application for business rescue as a bargaining tool during wage negotiations.[115] Should an employer adopt the position that it does not have the necessary resources to afford employees' proposed wage increases, the trade union may interpret this to mean that the company is in financial distress and institute business rescue proceedings on that ground.[116]

Registered trade unions and employees play a prominent role during the time when the business rescue practitioner performs his or her functions. Not only are they involved in the appointment of the business rescue practitioner, but also when a business rescue plan is being formulated and voted upon. While it is not yet clear to what extent employees will be able to influence the adoption (or not) of a business rescue plan, it is clear that they will have some influence in this sphere. Clearly employees do not have the same influence when a company is being wound up, and it will be interesting to see whether these newly obtained rights will be exercised by employees or their representative trade unions.

5.3 Entitlements under Winding-Up and Business Rescue

The preferential claims of employees and the amounts that may be claimed have already been dealt with above,[117] as have the effects of winding-up on employment contracts. We have also dealt with the contrasting situation under business rescue where the contracts of employment are not terminated, employees continue to be remunerated and salaries post-business rescue are seen as post-commencement financing. When one compares the entitlements of an employee under the provisions of the business rescue provision against those under the provisions of the Insolvency Act, it becomes clear that following the business rescue route will be most beneficial to the employees of the financially distressed company. The business rescue provisions erode the provisions of the Insolvency Act, and diminishe the already precarious position of creditors of the company.

6. CONCLUSION

While we do not dispute the fact that the drafters of the new business rescue procedure in South Africa had noble intentions when they designed this new mechanism, there are some worrying aspects that make one wonder if they have not gone too far in their quest to protect the interests of employees. In our assessment the provisions do not place enough emphasis on

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[112] A. Loubser LLD Thesis *op. cit.*, p. 53.
[113] A. Loubser LLD Thesis *op. cit.*, p. 53 note 232.
[114] A. Loubser LLD Thesis *op. cit.*, p. 54 mentions that this may lead to the unsatisfactory situation where an individual employee with malicious intent may initiate the business rescue process if that employee has a totally 'unrelated grievance against the employer'. It is submitted that although this may be theoretically possible, it will in all likelihood not happen in practice. Court applications are expensive, and there are more affordable remedies in terms of other legislation that could be used to resolve labour-related grievances. In any event, the courts are hardly likely to grant orders for business rescue where the applications contain no substance.
[115] A. Loubser LLD Thesis *op. cit.*, p. 54.
[116] *Ibid.* The author suggests that the Companies Act 2008 should be amended to give the company the right to claim damages against a trade union or employees, should they abuse the process.
[117] See the discussion in par 3.2 and par 4.6 above.

the primary objective of the legislation, namely that of saving the company or its business that could ultimately be in the best interest of employees, shareholders, creditors and society at large.

While the protection of employees should of course be included in any corporate rescue procedure, it is our submission that the provisions could be more balanced between the rights of employees, debtors and creditors. It is our view that a more nuanced approach in respect of the protection of employees' rights during corporate rescue would have had the likely result of giving business rescue practitioners a better chance of succeeding in resuscitating companies in distress. As pointed out earlier in the contribution, South Africa has followed EU standards in so far as more flexibility is accorded to employers when an insolvent business or part thereof is transferred as going concern. So, for example, the wrongdoing (such as unfair dismissal) by the former employer is not transferred to the new employer. Unfortunately, no relaxations of the normal protection that are accorded to employees under solvent circumstances have been given to business rescue practitioners after commencement of the corporate rescue procedure. It is suggested that more creative thought should have gone into providing some suppleness in respect of the substantive and procedural requirements that have to be met in terms of the LRA that goes hand in hand with the reduction and or restructuring of the workforce.

This, added with the vastly improved situation of employees during the period of business rescue when compared to the situation that they would have faced had the company been liquidated (their contracts are maintained and not suspended) and the favourable status of their claims during business rescue compared to those of the providers of post-commencement finance suggest that employees could be tempted to misuse the process for their own interim gain. In our view this does not establish an appropriate balance between the economic and social rights of all of the stakeholders. Ultimately, the overprotection of employee rights may have the unintended result of being to the detriment of the employees and essentially erode the underlying efficiency of South Africa's new corporate rescue mechanism.