EXPLORING PRE-PACKAGING AS AN ENHANCEMENT TO BUSINESS RESCUE PROCESSES: THE CASE FOR SOUTH AFRICA

By

Mr R. S. Mkhondo	97160629

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Study leader: Professor Marius Pretorius

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Writing a doctoral thesis is one of the most challenging tasks to be undertaken by any student in their academic life. The process of becoming an expert in the area of research demands total dedication from the scholar, as well as a good supporting structure. It requires knowledge, wisdom and a good understanding of issues and concepts, and a very good bouncing board. I therefore wish to thank every single person who contributed in however small or big way to my progress in completing this task. Your assistance and encouragement are deeply appreciated.

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ABSTRACT

Pre-packaged sales are a common occurrence in most regimes that apply formal restructuring practices to rescue distressed businesses, giving them a fighting chance of survival. This study examines pre-packaged sales (or pre-packs) in a series of four articles termed publication-based-thesis to examine the operating environment, praxis and mechanics of the practice in order to develop a framework for the practice in South Africa (SA), being a newly established business rescue model. Using grounded theory to develop the framework, the study applies a thematic analysis of the legal, financial and operating environment of pre-packs in established and mature restructuring regimes to build towards a framework. The study follows with a survey of the practitioners in SA business rescue, and in particular, regarding cases that have culminated in sales as part of their successful termination, in order to determine the predictive pattern of such sales towards establishing pre-packs. It was, in fact found that pre-packs were already unofficially applied in the SA business rescue context. Applying the international theoretical framework to match local expert opinion in SA, the study culminates in building an operating framework for pre-packs in the local environment. The framework suggests amendments to the legislation that would remove uncertainties, especially regarding the acts of insolvency relating to directors' obligations. The recommendations also suggest practice notes by the practitioner organisations that would govern the conduct of business rescue practitioners to ensure fair and equitable implementation of pre-packs. Furthermore, resulting from an observation made throughout the study, a theoretical argument is made regarding precedent as a theory in pre-packs. Precedent for pre-packs emerges as a realisation that pre-packs are often not legislated for, occur consequently as a result of legislative grey areas or gaps, and they are often then accepted as practice after sanction by courts or general adoption by practitioners.

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EXPLORING PRE-PACKAGING AS AN ENHANCEMENT TO BUSINESS RESCUE PROCESSES: THE CASE FOR SOUTH AFRICA

1.1 INTRODUCTION

Scholars in management sciences have over the years, widely documented the decline of businesses. Although not forming part of the expected normal growth of businesses, it is recognised in the normal growth curve and needs to be properly anticipated and corrected where it occurs. Oftentimes triggered by financial distress, the threat of business decline remains relevant to managers worldwide, especially in light of persistent weakness in the global economy. This often necessitates turnaround processes that several regimes have made possible in order to counter the negative effects to their economies (Trahms, Ndofor & Simon, 2013).

Over the years, many regimes have introduced legislation to deal with resultant insolvencies and business shut downs. In order to reduce the economic impact of such insolvencies and winding ups of businesses, many of these regimes around the world have adopted formal reorganisations/administration/plan of arrangements (to complement their insolvency/bankruptcy laws) in order to aid rescue efforts for companies facing financial distress (Pretorius & Rosslyn-Smith, 2014). Formal reorganisations have over the years assumed great importance as a form of saviour for companies that would otherwise face liquidations.

Various tools are available during this process of saving or rehabilitating companies facing distress. This study therefore sought to examine one of the tools available in practice, namely pre-packaged funding solutions that are finding acceptance throughout the restructuring orientated regimes. As a relatively new restructuring regime, the developments pertaining to restructuring practices in many of the regimes also have an implication for South Africa (SA). It is with this in mind that this research was geared to study pre-packaging applications with a view to examine the impact on SA, and the measures needed to be taken to deal with these.

1.2 BACKGROUND

In order to deal with inevitable insolvencies and liquidations, most regimes, including SA, introduced appropriate legislations to deal with the interests of affected stakeholders in such processes, including creditors, debtors, employees and shareholders. The South African regime introduced Judicial Management as part of the Companies Act in 1926, to deal with distressed businesses that were not already considered insolvent and could perhaps be saved. According to Roodt Inc. (2017), this had an unintended consequence, as it became a kiss of death for companies under Judicial Management. In practice, the managed company became doomed with an irreparably damaged reputation, and thus no one wanted to do business with them. According to Loubser (2010), several amendments were made to the original version of judicial management in the subsequent Companies Act 61 of 1973, but the general view remained that it was a dismal failure.

In parallel, the Insolvency Act 24 of 1936 was introduced to govern the sequestrations of estates of individuals, trusts and partnerships that were deemed insolvent. The winding up and reorganisation of companies introduced in the Companies Act 61 of 1973, by reference, incorporates sections of the Insolvency Act in dealing with companies facing financial distress and unable to meet their financial obligations (van Zuylen, 2009). Such companies that underwent liquidation were treated in terms of the above legislations. Despite the fact that this legislation governed all companies including banks, pension funds and insurance companies, there was specific legislation pertaining to the administration of liquidation or winding-up of many of these entities (considered too large to fail). These include the Banks Act 94 of 1990, the Pension Funds Act 24 of 1956, the Long-term Insurance Act 52 of 1998, and the Short-term Insurance Act 53 of 1998. These specific legislations still apply with the new regime.

In order to replace the failed judicial management and address the challenge of reducing the level of liquidations, Chapter 6 in the new Companies Act 71 of 2008 was recently introduced. This was aimed at rescuing companies that would otherwise be liquidated, giving them a chance at survival. This legislation, which is used in several forms in various progressive regimes, is aimed at distressed companies before they are deemed irreparable, and therefore has to meet a basic stress test of being in distress, but with a reasonable prospect of being rescued. While the Act does not fully define “reasonable

prospect", courts have gone on to give opinions and adjudicate on these matters, and a practice note has been drafted by a practitioner member regulatory body, the Turnaround Management Association – South African chapter. It is therefore not a subject of this study.

1.3 BUSINESS RESCUE CONCEPT

1.3.1 Declining trading conditions

The number of insolvencies and liquidations in any regime is usually indicative of the general level of financial distress, and overall business health in the economy. The global economic crisis of 2008 has led the way in a world plagued by numerous economic uncertainties and economic failures. Globally emerging market economies are sensitive to slight changes in the economies of their trading partners. This in turn affects businesses in those countries and their global trading partners.

South Africa itself has not been immune to company failures or declines. In an article, August liquidations rise year-on-year amid tough operating conditions (Business Day, 2015), the author writes that company liquidations have risen in August 2015 compared to the same month in the previous year, as economic contraction and rising labour and input costs make it harder for companies to keep operating. Statistics SA (2016) paints a declining year on year number of liquidations, albeit on a smaller scale. Since the implementation of the new Companies Act, and Business Rescue in particular, liquidations have decreased from 3 599 (2011) to 1 962 (2015). While this is commendable, and probably alludes to the possible effect of business rescue on company failures, there is still no relationship determined. Furthermore, it seems apparent that an enhanced business rescue could contribute.

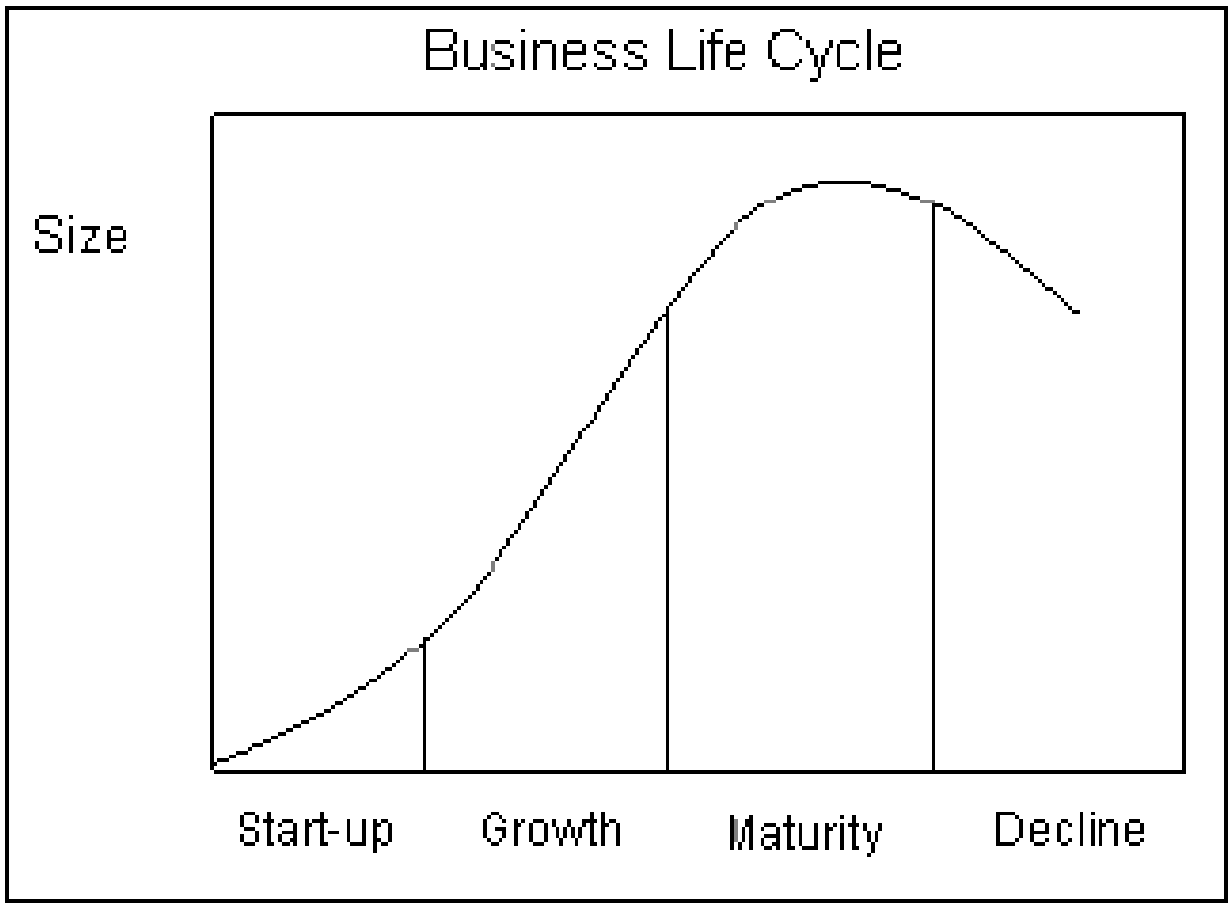
1.3.2 Stages of enterprise development and reorganisations

Typically, a business goes through a defined life cycle from inception to maturity, and may follow a path of decline should economic conditions fail or management not be alive to the changing climate for business and adapt, or other varied reasons. Trahms, Ndofor and

Sirmon (2013:2078) argue that evidence points out that most firms, if not all, face decline at some point or other.

A typical business life cycle is illustrated in Figure 1.1.

Figure 1.1: Typical business life cycle



Source: Adapted from Collins (2012)

The maturity phase is where the business plateaus and of course, experiences challenges and even failure that is epitomised by the decline in the curve, as indicated in Figure 1.1. The illustration is a typical life cycle and does not conclusively mean that failure would not occur at earlier stages. Reasons for failures often vary from exogenous conditions such as economic (environmental) catastrophes and changes in the competitive landscape, to endogenous causes such as operational deficiencies like inappropriate business models

and management incompetency's and fraud, and anything in-between (Trahms *et al.,* 2013:2078). These business failures invariably affect economic growth, employment and even the *fiscus* of the affected country. Consequently, most countries do get concerned about business failures and seek to introduce measures to curb or reduce these failures.

1.3.3 Business rescue processes

Prior to the introduction of business rescue provisions in SA in the Companies Act 71 of 2008, the regime relied on a system called Judicial Management to deal with companies facing distress situations. Judicial Management had been historically introduced under the Companies Act 46 of 1926, but subsequently dealt with under sections 427–440 of the Companies Act 61 of 1973. It involved companies being managed by court appointed administrators, with the companies obtaining moratorium over creditors whereby they cannot institute action against them (Ofwono, 2014). There were obvious limitations, including the fact that the judicial manager could not sell the assets of the business without court approval. Yet, they had to satisfy themselves of the company's ability to repay creditors or alternatively apply for liquidation (van Zuylen, 2009).

At the heart of every filing for business rescue, is the issue of financial distress. This could be the result of an uncontrollable liquidity issue, or poor management of cash flows, and even pure market failure. Creditors are therefore rightfully apprehensive about business rescue filing, particularly because the filing is usually done by directors of the distressed company, whilst the creditors might not have been fully privy to the intricacies leading to the filing.

Most business rescue processes around the world deal sufficiently with the rights of the interested parties in any business rescue process. In the South African context, the rights of creditors and other defined affected persons, such as employees, are also extensively dealt with in Chapter 6 of the Companies Act. However, given the often arms-length relationship between the distressed company and its creditors, it is often times too late for creditors to be taken into confidence, thus leading the road to potential tensions with business rescue practitioners (BRPs). As to be expected, not all creditors fully embrace the process once it is in motion, and this could result in challenging circumstances, especially since they are often required to partake in post-commencement-finance (PCF).

In terms of Chapter 6 of the Companies Act 71 of 2008, the involvement of affected parties, including creditors, only occurs after the filing of business rescue. Furthermore, the raising of capital related to business rescue is only legislated for application after filing, and aptly named post-commencement-finance (PCF).

According to Vriesendorp and Gramatikov (2010), business rescue can be impeded by lack of PCF. This underlies the importance of aligning affected parties to the rescue process to help promote its success. PCF has been fairly well applied in practice in South Africa, in particular because legislation specifically caters for it. The allocation of PCF is however, normally limited to related business rescue costs**,** employees and creditors, in that order, in terms of section 135 of the Act. The Act does not specifically legislate for outside parties not previously connected or related to the distressed business that is in business rescue, i.e. those without any previous dealings with the company and are not directors or affected persons as defined by section 128(1)(a) of the Act. These outside or unrelated parties seem to be offered little incentive for their participation in business rescue processes.

Pre-packaging could offer an opportunity for related, as well as, non-related parties to be accommodated earlier on, and for capital raising to occur early enough to give the distressed business a better chance of success. Due to the nature and form of pre-packaging, as well as its application process, room is created for negotiating a solution prior to formally declaring distress, thus applying for business rescue.

1.3.4 The Insolvency Act

Failed businesses in SA have principally been dealt with under the 'Winding up of Companies' in the Companies Act, in conjunction with the Insolvency Act 24, of 1936 (van Zuylen, 2009). Although the Insolvency Act was designed for persons, partnerships and trusts, it is in certain cases applied to regulate the process of liquidating legal persons. According to Boraine and van Wyk (2013), "*No substantive provisions relating to the grounds and procedure for the liquidation of insolvent companies were developed and incorporated into the 2008 Act.*[16] *Instead, should a company that is insolvent be liquidated, the provisions of Chapter 14 of the 1973 Act find application as if these have not been repealed".* Thus, the Companies Act 61 of 1973 (section 311) is still applied as in

reference to failed companies that have to be liquidated. Also, in the event a company is placed under provisional liquidation in terms of section 141 of the Companies Act, the process would then be governed by the Insolvency Act. The process essentially involves a winding up of the business and sale of its assets to pay off creditors. It is essentially the end of the company, which is a last resort for creditors when there is no prospect of saving the company.

1.3.5 Zone of insolvency

Chapter 6 of the Companies Act, which deals with business rescue and compromise with creditors, details the business rescue proceedings, the appointment, roles and dismissal of business rescue practitioners (BRPs), rights of affected persons during the business rescue proceedings, the development and approval of the business rescue plan, and compromise with creditors. Specifically regarding business rescue proceedings, the Act allows the directors of companies who believe that the company is under distress, to voluntarily file for business rescue (on behalf of the company), thus commencing the process.

The basic tenet for this process to occur is that there must be a reasonable prospect of rescuing the company. This therefore makes it important to understand the zone of insolvency in which the distressed company finds itself. The zone of insolvency (ZoI) attempts to describe the level at which a company finds itself in the distress range, and thus whether it is possible at all, at that point, to rescue the business. It describes what could be regarded as the verge of insolvency of a business, or proximity to insolvency before formally recognised as insolvency (Schmitt, Barker, Raisch & Whetten, 2015; in Pretorius, 2017:59).

Scholars suggest that a business that is a candidate for business rescue, whilst it is already in distress, has not yet entered an insolvent state (Pretorius, 2017). There is still lack of clarity as to when the ZoI begins, but it remains an important area to define when a business should commence business rescue, and by definition, partake in pre-packaging without violating insolvency regulations.

Sprayregen, Freedman and Cho (2002:7) in referring to a court decision by Del (1994), state that it was held that the corporation “operated within the vicinity of insolvency” at the

time that it approved the transaction because… the transaction… left the subsidiary "undercapitalised and unable to pay its debts". In citing Barnett (2000), the authors (Sprayregen *et al.,* 2002:7) state that the concept of 'unreasonably small capital' seems to approximate what is meant by the nebulous concept of "in the vicinity of insolvency". They go on to define the "unreasonably small capital" as set out in the Healthco case, as the result of "a transaction that 'makes insolvency reasonably foreseeable' or creates an 'unreasonable risk of insolvency'".

From the above it can be argued that the zone of insolvency hinges on the question of directors' knowledge of a likelihood of insolvency (Sprayregen *et al.*, 2002). Given the lack of sufficient up-to-date material on the subject and the role of its importance, there could be room for further research to be done on this subject.

There are on-going debates as to whether business rescue should take place before or during the early stages of the twilight zone, i.e. the uncertain or informal period prior to the business entering the ZoI (Bainbridge, 2006; Pretorius, 2017). Edge and Mulligan (2009) describe the twilight zone as the period that starts when a solvent company becomes an insolvent one and ends on the commencement of a formal insolvency process. From this definition, it seems that the twilight zone still forms part of the ZoI. What is also apparent is that business rescue may be possible before the "insolvent" or distressed company becomes formally recognised as insolvent, i.e. the pre-insolvency state.

1.4 PRE-PACKAGING AS A PRACTICE

1.4.1 The global practice

Pre-packaging practice has found universal use in many advanced regimes such as the United States of America (US), the United Kingdom (UK), Australia, Canada, parts of Asia and Europe. It is thought to have originated in the late 1980s, with the Chrystal Oil case acknowledged as the first pre-pack chapter 11 case of any significant size in 1986 (Palmer & Fink, 2008). According to Massel (2013), pre-packaged bankruptcy is one of three methods of restructuring a company, with the other two being an out of court restructuring (informal restructuring), and a conventional bankruptcy in which the debtor files for bankruptcy in order to commence the process of appointing an administrator and

developing a plan of reorganisation. He defines pre-packaged bankruptcy as a restructuring or bankruptcy case that begins with the filing of a plan of reorganisation that has already been accepted by creditors (or as to which solicitation of acceptances is already underway as of the initiation of the bankruptcy case). In such a case, the key creditors agree upon terms of restructuring in a lockup agreement, to the commencement of bankruptcy proceedings (Massel, 2013). Similarly, Mallon and Waisman (2011) describe a US pre-packed chapter 11 case as where a distressed company would have negotiated a restructuring plan with impaired stakeholders before entering bankruptcy. They would also be required to draft and distribute a disclosure statement to be tabled at a court hearing together with the plan, as well as solicit required votes. Furthermore, the authors describe what is termed pre-negotiated chapter 11 as a case where the distressed debt company has negotiated the terms of a chapter 11 plan with “at least some of its principal constituencies before commencement of the case”. This means sufficient consensus needs to be met before publicly announcing bankruptcy filing. In both these explanations, the word “sale” does not seem to feature. This seems to be reserved for the application of a section 363, where the sale has been arranged prior to bankruptcy filing, or outside of a plan, but with court approval. Alternatively, the sale is associated with section 1129, as a “sale pursuant to a plan”. The latter is a longer process sale during bankruptcy, and requires approval by at least a class of creditors.

In the UK, the pre-pack concept does not result from a legislative framework, and has developed over time. The UK regime introduced a practice note to deal with pre-packaged sales, and commissioned the Association of Business Recovery Professionals to draft the note. In the practice note, the Statement of Insolvency Practice 16 (SIP 16), the Association defines pre-packaged sales or pre-packs as “an arrangement under which the sale of all or part of a company’s business or assets is negotiated with a purchaser prior to the appointment of an administrator and the administrator effects the sale immediately on, or shortly after, his appointment”. It seems, in the case of pre-packaged sales or pre-packs, a sale transaction is a concomitant part of the agreement, unlike in what is termed “pre-packaged or pre-negotiated bankruptcy”, which appears to be an arrangement without necessarily including a sale of business or assets. Whilst this study examines the related concepts, it focuses on pre-pack sales as a proxy to pre-packs.

The sale of a business in a pre-packaged deal is usually negotiated as a going concern transaction, which allows the restructuring of the business through capital injection among other things. The term pre-packaged sales seems to be commonly known as pre-packs. In this research, pre-packaged sales are also associated with pre-packaged funding, pre-packaged financing, or pre-packs.

Being able to enter into a pre-negotiated arrangement, with or without a sale, helps avoid the pitfalls of bankruptcy. Some of the known benefits of pre-packs include:

- they often preserve value of assets, with the brand image better retained;
- they minimise the erosion of supplier, customer and employee confidence;
- due to the quick process, it can minimise the costs of restructuring;
- they can retain higher value for creditors;
- they can save more jobs than through the normal course of business rescue;
- sales of going-concern avoids the negative impact on business continuity; and
- they can result in quick and relatively smooth transfers of stressed businesses, e.g. the General Motors reorganisation of 2009 (Massel, 2013; Practical Law, 2015).

Pre-packs have also been criticised for a number of reasons, including:

- lack of transparency by the directors of the company being pre-packaged;
- lack of accountability, which could be due to prepacks not being legislated;
- potential high risk work for practitioners if no transparent accountability; and
- potential inability to maximise returns for unsecured creditors (Practical Law, 2015).

1.4.2 Pre-packaging explained

It seems as if prepacks as a terminology does not find universal description from both different regimes and different authors. Mallon and Waisman (2011) specifically state that the US “pre-packaged” chapter 11 case is not to be confused with the UK “pre-packaged” sale of the same name. The various definitions are given below in the table to give a baseline understanding.

Table 1.1: Pre-packaging explained

Terminology	Description	Country	Author
Pre-packaged plan	The company will have negotiated a plan with impaired stakeholders before entering chapter 11, and will have drafted and distributed a disclosure statement and solicited votes as well. Upon filing of the chapter 11 petition, the company will schedule a joint hearing to consider the adequacy of both the disclosure statement and the plan.	US	Mallon & Waisman (2011)
Pre-packaged plan/pre-pack	A plan in which a debtor proposes a plan with a disclosure statement that includes sufficient information. If the requisite majority of creditors accept the plan before commencement of a case, then the court approves the accepted plan soon after filing of a petition for the case.	US	Takagi (2011)
Pre-negotiated bankruptcy	Similar to pre-packaged bankruptcy – is a restructuring in which the company and key creditors agree upon the terms of a restructuring and contractually bind themselves to such terms through a lockup agreement without yet having engaged in the voting process mandated by section 1126 of the Bankruptcy Code.	US	Massel (2013)
Pre-negotiated plan	The debtor will have negotiated the terms of a chapter 11 plan with at least some of its principal constituencies before the commencement of the case.	US	Mallon & Waisman (2011)

Terminology	Description	Country	Author
Pre-negotiated plan	When the debtor negotiates a plan with less than all groups or obtains the acceptance of less than all groups necessary to confirm before the bankruptcy case is filed.	US	LoPucki (in Jian *et al*., 2012)
Pre-packaged case	A case is pre-packaged if the debtor drafted the plan, submitted to a vote of impaired classes, and claimed to have obtained the acceptance necessary for consensual confirmation before filing.	US	LoPucki (in Jian *et al*., 2012)
Pre-packaged filing	The terms of the plans are negotiated in advance, and firms file the reorganisation plan along with the bankruptcy petition, which is accepted almost immediately by the creditors.	US	John, Mateti & Vasudevan (2013)
Pre-pack	Pre-pack is a pre-agreed business sale by an insolvency practitioner, which does not require prior court and/or creditor sanction.	UK	Windsor & Jarvis (2011)
Pre-pack	In its basic terms, pre-pack is a method of selling the business of an insolvent company as a going concern. Therefore, what a pre-pack does is to achieve a rescue of the business with the onus for funding the rescue on the new buyer who would be taking with injecting fresh funds into the business.	UK	Aruoriwo (2014)
Pre-pack/pre-packaged sale	An arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the	UK	Association of Business Recovery Professionals (in

Terminology	Description	Country	Author
	administrator effects the sale immediately on, or shortly after, his appointment.		SIP 16)
Pre-packaged bankruptcy	A bankruptcy case that begins with the filing of a plan of reorganisation that has already been accepted by creditors (as to which solicitation of acceptances is already underway as of the date of the initiation of the bankruptcy case). The bankruptcy case is the means of implementing the accepted plan.	US	Massel (2013)

Source: Own compilation

From the above definitions and descriptions, a number of things become apparent:

- the US and UK definitions of prepacks are quite different;
- the UK definition of pre-pack includes a sales process;
- in the US, pre-pack takes on different forms with different meanings, being pre-packaged bankruptcy; pre-packaged filing or case; pre-negotiated plan; pre-negotiated bankruptcy; pre-packaged plan; and
- importantly, the above US definitions all do not include sales.

It is therefore understandable that, for the process to include a sale, a section 363 “quick sale” has to be a part of the process. When benchmarked against the UK and other European countries, it seems an equivalent pre-pack would have to be section 363 sales accompanied by either a pre-packaged plan/filing/case, pre-negotiated plan, or pre-packaged bankruptcy or plan. For the purposes of this study, the 363(b) sale in combination with the latter “pre”- fixes, as well as the UK definition are being adopted as a proxy for pre-packs.

1.4.3 Framework for pre-packing in South Africa

Since the South African regime has not defined nor specifically legislated pre-packaged funding for distressed businesses, this study sought to work with a construct that would be applicable in a SA context. In that regard, the study looked for a more universally accepted global definition of pre-packs and then determined whether that could be applicable in the SA context. Most countries, it seems, prefer to work on a universally accepted definition of pre-packs to avoid inconsistencies in application.

From a SA perspective, since Chapter 6 of the Companies Act provides for and defines PCF, it would appear appropriate for this study to culminate in a contextualised definition of pre-packs. Furthermore, a proposed framework needs to define an environment in which pre-packs would emerge and flourish. In other words, what the legislative, commercial, and operative environment should be ideally. This necessitated understanding the elements that would link to such emergence and growth, particularly from a global perspective as well. The study would then culminate in providing a basis for suggested improvements in the legislation governing pre-packs in particular. Thus, in developing a framework for pre-packs in this research, an analysis of pre-packs is made from global observations, and carefully crafted to find meaning in the South African context.

It needs to be said from the onset that an operative environment may be determined, to a reasonable extent, by the legal origin in the country. This could give a contextual meaning to the application of pre-packs wherever they are applied. South Africa over the years, has adopted a hybrid system of common and civil law. According to Lenel (2002), the genesis of the SA law has its roots in the Roman-Dutch law, because of the early occupation of the Cape colony by Dutch merchants, the VOC (Vereenigde Geoctroyeerde Oss-Indiese Compagnie). Roman-Dutch law itself had its influences from Roman law, thus the twin influences of the Roman and Roman-Dutch laws.

Over the early centuries, however, English law became increasingly introduced owing to successive British invasions, until formally introduced following the Colebrooke-Bigge commission of 1823. Of importance, however, is that Roman-Dutch law applies mainly to criminal and civil law, while company/commercial and constitutional law is mostly

influenced by English law. Even though criminal law was reformed in the 1800s according to English law, it still has its roots in Roman-Dutch law (p. 7). Benade, Henning, du Plessis, Delport, Koker and Pretorius (2008) write that common law is the "*non-statutory law that applies in SA, and mainly based on Roman-Dutch law*".

Of further importance, according to Lenel (2002, p. 9), is that the SA law is largely uncodified, meaning that several sources are available, such as "*statute laws, precedents, common law, customary law, newer doctrine and the constitution.*" The importance is that "*legislation is only made where newer technical developments or gaps make it necessary*". This factor underlies the basis of this study, and the influence of precedent regarding pre-packs is explored in later chapters of the study.

1.5 PRE-PACKAGING CONTEXT IN SOUTH AFRICA

In terms of Chapter 6 of the Companies Act, the raising of PCF is only legislated for implementation after filing for business rescue as per section 135 of the Act. Section 134 refers to sales during business rescue proceedings, in the ordinary course of business; at arm's length at a fair value approved in advance by the practitioner; or as part of the implementation of an approved business plan. Specifically, regarding section 134(a)(ii), a *bona fide* transaction at arm's length for fair value and approved in advance by the practitioner, could be opening a possibility for pre-pack sales to take place. There is however, little to no work in that regard, as no further guidance is given beyond this section of the Act.

As alluded to in earlier discussions, due to the context of the ZoI, the stage at which a financial arrangement is negotiated is affected by the stage of the business in the Zone of Insolvency, and consequently, could have an impact on directors' liability in the event that directors have not filed for either bankruptcy or business rescue. Depending on when this step is instituted, this clearly is an issue for the applicability of pre-packaging in South Africa.

In its own right, pre-packaging is not legislated in South Africa, whether as part of the business rescue process or the bankruptcy laws. In order to apply it in practice effectively, it may need to be regulated or legislated ideally as part of the business rescue regime.

Legislating for pre-packaging might necessitate clarifying issues around the level of distress within the ZoI. On the understanding that business rescue occurs during the pre-insolvency stage, the same principle could be applied to investigate pre-packaging.

This work needs to be studied with an idea of developing an international best practice with possible application in South Africa. There was thus a need for some studies to be conducted in order to explore the developing of a framework for potential alignment within the South African context.

1.6 PROBLEM DEFINITION

1.6.1 Progress (success/failure) of business rescue in SA

According to an article in The Citizen (Visser, 2015), South African business rescue seems to be failing, with few companies emerging from the process in better health. Quoting a report from the Companies and Intellectual Property Commission (CIPC), the author mentions 771 companies have been rescued since the legislation of business rescue in 2011, against 1 654 proceedings on business rescue in that period (Visser, 2015).

The main factors for this failure, according to the article, are a continued focus on liquidations rather than restructurings, lack of experience of BRPs, and a lack of forgiveness for failure culture (Visser, 2015). Whilst this view might be more focused on cultural practices and perceptions of the experience of practitioners, it may be worthwhile to study the causes of this poor performance of business rescue from a wider perspective. This might reveal other inherent challenges facing practitioners, thus affecting the performance. This provides an opportunity for further research in the field of rescue.

1.6.2 Options for distressed businesses

Distressed companies are by definition experiencing cash constraints, and finding it potential difficult to pay their debts when due and payable within the ensuing six months, as per section 128(f) of the Companies Act 71 of 2008. This would be irrespective of whether these conditions are imposed by external business dynamics or are self-inflicted. For such companies generally, their rescue and survival depends on financial injection (Pretorius & du Preez, 2013). As mentioned, PCF is theoretically available albeit after the

filing for business rescue. However, according to du Preez (2012), the presence of distress lenders in South Africa was either non-existent or unknown at the time of writing. This situation may not have changed much today. Underscoring this disadvantage is that few products have been designed to accommodate the high level of risk associated with this type of financing (du Preez, 2012).

At the point of requesting PCF by BRPs, existing creditors are generally looking to mitigate their risk exposure by reducing rather than expanding their exposure (Pretorius & du Preez, 2013). This is the case, despite the fact that PCF has been regulated in the Companies Act.

1.6.3 Need for pre-packs

Due to the fact that pre-packaging is a mechanism that commences prior to filing for business rescue, there might be an opportunity to apply it prior to the distressed company being labelled as a “failure”. Lack of forgiveness for failure has been cited as a reason for business rescue failure in South Africa (Visser, 2015). At this point prior to filing, the target company may be seen to be less risky for the pre-package investor/funder, especially because a moratorium on creditors’ claims would immediately be imposed upon the subsequent filing.

An argument could thus be made that funders could be more willing or flexible at this stage, provided they are protected by legislation. Given that financial negotiations are often held with external funders at this stage of pre-insolvency, this might help encourage the establishment of a distressed funding market in South Africa.

In the US, pre-packs played a key role in rescuing key industries such as the motor industry during the 2008 economic meltdown. Massel (2013) notes, pre-packs resulted in a quick and relatively smooth reorganisation of General Motors in 2009. Pre-packs can further minimise the erosion of supplier, customer and employee confidence (Practical Law, 2014).

1.6.4 Problem statement

The research opportunity lies in contributing to building a framework for the application of pre-packs as a tool that will help develop a robust and legally acceptable practice that finds acceptability within the business rescue community of South Africa, and adds to the success rate of business rescue processes. There is furthermore an opportunity to help developing a regime that encourages compliance with internationally acceptable standards.

This study thus envisaged to attempt to find a robust, pragmatic and acceptable prepack model for South Africa, or a suitable alternative, that could enhance business rescue in practice, using international best practice. The problem statement could thus be defined as, using international best practice to understand pre-packaging as a suitable application for enhancing business rescue, and extrapolating that concept for purposes of drafting a suitable legislative framework in South Africa.

1.6.5 Limiting factors affecting the problem statement

Within the Companies Act 71 of 2008, certain provisions could be seen to affect directors of companies (without notice) attempting pre-packs during distress situations. By definition, pre-packaged funding requires the directors of the distressed company to make a resolution to negotiate some form of pre-arranged sale with a potential buyer or funder prior to filing for business rescue. Section 129(7) requires the directors that have not filed the resolution to deliver written notices to affected persons explaining the distress situation and their reasons for not adopting a resolution. In the event of adopting and filing of the resolution, the board has five business days to publish a notice of the resolution and appoint a BRP, unless the Commission allows an extension. Failure to do so, section 218(2) could potentially be used as an argument to sue directors. The crux here would be finding that right spot to negotiate and agree a pre-pack, prior to falling foul of the law.

This issue may therefore require careful navigation in the process of negotiating a pre-packaged funding. Alternatively, the Act may need to be slightly amended to accommodate the application of pre-packaged funding negotiations.

1.7 RESEARCH QUESTIONS

To cover the research problem for the study, four broad research questions are outlined. These questions are further elaborated on in the various discussion articles written specifically to explore these questions, and covered in sections 2 to 5 of this study.

These are the broad research questions:

- Do the four major regimes identified as practicing pre-packaging employ similar or different principles and methodologies?
- Do these regimes employ particular funding mechanisms and financial products specific to pre-packed funding or distress M&A?
- What are the current practices in the SA distress funding market and are they indicative of a predictive behaviour towards an establishment of pre-packs?
- Are antecedents to implementing pre-packs too onerous, and can a framework be constructed based on these?

In an effort to fully appreciate the study's key research problem, the study is further guided by dividing the above questions into sub-questions that are addressed in the four articles (chapters), as follows:

- What is pre-packaging, and how can it be applied?
- Is pre-packaging an internationally accepted practice?
- Does it positively contribute to successful outcomes for business rescue efforts?
- Can pre-packs operate without regulation, or do they require regulation to have effect?
- What is the nature of the regulation required for applying pre-packaging?
- What is the context of pre-packaging in the identified international established practice regimes?
- What common elements are found on pre-packaging in those regimes?
- What motivates pre-packaging in any regime?
- What would be required to make it successful as a business rescue intervention?
- What would be the value of introducing such intervention?
- Who generally stands to benefit from a pre-packaging intervention?

- Could pre-packs be made applicable in South Africa?
- What are the limitations, if any, of introducing pre-packaging in South Africa?
- How would practitioners deal with those limitations?
- What form of modifications would pre-packs require in South Africa in order to add value?
- Are there alternatives to pre-packs found in other regimes, and how are they applied?
- Would it work to apply these alternatives in the South African context?
- Does South Africa have any cases resembling some form of unregulated pre-packaging to date, and is that an indication of a need for such?
- What are the possible benefits of applying pre-packaging in South Africa?
- Who would stand to benefit from the introduction of pre-packs in South Africa?
- What effect would that have on creditors in general?
- Could a vibrant distressed funding industry emerge from the emergence of a regulated pre-packaging industry in South Africa?
- Is there room for pre-packaging or its various alternatives to contribute to a vibrant distressed funding industry?

1.8 RESEARCH AIM

Prolonging the lives of distressed companies and saving jobs is the primary focus of business rescue (Ensor, 2016), thus it is important to theoretically explore various improvements to the existing business rescue regime, whether through legislation or best practice. Various parties have become stakeholders in the success of business rescue, most of all the affected parties as defined in the legislation. The South African government, who through the Companies Act No 71 of 2008, has sought to address the challenges of business failure in its Chapter 6, is also a major stakeholder in ensuring the success of this practice. Additionally, an important potential by-product of a successful pre-packaging practice is the development of a distress funding industry specifically focused on the distressed companies market, which could be encouraged by the adoption of pre-packaged sales solutions or such appropriate alternatives.

Therefore the aim of this study was, through an exploratory and qualitative research, to contribute towards development of a framework that could ultimately be adopted into the business rescue regime, whether legally or by practice, for purposes of improving the execution of business rescue. To develop this framework, the researcher had to look into the broad principles governing pre-packaged applications on the international stage (especially major regimes such as USA, Canada, Australia and United Kingdom), define the elements that comprise these principles, match them against the required elements locally, develop a framework, and then possibly develop appropriate theoretical principles.

1.9 RESEARCH APPROACH – FOUR ARTICLES (FORMAT)

The aim of this study was not to statistically test pre-pack theory, but to obtain quality information to be applied in determining its suitability in the SA environment and obtain a legal or practice procedure for its application. Thus, qualitative research became the approach of the study throughout. By applying grounded theory to conduct the research, a process of publication-based-thesis (P-B-T) was employed, with four topics compiled in order to study the how's, why's and what's of pre-packaging, as well as antecedents and possible alternatives. This involved the compilation of four key articles for purposes of publication in academic journals, and covered under the following headings:

Pre-packaged applications in business reorganisations: International principles – studying operating environment of pre-packs in established regimes such as the United States (U.S.), United Kingdom (U.K.), Australia and Canada, including the praxis and legal frameworks. A content analysis provides a thematic presentation of the legal principles and culture and influencers of a practice of pre-packs in these regimes.

Funding structures in business reorganisations: Locating the role of pre-packaging as a restructuring tool – a study of the funding structures and mechanisms of pre-packs in major established regimes, including the financial complexities involved. This article explains who participates in pre-packs, how they structure the transactions, the valuations done, etc., in key regimes practising formal restructurings.

Exploring the role and extent of sales transactions in business rescue: A precursor for pre-packaging? – a survey of distressed sales that have taken place in SA since the

establishment of business rescue, to determine possible patterns leading to pre-packaging. Despite a lack of legislation regarding sales of distressed assets, sales that have taken place are examined through the practitioners involved.

Developing pre-packaging for the South African business rescue industry: Antecedents for applications – a building up of the framework for pre-pack application in SA, based on a thesis and expert opinion analysis. Expert opinion is added to global practice derived from literature gathered in the earlier articles.

Table 1.2: Summary of the four key questions for each article

Article	Chapter in thesis	Research question
Article 1	Chapter 3	What are the similarities in the guiding principles and practices of pre-packaged financing observed among global restructuring regimes?
Article 2	Chapter 4	What is the role played by pre-packaging in the funding mechanisms of business reorganisations?
Article 3	Chapter 5	What is the status and extent of sales of businesses or assets in business rescue processes and their possible influence on the development of pre-packaged funding?
Article 4	Chapter 6	What are the key elements to a succesful development and monitoring of pre-packs in South Africa?

Source: Own compilation

1.10 IMPORTANCE OF STUDY

As a theory, pre-packaging has not been debated or written much about in South Africa. In practice, however, there have been a few corporate acts, which could be construed as attempts at pre-packaging, albeit some without any meaningful results. For example, Business Day reported recently that Chemical Specialities (t/a Chemspec) Limited had been negotiating with their large investors for new capital injection, almost a year prior to filing for voluntary business rescue (CNBC Africa, 2015). Once these negotiations failed, the company filed for business rescue. It is unclear from the reports whether these financial negotiations could have been entered into with a view to subsequently file for business rescue. On speculation that this could have been the case, it could be indicative of a need to bring this discussion to the fore at least for exploration purposes, and at best,

to shape policy. It has to be noted that in the regimes where it is practiced, pre-packaging is recognised as such only once it is followed by a filing of bankruptcy.

Using the benefits of a pre-packaged strategy, there is an opportunity to create an alignment with the current business rescue legislation to improve the results of business rescue attempts in the South African context. In many cases, the formal voluntary filing for business rescue by distressed businesses during pre-packaged administration is viewed suspiciously by some affected parties as in the UK and Australia (Practical Law, 2014). By involving some of the major affected parties before a formal process is engaged, may reduce some of the tension and increase their confidence in the process to be followed, provided it is handled properly.

By studying international best practice on prepacks, its praxis, and financial and legal complexities, it was hoped that a framework could be built that could likely be adopted locally, and assist in increasing the success rate of business rescue processes in South Africa. This framework will obviously only work with businesses in distress that have a real reasonable prospect of success. At the onset, the researcher was open to examining whether pre-packs were applicable, in the first place, in the SA environment and whether an alternative approach to pre-packaging could rather be applicable.

Furthermore, it was envisaged that the study would contribute to the debate on business rescue in South Africa, a relative newcomer to the business rescue practice, and provide the basis to further empirical studies on pre-packaged application and theory building. It was further envisaged that the study would advance specific theoretical aspects of pre-packaging where possible, particularly in regimes that have not legislated for its specific role in business rescue processes. Specifically, some theoretical principles are proposed on the linear relationship between pre-packs and various independent variables assumed to affect the growth and development of pre-packs, based on literature review and expert opinion. Furthermore, precedent is also advanced as a theory, based on the drivers and antecedents of pre-packs observed in more established regimes. The theory is derived from a legal principle of precedent, which ratifies, through courts or practice, actions that have been taken in view of legal loopholes or grey areas.

1.11 LIMITATIONS OF STUDY

This study has several limitations related to its constructs, research methodologies and theoretical perspectives. Firstly, this study does not consider regimes that are naturally similar to SA in terms of their economic development and novelty to the phenomenon studied. This could possibly lead to an argument that advanced laws in those regimes that have instead been used as proxies, may not necessarily be applicable to SA.

Secondly, the research methodology focused only on qualitative methods because there is no observation yet of the phenomenon studied to be applied locally, and therefore has little data available for empirical tests to be conducted.

Thirdly, the study is based on building a framework, and is focused mainly on the adoption and application of pre-packs or possible alternatives, and not on assessing or developing new theory on distress funding. The contribution to the development of theory that eventually emerged came as a result of observation and analysis as opposed to being a primary focus.

1.12 ASSUMPTIONS OF STUDY

According to Leedy and Ormrod (2010:6), an assumption is a condition that is taken for granted, and without which a research project would be pointless. In making assumptions for this study, regard is made of the global interconnection of the rules of doing business, and a general trend to form global forums that assist learning of organisations and common interest groups.

The assumptions thus made in this study are as follows:

- The departure point of regimes, which engage in practices discussed in this study is to assist financially distressed companies to avoid or reduce the effect of liquidation;
- The regimes studied, experience similar circumstances and conditions affecting and influencing distressed companies;
- The observation and analyses of the cases in the regimes studied will provide revealing insights relating to the phenomena studied;

- The different definitions and legislations applied in different countries observed under this study do not necessarily detract from the substance of the phenomena studied;
- The above assumptions make it possible to review the relevance of the phenomena in different circumstances. However, this does not create a generalisation of applications, and further studies may need to be taken to test applicability elsewhere.

1.13 ETHICAL CONSIDERATIONS

Ethical considerations are present in any research. Ethics can be thought of as the study of good conduct and of the grounds for making judgements about what is good conduct (Mauthner, Birch, Jessop & Miller, 2002).

There is currently no known work completed on the subject of pre-packaging in South Africa, and this study is unlikely to follow any existing pattern. The researcher was also not sponsored to complete the research by any interested party, and was therefore unlikely to be conflicted by the outcome of the study. In cases where interviews were conducted in some form or other, experts in the area were used, and unless otherwise agreed to, their identities kept confidential. In all instances where names of companies were disclosed, only publicly held information was disclosed.

Wherever sanction was required to carry out this study, it would have been sought. Participants' consent was sought through a university-sanctioned letter (Annexure A). Access to business rescue, termination information was sought from the CIPC through a letter from the faculty, at the university (Annexure C). Furthermore, the Department of Trade and Industry, as a custodian of the CIPC, would be particularly interested in the outcome of such a study, in particular, the third and fourth articles, as they involve business rescue in the SA context. It may be important, therefore, to keep them abreast on the study and the results. As the researcher, one would also have the responsibility to assure institutional stakeholders that the outcome of such research would be in their best interest, and hence a need to co-operate. Every attempt was made to interpret data in a fair presentation, to avoid any misleading of the readers.

1.14 DEFINITIONS AND ABBREVIATIONS OF KEY TERMS

A list of definitions of key words and abbreviations used in the text is provided below under Tables 1.2 and 1.3 respectively.

Table 1.3: Definitions of key terms and concepts

Key terms or concepts	Meaning
Affected parties/persons	In relation to a company, a shareholder or creditor, or registered trade union representing employees, or each employee or their representative where such are not represented by a union
Antecedents	A thing or act that precedes another or existed before it
Bankruptcy	A condition of financial failure, or a person or entity that is unable to pay outstanding debt, and is often followed by a legal process of liquidating them
Business life cycle	Represents the different phases a business goes through as it evolves over time, with the most critical being establishment, growth, expansion and maturity
Business rescue	Proceeding to facilitate the rehabilitation of a company that is financially distressed by providing temporary supervision of the company, temporary moratorium from creditors, and developing and implementing a plan to rescue the business
Business rescue practitioners	A person appointed, or two or more persons appointed jointly, in terms of chapter 6 of the Companies Act, to oversee a company during business rescue proceedings.
Business shutdown	Closing a business and ceasing to operate it, usually permanently

Key terms or concepts	Meaning
Comparative analysis	A scientific comparison of two or more comparable processes, alternatives, sets of data, etc. in order to identify trends in the data
Content analysis	A qualitative research technique that systematically describes written, spoken and visual communication to determine meaning, purpose or effect
Filing (for business rescue)	The act of registering with a company's legal authority or courts, the intention to take a company into business rescue or formal reorganisation as per the prescribed legislation
Financial distress	Refers to a company that appears reasonably unlikely to be able to pay its debts as they become due and payable within the immediately ensuing six months or it becomes reasonably likely that they will become insolvent within the immediately ensuing six months
Formal reorganisation	A process designed to revive a financially troubled or bankrupt firm through special arrangements that are legally formalised, sometimes through court processes
Framework	A basic structure of something or a set of ideas or facts that provide support for something
Insolvency	Situation where the liabilities of an entity or person exceed their assets, or they can no longer meet their debt obligations as they become due
Post-commencement funding	Funding paid into a distressed company that has filed for business rescue, and enables them to pay all defined costs (per section 135 of the Companies Act) related to the process, and

Key terms or concepts	Meaning
	often have priority over existing debt
Reasonable prospect (of success)	A sufficient basis to believe that an action or intervention will succeed, in this case, whether a company filing for business rescue may be rehabilitated and survive
Restructuring	A corporate action of reorganising the legal, ownership and debt, operational and other structures of a company in order to make it more profitable or better organised for its current needs
Synthesis review	Combining two or more elements of a finding in the literature gathered into a new whole, based on the conclusions drawn
Winding down or up	The process of selling all the assets of a business, paying off creditors, and distributing the remaining assets to the shareholders then dissolving the business
Zone of insolvency	Describes the verge of insolvency of a business, or proximity to insolvency

Table 1.4: Abbreviations

Abbreviation	Meaning
BRP	Business rescue practitioners
CIPC	Companies and Intellectual Property Commission
M&A	Mergers and acquisitions
P-B-T	Publication based thesis
PCF	Post-commencement funding
SA	South Africa
TMA-SA	Turnaround Management Association of South Africa
UK	United Kingdom
US	United States of America
ZoI	Zone of insolvency

1.15 CHAPTER OUTLINE

Table 1.5 is an outline of the chapters in the study.

Table 1.5: Chapter outline

Chapter	Purpose	Title
1	Introduction	Introduction, including historical background of insolvency and business rescue in South Africa, and basis of Chapter 6
2	Research design & methodology	Research design and methodology
3	Article 1	Pre-packaged applications in business reorganisations: International principles
4	Article 2	Funding structures in business reorganisations: Locating the role of pre-packaging as a restructuring tool
5	Article 3	Exploring the role and extent of sales transactions in business rescue: A precursor for pre-packaging?
6	Article 4	Developing pre-packaging for the South African business rescue industry: Antecedents for applications
7	Conclusion	Summary and concluding remarks
	Bibliography	
	Appendices	

1.16 REFERENCING TECHNIQUE

The referencing used in this study is the Harvard referencing guide. Articles submitted for publishing at various academic journals have also been adapted to the Harvard code. The latter in essence, covers articles 1 through to 4.

1.17 CONCLUSION

Although not legislated for in SA, pre-packs seem to play a very important role as a restructuring tool for companies under business rescue. Taking from regimes where the practice is already established, this study sought to find principles to apply in the SA environment in order to ensure that pre-packs are given a fair chance of success. Thus, this study's prerogative was to explore a robust, practical and acceptable pre-pack model for SA. To this end, the study then developed a framework for pre-packs, based on a combination of internationally based literature and local expert surveys.

CHAPTER 2

RESEARCH DESIGN AND METHODOLOGY

2.1 RESEARCH SETTING

The research conducted in this study is based on grounded theory; hence, data had to be discovered in a systematically gathered and analysed manner. This meant that data collection and analysis had to evolve throughout the study, with each analysis used to guide the collection of new data. This process was applied in the discovery of data in both the established international regimes and the localised South African context.

Given the longevity of restructuring regimes and the history of pre-pack practice in those regimes, the setting for the mainly literature research was confined to pre-identified countries such as the US, UK, Canada, Australia, and a few west European countries. Rich qualitative information was obtained from studies in those regions. Once this was done, the research then focused on the SA environment, where data was collected via surveys and other interview methods discussed below. This was because the whole point of the study was to apply the data extracted in the study for application in the SA environment.

2.2 RESEARCH DESIGN

2.2.1 Research approach

Little or no research has been done to date on pre-packaging theory and practice in South Africa. The theory base for pre-packaging has emerged mainly from a few regimes in the developed world, and has only recently gained momentum in many other developed regimes. The aim of this study is therefore not to empirically test the theory or application in South Africa, but to follow a predominantly exploratory approach, which is qualitative in nature. In following the research through to contextualise it for South Africa, it would have been necessary to employ a measure of quantitative research to test the applicability of pre-packs locally. This study was aimed primarily at helping to develop a framework on pre-packs in the South African context, with theory building as a secondary outcome.

In conducting this study, two different methods of information gathering were employed. Initially, in order to gain an understanding and knowledge of the global restructuring industry and on pre-packs specifically, information had to be gathered using desktop research to find as much as possible, all relevant literature on the study. Patterns from the findings were developed using the analytical tools available, such as comparative and content analysis to form a thematic picture. Once this was done, it became part of a build-up to grounded theory and mapped out in the local SA context. The local SA environment then also needed to be studied. Since there is no known literature on the subject locally, surveys needed to be conducted among participants in the industry. This was done in the first part as survey interviews among practitioners (BRPs). In the second part, expert interviews among various experienced professionals in the field were conducted.

2.2.2 Research philosophy

In conducting a qualitative study, the researcher sought to understand the story behind the establishment and growth of pre-packs. In other words, what exactly are pre-packs, how do they operate, and why? Thus, the approach selected needed to purposefully describe and explain the phenomenon in order to create knowledge on the subject, and apply the knowledge to make sense of the functioning and associated relationships arising therefrom. Individual cases of pre-packs were not investigated, but rather, its general application. Given that pre-packs were not officially taking place in SA, the study sought by applying grounded theory through its four articles to scour the globe for an understanding of the subject matter, although ultimately only a few relevant countries were selected for examination, before examining the local environment for possible suitability of the phenomenon.

Saunders, Lewis and Thornhill (2009:108), in analysing the theoretical approach to research, use the onion as an analogy for a philosophical framework. Indeed, the researcher's perspective plays an important role as to how the research ultimately is approached.

Epistemology describes what constitutes valid knowledge and how it can be obtained (Saunders *et al*, 2009:112). The researcher's perspective is primarily scientific. Secondly, the researcher has had a perspective as a businessperson previously involved in several

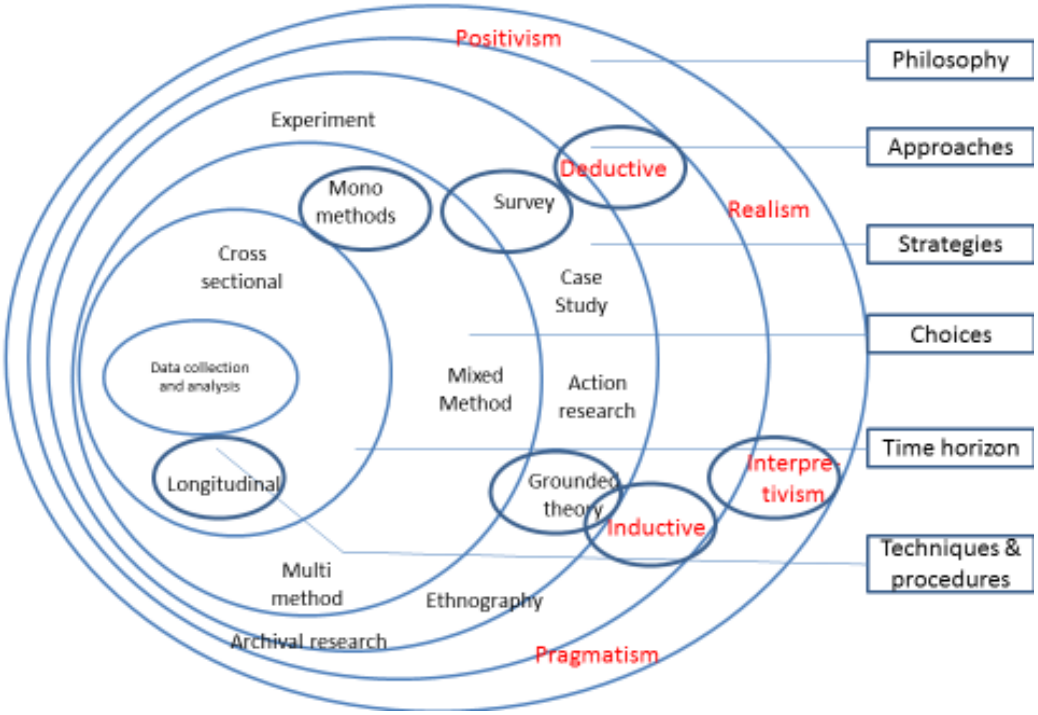
funding attempts in the business rescue arena. These two positions bring about a more rounded and practical view of the subject matter. That being said, the researcher had to find a different manner in which to understand the subjective meaning of the phenomenon. McKenna, Singh and Richardson (2008) state that a researcher cannot maintain a stoic and total objective view, given that both researcher and participants are actively involved in extracting meaning and knowledge from the research.

Saunders *et al.* (2009:110) describe ontology as that which constitutes reality and how existence can be understood in the context of research. In terms of the ontological model, there are two main beliefs in which to view social reality. One being an objective reality in which the researcher remains distant, detached and objective to their study subject, and the other being cognisant that reality is built by the researcher together with the participant. The researcher's ontological perspective was that from the facts realised from the research, there would be knowledge gained to use in building the framework or theory in a localised context. This effectively meant that objectivity was not going to be achieved at all costs.

The research approach was thus based on a philosophy of interpretivism, according to the Saunders' onion. This entails a look at the general to interpret the implications to the specifics. This set the scene for the ensuing study, and enabled an inductive approach to be used, especially in the first two articles, in order to develop grounded theory. While patterns emerged from the literature studied in the beginning, they had to be matched to the reality on the ground in the SA context. This enabled a survey strategy to be applied alongside grounded theory in order to ultimately develop a framework for the application of pre-packs. For the latter part of the study however, a deductive approach was necessitated by applying the general (international patterns) to fit the local specifics.

The philosophical approach is illustrated in Figure 2.1.

Figure 2.1: Saunders' onion on the philosophical approach for the research



Source: Adapted from Saunders *et al.* (2009:108)

Ultimately, while the last two articles were largely based on interpretivism, they relied to an extent on realism as a research philosophy, given that they spoke mostly to the SA position on pre-packs while also garnering expert opinion on the subject. The latter two articles therefore lean towards a deductive approach. A thread running through the four articles culminates in a closing argument in the final article.

2.2.3 Grounded theory strategy

First introduced by Glaser and Strauss (1967), grounded theory is effectively, a systematic generation of theory through a set of systematic inductive research procedures. According to the authors, it was founded on the premise that theory generation is at the heart of a deeper understanding of social phenomena (Glaser & Strauss, 1967; Glaser 1978; Strauss & Corbin, 1998). Regarded as being optimal where little research has been conducted, it is cited as useful in providing deep insights that may otherwise be overlooked with other qualitative techniques. Proponents of the theory purport that it has a great potential of

depicting social phenomenon more accurately, as it does not begin with a preconceived set of constructs and instruments, but rather seeks to find meanings, definitions and interpretations (Lawrence & Tar, 2013).

Often fitting with the interpretivism philosophy, grounded theory offers a way for systematically developing a theory about a phenomenon under study, particularly where no such work had been done before (Lawrence & Tar, 2013). According to Eisenhart (1989), theory building research should begin with an ideal of no-theory and no-hypothesis testing to avoid pre-ordained theoretical perspectives that may bring bias and limit the findings. Accordingly, when extending generalisations from the study, it is important to have a proper interchange between technical literature and emergent theory. This is achieved by integrating all analysis into theory despite possible conflicting or supplementary outcomes (Strauss, 1987).

Thus, in choosing grounded theory as a research strategy for this study, it was understood that no prior work was done on pre-packs in SA, and relatively little has been conducted elsewhere on the theory connecting pre-packs. Grounded theory thus became the basis on which data was collected, both from technical literature reviews from established regimes, and from local participants in business rescue who were be able to provide a local insight to validate the statements of relationships and concepts. This was done in order to develop emergent theory on pre-packs.

2.2.4 Description of broad research design

The study commenced with a review paper on pre-packaged application in four major regimes. Article 1 was thus used as a lead article to provide a theoretical framework, and its outcomes as a core in advancing towards propositions made in developing a framework.

The themes that were investigated were as follows:

- pre-packaged sales application (primary); and
- enhancement to business rescue (secondary).

By collecting data using a mono method of collection on a longitudinal basis, Article 1 was used to lay the basis of this research:

- using constant comparative analysis to build theory;
- using theoretical sampling to work along predetermined themes;
- categorising results according to schematic review and classification of data; and
- synthesising data and identifying patterns.

Sense making through this article and further two articles was helpful in developing the framework to be applied locally. Based on their dominance in the field of turnaround, the four regimes identified as the US, UK, Australia and Canada were studied initially.

Article 1, is an analysis of pre-packaged theory application in four leading regimes, which was key to the thesis, as:

- it was exploratory in nature, and managed to determine the extent of the scope of the study;
- it contains the theoretical framework for pre-packaging; and
- results were able to influence the theoretical basis and conclusions of the subsequent articles.

Article 2 was expected to follow the same pattern and process as the first article. The analysis was more commercial, with financial and structural financing mechanisms examined, and aimed to achieve a slightly different objective.

For purposes of Article 3 and 4, a survey method among local business rescue professionals was deemed more appropriate. Given the nature and speciality of the research topic and the potential size of the population that could possibly be researched, it was expected that a relatively small sample would be used in the surveys, with the aim of obtaining qualitative information as opposed to quantitative analysis. For purposes of obtaining expert opinion on building the framework in the fourth and final article, the Delphi technique was used. This technique relied on a panel of experts, and was a systematic and interactive forecasting method.

2.3 PILOT STUDIES

Given that two different surveys were conducted, pilot tests were conducted in both surveys. During the initial survey in Article 3, two pilots were conducted. These were

BRPs, who either had a relationship with the researcher or were very eager to help or partake. The surveys were typed sheets, included in Appendix B, and they were sent via email. One participant pointed out two errors in the questionnaire, one pertaining to confusing language and the other to a pure linguistic error. The other participant simply adjusted the two questions to what they should have been. The errors had not been material and could have been overcome by most participants; the errors were adjusted for the final survey, and given the size of the sample, the two pilots were included as part of the study since the questions were answered correctly anyway.

In the second survey process, a computer aided programme was used, namely Qualtrics. These questions were sent in two rounds to experts in the field of business rescue. A pilot test was however, conducted among two university colleagues and another industry professional, who were not part of the sample. A few errors were also pointed out, corrected and the survey was sent out to participants in the selected sample.

Lessons learnt were that it was always important to conduct a pilot test to iron out any deficiencies in the questionnaires, especially when using computer-aided techniques. Another challenge that was found was the various computer glitches that were inherent in the programme. The researcher had to contact the helpdesk at Qualtrics several times to iron out the glitches. Even so, two glitches could not be resolved. These arose during the scheduled run of the survey where one participant could not gain access to the questions during the second round, and another completed the survey in the first round, but the results did not reflect on the researcher's side. The result was that the researcher lost two participants from a very small sample.

2.4 POPULATION AND SAMPLING TECHNIQUES

2.4.1 Business rescue population in SA

Business rescue in SA was introduced in May 2011. Consequently, it is still a growing industry. A professional organisation for turnaround professionals, including formal and informal practitioners, and other professionals involved in different capacities in the field, the Turnaround Management Association of Southern Africa (TMA-SA) has a membership of 161. Furthermore, licenced BRPs were 377 as at 10 July 2017, and have been growing

rapidly over the years due to the growing popularity of the industry. A large part of this number is made up of “Junior category” members, meaning they have 0 to 5 years’ experience in turnarounds. This means that experienced personnel that have been in the field since inception are represented by much lower numbers, thus making the pool from which to draw samples with the required experience to be fairly small. This scenario extends to other fields in turnaround management, including legal practitioners, credit teams in lending institutions, funding managers, etc.

Given that as a qualitative study, this study sought not to understand numbers, but the factors behind the occurrence of pre-packs, depth of information was more important than statistical recordings of the evidence. In accordance with Leedy and Omrod (2001), the aim was to apply the findings to contribute towards building a theoretical framework. The sampling was therefore carefully done to extract the required depth of information from participants.

2.4.2 Sampling

Non-probability sampling was used in both level of surveys, with purposive sampling as the chosen method. Cooper and Schindler (2011) describe purposive sampling as non-probability sampling that conforms to a certain criteria. In this case, the researcher wanted to ensure that the selected cases have particular characteristics in either of the two surveys conducted. Tongco (2007) reflects on the importance of ensuring that participants possess the required qualifications when applying purposive sampling. Thus, in the initial survey, the criteria were that the BRPs to be selected for the test needed to have conducted sales as part of termination of their business rescue activities. A list of all business rescue transactions filed with the CIPC from inception (i.e. since May 2011) to end of November 2016, was obtained from CIPC. From the list, filings for substantial implementation were selected, as it represented business rescue processes that were successfully concluded. This new population of substantial implementations did not indicate however, whether there were sales concluded as part of the process (whether as part of a business rescue plan or outside of it). Therefore, all the listed transactions within this population were then searched for in the media (using Goole searches and newspaper cuttings), to determine whether they have been associated with any sales transactions.

The result was a total sub-population of 18, and all were included in the sample due to the already small number.

In the second survey, the criteria applied were business rescue professionals that are involved in funding activities of companies that are involved in business rescue processes, whether prior to or during business rescue. These included, among others, creditors involved in funding the businesses prior to distress as either secured lenders or unsecured lenders or funders. Distress funders and practitioners were also included in the survey. Given that most professionals involved in turnaround management and business rescue in SA are members of Turnaround Management Association of South Africa (TMS-SA), the initial database was provided by TMA-SA. Through purposive sampling, all credit managers involved in workouts at the four big banks, and State-Owned Enterprises (SOEs) were invited to participate, as well as a select number of BRPs and legal practitioners (all with long experience and some level of exposure to PCF). The only two distress funders in the market were also invited to participate. Letters of consent were sent to the willing participants of the survey.

In the first survey, 18 potential participants were emailed questionnaires and given 10 ten days, which was followed up with calls after the 10th day. Most of the participants that responded did so within the first week. Several of the participants had to be followed up several times before they responded. A few did not respond at all. A few promised to participate but became unavailable for whatever reason. It can be speculated that many of them were subsequently too busy to participate. One of the intended participants indicated that their transaction was actually not a sale transaction, although it had been reported as such in the newspapers. They were subsequently excluded from the sample, which then became 17. Ultimately, eight (8) responses were received. This indicated a response rate of 47%.

The second survey was done through Qualtrics. Sixteen potential participants were identified. These included BRPs, legal experts in business rescue, creditors (both secured and unsecured), credit insurers, and distress funders. Participants were given 10 days to respond, with reminders automatically sent to non-responses after seven days. Most of those who responded did so within seven days. Others were followed up with phone calls, with varying responses. One participant did respond and sent the “proof of completed

survey" screen shot, but the response was not reflected on the researchers account. Ultimately, only 10 responses were received during the initial round. This was a response rate of 62.5%. During the second round of this second survey, only the 10 participants who initially responded were included, since this was a ratification process of the first round. At this point, two (2) out of the 10 participants dropped out. One due to a technical glitch, being she could not access the questions even though she opened the research questionnaire. This problem did not abate even when the survey was resent. Another participant became too busy to respond during the second round.

Given the relative sizes of the samples in both surveys, reliance was placed on the study by Guest, Bunce and Johnson (2006) on data saturation point when applying purposive sampling techniques. Although the authors had pre-determined an ideal response of twelve in their study, the themes of the research were reached with the sixth response, thus reaching a saturation point. This principle is an important guide in qualitative studies, as it indicates a point where no new information is observed in the data. In this study, themes were generated within the number of responses received from participants in both surveys.

2.5 DATA COLLECTION PROCEDURES AND ANALYSIS PROCESS

2.5.1 Data collection and analysis

This study was primarily conducted in two parts, with the first part being data gathering through international literature studies and the second part being the application of this literature to the SA environment to ultimately develop a framework. During the first part, which was articles 1 and 2, data was collected through secondary evidence obtained from internationally available literature using sources such as Publish or Perish and Google Scholar, and applied a content and/or comparative analysis in synthesising the data. This data collection followed a typical format of literature review in research.

The aim of this part of the study was to identify internationally recognised principles and praxis of pre-packed funding. This literature review focused primarily on:

- regulatory application in identified regimes; and
- secondary material from academic and professional research.

Thematic analysis was the underlying factor in this study. From Article 1, where an understanding of the legal and commercial operating environment of pre-packs was obtained, to Article 2 with the financial mechanisms and structures, and ultimately to articles 3 and 4 explaining the local SA pre-pack environment, thematic analysis was applied. Articles 1 and 2 used content and comparative analysis on international regimes to identify patterns that could hopefully be applied anywhere, but particularly in SA. In identifying the patterns, principles, practices and methodologies were coded together under themes that emerged from the study of pre-packs. The major method of analysing the data was the "Synthesis Review Method" (Nienaber, 2010) from which patterns could be used to indicate whether there was enhancement to business rescue.

The last two articles, 3 and 4, applied literature reviews and evidence including that collected from the first two articles, to compile relevant surveys to members of the industry in SA, in order to map the current path and way forward for pre-packs locally. While Article 3 was to review current sales and predict patterns for future development of pre-packs, Article 4 was an expert opinion analysis to ultimately build an appropriate framework for pre-packs in SA.

Data in the first survey of article 1 was collected through online surveys. Emails with a questionnaire and a letter of consent were sent to each of the identified potential 18 participants. Some called back to indicate their interest in the study, and availed themselves to answer the survey questions. At least three participants required a face-to-face or telephone interview, and when those were arranged, they had already completed the surveys and merely wanted to have a "chat" regarding the interest shown in the subject. The subject of pre-packs seemed to be of particular interest among several BRPs and other professionals in the field. This electronic survey was made to last between 45 minutes to an hour, although some claim to have completed it in 30 minutes.

The second survey in article 2, which was an expert opinion survey and required a broad understanding of the subject prior to responding, was based on the precepts forming the intended framework. Literature studied thus far was used as the basis for formulating the principles for the framework. The survey questions were designed on a five-point Likert scale using the Qualtrics programme to agree or disagree with. The programme was designed to ensure that all questions were answered, and provided room for further

comments or additional points. The latter was on a free-hand basis. The response from this survey was used to either eliminate elements that were completely disagreed with by the participants, or add new elements not previously included. Once this was done, new questions were formulated based on the updated responses. A similar format was followed where all questions were to be answered. New comments were not requested in this round, however. The responses from this second round of the second survey then formed the final answers.

Finally, an unstructured and informal interview was conducted with a multi-manager of hedge funds and her team, in order to understand the role played, or not played in this case, by hedge funds in the distress funding market. This discussion was important in light of the fact that hedge funds were very dominant in funding pre-packs in major established regimes such as the US, Canada, Europe and parts of Asia (Mkhondo & Pretorius, 2017b). This interview was recorded with the consent of the parties involved, with the understanding that names of institutions and participants would not be disclosed. Nevertheless, in reporting the findings, only the salient points of the discussion were discussed in the study.

2.5.2 Coding

Due to the nature of the study, and the reliance placed on international literature coupled by the virtual non-existence of pre-packs in SA, questions formulated in the surveys were pre-coded. For the initial survey in Article 3, the responses received were fitted into the framework definition of pre-packs, based on this literature. The point of this survey was to identify patterns of sales of distressed assets that leaned towards the direction of pre-packs beginning to take place in the SA context. Because the questions only required ticking in boxes, pre-coding worked very well. This method of coding or categorising of data is generally known to be a deductive approach to the coding process (Thomas, 2006).

Regarding the second survey, Likert scale questions were pre-code as well, and fitted into the preliminarily drafted suggested framework that was used as the initial guide to designing the questions. Free-hand responses, on the other hand, were coded subsequent to the responses from the first round survey. These responses were aggregated according

to themes and classified into new factors to be included in the framework, and involved processing of this new data in order to create new meaning, as according to Thomas (2006). The reformulated questions were subsequently tested for consensus during the second round of this particular survey.

2.5.3 Research credibility

It is key for any research to ensure that its findings are valid and reliable. According to Cooper and Schindler (2011) and Yin (2003), the validity in research can be classified as either construct or external. Construct validity can be explained as ensuring that the correct operational measures are applied for the concept being studied. The researchers ensured a universal definition of pre-packs is established, and that the accepted global standards of measure for pre-packs are applied to whenever the concept is applied. This ensured a correct interpretation of the results is achieved.

External validity establishes the domain in which the findings of the study can be generalised. Given that pre-packs have been practiced internationally over several years, the researchers placed reliance on various literature on pre-packs in established regimes such as the US, Canada, Australia and Europe, and used this as a reliable base to apply in SA. Finally, reliability is that measure, which ensures that the operations of the study can be repeated severally with the same results. This is often addressed during the data collection phase. In this study, the data received from participants was triangulated with literature. In particular, the expert opinions in Article 4 were measured against a draft framework developed from literature.

2.6 CONCLUSION

This research scoured the globe to US, Canada, UK, France, Sweden, Netherlands, and Australia, i.a., to investigate the broader applications of pre-packs in order to investigate whether they could be applied to the specific SA environment. Consequently, the research applied in articles 1 and 2 could be interpreted as an in-depth literature review based on various established pre-pack regimes' practices. These studies still apply data analysis techniques such as content and comparative analysis to emerge with a thematic structure. In the last two articles, survey methods were then employed to the local (SA) environment,

first to investigate whether it is likely or possible for pre-packs to take place (Article 3), and secondly, to understand the rules under which such pre-packs can be equitably applied in the SA environment. These methodologies are explained in the specific articles.

CHAPTER 3

ARTICLE 1: PRE-PACKAGED APPLICATIONS IN BUSINESS REORGANISATIONS: INTERNATIONAL PRINCIPLES

Status on the publication of the article:

Title of article	Pre-packaged applications in business reorganisations: International principles
Authors	S. Mkhondo & M. Pretorius
Journal	South African Business Review
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3.1 ABSTRACT

This study aims to explore the operating environment of pre-packaged financing in various established reorganisation regimes, including the legal framework, practice, enablers, context and other governing structures. Pre-packaging in the US, UK, Australia and Canada was examined with a view to establishing common elements. It is hoped that the insights could assist in building up a framework for implementing pre-packaging in less developed regimes. Through examining secondary evidence using content and comparative analysis, the researchers developed a thematic outcome identifying common and divergent elements.

The findings indicate that pre-packaging has different contextual applications in each regime; it developed largely through evolutionary practice, often forcing the hand of the legislators to adapt accordingly. Apart from general rescue legislation, no other legislation was found to have been passed specifically for introducing pre-packaging. Lastly, the presence of a distress-funding culture appears to play a significant role in the establishment of pre-packaged financing.

Key words: Administration, Bankruptcy, Business Rescue, Pre-Packaged Funding, Business Reorganisation, Distress Funding, Insolvency, Post-Commencement-Funding, DIP financing

3.2 INTRODUCTION

Over the years, many regimes all over the world that operate insolvency or bankruptcy systems have adopted reorganisation plans in order to better aid financially distressed businesses, as opposed to allowing them to run the course of liquidations or bankruptcies. The prevailing view is that allowing companies to continue operations as going concerns provides better societal and economic value than breaking them up. In most cases, this financial distress can be associated with severe cash-flow constraints in the business, resulting in inability to service debt in the ordinary course of business. Consequently, some of these regimes have introduced various forms of funding mechanisms to allow the flow of funds into the distressed business. Pre-packaged funding is one such funding mechanism. It is defined by the UK-based Association of Business Recovery Professionals as an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator. The administrator effects the transaction immediately on, or shortly after his or her appointment.

Pre-packaged funding has been widely adopted in regimes across Europe, Asia and the Americas, and it has found universal use in many advanced states such as the United States (US), United Kingdom (UK), Canada and Australia (Burdette, 2004). Pre-packaged funding is often used interchangeably with pre-packaging or pre-packs in different research papers, as well as across different regimes. Many of these regimes operate under different laws of insolvency and reorganisation, and hence the application of pre-packaging is governed (overseen) by different rules. Although the basic premise might be similar, the different legislations under which the practice is applied pose different challenges and produce different outcomes for each.

This paper aims to review and gain a better understanding of the application of pre-packaging in select established regimes, namely the US, UK, Canada and Australia. The research aimed firstly to define or identify the set standard or principle by which pre-packaging is applied in each regime, the context under which it applies, and the nature of the regulation overseeing the application. A thematic analysis was then made to identify common and divergent elements found in the application of pre-packs in these major regimes.

It is expected that developing a pattern for pre-packaging would elicit insights that could be used to determine the applicability of pre-packaging to other less developed regimes. This would enable them to determine the ability of their existing regimes to accommodate new applications, and the relevant antecedents to the introduction.

3.3 LITERATURE REVIEW

Available literature provides an overview of pre-packaged funding across regimes globally. In line with this study of the four advanced regimes, it was necessary to identify key issues to be included in the study as part of the analysis. A number of studies have previously been conducted with these four regimes, either singly or in comparisons, but mostly in the broader context of business rescue or reorganisation. A common theme among these four regimes of the US, UK, Australia and Canada is that they all have a legal origin of common law. A thematic analysis of pre-packs would also need to consider this factor.

According to Windsor and Jarvis (2011), the term pre-pack is used contextually in different regimes. For instance, in the UK context it generally refers to a pre-agreed business sale, which does not require prior or subsequent sanction of the court or creditors. With other regimes, on the other hand, as in the US, it is described as a fast-tracked restructuring plan that is agreed to by debtor and creditors prior to filing, and is then subsequently sanctioned by the courts (Mallon & Waisman, 2011).

Overall, pre-packaging (or pre-packs) is regulated under varying legislations, which essentially govern restructuring under bankruptcy or insolvency, depending on the regime's legislation. What follows is a sense making of the concept, with descriptions of variants, legislations and contexts in the four regimes under study: the US, UK, Australia and Canada.

3.3.1 Pre-packs in the United States (US)

The US is regarded as probably one of the oldest reorganisation administrations, and yet it is not the least complex of the regimes under this study. The US law for incorporation of companies or corporates (corporate law) is based on a regional system of incorporation applied according to each of the federal states. However, insolvency and bankruptcy law is governed centrally under Article 1, Clause 8 of the US Constitution, which introduces

uniformity in dealing with bankruptcies in the US. The main insolvency legislation is the Bankruptcy Reform Act of 1978, commonly known as the US Bankruptcy Code. The code incorporates insolvency as well as reorganisation of companies facing bankruptcy (Bankruptcy Reform Act, 1978). Insolvencies are dealt with under Chapter 7 of the Code.

Legislation that specifically addresses reorganisation is found in Chapter 11 of the US Bankruptcy Code. Introduced in 1978, the legislation is applicable to individuals as well as to all forms of businesses. The legislation's premise is the rehabilitation of a corporate entity. The act, which is largely regarded as debtor-friendly, has been amended several times since 1978.

The triggering point generally used for insolvency and/or bankruptcy is failure to pay debts when they are due. Under Section 364 of Chapter 11, a debtor that has filed for bankruptcy is allowed to raise debt financing after filing and while management reassesses its business plan and negotiates the restructuring of its capital structure (Pretorius & Rosslyn-Smith, 2014). This financing, called debtor-in-possession (DIP) financing is used primarily to:

- pay for professional fees for the reorganisation process;
- be used as working capital to operate the business; and
- finance capital expenditure or maintenance of existing assets.

As a top priority debt, the DIP financing ranks higher than any existing debt, including secure debt on the proviso that courts have granted priming lien, and enables the debtor to remain liquid during the most challenging times after the filing. One of its major features is the control of the corporate by management throughout the DIP exclusivity period, which can range from the initial 120 days of automatic stay to allowable multiple extensions; however, it may not exceed 18 months (Altman, 2009).

Despite the relative success of DIP financing, pre-packs have found their way into the US bankruptcy legislation and practice. Normally arranged before filing by the debtor, pre-packs have emerged as a quick exit from bankruptcy. Pre-packs or pre-packaging in the US is often applied as part of Chapter 11 filings and has been coined "pre-packaged bankruptcy". Pre-packaged cases are typically implemented as a higher-level workout

while complying with the Bankruptcy Code regarding debt restructuring (John, Mateti & Vasudevan, 2013).

There is no specific regulation governing pre-packaging under Chapter 11. The various descriptions relating to agreements entered into prior to filing, such as pre-packaged bankruptcy, pre-packaged filing', pre-negotiated plan, pre-negotiated bankruptcy and pre-packaged plan serve as precursors to what has eventually become known as pre-packs, particularly when done in conjunction with a section 363(b) sale. Specifically, section 1126 of the Bankruptcy Code by providing for the solicitation of creditors before filing and court approval, provided Chapter 11 bankruptcy will then be filed, subsequently has been applied often to effect pre-packs (Mallon & Waisman, 2011). According to Chan-Ho (2009:1), in a US pre-pack, a debtor negotiates a restructuring agreement and solicits acceptances, prior to filing for chapter 11. He further writes that according to section 1126: "…*the proponent of a plan of reorganisation may file a plan and place before the court, previously obtained acceptances and rejections, provided that (1) the solicitation of such acceptance or rejection was in compliance with any applicable non-bankruptcy law, rule or regulation governing the adequacy of disclosure in connection with such solicitation or (2) in the absence of such law, rule or regulation such acceptance or rejection was solicited after disclosure to such holder of adequate information*". Takagi (2011:3) writes that, section 1126(b) provides for a "pre-packaged plan" where a debtor proposes a plan with a disclosure statement that includes sufficient information, and if the requisite majority of creditors accept the plan before commencement of a chapter 11 case, then the court approves the plan soon after the filing of a petition for the case.

According to Mallon and Waisman (2011:205), a pre-packaged bankruptcy occurs in a situation where a debtor approaches its creditors and proposes a plan of reorganisation in advance. The debtor thereafter files for bankruptcy protection, with the votes for the plan of reorganisation already having been agreed to by the requisite number of creditors. In this scenario, the debtor files a Chapter 11 petition simultaneously with a creditor-supported plan of reorganisation and disclosure statement. The simultaneous filing allows the courts to immediately set a hearing date for the approval of the disclosure statement, as well as the reorganisation plan immediately thereafter, thereby significantly reducing the bankruptcy period. Automatic stay is only applicable after filing.

Furthermore, Section 363 allows a debtor to sell its assets outside of a plan of reorganisation, free and clear of liens, claims and other encumbrances, provided it can be shown that such a sale was necessary to preserve the value of the assets. While this sale process occurs after filing and notification of Chapter 11 bankruptcy, it is normally quite quick, because the sale is not imbedded within a plan of reorganisation. Upon notice and hearing before the bankruptcy court, a Section 363 sale may proceed, with only consent required from creditors (Mallon & Waisman, 2011). With the exception of section 363(c), which refers to sales in the ordinary course of business, provided that certain requirements are met, section 363 is intended to allow a quick sale of any or all of the debtor's assets that are not in the ordinary course of business, and outside of a plan. These conditions include that the directors need to file a notice and obtain court approval after a court hearing, in order to sell the assets. This quick sale method, while very popular (Ben-Ishai & Lubben, 2001:597), has not been without its own criticism. Part of the criticism is that because creditor approval is not required, the section 363 sales are sometimes seen as designed to "scheme around statutory protections afforded to creditors" under a normal section 1129 sale of business during bankruptcy. Secondly, courts are viewed to be less strict with granting approvals. Consequently, numerous debtors have seen it fit to negotiate the terms of the section 363 sale or a plan prior to filing for bankruptcy, under section 1126. Section 1126 allows the holder of a claim to accept or reject a plan. When used together, the two sections 363 and 1126 provide the background legislation for what is termed a pre-packaged sale under bankruptcy. It needs to be pointed out, however, that quick sales under section 363 can and often do occur on their own, in order to provide expediency and out of plan sales.

Ben-Ishai and Lubben (2011) mention, however, that in cases where a debtor-in-possession elects to use Section 363 to effect a sale of assets, the process would typically involve a "stalking-horse", whereby the initial bidder is used to attract competing bidders in an auction. This would be done on the proviso that the stalking-horse would be compensated for costs in the event of losing the bid. Once the sale is consummated, the debtor completes the Chapter 11 proceedings or converts to Chapter 7. Interestingly, there does not seem to be much reference to a stalking-horse concept, particularly in Section 363.

McCormack (2008:103) describes pre-packaged bankruptcy as mixing the elements of a private restructuring, by conducting restructuring negotiations outside of Chapter 11, with a traditional Chapter 11 restructuring process. Pre-packs are not formally subject to any of the rules associated with the confirmation of a plan (Ben-Ishai & Lubben, 2011).

According to Ben-Ishai and Lubben (2011), the preference for section 363 sales is driven largely by two factors:

- the speed of the process; and
- the ability to sell assets free and clear of most claims, under Section 363.

It appears, using either sections 363 sales or 1126 that speed and flexibility are of the essence in administering the US Chapter 11 process. This is strengthened largely by the sophistication of the bankruptcy courts and the constituency of major creditors. John *et al.* (2013) view pre-packaged Chapter 11 filings as combining the advantages of the issuing of a super-priority debt (Chapter 11 filing) and a workout. In terms of this view, the reorganisation plans are negotiated in advance, and filed along with the bankruptcy petition, and are almost immediately accepted by creditors. Management is allowed to run the business during the process of reorganisation. An important consideration about the whole US bankruptcy process (including pre-packaging) is that it is highly court driven. In fact, the country operates one of the most advanced bankruptcy legal systems in the world, with specialised courts.

Through the buying of debt, taking advantage of the existence of DIP provisions in bankruptcy, many hedge funds hitherto not involved in the business of the debtor have found a way of participating in Chapter 11 reorganisations (Baird & Rasmussen, 2010). This seems to have encouraged the use of pre-filing financing instruments, such as pre-petition loans and equities, as most of these financing agreements could be made prior to filing. Section 363 allows the use of debt swaps either prior to or after notice and filing.

As is clear from the above, pre-packs in the US were essentially designed as pre-arranged plans of restructuring as per section 1126. In reality, however, many pre-packs involve sales of assets allowable under section 363, after which the proceeds are then allocated (Ben-Ishai & Lubben, 2011).

3.3.2 Pre-packs in the United Kingdom (UK)

Corporate law in the UK is governed by the Companies Act of 2006. This act governs the registrations, de-registrations and restructurings of companies registered in the UK. In the event that such companies fail the solvency test, the act refers their treatment to the Insolvency Act of 2000. First introduced in 1986, the act traditionally provided a remedy to creditors through the appointment of a receiver over the assets of the company. The receiver's main function is to realise the secured assets for the benefit of the secured creditor(s) who made the appointment (McCormack, 2009).

In order to be responsive to the concerns of all stakeholders, the UK introduced the Enterprise Act in 2002, while also abolishing the administrative receiver (Brown, 2009). This act, introduced as an amendment to the Insolvency Act, was aimed at rescuing the businesses of the affected companies as going concerns. To trigger business rescue under the act, a company has to pass the test of illiquidity, meaning being unable to meet due debts in the ordinary course of business. It is worth noting that the rescue of a business entails either saving a particular company as a going concern or conducting a piecemeal sale of its assets for the benefit of creditors. The latter is often characterised by the sale of assets of the company, often to a new company (newco). This distinction inadvertently gave impetus to the growth of pre-pack sales as part of the administration or business rescue process.

As a concept, pre-pack sales (or pre-packs) do not feature in or result from legislation in the UK (Mallon & Waisman, 2011). Because there is nothing akin to the US DIP financing, pre-packs found their way into the UK on the back of the Enterprise Act. This has addressed the risks pertaining to lack of working capital for trading purposes once a company has filed for administration. Windsor and Jarvis (2011) describe UK pre-packs (or pre-pack sales) as a term used to describe:

- A sale of the business or assets of an insolvent company (which could include a sale of shares in its subsidiaries)
    - by an insolvency office holder (typically an administrator); and
    - where the preparatory work (identifying the purchaser and negotiating the terms of the sale) takes place before the appointment of the administrator.

The sale is then concluded almost immediately after the appointment of the administrator, without the sanction of either the court or creditors, and often with limited formal marketing of the business or assets being sold.

In terms of the Enterprise Act (2002), the process of voluntary administration, which often leads to the arranging of a pre-packaged sale, is usually initiated by the distressed company's management. Insolvency Practitioners who are appointed as administrators for the "insolvent" companies under the Enterprise Act usually work with the management to arrange the sale of the business under pre-pack arrangements. Creditors' rights are anchored in their right to veto the appointment of such administrator. Once the administrator is appointed, he or she plays a leading role in executing the pre-arranged sale.

Thus, in the UK there is no formal legislation governing the application of pre-packaged sales. However, the government in 2009 introduced guidelines: *Statement of Insolvency Practice* (SIP) 16 (2009), to regulate the conduct of administrators in the application of pre-pack sales. More importantly, these guidelines aim to ensure that the administrators implement a transparent process for creditors, and ensure that a fair value is obtained in the sale (Conway, 2015). In terms of SIP 16 (2009), sanction for non-compliance with this guideline is a possible disciplinary or regulatory action on administrators by their respective practitioners' regulatory authorities. The administrator works with management to finalise a business rescue plan, which is then presented to creditors for approval.

It is important to note that the process is mostly market driven, and the role of courts is very limited. While the UK process is deemed creditor-friendly, it is worth noting that cram down is the norm when a two-thirds majority vote by creditors has been obtained, and unsecured creditors invariably have to accept the decision.

One of the major criticisms of the UK pre-packs is the lack of transparency in the process (Conway, 2015). SIP 16 relies heavily on the practitioner industry regulation's sanction on the duty of care to shareholders and obligations to creditors to monitor the independence of the administrators. According to Crouch and Amirbeaggi (2011), the same administrator, while not yet appointed, will work with management in the sale process to achieve the following:

- valuations of the business(es);
- negotiations with potential buyers;
- obtaining the support of secured creditors and suppliers; and
- setting the sale price and terms of contract for the sale.

Once appointed, the same administrator proceeds to finalise the sale. Furthermore, sales of businesses under pre-packs are not openly advertised, and it is common for these to be sold secretly. The justification for a non-publicised sale is that the business would like to continue trading in the period leading up to the sale, without any negative connotations related to an administration (Crouch & Amirbeaggi, 2011).

It is worth noting that a 2007 empirical study conducted by Frisby (2007) found that many insolvency practitioners in the UK stated in their reports to creditors that the uncertainty associated with selling a business after the process of insolvency had commenced (and had therefore been publicised) was potentially fatal to the business.

3.3.3 Pre-packs in Australia

The Corporations Act of 2001 governs all activities of corporations in Australia, including insolvencies of companies. Reorganisation of companies was only introduced in 1993 through Voluntary Administration, filed by entering a Deed of Company Arrangement (DOCA). According to O'Brien-Palmer (2012), Voluntary Administration is designed to maximise the chances of a company or its business remaining in existence, or alternatively providing better returns to creditors. This it does through:

- an automatic stay on creditors; and
- providing the appointed administrator with time to investigate the affairs of the company and consider a possible proposal for the compromising of debt for the company.

The Corporations Act allows for the introduction of reorganisation through the Voluntary Administration. The trigger to proceed with reorganisation/administration is insolvency of the corporation. Voluntary Administration is based on the premise of rescuing either the company or the business. The latter has been the basis of sales of company assets to a newco, a process regarded by critics as a "phoenix scheme" or the phoenix of an insolvent

company. Staff, goodwill and goods or services of the old company are usually retained by the newco. This practice is the prevalent *modus operandi* of pre-packaged sales in Australia.

Pre-packs first became formal in Australia in 2009. According to Crouch and Amirbeaggi (2011), Australian pre-packs were formally introduced in a specific insolvency sale in 2009. The firm of accountants and lawyers involved in the transaction thoroughly examined the law and came to a conclusion that pre-packs could be made commercial and compelling, despite the apparently stringent and tight legal framework in Australia. This conclusion was, in effect, just a confirmation, because pre-packs had already been in practice for a while by then.

Pre-packaged sales are defined in Australian terms as a process whereby the sale of a business or assets of an insolvent company are agreed upon prior to the appointment of an insolvency practitioner, whose task is to review the sale terms and, if thought appropriate, ratify the sale (O'Brien-Palmer, 2012). According to O'Brien-Palmer, an Australian pre-pack model encompasses the following measures, among others:

- The directors of the distressed company are required to employ a reputable valuer, and the sale of this business will be based on that valuation.
- While the directors then arrange for the sale of such business based on this valuation, the completion of the sale will be subject to ratification by an administrator, and he or she will in turn ordinarily seek creditor input.
- The distressed company will then appoint the administrator, who will then investigate the sale, test the market if appropriate, and report to the creditors.
- Only if the sale is ratified by creditors will the administrator complete the sale; otherwise, the sale will be rescinded.
- Most importantly, the administrator to be appointed should not advise the company on the process.

In the event that such a sale should be completed prior to the appointment of the administrator, it would trigger the insolvency provisions and such a company would likely be wound up through a creditors' voluntary liquidation. This has not happened yet, though (O'Brien-Palmer, 2012).

Although there is no formal legislation in Australia governing pre-packs, the legal framework permits the use of pre-packaging. There is no prohibition of “phoenix’ sales in the Corporations Act or any other legislation. There are a few minor constraining factors, however, such as the provisions governing the duties and responsibilities of directors and the prohibition of directors trading under insolvent conditions, both found within the Corporations Act (Crouch & Amirbeaggi, 2011). Furthermore, the Insolvency Practitioners Association (IPA) Code of Professional Practice sanctions members who contravene their professional ethic. As in the UK, the role of the courts is very limited regarding pre-packs, except in general jurisdiction.

A major comforting factor for creditors of a pre-packaged sale company is the knowledge that the sale is subject to the review and ratification of an independent administrator. The IPA adopted a Code of Ethics, which essentially imposes independence requirements upon practitioners, particularly with pre-packs. In combination with the act, this makes provision for the appointment of an independent administrator to overlook the valuation and sale of the company or assets (Crouch & Amirbeaggi, 2011).

3.3.4 Pre-packs in Canada

Corporate law in Canada is governed under the federal Canada Business Corporations Act (CBCA), or regionally under various provincial laws. These allow companies to register, as well as be administered, either nationally or according to the provinces in which they are registered. The CBCA, however, plays an additional role, which includes the regulation of debt compromises while also referring to the insolvency laws.

The Bankruptcy and Insolvency Act (BIA) is one of the statutes that regulate the law on bankruptcy and insolvency in Canada. While the Canadian commercial insolvency law is not codified in one exhaustive statute, the BIA is the main one. This is a law that applies to both natural and legal persons, and provides for both reorganisation and liquidation. It is the sole law that governs company insolvencies in Canada. Financial institutions are governed by the Winding-Up and Restructuring Act.

The Companies’ Creditors Arrangement Act (CCAA) was introduced in 1933 to deal with reorganisations. It is more remedial in nature than the BIA, and it was intended to encourage reorganisation over liquidation. The act allows the “insolvent” company to

restructure its financial affairs using a Plan of Arrangement (Pretorius & Rosslyn-Smith, 2014). The prerequisite for commencing with the CCAA arrangement is insolvency, and the plan's main premise is the rehabilitation of the corporate entity as a going concern. Prearranged restructuring, commonly referred to as pre-packs, is based mostly on the CCAA. The literature reviewed is silent as to the timing of the initial use of pre-packs under CCAA. The Canadian process appears less flexible than the US process, and therefore much slower (Ben-Ishai & Lubben, 2011). Like the US administration, it is largely regarded as debtor-friendly.

According to Ben Ishai and Lubben (2011), although the CCAA has been likened to the US Chapter 11 Bankruptcy Code, it lacks the detailed statutory framework for quick sales that is found in Chapter 11. Numerous statutory amendments have been made to the CCAA since inception. Among these is the new Section 36, which regulates the sale and disposition of assets. Intended to provide guidance in a manner similar to the US Section 363, the Section 36 amendment proposes the following process for quick sales under CCAA:

i. submission of letters of intent by potential buyers;
ii. due diligence by the buyers;
iii. binding offers and deposits by all interested buyers;
iv. negotiations between debtor or monitor and shortlisted bidders, who are requested to submit "best and final offers";
v. selection of preferred buyer;
vi. application to court for approval of purchase agreement; and
vii. court approval of final purchase agreement, which cannot be changed even when circumstances change.

In Canada, no special provisions exist regarding directors' liabilities in terms of trading under conditions of insolvency. The directors' duty of care extends only to the relationship with shareholders, and then only affects creditors if proven to be oppressive. However, merely operating in the knowledge of insolvency and creditors possibly not being paid when due is not deemed oppressive (Wood, 2007).

Of importance under the CCAA is the introduction of a monitor, which is often an accounting firm, typically the firm involved in auditing the company's books. The purpose of the monitor is to observe the proceedings and the behaviour of management and business operations while a plan is being drafted. The monitor is required to report to the bankruptcy judge and other parties regularly, throughout the restructuring process. In practice, however, such monitors often are conscripted as advisors to the debtor. To complicate matters, bankruptcy judges often have discretion on the precise roles of these court-appointed monitors (Ben-Ishai & Lubben, 2011).

On the other hand, the CBCA, because it permits debt compromises and therefore is able to implement prearranged restructuring, has also been used in certain circumstances for implementing pre-packs. It was used to implement pre-pack financing in the Essar Steel Algoma Inc.'s plan of arrangement. The CBCA is in fact recognised by US bankruptcy courts under Chapter 15 of the Bankruptcy Code, and it seems to have a symbiotic relationship with US Bankruptcy (Basta, Greco, Evans, & Nguyen, 2015). These authors argue that the CBCA plan of arrangement is less formal than the US Chapter 11 pre-packaged bankruptcy.

Thus, under the CBCA a debtor can only apply for court approval for a plan of arrangement that affects security holders. ("Security holders" generally denotes shareholders.) The court has jurisdiction to apply a stay of proceedings, though with limited authority over creditors. The court also does not appoint a monitor over the proceedings, as in the CCAA. DIP financing is also not normally available under the CBCA. The process of the CBCA typically involves two court hearings and a meeting of security holders. The first court hearing obtains an interim order approving procedures and a notice of a meeting with security holders, very similar to the disclosure statement hearing of US Chapter 11. A final order is obtained in the second hearing approving the plan, again similar to the US Chapter 11 process. In the Essar Steel case, though, the CBCA process seems to have been followed mainly to obtain recognition and alignment with the US Chapter 15 proceedings (Basta *et al.,* 2015). The effectiveness of this case was that the debtor had negotiated a restructuring support agreement with the majority of its creditors and the main shareholder (a fund) beforehand, and required a court process to bind other

shareholders to the process. The main benefit was that the pre-pack financing arrangement became faster and more effective.

3.3.5 Pre-packs in South Africa (SA)

The South African business rescue regime was introduced into practice in Chapter 6 of the new Companies Act 71 of 2008, as recently as in May 2011. The sale of a distressed business or its assets under business rescue has not been specifically included in the Act's governance structure. Furthermore, pre-packaging by definition refers to a sale that is negotiated before filing for business rescue, but after the directors have identified financial distress in the company. Within the SA context, such action by the company directors could potentially be raised as an argument to sue directors under s 218(2), if they fail to comply with s 129 that requires them to adopt a resolution declaring financial distress, file it, and within five days publish notice of it, and appoint a BRP. Alternatively, to deliver written notices to each affected person, stating the distress situation and explain why a notice has not been filed. This small five-day window is the time during which a pre-pack can be negotiated, unless the Commission allows an extension in terms s 129(3). Nevertheless, the distress funding market is in its infancy, and has not yet developed enough to significantly influence the introduction of pre-packs in business rescue. An investigation of this distress funding culture and its effects will be the subject of a later study.

3.4 RESEARCH AIMS AND QUESTIONS

This study aims to describe the similarities and differences in the application of pre-packaged funding in the four established regimes. In other words, it aims to understand the operating environment of pre-packs where these are deemed to have been well established. It therefore poses the following questions:

1. Do the four regimes being studied espouse the same objectives, principles and methodologies in applying pre-packaged funding?
2. What are the conditions under which pre-packaging is allowed to operate effectively?

The operating environment includes elements such as:

- the legal framework;
- generally accepted practice;
- enabling environment;
- context under which pre-packaging occurs; and
- the existence or not of governance structures.

Table 3.1: Research design applied to this study

Component	**Description**
Research problem	What are the similarities in the guiding principles and practices of pre-packaged financing observed among global restructuring regimes?
Context	Business restructuring/rescue and administration
Propositions	1. Pre-packs are universally defined and consistently and analogously applied throughout the four major regimes. 2. Standard legislation is required in order to introduce and apply pre-packs. 3. The introduction and sustainability of pre-packs is underpinned by a defined rescue culture.
Phenomenon investigated	The operating environment of pre-packaged financing
Unit of analysis	Internationally available literature International restructuring/rescue regimes' practices Relevant acts in international restructuring/rescue

Component	Description
Logic linking data to propositions	Regime contexts, legislation proven as functional, accepted practices and principles that exist.
Criteria for interpreting findings	Principles Themes

Source: Adapted from Yin 2003:21

3.5 RESEARCH DESIGN AND APPROACH

3.5.1 Research approach

This study is exploratory and qualitative, and is aimed at analysing and identifying the principles and praxis of pre-packaged funding, to develop a theme that can be used as a scoreboard for future implementation of pre-packaging in other regimes.

Given that the conceptual base for pre-packaged funding has emerged mainly from established regimes that have practised business rescues or reorganisations for a considerable time, it is to be expected that their existing practices could be used to establish frameworks in developing regimes. Therefore, a largely qualitative study was deemed appropriate for the initial building of a theoretical framework on pre-packaging. The questions raised under the research objectives and questions section were used as a guide to the research. Content analysis and comparative analysis methods were then applied to develop schematic themes for discussion under the conclusions. In developing this narrative, care was taken to apply regime-specific terminology for each regime studied, although against a similar context throughout.

3.5.2 Ontological positions

Ontological positions are the researchers' views on the nature and essence of things in the social world, thereby articulating the essence of their enquiry (Mason, 2002). The first

author believes that while given facts often determine people's positions and their reaction to the same set of facts, most situations can often be explained through closer observation or interaction. Nuances such as people's backgrounds, early influencers and experiences, cultural practices, and other social dynamics tend to shape their actions, outlooks, paradigms and temperaments. It is therefore important to fully appreciate the background information prior to taking a position on any matter or subject. The first author's interest is mainly in funding for business rescue and turnaround purposes. As a positivist who is forced by the context of the research field to do qualitative research, the second author, when finding repeated appearances of issues and principles over regimes, "generalised" from them. His interest was mainly to identify directives to apply to local legislation or absence thereof to guide business rescue processes.

3.5.3 Epistemological positions

This represents the theory of knowledge of the researcher, and indicates how underlying principles on social phenomena can be uncovered through a fully informed research that demonstrates knowledge. The first author had personally experienced a pre-packaged funding failure as an investor, and this ignited his interest in the subject. Therefore, as a postgraduate scholar, he was looking to find better ways of participating in funding for business rescue, and in the process help ignite interest among potential distress funders. The second author was influenced by his role as a strategy consultant when facilitating strategic critiques and analyses to guide company boards and management – that of the "devil's advocate". Being the devil's advocate depends heavily on challenging existing (conventional) thinking, assumptions, reasoning, accepted principles and rules. Sense making from these could lead to application in other regimes.

3.5.4 Research method

The data collection was guided by the research questions being answered. It followed a typical format of literature review in research (Babbie, 2007; Creswell, 2009). Wherever possible, recent literature was used. However, in cases where authoritative sources needed to be used, particularly much-cited text, older literature was used.

Firstly, the legislative literature on business reorganisations or turnarounds in the four regimes of the US, UK, Australia and Canada was studied, to understand the full context of the establishment of the regimes, and furthermore, the place of pre-packaging in those regimes. This literature was available in standard search engines. Secondly, scientific literature on reorganisations and turnarounds, and especially pre-packaging, was searched to provide background and analysis on the given subject. The source engines for these searches included Harzing's *Publish or Perish* and Google Scholar, and especially for titles and authors, SABINET, ProQuest and EbscoHost.

3.5.5 Research setting

Four key established regimes were identified and studied regarding their pre-packaged practices over the years. These regimes were selected due to their long-standing practices, the modification of their practices over the years, and the transparency of their processes and proven case law, as well as the ease of availability of literature on such regimes. As themes emerged on the practices of these regimes, guidance on development of the framework on the principles, praxis and antecedent factors also emerged. These themes emerged from the shared, as well as divergent, praxis of the regimes (see Tables 3.2 and 3.3).

3.5.6 Data analysis

Data was categorised into coherent themes for a proper mind mapping. A combination of content and comparison analysis was used to formulate the insights for final discussion and conclusion.

3.6 OBSERVATIONS AND FINDINGS

3.6.1 Key observations

Regarding the global view of insolvencies and reorganisations, it is important to recognise that different jurisdictions have a need to address their own issues of fairness and social justice, as understood by their societies. Consequently, the insolvency laws of any country will be closely linked to its other laws and it will inevitably reflect its fundamental values (Westbrook, Booth, Paulos, & Rajak, 2010).

Tables 3.2 and 3.3 below provide a schematic outline of the environments in which pre-packs apply, starting initially with the legislative environment and then the specific pre-pack framework. It should also be noted that while different terminology in various regimes often relate to the same things, there are a few exceptions where different meanings need to be ascribed. For example, the various practitioners used in the different regimes may occupy completely different roles in practice. Different professionals are used to fulfil the role of administrator, with the US employing a Trustee, while the UK and Australia use an Insolvency Practitioner and Canada a Monitor.

Table 3.2: Legislative environment and key issue comparison (own compilation)

	Main corporate legislative regime			
Legislative Regime	**United States**	**United Kingdom**	**Australia**	**Canada**
Legal origin	**English law** **Common law**	**Common law**	**English law** **Common law**	**Common law**
Main Corporate legislation	Regional – mostly Model Business Corporations Act & Delaware General Corporations Law	Companies Act 2006	Corporations Act 2001	Canada Business Corporations Act (federal); Various (provincial)
Main Insolvency legislation	Bankruptcy Reform Act 1978 (U.S. Bankruptcy Code) Chapter	Insolvency Act 1986; 2000	Corporations Act	Bankruptcy and Insolvency Act

	Main corporate legislative regime			
	7			
Reorganisation legislation	Chapter 11	Enterprise Act 2002	Voluntary Administration	Companies' Creditors Arrangement Act (CCAA) 1933
Commence date (reorg.)	1978	2002	1993	1933
Reorganisation triggers	Failure to generally pay debts when due	Illiquidity – inability to meet due debts in ordinary course of business	Insolvency	Insolvency
Reorganisation premise	Rehabilitation of corporate entity	Rescuing/Saving the business – going concern or piecemeal sale (for creditors' benefit)	Rescuing company or business	Rehabilitation of corporate entity – as going concern
Reorganisation terminology	Reorganisation	Administration	Administration	Administration
Regime orientation	Debtor friendly; migration to creditors	Creditor friendly	Creditor friendly	Debtor friendly

In the first instance, the US and Canada have, as federal states, tended to legislate on the behaviour of their corporates in a manner that speaks to the independence of their various states. The basic legislation governing the registration of companies is left to the different states. While Canada has subsequently sought to also have an overall national standard in parallel, the US has left legislation as such, with many corporates migrating to the state of Delaware as a corporate haven.

In both cases, however, legislation governing insolvencies, bankruptcies and restructurings have been placed at the epicentre as standards for national application. In Canada, the Bankruptcy and Insolvency Act (BIA) is enacted to deal with all matters of insolvency and bankruptcy, while the CCAA has been established to deal with corporate restructuring. Although this is limited to corporates that produce turnovers from C$5 million upwards, it is a standard for such. The US, on the other hand, established through the constitution the US Bankruptcy Reform Act. This act governs all matters pertaining to restructurings, from basic balance-sheet reorganisations to complex sales of distressed assets of businesses, and ultimately to insolvencies. It is also applicable to individuals, as well as corporates (Spiro, Westerman & Dela Cruz, [n.d.]). The reorganisation of Chapter 11 that deals with distressed businesses is also found in this act.

In contrast with the US and Canada, the UK and Australia operate single registries for companies or corporates. In the case of Australia, this legislation, the Corporations Act, also deals with all matters of insolvency and bankruptcy, including Voluntary Administration, which was established to deal with business rescues for companies that are under financial distress and therefore facing insolvency. Voluntary Administration is a process to be followed in dealing with companies that wish to voluntarily file for rescue administration under DOCA, in order to avoid facing possible liquidation.

Slightly varying from the Canadian practice, the UK applies the Insolvency Act to deal with all insolvency-related issues, for individuals as well as companies. A separate Enterprise Act was legislated as an amendment to the Insolvency Act to deal with distressed companies, with the distinction being illiquidity as opposed to insolvency.

The reorganisation culture also seems to follow similar dichotomous patterns among the four regimes, with firstly, the US and Canada being more focused on rescuing the existing

corporates as going concerns, while the UK and Australia, on the other hand, seek to rehabilitate the business, as opposed to the corporate. This culture of business rescue in the UK and Australia has led to the practice of the stripping of assets of distressed businesses into newcos, newly established companies. This practice is implemented using new funds injected into newcos, irrespective of the stage in the process of restructuring of the said business. It has nevertheless led to some criticisms about “phoenix” practices, which in effect mimic this practice, though in that case, with the purpose of evading creditors. Pre-packaged financing has therefore not escaped this criticism, as its nature makes it easily amenable to this practice.

Table 3.3: Pre-pack framework showing key elements (own compilation)

	Reorganisation funding and principles			
Funding	**United States**	**United Kingdom**	**Australia**	**Canada**
Forms of funding	Debtor in possession (DIP) financing; pre-packaged finance	Pre-packaged financing	Pre-packaged financing	DIP Financing; Pre-packaged finance
Post-commencement funding	DIP financing	None specific	Non specific	DIP financing
Pre-pack first year of use	1978	Unclear, but predates 2009	2009	Unknown
Pre-packs	Fast-tracked	Sale of	Sale of assets	Sale of

	Reorganisation funding and principles			
theme/premise	process; sale of assets; funding of corporate	assets, often to newco	to newco	company or assets
Pre-pack driver	Process base	Sale based	Sale based	Sale based
Pre-pack governing legislation/ guidelines	Chapter 11: Section 363 Sales, Section 1126	None Guideline SIP 16	None; IPA's Code of Professional Practice (Code)	CCCA: S36 Sale process & S11.7 Appointment of monitor by courts
Other related legislation	None	None	Corporations Act: Directors' liabilities & insolvency trading provisions	CBCA: Insolvency provisions
Legislation introduction	1978; several amendments	2009; revised in 2011	N/A	1933; amended in 2009
Legislation / guidelines' main purpose	Allow quick sale; stalking-horse bidding process (in practice)	Transparent process for creditors; fair value obtained	Ensuring fair price and administrator independence; creditor loss protection	Normal once-off bid process; Monitor (CA) appointed as watchdog

	Reorganisation funding and principles			
Non-compliance sanction	Not applicable	Fines to administrators	Civil & criminal penalties for directors (s181) & advisors (s79) per Corporations Act	Possible sanction by professional bodies
Directors' Insolvency provisions	Not applicable	Trading allowed to a point	Not allowed to trade beyond insolvency point	None specific
Role of creditors	Involved in negotiations with debtor; often part of buyers	Not involved in pre-pack negotiation; have veto rights on appointment of administrator; unsecured creditors "forced"	Ratifying the sale	To receive notice of sale; Onus to prove un-reasonableness of sale in appeal
Role of courts	Specialised; sanctioning agreement &	None	None – limited to directors' liabilities	Approval & sanction

	Reorganisation funding and principles			
	process			
Management / Directors' role	Runs the business during process; appoints trustee	Management works with administrator to arrange sale	Directors arrange the sale; administrator completes sale	Arrange the sale; monitor evaluates sales and reports to court – CCAA; but court has right to remove directors
Role of Administrators	Trustee (where appointed) – negotiates and consummates sale	Lead role in executing sale process, end to end	Ratifies sale with creditors; Completes sale	None (Monitor acts as watchdog over management)
Administrator independence	Appointed by debtor	No role distinction for IP	Administrator not same IP as advisor	Monitor independent
Asset valuation	Management's valuation	Directors' valuation; proposal of independent valuer tabled	Independent valuer	Management, but assessed by monitor
Fundamental goal	Speed	Funding	Funding	Speed

Specifically regarding pre-packs, the US is very process-driven, with every action along the way being detailed in the act, including the stages of involvement by the courts or judiciary. This means that the judiciary is very involved throughout implementation, with specialised bankruptcy courts in place. Because different sections of Chapter 11 of the act are used to detail each step in the process, it is possible to implement pre-packs without the funding- or capital-raising aspect. In this case, the main goal is the speed of the process. This seems to be a fundamental difference between US pre-packs and European-based, particularly UK, pre-packs. However, despite the definition, funding often follows, due to the unavoidable requirement for funding by most companies under Chapter 11.

Like the UK and Australia, Canada's major driver in pre-packs is sale of assets or the company. However, unlike the former two regimes, Canada seems to mirror its practice and legislation on the US, with the involvement of courts, although to a much lesser extent. Canada's legislation is also made user-friendly for US processes (Basta *et al.,* 2015). Another cultural similarity to that of the US is the regime orientation, which is regarded as debtor-friendly, unlike those of the UK and Australia, which are largely regarded as being creditor-friendly. The debtor-friendliness of Canada and the US is exemplified by the DIP reference in their regimes. DIP, in essence, puts the management or directors in the driving seat of a company under administration. In Canada, this is further exacerbated by the fact that the creditor also has the onus to prove the unreasonableness of a sale of the company or assets by debtors, on appeal.

The creditor-friendliness of the UK and Australia can be seen as merely a compensatory safeguard to protect creditors, since the concept of business rescue itself is intended to protect debtors against possible rogue creditors, whose only interest may be quick exit and maximum recovery. In the UK, specifically, the direct route to insolvency is followed by the creditor appointment of a receiver, whose sole aim is to maximise the recovery to the creditors. Nevertheless, a creditor in the UK is still not involved in a pre-pack negotiation (unlike in the US), and its powers are limited to vetoing the appointment of an administrator. Australia is slightly different, in that the creditor can still ratify the sale.

Of great interest is the fact that Australian pre-packs are governed neither by legislation nor by guidelines. The only check to pre-packaged sales in Australia is the Voluntary

Administration process, requiring the appointment of an independent administrator in valuing of assets of the business being sold, and that of creditors ratifying the sale. This process, based on DOCA, is included as part of restructuring in the Corporations Act. Outside of that, the only other check is the sanctioning of directors on their liabilities in cases where it has been deemed that insolvency has been triggered by trading under insolvency, also under the Corporations Act. This insolvency provision places little time or incentive for directors to pre-pack, if it means that a liquidator may later allege that they held off past an insolvency point. In the case of the UK, directors are allowed to trade up to a point, even though the business may be under the cloud of insolvency, with a generous interpretation of when the directors ought to have stopped trading (Brown, 2009).

An interesting aspect of the restructuring process in these four regimes, in particular regarding pre-packaged financing applications, is that management or directors are allowed to run the companies or businesses even when under administration. It is not clear if there is a distinction between management and directors; this is a moot point. The role of the appointed administrator differs, but is essentially in relation to conducting or overseeing the sale. In the US and the UK, the Trustee and administrator respectively play a lead role in negotiating and consummating the sale, although it needs to be pointed out that management is often in charge in the US, and an administrator is only appointed in exceptional circumstances where acts of dishonesty are suspected. In Australia, while the administrator ratifies a sale that has already been negotiated by the directors, he or she is then also charged with executing this sale agreement. Furthermore, distressed companies in Australia often appoint their own advisors, who are often audit firms, to work in parallel with the administrator. The advisors also provide an independent valuation of the sale price. This practice is deemed to create price fairness, although one can question the independence of these “independent” advisors, since they are appointed by the directors themselves.

Independent valuations have not been deemed necessary in the regimes other than Australia, and are normally done by managers or directors. Furthermore, in the UK, the sale process is not even considered transparent, as it can be concluded almost entirely without any assessment of fair value in the process. This is done in order to avoid publicly

advertised processes, which may have a negative impact on the employees and customers (Crouch & Amirbeaggi, 2011).

The Canadian monitors' role is even more arms-length, as their sole duty as watchdog is to evaluate the merits of the sale and report to the courts. The sale, however, is through a bid process that is conducted in an iterative process with a view to obtaining the highest bid price. This sale process therefore makes up for the lack of independent valuation.

Section 363 in Chapter 11 in the US regulates the sale of the companies under distress. A peculiarity is that while the act makes no mention of the particular process to be followed in the sale, some authors make mention of a stalking-horse process that allows the price of the original bidder to be iterated through the process in determining the fairest price. A note has been made of this inconsistency in the relevant section.

3.6.2 The evolution of pre-packs

The US and Canada are characterised by DIP, and in particular, DIP financing, which is a form of post-commencement financing, although this is informally practised in Canada. What distinguishes this form of financing is that it is legislated to be implemented right after filing, but prior to the approval of business plans by the debtor. It furthermore leaves the possession of the business in the hands of the management or directors. The intention is to introduce cash flows into the already distressed company in order to avoid further deterioration while the formalities of restructuring are being followed. It also helps to dilute the effects of stigma normally associated with distressed companies. The practices related to DIP financing have encouraged distress funders to proactively engage in such funding practices in anticipation of distress. Distress funders, especially in the US, have created hedge funds, with mandates to acquire existing debts of existing creditors (Moyer, Martin, & Martin, 2012). In fact, it is common practice for these hedge funds to enter into agreements with creditors from the onset of the debt, with a clause that replaces them as new creditors in the event of distress in a "loan-to-own" strategy (Jiang, Li, & Wang, 2012).

It appears that this practice subsequently evolved to full funding of distressed companies with the idea of influencing the subsequent business plans formulated by management. In some cases, the funders would even be able to introduce their own management team (Jiang *et al.,* 2012). Such a management team would be able to sell assets of the

business, which it deemed to be surplus to its needs and helping to increase the business cash flows. In the case of the US, such sale would happen under Section 363 of the act. An agreement to complete the reorganisation of the distressed company in the shortest possible time is permitted under section 1126 in Chapter 11 of the act, a process that has subsequently been known as pre-packaged restructuring. The normal definition of a pre-packed process in the US does not include the funding aspect, and strictly relates to a quick process that culminates in a business plan. A combination of sections 363 and 1126 would be used to fund the fast-tracked process of restructuring in what has generally been accepted as a pre-packaged sale.

Having closely followed the developments in the US, UK practitioners and companies have adopted practices over time, which mirror the US pre-pack sale. However, this has had to be adapted to local legislation. According to Conway (2015), pre-packs in the UK is not specifically provided for in legislation, but it has arisen from practice and judicial approval. Wellard and Walton (2012) argue the ability under Schedule B of the Enterprise Act (2002) to appoint an administrator out of court with minimal formalities, has led to the widespread use of pre-packs in the UK. In adapting to the new changes, rescue-based legislation had to make do with these changes in practice, and practice note SIP 16 was introduced to at least avoid potential fallouts with the creditor community, while allowing developments that brought about speed in resolution, as well as saving jobs and businesses. It should be noted that SIP 16 introduces the only formal and “legal” reference to pre-packs among the four regimes studied.

Canada, on the other hand, has a detailed definition of pre-packs that includes the sale and acquisition of the distressed business. Canadian law on corporate restructurings, while even older than the current US legislation, had to be adapted as the years progressed to accommodate its neighbour’s updated requirements. The CCAA was first introduced in 1933, but due to several amendments, now looks a lot closer to the US regime. The Canadians have gone as far as informally adopting terminology such as “DIP funding” to recognise debt-related financing of distressed companies. The benefit of adapting has been that they have managed to make some improvements, such as the introduction of an independent monitor to oversee the sale process, in sections 11.7 and 36. A further improvement is that of being less reliant on courts to sanction and oversee

the entire pre-pack processes, making it slightly less expensive. Arguably, pre-packs can also be done purely based on CBCA, saving even more costs.

The Australian legislation governing restructuring, while covered only in the Corporations Act, closely follows that of fellow Commonwealth country, the UK. This development has gone further to encapsulate even the UK practices of pre-packaged financing, which are very similar. Due to the fact that as in the UK, the restructuring legislation is geared towards business rescue as opposed to corporate rescue, both countries' practice of pre-packaged financing involves mostly the transfer of assets of the existing company into a newco, bringing along the same management. This practice has largely been criticised as being virtually a phoenix scheme.

Australia has decided not to legislate further to include governance on pre-packaged financing, and has left the regulation mainly in the hands of the practitioner bodies. The effect is obviously a diluted sanctioning in the event of failure to comply; it is, in fact, more of a professional misconduct than law breaking. Therefore, as it stands, Australia has no legislation on pre-packaged financing, yet the practice is prevalent in the country.

The existence of a healthy funding appetite for distressed businesses in these markets appears to fuel most of the activity in pre-packaged financing. Of these four regimes, the US appears to have the most robust distress funding market, dominated mostly by hedge funds and private equity funders. Some non-private equity funders also exist to fund this market. As part of Europe (until Brexit), the UK has experienced a steady flow of funders in this market that have aided evolutionary growth of pre-packed funding.

Due to the advantages of speed and prospects of a successful corporate or business rescue, pre-packaged financing seems a process that is simply driven by market forces, and legislators may need to be prepared for this eventuality.

3.6.3 Findings

In explaining the findings, the words pre-packs, pre-packaged financing, and pre-packaging will be used interchangeably, as all these terms are used by various authors in the literature.

The data gathered indicates that pre-packs are generally accepted as a practice in all four regimes, as they have the potential to rescue corporates or businesses speedily enough to give a better chance of maximising stakeholder returns. While it was perhaps not originally intended as currently practised, it is a concept that has evolved in many of these regimes, forcing the hand of legislation and/or practice guidelines.

In responding to the proposition, the following questions would need to be contextualised:

- What is the context under which pre-packaging applies, and is it specific to each of the international regimes?
- What are the common or divergent elements found in pre-packaging in international business restructuring regimes?
- What is the standard required of each participant in pre-packaged financing in order to achieve set objectives for pre-packaged financing?
- Is there a typical restructuring/administration philosophy that serves as a basis for successful implementation of pre-packaged financing?
- Are the regulatory conditions in each country made conducive for the implementation of pre-packaged financing?

The themed presentations that follow seek to answer these questions using propositions defined earlier. It is quite clear from the table that all four regimes display both similar and dissimilar rules and applications.

Table 3.4: Schematic comparison of pre-pack principles for US, UK, Australia and Canada

Pre-pack rules and application	US	UK	Aus.	Can.
1. Pre-pack defined by sales of business/corporates	N	Y	Y	Y
2. Judiciary-driven pre-pack practices	Y	N	N	Y
3. Use of new companies to absorb the assets of the former company	N	Y	Y	N
Legislation required				
4. Pre-packs governed by legislation	Y	N	N	Y
5. Pre-pack guidelines	N/A	Y	N	N/A
6. Legislated PCF	Y	N	N	Y
7. Insolvency legislation in tandem with pre-pack concept	Y	Y	N	Y
Rescue culture				
8. Business rescue vs corporate rescue	N	Y	Y	N
9. Strong creditor protection in pre-pack practices	N	Y	Y	N
10. Existence of strong PCF practices	Y	N	N	Y
11. Established distress funding communities	Y	Y	Y	Y

Source: Own compilation

Proposition 1: Pre-packs are universally defined, and consistently and analogously applied throughout the four regimes

A common motive for pre-packs is that they provide for speed in execution, even though the definition and the means to get there may be different.

The US, as the pioneer of pre-packs, has a plethora of terminology that describes what became colloquially known as pre-packaged bankruptcy, and may or may not embrace the sale aspect. Technically, therefore, pre-packaged plans in the US do not include sales, whilst “quick sales” are embraced under section 363, but without a plan. In practice, when the funding includes a sale, and the entire process can occur as a combination of sections, especially 363 (quick sale) and 1126 (speedy agreement), within Chapter 11. This application ultimately produces similar outcomes to those of the other three regimes, which are technically premised on sales of assets or corporates.

Despite all four regimes having a common law origin, the North American countries seem to operate quite differently to the other two countries, although all four are distinct from one another. For instances, the UK and Australian environments differ from the US and Canadian situation, in that their processes are not court driven. Furthermore, the application of pre-packs in both the US and Canada is fully covered in legislation, while in Australia, pre-packs are not covered at all in legislation, and the UK pre-packs are covered only by government-sanctioned guidelines.

Both the UK and Australia tend to prefer the sale of assets of the distressed companies to newly established companies (newcos), based on their respective legislations’ bias towards business rescue instead of corporate rescue. In the US and Canada, on the other hand, restructurings with pre-pack sales often retain the original company, with a few structural adjustments; rarely do new companies result, in typical phoenix sale, from the pre-packs.

Therefore, while pre-packs generally embrace a similar definition in practice, their respective applications are different, and made to suit the circumstances and context of each regime.

Proposition 2: Standard legislation is required in order to introduce and apply pre-packs

Apart from the context of a rescue-based regime, there is no specific legislation required to introduce and apply pre-packs. Only the US and Canada have legislation that ultimately governs pre-packs, whilst the UK has government-sanctioned guidelines that regularise pre-packs.

The UK regulation aims to set standards under which company directors/management and administrators would operate in order to give some credence and create confidence in the pre-packaged financing process. Without these standards, management and practitioners run the risk of delegitimising the process. For some reason, though, Australia manages to pull through without directly aimed pre-pack legislation. With the US and Canada, the court-sanctioned process ultimately sets and administers the standards of application of pre-packs.

The US, UK and Canada have insolvency legislation that does not typically contradict pre-packs, and therefore is essentially friendly to pre-packs. Australia's pre-packs, on the other hand, are susceptible to a flouting of insolvency provisions insofar as directors' liabilities are concerned. The UK does have a similar risk in legislation, though in practice it is rarely applied. This could be in part because the onus lies heavily on the creditors to prove that directors knowingly triggered the insolvency provisions.

The US and Canada have legislated for PCF in the form of DIP financing, which has, through an active distress-funding market, interestingly encouraged the expansion into pre-pack financing. The UK and Australia, on the other hand, have not adequately legislated for PCF, with the result that pre-packaged financing has been forced on their regimes, since there were not enough options for funding distressed businesses. The argument could be raised that this lack of adequate legislation has only served to fuel phoenix-type transactions.

In most cases, the US and Canada seem to apply similar standards to pre-packs, while the UK and Australia work on slightly different standards from the rest and from each other. A major factor is that Australia, even though it works on broadly the same legislation as the UK, does not have pre-pack regulating legislation or guidelines.

Proposition 3: The introduction and sustainability of pre-packs is underpinned by a defined rescue culture

Rescue culture does seem to define the method of execution of pre-packs. A case in point is that because of the UK and Australian rescue orientation towards business and not companies *per se*, pre-packs in those regimes are geared towards asset purchases by newcos created specifically for that purpose.

The court-imposed protection mechanisms in the US have encouraged a debtor-friendly culture, which in turn, has assisted the growth in strength of US and Canadian pre-packs with lesser caution needed, since protection is adequately offered by the courts. More caution by distressed debtors has been necessary in the UK and Australia due to the strong creditor-protection culture prevalent in those countries.

Of particular interest, is that there appears to be no specific reference to PCF in either the UK or Australia, whether in legislation or by practice, with funders and financiers seeming rather more comfortable with early funding engagements, which is pre-packaged financing. While there is no proven correlation between lack of PCF and pre-packs, it may seem that the absence of PCF in legislation makes it relatively easier to commence negotiations to finance distressed businesses prior to any announcement of filing. On the other hand, the existence and robustness (especially in the US) of PCF (in the form of DIP) has inadvertently fuelled and pushed for the creation of early-stage funding of distressed corporates (pre-packaged finance) through innovative funding structures. In other words, pre-packaged finance seems to have strengthened the distress-funding process in the US, through a supplementary role to DIP financing. The same seems to have occurred in Canada.

The four regimes have a vibrant distress-funding market, with the US at the stronger end and Australia at the weaker end of the spectrum. Nevertheless, these serve as a strong basis for the implementation of pre-packs, with the strongest market providing more pre-pack solutions than the weaker one.

It seems clear that in all four regimes, culture plays a major role in business rescue or administration, with the existence of a vibrant distress-funding market being very influential in fuelling and sustaining pre-packaged financing. Also worth noting is that the existence

and non-existence of PCF in both cultures has, with opposite effects, ultimately helped fuel pre-packs.

3.6.4 Gaps, inconsistencies and controversies

The following issues have been identified as being either inconsistent or controversial:

- Phoenix-style criticism in Australia (controversial): several researchers raise this argument but defend it based on the Australian process being very transparent and therefore preventing such practice.
- Wellard and Walton's (2012) argument that there is no real pre-pack in Australia (controversial): despite contradicting literature, further research needs to be done on the incidence of pre-packs in Australia, and whether they are reflective of the true practice.

3.7 DISCUSSIONS AND IMPLICATIONS FOR INDUSTRY

This study was intended to provide some key insights into pre-packaged financing as practised by more established international regimes. These insights could be used to assess the appropriateness of environments or regimens involved in business rescue to allow and regulate pre-packaging. The patterns identified in the four regimes give an indication of the circumstances surrounding the seemingly successful practice of pre-packaged financing. Many of the regimes had not legislated for pre-packaged financing from the onset, but they were affected by pull factors towards such a practice. This could be largely due to the influence of common law in those regimes, as this seems to rely more on *stare decisis* and other court-driven processes. An example would be the stalking horse principle in the US, which is not reflected in legislation, but is a known and accepted practice through court applications and *stare decisis*. For new business-rescue regimes, there should be an expectation of the creeping in of pre-packs in one form or another, and legislators may need to take note and accommodate more sustainable environments.

Secondly, despite general similarities in the business-rescue environment, every regime has its own nuances that make it more or less practical to implement pre-packaging. Of more importance is that pre-packs do not seem to require legislation in order to apply in environments with a rescue culture, as they seem to rely mainly on common law

principles. In fact, they seem to be a reality created by the existence of vibrant investment communities. For a country like South Africa, in particular, business rescue is relatively new. However, the global influence of rescue culture from as near and far as Europe and the US could open doors for the evolution of pre-packs, whether legislated for or not, and legislators would do well to prepare for this eventuality.

3.8 IMPLICATIONS, LIMITATIONS, AND FUTURE RESEARCH

3.8.1 Implications for business

This study is intended to provide insight to stakeholders affected by business rescue or administration, particularly in the developing world, where the legislation is fairly new. This specifically relates to funding for financially distressed companies, and the relatively quick turnaround offered by a pre-packaged financing regime. Practitioners and legislators alike need to be equipped to deal with pre-packs, as they continue to spread throughout business-rescue regimes.

It is evident in many of the cases studied that pre-packs are a market-driven phenomenon, and tend to drive their own agenda if not properly anticipated and regulated. It is therefore clear that legislators need to plan in regimes where business rescue or administration is practised. Pre-packs seem to thrive under different legislative environments. Many regimes already provide the right elements for its introduction by either practitioners or legislators, and legislators may therefore need to ready themselves. A case in point is SA, which has a similar environment to Australia in that directors are called to account for any breach of insolvency provisions. This has not prevented pre-packs from being introduced by practitioners, however, and it can be expected that eventually pre-packs will also see the light of day in South Africa. In such cases, legislators need to either adapt the legislation to accommodate pre-packs, or take active steps to regulate pre-packs in the event that they occur.

3.8.2 Research limitations

As with most research, there are numerous limitations with this study. Firstly, while pre-packaged financing is a growing phenomenon in Europe and Asia, this study focused only

on the four previously mentioned regimes. Consequently, new factors influencing or affecting the practice that are outside of these four regimes may have been overlooked, as the established regimes studied may not be accounting for any new dimensions affecting the phenomenon.

The most significant limitation is that as this was a qualitative study, reliance was placed on available material and therefore, the bias of authors of the material used can possibly not be discounted. This was further illustrated by one or two authors who were found to speak in discord.

3.8.3 Suggested future research

Empirical research needs to be conducted on the use of pre-packs in Australia, measured against the use of directors' liabilities' provisions to call the directors to account for trading beyond insolvency. Also, judging from Wellard and Walton's argument that there are no real pre-packs in Australia, an empirical test that follows the pre-pack processes against a set standard may need to be conducted.

For SA, the potential contextual limitations imposed by the impact of s 129 and 218(2) of the Companies Act on the directors who are aware of the financial distress of a company and wish to implement pre-packs, need to be studied in depth. An empirical study needs to be conducted to understand the extent of sales of distressed businesses in the SA business rescue scenario, as well as their implications on pre-packs. A further paper would seek to investigate this phenomenon.

CHAPTER 4

ARTICLE 2: FUNDING STRUCTURES IN BUSINESS REORGANISATIONS: LOCATING THE ROLE OF PRE-PACKAGING AS A RESTRUCTURING TOOL

Status on the publication of the article:

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4.1 ABSTRACT

Pre-packaged funding increasingly plays a prominent role in resolving distressed assets under reorganisation laws globally. Based on a qualitative and exploratory analysis, this article examines the actual operations of pre-packs, including the various structures and funding mechanisms used. In many cases, funders and acquirers of distressed assets under reorganisation do not distinguish between pre-pack and post-filing opportunities, but the funding and structuring mechanisms and timing thereof often become the determining factors in the how they are classified.

This study improves our understanding of the financial complexities involved in pre-packaged funding such as the structuring and valuation of transactions, which would be particularly useful to newer entrants to pre-packaging who are considering its application. The analysis of available scientific contents revealed that many of the funding institutions employ a variety of funding mechanisms that often complement one another. It was also found that many of the funding institutions, especially hedge funds, often apply pre-packaged funding as an entry to the acquisition of such distressed assets, usually before the occurrence of the distress event. This study further revealed a correlation between a vibrant distress funding market and sophisticated funding mechanisms, which often charts the course for the establishment of pre-packs.

Key phrases

business reorganisation; business rescue; debt; debt-to-equity; distress investors; equity; funding structures; pre-packaged funding; pre-petition; post-filing; restructuring; secured debt; unsecured debt; valuation methodologies

4.2 INTRODUCTION

The world has woken up to the realisation that the rehabilitation of insolvent or distressed companies is more beneficial to their economies than outright liquidations, particularly where this can potentially be avoided. With the introduction of business rescue-related legislation to deal with rehabilitations, it has also become necessary for regimes to allow some kind of funding to assist many of these companies undergoing administration or reorganisation or business rescue – the terminology is mainly territorial.

Various funding mechanisms are available to fund companies facing this administration or reorganisation, including post-commencement-funding (PCF), pre-packaged funding and other forms of mergers and acquisition activities specifically related to reorganisations. PCF is found in different wrappings in various regimes, and is usually legislated or otherwise regulated. It refers to funding that occurs post such companies filing for administration or reorganisation, and is used to enable the companies under the administration to pay fees for rehabilitation, carry on trade and pay for fixed costs.

Pre-packaging, on the other hand, mostly involves new or existing funders acquiring an (further) equity in the business or new company formed to acquire the assets of the business. The agreements for the acquisition of shares or assets of the business are concluded prior to companies filing for administration or reorganisation, are concluded soon after filing and once an administrator has been appointed to carry out the sale and conclude the administration process. This usually results in a quick return that saves time for the debtor company, consequently potentially saving jobs, and most importantly providing more and meaningful returns for creditors (Meier & Servaes, 2014:11).

Pre-packaged funding appears to be a growing phenomenon throughout the developed world where business rescue or corporate reorganisation is practiced, and could soon find its way into the developing world where business rescue is relatively new. It is defined by the Association of Business Recovery Professionals as an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator. The administrator puts the transaction into effect, immediately on, or shortly after his or her appointment.

What is behind this growth in pre-packaged funding, and who are the significant parties in this practice? How is it done? In examining distress funding as a whole, Harner (2008:76) argues that the presence of non-traditional lenders in troubled situations changes the dynamics of corporate restructurings.

This article is written as part of a series of articles examining the operating environment of pre-packs in regimes where it is thriving. In particular, this article seeks to examine the actual operations of pre-packs, including who is funding this wheel, why they are continuing to do so, and how they are doing it. In examining these issues, the article has to start by examining the mechanisms used in acquisitions of companies undergoing reorganisations as a whole, before proceeding to isolate the application of pre-packaging in particular. Moeller and Carapeto (2012:2) support an argument proposed by Jensen (1991:15) and further supported by Betton, Eckbo and Thorburn (2008:350–351), that mergers and acquisitions provide an effective means of resolving financial distress. It preserves business rather than companies.

For purposes of understanding the context of pre-packaging in the US, it is important to understand that what is termed a pre-packaged plan (sometimes called “pre-pack” by other authors, e.g. Takagi, 2011) occurs as part of pre-negotiated arrangements with all or most stakeholders, often in terms of Section 1126 of the Bankruptcy Code, when a debtor approaches its creditors and proposes a plan of reorganisation in advance. Thereafter, the debtor files for bankruptcy protection with the votes of the plan of reorganisation already been agreed to (Mallon & Waisman, 2011:17). A quick sale can also be conducted after notice and court hearing, free and clear from any encumbrances, under section 363(b). The law also allows the terms of a 363 sale to be negotiated prior to filing. Often debtors apply the 363 sale together with the 1126 plan acceptance.

The other regimes that were reviewed include the United Kingdom (UK), Australia and some regimes in Europe with bankruptcy laws. Throughout this article it should be understood that companies in financial distress that do not wish to be liquidated, are given an opportunity to file for bankruptcy in the US, insolvency in the UK, Australia and part of Europe, bankruptcy in other parts of Europe, and business rescue in South Africa (SA). Consequently, the process embarked on is then called reorganisation in the US and Australia, administration in the UK and parts of Europe, bankruptcy in other parts of

Europe, and business rescue in SA. As such, the above terminologies are used interchangeably in this article.

4.3 OVERVIEW OF FUNDING STRUCTURES FOR BUSINESS RESTRUCTURING IN SOUTH AFRICA

South African authorities only introduced reorganisation under business rescue in May 2011, under Chapter 6 of the new Companies Act 71, of 2008. The Act specifically allows for funding to the distressed companies that have filed for business rescue, under section 135 dealing with post-commencement-finance (PCF).

PCF is a SA version of the US type DIP financing, as it allows financing to be introduced into companies that have filed to enable access to cash flow for aiding normal operations and payments by business rescue practitioners (BRPs). BRPs would have been appointed by the distressed company immediately upon filing for business rescue.

There are no specific provisions in the Act for how a sale of a distressed business in whole or parts to third parties or even creditors should be handled during business rescue, except for the reference in section 134 dealing with the protection of property interests. This section of the Act specifically allows a distressed company to dispose of property in the ordinary course of business, at arm's length, and for a fair value approved by the BRP or if it is conducted as part of the business rescue plan. From specifically sub-section (a)(ii), it does seem possible to negotiate a sale of the business, or assets or rights of the business outside of a business rescue plan or prior to filing for business rescue. However, the details of how this should be carried out, how the rights of affected persons can be seen to be protected, how the sale value should be monitored, etc., have been left out.

Nevertheless, this glaring omission to regulate how such sales should be conducted may have been a deliberate attempt on the part of the regulators, to allow the market to dictate how they wish to conduct such sales. For that matter, the words "pre-packaged sales" are not even specifically mentioned in the Act.

Another important contextual insight relates to the market in SA that in practice, appears slow to adopt sales of distressed businesses or assets. It seems that sales of businesses or assets have only recently begun gaining some momentum, despite there not being any

recognisable distress funding markets. Many sales that have taken place have been to industry players, and even fewer seem to be recognised as being concluded on a pre-packaged basis. An investigation into the patterns of these sales, as well as how they have been conducted will be the subject of a future study.

4.4 PURPOSE OF THE STUDY METHODOLOGY

This study aims to find the pull factors for distress investors to find opportunity and remain in an investment friendly funding market. In particular, the focus is on the attraction for pre-packaged funding mechanisms and tools applied by these investors. This study follows particular funding patterns observable in these environments, and attempted to answer the following:

1. What makes some markets more vibrant for distress investments than others do?
2. What are the popular funding mechanisms used, and what value do they bring to the market?
3. Do certain funding practices act as precursors to other more sophisticated models such as pre-packaging?
4. Who are the key players in the distress funding market, especially pre-packaged financiers, and why do they stay in the game?

The table below provides a summary of the research design applied in the study.

Table 4.1: Research design applied in the study

Component	Description
Research question/ problem	What is the role, played by pre-packaging in the funding mechanisms of business reorganisations?
Context	Business reorganisations and administrations
Propositions	1. A wide variation of funding mechanisms for distressed acquisitions is found in regimes with an active, vibrant distress-funding market; 2. Pre-packaged financing complements other funding mechanisms in the rehabilitation of distressed businesses; 3. Pre-packaged funding introduces new shareholders with altered capital structures in distressed companies; 4. Third-party investments in distressed assets are driven by a perception of good value for money.
Phenomenon investigated	Pre-packaged investment methods, capital structures, timing of investments
Unit of analysis	Internationally available literature; documented practices of the distress funding markets
Logic linking data to propositions	Context, methodologies and motivation of role players, enabling legislation and prevailing practice will inform the use of pre-packs in practice
Criteria for interpreting findings	Types of funding instruments; timing of funding; change in capital structures

Source: Adapted from Yin 2003:21

4.5 RESEARCH DESIGN

4.5.1 Research approach

This study is qualitative and exploratory, and is aimed at identifying the various practices used in funding distressed assets, including the valuation methodologies, funding instruments and structures typically employed in such funding. The results obtained were used to map out the possible contribution made by acquisition-based funding of distressed assets, in particular, the role played by pre-packaged funding.

It is understood that the theory base for investments in distressed assets is the developed restructuring regimes that have established some form of distress fund market. Therefore, the studies were drawn from the literature developed on these typical regimes. This is largely a qualitative study intended to create a thematic presentation based on content analysis. Questions raised under the research objectives guided the research.

4.5.2 Research method

The data collection is guided by the research questions being answered. In following a typical format on the literature review, care was taken to specifically target financially based literature as opposed to legally based journals. Every effort has been made to use recent literature, although where necessary, older literature was used. This would apply in cases where authoritative sources were required or no new literature could be found.

As indicated in the introduction, most of the literature available was authored in the US, and had an inclination to report on US practices. This literature was used to capture the full context of the subject. In other words, the extent of the practices involved in pre-packaged funding. Many of the rest of the regime countries were found to practice some or all of the phenomena applied in the US. European literature was found and used, which applied specifically to European practices. Much of this literature was available in standard search engines.

Secondly, scientific literature on reorganisations, and specifically pre-packaging, was searched to provide detailed understanding of the methodologies applied. The source

engines for these searches included Harzing's Publish or Perish and Google Scholar, especially for titles and authors, SABINET, ProQuest and EBSCOHost.

4.5.3 Research setting

The US, UK and central Europe were identified and studied in-depth to understand their pre-packaged practices developed over recent years. The researcher identified these regimes due to their efforts to attract investments, through their recent efforts to accommodate and assist companies that have faced financial distress. Many of these regimes have been adapting to changes over the years to make it easier for business, and have made an effort to promote transparency for their pre-pack processes.

4.5.4 Data analysis

Content analysis was largely used to define a theme along the practices of pre-packaging, which have been used to develop insights for the final discussion and conclusion. Whilst only a few regimes could be studied, they could provide sufficient material on the praxis of pre-packaged funding to determine a theme. Furthermore, while there would be slight differences in application of terminology in the different regimes, the business of finance is universal to ensure an ultimate congruence of these concepts. In analysing the results, a universal language of finance was applied.

4.6 ANALYSIS OF FUNDING STRUCTURES IN REORGANISATION IN THE US, UK, AUSTRALIA AND EUROPE

Most of the literature available for studying the mechanics of investing in distressed assets in reorganisations, and specifically pre-packaged funding, emanate from the US. Even so, fewer journals and articles deal with the financial aspects of the mechanics, including funding instruments used, transaction structuring and pricing. Since this is a qualitative study, great reliance was placed on the reviewed literature for deriving insights and drawing conclusions.

In this review, we examined the nature of the environment that gives rise to pre-packaged funding, the type of institutions involved, their methods of valuation, the financial and transaction structuring involved, as well as their motivation for being active in the field. This

is addressed based on the specific countries earmarked for this study, being the US, UK, Australia and Europe in general. While many of these investment methodologies may not be regarded as typical pre-pack sales, they tend to be positioned for acquisitions of potentially distressed businesses even prior to the distress situations. Many of these investments are done through debt investments in various forms. They have been included in the study to provide a full background to distress investing, and it can be argued, in some cases they serve as a precursor to pre-pack sales.

4.6.1 The United States of America

4.6.1.1 Background

The US is among the oldest insolvency regimes in the world, and thus, according to Harner (2008:75), the practice of distressed debt investing is not new in the country and is expanding. Accordingly, distressed debt investors in the US are actively seeking investments in troubled companies, including Chapter 11 debtors, and they have the financial resources to be successful in their pursuits. These distressed debt investors typically look to acquire troubled debt or new equity in distressed companies.

Harner (2008:75) defines a distressed debt investor as an entity that buys the debt of a financially troubled company at a discount to the face value of the debt, to ultimately make a profit. This profit is usually made by reselling the debt, making recoveries of the debt (through restructuring) or converting the debt into an equity position.

The distress funding allows traditional lenders and investors to exit in favour of hedge funds, private equity and other non-traditional lenders. The new investors are generally repeat funders for several troubled companies. How this typically happens is that distressed companies increasingly face demands and pressures from their debt holders, resulting in some restructuring processes, even before the filing of Chapter 11 bankruptcy. Distressed debt investors may have typically entered into contractual covenants or promises of post- bankruptcy financing with traditional creditors, or through other statutory rights. The latter typically happens under Article 9 of the Uniform Commercial Code or Chapter 11 of the Bankruptcy Code or a combination of the previously mentioned.

It appears that many distressed debt investors in the US do not necessarily distinguish between prearranged ("pre-packaged") and post-filing, including post-commencement-financing, bankruptcy investments in terms of investing. In either case, it seems much of the investments occur through debt positions taken by distressed debt investors. In explaining the influence on the cost of financial distress by the type of ownership structure on corporate debt, Ivashina, Iverson and Smith (2016:316) have shown that where ownership of corporate debt is highly concentrated, cases are more likely to be filed as pre-packaged bankruptcies.

In this argument, many of these increases in ownership concentration occur because of consolidation of claims through purchases from trade creditors. Debt markets in the US allow distressed claims trading including bonds, bank debt, trade credit and lease, tax, insurance, and derivative claims.

4.6.1.2 Identifying the distress investors

Investors in distressed assets typically include hedge funds, Private Equity firms, investment banks, and also pension funds and other parties. Historically, capital for distress investing has been concentrated in the US. However, many of these funds are actively seeking to invest outside the US (Gilson, 2010:18).

Baird and Rasmussen (2010:657) describe distressed debt professionals as holding complicated positions, combining ordinary claims with derivative instruments, and pursuing their own agendas. They are further described as being well informed and close to the process. This sets the stage for new investors in distressed assets. This has been precipitated by claims trading, which took hold in the 1980s, and was further deregulated in 1991. This deregulated market provided an opportunity for firms' control in easier ways than normal equity acquisition could not. This created the entry for hedge funds into the distressed investing market, with several funds currently occupying that space.

Claims trading, it seems, creates a market for those seeking outsized returns. The rationale is simple, it provides easy exit for those that are ill equipped to deal with the bankruptcy process, while allowing the informed distressed investor an opportunity for easy entry and control. For an experienced hedge fund, they are more able to examine a company in full thereby being able to find overlooked value in the debt instruments used

by the firm. Furthermore, they would be able to use their knowledge of reorganisations to generate a higher return on the investment than the incumbent creditor. A hedge fund may want to advance the reorganisation plan of a distressed business, ending up with an equity holding (Baird & Rasmussen, 2010:670–671).

The first category of investors is hedge funds that specialise in distress investing. According to Jiang, Li and Wang (2012:516), hedge funds have more incentives to pursue high returns, and due to their unique portfolio category are unlikely to experience conflicts of interests with other portfolio firms. Furthermore, hedge funds in the US do not operate according to the prudency rules of other managers such as pension and mutual funds, and can consequently hold risky positions such as concentrated and illiquid securities in distressed firms in order to strengthen their hand in negotiations. Ultimately, their ability to use derivative instruments, combined with minimal disclosure requirements, provides them with additional flexibility to invest in distressed assets.

Jiang *et al*. (2012:513) state that hedge funds participate in bankruptcy investing, in various ways, including investing in debt claims and buying equity stakes in distressed businesses. Furthermore, hedge funds also acquire debts of distressed companies with a view of converting them to equity upon a successful restructuring. According to these authors, evidence suggests that close to 90% of cases in Chapter 11 have an involvement of hedge funds, making them the most active investors in the distressed debt market. The presence of hedge funds in Chapter 11 bankruptcy appears to increase the probability of successful corporate restructurings.

Rosenberg and Riela (2008:1) describe the growth of hedge funds as being in excess of that of mutual funds and the equity market as a whole. Accordingly, distressed companies have increasingly become popular targets for the funds.

Private equity funds also play a large role in distressed investments, albeit with less flexibility due to the prudency rules that apply to them. In an empirical study by Gilson, Hotchkiss and Osborn (2015:1–2) of 350 public firms that filed for Chapter 11 bankruptcy between 2002 and 2011, 75 (21%) of them sold their assets as going concern businesses, of which approximately 40% were sold to financial buyers such as private equity firms. These sales are typically done based on section 363, being essentially a section mostly

used under pre-packaged financing. Furthermore, it was found that some sales take place when buyers buy debt in exchange for a controlling stake in the firm undergoing reorganisation, with a similar effect as that of a section 363 sale.

Meier and Servaes (2014:11) argue that firms acquiring distressed or bankrupt assets earn returns greater than when they make regular acquisitions. Gilson *et al*. (2015:6) conclude that mergers and acquisitions (M&A) have become a significant part of the Chapter 11 process, given that when firms face failure they only have two options, either M&A or bankruptcy.

4.6.1.3 Funding structures for distressed assets

Distress trading occurs in virtually every kind of distressed claim, whether bank loans, bonds, trade payables, private debt placements, asset-backed securities, and real estate mortgages. Investors in these markets follow diverse strategies, such as acquiring debts of firms undergoing Chapter 11 reorganisation, or providing new debt or equity financing, or purchasing assets of distressed firms in bankruptcy courts, or even various combinations of the above (Gilson, 2010:17).

As an investor category, hedge funds appear indifferent as to whether they participate in pre-packaged investments or post-filing investments such as DIPfunding. They appear to entertain various avenues of investment in distressed companies available to them. Various strategies are employed by these funds to invest in distressed companies. As sophisticated investors, hedge funds often select distressed firms and positions on the capital structure that offer the best prospects of returns. It is important to note that the Bankruptcy Code (Chapter 11) does not explicitly regulate trading in distressed claims, which therefore leaves the investor at the same level as the original claimants (Gilson, 2010:20).

Three broad roles for hedge fund involvement in distressed companies are described as creditors, equity holders, and loan-to-own participation (Jiang *et al*., 2012:513). According to their empirical studies, pre-packaged Chapter 11 financing is directly correlated to hedge funds' loan-to-own strategy of investing. Interestingly, the higher ratio of secured debt to total debt in distressed companies is negatively correlated to the loan-to-own strategies of hedge funds. Conversion of debt to equity in a loan-to-own structure is

usually, naturally precipitated by high debt leverage, and combined with a low ratio of secured debt (Jiang *et al*., 2012:533). Evidence suggests that loan-to-own strategies are done by first investing in unsecured debt, which often experience higher recovery rates under pre-packaged bankruptcies. In general, hedge funds seem to enter the distress investment market through investing in debt, and most often unsecured creditors, where most end up as equity holders post filing (Rosenberg & Riela, 2008:5; Jiang *et al*., 2012:514, 516).

Hedge funds invest in distressed companies, in either pre-filing or post-filing for bankruptcy, and these include the following (Rosenberg & Riela, 2008:4–8):

- DIP loans – these normally allow funders entry and access to confidential information, as well as super-priority status among the creditors. In addition, the position allows them to have influence over the reorganisation process and an advantage in negotiations with debtors.
- Pre-petition secured loans – the nature of secured debt allows hedge funds the underlying benefits such as significant leverage in negotiating the distressed company's reorganisation plan and their use of cash collaterals, protection of their interest in the company's property and ability to bid in assets sales.
- Pre-petition unsecured debt – due to the status of the unsecured debt, hedge funds are able to acquire these at significant discounts. Hedge funds will typically pursue unsecured debt if they believe that the reorganisation will yield much higher returns than their cost of the debt acquisition, and that the reorganisation will be consummated quickly enough to justify their costs of holding the asset. Hedge funds mainly rely on their use of investment professionals who understand bankruptcy, and in their ability to adequately analyse the distressed businesses to project the true value of the debt.
- Pre-petition equity – Hedge funds' investment in distressed equities carries a higher risk and lower priority than in debt. Investing in distressed equity is premised on a successful outcome of the reorganisation plan, backed by negotiations with creditors, litigation or both. Some such cases are known to yield returns for investors that are more than a hundred times over the initial investment.

- Asset acquisitions – a further popular way of equity investing in distressed businesses is through the acquisition of the distressed firm's assets with the court's approval in terms of Section 363 (Gilson, 2010:23).
- Funding the plan – this involves acquiring new shares issued under the distressed firm's reorganisation plan, with proceeds either used to finance cash distributions to pre- petition claimants or retained in the company in order to support the business post- bankruptcy (Gilson, 2010:22).
- Post-emergence equity investments – in some cases, hedge funds seek to play a role as post-emergence investors by making equity investments in companies that have just emerged from Chapter 11 reorganisation. This investment is made on the basis that the infusion of new capital reduces the leverage of the emerged company and increases distributions to both unsecured creditors and shareholders. Thus, these investments provide hedge funds with the opportunity to obtain significant discounts to values estimated in the reorganisation plan, allowing potential long-term capital profits, whilst allowing them negotiation leverage concerning the plan of reorganisation. Furthermore, the funds often earn large commitment fees on such transactions.
- Credit swaps – another way is to engage in credit default swaps, which are contracts in which creditors buy credit risk protection from hedge funds who in turn sell the protection for a fee. In this "insurance" arrangement, the seller of the credit risk undertakes to pay the buyer (creditor) a stated amount upon the occurrence of a credit event such as bankruptcy.
- Other investments – one other way of participation in distressed investments is by selling short the unsecured debt while buying long the secured credit positions. This is based on betting that in the event of the company filing for bankruptcy, the unsecured debt would likely fall in value, making a profit for the short positions. On the other hand, the hedge funds might be able to extract concessions from the debtor in the event of covenants required. Furthermore, an investor can consider a "loan-to-own" strategy, which is defined by Gilson (2010:25) as providing equity at the same time as providing a secured loan outside of Chapter 11 bankruptcy, with the expectation that the secured debt would convert into controlling equity once the firm files for bankruptcy.

The primary aim thus is for hedge funds to influence the restructuring process of the distressed firm. Hence, a strong activist bias is key to successful hedge funds investment in a distressed firm. They do this through their participation in relevant committees during the restructuring process, such as the creditors' committee, or the equities committee where applicable. Overall, hedge funds seem to have a relatively long-term investment horizon. Through their empirical studies, Jiang *et al.* (2012:546) show that hedge funds' participation is associated with returns that are more favourable to shareholders of the distressed companies.

Often, some of the above-detailed investment structures enable the hedge funds to acquire the distressed businesses, having anticipated this move (Baird & Rasmussen, 2010). These include pre-petition loans and equities, section 363 asset acquisitions, credit swaps and loan-to-own investments. A popular view in the US is that the active participation of hedge funds in the bankruptcy process gives them an unfair advantage over other potential investors who are not connected to the bankruptcy process of the distressed company, because of the access to confidential information. Consequently, various measures are being developed to regulate them accordingly (Sharfman & Warner, 2014:61).

4.6.1.4 Valuation methodologies

For hedge funds in the loan-to-own structure, a good investment selection is the starting point in entering a transaction at an optimal value. In making this selection, it is important to find that "fulcrum" in the capital structure where the enterprise value is unable to fully cover the claims. This point is usually fulfilled by unsecured debt due to its upside potential (Jiang *et al.,* 2012:533). Thus, the low secured ratio is a key element in the valuation process for a hedge fund, but it is the potential for reorganisation and emergence, attracting more hedge funds. In general, hedge funds tend to pick firms with good fundamentals but bad balance sheets, meaning that although they suffer from financial distress they would have a strong operating performance (Jiang *et al.,* 2012:514).

Due to the potential upside upon emergence, it is advantageous for a hedge fund to push for a lower valuation, even once converted to equity. Rosenberg and Riela (2008:1) report

that hedge funds provide substantial returns to investors even in tight markets, with some of these returns pertaining to investments in distressed assets.

For equity investments, the valuation methodologies are generally similar to typical M&A valuations, except that the state of the organisation has to be taken into account. In comparing pre-pack practice and legislation in the US and UK, Theunisse (2014:24) argues that valuation is always marked by uncertainty, even in non-distress situations, and are accentuated during financial distress. This is due to the market being heavily influenced by the problems financially distressed businesses face, and that multiple valuations are usually required during bankruptcy. The main driver of valuations is the behaviour of firms, management, creditors and investors, who are then greatly impacted by bankruptcy proceedings.

Theunisse (2014:26–27) identifies three methods of valuation as being available for distressed companies:

- Company/market comparison – which provides an interpretation of financial performance as measured against other comparable measurements in the market. EBITDA is one such market comparison.
- Comparable transaction – this looks instead at similar acquisition transactions undertaken in the market, and the prices paid for them.
- Discounted cash flow – which analyses past cash flows, discounts them for projections using investors' expected returns then applying inflation correction (typically, Weighted Average Cost of Capital), and the results complemented or corrected with a perpetual growth value.

The problem with these valuations, and arguably the reasons for the uncertainties surrounding valuations of distressed companies, is the choice of variables for input, given the uncertainty of the company's trading environment. It is important to note that the valuation argument advanced above can also be specifically advanced towards pre-packaged financing solutions.

In comparing market values of firms that reorganise in bankruptcy, with value estimates that are based on management's published cash flow information, Moyer, Martin and Martin (2000:48–54) corroborate two of the three above valuation methods by Theunisse

(2014:26–27), with the exception of the comparable transaction methodology. Their study, however, focuses on valuation errors resulting from their comparisons. This seems to confirm the valuation uncertainty argument advanced by Theunisse (2014:24).

An additional element that usually drives valuations, even in non-distress situations, is negotiations with stakeholders. In the case of distress, creditors become an additional and very important stakeholder to deal with. Thus, Moeller and Carapeto (2012:10) confirm Hotchkiss and Mooradian (1998:240–262) that negotiations with creditors add complexity to the overall negotiations, as they also involve different classes of claimant, and often become a key determinant of the price paid for the business.

Despite the valuation methodologies and the investment strategy pursued, it appears one of the most important value creating strategies involves restructuring of equity and assets post- restructuring. Gilson (2010:473) explains restructuring of equity as changing how the firm's residual cash flows are distributed among the firm's shareholders, with the goal of increasing the overall market value of the firm's share equity. Accordingly, the commonly used techniques for equity restructuring include corporate spin-offs, equity carve-outs, and tracking stock (shares). With a spin-off, the company issues shares to existing shareholders in a new subsidiary created to house the new business free of liens, whilst the parent company remains with claims against remaining assets. An equity carve-out on the other hand, involves the selling off, of some equity for cash, usually in a public offering, with the cash available for liquidity in the firm.

Lastly, tracking stock involves isolating a claim against the profits of a particular division, without creating it into a subsidiary. It in effect creates the same equity structure as a spin-off without changing the firm's corporate and organisational structure.

4.6.2 The United Kingdom

The UK does not operate a typical US chapter 11 DIP financing for companies facing distress. What is in place instead is a super-priority lending, which essentially allows new and existing creditors to lend the distressed company further debt in order to fund its administration. Typically, such new debt receives a super-priority status. However, the idea of super-priority finance in administration seems not to have garnered enough support

to make it a popular option and seems instead to have paved the way for a more popular sale of assets or business (Aruoriwo, 2014:12–14).

Using the Company Voluntary Arrangement (CVA) and administration, an administrator is appointed to manage the distressed company. As part of this administration, the administrator can reach an agreement with creditors, either before or after filing, to sell the company or its assets to either third parties or management. Where this agreement is made before filing and the sale is concluded shortly after filing this process is called pre-pack administration (Payne, 2016:5–6). Currently, the administrator is responsible for setting the sale price and terms of the sale in pre-pack administration, and negotiating with the potential buyers (Crouch & Amirbeaggi, 2011:32). It is unclear what this valuation should look like, except that according to the guidelines by Statement of Insolvency Practice (SIP) 16 (2009), the administrator should ensure that a fair value is obtained for the sale (Conway, 2015:3–4). Since this step is meant to address transparency issues and satisfy creditors as to the fairness of the process, it can be presumed that the fairness of the value is to the benefit of creditors.

Windsor and Jarvis (2011:3) state the various steps that the administrator needs to take in ensuring fair value is obtained. This entails firstly looking at recent attempts to sell the company, failing which the administrator may seek to have the company marketed. Should the latter not be practical, the administrator is expected to obtain desktop valuations from independent valuers and obtain expert advice on recent mergers and acquisition activities in the sector, to be satisfied with the reasonableness of the price offered.

Recently, the Secretary of State in the UK commissioned a review of the corporate insolvency framework, through which a reform of the insolvency laws is proposed in the UK (Insolvency Service May, 2016:5). An important recommendation in the framework affecting this research is the recommendation concerning valuations for companies under distress. In terms of this recommendation, government is considering legislating for the use of a minimum liquidation valuation, which would essentially be a liquidation value, whenever a company or assets of a company is sold to an investor in a restructuring situation.

The idea is to ensure that creditors are not off worse than under liquidation, while providing guidance for rescue finance providers regarding the remaining value that can be secured as part of the plan. The point made is that the latter should not be paying for potential future earnings they would be party to creating. Government is currently reviewing the recommendations, following consultation with stakeholders. Interestingly, it seems many of the stakeholders in the UK have rejected the proposed changes regarding valuation, on the basis that there is a sufficient market for distress investing and thus, no need for further incentives (Insolvency Service September, 2016:10). It remains to be seen what the implementation of the overall recommendations will look like.

The purchaser of the distressed company's business may be new to the company or a competitor, and may even be the existing management of the company. A typical structure of such acquisition is that a new company is formed to acquire the business or assets of the company under administration. According to Conway (2015:2) in 2011, the Insolvency Service (an insolvency agency) estimated that 25% of companies that entered into administration in that year used the pre-pack procedure.

Conway (2015:2) further mentions that the survey also revealed that nearly 80% (or over 70% according to Windsor & Jarvis, 2011:4) of the pre-pack sales are to purchasers with existing links to the business being sold, such as current and past management or shareholders. The balance of sales are, accordingly, to competitors and specialist investors, sometimes even secured creditors who have formed special purpose vehicles (SPVs) to acquire such assets (Windsor & Jarvis, 2011:4).

4.6.3 Australia

The Australian rescue regime does not formally address the sale of businesses under distress, leaving it to market forces. There are however, guidelines regulating the behaviour of members of the Insolvency Practitioners Association to behave ethically while dealing with matters of sales of distressed businesses, in particular with pre-pack sales (Crouch & Amirbeaggi, 2011:32). Using the Corporations Act and Voluntary Administration, distressed companies are able to embark on a process of reorganisation by claiming insolvency.

The companies can negotiate with potential buyers for the sale of the business or assets to a newco prior to filing for administration under a Deed of Company Arrangement (DOCA). Thereafter the debtor company then appoints an Insolvency Practitioner whose responsibility is to review the sale terms and ratify the sale. To show independence of value, the directors also have to appoint a reputable valuer, who often is an independent audit firm, to conduct a valuation, upon which the sale is concluded (O'Brien-Palmer, 2012:2). Similar to the UK, there does not seem to be any pre-pack sale activity on the credit side in Australia.

4.6.4 Europe

Within Europe, the European Commission embarked on an initiative to ensure that all member states have in place adequate mechanisms to deal with distressed but viable businesses (Payne, 2016:13).

According to Clowry (2010:51), there has been a resurgence of debt-for-equity swaps as a corporate rescue tool throughout Europe. This is characterised by creditors receiving equity interest in exchange for a reduction in debt claims against the debtor company. These are generally used by classes of secured creditors and debenture holders. For these creditors, the strategy offers a streamlined process of acquiring the business while eliminating the structural risks of competitive bidding in a sale process (Goldberger, 2010:97). Debt-for-equity swaps usually occur because of a bankruptcy filing. However, it can also be applied prior to debtors filing for bankruptcy or reorganisation, thereby lending themselves as part of pre-packaged arrangements. For instance in Germany, a debtor company can negotiate an insolvency plan that includes a debt-for-equity swap prior to petitioning for insolvency, in a manner similar to the UK pre-pack administration.

The fundamental issue with debt-for-equity structures is determining the value of the business or assets of the debtor. A fulcrum needs to be reached where the enterprise value of the debtor company can no longer fully cover the creditor claims. At that point, out-of-the-money junior creditors may be disenfranchised to the point where they have no economic interest. This leaves room for courts to assess the valuations because of inter-creditor disputes that arise (Clowry, 2010:56).

In certain jurisdictions, when debt-for-equity swaps cannot be implemented due to lack of consensus, the alternative may be an enforcement of share security, which requires the enforcement of a security interest over that of the existing shareholders. This is done by creating a holding structure, Bidco, over the debtor company, structured in a similar manner to the newco structure in the UK. Creditors agree on the participation of existing lenders in the debt and equity of the new Bidco structure in advance of any bid (Clowry, 2010:55).

In essence, the creditors agree to release their claims against the debtor company/borrower in consideration for the transfer of the secured shares to Bidco. These creditors, who are now share-owners in the new Bidco structure, would essentially have converted their debt to equity, i.e. without any consideration paid. Alternatively, as part of the consideration, cash may also be required for the shares. In either case, in order to preserve value and confidentiality, the acquisition could be completed on a pre-pack basis, with terms of the acquisition transaction agreed in advance of an enforcement of the sale of the debtor company or its assets into Bidco. In common law jurisdictions, such a sale would be completed by a Receiver who has been appointed by a trustee, under a sale and purchase agreement without the need for a public auction. The receiver will be responsible for undertaking the valuation of the shares to ensure reasonability (Clowry, 2010:55).

The French regime seems to have favourably adopted the European Commission's initiatives, and have introduced reforms that have made it easier to finance companies facing bankruptcy. The most relevant development is the introduction of the Order of 18 December 2008, which, according to Vermeille and Pietrancosta (2010:8), "*provides a very advantageous option for the company*" in that it allows the conversion of debt into equity by minority creditors. By "*replacing the requirement for the plan to be approved by creditor classes on a double majority with headcount and value of claims, with a requirement for a double majority with value of claims only*", this practice evens out the analysis of power. This debt to equity conversion essentially allows loan-to-own structures to be implemented, as many creditors ultimately insure their debtors' books or sell them in a securitised form to third parties.

The injection of new funds into the market created by the arrival of non-bank lenders, institutional investors such as pension and hedge funds, has also encouraged this

practice. As in the US with a vibrant investor market, new debt instruments have now been introduced, such as collateralised debt obligations (CDOs) or collateralised loan obligations (CLOs). The selling of loans to the secondary market through syndication and securitisation has been among the by-products of these new reforms. Furthermore, derivative instruments are being introduced into the market such as credit default swaps (CDS), with these essentially used as a form of “pre-packaging” by buyers of the debt instruments (Vermeille & Pietrancosta, 2010:5).

Nevertheless, the prevailing method of investment in distressed businesses in many parts of Europe is mainly based on direct equity acquisitions. Sweden operates an auction bankruptcy system, which requires an immediate sale of the distressed company in order to reduce the period of bankruptcy process and increase chances of survival. On average, auction sales are resolved within two months. Once filed, a trustee is appointed, whose task is to oversee the sale of the business in an auction process, in a piecemeal or company as a whole. Valuation for this auction is based on a liquidated piecemeal value calculated by industry experts. This break-up value can be improved on by bidders willing to put a premium to the liquidation value (Eckbo & Thorburn, 2009:40). A pre-packaged sale is conducted by debtor companies negotiating a sale before filing, which needs to be approved by the trustee. Sweden further does not have provision for negotiating secured debt claims, with the result that no debt sales occur.

The Dutch have recently introduced pre-packs as part of the process of dealing with bankruptcies. The draft Act on the Continuity of Companies I allows for the appointment of a silent trustee to oversee the pre-pack proceedings, leading to a sale of the distressed company’s assets to a buyer, who then continues the business by offering key personnel new employment contracts (Verwey, 2014:35). This structuring seems similar to the UK and Australian pre-pack structuring. Because valuation methods and practical experience have mostly been developed in the US, Theunisse (2014:26–27) argues that the UK and Dutch seem to apply the same principles, in many respects.

4.7 DISCUSSION

Many countries have adopted different practices for funding the acquisitions of distressed businesses, in line with what they deem suitable for their circumstances. In turn, the

suitability of the laws and regulations has served to dictate the pace of advancement of the distressed funding market in each regime. Consequently, certain countries such as the US and, to some extent, France, have developed sophisticated distressed funding markets, whilst Sweden seems to operate a singular model of funding. Many of the distress funding mechanisms, particularly for acquisitions, straddle either or both sides of the filing process, thus either used as pre-packaged funding or after the filing process commenced (post-filing). The table below specifically illustrates the available pre-pack sales structures and models, observed in the literature. Many of these sales structures do not constitute typical sale of shares or assets for cash, but ultimately often include legal change of ownership through conversion of securities.

In broad terms, the focus of pre-packaged funding models appears to be classifiable into two major categories, namely debt and equity. Equity funding models appear to be more widely used throughout the advanced reorganisation regimes, and range from simple acquisitions by special-purpose-vehicles (SPV) setup for purposes of acquiring the distressed assets, to the more imposing enforcement of share security by affected creditors. In the case of the former, industry buyers, or existing management, or even unrelated institutional investors such as hedge funds and private equity firms take up these positions after negotiations with management/shareholders. These are discussions taking place before the distressed debtor company files for reorganisation or business rescue. Sometimes, even secured creditors participate in pre-petition equity.

Sales of business or assets into a “newco” structure seem to be the model of choice for pre-packaged funding in the UK, Australia and Netherlands. The acquired assets are then usually priced at going concern valuations, although adjusted for the effects of insolvency (Theunisse, 2014:26–28). These valuations include a Discounted Cash Flow (DCF), market comparisons using earnings multiples, and comparable transactions. The mechanisms that are put in place to regulate the reasonability of these valuations include, stalking-horse bid (in the US), the use of an administrator for valuations in the UK, and the appointment of an independent valuer in Australia, among others. Sweden applies an auction process to facilitate the transaction, although a generally accepted valuation there is a liquidated piecemeal value. The idea therein is that buyers should not be left worse

off than if the company had been liquidated (Eckbo & Thorburn, 2009:40). This is probably the most conservative valuation in reorganisations.

Debt funding models appear even more complex than equity models, mainly because many of them are designed much prior to a known event of bankruptcy or distress. By their definition, pre-packaged debt funding instruments are credit instruments purchased in anticipation of a distress event or insolvency. Universal law dictates that a creditor who is being owed by a debtor assumes superior rights over the debtor's assets in the event of payment default. This is especially true for secured creditors who would have specifically secured their loans against specific assets of the debtor.

The concept also applies to unsecured creditors, albeit that they are only entitled to residual assets of the debtor after allocation to secured creditors. In either case, their claims supersede those of shareholders, rendering them with superior rights. The transactions involve mostly hedge funds, who look to invest in loans to debtors, by either out-rightly buying the debt from the creditors (in a factoring transaction), or selling insurance on the loans against default. In either case, there will be no further action from the hedge funds if no default event happens.

Secondly, they tend to involve more sophisticated instruments and complex valuations. Even a simple pre-petition debt requires a seasoned investment professional from a hedge fund, who also understands credit, to determine the valuation, which happens upfront before an event of default may or may not occur. A debt-for-equity transaction occurs either pre- or post-filing of bankruptcy. In the event of pre-filing, the pre-pack transaction is conducted in a similar manner as an equity funding structure, i.e. once there is a view that the company would file but prior to filing.

The buyer, usually a hedge or a pension fund, would rely on the expectation that they would be influential in the development of the business plan of the reorganised debtor company. The valuation here is more complex and uncertain, as it involves the buyer finding a fulcrum at which to determine the price they would be willing to pay. This fulcrum value has to be reached in order for the transaction to make commercial sense for the buyer.

A credit default swap (CDS) appears to be the most complex instrument, as it involves credit derivative instruments, which can only be actuarially valued, way before the possibility of a default event. CDS' are prevalent in the US, with its sophisticated distress fund market, with some countries in Europe beginning to open up to them, particularly France. The CDS involves a hedging process over the investment instruments, in this case, different classes of creditors. As can be expected, only hedge funds would have an appetite for and ability to execute on such transactions. Debt funding models enable the investor to have access to inside information during insolvency proceedings, which gives them leverage to influence the resulting business (rescue) plan.

A summation of the funding models applied globally is provided in the table below.

Table 4.2: Pre-pack funding models' summary

Funding type	Typical funders	Transaction structure	Typical countries	Suitable valuations	Valuation custodian	Instrument/ method
Pre-petition equity	Hedge funds (US), Private equity, Management, Industry buyers	Newco SPV; Bidco	US, UK, Australia, Netherlands	Going concern (adjusted)	Independent valuer (Australia); (UK)	Cash acquisition
Pre-petition debt	Hedge funds	Form of insurance	US, France	N/A	Hedge fund professionals (done upfront)	Debt instruments
Auctions bankruptcy	Banks prohibited	SPV, existing comp.	Sweden	Liquidated piecemeal value	Industry expert	Cash acquisition

Funding type	Typical funders	Transaction structure	Typical countries	Suitable valuations	Valuation custodian	Instrument/ method
Debt-for-equity	Hedge funds, Pension Funds	N/A	US, Europe	Fulcrum debt value	Hedge fund professionals Courts (in disputes)	Debt instruments
Credit default swaps	Hedge Funds	Insurance transaction	US, France	N/A	Actuarial (done upfront)	Fixed income derivatives
Enforcement of share security	Creditors	Bidco SPV	Europe	Going concern	Receiver (trustee appointed)	New issue of shares for credit

Source: Own compilation

4.7.1 Variation of funding mechanisms found in vibrant distress funding markets

The countries that have been studied for the purposes of this research, being the US, UK, Australia and Europe in general, have fairly established reorganisation regimes, and have been applying pre-packaged funding for varying periods. Many of the newer regimes among them have applied some of the principles observed in the other more established ones, thus together giving a more rounded impression. Generally, all regimes that have adopted reorganisations or business rescue in their insolvency provisions recognise the need for financial assistance for such distressed companies. The financial assistance legislated for, differs in each country, as does the number of ways this assistance is usually provided.

There is a great variety of ways in which this funding is provided, including using either equity or debt instruments, whether post-filing or pre-filing of bankruptcy. Countries that apply a variety of these investment methods into distressed companies, like the US and France, seem to have an established market for such funding variations. Hedge funds in both countries seem to play a dominant role in funding or buying up distressed businesses in both countries. These funds seem to have developed a reputation for venturing into riskier transactions with a penchant for higher returns. They are furthermore, not burdened with similar prudency rules that regulate private equity firms. What seems to be clear though is that where hedge funds are active in the market for funding distressed assets, the market does appear vibrant.

On the other hand, while countries such as the UK, Australia, and the rest of Europe do seem to have enough options in securing buyers for distressed assets, many of these seem to prefer equity related asset acquisitions such as post- and pre-equity funding. With the exception of the US, hedge funds do not seem to be dominating the market.

It is not too clear whether the variety of funding mechanisms is a result of this established market for funding of distressed assets, or whether the latter influenced the former. However, there seems to be some positive correlation between the wide variety of funding mechanisms and the vibrancy of the distress funding market. About funding mechanisms, the study confirmed the proposition as follows:

Proposition 1: A wide variation of funding mechanisms for distressed acquisitions is found in regimes with an active, vibrant distress funding market.

4.7.2 Pre-packaging as complementary funding to other funding mechanisms

Furthermore, many of the equity related investment products are in principle, applicable during pre- and post-bankruptcy filing. It seems that funders often apply pre-packaged funding because it gives them some advantages, but would also fund or acquire assets after they have filed for bankruptcy. Hedge funds are known to straddle both lanes with ease, as they are also active in the debt related funding or acquisition market. For such funders, acquisition of distressed assets is the primary goal, with both pre-packaging and post-filing used as complementary methodologies.

Debt related instruments for funding or acquiring distressed assets are mostly used in pre-packaged funding mechanisms. These are usually arranged way before the known occurrence of such an event of insolvency. Countries that do not apply equity funding instruments often do not apply debt instruments as well. In other words, debt instruments, which are mainly pre-packaged funding instruments, seem to exist only when post-filing equity instruments are already in place in distressed acquisitions, thus complementing them.

It therefore appears that where pre-packaging occurs, it often complements other funding mechanisms. This study thus proposes as follows:

Proposition 2: Pre-packaged financing often complements existing traditional funding mechanisms in the rehabilitation of distressed businesses.

4.7.3 Introduction of new shareholders with altered capital structures in pre-packaging

The thesis of pre-packaged funding is that it is an acquisition of assets or a whole business of a distressed company. Consequently, it introduces new capital into the structure and thereby alters it with new equity either replacing debt or as an addition to the existing debt, which in itself alters the debt-to-equity ratio. One can further argue that the debt structure will be further altered down the line as the new capital repays it.

As seen in Table 4.2, in all the cases where pre-packaging is introduced, there are new shareholders that come along with it. In many of the cases, the new shareholders are completely new to the business being financed, including Hedge funds, private equity firms, industry players, and management in some cases. Where creditors come in as new shareholders, these may be existing creditors such as in the enforcement share security or pre-petition debt, or new creditors altogether such as in CDS and debt-for-equity transactions. In the end, the following is proposed:

Proposition 3: Pre-packaged funding often introduces new shareholders and altered capital structures in distressed companies.

4.7.4 Perception of good value for money as a driver of third-party investments

Valuation plays a key role in investment decisions of investors in distressed assets. According to Harner's (2008:75) definition, a distressed debt investor is an entity that buys the debt of a troubled business at a discount to its face value in order to ultimately profit from it. In order to increase the chances of profitability, the entity has to ensure that the entry price is set favourably from the onset of the transaction. This issue applies to both equity and debt driven acquisitions.

There, however, does not seem to be any uniformity in the valuations offered around the world regarding distressed acquisitions. On the equity side, valuations vary from one extreme in Sweden's auction bankruptcy of a piecemeal liquidation value, to a going concern value in the enforcement of share security in other parts of Europe. A pre-petition equity offers some middle ground with an adjustment being allowed to the going concern value.

From an acquisition through debt perspective, actuarial calculations have to be done by seasoned investment professionals employed by hedge funds in order to ensure optimal values for the instruments. Knowledge of the creditors' market backed by an understanding of bankruptcy is a useful skill in conducting proper valuations, especially since many have to be conducted way before the occurrence of the default event. In addition to that, a fulcrum also has to be determined during the event of default. A further tool in the shed for acquisitions through debt instruments is the negotiations with creditors. A good negotiation can always assist to achieve a good valuation. This study concludes therefore that:

Proposition 4: Third-party pre-packaged investments in distressed assets are driven by a perception of good value for money.

In conclusion, to agree with Meier and Servaes (2015:22), investors (in a pre-pack) only invest once their valuation calculations point to a profit befitting the risk incurred in acquiring the distressed asset, as opposed to regular mergers and acquisitions.

4.8 MANAGERIAL IMPLICATIONS

Pre-packaged financing is in essence the acquisition of the business (as a whole) or assets (in whole or parts) of a company in financial distress. It normally takes place where acquisitions of such assets are permitted, either legally or by practice, after filing for bankruptcy. In those environments, pre-packaging occurs as a complementary and possibly even more effective method of acquisition of such assets. The advantages of pre-packaged financing are numerous, including the speed of execution, avoidance of reputational damage for the distressed company, and preservation of key employees.

Earlier studies indicate that pre-packaging is a market driven phenomenon. When one understands that pre-packaging is another mechanism of acquiring distressed assets, and often follows when the post-filing mechanism is in place, it becomes easier to predict that as post-filing acquisitions occur, pre-packaging is also possible earlier down the line. Once the funding market becomes used to acquiring assets post-filing for bankruptcy, they will find it easier to start implementing pre-packs. With the global investment market at our disposal, hedge funds as major participants in the distress funding market will begin to find new avenues and markets. A further study needs to be undertaken to understand what attracts experienced international hedge funds to new markets for distress funding, including SA. A further study for SA is to understand the extent of post-filing acquisitions, as well as whether they may influence or facilitate the entry into pre-packaged acquisitions.

The market for debt-based acquisition instruments encompasses relatively complex models, but they can easily be exported to countries where opportunities exist. This is a glaring opportunity for business, especially financial services companies in new business rescue or reorganisation environments. There is no doubt that this is a growing market.

Previous studies have been used to discuss the prevalence of pre-packaged financing throughout the world, especially in countries with established practices. In this study, the complexities of investing in distressed companies were explored, especially regarding the financial complexities. Much of the research that has been completed thus far specifically details the legal environment and complexities accompanying them. This study, however, is pivoted on an improved understanding of financial structures and valuations applied in these different structures, including the profile of participants in distress funding.

Ultimately, once the legal complexities have been dealt with, the financial intricacies will determine pre-packaging to be practical, or not.

Regimes that are aware of pre-packaging and likely to implement it, in perspective, might not be ready either from a regulatory perspective, or from a financial sophistication to handle the myriad of transactions. As can be realised from the study, the investment into distressed assets offers many avenues of entry in either equity or debt. Even using those avenues requires different skills from the investor markets. A country such as the UK, with a more established insolvency (reorganisation) regime, has not yet ventured much into debt instruments for investment in distressed assets. One cannot, however discount the possibility of this sophistication creeping in over the years in the UK, as well as in countries new to reorganisations, such as SA. In fact, a guideline in this regard could be that once investors become very active in a market, there may be openings for new ideas and therefore diverse financing products.

For SA, the hedge fund market has not yet developed well enough to enter the distress funding market, whereas it is the biggest participant for distressed investments in the US. A further study may need to investigate the constraints of hedge funds in entering this market in SA.

4.9 CONCLUSION

In search of directives for South African application, this study focused on the financial intricacies of restructuring based on global models. Specifically the research intended to isolate pre-package funding models in terms of valuation and transaction structuring. It is clear from the findings, firstly, that while pre-packaged funding is used extensively in many regimes, and it is often applied alongside post-bankruptcy filing (post-filing) funding mechanisms by active participants in the distress funding market. Thus, most established distress funders use pre-packaging inter-changeably with other post-filing mechanisms. With the development of the M&A market in the distress environment in SA and the applicable equity instruments, a course may be chartered for the future development of pre-packs.

Secondly, it can be established conclusively that sophisticated funding mechanisms are used in both pre-packaged and post-filing funding. Most notably, pre-packaged funding strategies, structures and valuation methods tend to be more sophisticated due to the very early timing of the process and the related greater uncertainty and risks. In adopting pre-packaging, newer regimes like SA need to be cognisant of the required resources, including the highly developed analytical and negotiation skills.

Thirdly, while it may not be clear whether a variety of funding mechanisms influence the vibrancy of the distress funding market or vice versa, it is clear that there is often a correlation between the two. The role of hedge funds in developing a vibrant distress market in a regime such as SA would then need to be established, given the dominant role these play in more developed markets.

Specifically in the SA context, pre-packaging is not yet officially documented. However, post- filing acquisitions appear to be taking place, albeit in isolated cases. An empirical study into the nature of these acquisitions, the participants thereof, as well as whether the benefits are being reaped, needs to be undertaken. Furthermore, whether such post-filing acquisitions could be a precursor to pre-packaged funding should also be conclusively researched.

The role of hedge funds (or absence thereof) in the future of pre-packaged funding needs to be investigated for SA, as well as in other potential global markets. In other words, what are the antecedents to a hedge fund driven vibrant distress funding market?

CHAPTER 5

ARTICLE 3: EXPLORING THE ROLE AND EXTENT OF SALES TRANSACTIONS IN BUSINESS RESCUE: A PRECURSOR FOR PRE-PACKAGING?

Status on the publication of the article:

Title of article	Exploring the role and extent of sales transactions in business rescue: A precursor for pre-packaging?
Authors	S. Mkhondo & M. Pretorius
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5.1 ABSTRACT

Researchers have continually pointed out that sales of distressed businesses or assets, especially during bankruptcy, have become more frequent over time. Despite that, the recently established legislation in the South African (SA) business rescue (or bankruptcy) does not refer to sales of distressed businesses. This article examines distressed sales that have taken place since the introduction of business rescue in SA in May 2011, despite no reference in legislation, to see if these could be indicative of a trend towards pre-packaged sales in the business rescue environment. Based on a qualitative study examining successfully terminated business rescue cases where sales of businesses or assets were concluded, it was found that pre-packaged sales were in fact already occurring in business rescue, although not yet formally recognised by the legislation, or even by the recording mechanism within the regulatory body or the courts. The implications are that in the absence of specific legislative guidelines, business rescue practitioners (BRPs) are left to their own wits in applying fairness principles when dealing with pre-packaged sales.

Key words: business rescue, post-commencement-finance, pre-packaged sales, distress investing, successful termination, M&A in bankruptcy, pre-filing, post-filing, substantial implementation, restructuring, leverage, information asymmetry

5.2 INTRODUCTION

It is generally accepted that most businesses go through a typical life cycle, from inception to stagnation (low or no growth) or even eventual demise. This is a normal business life cycle, unless certain interventions occur along the way. While some of the cycles are inevitable, some could be avoided through anticipating and dealing with the challenges as they come. Many of these challenges occur due to some form of industry pressures, management incompetency, technological advances that were not considered, and so forth. These sometimes manifest as cash-flow crunches, illiquidity, or technical insolvencies. The implications of these manifestations could be mild or severe, sometimes resulting in the companies' liquidations.

Regimes around the world have made it possible through legislation to introduce some form of intervention by affected parties, such as creditors, shareholders, suppliers, etc., or even third parties who may be incentivised to intervene. One of the most widely known legislations in this regard is the United States (US) Chapter 11 Bankruptcy Code, which caters for all manner of interventions from a "simple" informal workout, to bankruptcy restructuring, as well as eventual liquidation if all else fails. In South Africa (SA), the same are dealt with in separate legislations. While informal restructuring or turnarounds, through legislation on schemes of arrangements and takeovers, and formal business restructuring through business rescue legislation, are dealt with in the Companies Act, liquidation is treated in a separate act, the Insolvency Act 24, of 1936. It is important to point out at this stage that bank insolvencies are dealt with separately under the Banks Act 94 of 1990.

The turnaround and business rescue legislations are respectively called 'Fundamental transaction, takeovers and offers' in Chapter 5, and 'Business Rescue and compromise with creditors' in Chapter 6, in the Companies Act 71, of 2008. Business rescue was introduced in South Africa (SA) in May 2011, through the same Act, and among other things, specifically deals with the provision of finance for companies undergoing business rescue, in the form of post-commencement-finance (PCF) in section 135. PCF is intended to provide much-needed cash flows into the distressed business in order to cover working capital requirements, fees for BRPs, and any other costs related to the process of business rescue.

Moeller and Carapeto (2012) point to a view by Jensen (1991) and confirmed by Betton (2008), that M&A is an effective means of resolving financial distress. They also point out that research from the late 1990s into the 2010s indicates that sales of bankrupt firms have become more frequent over time. According to the authors, Carapeto, Moeller and Faelten (2009) showed that almost 25% of the 12 339 deals transacted between 1984 and 2008 involved distressed or bankrupt targets. Quoting Clark and Ofek (1994), the authors further argue that research on distressed acquisitions is scarce on a global scale, as most research still reflects acquisitions of distressed companies outside of bankruptcy (business rescue in the case of SA). Accordingly, the above evidence points to the importance of studying the distressed acquisition market as a topic within mergers and acquisitions (M&A).

Regimes that practice the acquisitions of distressed assets are often guided by the regulations governing bankruptcy, as in the US, UK and Canada. Other regimes such as Australia conduct M&A outside of the bankruptcy laws, but the practitioners conducting M&A are then regulated by their practitioner organisations in terms of independence requirements preventing practitioners from taking appointments where they may be conflicted. This is then complimented by the Corporations Act duty of care requirement from controllers administering a sale (Crouch & Amirbeaggi, 2011). In South Africa, the Companies Act does not refer to M&A activity. The closest legal equivalent to M&A in the Companies Act is mergers and amalgamations, but this does not specifically deal with business rescue related transactions. In fact, sections 112 and 115 specifically exclude disposals of all or the greater part of assets or business in transactions that are pursuant to an adopted business rescue plan. Should this disposal be in pursuit of an adopted business rescue plan, it appears it can be dealt with in terms of section 134(1)(a)(iii). The latter section, however, does not go far enough in detailing the process to be followed in executing the sale of property during business rescue.

However, in the event that the disposal is prior to the commencement of business rescue proceedings, the requirements of sections 112 and 115 have to be met, namely that a special resolution of shareholders in accordance with the terms of these sections, is required to approve the sale. Furthermore, these same requirements need to be met where the disposal is made after commencement of business rescue proceedings but prior

to approval and adoption of a business rescue plan, together with the requirements of section 134(1)(a)(ii). The former type of disposal is unlikely to be recorded or filed as part of business rescue if consummated at this stage. However, should the disposal be agreed to after the special resolution has been passed (as per sections 112 and 115), but implemented during business rescue under section 134(1)(a)(ii), it may need to be implemented in terms of section 137. In that case, it can be filed either under Cor 125.2 (as no longer financially distressed), or Cor 125.3 (transaction has been substantially implemented, with plan drafted and approved accordingly), or Cor 125.1 (being a progress report). In the latter case, though, it may seem the BRP might have to eventually file under substantial implementation, i.e. Cor 125.3., unless they believe that the terms of the plan have not been substantially implemented, despite the sale of business and the approval of the plan. It needs to be noted that Practice Note #10 of the Turnaround Management Association of South Africa (TMA_SA) when discussing Substantial Implementation, notes that complete implementation of every single aspect of the plan may still be underway and subject to the provisions of the BRP plan, while filing for substantial implementation. Therefore, complete implementation of every single aspect of the plan is not a necessary requirement for substantial implementation.

Furthermore, section 113 specifically states that companies involved in an amalgamation or merger should satisfy the solvency and liquidity test. This requirement, however, does not apply if the amalgamation or merger occurs as contemplated in terms of an approved business rescue plan.

Furthermore, while section 137 of the Act allows a transfer of shares in the ordinary course of business or in terms of an approved business rescue plan, it does not elaborate on the mechanisms of the transactions. Even more so, the use of pre-packaged funding in mergers and amalgamations sections of the Act is not specifically mentioned. Pre-packaged funding or pre-packs is an important part of formal restructurings or business rescue (in the case of South Africa), and has found wide acceptance in many established restructuring regimes. It is therefore important that it be looked at closely, and its role be monitored for compliance to fairness principles for all stakeholders. The meaning of pre-packs is best captured by the Association of Business Recovery Professionals (in drafting the SIP 16) as an arrangement under which the sale of all or part of a company’s business

or assets is negotiated prior to filing for bankruptcy (or business rescue) and appointment of an administrator (or business rescue practitioner). The administrator then effects the transaction immediately upon appointment, or shortly thereafter. The idea is that this results in a quick return for the debtor company, while potentially saving jobs and providing meaningful returns to creditors (Meier & Servaes, 2014). This advantage of speed and improved prospect of success seem to be the catalyst for a market-driven establishment of pre-packs (Mkhondo & Pretorius, 2017). According to Wellard and Walton (2012), the ability to appoint administrators with minimal formalities has also contributed to the widespread use of pre-packs in the UK. Accordingly, since sales appear to be an important part of “pre-packs” according to the above descriptions, it seems fitting that sales in pre-packs could be used as a proxy when investigating the application of pre-packs, especially in SA.

It is in this context that this study is aimed at investigating the role played by sales during substantial implementations in business rescue terminations, in influencing or pre-empting the possible introduction of pre-packaged funding. Substantial implementation is as defined in section 132 (2) of the Companies Act 71 of 2008, and this would be indicated by the companies successfully (or substantially) implementing business rescue, and not entering liquidation. Such companies would proceed to run under old or new management outside of the business rescue. Furthermore, preliminary evidence suggests that this funding also plays itself in the different arenas of business restructuring, including during Scheme of Arrangements and liquidation processes followed in the Insolvency Act.

The research questions to be answered therefore are:

Firstly, have sales of distressed businesses or their assets played a role in substantial implementations of business rescue processes? Secondly, could some of these sales possibly have been negotiated prior to filing for business rescue, thus qualifying as pre-packaged funding?

The investigative questions to be explored include:

1. Are there sales of businesses or assets being concluded in BR as part of business rescue plans?

2. Does there appear to be a trend of acquisitions of businesses or assets in BR as a solution?
3. Do the capital structures of these companies that are sold in BR indicate a high degree of leverage?
4. At what point of the BR process were negotiations begun on these sales?
5. Were the buyers of the distressed businesses or their assets aware of the distress situation of their targets prior to filing?
6. How many of these buyers started their acquisition negotiations prior to the businesses filing for BR?
7. Were BRPs aware of negotiations with buyers upon their appointments?
8. Were buyers complete outsiders to the businesses or assets they bought?
9. Were the acquisitions done using equity or debt related instruments?
10. Would new shareholders (buyers) be allowed to approve the business rescue plan upon acquisition?
11. What is the typical profile of buyers of such distressed businesses or assets?
12. What are the practical and legislative obstacles to such acquisitions?
13. Are the acquisitions of these businesses or assets done at favourable price terms to the acquirers?

In undertaking this research, an assumption was made that pre-packs are not currently applied in the SA context, since they have not been formally recorded as such.

5.3 LITERATURE REVIEW

Some available literature provides insights into funding for distressed or insolvent companies in the main. Most of this literature is however, not based on the South African scenario, but drawn mostly from internationally based journals for dominating regimes. In utilising this material, an attempt was made to draw a parallel for South Africa, in order to enrich the local context. This literature was drawn from environments where business rescue has been in practice for a while, as well as its link with the successful termination of business rescue processes.

Initially, the review was made open to examining both pre-filing and post-filing funding mechanisms in order to capture the full implications of the funding. Pre-filing funding was

ultimately identified and discussed to give full context to the subject. This article deliberately excluded discussions regarding priority lending, defined locally as post-commencement funding (PCF). Only funding that relates to sales of the distressed assets or businesses to “new” owners, who would in turn fund the assets or business in their own terms was considered. Terms of these funding often include change of leadership, capital restructuring, business rescue plans influenced by new shareholders, etc. In other words, this funding is the activity of mergers and acquisitions (M&A) being done under business rescue or bankruptcy protection.

In examining the use of M&A in bankruptcy, Gilson, Hotchkiss and Osborn (2015) note that the years following the onset of the 2008 financial crisis posted a spike in M&A activity under Chapter 11 Bankruptcy in the US, compared to the preceding 20 years. In their evidence, based on an extensive analysis of bankruptcy court documents, they reveal that 53% of the cases in a sample of 350 public firms involved a sale of some kind. The authors have renamed restructuring financing (PCF in SA terms) as “exit financing”. They argue that in periods of tight credit (such as during a financial crisis or other industry related shock) an independently restructured firm is more likely to be credit constrained and of lower credit quality than a potential acquiring firm. Therefore, in periods of tight credit, exit financing is more likely to be unavailable or costly, compared to acquisition financing. This is what leads to greater M&A activity in bankruptcy. Furthermore, in a situation possibly peculiar to the US, the sale of a distressed business under section 363 (created for such sales) increases the attractiveness of selling assets by reducing the risk to buyers and increasing the proceeds of sales to the sellers.

In citing Hotchkiss and Mooradian (1998), Moeller and Carapeto (2012) state, the M&A target firms in bankruptcy are typically highly leveraged and in financial distress. This supports the view by Gilson *et al.* (2015) that such firms will likely be credit constrained and of lower credit quality. The authors further support the view that acquisitions of distressed and bankrupt companies tend to increase following major external crises. Interestingly, based on a study by Carapeto *et al.* (2009), Moeller and Carapeto (2012) point out that in distressed acquisitions, acquirer and target typically belong to the same industry. The assertion supports an argument that firms outside the industry are deterred from bidding due to asymmetric distribution of information. This argument seems to fly in

the face of a very vibrant distress funding market dominated by hedge funds, which typically take positions in targets that are typically outside of their industry, financial services. In a study to determine the value of fund participation in Chapter 11 reorganisations, Harner, Griffin and Ivey-Crickenberger (2014) report, hedge funds, private equity firms, and other alternative investment funds are invariably key players in corporate restructurings. They argue that whilst many commentators perceive distress investors as raiders or vultures, some view their intervention and activism as adding value in the restructuring process. Their studies show that the presence of such activist investors as hedge funds, private equity firms, etc. is significantly associated with the survival of the distressed company. Of particular interest is that whilst there was not enough statistical power (due to the limited number of cases) to correlate a relationship between DIP financing (similar to SAs PCF) by the funds and emergence (successful termination) from bankruptcy, some patterns were identified. Of importance to this study is that these funds tend to use DIP financing as a tool to achieve emergence (termination). This is important especially in the SA context where it appears that regular lenders tend to be reluctant to fund PCF. It seems such funds, once in place, could have an appetite for funding PCF.

In analysing distress investing, Moyer, Martin and Martin (2012) state that, distress investing is a critical part of US capital markets. They argue that distress investors become a valuable source of liquidity by allowing original lenders to exit their investments, which were anticipated to be relatively low risk and performing debt instruments, and mitigate their exposure to the invariably risky process of bankruptcy. These original lenders are often replaced by distress investors with a higher risk tolerance, willing to participate in the restructuring process. Often these are made up of hedge funds and other sophisticated investors.

Moeller and Carapeto (2012) conclude that selling to another company is an important alternative to liquidation and even restructuring of the business, as this may be useful in saving what is salvageable in a struggling company due to the speed of execution. Yet, despite this, it is a complex process requiring careful consideration from management, including decisions whether to sell piecemeal or whole.

Meier and Servaes (2014) argue firms that invest in distressed businesses or their assets, achieve much higher returns on their investments than in regular acquisitions. They were

answering the question in their study, when sellers are forced to sell at below fundamental value due to their distress position, whether it does not result in higher value for the buyers. Of importance is that their study shows that buyers can take advantage of such sales to substantially increase their shareholder wealth through acquiring such distressed businesses or assets.

According to Moyer *et al.* (2012), opportunities for distress investing exist precisely because investing in distressed assets is difficult. They identify the factors that make distress investing difficult, as follows:

- Information asymmetries – information about distressed companies not being publicly available, leaving potential investors with little information to work on, unless they have conscientiously been privately following the developments over a period. Moeller and Carapeto (2012:8) state that due to asymmetric issues, investors will not know the true type of firm.
- Market frictions – market driven valuations are often subject to fluctuations, particularly for publicly traded companies, and potential investors would need to have the conviction of the valuations to avoid subjectively driven losses that cannot be recouped without holding out for longer than anticipated.
- Behavioural distortions and "irrational" transaction motivations – this relates especially to publicly traded securities. Due to the fact that most investors are subject to investment guidelines that require them to acquire securities at certain thresholds, or dump them once they trade below the thresholds, many of these investors miss an opportunity to invest in undervalued transactions despite trading below intrinsic value.
- Intestinal fortitude – investing in distressed assets requires an outlook contrary to a typical investment outlook in a bear market. In fact, it is an opportunity to invest when typical investors are rushing to exit.
- Specialised skills and the knowledge required – since this is a more risky investment arena, it has fewer skill and financial resources than typical debt and equity markets, and investors therefore need to have the requisite specialised knowledge to ensure success.

- Risk and uncertainty – distress investing is characterised by uncertainty over the restructuring plan and capital structure, as well as negotiations among different security holders. A possible prolonging of the process could result in deviations from the intrinsic worth of the target.

Accordingly, distress investing is not for the faint-hearted and it should be done with due skill and care. As Moyer *et al.* (2012) further suggests, investing in distressed assets is not a passive portfolio investment process, but requires a high level of business acumen, combined with a deep understanding of accounting, finance, and corporate and restructuring laws.

Moeller and Carapeto (2012:8) in fact argue that in reorganisations there is a choice to grow out of bankruptcy (business rescue processes), which is a rare occurrence, or be acquired. This, they argue, is the reason for the prevalence of sales in bankruptcy or business rescue. The authors further state the existence of evidence to support the fact that acquirers tend to perform well in acquisitions of bankrupt or distressed firms due to the limited bargaining power of the sellers. This view is confirmed by Meier and Servaes (2014:17), who prove that bidder returns in distressed assets are indifferent as to the industry origin of the acquirer. This effectively casts doubt on previous arguments that within-industry buyers achieve higher synergies and therefore gain more from distressed acquisitions, even when compared with their non-distressed acquisitions.

Specifically regarding pre-pack sales, Windsor and Jarvis (2011:2–4) state that statistically in the UK, most sales are to purchasers with existing links to the businesses being sold, such as shareholders and managers of the firm (both current and past). The pre-packs are also frequently used by outside investors such as specialist investors and competitors, who follow these sectors closely and are able to act swiftly. This is because such buyers frequently possess enough understanding of the target business due to a healthy access to information. The main feature of pre-packs is that the preparatory work takes place prior to the appointment of the administrator (or business rescue practitioner), opposed to post-filing sales. Pre-packs are a quick means through which administrators realise some cash over the assets of the distressed business, often to pay off creditors and prevent the company going into liquidation (Conway, 2015:2).

This is a commonly used practice, with Conway (2015:2) stating the 2011 Insolvency Service (2011) study estimated that 25% of the 2 808 companies in the UK that entered administration that year used pre-pack sales procedures. Of particular note in the study is that 80% of those pre-pack sales were to connected companies. A company involved in pre-packs does not need the approval of its unsecured creditors to negotiate a sale, and often these sales are negotiated without the creditors' knowledge about the distress situation.

5.4 RESEARCH OBJECTIVES AND QUESTIONS

This study aimed to determine whether distressed funding in the form of business sales, in whole or in part, was taking place in South Africa, despite having no provision in legislation, as well as whether these sales can be linked to successful terminations of BR processes. Such results would also likely determine whether there is a pattern of such sales, and if this pattern can be used as a driving force for the implementation of pre-packaged funding.

Based on the available data in the BR environment, this study was conducted as a qualitative analysis, using empirical evidence to confirm the theory in the literature review.

Table 5.1: Research design components

Component	**Description**
Research problem	As a market driven phenomenon, pre-packaged funding for distress sales could soon be applied in SA, and therefore needs to be anticipated and statutorily prepared for to ensure success.
Research question	What is the status and extent of sales of businesses or assets in business rescue processes and their possible influence on the development of pre-packaged funding?
Context	Business rescue or reorganisations
Propositions	1. Proposition # 1: The sales of businesses or assets in BR occurred as part of the business rescue plan, resulting in

Component	Description
	substantial implementation 2. Proposition # 2: BRPs are aware of sales negotiations with buyers that commenced prior to their appointments or the companies' filing for BR 3. Proposition # 3: Some of the acquirers of these businesses were aware of and tracking the distress situation of their targets prior to filing 4. Proposition # 4: A significant number of the buyers of these businesses were outsiders prior to the acquisitions 5. Proposition # 5: The buyers of many of these businesses are financial investors, and not industry insiders 6. Proposition # 6: The outsider buyers often faced legal or practical obstacles with the acquisitions 7. Proposition # 7: Information asymmetry often created an obstacle or hindrance to outside buyers 8. Proposition # 8: Some of the acquisitions occurred using debt instruments, whilst some used equity or mixed instruments 9. Proposition # 9: The new buyers were able to play an influential role in the development of the BR plan 10. Proposition # 10: The high degree of leverage in the capital structures of the distressed companies often get appropriately adjusted after the sale 11. Proposition # 11: The sales of businesses or assets are often viewed as fair and equitable by stakeholders

Component	Description
	12. Proposition # 12: The sales of distressed businesses or assets are often done at favourable price terms to the acquirers
Unit of investigation	Transactions involving sales of businesses (full or partial) or assets in BRs that filed for substantial implementation as successful rescues (primary) as reported on by the BRPs Pre-packaged funding elements and predictors (secondary)
Unit of analysis	Internationally available literature on restructuring (for theory) Reported practices of the distress funding markets in South Africa Experienced BRPs dealing with distress funding
Logic linking data to propositions	Sales of businesses or assets in business rescue after filing for BR using equity instruments, as a precursor to such sales occurring prior to filing for BR and using a variation of equity and debt instruments
Criteria for interpreting findings	Substantial implementation of business rescue Sales through capital injection or debt-to-equity conversion

Source: adapted from Yin model (Yin, 2003:21)

5.5 RESEARCH DESIGN

5.5.1 Research approach

The research conducted was a qualitative study based on information collected from a targeted sample of BRPs with successfully terminated BR cases. A full database of all

terminated business rescue transactions conducted in SA since the inception of Chapter 6 of the Companies Act 71 (2008) in May 2011 to October 2016 was obtained from CIPC. This database, that contains the status of all the transactions and the names of the responsible BRPs, formed the original data from which the test would be drawn. The total population in this database is 759 (seven hundred and fifty nine) entries.

The database contains three important columns that determine the status of the transaction or nature of the termination of the business rescue process. The first is the notice on the Status Report applied on Form CoR 125.1. The second column contains the Notice of Termination filed on Form CoR 125.2, whilst the third column contains a notice of Substantial Implementation filed on Form CoR 125.3. These are the prescriptive requirements of the CIPC to BRPs to submit on discontinuation of projects or statutorily regulated update reports. The importance of the forms is to indicate primarily why a rescue process was terminated, including the reasons for an extension in cases where the process went beyond the stipulated three months. Each is regulated by Chapter 6 and has the following main features:

- Form CoR 125.1 – Status Report: main feature is that the BRP has filed a notice of approval of the business rescue plan, or alternatively, as a progress report where the proceedings have not been completed in the 3 months in terms of Section 132 of the Companies Act. Alternatively, in accordance with Section 141 of the Act, having determined whether there is a reasonable prospect for recovery, the BRP is to determine whether to terminate proceedings or report evidence of voidable, fraud or reckless dealings to authorities if this exists.
- Form CoR 125.2 – Notice of Termination: where there are no longer reasonable grounds to believe that the company is financially distressed, and the BRP files a notice of termination.
- Form CoR 125.3 – Substantial Implementation: in accordance with Section 152 (8), the business rescue plan has been substantially implemented, and the BRP files a notice of substantial implementation.

For the purposes of this study, the columns (in Annexure A) titled ‘forms CoR 125.3’ and to an extent ‘CoR 125.1’ (only as far as its applicability to Sections 132 and 134(1)(ii)), provided the backdrop to our investigation. In terms of these, progress reports as well as

substantial implementation due to the approval and implementation of the business rescue plan, would have been filed. Also, based on the explanation under 5.2 above, it was envisaged that the BRP would, in the event of progress reports, eventually file for Cor 125.3 if successful, or Cor 125.2 if not. In terms of the Companies Act (2008), there is no prescription as to the extent to which the business rescue plan must be implemented in order for the BRP to conclude the BR proceedings. This has largely been left to the BRP to determine, and practice notes are currently being put into place to provide reliable guidance on this matter. In his unpublished thesis, Makhalemele (2016) argues that there is no indication in the Act of what would constitute substantial implementation of a business rescue plan. Subsequently, a practice note number 8 was issued by the TMA-SA on substantial implementation. According to the practice note, substantial implementation may take place, albeit “the complete implementation of every single aspect of the plan may still be underway and subject to the provisions of the business rescue plan”. This justified the research approach to target the population filed under Cor 125.3. For purposes of framing a sampling frame, reliance was placed on the information at hand, and indirectly on the BRPs that provided the information.

To determine the target population from which to draw the sampling, the researchers extracted the data under columns with Form CoR 125.3. The list from this extracted data is 358 (three hundred and fifty eight) items, and forms the sample frame. The sample frame in this study is defined as BR processes that were concluded by a substantial implementation, and it includes capital injection or conversion of debt to equity.

Research method and sampling techniques

Since the key dimensions of this study include business sales as a substantial implementation of business rescue, it was important to ensure that the study sample purposefully includes such cases. From the above sampling frame, the researchers needed to choose elements that were relevant to sales of businesses or assets. For this reason, non-probability sampling was deemed more appropriate and purposive sampling as the method chosen, as it avails a judgement-based sampling. Purposive sampling is defined by Cooper and Schindler (2011) as a non-probability sample that conforms to certain criteria. The researchers needed to ensure that cases were selected that have a

particular characteristic that is of interest within the population, namely that of having business sales included as part of the solution in substantial implementation.

Palinkas, Horwitz, Green, Wisdom, Duan, and Hoagwood (2013) describe several types of purposive sampling. This study has been confined to utilise two main types, the extreme or deviant form and the critical case form. Extreme or deviant form of purposive sampling is used to focus on cases that are extreme or unusual, typically because they tend to highlight notable outcomes in order to provide specific insights on a phenomenon, which can be used as lessons for future studies. In this case, it was used to identify choice of cases with sales of business (in whole or in part) as a method of substantial implementation, particularly because this method of substantial implementation has not been specifically catered for in the Act. Applied at the same time, is critical case sampling, which is particularly useful where a small number of cases can be decisive in explaining a phenomenon. Whilst such critical cases cannot be used to make statistical generalisations, they assist in making logical generalisations. Key dimensions that make an argument for a critical case include the application of the same phenomenon in other developed regimes such as the UK, US, Canada and Australia (Mkhondo & Pretorius, 2017).

It needs to be noted that statistical inference is not the goal of this research, but rather making a logical inference for purposes of prediction of another phenomenon. Further quantitative investigations may need to be done in the future to affirm the conclusions in this regard. In the current study, the role of the sample size is in increasing the likelihood of logical inference, using deduction. This process of deduction was used to test the above propositions against the reality that emerged from the collected data (Du Preez, 2012). As a qualitative study, the ultimate aim of making a logical inference is to use the findings to contribute towards building up of theory (Leedy & Omrod, 2001).

Citing Allen (1971) Tongco (2007) states that it is especially important to be cognisant of informant qualifications in using purposive sampling. The schedule source listing BR transactions from CIPC is completed by officials of the CIPC based on information submitted by individual BRPs involved in each transaction. Each BRP is licenced by the CIPC to carry out BR work, with the qualifications ranked according to level of experience. The ranks are respectively junior, experienced, and senior. A junior BRP would have had limited (under five years) or no experience in related work, prior to appointment as a BRP,

whilst a senior and an experienced member would have extensive experience of more than five (5) years, with the senior practitioner at the higher end of the spectrum (over 10 years). With the exception of two of the practitioners, the rest of the surveyed practitioners were senior practitioners.

According to Saunders and Lewis (2012), it is important to explain the criteria for selecting samples, as well as the reason and premise for the choice when using purposive sampling. In choosing the sample cases from the sample frame, it was important to ensure that only cases where sales of businesses or assets had occurred as part of substantive implementation were selected, in order to provide data reliability. Therefore, the first step was to identify cases from the sample frame that had completed sales as part of the substantive implementation of business rescue. Google search was used to search each company from the sample frame and selecting all those cases with a publicly documented coverage of sales. Websites like Corporate Recovery (www.corprecover.co.za), and BRP companies' websites were searched for the public listing and documentation of transactions to corroborate or supplement normal Google searches.

Arriving at the appropriate sample size was a statistical challenge for the exercise, since the number of transactions identifiable by purposive sampling could only be determined once all the cases had been identified to meet the set criteria. Reliance was thus placed on the work done by Guest, Bunce and Johnson (2006) on data saturation point. They based their study on purposive sampling and found their data saturation point at their twelfth interview, although the basic tenets of the themes were reached as early as the sixth interview. In this study, the authors determined upfront that reaching twelve (12) sample responses would be ideal, based on Guest *et al.* (2006). Forty-two (42) companies were identified as having undergone sales as part of the BR process, spread among eighteen (18) BRPs. Some of the BRPs had several transactions done in the same group of companies. In most cases, this amounted to one type of transaction being replicated several times, with each subsidiary being sold to the same company under similar terms, thus raising the saturation issue illustrated by Guest *et al*. It was therefore decided to rather, base the survey on the BRPs that were involved in the transactions, which amounted to eighteen (18) BRPs in total, with each responding to one transaction.

5.5.2 Research setting

A questionnaire was developed with thirty-eight (38) questions, six (6) being administrative and classification questions, and thirty-two (32) being target questions designed to answer the twelve (12) research propositions. The questionnaire consisted of structured questions, with the target questions as multi-choice questions. Nominal scales of measurement were used in the questionnaire, ranging from three mutually exclusive choice categories to five. Nominal scales are particularly useful where the objective is to uncover relationships and not necessarily to secure precise measurements, as in this case.

Due to the simplicity of the survey, it was decided to conduct an emailed survey to the chosen respondents. An initial pilot test was done with three (3) participants, who were chosen according either to existing relationships or some form of familiarity with the first researcher. Each survey was estimated to take about 30 minutes, depending on the recollection of the respondent BRP. Once the pilot was returned successfully without any significant changes, it was agreed to survey the rest of the respondents. Questionnaires were sent to each respondent in an emailed survey and responses completed manually.

5.5.3 Data collection

Respondents were given sufficient time to respond, given that many of them had been travelling. Initially, the respondents were asked to return the questionnaires within 10 days of receipt, unless they were unable to do so for whatever reason. To ensure compliance, reminders were sent to respondents every 4^{th} day, and those who did not respond in the 10 days were called and asked to submit responses. Most respondents responded within the initial 10 days. Despite several reminders thereafter, only one response was received afterwards. It also turned out that one transaction which appeared to have been a sale transaction, actually did not pass as a sale transaction in the end. Therefore, of the eighteen BRPs targeted for responses, one was dropped and seventeen remained.

In total eight (8) responses were received. Given that the study was a qualitative exploratory analysis, and required insight rather than quantum, it was decided to proceed with the analysis on the responses received. Based on the principles of the Guest *et al*. (2006) study, where the tenets of the theme for the research were reached at the sixth response, it was decided that the eight responses were sufficient to provide the thesis of

the study. Furthermore, given that business rescue is still in its infant stage in SA, and a relatively small number of M&A transactions have taken place in relation to the total number of business rescue transactions, the number of responses seemed reasonable for a qualitative study.

5.6 FINDINGS AND OBSERVATIONS

5.6.1 Findings

The responses revealed that transactions were varied in value from R6 million to R385 million. These transactions varied from the sale of contracts to sales of entire businesses. The transactions however, revealed an interesting set of facts. Firstly, the negotiations for the sales of the businesses or assets were in at least four cases commenced prior to filing for business rescue, and in three (3) cases, even before the appointment of a BRP, although the sales were subsequently concluded after the appointment. This indicates the existence of pre-packs in those cases. The second important observation is that most buyers came from outside the distressed company, with at least six (6) not identified as existing creditors or shareholders, and came mostly from industry “insiders”. A third major observation is that stakeholders were often content with the transactions, and viewed them as being conducted in a transparent manner. Tables 5.2 and 5.3 provide a summary analysis of the findings, with the discussions covering each proposition.

Table 5.2: List of questions linked to propositions answered on a yes-no scale

	QUESTIONS	Yes	No	Unsure	Other	TOTAL
	Proposition 1					
Q5	Was sale of business/assets concluded as part of business rescue plan?	6	2	0	0	8
Q6	Did the sale of business/assets result in substantial implementation of BR process?	4	3	0	1	8
Q7	Was it a total sale of the entire business?	3	5	0	0	8
Q8	Was it a partial sale of the business?	3	5	0	0	8
Q9	Was it a sale of a subsidiary/assets of the business?	3	5	0	0	8
Q31	At substantial implementation, the rescue was classified a success.	7	0	0	1	8
	Proposition 2					
Q10	Did negotiations for the acquisition begin prior to your appointment as BRP?	3	5	0	0	8
Q11	Did negotiations for the acquisition begin prior to the filing for BR?	4	4	0	0	8
Q12	Were you as BRP made aware of such negotiation during your appointment?	3	0	0	5	8
Q13	If you were aware of the negotiations prior to your appointment, were you tracking the developments prior to your appointment?	1	2	0	5	8
Q14	Was the sale transaction concluded before your appointment?	1	5	0	2	8
Q15	Were you as BRP involved in the negotiations for the sale of the distressed business/assets?	7	1	0	0	8
	Proposition 3					
Q16	Was the target on buyer's acquisition horizon prior to the filing?	4	4	0	0	8
	Proposition 4					
Q17	Were the buyers existing creditors?	1	7	0	0	8
Q18	Were the buyers existing shareholders?	2	6	0	0	8
Q19	Did the buyers have any previous relationship with the debtor company?	2	4	1	1	8
	Proposition 5					
Q20	Were the buyers from within the industry?	7	1	0	0	8
Q21	Were the buyers financial investors?	2	6	0	0	8
	Proposition 6					
Q22	Were there any known legal, regulatory or other practical obstacles such as information asymmetry, faced by the buyers of the disressed business?	6	2	0	0	8
	Proposition 8					
Q23	Did the buyers acquire the distressed business through a debt to equity conversion?	0	8	0	0	8
Q24	Did the buyers acquire the distressed business through new equity?	2	6	0	0	8
	Proposition 9					
Q25	Were the buyers involved in the approval of the business rescue plan?	3	5	0	0	8
	Proposition 10					
Q26	Did the acquisition transaction change the capital structure of the distressed company?	5	3	0	0	8
Q27	Did the sale of the business/assets result in decreased leverage for the targets?	3	3	0	2	8
	Proposition 11					
Q28	Was the sale of the business/assets conducted through a bid process?	5	3	0	0	8
Q29	Was the sale of the distressed business a negotiated sale?	6	2	0	0	8
Q30	Was the sale price determined by an independent valuer?	3	5	0	0	8

Source: Own compilation

Table 5.3: List of questions linked to propositions on a 5-point scale

	QUESTIONS	Highly	Large extent	Unsure	Small extent	Not at all	TOTAL
	Proposition 7						
Q36	Information asymmetry was a hindrance to outside buyers.	0	0	3	2	3	8
	Proposition 9						
Q32	The buyers were involved in the drafting of the business rescue plan	0	1	0	5	2	8
	Proposition 11						
Q33	The stakeholders were in agreement with the transaction	3	5	0	0	0	8
Q34	The sale process was viewed as transparent by the stakeholders	4	4	0	0	0	8
	Proposition 12						
Q35	In my view, the acquisition was concluded at a substantial discount to enterprise value	1	3	2	0	2	8

Source: Own compilation

Proposition # 1: The sales of businesses or assets in BR occurred as part of the business rescue plan, resulting in substantial implementation

In response to the questions whether the sales were concluded as part of business rescue plans, six affirmed, whilst four affirmed that the sales resulted in substantial implementation, with only two negations. Thus, in general, it may seem that the proposed sales are often included as part of business rescue plans, even though the business rescue process is not always concluded immediately upon the sale. While answering whether the sale of businesses that occurred as part of the business rescue plans were sales of entire businesses or partial sales of businesses or assets, five out of eight responded that they were not any of those, which represented an inconsistency, which can be explained. The one company actually entered business rescue after the sale was concluded, and the respondent's negation on all fronts was intended to bring that fact. Another respondent's negation on all fronts was to make a point that this transaction was not a pure sale, but a provision of PCF by a third-party fund with an existing relationship, for purposes of the restructuring. It appears, however, that the PCF was considered equity or quasi-equity by the fund (International Adviser, 2014). Overall, it appears that an equal number of transactions (3 each) were divided between partial and entire sales.

Proposition # 2: BRPs awareness of sales negotiations with buyers that commenced prior to their appointments or the companies' filing for BR

In response to the questions as to whether the sale negotiations occurred prior to filing or the appointment of BRPs, four affirmed prior while three affirmed the latter. A further analysis indicated that over and above the negotiations occurring prior to the appointment

of a BRP, in the one case, the BRP was appointed prior to filing for business rescue. In this particular case, the BRP was appointed by a major creditor initially to draft a business rescue plan, which seemed to have included a financing solution with a possible funder. Once all parties were happy with the plan, the company then filed for business rescue. Furthermore, when asked whether they were aware of any negotiations prior to their appointments, and whether they tracked developments prior to their appointments, most responded that this was not applicable to them. This could be attributed to the fact that some of the transactions did not involve any sale negotiations prior to their appointment, and therefore not pre-packs, or that where they were part of pre-packs, but negotiations were generally not entered into without the BRPs involvement, as confirmed by seven respondents to the direct question. Nevertheless, with four of the respondents affirming that sale negotiations began prior to filing for business rescue, this does confirm the basis of pre-packaged financing.

Interestingly, three responded that they were made aware of negotiations during their appointments. The inference in this case may be that negotiations did commence prior to BRP appointments in those cases, but they (BRPs) were brought up to date upon their appointments, and continued the negotiations.

In one case where pre-packs have been acknowledged by the BRP, in their response however, they dissented when asked whether negotiations were commenced prior to filing or to their appointment. It may be that discussions were informally held prior to the BRP appointment, and only became formal negotiations soon after the appointment. The above further confirms the existence of pre-packs, or even a trend towards pre-packs that is perhaps not yet acknowledged or even recognised by the participants.

An important factor is that BRPs are overwhelmingly involved in the negotiations with buyers for the distressed businesses, as indicated by the response to the relevant question.

Proposition # 3: Some of the acquirers of these businesses were aware of and tracking the distress situation of their targets prior to filing

There appears to be an indifferent feedback among respondents to this question. However, it does seem, from the responses, that some buyers would be tracking their

targets for some time prior to the filing for business rescue. This factor may have some important implications for planning of pre-packs.

Proposition # 4: A significant number of the buyers of these businesses were outsiders prior to the acquisitions

Most respondents indicated that buyers of distressed businesses were not part of the existing creditors or shareholders, and largely, many did not even have a relationship with their target. With the exception of two (2) cases where the buyers were shareholders, this may be indicative that buyers tend to be outside buyers and were not connected to the businesses they were buying prior to the acquisitions.

Proposition # 5: The buyers of many of these businesses are financial investors, and not industry insiders

Most of the respondents indicated that more buyers were, in fact, industry buyers and not typical financial investors.

Proposition # 6: The outsider buyers often faced legal or practical obstacles with the acquisitions

Respondents to this question indicated that most of the buyers experienced some form of legal or regulatory obstacles.

Proposition # 7: Information asymmetry often created an obstacle or hindrance to outside buyers

From the responses, it seems that information asymmetry is not acknowledged as an obstacle or hindrance to the outside buyers. This may be because such buyers, as indicated, are industry participants who would nevertheless have some knowledge about the businesses they subsequently buy into.

Proposition # 8: Some of the acquisitions occurred using debt instruments, whilst some used equity based or mixed instruments

The respondents indicated that, with the exception of two transactions, the transactions concluded were not done through the injection of new equity. They further indicated that

none of the transactions was done as a conversion from debt to equity. This may suggest that PCF was used as a means of investment. The available information was not sufficient to further explore this assumption and thus had to be cautiously interpreted.

Proposition # 9: The new buyers were able to play an influential role in the development of the BR plan

Responses to questions relating to this proposition indicate that buyers were minimally involved in the drafting of the business rescue plans of the companies they bought. Three (3) were involved in the approval of the plan, while the other five (5) did not even approve the plan. This seems to imply that buyers may not often play a significant or influential role in the development process of business rescue plans.

Proposition # 10: The high degree of leverage in the capital structures of the distressed companies often are appropriately adjusted after the sale

Three of the respondents indicated that the sale transaction did not change the capital structure of the distressed company. Furthermore, three of the respondents also indicated that the sale transactions did not reduce the leverage ratios of the distressed companies, with another two unsure of the answer. The overall response is ambivalent to whether the sale transaction actually improves the degree of leverage of the distressed companies. In cases where deleverage was not visible, the respondents indicated that this was because the companies were broken up and sold as separate parts, with most proceeds being used to pay major secured creditors, and the original companies wound down in accordance with the business rescue plan. This amounted to substantial implementation, since the separate companies operated and most of the staff was retained. Having said that, at least five of the respondents agreed, the capital structures of the distressed companies do change after the sales transactions.

Proposition # 11: The sales of businesses or assets are often viewed as fair and equitable by stakeholders

All respondents indicated that they viewed the sale transaction as being a transparent process, and had all stakeholders fully on board in the transactions. When asked further whether a proper bidding process was conducted, five respondents affirmed while another

three declined. To a further question as to whether it was a negotiated process, most (6) respondents affirmed. It may seem in some of the cases that respondents probably interpreted a negotiated process to be a negotiation with the preferred bidder, hence the double dip in the responses, whereas the question was meant to distinguish between a bid process and a negotiated process. In three of the responses, independent valuers were appointed to conduct the valuation, which would have increased the fairness of the process. Overall, the respondents seemed to believe the sale processes to have been fair and equitable, at least in the eyes of the stakeholders.

Proposition # 12: The sales of distressed businesses or assets are often done at favourable price terms to the acquirers

The responses to the question on this proposition produced varied results. Four respondents believed that the sale transactions were done at substantial discounts to enterprise value, whilst two believed otherwise and another two were unsure. The conclusion would then be that while sale transactions were often done at favourable terms to acquirers, it was not done in all cases.

5.6.2 Key observations

This study was never meant to determine the quantum of transactions conducted using pre-packs or funded post-filing. It was meant to indicate whether M&A practices were taking place within the business rescue environment despite not being adequately legislated for, and whether these practices could be indicative of a trend towards an advancement of pre-pack sales. This would be expanding on the argument by Gilson, Hotchkiss and Osborne (2015:6) that M&A activity has become a significant part of bankruptcy procedures. Thus put differently, the study was meant to better understand whether the trend in distress M&A activity in SA could be indicative of a behavioural pattern that may be predictive of a growth trend towards pre-packs in the near future.

In this regard, the major observation was that not only were sales (in distress M&A) prevalent within the business rescue context in SA, but also that pre-packs were already taking place, albeit not yet formally recognised as such, but fairly significant, based on the sample results. The obvious reason for lack of recognition is that the recording mechanism for business rescue transactions at the official body of authority, the CIPC, does not make

provision for recording the type of funding used to bail out a distressed company. Furthermore, the legislation does not make particular mention of pre-packaged financing. There may be other less obvious reasons, which could be investigated in further studies. Nevertheless, due to the fact that some of these distress M&A transactions used pre-packs, some BRPs would appear to have been appointed while the distressed companies were already in the market to sell, and negotiations would have been taking place between potential buyers and the target distressed companies. In such cases, the BRPs would then have taken over the negotiations to finalise the sale transactions. One would hope that this would have manifested itself in the speed of execution, which is the main principle driving pre-packs.

The second important observation is that buyers of distressed assets seem to be made up of industry related participants who may be seeing an opportunity for expansion or increased market share, confirming a previous study by Moeller and Carapeto (2012) that in distressed acquisitions, acquirer and target typically belong to the same industry. Most of the transactions observed under this study did not involve non-industry players or pure financial investors, and were further not connected to the businesses they were buying through management or shareholders. This may be indicative of an under-developed market for funding distressed assets. Because most buyers are based in the industry, they would possess enough information on which to base their acquisition decisions. While this indicated that information asymmetry might not be a factor for industry buyers, it remains to be seen whether this would not be a factor for non-industry buyers, thus delaying the growth and maturity of the distress funding market.

The respondents further indicated that industry buyers experienced some legal or other challenges in the acquisition process. It is not too clear what these may be as it was outside the scope of the study. However, one can expect that competition rules may play a role since the buyers are within similar industries.

The stage at which substantial implementation is claimed is important, as it shows whether such sales were instrumental in rescuing the businesses they acquire from distress. Thus, it is significant that two respondents indicated that substantial implementation was not achieved due to the sales. This could be indicative of further elements in the business rescue plan requiring implementation post the acquisition. Of concern though, is that

respondents indicated that the buyers were not necessarily involved in the preparation of or approval of the business rescue plans. This is a significant deviation from international practice and raises a question as to whether there is any buy-in at all from the new shareholders, especially because the plan is often binding upon shareholders, creditors and all other stakeholders. Jiang, Li and Wang (2012) state that one of the factors driving pre-packs is the ability to influence the development of restructuring plans.

Finally, being viewed as having conducted the transactions under fair and equitable rules seems to be important to the BRPs, with all of them affirming that it was the case in their transactions. The point has to be raised, however, as to which standards of fairness and transparency were used since the regulation does not refer to pre-packs and M&A as a whole.

5.7 ANOMALIES OBSERVED FROM THE STUDY RESULTS

Based on public information, it was expected that some high profile companies would be covered in the study, as they were widely thought to have filed for BR at the time of their sales due to their severe distress. It appears that these companies were in fact, not sold through the BR process for various reasons. Some were terminated from the BR process without substantial implementation and were subsequently sold, whilst others did not file for BR at all. Because these transactions were not found under substantial implementation (CoR 125.3), they were not part of the sample frame and therefore not selected for the study sample. Subsequently, the case studies for some of these companies were followed from available public information, as part of this research to determine the circumstances of the sales outside of the BR process.

Some of these companies include:

- Optimum Coal Mine – this company was terminated from business rescue in terms of CoR 125.1, based on the approval and adoption of the business rescue plan. The company was bought in whole by Tegeta Exploration and Resources, a subsidiary of Oakbay Investments. The BRPs expressed satisfaction that all the conditions of the plan were fulfilled, save for the receipt of the cash for the sale, which seemed imminent (Dick, 2016).

- On Digital Media (ODM) – the company went into business rescue in October 2012 and only exited in July 2016, despite acquisition negotiations with Star Times having commenced much earlier on. The company continued to stay in business rescue in order to seek protection from creditors until they could start showing some recovery. This seems to be a case where the sale of the business was negotiated prior to filing for business rescue. Once placed under business rescue and the sale consummated, the company was steadily brought to stability, presumably with various steps of the business rescue plan still being implemented. According to the filed CIPC database, the company filed for several notices under Cor 125.1 between 18 February 2012 and 27 June 2016, but eventually filed for notice of termination under CoR 125.2 on 18 July 2016, meaning that there was no longer a reasonable ground to believe that the company was under financial distress (Ensor, 2016). However, a notice to the stakeholders from attorneys dated 31 May 2016, and attached to a Form CoR 125.1 seemed to indicate that the BRP filed for substantial implementation under CoR 125.3, which seems to be inconsistent with the CIPC file information (Norton Rose Fulbright, 2016). Perhaps the filing under Cor 125.2 in July 2016 was an error. As part of future research, a case study may need to be conducted to understand the dynamics of this transaction.

These companies form an important backdrop to this study, as is indicative of sales of distressed assets that occur either during and sometimes prior to the BR process. The existence of sales in BR suggests an interest in acquisitions of distressed assets in SA, which could even translate to some form of pre-packaged sales, even though some of them subsequently do not file for BR. The reason why some companies do not file for BR once they have negotiated a sale, is often because their major creditors would be on-board with the sale arrangement and thus obviating a need for enforcing a legal stay of creditors. Furthermore, Optimum terminated business rescue as a direct consequence of the adoption of the business rescue plan and not as a direct result of the consummation of the sale.

A potential controversy on the subject of pre-packaging could relate to the directors' liabilities as enunciated under s 129. Under this section, the directors are required to adopt a resolution to commence business rescue proceedings once they have reason to believe

that the company is in financial distress and there are reasonable prospects of rescuing it. They then have five business days to publish a notice of the resolution and appoint a BRP, unless the Commission grants extension. Alternatively, the directors have to deliver written notices to affected persons underlining that the company is in financial distress. In the event that the Commission does not grant an extension, and the five days are not enough to have a pre-pack in place, the directors could be under pressure to pursue the business rescue proceedings without pre-packs, in order to avoid affected persons using s 218(2) against them. The process of pre-pack sales starts when the directors or management of the distressed debtor become aware of a distress situation, and often begin taking such steps as negotiations with some creditors, potential buyers, etc., culminating in pre-packs.

In the Australian context, since this occurs usually before the filing for business rescue (or insolvency) and consequent appointment of a BRP (or liquidator) it could potentially trigger the insolvency provision in the event of liquidation (O'Brien-Palmer, 2012). There has so far not been a court case on this matter in Australia, however, to enable the formulation of a firm opinion, thus it remains a point of controversy. The prevailing view, though, seems to be that this act will be triggered only if the debtor eventually ends up in liquidation following a pre-pack sale. In the SA scenario, it also remains to be seen if s 129 read with s 218(2) could be used against directors.

5.8 DISCUSSIONS AND IMPLICATIONS FOR INDUSTRY

While business rescue in SA is relatively young (since May 2011), it is beginning to show signs of growth, with the sector gradually becoming more organised. It has certainly not escaped the attention of global funders, as can be evidenced by the involvement of some international hedge funds in the informal restructuring of Edcon, among others. Furthermore, M&A activity in the sector appears a reality, both from a pre-packaged and post-filing perspective. Most restructuring regimes have created some form of guidelines, whether formal or informal, to govern the above and promote transparency and fairness. One of the key factors emerging from this study is that BRPs are not formally equipped with the tools to deal with distress M&A in general, and pre-packs specifically, when conducting these transactions, leaving them to use their own judgements as to fairness and reasonability. While they seem to have acquitted themselves well, as can be seen

from the above responses to the transparency questions, it may be only a matter of time before there are industry-changing disputes. It is therefore expected that the industry will be pro-active and begin to look at developing standards to which they will be accountable. This may be through formal legislation by the legislative authority as in the US, or through guidelines or practice notes developed and monitored by the legislative authority as in the UK, or even through member bodies developing their own standards through which they hold their members accountable.

The second factor to be considered by the industry is how to grow the distress funding market, which seems relatively subdued currently, particularly the financial investors. The existence of distress M&A activity in all forms is an indication that more may come, as Moeller and Carapeto (2012) point out, and it would require the funding market to be ready.

Another important implication relates to the possible directors' liability that could be triggered by the violation of s 129 on the part of the debtor companies and their related directors. Fortunately, in the case of Australia, which has an older business rescue regime and therefore a longer practice of pre-packs in a regime similar to SAs, no reported cases of a directors' liability provision have been triggered. This may augur well for SA in the short-term. However, attention may need to be given to this section and the trigger section 218(2), to ensure that there is further clarity on the matter going forward.

Harner, Griffin and Ivey-Crickenberger (2014:194) conclude in their study that policymakers, practitioners and academics have a challenging role to identify factors that support value-enhancing activities while mitigating potentially damaging investor tactics. As a referee and policy maker in the business rescue space, government has a key role to play in ensuring an even field for all stakeholders.

5.9 LIMITATIONS, FUTURE RESEARCH

5.9.1 Research limitations

There are no publicly known and adequately recorded cases of formal pre-packaged funding in SA, despite a few having passed under the radar. The consequence is that there are limitations in studying the prevalence of pre-packaged funding and its impact on

business rescue. This study was consequently a qualitative exploratory investigation, designed to link existing M&A activity to future development of pre-packs. Although the study succeeded in not only showing some patterns, but also pointing out that pre-packs are already taking practice, the frequency of pre-packs could not be established in this study. Furthermore, the Companies Act does not make adequate provision for the application of this practice, leading to it being implemented apparently unnoticed. Where sales of businesses or assets were identified during the BR process, they were mostly executed by the same few practitioners, meaning many were involved in the selling of assets/subsidiaries from the same group of companies. The result was that they were reluctant to participate more than once, especially on the same group of transactions. This limited the mining of further information.

Added to that is the fact that when such pre-pack sale negotiations fail or otherwise succeed, they often do not reach the BR filing process, and are thus not recorded as such. It is suspected, for example, that in the AEIC Chemicals case, initially several negotiations for funding were held prior to filing for business rescue, and filing only occurred after these failed.

5.9.2 Suggested future research

The research was a qualitative exploratory study that sought to understand the potential impact of distress M&A transactions on the development of pre-packs. The incidence of M&A transactions or sales of distressed businesses or assets was not a part of the study, and would probably need to be captured in future studies to empirically determine funding patterns. Added to this, a further quantitative study would also need to be done to determine the impact of such sales of businesses or assets of distressed companies on the full recovery and profitability of the acquired businesses. The latter might need to be a longitudinal study in order to capture the full impact.

Other possible future research could include determining the reorganisation value of businesses that have achieved substantial implementation through BR plans that include funding through sales of business or assets. This could be done in order to establish whether the social benefits of restructuring actually translate to a tangible financial benefit. Reorganisation value is the substitute for market value when in reorganisation (Blum,

1950:571), defined as the enterprise value of the reorganised debtor determined by the expectation of accumulated value from the going concern of the company (Pantalev & Ridings, 1995:420).

A detailed study on the dynamics of companies that have held on to business rescue or re-entered business rescue despite having completed a sale, such as ODM, could also reveal interesting results. Harner, Griffin and Ivey-Crickenberger (2014:167–169) detail the Tribune Company transaction in the US, which was in Chapter 11 bankruptcy for years, despite a sale to a hedge fund, and reveals divergent interests and acrimonious relationships between the fund and major creditors, due to their relative positions in the distressed company. Such dynamics are typical of M&A in business reorganisations or rescue and may need to be properly captured in transaction specific case studies.

CHAPTER 6

ARTICLE 4: DEVELOPING PRE-PACKAGING FOR THE SOUTH AFRICAN BUSINESS RESCUE INDUSTRY: ANTECEDENTS FOR APPLICATIONS

Status on the publication of the article:

Title of article	Developing pre-packaging for the South African business rescue industry: Antecedents for applications
Authors	S. Mkhondo & M. Pretorius
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6.1 ABSTRACT

This study aims to understand the antecedents to a thriving pre-packaging environment and its success factors, with the ultimate aim of developing a framework for the South African business rescue environment. Experts in the area of business rescue were used for identifying factors that are required in a business rescue environment to investigate whether pre-packs can emerge and thrive. Seven research questions were posed to the experts for data. The responses were analysed to determine the building blocks of a framework to pre-packs in SA. Based on literature on pre-packs from more developed regimes, precedent was applied as a theoretical principle to explore the emergence of pre-packs. This was done on the basis that SA may likely follow other more developed regimes with the application of pre-packs, despite the lack of legislation governing them. The industry implications led to a framework to assist and guide pre-pack applications for implementation.

Key words: business rescue, post-commencement-finance, pre-packaging, pre-packaged funding, pre-packs; framework; precedent; mergers & acquisitions; restructuring; bankruptcy; antecedents; pre-pack emergence; distress funding; early intervention

6.2 INTRODUCTION

Formal and informal business restructurings of distressed companies are an effective tool to curb or reduce complete business failures, thereby ensuring businesses are returned to acceptable levels of operations and jobs saved. Very often, these restructurings require funding to ensure not only success of the rescue or restructuring process, but to enable the distressed businesses to get back to normal or near-normal operation. This funding often comes in different forms, and can include further lending by interested stakeholders, restructuring of the debt structure, mergers and acquisitions (M&A), and other forms of financial restructuring that may or may not involve cash-based transactions.

Pre-packaging is one such tool often used in global regimes to resolve business restructurings. As a restructuring financing tool, pre-packaging has gained wide application over the past several years, often being heralded as an efficient and effective tool (Harner, Griffin, & Ivey-Crickenberger, 2014:187). It is explained by Mallon and Waisman (2011:205) as occurring when a distressed debtor voluntarily approaches courts to file for bankruptcy after having proposed and obtained votes for a plan of reorganisation with the requisite number of creditors. This application has found favour in many restructuring regimes despite lack of applicable legislation in some of the regimes. Speed and flexibility to dispose of assets free of claims, seem to be the driving force for pre-packaged bankruptcies (Ben-Ishai & Lubben, 2011).

By applying this, Mallon and Waisman's (2011) definition together with funding, a pre-packaged funding solution is then defined as a sales package for distressed assets applied in business restructuring situations. It is a growingly significant part of M&A activities being done under business rescue or bankruptcy protection. This pre-packaged funding is essentially a quick sale, that is negotiated prior to filing for bankruptcy (UK definition by the Association of Business Recovery Professionals), restructuring and business rescue (in the rest of the world), and such sales are consummated immediately upon appointment of an administrator or business rescue practitioner. This sale consummation often occurs within a short while after the appointment. Filing for bankruptcy is consequently a necessary step in ensuring an effective implementation of pre-packaging.

The precepts for pre-packaged funding are best explained by the United States (US) model, which separates the action of sales (s 363) from the action of a pre-negotiated filing for bankruptcy (s 1126). This means a sale can actually take place without the filing for bankruptcy, although this would then not be considered pre-packaging. For pre-packaged funding or sale to happen, both actions need to occur. Filing usually takes place for a number of reasons, with the main reason being the abeyance or stay of creditors. In cases where creditors are on board during the negotiations, the “creditors stay” and therefore the filing may not be necessary unless other reasons prevail. An example of such a scenario in South Africa (SA) is that of the Edcon Group’s restructuring (Bowker, 2016), where the company’s shareholders changed hands in a debt-to-equity arrangement without filing for business rescue. One could argue that in practice, pre-packaging has not yet been formally recognised or even recorded as such within the SA environment. This could be for a number of reasons, which may include absence of a legal framework to conduct pre-packs, failure to consummate the transactions after filing for business rescue, early exit from restructuring without filing for business rescue (as in the Edcon case), or forced liquidations by complicit potential buyers.

Chapter 6 of the Companies Act 71, of 2008, aptly named Business Rescue and Compromise with Creditors, was specifically created to facilitate the rehabilitation of financially distressed companies by among others, providing for the development and implementation of business rescue plans that maximise the likelihood of the companies’ continued existence in a solvent state as per section 128(1)(b) of the Act. Any effective means to restore the distressed companies to solvency and avoid liquidation should be given due priority, provided it is framed within an acceptable legal framework. Chapter 6 specifies the process for implementing business rescue and compromise with affected creditors, but is not prescriptive on applicable tools to be used in the process. This leaves room for industry participants to frame an operating environment appropriate for effective tools, including distressed sales and in particular, pre-packaged funding.

This article aims to study the factors that may affect and influence the existence and growth of distress funding, and in particular, pre-packaged funding under business rescue, with the ultimate aim of proposing a framework for such role in the South African environment.

In conducting this study, the following research questions were addressed:

- Does an omission in the legislation regarding pre-packaged solutions in restructuring encourage their application instead?
- What are the factors that need to be considered in ensuring pre-packaged solutions are applied in an acceptable manner that ensures their success?
- What are the expectations regarding the behaviour of business rescue practitioners during a pre-packaged sale process and what can be done to meet them?
- Do business rescue practitioners have a role to play in influencing the direction of pre-packs?
- Who are the active investors for distress assets in SA, and what motivates them?
- Is there an availability of multiple funding options that are covered through the debt and equity products offered by distress funders in SA?
- Can creditors and/or credit insurers play a role in funding business rescues, and specifically regarding pre-pack financing?

Patterns observed in established global regimes on restructuring and particularly on pre-packaged funding were used in data analysis and framework construction in the South African environment. Expert opinion analysis was then used for data validation, and ultimately validating the framework. For the purpose of this study, pre-packaged sales or funding/financing solutions is interchangeably used with pre-packs.

6.3 LITERATURE REVIEW

Business rescue, which was introduced in South Africa (SA) in May 2011, through Chapter 6 of the Companies Act 71, specifically deals with the provision of finance for companies undergoing business rescue, being post-commence finance (PCF) in section 135. There is however, no specific reference to pre-packaged financing or sales in the Act, or even mergers and acquisitions in general. This state of affairs is not exclusive to SA, but generally follows a pattern observed in several countries.

In numerous cases, pre-packs were not backed by legislative framework upon their initial implementation, such as in the UK (Conway, 2015) and Australia (Crouch & Amirbeaggi, 2011), and have often arisen out of practice. In other cases, court processes such as

judicial approval/ratification have also assisted in the application of the pre-packs practice. As an example, the most established pre-pack regime, the US, has a court-driven bankruptcy system, meaning all processes go through the courts for approval or ratification. This covers disputes by creditors, pricing issues and other process related issues, which are subject to courts, or even adjudicated by court appointed officials. A case in point is the stalking-horse type of auction sale system, which is based on case precedent despite not being specified in the Act (United States Bankruptcy Code, 1978). Stalking-horse occurs when an initial bidder for the acquisition of a distressed debtor is used to attract other competing bidders through an iteration of prices in the process. This has the effect of making the pricing of the assets or business sold to be competitive, and has the flexibility to compensate the initial bidder with reasonable costs for any expenses incurred in the event that they lose the final bid (Ben-Ishai & Lubben, 2011). Suffice to say that pre-packaged funding, which is applied through a combination of two sections in the Bankruptcy Reform Act, being section 363 for the sale process and section 1128 for the pre-filing negotiation, has been sanctioned by the courts as a pre-pack process. Moreover, individual new cases have to go through a court ratification process to make it official.

On the other hand, many European countries, including the UK, Netherlands and France have subsequently introduced legislation or practice guidelines to regulate pre-packs. The UK government specifically introduced the Statement of Insolvency Practice (SIP) 16 (ICAEW 2009) for this purpose (Vermeille & Pietrancosta, 2010:5). This happened after pre-packs had been practised as a restructuring solution for a while anyway (Conway, 2015). The main reason for legislation and guidelines is to ensure that affected parties are adequately protected. South Africa seems to be positioned similar to these countries in terms of the type of legislation adopted thus far, and the attempt to move away from court driven processes. It may therefore be more sensible for SA to either introduce guidelines through a regulatory body or introduce legislation through amendments to the Companies Act. While pre-packs may have found their way into the SA environment, they are yet to be formally recognised and applied according to a set standard. Regulating them may well provide an avenue for their formal introduction, and thus to introduce guidelines that will improve the perception of stakeholders. SA may not be the only country not to have formally recorded or recognised pre-packs during their nascent stages. Crouch and Amirbeaggi (2011) contend that Australian pre-packs were formally introduced in a 2009

insolvency transaction, despite Wellard and Walton (2012) arguing that there had been no real pre-packs by the time of their writing.

In most contexts, pre-packs involve a sale of assets (subsidiaries) or whole business and are typically represented by sale of business operations into a ”Newco” structure like in Australia (Crouch & Amirbeaggi, 2011). In some other contexts, debt instruments are applied initially as investing instruments, usually prior to the distress situation, although at times as direct consequence of filing for bankruptcy. Jiang, Li and Wang (2012:513) showed in their studies that loan-to-own strategies are applied by hedge funds in pre-packaged Chapter 11 financing. Loan-to-own strategies involve the conversion of debt to equity naturally precipitated by high debt leverage. According to Rosenberg and Riela (2008:4–8), hedge funds employ various debt instruments to invest in distressed business, and these include DIP loans, pre-petition secured and unsecured debt, etc. This strategy enables them to have access to confidential information on the debtor company, exercise influence over the reorganisation process, as well as leverage over negotiations with the debtor companies. According to Gilson *et al*. (2015:2), the strategy of investors buying debt in a bankrupt firm with the goal of exchanging it for a controlling equity stake under a reorganisation plan gives them effective control and economic ownership that is “equivalent to having purchased the business directly in a section 363 sale.” While some of the sophisticated instruments may not be prevalent in the SA distress investment environment, there are debt instruments currently used to invest in distressed business, such as debt-to-equity swaps, claim purchases or credit swaps, PCF, and asset-based-financing. The popularity of these instruments was confirmed by the participants of the Rosenburg and Riela (2008) survey. It is the view of the researchers that nothing precludes these instruments being applied or even negotiated prior to filing for business rescue. It therefore seems logical to extend the definition of pre-packs in a SA context, to include debt instruments when proposing a framework.

6.3.1 Antecedents for pre-packs

Pre-packs are a widely accepted practice in regimes that have introduced restructuring (or bankruptcy in the case of US), irrespective of whether legal or regulatory provisions were also introduced to put them into effect. Pre-packs, in fact, do not seem to require formal legislation and mainly work based on precedent. This is the case particularly where

common law is the basis of law and, therefore, court precedents and case testing based on international observations drive the application of legal principles in practice. The English dictionary describes precedent as an earlier event or action that is regarded as an example or guide to be considered in subsequent similar circumstances (Concise Oxford English Dictionary, 2006). Adapting this to the case of pre-packs, it could thus be regarded as a pre-pack activity that serves to guide or to justify subsequent pre-pack situations.

Based on this principle, the researchers proceeded to investigate whether this can be used to develop a framework for pre-packaging, explained through a relationship equation. According to Siltala (2000:5), the theory of precedent could be understood as linking the elements analysing legal theoretical literature with judges' professional self-understanding and actual court practice. For an act of precedence to be contextualised, the requirement for systemic formality found in bound judicial decision-making has to be relaxed, for by its definition, precedent is non-systemic. This lower formality aspect cannot be overemphasised by pre-packs creating precedent through court ratifications on the one hand, and continuous repetitive practice in, not one regime but several, on the other. The court-driven nature of formal restructurings in regimes such as the US does play a significant role in providing the binding element of precedent for pre-pack practice.

In determining the relationship between the variables, various factors were at play in building the linearity or dependence. These factors in the equation are the independent variables that determine how the pattern of pre-packs occurs, or rather the probability of the pre-packs occurring, in accordance with the theory of precedent. The latter may be described as a dependent variable in the relationship.

A legislation that establishes a restructuring or business rescue framework without making provision for the involvement of pre-packs in the legislation, seems to inadvertently create the ground for their eventual establishment, due to the legal vacuum created by push or pull factors, ultimately leading to the establishment of pre-packs (Mkhondo & Pretorius, 2017a). Secondly, pre-packs seem to be more visible when an active and vibrant distress funding market is prevalent, indicating some correlation between the two variables. Thirdly, the availability of various funding options based on a multiplicity of funding products or instruments by investors seem to be a factor in the introduction and growth of pre-packs in restructuring environments (Mkhondo & Pretorius, 2017b). Lastly, access to reliable

information on investment opportunities by unrelated third parties has arguably been raised as a factor to increase the likelihood of pre-packs (Rosenberg & Riela, 2008:4–8).

According to initial literature, a legislative vacuum on pre-packs creates an opportunity for their emergence. Coupled with an active distress funding market, the availability of various funding options and access to reliable information by unrelated third-party funders, together have a positive influence on the possibility of introduction and growth of pre-packs. Furthermore, BRPs were thought to be playing a role in influencing the emergence of pre-packs in the market. This is done through their various roles and activities, which include their own conduct during the rescue process, providing access to information regarding distress funding activity in the market, availability of various funding products or instruments, as well as providing access to reliable information on the distressed companies to potential third-party funders.

6.3.2 Legislative vacuum for pre-packs

In many of the regimes where pre-packs are practiced, no legislation is in place to govern or create such practice, with marginal exceptions such as the US, Canada, France and the Netherlands. Of note here, is that the US legislation, while it accommodates pre-packs, was not specifically designed for their practice, as it is the simultaneous application of two sections in the Act (sections 363 on sales, and 1126 on pre-arranged restructuring). France and the Netherlands appear to have introduced legislation that encourages, rather than guide or regulate pre-packs. Conway (2015:1) states that the UK insolvency legislation does not specifically provide for pre-packs, and the associated processes have arisen out of practice and through judicial approval, a practice that contributes to the precedent theory. Under the Voluntary Administration in Australia, which has been the basis of practitioners applying pre-packs, there is no specific legislation or guidelines for pre-packs (O'Brien-Palmer, 2012).

As explained earlier, and in supporting Conway (2015:1), the vacuum in the legislation then creates an opportunity for pre-packs to thrive in a restructuring environment. This proposes a relation between the probability of introduction of pre-packs and a vacuum in the restructuring legislation. The vacuum in the legislation can be described essentially as a function of lack of direct regulation for pre-packs, no formal or legal prohibition of pre-

pack activity, and an enablement of, or non-prohibition of sales of businesses or assets of distressed businesses.

The SA legislation on business rescue makes no mention of pre-packaging and has a limited mention of sales during the business rescue process in section 134, although this does appear to be an avenue for allowing the practice of pre-pack sales. An attempt needs to be made to govern or regulate the process to protect the interests of affected parties and ensure transparency.

6.3.3 Availability of multiple funding options

In advanced regimes where M&A in restructurings is prevalent, and specifically where pre-packs are dominant, numerous multiple products are available in the market for funding distressed assets, in particular, distress acquisitions. Rosenberg and Riela (2008:4–8) discuss various funding products often used by hedge funds and other distress fund investors, namely DIP loans, pre-petition loans (secured and unsecured), pre-petition equity, asset acquisitions, derivatives such as credit swaps and other investments. Further funding options are applied to fund the plan out of bankruptcy or as post-emergence funding, to fund the company once it is out of bankruptcy. These various funding options offer funding flexibility to potential distress market funders.

The availability of many funding instruments in the market offers entry points to potential funders, especially financial investors such as hedge funds, due to the ability to participate in acquisitions pre- or post-filing for bankruptcy or restructuring (Rosenberg & Riela, 2008). Many of these funding institutions hold complicated positions in the debtor companies, combining ordinary claims with derivative instruments to pursue their acquisition agendas. These may want to advance the reorganisation of the distressed debtors, while ending up with an equity position in the distressed business (Baird & Rasmussen, 2010:657, 670).

6.3.4 Activity in the distress fund market (availability of distress funds)

6.3.4.1 Third-party funders

The market for distress funding has developed over the years, most notably in the US and UK, and recently in parts of Europe. Gilson, Hotchkiss and Osborne (2015:1–6) note that

there has been a rise in M&A activity in bankruptcy fuelled by an increasing presence of funders in distressed assets. They significantly point out that “when a firm is in danger of failing, it faces two options, either bankruptcy or M&A”. Harner, Griffin and Ivey-Crickenberger (2014:169) describe distress investors as funders who hold or acquire positions in a distressed company’s capital structure. These positions often allow them to emerge as owners of the restructured company.

Rosenberg and Riela (2008:5), and confirmed by Jiang *et al.* (2012:514), report that distress investors typically consist of hedge funds, private equity funds, pension funds and investment banks. Of these investors in the US, hedge funds appear to be the most active in the distressed debt market (Jiang, Li, & Wang, 2012:513). This it seems is due to their unique portfolio category that enables them to hold risky positions such as those in distressed firms and the fact that they are not governed by prudency rules of the other managers such as pension and mutual funds (Jiang *et al*., 2012:516). Many of these hedge funds continue to provide substantial returns to their investors and managers, mainly due to investments in distressed assets throughout the world. However, according to Rosenberg and Riela (2008:1) the term hedge funds appears nowhere in the US Securities laws, and there does not seem to be an industry agreement on a single definition. Loosely, it appears to describe a pooled investment vehicle that is privately organised, administered by investment professionals, and not widely available to the public. These funds are anything but private equity funds, mutual funds, venture capital funds or commodity pooled funds. The funds are exempt from coverage under the Investment Company Act of 1940 because either they have hundred or less beneficial owners or their investors are “qualified” individuals or institutions.

Harner, Griffin and Ivey-Crickenberger (2014:178) also confirm the growth of funds’ participation in Chapter 11 bankruptcies. In examining the role of funds in bankruptcy (2014:168), they note that some commentators view distress funders as raiders or vultures, whilst others perceive value in their intervention. They however, show in their study that the presence of distress investors is significantly associated with the survival of distressed companies. Accordingly, supporters of hedge fund participation in bankruptcies point to the liquidity they provide to the distressed businesses and their role as lenders of the last resort. The raw data in their study reveal a marginally significant relationship

between having a fund and pre-packaged or pre-filing strategy (2014:187). They conclude that there is a strong indication that funds influence the restructuring of distressed companies.

6.3.4.2 Bankruptcy/Distress exchanges

As the most established reorganisation market, the US appears to have a well-established "claim trading market". Baird (2009) writes that there is a need to regulate the claims trading market, in much the same way every trading market is regulated. He argues that claims-trading has become a fundamental feature of bankruptcy. According to Baird and Rasmussen (2010:647), the ability to trade in the debt claims of Chapter 11 bankruptcy firms began to take hold in the 1980s. This provided the opportunity for investors who could not otherwise invest in equity to invest due to the high regulation of the latter. This practice has been fuelled by the increased presence and sophistication of hedge funds in restructuring. This also provided a safe route towards exercising influence over the distressed companies by the hedge funds. On the other hand, this practice allowed for the exit of those creditors who were not equipped to navigate the distress field, especially the small distant creditor. It seems courts play a significant role in the claims exchange market in the US. Altman and Karlin (2009:5) calculate the value of distress exchanges or bankruptcy exchanges at US$30.3 billion in 2008, which is quite significant, despite the huge size of the US economy.

6.3.5 Access to reliable information on distressed companies

The major factor impeding access to entry for unrelated third parties appears to be information asymmetry. Often, the related parties such as creditors, managers and shareholders are the ones with access to information for the distressed business, albeit at varying levels. Such stakeholders are able to utilise this information to make appropriate decisions regarding their response to the distress situation. This information often includes an understanding about the management decision-making process, detailed issues regarding the financial position, and other issues that may not be public knowledge. In citing Carapeto, Moeller and Faelten (2009), Moeller and Carapeto (2012:7) state that in samples studied over a 25-year period, it was found that most acquirers of distressed assets belonged to the same industry as their targets. This, they argue, supports a Gertner

and Picker's (1992) argument that asymmetry may cause less informed outsiders to be deterred from bidding for distressed assets.

In terms of the latter argument, the unrelated third parties may not be privy to non-public information unless they are industry insiders or active distress investors who may have been following the developments in the specific distressed firm. Active investors such as hedge funds often have skilled investment professionals and analysts who have a good grasp of restructuring and technical understanding of the firms they are targeting, and can consequently make proper decisions. Such active investors, including other industry players, are likely to take up positions in the firms even prior to their filing for business rescue or restructuring/bankruptcy. According to Baird and Rasmussen (2010), these distressed debt professionals are well informed and close to the process. This access to information tends to have a significant bearing on the ability of these funders to access potential transactions.

6.3.6 Overview of the distress funding market in SA

Relatively, the SA business rescue regime is at a nascent stage and still undergoing some growing changes. While M&A in business rescue is occurring, it is not yet a dominant force and pre-pack sale practices are even unrecognisable to those outside of the business rescue circles. The above factors identified as influencing pre-pack application are discussed below, within the SA context.

6.3.6.1 Vacuum in the legislation

The non-legislation of the administration of pre-packs in the SA regime has been documented (Mkhondo & Pretorius, 2017a). In addition, the industry regulators and membership bodies have not yet advanced any practice notes or guiding principles in dealing with pre-packs. It is thought that the lack of legislation or guidelines has not stopped industry practitioners from at least thinking about their application in the SA context, and even applying them. It is further hoped that as part of the output from this study, the framework that is developed for the regulation of this otherwise healthy process, could be used to create legislative or regulatory guidelines for the administration of pre-packs.

6.3.6.2 Availability of multiple funding options/products

Currently in SA, the active participants in distress funding, including both industry and financial investors, have access to certain funding instruments but may not have yet reached optimum levels. Conversely, most distressed companies are aware of only a small range of funding options in the market. Because the business rescue legislation has specifically made provision for PCF in section 135 of the Companies Act 71, of 2008, it appears that funders prefer it. Given the multiple products offered by hedge funds in the US as described by Rosenberg and Riela (2008:4–8), there is certainly more room for the use of other funding products. The credit products that are often applied prior to distress situations in other markets are a case in point. Credit insurers, who by default inherit the superior claim status in the distressed debtor companies, do not typically use that newly acquired status to convert their claims into equity, as is usually done in the US for instance. This may merely be an issue of them not being desirous of holding long-term positions in distressed businesses.

6.3.6.3 Activity in the distress fund market (availability of distress funds)

Typical financiers of PCF are banks, creditors and shareholders according to Du Preez (2012), essentially because they would try to find a way to recoup their losses even if it means funding the distressed companies out of a distress situation. Accordingly, many of them do not go out of their way to finance transactions that are out of their scope. She further reported at the time that distress lenders were either non-existent or unknown, with few products designed to accommodate the high level of risk associated with distress funding. Jiang *et al*. (2012) assert that investing in distress assets typically requires specialised skills, thus it is understandable that traditional lenders may avoid distress investing.

The vibrancy of the distress funding market would therefore be enhanced by the entrance of non-industry or financial investors such as new funds designed especially to invest in distressed markets. Typically, in the US and some parts of Europe such as France, these investors would be dominated by hedge funds. It is definitely not the case in SA, with the SA distress funding markets being steadily occupied by completely new funds with no previous history of distress funding. Although these funds are far and in-between, with

typically very small funds, it does seem that there is increased interest in the market, albeit very slow.

Hedge funds in SA have not yet taken an interest in the market, unlike their counter-parts in the US and some parts of Europe. Until 2015, hedge funds in SA operated under a category 2 licence governed by the Financial Services Board (FSB). Operating under the Law-of-One-Price (as LOPs) where their only major requirement was to deal in securities according to a particular pre-determined rule, they were mostly unregulated like their US counterparts. However, since April 2015 they were moved by the FSB to Collective Investment Schemes, which governs mutual funds and operate with more rules, with the aim of establishing greater transparency to how they operate. This move has essentially introduced some operating parameters, which would limit undertaking of risky investments without properly accounting for such activities.

Having said this, the opportunity for hedge funds to participate in the distress funding market still exists, as they can still invest in risky private equity related deals within the parameters required by FSB. This however, requires specialised skills such as credit analysis, M&A for distressed assets, etc.

6.3.6.4 Access to reliable information on distressed companies

Information asymmetry is often a reason for poor exposure to the distressed businesses. This may arise from such companies not being on the investment horizon of potential investors, alternatively that the investors are not financially exposed to the businesses and thus not forming part of creditor committees and any stakeholder meetings where information is shared. In such cases, the only available information is that which is available to the public anyway. Important insights such as management competence, credibility of financial information, etc., become unavailable to them resulting in lack of interest to participate in any form of financing. In the SA scenario, there may still be some form of heightened confidentiality by BRPs in dealing with distressed debtors due to the potential fallout and credibility issues affecting the debtor company and its management.

In in an attempt to look deeper into the current and future operating environment in the SA context, the researchers proceeded by looking at the potential factors that could affect the implementation of pre-packs. These were developed in a form of research questions,

based on literature reviewed. The researchers then developed the responses into propositions, with the aim of mapping out a framework for implementing pre-packs in the SA context.

6.3.7 Overview from literature

Prior to commencing with the research study, a view was formed based on the literature studied. The following factors were thought, from the literature, to influence the emergence of a pre-pack distress funding market:

- Legislative vacuum (due to gaps found in the administration of pre-packs);
- Availability of multiple funding options;
- Activity in the distress fund market (availability of distress funds); and
- Access to reliable information on distressed companies.

Once these factors were identified in literature, it was necessary to test them in the market, though on an exploratory basis, in order to determine what would be applicable in the SA environment.

6.4 RESEARCH OBJECTIVES AND QUESTIONS

This study aimed to investigate what would influence the establishment and growth of the market for pre-packs in SA, as seen from the eye of active participants in business rescue related work in SA, and benchmarked by global applications. In predicting the possible establishment and growth of prepacks in SA based on the existence or not of the factors explained above, the authors attempted to answer the following objectives: What motivates distress funders to adopt pre-packs? What are the benefits of adopting pre-packs, for the stakeholders? What is inhibiting pre-packs from being widely applied in SA? What should be the rules for applying pre-packs for both practitioners and funders? Does a legal vacuum regarding pre-packs in the restructuring legislation create an opportunity for their application? What are the critical factors that need to be present for pre-packs to be successful? Are there active third-party investors for distress assets in SA? What are the available avenues for distress investment in SA? Is the distress funding market

sophisticated enough to avail various funding options, and consequently advance towards an enabling environment for pre-packs? Lastly, what role do practitioners play in advancing or inhibiting pre-packs?

The above questions were refined into seven major research questions, which were then raised with various experts in the field. Based on the responses to these questions, propositions linked to each question were then made, for possible adaption into a framework building process.

Table 6.1: Research design components

Component	**Description**
Research problem	Pre-packaging could possibly already be in operation in SA, without key elements being in place, such as legislative guidelines and code of conduct for role-players, without which there is uncertainty and poor support, thus a framework for these may need to be developed.
Context	Business rescue or reorganisations
Specific Research Questions to participants	**Question 1:** What factors contribute to growth and development of the pre-pack market? **Question 2:** Which funding options are available for distress funding purposes in the SA market? **Question 3:** What measures should be in place to ensure transparency in a pre-pack sale process in SA? **Question 4:** Who should be responsible for regulating the behaviour and conduct of BRPs during pre-pack implementation and how? **Question 5:** What elements contributing to the growth of pre-packs could be influenced by BRPs? **Question 6:** During a default situation, creditors hold superior rights due to their superior claims to the existing shareholders. What should be their ideal role?

Component	Description
	Question 7: Given that credit insurers replace insured creditors during default, and enjoy superior rights due to their superior claims, what role do you believe they should play during default?
Unit of investigation	Expected practices, rules and regulations when implementing pre-packs in business rescue as viewed by experts in the field
Unit of analysis	Internationally available literature; Documented practices in global restructuring regimes; Views and opinions of experienced professionals in business rescue in SA; Expert opinions of professionals that have experienced pre-packs
Logic linking data to propositions	Global regime context on pre-packs as observed from literature, as measured against views and expectations of industry practitioners.
Criteria for interpreting findings	Principles derived from experience and knowledge from global practice (observed in literature); Value to be derived from available output

Source: Adaptation of Yin (2003)

6.5 RESEARCH DESIGN

6.5.1 Research approach

This study was a qualitative investigation to better understand the market for distress funding in business rescue, and in particular, whether and how pre-packs could be made appealing. The theoretical basis for this study is the international regimes on restructurings that apply pre-pack administration.

6.5.2 Research method and sampling techniques

Baird and Rasmussen (2010:648) note that Chapter 11 bankruptcy has become successful primarily because a new breed of bankruptcy professionals, including lawyers, judges and turnaround specialist who are not caught up in the emotions, but can make tough decisions, have emerged on the scene. This is not much different in the SA environment, although following a few decades behind. The major challenge in the case of SA is that the pool of such professionals is very small. Added to this is the fact that the market for pre-packs is not yet recognisable in SA, thus making the drawing of a sample of experts in this specific area somewhat challenging. Thus, in finding appropriately knowledgeable experts in the field, purposive sampling was pursued as the appropriate strategy.

This study was an analysis of expert opinions on pre-packaged financing and involved formal questionnaires with fixed and open-ended response options among professional representatives from various platforms in the business rescue environment in SA. According to Tongco (2007), it is especially important to be cognisant of the participants' qualifications in choosing participants during purposive sampling. Initially, fifteen professionals were identified from among credit insurers, credit recovery and workouts, distress investors, as well as legal practitioners and business rescue practitioners (BRPs). These professionals are often involved in business rescue and turnaround situations as interested parties and are often involved, in one way or the other, in finding solutions for distressed companies to trade out of insolvency, particularly in funding solutions. Credit insurers often insure the risk of creditors and, therefore, invariably require a financial solution that would possibly stabilise the distressed company to minimise their own losses. Credit recovery and workouts professionals are often the face of creditors during distress situations, and their duties are to seek redress from the distressed debtors, and get deeply involved in recovery solutions, mostly through creditor committees and other related mechanisms. Distress investors, although not many in SA, are heavily involved in funding distressed companies out of distress, and often issue PCF and sometimes even take equity risks in such transactions. While all the above would have been financially exposed to the distressed businesses and offer the insight of personal (or employers') financial liability, legal experts and BRPs offer third party advisory insights. It was thought that the

individual insights brought by each of these participants could provide a broad insight into whether funding for distressed debtors does work, and how it would ideally function, particularly under pre-pack circumstances.

Prior to that, an informal interview was held with a hedge fund multi-manager, in order to understand the operating environment of hedge fund managers, including their legal and financial constraints. The importance of this understanding was the key position hedge funds occupied in distress funding in other more mature markets.

6.5.3 Research setting

The collection methodology chosen was the Delphi technique. This involved a set of semi-structured questions that were sent to each of the selected participants in the sample, recalibrating the questions and resending to the same participants once the initial feedback was received. This was to ensure consensus on contentious issues. A background was given to the participants, including a brief analysis from literature review. The participants were then asked to give their opinions on selected topics. The first set of questions for each category of questions required free-hand written responses, where participants were asked to provide their own uninfluenced thinking, prior to literature studies being considered. This was then followed by corresponding questions and response choices based on reviewed literature, which participants were asked to rate. They were further asked to add further comments if any. This was the first or initial round of the Delphi study.

In the second round of the Delphi, the questions were recalibrated after collating the responses from the first round, together with additions made by participants. These were then resent to the same participants for confirmation, after being pre-codified in accordance with the first round of Delphi. An attempt was however made to keep certain technical words or phrases used by the respondents if they were used by more than one participant. Furthermore, discrepancies found from the first round responses were also homogenised and included for confirmation or repudiation as part of this second round of questions.

Purposive, judgemental sampling was used in making the selections of participants, based on a referral network. In total, fifteen experts were chosen for the study from all the above-

mentioned areas of expertise. During the initial round of the Delphi survey, responses were received from ten participants, which represent a response rate of 66.6%, and these were representative of all the relevant fields in the business rescue processes. The second (and final) round of the Delphi was done as a follow-up to the initial round, and it consequently surveyed only the ten participants. During this second round, eight out of the ten responses were received, representing 80%. The two other participants experienced challenges, including one with a software system related technical glitch. Participants were all professionals, even though in different roles, within the business turnaround/rescue environment and they belong to the Turnaround Management Association of South Africa (TMA-SA). They are all involved in fund-raising activities related to exiting distressed companies, including PCF and related funding instruments. To this end, this sample was regarded as homogenous. Furthermore, the business turnaround/rescue community in SA is quite small due to the newness of the industry, and is made up mostly of BRPs. Any genuine attempt to increase this number would have skewed the sample in favour of BRPs, when it was in fact, important to have a balanced view among the professionals. Therefore, in relying on Guest, Bunce and Johnson (2006), where the basic tenets of their themes were reached as early as the sixth interview, with a saturation point at twelve (12), it was accepted that the initial ten, and final eight (8) expert participants in this study were sufficient to derive the depth required for this investigative study.

6.5.4 Data analysis

The Qualtrics system was used to field questionnaires to selected participants. In turn, responses were automatically recorded as reports in the system, and automatically analysed. For the responses that were freehand written by the participants, a manual collation was applied to find meaning and symmetry or alignment, and then coded. From these responses, pre-coded additions and amendments were made to multiple-choice responses (literature-based pre-formatted responses) to formulate some consensus building, before being resent to the participants for their second round of ratings. It is important to mention that the purpose of rating the responses at this stage was to be able to formulate a feedback, based on consensus, to be resend for confirmation. Consequently, questions that solicited a completely unfavourable response were subsequently discarded after this round. A second series of collation of responses was

then automatically made by Qualtrics, with a rating for each response. These multiple responses were formatted in a compulsory tick-box style, with a rating required for each response. This last round then formed a final consensus and it is discussed below as observations and findings.

6.6 FINDINGS AND KEY OBSERVATIONS

6.6.1 Findings and interpretation

The questions in the Delphi study were linked to the research questions of this study, to assist in the formulation of an appropriate framework for the monitoring of pre-packs in SA. Expert opinion thus became key to the study. Whilst the Delphi contained two rounds of questions, the second round was used as the final round to tabulate the findings (Table 2). The views of the two participants who only participated in the initial round were however, reflected in the final analysis where they were deemed to add value. Each of the research questions are related to the eventual proposition.

The resulting propositions are then intended to assist in the development of the framework for pre-packs in the SA context. In other words, the output from industry experts was used as a guideline, in conjunction with the literature to develop the framework. Key points were therefore taken from the resulting propositions to fashion into inputs for the framework development. The key point of departure is that the researchers were beginning to build a consensus regarding the development and growth of pre-packs in a restructuring regime. In so doing, it was important to begin by looking at what pre-packs can encapsulate in a SA context.

As an overview, all participants agreed that early intervention in business rescue, and creditors support and participation were significant contributors to the growth and development of pre-packs. This early intervention can be explained as directors or other affected parties being proactive, in recognising distress factors in the debtor company, and proactively activating the process of business rescue before it is deemed too late. The introduction of legislative guidance to govern the conduct of BRPs in handling the process was also deemed relevant in ensuring pre-pack growth. Access to reliable information on distressed assets by third parties to properly evaluate risks was also supported. Availability

of a vibrant distress funding market, as well as awareness of available multiple funding options in the market were also considered important potential drivers of growth of a pre-pack market.

However, the apparent lack of legislation to govern pre-packs was not overwhelmingly seen as a prerequisite of the growth of pre-packs, given the indifferent response from some participants. Their indifference appears to be in contrast with literature studies indicating that lack of legislation creates a gap for entry and proliferation of pre-packs. The response is nonetheless understandable given the relative perspective of the participants. Literature shows an establishment and growth of pre-packs to be prevalent in regimes where their legislation is limited or non-existent, an aspect the researchers have attributed to the precedent principle. Without the benefit of having studied the literature, it may not have been likely for the participants to make such an observation. Having said that, one of the “first round only” participants had initially expressed high confidence when stating that the lack of legislative clarity was a contributor to the emergence of pre-packs, due to the legal gap created.

Table 6.2 tabulates the final round responses, being the consensus building final, outcome, which were used to develop the propositions. Thereafter, the researchers proceed to address the research questions individually.

Table 6.2: Delphi survey responses

	Strongly disagree	Somewhat disagree	Unsure	Somewhat agree	Strongly agree	TOTAL COUNT
Q1: What factors contribute to the growth and development of the pre-packs market?						
Description						
1. Early intervention in business rescue process due to identification of early distress symptoms;	0	0	0	4	4	8
2. Creditor support and participation in pre-packs;	0	0	0	5	3	8
3. Legislative guidance regarding conduct of BRPs and handling of process;	1	0	0	3	4	8
4. Legislative vacuum resulting from pre-packs not being regulated by regulatory authority;	1	0	3	4	0	8
5. Distress funding availability - high activity of distress funders in the distress funding market;	1	0	1	3	3	8
6. Awareness of various available funding options/ products in restructuring;	0	1	1	3	3	8
7. Access to reliable information on distressed companies to properly evaluate risks;	0	1	0	3	4	8
Q2: Which funding options are available for distress funding purposes in the South African market?						
1. Deb-to-equity swaps;	0	0	0	7	1	8
2. Credit swaps/claim purchases;	0	1	2	5	0	8
3. Convertible loan instruments (for pre-petition equity);	0	2	3	2	1	8
4. PCF;	0	1	1	5	1	8
5. Asset acquisitions (of good assets);	0	2	0	3	3	8
6. Equity acquisitions by 3rd parties;	0	1	1	4	2	8
7. Equity funding by existing shareholders;	0	2	2	2	2	8
8. Secured loans (post-petition);	0	2	2	3	1	8
9. Unsecured loans (post-petition);	1	3	2	1	1	8
10. Asset-based-financing;	0	2	1	4	1	8
11. Debtors/invoice factoring;	0	0	4	4	0	8
12. Supplier credits and discounts.	1	2	3	1	1	8
Q3: What measures should be in place to ensure transparency in a pre-pack sale process in SA?						
1. Independent valuation by an independent valuer;	1	1	0	2	4	8
2. Marketing for value among potential buyers through a bidding process or auction process;	0	1	0	4	3	8
3. Sale ratification by creditors;	0	0	2	4	2	8
4. Independence of BRPs from shareholders and management;	0	0	0	1	7	8
5. Independence of BRPs from distressed debtors' auditors ("Chinese wall effect");	0	0	0	2	6	8
6. Adequate regulation or guidelines for BRPs;	0	0	1	2	5	8
7. Review of pre-pack sale process by an independent body;	2	1	1	2	2	8
8. Adequate information on rationale for pre-packs.	1	0	0	3	4	8
Q4: Who should be responsible for regulating the behaviour and conduct of BRPs during pre-pack implementation and how?						
1. Sanction by regulatory body (CIPC);	0	0	1	2	5	8
2. Professional sanction by respective professional bodies;	0	0	0	4	4	8
3. Legal prosecution by courts;	0	1	2	3	2	8
4. Removal by creditors.	1	0	1	4	2	8

Table 6.2 (cont.): Delphi survey responses (cont.)

	Strongly disagree	Somewhat disagree	Unsure	Somewhat agree	Strongly agree	TOTAL COUNT
Q5: What elements that contribute to the growth of pre-packs could be influenced by BRPs?						
1. Early intervention;	2	1	1	3	1	8
2. Stakeholders' awareness of and access to information on various available funding options/products for restructuring;	0	0	2	4	2	8
3. Stakeholders' support and participation in pre-packs;	0	0	3	3	2	8
4. BRP conduct;	1	1	0	1	5	8
5. Access to quality, reliable information on distressed debtors by 3rd parties.	0	1	3	3	1	8
Q6: During a default situation, creditors become default shareholders because of their superior claims to the existing shareholders. What should be their ideal role?						
1. Through credit committees, have limited consultative and supportive role, in order to salvage as much of their claim as possible, before walking away;	0	1	3	3	1	8
2. Use credit committees to assume a shareholder status and play oversight role on process, including influencing the development of the business rescue plan;	0	1	2	4	1	8
3. Formally converting their debt to equity, then take an active role in ensuring rescue of business by the selection of BRPs, appointing directors, and holding all accountable;	3	2	2	0	1	8
4. Providing further funding to ensure success of business rescue.	0	1	4	2	1	8
Q7: Given that credit insurers replace insured creditors during default, and become default shareholders due to their superior claims, what role do you believe they should play during default?						
1. Taking current role of creditors and working through credit committees to support the plan and salvage as much claim as possible before walking away;	0	0	2	2	4	8
2. Working through credit committes to play an oversight role over BRPs and directors and influence the business rescue plan;	0	0	2	2	4	8
3. Assume a more active leadership role in rescuing the debtor company by actively managing BRPs and holding them and directors accountable;	1	1	2	1	3	8
4. Formally play a shareholders' role and consider converting their debt to equity;	1	1	4	2	0	8
5. Provide further funding to improve the success of business rescue.	0	2	3	3	0	8

Source: Own compilation

Question 1: *What factors contribute to growth and development of the pre-pack market?*

The eight participants all confirmed that early intervention is key to business rescue, and together with creditors' support and active participation, would play a significant role in the emergence of pre-packs as an attractive business rescue tool. Seven of the eight participants further suggested access to reliable information on distressed assets, while six supported the availability of a distress funding market and an awareness of available funding products as potential drivers in the emergence of pre-packs. The latter was further supported by one of the "first round only" participants.

In view of these findings, the proposition is set as follows:

Proposition #1: The factors that enhance the growth and development of pre-packs in SA include an active distress funding market, an availability of various funding options for distress investing, and access to information on distressed assets by potential funders.

Question 2: *Which funding options are available for distress funding purposes in the SA market?*

Various options seem to be available in the distress funding market in SA and have been evidenced by the participants in this order of ranking, debt-to-equity swaps (8/8), PCF, equity acquisitions by third parties, asset acquisitions (including subsidiaries) (6/8), and credit swaps or claims purchases and asset-based-financing (5/8). Whilst equity funding by existing shareholders, post-petition secured loans and debtors or invoice factoring do occur, they seem to have been observed by fewer participants (4/8 each). Less popular are the supplier credits and discounts, as well as convertible loan securities, which would have been obtained prior to distress, as observed by two (2/8) and three (3/8) participants respectively. What is clear though, is that the products for investing in distressed assets seem to be fairly varied, thus showing support for the following proposition:

Proposition #2: The basic funding instruments appear to be available in the SA distress funding market, including various equity and debt based products, although some appear underutilised.

Question 3: *What measures should be in place to ensure transparency in a pre-pack sale process in SA?*

The participants all seemed to agree that independence by BRPs was key to the transparency of the process, both from the auditors of the distressed firm and from shareholders and management. This was followed closely by value marketing (for price) through a bidding or auction process, setting of guidelines or regulations for BRPs conduct during the process, and compilation of adequate information by BRPs on rationale for pre-pack decision, as confirmed by seven participants. At least six of the participants believed a ratification of the sale process by creditors could assist in the transparency of the pre-pack process, with four of the six participants only somewhat agreeing to this assertion. Down the line, only four participants believed that a review by an independent body would help increase the transparency of the pre-pack process, with only two of them strongly suggesting this. Support was therefore found for proposition 3, namely:

Proposition #3: The transparency of pre-packs will be better served by the independence of BRPs and a valuation deemed fair and reasonable.

Question 4: *Who should be responsible for regulating the behaviour and conduct of BRPs during pre-pack implementation and how?*

According to the participants, there should be some sanction against BRPs in order to ensure they play to the rules of fairness in implementing pre-packs, with the most popular being sanctions by the practitioners' professional bodies (8/8) and by the regulatory body (CIPC in this case) (7/8). There was overall, a stronger support for a sanction by the regulatory body than by the professional bodies, with five participants strongly agreeing as opposed to four respectively. Six participants further suggested a removal of creditors as a right step towards sanctioning by creditors and five agreeing to a legal prosecution by courts, and even then, only two strongly agreeing. It seems from the findings, that a strong case may be made for sanctioning powers by the regulatory authority, as well as professional bodies, thus supporting proposition 4 as follows:

Proposition #4: BRPs' conduct and behaviour during pre-pack implementation should be regulated by the regulatory authority and their respective regulatory bodies.

Question 5: *What elements contributing to the growth of pre-packs could be influenced by BRPs?*

Participants believe that BRPs are more strongly in control of, and can therefore influence, their own behaviour in the process, and making stakeholders aware of and providing them with access to information regarding the various funding options in the distress market. Six participants supported this. Furthermore, five participants suggested that the support of and participation of stakeholders in pre-packs would be directly or indirectly under the influence of BRPs. Only four believed that early intervention in the process and access to quality, reliable information on the distressed debtors would be under the influence of BRPs. Overall, the BRPs are deemed to be more in control of their own conduct, while also able to make stakeholders aware of various funding options or instruments that they can use. Having said this, one of the two "unavailable" participants had initially strongly suggested the awareness of various funding options/instruments and easy access as key elements within the BRPs influence, although it was not too clear what was meant by the "easy access". Another had mildly narrated the BRPs ability to make stakeholders aware of pre-packs and other products in the market as a factor under their influence.

In conclusion, while there are aspects that might come out more strongly than others, the responses generally support the proposition as follows:

Proposition #5: BRPs involved in sales of distressed businesses are in a position to influence the activity of distress funders, their use of various funding instruments, and access to information on the targets (distressed debtors).

Question 6: *During a default situation, creditors hold superior rights due to their superior claims to the existing shareholders. What should be their ideal role?*

In general, there were no strong affirmations regarding the proposed roles of creditors in a default situation. Many somewhat agreed to creditors playing an oversight role and influencing the development of the business rescue plan through their participation in credit committees, with five affirmations in total. Slightly fewer (4) agreed to creditors playing a less active role with the ultimate aim of walking away after salvaging as much as possible of their claims, whilst even fewer (3) thought they should provide further funding, despite this suggestion having arisen from the participants themselves during the initial round. Ultimately, all but one of the participants disagreed that creditors should formally convert their debt into equity, with some believing this to be a last resort move. The

“unavailable” participants suggested in the initial round that creditors should take a role of holding BRPs and directors accountable, but without necessarily, formally converting their debt positions.

In view of these findings, the suggested proposition is set as follows**:**

Proposition #6: Despite their default, shareholders’ status in the distress companies during default, creditors should not formally take up a shareholders status by converting their debt to equity, and should rather participate at arms’ length during business rescue.

Question 7: *Given that credit insurers replace insured creditors during default, and enjoy superior rights due to their superior claims, what role do you believe they should play during default?*

The role of credit insurers was somehow looked at a bit differently. Most participants (6) believed that credit insurers should use creditor committees either to support the plan or to assume an oversight role over BRPs and directors, while influencing the business rescue plan, with four participants believing strongly over this. Fewer participants (4) believed an even more active leadership role should be assumed by credit insurers through actively managing the BRPs and holding directors responsible. One of the “unavailable” participants had initially advocated a more active role of saving the distressed businesses, whilst another had suggested a more active role in managing the BRPs. It is not immediately clear what a more active role entailed.

A more financially active role such as providing more funding or converting debt into equity was overall not encouraged by the participants. In the main, three and four respectively were ambivalent while two each rejected the idea. Those who were not opposed to the idea of active funding were only somewhat agreeable, at three and two respectively. The above findings suggest the following proposition regarding credit insurers:

Proposition #7: While insurers of credit risk should not consider formally taking up equity positions in the distressed businesses during business rescue, they should take a leadership position in influencing the outcomes through various measures such as oversight, creditor committees, and supporting the business plan.

6.6.2 Key observations from the initial exploratory interview

In examining the history of the development of hedge funds in SA, it was established that hedge funds entered the market in 2007 under a category 2 licence, and were then open to do investments on a discretionary basis. Following the 2008 global economic downturn and numerous discussions, an amendment was promulgated in April 2005. This had the effect of reclassifying hedge funds together with unit trusts, under the Bond Notice 52. This reclassification created certain accountabilities by hedge fund managers, whilst still allowing them to do some discretionary investments, within certain parameters of course. In conclusion, whilst this provides some leeway towards channelling a considerable amount to distress investments, most hedge fund managers seem reluctant to enter the market. This may be largely due to lack of requisite distress investment skills and consequently poor incentives to enter the space.

6.6.3 Key observations from the expert contributions

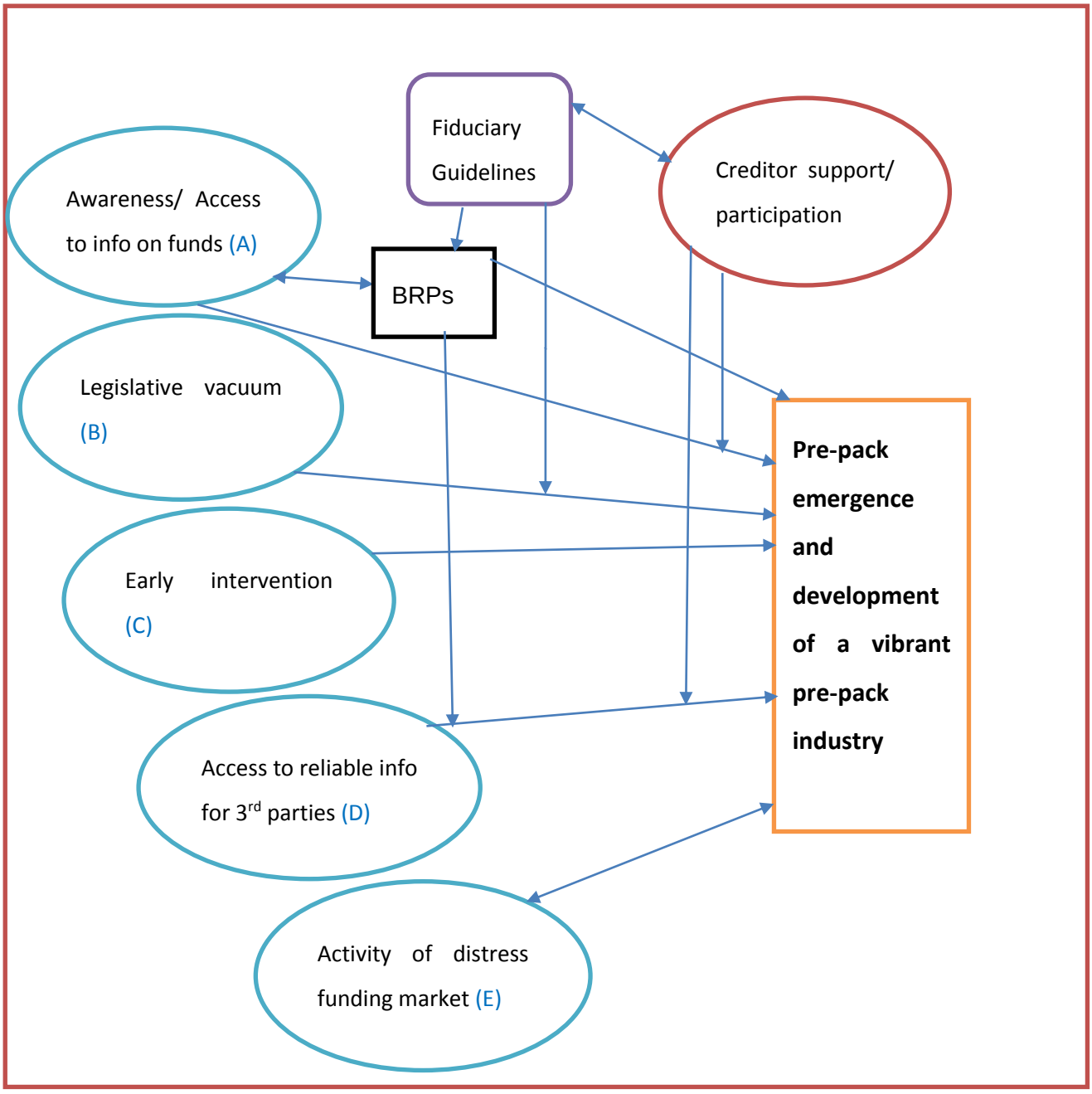
From the findings, it seems that among the key drivers of this development and growth of pre-packs are an early or proactive intervention into the business rescue process, having identified early distress symptoms, and the support and participation by creditors in the pre-pack process. It needs to be understood that while these factors have not yet been empirically tested, they have been identified in this study by experienced business rescue professionals after several years' exposure in the field. The participating experts were also of the view that credibility still has to be built in the market for pre-packs to develop and grow. One of the ways in which this could occur has been identified in the study as the introduction of guidelines to govern the conduct of BRPs appointed to preside over the process. Encouragingly, in accord with literature, access to reliable and quality information on the distressed debtors by third parties has also been cited as a requirement for development and growth. In the same vein of confirming literature studies, the activity in or vibrancy of the distress funding market, as well as awareness of various funding options in the market for distress funding, including pre-packs, have also been mentioned in the study as possible contributors to the development and growth of pre-packs. The latter issues have been identified in literature as indicated in previous sections.

Lack of legislation and thus a legislative vacuum was confirmed with a relatively weak response, including a 'first round only' participant of the Delphi study. This has been assumed to be largely due to the limited exposure to literature on the evolution of pre-packs, as this was not provided to the participants. Such a factor would not necessarily have been evident to every respondent since this is largely a phenomenon observable in international regimes, whilst pre-packs have not been formally introduced in SA. The confirmed responses on this aspect support the literature, and it would still inform the proposed framework. Based on the above observations, the relationship between the emergence of pre-packs as a dependent variable, and the influencing factors as independent variables, could then be represented in a form of method of agreement, or alternatively, in a potential linear equation. This agreement or equation represents and includes the consensus factors identified by literature and business rescue experts in SA.

Prior to building the relationship equation between the emergence of pre-packs and the other variables in the equation, consensus also needs to be built regarding the role that BRPs could play in influencing or interfering with the independent variables. According to the findings, BRPs are responsible for their own conduct, although those need to be regulated by the responsible body organisations. Apart from influencing the role of BRPs, this regulation may not seem to play a significant role in influencing the emergence of pre-packs, except in moderating a few factors such as playing a part in helping to close the legislative gap governing pre-pack implementation, and indirectly encouraging BRPs to ensure reliable information is accessible to potential funders. The only aspect where the BRPs are viewed as being able to influence (thus being able to mediate) is in the awareness of and access to information of available funding options (including pre-packs) to stakeholders of the distressed company. As administrators to the process, they are also in a position to assist the distressed company with distribution of reliable information on the company, thus playing a moderator role. This moderating role also applies to stakeholders' (read creditors) support and participation in the pre-packs. In this instance, their support and participation help to ensure information on funding options is available to stakeholders of the distressed company, as well as assist in providing reliable information so it can be accessed by potential funders. Their role is thus a moderator role. The roles of BRPs and creditors (in their support and participation) can thus be viewed as catalytic to the process, while fiduciary guidelines for BRPs can be seen as providing an environment

for BRPs to operate and creditors to co-operate in their catalytic roles. In this relationship illustrated in Figure 6.1, the emergence of pre-packs is depicted as the dependent variable, whilst the above factors all play the independent variable role. Adapting the Mills method of agreement (proposed by John Stuart Mill in the 19th century), the relationship is then depicted in Figure 6.1 below.

Figure 6.1: Framework of factors influencing pre-pack emergence for South Africa



Source: Adapted Mills method of agreement between dependent and independent variables

Alternatively, these relationships could be depicted in the form of an equation, as follows:

$$P_e = C(CS \times BRP(A+D) + B + E + (FG \times B))$$

Where:

- P_e is the eminence of pre-packs and development of vibrant pre-pack industry;
- BRP represents the mediating and moderating influence of BRPs over factors;
- A is the access to information on the multiple funding options and products that are available in that particular environment;
- B is the legal vacuum created by the absence of relevant legislation;
- C is the early intervention in the business rescue process;
- D is the access to reliable and credible information for M&A by unrelated third parties to the distressed firm;
- E is the activity or availability of the distress funding market;
- FG is the guidelines to govern BRP behaviour;
- CS is the creditor support and participation in pre-packs; and
- Error signifies accommodating the occurrence of error inherent in the accuracy of the relationships.

Further work, however, needs to be done in developing the values of the independent variables according to their contribution to the equation. Such a calculation could enable the empirical testing of factors influencing the emergence of pre-packs in restructuring environments.

Having developed the above framework in Figure 6.1, an attempt was then made to develop legal guidelines for the ideal functioning of pre-packs once they are in place. These guidelines assist to build measures of transparency in the process, sanctioning principles for non-compliance by BRPs and role differentiation or clarification by different parties during the pre-pack process. However, it is important to note that the guidelines are not an attempt to write or amend the law or practice notes, but rather to suggest recommendations towards the same.

6.7 GAPS, INCONSISTENCIES AND CONTROVERSIES

A potentially controversial issue in the framework regarding pre-packs in SA could be the application of section 129 of the Companies Act 71 of 2008, read together with s 218(2). In particular, section 129(7) requires the board of directors to make a written submission to all affected persons, in the event that they have reasonable grounds to believe that their company is facing financial distress, but have not taken a company resolution to that effect. They are required in this notice, to explain why they have not adopted the resolution. Adopting and filing the resolution necessarily gives them five working days to publish the notice of the resolution and appoint a BRP according to section 138, and effectively kick-starts the business rescue proceedings. This theoretically creates a thin line between entering a pre-pack phase and violating the provisions of the Act. Australia faces a somewhat similar challenge, with the directors in this case, being liable for trading in insolvency and neglect of fiduciary duties if deemed to not have minimised losses to creditors. It is said that this situation affects the occurrence of pre-packs due to directors being concerned about their exposure to insolvent trading and fiduciary duties. The fact that there have been relatively few test cases with judgements does not completely eliminate the risk. Crouch and Amirbeaggi (2011) argue however, that insolvency-trading provisions create a very limited barrier to directors engaging in pre-packs. They nevertheless, recommend that insolvency trading not be subject to prosecution during pre-packs. Whilst non-adherence to section 129(7) might create impeachable conditions for directors in SA, there may be merit in the directors adopting a resolution that the company voluntarily begins the process of business rescue, without necessarily filing it, thus bringing section 129(2)(b) to being, in order to properly accommodate pre-packs.

6.8 DISCUSSIONS AND IMPLICATIONS FOR INDUSTRY

Often pre-packs are defined by the industry as opposed to the authorities. Building a framework for pre-packs in South Africa should then commence with a contextualised definition of pre-packs. Given the finding regarding available funding options or instruments, it appears important to include both debt and equity products into the definition of pre-packs. Pre-packs essentially involve transactions that have begun prior to filing for formal reorganisation (or business rescue), and are only formally completed after

the filing. John, Mateti, and Vasudevan (2013) regard pre-packs as combination of the advantages of super-priority debt (DIP financing) and a workout (restructuring), which essentially may not include an equity play. McCormack (2008:103) describes pre-packs as conducting restructuring negotiations outside formal restructuring, then using formal restructuring to finalise the process. Perhaps the best explanation is that of Mallon and Waisman (2011:205) that pre-packs really are a negotiation between a debtor and a creditor regarding a proposed restructuring plan in advance, which then gets ratified by filing (in courts). Thus in a SA sense, pre-packaging does not always have to result in a sale, and could be seen also as agreeing to a business rescue plan in advance by debtor and major creditors and/or potential financiers, prior to filing for business rescue. This could involve either a sale of the business, provision of priority debt (PCF), or an investment through other debt instruments such as debt-to-equity swaps, credit swaps or asset-based-financing. A more refined definition could therefore be that *pre-packs are negotiations that commence prior to filing for business rescue, and could involve either a purchase of assets or the business, or an advance agreement over the business rescue plan with creditors, or the use of debt instruments that could be convertible to equity. This arrangement then becomes consummated after filing for business rescue.* This definition would set the tone for the development of a framework in SA.

Given the nature of the findings, the framework development can be suggested on two levels. Some issues may require the intervention of the state in terms of legal clarity and certainty, while others can be dealt with at industry level, and may require only the creation and application of guidelines. In this instance, recommendations have been made to the legislators and the industry regulator, while the industry's professional bodies are charged with ensuring fair practice by their members.

In making a recommendation to the legislator and regulators, an issue to be fully considered is the forging of legal clarity regarding the process of disposals of assets or businesses of distressed companies during or before business rescue proceedings. The process of disposals or even amalgamations and mergers, for purposes of business rescue is found in varied sections of the Companies Act and is often the result of reading various sections in conjunction, including those outside Chapter 6. It is understandable that Chapter 6 was designed to allow freedom of application for various processes without

prescriptions, in a similar way as in regimes such as the US. This however, leaves room for varied interpretations, and the SA business rescue is not court-driven such as the US. The result is that many practitioners operate without certainty, and may apply pre-packs outside the parameters of fair play. Thus, legislative clarity is required to bring about legislative certainty.

The required amendments in this regard, would need to provide clarity for sales in plan, out of plan and “quick” sales, in particular where negotiations begin prior to the filing for business rescue, thus paving the way for pre-pack sales. Given the observation of Harner *et al*. (2014) that pre-packs have gained popularity as an effective tool in resolving restructurings, it could be argued that these slight amendments to the Companies Act could encourage sales of assets and thus give impetus to pre-pack sales. Nonetheless, it is only a matter of time before pre-packs become a normal part of business rescue proceedings. Given the global history of evolution of pre-packs, such a move may likely happen with or without additional legislation, which could leave some affected parties vulnerable or without adequate protections.

From the findings, it is apparent that the participants believe that adequate guidelines need to be put in place, as a top priority seems to be the conduct of BRPs. This would also ensure that BRPs have a referral basis for purposes of correcting or prescribing adequate behaviour in an M&A transaction, especially regarding pre-pack sales. This may also mean that the conduct of BRPs assigned to conduct such sales could then be left to the member practitioner bodies to develop guidelines for and manage the process, through monitoring and sanctioning. In this regard, membership bodies for business rescue practitioners, such as South African Restructuring and Insolvency Practitioners Association (SARIPA) and Turnaround Management Association (TMA), need to adopt a regulatory role and create a code of conduct to which their membership will adhere. For this to be effective, it would be imperative for the membership bodies to be given the authority by the regulatory authority to impose sanctions for non-compliance by members.

These guidelines may take the form of Practice Notes, and would need to consider the following:

- prescription for the independence of BRPs during the pre-pack process, from shareholders and management, in the event of a sale of business or assets;
- prescription for the independence of BRPs from auditors of the distressed company, requiring different professional firms to conduct business rescue from the auditors;
- alternatively, then a “Chinese wall” concept can be applied, ensuring that a firm can be engaged as BRPs only if they can prove that they operate independently of and without any disclosure to their audit division;
- ratification of the advance business rescue plan by a prescribed majority of creditors, with limited cram down options, where a sale is not part of the process;
- independence of the valuation regarding pre-pack sales, to be prescribed either through a bidding or auction process, usage of an independent valuer to conduct the valuation, or a compulsory ratification of the sale by a prescribed majority creditors;
- a prescription for BRPs to include in the business rescue plan adequate information on the rationale for pre-packs, where a sale occurs; and
- sanctioning measures for BRPs who violate the code of conduct, which may include fines, suspensions or formal sanctioning from practice.

6.9 LIMITATIONS, FUTURE RESEARCH AND IMPLICATIONS

6.9.1 Research limitations

There currently does not seem to be any research done analysing the predictive effect of precedent on the behaviour of the pre-pack market given certain circumstances, thus this study explores what seems to be an unexplored area. The result is that the study is largely explorative and could not at this stage, be empirically researched. This therefore means, firstly, that the resulting equation needs to be empirically tested and each independent variable appropriately measured. Secondly, whilst some of the factors affecting pre-packs have somewhat appeared before in the literature, albeit in isolation, there are several new assumptions included that are purely based on the relatively “untested” opinion of experts in the field of business rescue in SA. An opportunity may have been created for these assumptions to be tested in future studies.

6.9.2 Suggested future research

An important further research to be done is to empirically test the relationship between the dependent variable, namely pre-pack emergence, and the independent variables as illustrated in Figure 6.1. Furthermore, in order to understand the relationship in more detail, the relative weightings of each of the factors in the linear equation may need to be developed, although the latter study may be more relevant for mathematical analytics, but the results could be used to predict or monitor the success or failure of introducing pre-packs.

6.9.3 Implications for business

The importance of pre-packs in helping to fast track the business rescue or formal restructuring processes cannot be overemphasised. Due to the speed of completion, pre-packs manage to reduce the risks associated with formal restructurings or business rescue and have thus become popular globally. In many markets, pre-packs appear to have entered the system and then subsequently regulated to ensure compliance with fair practice and transparency for stakeholders. Currently in SA, pre-packs have not been officially recognised or formally recorded, but seem to have begun the process of creeping in. In this situation, there are no guidelines yet on fair practice and transparency of process. Accordingly, the industry needs to be pro-active and implement regulations and guidelines to ensure the above criteria are met. This study was intended to assist in developing a framework towards establishment of such guidelines in order to give pre-packs a fair chance of survival without undue criticism. The implications for the industry and for business are an awareness of the virtues of pre-packs, and an opportunity that this presents for effectively executing business rescue. Furthermore, it is hoped that the framework will enable an amiable operating environment for the implementation of pre-packs. This means clarifying roles for stakeholders and some protection to nervous stakeholders such as creditors, and ultimately offering guidelines or regulations to BRPs in implementing pre-packs. Finally, it is hoped that once these things are in place it may be easier for all parties to come on board and embrace pre-packs, which are inevitable anyway.

6.10 THEORETICAL IMPLICATIONS

The precedent effect seems to be better explained in legal terms, where the legal precedent principle is applied in cases where a reasoning or decision in a previous legal case is applied in subsequent cases. This case is then used to establish a legal principle or rule, where none existed. It could be argued that this principle could be applied or extended to other areas and built as a theoretical principle beyond legal parameters and prescriptives.

A legal vacuum thus occurs when the applicable legislation does not adequately address the issues at hand or does not provide guidance. As explained earlier, whenever there is a legal vacuum and an activity subsequently takes place within the grey area, which subsequently gets ratified through continued practice, court decisions, legislative amendments or practice guidelines, precedent becomes established. This sequence of events has happened in the case of pre-packs in the US, UK, and Australia (Conway, 2015:1). This is the researchers' basis in this study, for advancing an argument on the precedent principle as a theory applicable specifically to pre-packs. The theory can be applied two-fold in the case of pre-packs, being exogenous and endogenous precedent theories. A newly established business rescue or restructuring regime without adequate legislation for pre-packs will likely adopt the practices of established regimes that themselves adopted pre-packs outside of the applicable legislation. This exogenous expression of precedent is often made possible by the existence of fairly, similar legislation regimes on restructurings. Endogenous precedent on the other hand, is based on the internal pull or push factors in a particular regime, which forces a legislative adaptation or an accepted behavioural practice regarding pre-pack practice.

Given the above, SA is likely to follow suit, especially if one considers that other countries have already followed a similar route. The conclusion of this study thus includes an advancement of the theory of precedent as being applicable in the case of pre-pack applications.

CHAPTER 7

CONCLUSION

7.1 INTRODUCTION

Globally, formal and informal restructurings have become a major tool for the resuscitation and rehabilitation of companies that are facing financial distress. This study is a perspective on formal business restructurings, and explores a concept applied therein to produce (often) favourable outcomes as speedily and as cost effectively as possible. This concept called pre-packaging has found common acceptance and seems to have become an important part of formal restructuring regimes. A key element of pre-packaging is that it involves a restructuring plan taken on and negotiated with stakeholders prior to filing for the formal restructuring process, then filing afterwards with the aim of implementing the plan immediately thereafter. When concluded, together with funding or a sale of the distressed business, the sale is agreed to prior to filing and implemented immediately after filing for the formal restructuring. Given that literature often refers to pre-packaging in the mode of sales, this study focussed on pre-packaged sales.

The study intended taking the concept from other more established restructuring regimes and placing it in a SA context to determine its applicability, and suggested application. While doing so, it was important to note that literature asserts that pre-packs are applied contextually in different regimes. Therefore, over and above the differing names ascribed to formal restructurings in different regimes, there were also nuances in the legislations governing the different restructuring regimes. This in turn, influenced the antecedents required to place the concept in the different environments. An example is the Australian and SA regimes, which place an onerous insolvent trading provision on the directors of a company, thus creating additional responsibilities to be carried by such directors when involved in pre-packaged sales.

The key problem researched in this study was to find a robust, pragmatic and acceptable pre-packaging model for SA that could enhance business rescue in practice, by applying grounded theory strategy. In so doing, antecedents for its implementation could be identified and applied in an attempt to develop a theoretical framework for its application.

In the introductory Chapter 1, the role of restructuring (or business rescue in SA) was explained in the context of a typical business life cycle and the often, associated possible failures during the course of the life cycle. Key to the introduction and emergence of pre-packs in SA is the legislation, which is at best silent on sales of businesses or assets during business rescue, as well as the seemingly conflicting legislation on Insolvencies.

Chapter 1 also explains the broad research philosophy followed in the study, together with an overview of the methodologies. That being done, the specific role and purpose of pre-packaged funding were then provided for a much clearer context. In order to provide a more complete understanding, the study had to look to a more established regime base to understand common principles and praxis, and then examine their applicability within the SA legislative environment. Thus, the discussions on *the legal and operating environment on pre-packs, financial structuring of sales transactions, the role of sales in the current SA environment, and the antecedents for the emergence of pre-packs in SA*, were each examined as part of four separate articles laid out in Chapters 3, 4, 5 and 6 respectively. These forming the core of the study. The articles were explored as follows:

Article 1: Pre-packaged applications in business reorganisations: International principles

- *Research question explored*: What are the similarities in the guiding principles and practices of pre-packaged financing observed among global restructuring regimes?

Article 2: Funding structures in business reorganisations: Locating the role of pre-packaging as a restructuring tool

- *Research question explored*: What is the role played by pre-packaging in the funding mechanisms of business rescue?

Article 3: Exploring the role and extent of sales transactions in business rescue: A precursor for pre-packaging?

- *Research question explored*: What is the status and extent of sales of businesses or assets in business rescue processes and their possible influence on the development of pre-packaged funding?

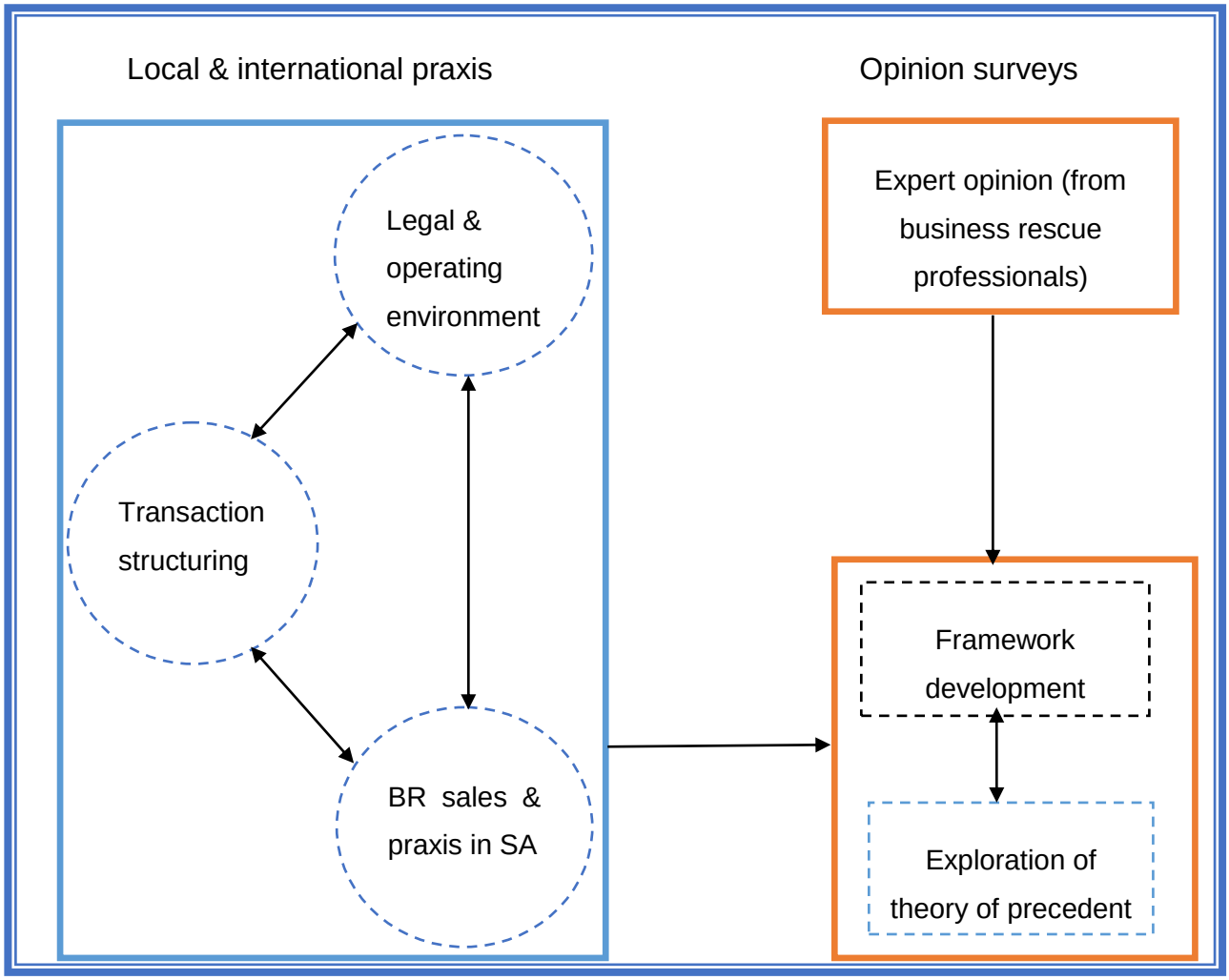
Article 4: Developing pre-packaging for the South African industry: Antecedents for applications

- *Research question explored*: What are the key elements to a successful development and monitoring of pre-packs in SA?

The highlighted research questions in these articles were the drivers in answering the broad research questions and sub-questions detailed in section 1.7. The overall study is illustrated by the Figure 7.1, indicating that international literature and surveys on local practices were employed, together with local opinion surveys to map out a framework for pre-pack application in SA.

The rest of this chapter provides a summary of the above work, together with conclusions on each of the article topics.

Figure 7.1: Summary illustration of the research



Source: Own compilation

7.2 PRE-PACKAGED APPLICATIONS IN BUSINESS REORGANISATIONS: INTERNATIONAL PRINCIPLES

As the first article in this paper-based-thesis, this article formed a significant basis of the study, as it examined the frameworks within which pre-packs existed in key established restructuring regimes. This covered the operating environment, including the context, the legal frameworks governing pre-packs, praxis and other enablers. The aim of the paper was to provide the necessary insights into the *raison d'etre* of pre-packs.

7.2.1 Overview of article

Using the pre-identified established restructuring regimes of the US, UK, Canada and Australia, a comparative analysis method was applied to develop schematic themes on the principles, praxis, governance and contextualisation of pre-packs in those environments. Great reliance was placed on a literature review to conduct a content analysis on the operating environments of the four regimes. The data gathered was structured into coherent mind mapped themes in order to develop insights on the operating environments.

Probably the oldest restructuring regime in the world, literature points to a sophisticated and court-driven process of restructuring in the US, which seems to have taken a lead regarding applying a concept such as pre-packaging. In this case, pre-packaged sales have been adapted from varied sections in the bankruptcy legislation, which do not seem to have been intended to function together. Ultimately, the sections that seem to be applied well together to apply pre-packs (with sales) seem to be sections 363 governing sales during distress, and 1126 allowing a pre-negotiated filing.

At the same time, a regime such as Australia seems to operate on the other end of the spectrum as a follower, but nevertheless seems to bring an important context to the discussion on pre-packs, as it is not reliant on courts and has no legislation nor guidelines to govern their application. This provides two asymmetrically opposite operating environments where pre-packs are in operation and seem to be thriving. The UK and Canada, on the other hand, appear to have adapted their governance structures to accommodate pre-packs, which had preceded this governance anyway. In the case of the UK, these guidelines (SIP 16) were developed to ensure fair practices by the administrators or insolvency practitioners. Nevertheless, it seems clear in many of these cases, that the hand of the legislators was forced into action to control the application of this concept, which had found its way into use over a period.

7.2.2 Findings and conclusions

Despite all the varying backgrounds of the legislations in the various regimes, there were common elements identified in the evolution and application of pre-packs throughout. However, it was quite clear that the four regimes displayed similar, as well as dissimilar rules in their applications of pre-packs. The research found that there does not seem to be

a standard definition of pre-packs globally, especially comparing the US and Canada with the rest of the European world. Consequently, even the applications differ, for instance, the US and Canada do not necessarily include sales and have a number of terminologies to explain various aspects of “pre-packs”, whereas the meaning seems to be similar within Europe, UK and Australia. Even so, Australia’s standard was also slightly different from that of the UK, mainly because they did not even have guidelines to govern them such as in the UK. In general, the US system seemed to have been largely copied by Canada, especially since they were neighbours with strong trade links. On the other hand, Australia seemed to an extent, to have copied their fellow commonwealth country, the UK, in their application of the process.

It was further noted that rescue culture played an important role in all four regimes, towards driving the growth of pre-packs, largely due to the existence of active distress funding markets in all four regimes. A more important factor was that both the US and Canada had legislated debtor-in-possession (DIP) financing (a form of PCF) in their countries, with the result that this seemed to encourage pre-pack emergence. Similarly, the absence of PCF in both the UK and Australia seemed to encourage pre-pack emergence, as an outlet (for funding) in this case. In the latter case, it seems that funders consequently found some comfort in early funding engagements, while in the former case, pre-packs seemed to have become a logical next step. This phenomenon of a pull-and-push effect towards pre-packs, seemingly inadvertently drives the emergence of pre-packs. It needs to be pointed out, though, that there seems to exist a school of thought in the UK that PCF could, in some cases, find expression as part of administration expenses.

7.3 FUNDING STRUCTURES IN BUSINESS REORGANISATIONS: LOCATING THE ROLE OF PRE-PACKAGING AS A RESTRUCTURING TOOL

After examining the operating environment under the first article, it became necessary to understand how the pre-packaging transactions are conducted in the global restructuring environment. This second article was then used to study the various structures and funding mechanisms applied in the implementation of pre-packs. This study was useful to improve an understanding of the financial complexities involved in pre-packaged funding mechanisms, including valuations and transaction structuring.

7.3.1 Overview of article

Interestingly, a lot of the literature on pre-packaged sales focuses on the legal and commercial environment, and there seems to be very little focus on the financial aspects, namely valuation techniques, capital structures and transaction structuring. Nevertheless, the available information was enough to provide direction and determine a trend. This study focused on the US, UK, Australia, and other parts of Europe such as France, the Netherlands and Sweden. A limited consideration was made on the SA distress-funding environment, as there was very limited literary information, with the exception of PCF as the only widely known and legislated form of funding.

In the process of this study, it was discovered that hedge funds played a very important and dominant role in the distress funding market, and in particular, with pre-packs, especially in the US and some parts of Europe, with Jiang *et al.* (2012) estimating their presence at 90% of chapter 11 transactions. This was mostly because they operated under less prudent rules, and could take higher risks, with potential higher returns compared to private equity funds and other potential investors. Another reason is that distress funding requires specialised investment skills not usually found in other investment houses. Literature describes professionals with such skills, as being able to hold complicated positions by combining ordinary claims and derivative instruments, as well as being informed and close to the process. Other researchers describe distress investing as requiring a high level of business acumen combined with a deep understanding of finance, accounting, corporate and restructuring laws. Therefore, due to their unique portfolio category, hedge funds are able to employ such highly skilled professionals.

Importantly also, is the fact that most hedge funds made no strategic distinction in pre- or post-filing investments in the distress assets. Most of their funding structures are borne from debt and equity instruments, which are invested either prior to distress or during the distress period. They often acquire debt claims from secured and non-secured creditors who want to exit, with the aim of controlling the process of restructuring and influencing the business rescue plan, and sometimes even appointing management. Accordingly, there are three broad categories of investments by hedge funds, namely as credit or equity holders, and in loan-to-own participation. Accordingly, the various funding structures used

by mostly hedge funds, and other investors, include pre-petition secured loans, pre-petition unsecured loans, credit swaps, pre-petition equity, etc. Literature also recognises that various valuation methodologies are used in distressed acquisitions, including adjusted Discounted Cash Flow, comparable transactions value, and company and market comparisons. An exception seems to be Sweden, which employs an auction method of sales in pre-packs, and furthermore applies a liquidated piecemeal valuation. Lastly, it was established that in distress situations, negotiations with creditors add complexity to transactions, as they become a key determinant to price negotiations.

While sophisticated distress investment dealings have become the order of the day in the US, various parts of Europe are beginning to take centre stage, with developments in France and Germany among countries that are adopting debt-to-equity swaps, credit default swaps (CDS), collateralised debt obligations (CDOs) and other instruments. Despite all this though, equity acquisitions still appear to be the prevailing method of distressed acquisitions in Europe.

7.3.2 Findings and conclusions

In this study, various propositions were confirmed. The main ones being that in markets with an active distress funding activity, there are various funding options available. These are that pre-packaged funding does not often exist in isolation – it usually is part of a basket of funding options in the distress funding market. Pre-packaging often introduces new investors as it is often conducted as a sales transaction and results in some new owners of the distressed business. Given the complicated nature of the investment space and concomitant risks, pre-packaged investments by third parties are often driven by a perception of good value for money. Consequently, as opposed to regular M&A transactions, investors in pre-packs often invest once their calculations point to a return befitting their abnormal risks.

7.4 EXPLORING THE ROLE AND EXTENT OF SALES TRANSACTIONS IN BUSINESS RESCUE: A PRECURSOR FOR PRE-PACKAGING?

Having studied the external environment (international regimes), it was then necessary to look at the South African environment in the third article and determine whether it was

feasible for the introduction of pre-packs to begin with. To do this, an examination of sales transactions that were conducted during business rescue in SA was conducted to see if this could be indicative of a trend towards the development of pre-packaged sales, thereby being able to anticipate their emergence.

7.4.1 Overview of article

While pre-negotiated plans or pre-packaged plans and filings (in terms of the US definition) play an important part in determining the role of “pre-packs”, the UK definition of pre-packs appears more useful and relevant for exploring the value of pre-packs in new environments such as SA. This is largely because pre-pack sales are relatively easier to investigate in retrospect compared to pre-plans once they have been archived. Most importantly, the avenue created by section 134 in the Companies Act 71 of 2008 in SA, makes it theoretically feasible for pre-packs to be applied in sales. Furthermore, since funding is considered key to the success of business rescue in SA, and arrangement that involves sales or funding at an early stage of business rescue became paramount to the study.

Globally, M&A (mergers & acquisitions) has become an important tool in resolving financial distress. According to researchers, sales of distressed businesses or assets have become more prevalent over time. As part of distressed acquisitions, pre-pack sales occupy an important space within M&A. In this context, the role of sales in the substantial implementation of business rescue terminations was investigated, in order to determine patterns that could encourage the emergence of pre-packs. Substantial implementation is specified in the Companies Act governing business rescue, and is indicated by companies that have successfully completed the process of business rescue.

In determining this role, the question that had to be answered was whether sales have played a role at all in substantial implementations of business rescue in SA, and whether some of these sales were even negotiated prior to filing for business rescue. Substantially implemented business rescue cases, which involved a form of sales of business or assets, were identified since inception of the Act, and a survey made to understand the processes. Forty-two such sales were identified mostly from public records, and were spread among eighteen BRPs. It has to be stated that many of these sales comprised of subsidiary

companies under the same holding company or group, and were thus administered by one BRP as part of one transaction. This in effect reduced the overall number of company groups to have undergone sales. Nevertheless, eight responses were received from the eighteen email surveys, which were sufficient to extract the quality required for this research.

7.4.2 Findings and conclusions

A key finding of this research was that some transactions exhibited all the elements of a pre-pack, and were acknowledged as such by the BRPs. These transactions were however, not recorded as such in the regulatory authority's (CIPC) records because the recording system does not make room for that. The effect is that pre-packs have in fact, taken place in the SA environment but have not been formally recognised as such.

Some of the findings include the discovery that transactions that occurred included partial sales and whole company sales in some cases. Other sales were sales of assets (including contracts). Another important finding was that most buyers were industry buyers and not financial investors, although many of these were previously not linked with the distressed companies. The significance of the former discovery is that it explains the apparent underdevelopment of the distress funding market in SA. Another finding was that many of the sales did not involve new equity or conversion of debt to equity. It seemed that PCF was involved as quasi-equity. This may have been due to funders considering the prospects of repayment being dim. However, the information gathered on this development was not sufficient to firmly conclude thus. The possibility however, presents an interesting aspect on pre-packs in this case.

In view of the literature in the previous article, two further considerations were whether the sales were viewed as fair and equitable, and that the sales were done at considerable discounts to the buyers. Responses to the above affirmed these positions, with the former confirming literature that distress funders only do so because they perceive high returns.

7.5 DEVELOPING PRE-PACKAGING FOR THE SOUTH AFRICAN INDUSTRY: ANTECEDENTS FOR APPLICATIONS

The fourth and last article was then used as an attempt to understand the antecedents to a possible emergence of pre-packs in the SA environment. For this, a group of carefully selected business rescue professionals were surveyed as experts to provide their opinions and possible understanding of pre-packs, with the purpose of identified key factors that could make their emergence successful. This was in view of the fact that pre-pack applications had already been identified as being in operation in the earlier article. This is despite references in legislation not going far enough or guidelines to govern them not being available. The article was in essence, a culmination of all the work gathered so far, and utilised literature reviewed so far, as well as data gathered in the third article, to articulate a possible way forward on pre-packs in SA.

7.5.1 Overview of article

While it was recognised that pre-packs had already found their way into the SA business regime, albeit without formal recognition, the article sought to understand the additional factors to be considered in applying them in a manner acceptable to broad stakeholders. To this end, relevant stakeholders to the process of business rescue were invited on a panel of expert interviews, conducted online. These stakeholders covered BRPs, creditors (including those normally involved as either secured or unsecured), credit insurers, distress funders, legal practitioners in business rescue, and other practitioners involved in both formal and informal restructurings.

Prior to developing the survey questionnaire, literature was used to compile a template of possible antecedents against which the expert views were tested. The result was then applied to commence with the development of building the blocks for a framework on pre-pack application in SA.

7.5.2 Findings and conclusions

A key finding from literature is that pre-packs in fact do not require formal legislation to take effect in restructuring regimes. They seem to be applied initially through the legal gaps in the restructuring regimes, and subsequently, are ratified by courts or repetitive

practice, giving effect to the legal principle of precedent. The precedent principle in this case manifests as the pre-pack activity that serves to guide or justify subsequent pre-pack practice. According to the Insolvency Service (2014), pre-packs have arisen out of practice and through judicial approval.

The framework building process seeks to determine a relationship between the successful emergence of pre-packs and various factors that contribute to its successful implementation. Through a confluence of literature reviews and expert opinion, several key drivers of pre-pack emergence were identified, as indicated in Figure 6.1. These include firstly, creditors' support and participation in the process and largely, the conduct of BRPs involved in the process. These factors formed an important background, and when successfully effected would likely play a moderating and mediating role to the other factors. To this end, the participants in the expert interview suggested that fiduciary guidelines for BRPs, particularly regarding pre-packs, would be necessary to ensure the latter play their role properly and ethically.

The other factors identified as potentially playing a role in the emergence of pre-packs are the awareness of and access to information on available funding options for stakeholders (directors, shareholders, etc.). As well as early intervention in the business rescue process, access to reliable and credible information for M&A by potential funders, activity or availability of the distress funding market, and lastly, the legislative vacuum that allows for pre-packs to occur regardless. The above relationships between the variables formed the backdrop to the development of a framework for pre-packs in SA. Furthermore, this framework development suggests the development of specific fiduciary guidelines to be established by practice organisations for BRPs and the industry as a whole. The Insolvency Act might also require an adjustment to limit the insolvent provisions for directors where pre-packs are applied, so that they can make timeous intervention decisions when required.

7.6 OVERALL SUMMARY OF FINDINGS AND THE RESEARCH IMPLICATIONS

7.6.1 Summary of findings

Due to the associated speed of execution, pre-packs reduce the risks of restructuring or business rescue, and consequently, widely adopted globally. One of the managerial implications is the creation of an awareness of pre-packs as an effective restructuring tool, and the possible creation of an amiable implementation of pre-packs. Role clarification for all stakeholders becomes a concomitant result of this. Expectantly, once these are in place, it would be easier for all stakeholders to embrace pre-packs and their relative advantages.

The overall objective of this study was to use international benchmarks to develop an acceptable framework for applying pre-packs in SA, in order to enhance the process of business rescue. In so doing, it was necessary to first understand the global operating environment, including all legal, commercial and financial aspects of pre-packs before attempting to draw parallels with SA and attempting to draft an applicable framework. Key questions were asked in the beginning, with an attempt to answer them in the four subsequent articles. The key findings are explained below.

- Although established restructuring regimes have similarities in their applications of pre-packs, they also have nuances in their legal frameworks that make their application uniquely suitable to their contextual environments;
- In most cases, pre-packs are introduced into practice by industry participants without the relevant legislation being in place, and only then do regimes introduce changes to legislation, or guidelines, or allow ratification by courts to regulate them;
- A business rescue culture seems to play a role in encouraging a vibrant distress funding market, and consequently, the use of pre-packs as a funding tool;
- Sophisticated funding mechanisms that often include various debt and equity instruments and complex valuations are often applied in funding for business rescue or restructuring, and ultimately, in implementing pre-packs;
- A more developed distress funding market dominated by savvy investors is often useful in encouraging the development of pre-pack funding;

- Although not yet officially recognised as such, pre-pack sales have actually started taking place in the SA environment, despite lack of legislation regarding sales transactions, and pre-packs in particular;
- Industry related acquirers looking for expansion or market share increase seem to be fairly active in the market for distressed assets in SA, compared with financial investors whose market seems underdeveloped at this point;
- The support and participation of creditors in a business rescue process is key to encouraging the emergence of prepacks, as well as an early intervention in the process;
- Early (proactive) intervention in business rescue efforts could play a significant role in encouraging pre-packs, as well as other factors identified in Figure 6.1;
- BRP conduct in administering pre-packs requires monitoring and sanction by professional bodies to ensure compliance to the rules of fairness.

The above findings provided a background towards developing a framework for pre-packs in the SA environment. Together with suggested clarity changes to the legislation and guidelines for BRPs (that were highly recommended by participants in the survey) they could complete the framework.

7.6.2 Managerial implications

The patterns observed in established international regimes gave a good indication of the operating environment for pre-packs, particularly because like SA, many of these regimes had not build pre-packs into their restructuring legislation from the onset. A key implication here is that governments and restructuring industries need to be prepared for pre-packs even though they may not have been initially legislated for. Not legislating for them does not make them unattractive for potential participants and practitioners. Secondly, the complexities involved in valuations and transaction structuring of distressed assets requires corresponding intricate understanding of finance, accounting, corporate and restructuring laws, as well as skilled negotiations with creditors. For potential entrants into distress funding, whether at pre- or post-filing, an understanding of what this entails is important to assist their risk management.

Thirdly, typically, hedge funds play a dominant role in investing in the distressed market due the flexibility of their rules. In SA however, hedge funds do not seem keen to participate in distress funding, mostly because of the skill set requirements, but fundamentally, because they do not yet see value in this sector, despite the apparent returns globally. This does have a negative impact on the vibrancy of the market in SA. That being said, the international market of hedge funds seems to be keeping an eye on the SA distressed assets market, as can be evidenced from the Edcon Group transaction, with two foreign funds having taken positions in the capital structure. Although the Edcon case was an informal restructuring transaction, the effect is essentially similar.

Lastly, due to the steadily increasing M&A activity in the SA distressed market, it may be necessary for the legislators to take note and make appropriate clarities in the legislation. In particular in the governance and treatment of sales of shares or assets out of plan, in plan, quick sales, etc., in order to accommodate the sales of distressed assets to promote fairness and transparency. Whilst many of these are somewhat covered under sections 112, 113, 155 and 134, more clarity is required. Even though the SA corporate law is based on English common law, the legal basis in SA is still largely of a Roman-Dutch origin, meaning some reliance on legislation is largely required. Hence, more legislative clarity would go a long way in preventing uncertainties. Besides, the bankruptcy jurisdiction is not yet mature enough to handle the complexities emanating from the legal uncertainties, such as is the case in the US.

A further issue emanating from this study is that the lack of industry-originating guidelines towards M&A in general, and pre-packs specifically, leaves BRPs vulnerable to inconsistencies and errors in executing their duties. They are currently reliant on their own judgements, without a set standard of conduct. This needs to be urgently corrected.

The provisions of sections 129(3) and (7) need to be carefully watched, and perhaps the reasonability of the Commission in granting an extension under section 129(3) be ascertained. While pre-packs are not yet official and have not yet led to subsequent litigations, directors of companies opting for pre-packs may be walking a tightrope and could be left vulnerable in the event subsection (3) is violated and the affected parties invoke section 218(2). The industry also needs to take the responsibility and lead the way regarding drafting fiduciary guidelines to govern the conduct of BRPs, particularly

concerning executing M&A transactions in general and pre-packs specifically. This also means having the requisite authority to monitor and sanction erring members.

7.6.3 Research implications

At the core of this study is an attempt to develop a framework for pre-packs' emergence and growth, to be applied as a guidance particularly where pre-packs are yet to take place. This study applied grounded theory in an effort to arrive at a suitable framework for pre-packs. It is envisaged that this study has made a significant contribution to the dearth of knowledge on pre-packs in the SA environment, and through the theoretical framework, a contribution to the knowledge and understanding of pre-packs in general. Thus far, it may seem that pre-packs are frequently observed and studied from functionalist paradigms. Therefore, an interpretivist approach that employs grounded theory such as in this study could contribute a lot to theory building for pre-packs in general. It is envisaged that the theoretical framework structured in Figure 6.1 can be used by scholars as a basis for debating the theory and application of pre-packs, and either adjusted or amended accordingly. To date, there does not appear to be a known theoretical basis for the advancement of pre-packs. Future research can also test its application.

This study further proposes the application of a known legal principle, the precedent theory, in predicting the behaviour of markets towards the introduction of pre-packs in practice. This precedent application is based on observed phenomenon throughout regimes that are advanced in the application of pre-packs. Thus far, it does not seem that researchers have linked the legal acceptance in the introduction and proliferation of pre-packs and precedent as a theory, particularly in the field of pre-packs. This is despite the fact that pre-packs are often applied through court ratification or general market acceptance, based on the seeming legal grey areas attributed to it.

Lastly, the use of qualitative methods in researching pre-packs in SA was applied due to the fact that there does not appear to be any study done on pre-packs, making an exploratory study more efficient and effective. Given the discovery during the study, that pre-packs are already beginning to take place in SA, this research opens the way for more statistically empirical studies to be embarked on. Furthermore, the use of the four-article method of research allowed a carefully orchestrated thematic application of content and

comparative analysis of secondary data in the first two articles, to create a basis for field interviews in the final two articles. This was done in a seamless thread running through the research study. This thematic approach to research for pre-packs, combined with field interviews can be regarded as contributing to research, particularly in the sector in the SA context.

7.7 OVERALL LIMITATIONS OF STUDY AND THE SUGGESTED FUTURE RESEARCH

This study overall is a qualitative study based on grounded theory. Through this, the use of pre-packs on a global platform is explored through literature, with an attempt to transpose those observations on the SA environment, despite the latter's unique properties. In order to counter the practical limitation caused by the uniqueness of the SA environment, practitioners (administrators) and other expert surveys were utilised to ensure an understanding of the local environment. However, the final propositions concluded in this study were not intended to be tested in this study and have been left for future empirical studies. This is largely because the business rescue regime in SA is relatively new and lacks sufficient academic research on which to base quantitative research, especially with pre-packs.

Due to the fact that business rescue is new in SA, there were not sufficient cases to investigate when looking at M&A transactions that have occurred since the regime's inception. In addition, the method of recording transactions at the regulator, CIPC, makes it difficult to do so from the information provided. Fortunately, in this case, the study was qualitative, and therefore managed to extract the required depth despite a relatively small sample frame. The basic tenets of respective themes were reached through the data gathered in the study. It would perhaps have been ideal, although not paramount, to conduct an empirical study into the frequency of such M&A transactions or sales of distressed assets since inception of the business rescue regime. A further suggestion for future studies would be to determine the impact such sales of distressed assets or businesses would have on the recovery and profitability of such businesses or assets. Some companies seem to have held on to, for a while, or re-entered business rescue

status, despite having participated in a sale transaction. A case study investigation into the dynamics of such transactions would also be an interesting study to conduct in the future.

This study is largely explorative and most propositions were not empirically tested at this stage. It however, culminates in an illustration of a relationship between pre-pack emergence as a dependent variable and contributing factors to the emergence as independent variables, based on the Mills method of agreement and/or a linear equation. Researching the predictive effect of such independent variables on the dependent variable would be an important subject of future research. This study would need to also weigh and measure the importance of each variable in the equation, and lastly, test the robustness of the equation against empirical evidence. This study further concludes with the adoption of several propositions, which should open the way for further empirical investigation and generation to hypothesis.

7.8 CONCLUDING ASSESSMENT/OBSERVATION

This study set out to understand the concept of pre-packs, in particular pre-packaged sales as it is applied globally, with the aim of understanding the rules, praxis, and operating environment. The intention ultimately was to understand how this affects or might affect other restructuring regimes that are behind the development curve of formal restructurings, such as SA. With this in mind, the narrative built from these international discoveries needed to be applied in developing a framework for the application of pre-packs in the SA context. Thus the purpose, which was to apply international benchmarks to adapt and to develop a workable framework for pre-packs in SA, was achieved through an application of appropriate comparative analysis tools. A four-article focused paper-based-thesis was applied to undertake the journey of discovery and ultimate framework development. In this journey, use was made of available literature, practitioners' M&A experience, expert opinions and general analysis of data. Each of the articles played a specific and distinct role in the narrative, gradually moving from an understanding of the operating environment, to the detailed applications, an analysis of the current SA context and eventually, developing a framework.

One valuable insight provided by the study is that while pre-packs seem to emerge in spite of inadequate legislation, it is important for the industry to be proactive and formulate

guidelines to ensure a conducive environment for all participants. A further important part of the study is in exposing the relationships between the emergence of pre-packs and numerous factors affecting its successful implementation and growth. In addition, because the business rescue regime in SA is relatively new, and is behind the curve in literature development, the qualitative and mainly explorative nature of this study was very useful to guide future studies on this subject. The findings and propositions developed in the end help chart a way for empirical testing on the framework in the future studies.

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APPENDIX A

- PERMISSION TO PARTICIPATE IN RESEARCH STUDY -

University of Pretoria

Faculty Of Economic And Management Sciences

Date: 05 April 2017

[Recipient name]
[Recipient address]

Permission for you/your organization to participate in an academic research study

Topic:

EXPLORING THE ROLE AND EXTENT OF SALES IN BUSINESS RESCUE IN SA: A PREDICTOR OF PRE-PACKAGING?

Dear respondent (<name>)

You and your company are invited to participate in an academic research study conducted by Sello Mkhondo (Student Number – 97160629) a Doctoral student from the University of Pretoria.

The purpose of the study is to explore the role of sales of businesses or assets of distressed companies under business rescue, and the extent to which these may influence the advent of pre-packaged sales in South Africa. This study is part of a thesis on the application of pre-packaged sales in the SA context.

This research is an exploratory qualitative research that seeks an understanding of sales patterns of distressed businesses or assets in substantial implementation since inception of Chapter 6, and whether

this can be used to predict the likelihood of pre-pack sales in SA. The theoretical basis of this research is secondary studies conducted from advanced international restructuring regimes which indicate a pattern of pre-packaged sales where vibrant distress funding markets are evident.

With regards to this particular study, please note that:

1. The input and output of the study will be treated as strictly confidential, and your names or that of your organization will not be visible to the readers.
2. Your participation in this study is very important to us. You and your organization may however, choose to not participate in the study or may stop your participation in the study at any time without negative consequences.
3. The results of the study will be used for academic purposes and may be published in an academic journal or other lay articles. We will discuss interim results of our research with you and will provide you with a summary of our findings on request.
4. The data to be included in the study will be selected in collaboration with yourself and all of your organizational requirements in respect of privacy and security of information will be observed.
5. Please feel free to contact my supervisor, Professor Marius Pretorius on 082 882 6333 or marius.pretorius@up.ac.za if you have any questions or comments regarding the study.
6. The study has commenced and the aim is to submit the final complete thesis by August 2017.

Please sign the form to indicate that:

1. You have read and understand the information provided above.
2. You give your consent for your organization to participate in the study.

Initials and Surname

Name of the organization

Signature

Title

APPENDIX B

- SURVEY DOCUMENT -

SURVEY DOCUMENT

Questionnaire number

v1					

Exploring the role and extent of sales in business rescue in SA: A predictor of pre-packaging?

Dear Respondent,

Thank you for giving up some of your precious time for this research without which success is not possible.

The following questionnaire is part of a research study undertaken to investigate deliberate practices of leaders or those that play leader roles in teams/units/organisations. Your personal thinking is crucial. There are no right or wrong answers but it is important to indicate **your personal view and experience** irrespective of what you may believe others will think.

It will be highly appreciated if you would complete it as thoroughly as possible. All information is be treated as confidential and will only be used for academic purposes and reported as mathematical averages, variances and correlations.

Participation is voluntary and you may withdraw from participation in the study at any time and without any consequences. By completing this survey you

- **Consent to take part in the research study (as mentioned above)**

  by completing the attached questionnaire;

- **Understand that the data gathering will be confidential; and**
- **That the respondents will have access to the data and the results thereof.**

Thank you very much,

Dr Marius Pretorius and Mr Sello Mkhondo

Department of Business Management

University of Pretoria

marius.pretorius@up.ac.za, sello@mkhondotrust.co.za or Fax: 012 362 5198

……

Instructions for completion:

Select transactions where substantial implementation of business rescue processes included sales of distressed companies or assets, were identified. The business rescue practitioners selected to participate in this survey were selected from that list of transactions. As a participant, you are requested to respond to the questionnaire to indicate your views and experiences with regards to the transaction.

PLEASE DO NOT USE GROUP DECISION-MAKING

ONLY IN EXTREME CASES SHOULD YOU NOT MAKE A CHOICE

Consider your own thinking. Be as honest as possible. There is no right or wrong answer.

In order for us to classify the different transactions for analysis, please provide the following information (1 questionnaire per transaction)

v2			

1. The name of the company sold during BR is: _____

v3			

_____

2. The name of the buyer is: _____

v4			

3. Date transaction concluded was: _____

v5			

4. Value of transaction was:_____

v6			

	Statement	0 Not applicable	1 Yes	2 No	3 Don't know/ Unsure	v	
5.	Was the sale of the business or assets concluded as part of the business rescue plan?		☐	☐	☐	7	☐
6.	Did the sale of the business or assets result in substantial implementation of the business rescue process?		☐	☐	☐	8	☐
7.	Was it a total sale of the entire business?		☐	☐	☐	9	☐
8.	Was it a partial sale of the business?		☐	☐	☐	10	☐
9.	Was it a sale of a subsidiary ***or*** assets of the business?		☐	☐	☐	11	☐
10.	Did the negotiations for the acquisition begin prior to your appointment as BRP?		☐	☐	☐	12	☐
11.	Did the negotiations for the acquisition begin prior to the filing for business rescue?		☐	☐	☐	13	☐
12.	Were you as the BRP made aware of this negotiation during your appointment?		☐	☐	☐	14	☐

13.	If you were aware of the negotiations prior to your appointment, were you tracking the developments prior to your appointment?		☐	☐	☐	15	☐
14.	Was the sale transaction concluded before or after your appointment?		☐	☐	☐	16	☐
15.	Were you as the BRP involved in the negotiations for the sale of the distressed business or assets?		☐	☐	☐	17	☐
16.	Was the target on the buyer's acquisition horizon prior to the filing?		☐	☐	☐	18	☐
17.	Were the buyers existing creditors?		☐	☐	☐	19	☐
18.	Were the buyers existing shareholders?		☐	☐	☐	20	☐
19.	Did the buyers have any previous relationship with the debtor?		☐	☐	☐	21	☐
20.	Were the buyers industry buyers?		☐	☐	☐	22	☐
21.	Were the buyers financial investors?		☐	☐	☐	23	☐
22.	Were there any known legal, regulatory or other practical obstacles such as uneven data spread, faced by the buyers of the distressed business?		☐	☐	☐	24	☐
23.	Did the buyers acquire the distressed business through a debt to equity conversion?		☐	☐	☐	25	☐

24.	Did the buyers acquire the distressed business through new equity?		☐	☐	☐	26	☐
25.	Were the buyers involved in the approval of the business rescue plan?		☐	☐	☐	27	☐
26.	Did the acquisition transaction change the capital structure of the distressed company?		☐	☐	☐	28	☐
27.	Did the sale of the business or assets result in reduced leverage for the targets?		☐	☐	☐	29	☐
28.	Was the sale of the business/assets conducted through a bid process?		☐	☐	☐	30	☐
29.	Was the sale of the distressed business a negotiated sale?		☐	☐	☐	31	☐
30.	Was the sale price determined by an independent valuer?		☐	☐	☐	32	☐
31.	At substantial implementation, the rescue was classified a success.		☐	☐	☐	33	☐

	Statement	1 Highly	2 To a large extent	3 Un-sure	4 To a small extent	5 Not at all	v	
32.	The buyers were involved in the drafting of the business rescue plan?	☐	☐	☐	☐	☐	34	☐
33.	The stakeholders were in agreement with the sale transaction?	☐	☐	☐	☐	☐	35	☐
34.	The sale process was viewed as transparent by the stakeholders?	☐	☐	☐	☐	☐	36	☐
35.	In my view, the acquisition was concluded at a substantial discount to enterprise value?	☐	☐	☐	☐	☐	37	☐
36.	Information asymmetry was a hindrance to outside buyers?	☐	☐	☐	☐	☐	38	☐

37. I have been licenced to practice as a BRP under category: _____

39	☐
40	☐

38. Completing this questionnaire was: **very easy / easy / difficult / very difficult** for me. (Circle your choice)

41	☐

42			

APPENDIX C

- LETTER OF CONSENT FROM CIPC -

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

Faculty of Economic and Management Sciences

1 September 2016

CIPC

Ms Marietjie Swart: Data Manager

MSwart@cipc.co.za

For attention: CIPC Data Sales and Maintenance Division

Re: Request for access and to waive disclosure fee on data for academic research

Dear Madam,

This serves as a request to access data concerning business rescue to be used for scientific research.

- The purpose of the research to be done is academic in nature specifically for the PhD degree Business Management.
- The student name is ___Sello Mkhondo____ registered for PhD.
- The student number / employment number of person doing research is: _student no:__97160629__
- The research title is: ___Pre-packs application within Business rescue _____
- Detail of the required data will be furnished once permission is granted. The basic data involves contact details etc. of completed rescues in order to access information about PCF and funding of rescues completed.
- This research will be done under the control of this Institution and specifically the supervision of myself (Marius Pretorius) who have completed research for CIPC and is known (for reference checking) to the key staff of the rescue unit namely: Rory Voller, Vuyani Nkohla, Christa Klocow, Lucinda Steenkamp and Donovan van Schalkwyk, Lana van Zyl.
- The Department of Business Management confirms that access to such data will be used for academic research purposes only and not for selling, marketing etc.

Room 3-50, Level 3, EMS Building
University of Pretoria, Private Bag X20
Hatfield 0028, South Africa
Tel +27 (0)12 420 3394
Fax +27 (0)12 368 5192
Email: marius.pretorius@up.ac.za
www.up.ac.za

Fakulteit Ekonomiese en Bestuurswetenskappe
Lefapha la Disaense tša Ekonomi le Taolo

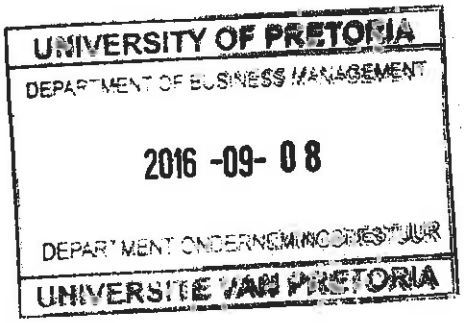
- Full contact details of the supervisor is: Dr Marius Pretorius, Professor in Strategy, Leadership and Business turnaround, Department Business Management, UP.
- The University of Pretoria is a well-known institution of higher education.
- We undertake to acknowledge the source of the data in findings.
- We confirm that the research is potentially not possible unless access to the requested data is granted.

Thanking you in advance

Prof M. Pretorius

Prof A. Grobler

HOD of Business Management



APPENDIX D

- DATA REQUEST LETTER TO CIPC -

19 September 2016

CIPC

Christa Klowtow

Re: Request for access to information for academic research

Based on a waving of fees confirmed by your office on 12 September 2016, I request the following information for my academic research:

1. List of companies that have filed for business rescue (since 2011) and have successfully exited (terminated – especially CoR 125.3) the BR process;
2. The BR filings for those companies detailing their reasons for filing, the BRPs appointed and date of appointment;
3. The recorded financial performance of the companies during listing, whether profitability or share price, etc.;
4. The date of BR completion together with the reason for the exit (from BR);
5. If provision of funding was a factor in the termination, what was the nature of the funding – PCF or sale of assets or entire business?;
6. If sold to 3rd party, whether in parts (asset sales) or entire business, who were the buyers? and
7. What were the sale prices in point 6 above?

I hope this information is all available in your files/archives.

Regards

Sello Mkhondo