

A comparative analysis of the legal framework for zombie companies in South Africa

by

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Abstract

This study analyses the phenomenon of zombie companies in South Africa. Although there is limited scholarship available on zombie companies in South Africa, the phenomenon is not new. This study reviews the history of zombie companies, particularly how they increase after a large economic shock such as Covid-19. This is greatly due to the lax monetary policy implemented, and aid extended, during these times.

South Africa's policy responses to Covid-19 is unpacked and discussed. This is to illustrate the link between the actions of South Africa, and other actions which historically led to the increase in zombie companies in foreign jurisdictions.

The study further provides criteria for zombie companies. The criteria includes a definition, the characteristics and lifecycle of zombie companies. Thereafter, the study unpacks international best practices regarding the design of insolvency regimes. In this respect, Portugal is used as a case study. In terms of international best practice, Portugal's regime was one of the most poorly designed. However, following reform to the insolvency regime, the number of zombie companies in the country continue to decline.

Against this background, South Africa's current insolvency framework and procedures are analysed. As an effective insolvency regime combats zombie companies through prompt restructuring and smooth exit, the study investigates whether South Africa's insolvency regime aligns with international best practice and whether there are shortcomings that need to be addressed. The lessons learned from the reforms in Portugal are considered as possible solutions to enhance the South African insolvency framework to address zombie companies. After a critical analysis of the research findings, observations are made in order to provide recommendations for law reform.

Acknowledgments and Dedication

I am incredibly blessed to have so many people in my life to thank for getting me to this point, so I will do my best to keep it short and sweet, despite the fact that I could fill books on the amazing people that they are.

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Acronyms and abbreviations

BIS	Bank for International Settlements
CIRE	The Code of Insolvency and Recovery of Companies
EBIT	Earnings Before Interest and Taxes
EBITDA	Earnings Before Interest Taxes and Depreciation and Amortization
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IAPMEI	The Portuguese Business Recovery Scheme
IMF	International Monetary Fund
MOU	Memorandum of Understanding
NPL	Non-performing Loan
OECD	Organisation for Economic Co-operation and Development
PER	The Special Revitalization Plan
RERE	The Business Restructuring Extrajudicial Regime
SARB	The South African Reserve Bank
SARS	The South African Revenue Service
SIREVE	The Extrajudicial Recovery System
SMEs	Small and Medium Enterprises
WHO	World Health Organization

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Chapter 1: Introduction

1.1. Background

On 5 March 2020, South Africa fell into the clutches of the Covid-19 pandemic, joining its global counterparts.¹ This was after the virus was first confirmed in Wuhan, China, in November 2019.² Covid-19 was a new and incredibly infectious disease that remained under the radar until it was too late, and the entire globe became enveloped with infections.³ On 11 March 2020, the World Health Organization (WHO) declared the Covid-19 outbreak a global pandemic.⁴

Governments across the globe began to introduce various policies and laws to limit the human and economic impact of the pandemic. Decisive action was taken by the South African government early on and a national state of disaster was declared on 15 March 2020.⁵ A national lockdown was implemented on 27 March 2020 to prevent the spread as much as possible.⁶ Following this declaration, South Africa continued to implement various policies to protect lives and to minimize the damage to the economy as much as possible. After 750 days, South Africa terminated the National State of Disaster on 5 April 2022, and social and economic activity began to return to its pre-Covid state.⁷

The WHO declared the end of Covid-19 as a global health emergency on 5 May 2023.⁸ During this period, Covid-19 was considered the most significant threat faced worldwide since World War II and the greatest global health disaster of the century.⁹ Economically, the International Monetary Fund (IMF) described the lockdown measures that were introduced – the so-called “Great Lockdown” – as the causal factor for the worst recession since the Great

¹ NICD “First Case of Covid-19 Coronavirus Reported in SA” 2020, available at <https://www.nicd.ac.za/first-case-of-covid-19-coronavirus-reported-in-sa/> (last accessed 2023-10-24).

² Hao *et al* “The origins of COVID-19 pandemic: A brief overview” 2022 *Wiley Transboundary and Emerging Diseases* 1.

³ Hao *et al* 2022 *Wiley Transboundary and Emerging Diseases* 1.

⁴ Cucinotta and Vanelli “WHO Declares Covid-19 a Pandemic” 2020 *Acta Biomed* 157.

⁵ Declaration of National State of Disaster, GN313 in GG 43096 of 15 March 2020 No 313.

⁶ GN11062 in GG 43148 of 25 March 2020.

⁷ GN11417 in GG 46197 of 4 April 2022.

⁸ Wise “Covid-19: WHO declares end of global health emergency” 2023 *BMJ* 1.

⁹ Naseer *et al* “COVID-19 outbreak: Impact on global economy” 2023 *Frontiers in Public Health* 01.

Depression, and of far greater impact than the Global Financial Crisis (GFC).¹⁰ The global economy suffered severely as a result. The collective gross domestic product (GDP) of the world fell by 3.4% in 2020, which represented over two trillion U.S dollars of lost economic output.¹¹ The World Bank opined that the mobility restrictions, lockdowns and other public health measures implemented to address the pandemic, caused the largest global economic crisis seen in more than a century.¹²

In South Africa, 8.2% of GDP was lost in 2020, representing approximately R389 billion.¹³ Only after two years, in the first quarter of 2022, did the South African GDP return to its pre-pandemic level.¹⁴ However, as of the second quarter of 2023, employment levels have not returned to their pre-pandemic level. It is estimated that there are about 74,000 less employment opportunities available than there were at the end of 2019.¹⁵ In this regard, the impact of Covid-19 exasperated the conditions of an already precarious economy.

In its assessment of the financial and economic impacts of the pandemic, the World Bank highlighted certain risks that have materialized or pose imminent threats.¹⁶ These include an increase in non-performing loans and financial sector distress; a lack of formal insolvency options for households and businesses to discharge debts that were incurred during the pandemic; restricted access to credit; and elevated levels of sovereign debt.¹⁷

As of 2023, South Africa's economy continues to be in a precarious position. Amid an energy crisis without an end in sight and the grey-listing by the Financial Action Task Force, the

¹⁰ Gopinath "The Great Lockdown: Worst Economic Downturn Since the Great Depression", available at <https://www.imf.org/en/Blogs/Articles/2020/04/14/blog-weo-the-great-lockdown-worst-economic-downturn-since-the-great-depression> (last accessed 2023-10-24).

¹¹ Statista "Impact of the coronavirus pandemic on the global economy – Statistics and Facts", available at <https://www.statista.com/topics/6139/covid-19-impact-on-the-global-economy/#topicOverview> (last accessed 2023-10-24).

¹² World Bank "Finance for an Equitable Recovery" 2022 *World Development Report* 1.

¹³ South African Presidential Advisory Council "Briefing Note for President Ramaphosa on Current Economic Policy Priorities" 2021, available at https://www.thepresidency.gov.za/sites/default/files/Briefing%20Note%20for%20President%20Ramaphosa%20on%20Current%20Economic%20Policy%20Priorities%20Jan%202021_1.pdf (last accessed 2023-10-30).

¹⁴ Stats SA "After two years, GDP returns to pre-pandemic levels" 2022, available at <https://www.statssa.gov.za/?p=15440#:~:text=South%20African%20gross%20domestic%20product,consecutive%20quarter%20of%20upward%20growth.&text=The%20size%20of%20the%20economy,before%20the%20COVID%2D19%20pandemic> (last accessed 2023-10-30).

¹⁵ The World Bank "The World Bank in South Africa" 2023, available at <https://www.worldbank.org/en/country/southafrica/overview#1> (last accessed 24/10/2023).

¹⁶ World Bank 2022 *World Development Report* 2.

¹⁷ World Bank 2022 *World Development Report* 2.

pandemic only exasperated problems within South Africa's delicate economy.¹⁸ Households grapple with inflation which continues to stifle economic growth and place strain on consumers. The prices for food increased by 14% in the twelve months up to March 2023, with the annual inflation rate at 7.1%.¹⁹ Throughout 2023, South Africa experienced high interest rates, with the repo rate currently set at 8.25% and likely to remain due to inflation risks.²⁰ South Africa has also seen an upward trend in its ratio of non-performing loans, illustrating the incapacity of the economy to repay its debts.²¹

In an inopportune and strenuous market, consumers and businesses alike are struggling to keep their heads above water. At the end of 2022, a total of 1091 businesses were liquidated and, of those, 139 were compulsory liquidations and 952 were voluntary liquidations.²² In the month of January 2023 alone, 81 companies were liquidated, with 7 being compulsory liquidations, and 74 voluntary liquidations.²³

An economic shock as large as the Covid-19 pandemic, and the resultant economic environment described above, create a breeding ground for a different kind of infection: that of zombie companies. "Zombie companies" refers to a phenomenon which has been experienced and documented globally, but which has received little attention in South Africa.

1.2. Zombie companies

Zombie companies are firms which are unable to repay their debts for a prolonged period of time and who ought to exit the market, but are able to remain in the market notwithstanding their insolvent circumstances.²⁴ These firms are able to survive due to external aid granted

¹⁸ International Monetary Fund "South Africa: Staff Concluding Statement of the 2023 Article IV Mission", available at <https://www.imf.org/en/News/Articles/2023/03/21/mcs032223-south-africa-2023-article-iv-mission> 2023 (last accessed 2023-5-25).

¹⁹ Stats SA "Inflation rises for a second consecutive month as food prices bite", available at <https://www.statssa.gov.za/?p=16254#:~:text=Headline%20consumer%20inflation%20edged%20higher,it%20was%201%2C5%25> 2023 (last accessed 2023-4-19).

²⁰ SARB "Current Market Rates" 2023, available at <https://www.resbank.co.za/en/home/what-we-do/statistics/key-statistics/current-market-rates> (last accessed 2023-4-19).

²¹ SARB "First Edition 2023 Financial Stability Review" 2023 16.

²² Stats SA "Statistics of liquidations and insolvencies (preliminary) January 2023" 2023, available at <https://www.statssa.gov.za/publications/P0043/P0043January2023.pdf> (last accessed 2023-4-19).

²³ Stats SA "Statistics of liquidations and insolvencies (preliminary) January 2023" 2023.

²⁴ Banerjee and Hofmann "Corporate Zombies: Anatomy and life cycle" 2021 *BIS Working Papers* 2.

either through additional bank credit, investor aid, government bailouts, or continued subsidies.²⁵

The concept of zombie companies was first formulated when the concept of “zombie lending” was identified during the investigating Japan’s lost decade of the 1990s.²⁶ Thereafter, zombie companies were increasingly seen following other economic shocks, such as the GFC and the sovereign debt crisis.²⁷ In this regard, research has shown a trend in other countries, whereby zombie companies increase following economic shocks such as those caused by Covid-19.²⁸ In governments’ efforts to thwart the negative economic effects of the pandemic through various policies, zombie firms are aided to stay afloat.²⁹

It is cause for concern that economic shocks lead to the increase of zombie firms as these companies pose a great risk to functioning capital markets for various reasons. Ideally, failing firms should promptly exit the market. The UNCITRAL Legislative Guide on Insolvency Law depicts this in its recommendations that the insolvency law of a regime should specify that distributions must be made promptly.³⁰ This is further emphasized by the recommendation that a specified duty should be placed on the liquidator to close the business promptly and efficiently.³¹ When these firms are able to remain in the market, it creates undesired “congestion” and healthy firms must compete with these zombie firms.³² As a result, the overall economy suffers in terms of productivity, investment and employment.³³ When capital is misallocated towards these unviable zombie firms, it essentially mimics the act of pouring money down the drain – with severe consequences as capital and investment opportunities are finite. If capital is misallocated, the capital and assets become trapped in non-viable entities and may not be utilized by firms which could boost the economy.³⁴ This is known as “capital

²⁵ Kane “Dangers of Capital Forbearance: The Case FSLIC and Zombie S&Ls” 1987 *Contemporary Economic Policy* 77-83; Albuquerque and Iyer “The Rise of the Walking Dead: Zombie Firms Around the World” 2023 *IMF Working Paper* 10.

²⁶ Caballero, Hoshi and Kashyap “Zombie Lending and Depressed Restructuring in Japan” 2008 *American Economic Review* 1943.

²⁷ Acharya *et al* “Zombie Lending: Theoretical, International and Historical Perspectives” 2022 *Annual Review of Financial Economics* 2.

²⁸ Albuquerque and Iyer 2023 *IMF Working Paper* 4.

²⁹ Banerjee and Hofmann 2021 *BIS Working Papers* 2

³⁰ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 276.

³¹ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 179.

³² Albuquerque and Iyer 2023 *IMF Working Paper* 2.

³³ Albuquerque and Iyer 2023 *IMF Working Paper* 2.

³⁴ Andrews, McGowan and Millot “Confronting the zombies: policies for productivity revival” 2017 *OECD Economic Policy Paper* 21.

sunk”.³⁵ Viable firms, which may strategically and purposefully boost the economy, are robbed of the opportunity. In respect of zombie companies, the higher the share of capital sunk (the higher amount of capital held by zombie companies), the less capital available to fund start-ups and assist productive firms.³⁶

This dissertation will conduct an in-depth investigation of the characteristics and composition of zombie firms, so that they may be readily identified. It is imperative that zombie companies are on the radar of the South African policy makers and legislature in order to ensure that these companies do not become an “invisible” threat to the economy. Therefore, as a brief overview, certain characteristics bear mentioning.

As firms that operate on the cusp of insolvency, their balance sheets are particularly sensitive to external shocks. This arises as their net liquid asset holdings are substantially smaller and more leveraged than non-zombie firms.³⁷ Their balance sheets differ substantially from non-zombie companies in that they are significantly weaker and susceptible to default.³⁸ As zombie companies are unable to pay their debts, the defaulting of these companies increases the ratio of non-performing loans in a country. This becomes a contributing factor in the decision of central banks to increase interest rates to account for the risk banks are taking on by extending further loans.³⁹ When simulating an interest rate increase test, it was found that, if interest rates were to rise by a factor of 1.5, the number of zombie companies would increase by 17%, with an increase of up to 38% if interest rates rise by a factor of 2.⁴⁰ More alarmingly, when applying the test to Africa, it was found that an interest rate rise by a factor of 2 would result in 1 of every 11 African-listed companies transforming into a zombie company.⁴¹

In terms of productivity and profitability, these firms show a low return on assets and a low factor productivity, paired with negative cashflows and an inability to pay dividends to shareholders.⁴² Firms consequently shrink down their operations, assets are disposed of, and

³⁵ Andrews, McGowan and Millot “Confronting the zombies: policies for productivity revival” 2017 *OECD Economic Policy Paper* 21.

³⁶ Andrews and Petroulakis “Breaking the shackles: Zombie firms, weak banks and depressed restructuring in Europe” 2019 *ECB Working Paper* 2240.

³⁷ Albuquerque and Iyer 2023 *IMF Working Paper* 19.

³⁸ Albuquerque and Iyer 2023 *IMF Working Paper* 19.

³⁹ Albuquerque and Iyer 2023 *IMF Working Paper* 19.

⁴⁰ Albuquerque and Iyer 2023 *IMF Working Paper* 19.

⁴¹ Albuquerque and Iyer 2023 *IMF Working Paper* 19.

⁴² Albuquerque and Iyer 2023 *IMF Working Paper* 19; Banerjee and Hofmann “Corporate Zombies: Anatomy and life cycle” 2021 *BIS Working Papers* 18.

employees are let go.⁴³ This leaves these firms highly dependent on the extension of credit to remain afloat, particularly through additional bank loans.⁴⁴

It is clear that these firms are unviable and it is desirable that they exit the market. However, the question arises as to what it is about these particular firms, that enables them to receive additional credit extensions. Although this will be unpacked in this dissertation, certain contributors include banks' evergreen loans extended to protect their balance sheets; the significance of the firm and the impact that its exit would have on the economy; employment; and government policies and incentives.

1.3. Problem statement

The South African economic landscape is struggling to survive high interest rates, loadshedding, and an investment grade rating of junk status. Following a massive global economic shock such as Covid-19, the economic hardships have only exacerbated. Even though zombie firms have always existed, the pandemic support measures and lax financing conditions further enable these firms to continue existing and draining the economy.⁴⁵

Historical research and investigation have shown the link between the rise in zombie firms and their capital sunk following previous economic shocks such as the GFC and the sovereign debt crisis.⁴⁶ Amongst advanced economies, the economic impact of this has been severe. Accordingly, the impact this may have on emerging markets such as South Africa, is of much concern, particularly given the fragile state of the economy.

It is highly unlikely that South Africa does not have zombie firms which continue to operate and stifle growth in the economy. It is essential to unpack the nature and characteristics of these firms that they may be identified. Once identified, the measures that may be effective in reducing the number of zombie firms and reducing the capital sunk in these firms, or those measures that may be aiding these firms in revival, must be investigated. In this regard, insolvency law reform will play an integral role.

⁴³ Banerjee and Hofmann "Corporate Zombies: Anatomy and life cycle" 2021 *BIS Working Papers* 17.

⁴⁴ Albuquerque and Iyer 2023 *IMF Working Paper* 19.

⁴⁵ Rojas, del Olmo and Aires "Zombie firms: An analysis of business sector vulnerability post-Covid-19" 2022 *Funcas SEFO* 43.

⁴⁶ Acharya *et al* 2022 *Annual Review of Financial Economics* 2.

If a country has insufficient insolvency regimes in place, whereby debt restructuring is not promptly resolved, a larger number of zombie firms arise following credit booms.⁴⁷ It has also been shown that, if the insolvency regime of a country delays the timely initiation and resolution of proceedings, the share of capital sunk in these zombie firms is higher.⁴⁸ In the converse, if insolvency reform minimizes the barriers to corporate restructuring, the share of capital sunk may be reduced.⁴⁹

In order to combat the rise and continued existence of these companies, it needs to be ascertained what a zombie company is and how can it be identified; how this problem has been handled internationally; what international best practices exist regarding zombie companies and whether any measures can be implemented in South Africa.

1.4. Research questions

Against this background, the dissertation addresses the following research questions:

- How is a zombie company identified: what is a workable definition and what are its characteristics?
- What are the international best practices regarding insolvency regimes which address zombie companies?
- How can South Africa's insolvency regime be reformed to align with international best practices and best address zombie companies?

1.5. Significance of the study

Although zombie firms have been in existence for quite some time, this study is significant as little is known about these firms in the South African context. To the knowledge of the author, no research has yet undertaken to determine how a regulatory framework sensitive to zombie companies in South Africa would look or to investigate the role that insolvency law has to play in addressing South Africa's zombie companies.

⁴⁷ Banerjee and Hoffman 2021 *BIS Working Papers* 12.

⁴⁸ McGowan, Andrews and Millot "The walking dead?: Zombie firms and productivity performance in OECD countries" 2017 *OECD Economics Department Working Papers* 27.

⁴⁹ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 27.

As other countries have already identified the problem of zombie companies, and taken steps to address the problem, it is essential that South Africa does the same. No two jurisdictions are the same, therefore it is impossible and inadvisable to simply copy-and-paste the approach of another jurisdiction. Therefore, it is essential to understand the nature of zombie companies; to understand what international best practices advise when it comes to dealing with zombie companies; how measures have been implemented in other countries and whether these may be implemented in South Africa's own corporate insolvency law regime.

This research will uncover international best practices regarding insolvency regimes, with particular emphasis on components applicable to zombie companies. From international research and trends, a definition of zombie companies will be drafted to create criteria for the characteristics and identifiers of zombie companies. Following the creation of this criteria, it will be easier to establish whether a company may be considered a zombie company, and what particular considerations of insolvency law is brought to the fore, such as aspects of pre-insolvency procedures and liquidation.

In the pursuit of ascertaining the viability of implementing international best practices in South African insolvency law, the amendment and implementation of these standards by Portugal will be investigated. It will be investigated what the international best practice standards are; how Portugal implemented these standards and the impact of these changes on the country's zombie companies; whether South Africa (albeit unintentionally) aligns with international best practice; and whether South African insolvency law requires reform to align with international best practice.

1.6. Definitions

For ease of reference, the definitions of a number of core concepts are provided:

Advanced economies: an advanced economy is a term used by the IMF to describe the most developed countries in the world. They are usually defined as having a high level of per capita income, a very significant degree of industrialization, a varied export base, and a financial sector that is integrated into the global financial system.⁵⁰

⁵⁰ IMF "Miles to go: Emerging markets must balance overcoming the pandemic, returning to more normal policies, and rebuilding their economies" 2021 available at <https://www.imf.org/external/pubs/ft/fandd/2021/06/the-future-of-emerging-markets-duttagupta-and-pazarbasioglu.htm> (last accessed 2023-11-27).

Bank forbearance: forbearance is a form of concession granted by banks in the event that borrowers are unlikely to repay their loans under the current terms and conditions. This can take the form of refinancing, restructuring or modifying the terms and conditions.⁵¹

Capital sunk: the capital which is trapped within zombie firms, that cannot be utilized by other healthier firms.⁵²

Credit risk: this is the possibility of loss due to a borrower defaulting on a loan or not meeting contractual obligations.⁵³

Debt servicing capacity: the ability of an individual or company to repay the interest and principal on debt obligations.⁵⁴

Emerging economies: an emerging economy is a term used by the IMF to describe economies which are transitioning towards a modern, industrial economy, that is becoming more engaged in the global market as it grows.⁵⁵

Evergreening: this refers to the evergreening of loans. This is when a bank extends additional credit to a struggling firm in order to enable the firm to make the interest payments on outstanding loans in order to avoid formal insolvency.⁵⁶

High-yield bonds: these are bonds which pay higher interest rates because they have lower credit ratings than investment-grade bonds.⁵⁷

⁵¹ European Central Bank “Forbearance: banks need to gear up” 2023, available at https://www.bankingsupervision.europa.eu/press/publications/newsletter/2023/html/ssm.nl230517_1.en.html#:~:text=Forbearance%20involves%20granting%20concessions%20to,the%20interest%20rate%20and%20maturity (last accessed 2023-11-27).

⁵² Andrews, McGowan and Millot “Confronting the zombies: policies for productivity revival” 2017 *OECD Economic Policy Paper* 21.

⁵³ Investopedia “Credit risk: Definition, Role of Ratings, and Examples” 2023 available at <https://www.investopedia.com/terms/c/creditrisk.asp> (last accessed 2023-11-27).

⁵⁴ FreshBooks “Debt Service: Definition, Overview and How to Calculate” 2023 available at <https://www.freshbooks.com/glossary/financial/debt-service#:~:text=Summary,will%20require%20payment%20on%20time>. (last accessed 2023-11-27).

⁵⁵ IMF “Miles to go: Emerging markets must balance overcoming the pandemic, returning to more normal policies, and rebuilding their economies” 2021.

⁵⁶ Peek and Rosengren “Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan” 2005 *The American Economic Review* 1144.

⁵⁷ Investopedia “High-Yield Bond: Definition, Types, and How to Invest” 2023 available at https://www.investopedia.com/terms/h/high_yield_bond.asp (last accessed 2023-11-27).

Idiosyncratic risk: this refers to a specific risk. It is a type of investment risk that is endemic to a particular individual asset, such as a company's stock.⁵⁸

Interest rate cover ratio: a measurement of how well a firm can pay the interest due on outstanding debt. It is calculated by dividing a company's EBIT by its interest expense during a given period.⁵⁹

Interest rate risk: the potential investment losses that can be triggered by a move upward in the prevailing rates for new debt instruments. If interest rates rise, the value of a bond for instance, will decline.⁶⁰

Leverage: is when borrowed capital (debt) is used by a firm to finance its assets.⁶¹

Leverage ratio: is used to identify how much of a firm's capital comes in the form of debt, such as loans, and assesses the ability of the firm to meet its financial obligations.⁶²

Leveraged loans: are loans which are extended to companies or individuals which already have considerable amounts of debt or a poor credit history.⁶³

Liquidity coverage ratio: is a requirement whereby banks must hold an amount of high-quality liquid assets that is sufficient to fund cash outflows for 30 days.⁶⁴

⁵⁸ Investopedia "Idiosyncratic Risk: Definition, Types, Examples, Ways to Minimize" 2022 available at <https://www.investopedia.com/terms/i/idiosyncraticrisk.asp> (last accessed 2023-11-27).

⁵⁹ Investopedia "Interest Coverage Ratio (ICR): What's Considered a Good Number" 2023 available at <https://www.investopedia.com/ask/answers/121814/what-good-interest-coverage-ratio.asp#:~:text=The%20interest%20coverage%20ratio%20is,of%20the%20company's%20outstanding%20debts.> (last accessed 2023-11-27).

⁶⁰ Investopedia "Interest Rate Risk Definition and Impact on Bond Prices" 2022 available at <https://www.investopedia.com/terms/i/interestraterisk.asp> (last accessed 2023-11-27).

⁶¹ Investopedia "What is Financial Leverage, and Why is it important?" 2023 available at <https://www.investopedia.com/terms/l/leverage.asp> (last accessed 2023-11-27).

⁶² Investopedia "Leverage Ratio: What It Is, What It Tells You, How To Calculate" 2023 available at <https://www.investopedia.com/terms/l/leverageratio.asp#:~:text=A%20leverage%20ratio%20is%20any,to%20meet%20its%20financial%20obligations.> (last accessed 2023-11-27).

⁶³ Investor.gov "Leveraged Loan" available at <https://www.investor.gov/introduction-investing/investing-basics/glossary/leveragedloan#:~:text=Generally%20speaking%2C%20a%20leveraged%20loan,as%20the%20risk%20of%20default.> (last accessed 2023-11-27).

⁶⁴ Investopedia "Liquidity Coverage Ratio (LCR): Definition and How to Calculate" 2022 available at <https://www.investopedia.com/terms/l/liquiditycoverageratio.asp#:~:text=How%20to%20Calculate%20the%20LCR,Calculating%20LCR%20is&text=The%20LCR%20is%20calculated%20by,easily%20and%20quickly%20into%20cash.> (last accessed 2023-11-27).

Negative equity: this arises when a firm owes more than it owns.⁶⁵ It is calculated by taking the total assets of a company and subtracting its liabilities.⁶⁶ If the result is negative, it means that if all assets were paid and all creditors paid, shareholders would receive nothing.⁶⁷

Net investment: this is the amount of money spent by a company on its capital assets minus the cost of the depreciation of those assets.⁶⁸ It illustrates how much a company is spending to maintain and improve its operations.⁶⁹ If net investment is positive, the company is expanding its capacity. If net investment is negative, the company is shrinking.⁷⁰

Net liquid asset holdings: this measures the liquidity position of a firm.⁷¹ It is calculated by subtracting current liabilities from liquid assets.⁷² Liquid assets are those which can be readily converted into cash at their approximate current value, these include: cash, marketable securities and accounts receivables.⁷³ If a company has substantial net liquid asset holdings, it shows that the company is in good health and is able to pay its short-term obligations.⁷⁴

Non-performing loan ratio: is calculated as all loans which are overdue for more than 90 days as a percentage of on-balance-sheet exposures.⁷⁵

Real sales growth: is a metric to identify the rate at which companies' sales revenue increases over time.⁷⁶ It determines the growth level of the company by comparing current and previous growth rates.⁷⁷

⁶⁵ Investopedia "Negative Shareholders Equity: What Does It Mean?" 2023 available at <https://www.investopedia.com/ask/answers/08/negative-shareholder-equity.asp> (last accessed 2023-11-27).

⁶⁶ Investopedia "Negative Shareholders Equity: What Does It Mean?" 2023

⁶⁷ Investopedia "Negative Shareholders Equity: What Does It Mean?" 2023

⁶⁸ Investopedia "Net Investment: Definition, Uses, How to Calculate, and Example" 2020 available at <https://www.investopedia.com/terms/n/netinvestment.asp> (last accessed 2023-11-27).

⁶⁹ Investopedia "Net Investment: Definition, Uses, How to Calculate, and Example" 2020.

⁷⁰ Investopedia "Net Investment: Definition, Uses, How to Calculate, and Example" 2020.

⁷¹ Investopedia "Net Liquid Assets: Meaning, Advantages, Example" 2022 available at <https://www.investopedia.com/terms/n/netliquidassets.asp#:~:text=Net%20liquid%20assets%20are%20a,at%20their%20approximate%20current%20value.> (last accessed 2023-11-27).

⁷² Investopedia "Net Liquid Assets: Meaning, Advantages, Example" 2022.

⁷³ Investopedia "Net Liquid Assets: Meaning, Advantages, Example" 2022.

⁷⁴ Investopedia "Net Liquid Assets: Meaning, Advantages, Example" 2022.

⁷⁵ SARB "First Edition Financial Stability Review 2023" 15.

⁷⁶ Indeed "How To Calculate Sales Growth (With Formula and Examples)" 2023 available at <https://www.indeed.com/career-advice/career-development/calculating-sales-growth#:~:text=Updated%20February%203%2C%202023,to%20develop%20strategies%20for%20improvement.> (last accessed 2023-11-27).

⁷⁷ Indeed "How To Calculate Sales Growth (With Formula and Examples)" 2023

Repo rate: is the interest rate at which the central bank of a country lends money to commercial banks.⁷⁸

Return on assets: is a measure used to determine the profitability of a company in relation to its assets.⁷⁹ It is calculated by dividing the net income of a company by its total assets.⁸⁰ A higher return, illustrates that a company is more efficient at managing its balance sheet to generate profit.⁸¹

Share of zombie firms: this refers to the number of zombie firms in a country as a percentage of the total number of firms.⁸²

SMEs: enterprises that are categorized as either micro, small or medium, in terms of the total employees it has and its annual turnover as listed in Schedule 1 of the National Small Enterprises Act 102 of 1996. The start-up entrepreneur (or owner) is often personally involved in the management of the enterprise. In terms of the involvement of the owner, an SME is managed by one owner or more, whereby the owner is uniquely present and personally involved in the practices of the entity and the results obtained therefrom.⁸³

Sovereign debt: the amount of money that the government of a country has borrowed.⁸⁴

Subsidized credit: credit provided below normal market rates.⁸⁵

⁷⁸ Better Bond “Five things you need to know about the repo rate” available at <https://www.betterbond.co.za/learn/five-things-you-need-to-know-about-the-repo-rate> (last accessed 2023-11-27).

⁷⁹ Investopedia “Return on Assets (ROA): Formula and ‘Good’ ROA Defined” 2022 available at <https://www.investopedia.com/terms/r/returnonassets.asp> (last accessed 2023-11-27).

⁸⁰ Investopedia “Return on Assets (ROA): Formula and ‘Good’ ROA Defined” 2022.

⁸¹ Investopedia “Return on Assets (ROA): Formula and ‘Good’ ROA Defined” 2022.

⁸² Carreira, Teixeira and Nieto-Carrillo “Recovery and exit of zombie firms in Portugal” 2022 *Small Bus Econ* 498.

⁸³ Boraine and Van Wyk “Various Aspects to Consider with Regard to Special Insolvency Rules for Small and Medium-Sized Enterprises in South Africa” 2015 *International Insolvency Review* 236

⁸⁴ IMF “What is Sovereign Debt?” 2022 available at <https://www.imf.org/en/Publications/fandd/issues/2022/12/basics-what-is-sovereign-debt> (last accessed 2023-11-27).

⁸⁵ Oxford Reference “Overview: subsidized credit” available at <https://www.oxfordreference.com/display/10.1093/oi/authority.20110803100540846#:~:text=Credit%20provide%20on%20terms%20below,of%20entrepreneurship%20among%20minority%20groups.> (last accessed 2023-11-27).

Tobin's Q: reflects the relationship between market valuation and the intrinsic value of a firm and illustrates whether a firm is overvalued or undervalued.⁸⁶ This means that if a firm has a low Tobin's Q, it portrays that in the eyes of investors, the firm has low future profit potential.⁸⁷

Total factor productivity: illustrates the productivity of a company by determining how much it produces versus what it needs to spend to achieve that result.⁸⁸ It is calculated by dividing total production output by average costs of the input.⁸⁹

Zombie companies: are companies which continue to operate under insolvent circumstances.⁹⁰ They are kept alive due to being extended additional credit.⁹¹

Zombie lending: is the act of providing additional credit to unviable zombie firms.⁹²

1.7. Methodology

This study is comparative in nature and qualitative research is undertaken through desktop research and the use of primary and secondary sources. The study is multidisciplinary and will span across three legal disciplines, namely banking law, corporate law, and insolvency law. It further traverses the fields of law and accounting due to the methods of defining a zombie firm discussed in chapter 2 of the dissertation. This dissertation, in unpacking the various considerations, makes use of graphs and tables to simplify the information that the research conveys to the reader.

The quantitative research of international institutes, such as the Organisation for Economic Co-operation and Development (OECD), the IMF, the Bank for International Settlements (BIS), and academic researchers, is analysed to ascertain trends regarding zombie companies in order to develop a concise definition of zombie companies, and to identify qualifying characteristics.

Following this, the OECD's Insolvency Indicators are used as a point of departure for international best practices. Alongside the unpacking of the OECD key indicators, the broader principles of the UNCITRAL Legislative Guide on Insolvency Law will be referred to, to

⁸⁶ Investopedia "Q Ratio or Tobin's Q: Definition, Formula, Uses and Examples" 2021, available at <https://www.investopedia.com/terms/q/qratio.asp> (last accessed 2023-11-1).

⁸⁷ Investopedia "Q Ratio or Tobin's Q: Definition, Formula, Uses and Examples" 2021.

⁸⁸ Investopedia "What Is Productivity and How to Measure It Explained" 2023 available at <https://www.investopedia.com/terms/p/productivity.asp> (last accessed 2023-11-27).

⁸⁹ Investopedia "What Is Productivity and How to Measure It Explained" 2023.

⁹⁰ Banerjee and Hofmann 2021 *BIS Working Papers* 2.

⁹¹ Banerjee and Hofmann 2021 *BIS Working Papers* 2.

⁹² This definition is derived from the definition of "zombie companies" listed above.

expand on the OECD key indicators. The UNCITRAL Legislative Guide on Insolvency Law is referred to as it illustrates international best practices on a broader, principled basis. This aids in providing a theoretical foundation, from which the OECD indicators provide more specific considerations to consider. The reasons for selecting the OECD key indicators are listed below.

Firstly, these indicators were developed to depict the key features that an insolvency regime should have for resource allocation and productivity growth.⁹³ If these features are not present in an insolvency regime, the adverse consequences are delayed productivity growth through delayed initiation and prolonged proceedings.⁹⁴ As was mentioned earlier on, if this happens, the share of capital sunk in zombie companies is significantly higher.⁹⁵ It has also been shown that, if insolvency regimes are appropriately reformed, the capital may be reallocated to productive firms.⁹⁶ The insolvency indicators provide a roadmap of what appropriate reform measures may require.

Secondly, the OECD provides data and insight into a large set of countries over a prolonged period, particularly in 2010, 2016 and 2022. As each country is scored on each indicator, it grants insight into when a particular country made changes to their regime and how these changes were made. It is off this basis that Portugal has been selected to investigate the impact of insolvency law reform on zombie companies. In 2010, Portugal had one of the worst scores. However, between 2012 and 2016, Portugal implemented reforms which saw it become one of the OECD countries with the highest improvement rates.⁹⁷ Interestingly, following the implementation of these reforms, studies have shown that the share of zombie firms decreased continuously from 2012 onwards.⁹⁸ It is for this reason that Portugal was selected as a point of reference in ascertaining what kind of reforms South Africa's insolvency law policy makers should consider, and whether these reforms would be suitable to South Africa.

Thirdly, the insolvency indicator dataset of the OECD is particularly useful as South Africa was included in its latest 2022 data set. This provides key insights as to how South Africa's

⁹³ McGowan and Andrews "Policies for Productivity: the Design of Insolvency Regimes Across Countries" 2018 *OECD Going for Growth* 88.

⁹⁴ Andre and Demmou "Enhancing insolvency frameworks to support economic renewal" 2022 *OECD Economics Department Working Papers* 8.

⁹⁵ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 27.

⁹⁶ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 27.

⁹⁷ Gouveia and Osterhold "Fear the walking dead: zombie firms, spillovers and exit barriers" 2018 *Banco de Portugal Eurosystem Working Paper* 10.

⁹⁸ Carreira, Teixeira and Nieto-Carrillo "Recovery and exit of zombie firms in Portugal" 2022 *Small Bus Econ* 498.

insolvency regime scores in respect of alignment with international best practices. This aids in ascertaining where the shortcomings are and where reform is needed in order to align the insolvency system with best practices. This scoring is used to inform the investigation into South Africa's current insolvency framework, in order to determine which processes are aligned, where reform is needed, and where new processes must be drafted.

This dissertation is referenced according to the guidelines of the Potchefstroom Electronic Law Journal (PER/PELJ).

1.8. Delineations and limitations

Zombie companies, as a global phenomenon, presents in countries all over the world. This particular study cannot investigate and discuss the effects on all affected countries. On account of the word limit, and with the understanding that the dissertation is to be completed in a year, the scope of work is narrowed and focused.

Scholarship exists on the factors that contribute to the rise and continued existence of zombie companies, such as government intervention, the role of banks through their relationships with clients, bank forbearance, and the reissuing of loans. While these will be briefly mentioned, this study does not investigate these factors in depth. This study is more centered around the role of insolvency regimes and how their reform may lead to a decrease in zombie companies and capital share sunk.

As the word count is limited, it is also important to note that only certain insolvency mechanisms were identified to be particularly relevant and only these will be discussed. Due to the size of the insolvency legislation of South Africa and that of foreign jurisdictions, the entirety of the legislation, and the length of the processes contained therein, cannot be explained. However, the most important factors and processes will be duly explained and unpacked to explain their impact and relevance to the study.

In this paper, the thirteen key indicators introduced by the OECD to assess the efficiency of country's insolvency regimes will be discussed and analysed.

In this study, not all of these indicators will be considered in depth for the purpose of the comparative analysis. The main factors considered relate to the streamlining of processes and the removal of barriers to access swift pre-insolvency and liquidation mechanisms.

Accordingly, special insolvency procedures for SMEs will not be considered in depth nor will the rights of employees be discussed. However, this does leave room for further study. Similarly, in referral to the principles of the UNCITRAL Legislative Guide on Insolvency Law, only certain principles will be discussed. In this regard, the principles discussed are limited to those which are relevant to this study and the specific considerations brought forward by the OECD.

Throughout this dissertation, the phrases “zombie company” and “zombie firm” will be referred to interchangeably. Throughout various jurisdictions, what denotes a company or a firm, may include various types of entities, such as sole proprietors, partnerships, registered companies or close corporations. For purposes of this study, these companies and firms are limited to companies registered with the Companies and Intellectual Property Commission (“CIPC”). However, this does not detract from the fact that other types of entities are also capable of being zombie firms.

Another consideration is that of small and medium enterprises (SMEs). These firms, for purposes of this study, are categorized in terms of size and the level of involvement of the owner/s in the business. In terms of size, an SME is categorized as either micro, small or medium, in terms of the total employees it has and its annual turnover as listed in Schedule 1 of the National Small Enterprises Act 102 of 1996. In terms of the involvement of the owner, an SME is managed by one owner or more, whereby the owner is uniquely present and personally involved in the practices of the entity, and the successes and failures of the entity.⁹⁹ These types of entities, due to their informal nature, require special considerations and mechanisms drafted for them specifically when it comes to their insolvency. As these SMEs play a dominant role in the economy, a policy strategy ought to target the specific challenges facing SMEs to assist them in respect of simplified and flexible restructuring and insolvency procedures.¹⁰⁰ Although SMEs can fall into zombie status and hold a large market share, due to the unique nature of SMEs, it is beyond the scope of this dissertation to deal with the special procedures required to aid SMEs.

⁹⁹ Boraine and Van Wyk “Various Aspects to Consider with Regard to Special Insolvency Rules for Small and Medium-Sized Enterprises in South Africa” 2015 *International Insolvency Review* 236.

¹⁰⁰ Boraine and Van Wyk 2015 *International Insolvency Review* 32; The World Bank “Principles for Effective Insolvency and Creditor/Debtor Regimes” 2021 *World Bank Group* 9.

1.9. Overview of chapters

Chapter 1 provides a background to the link between zombie firms and large economic shocks such as Covid-19. A brief overview of what a zombie firm is, and why these firms are cause for concern, were provided. The chapter also provided the research questions to be investigated, as well as the methodology to be utilized in answering these questions.

Chapter 2 unpacks the history of zombie companies and their link to economic shocks. This is illustrated in discussions of the stagnation of Japan in the 1990s, the GFC and the sovereign debt crisis. Thereafter, South Africa's policy responses to Covid-19 are unpacked to show the correlation between the response of South Africa and other historical policy responses which led to the increase in zombie firms. The various definitions of zombie companies are discussed in order to arrive at a conceptualised definition of zombie companies, as well as their characteristics and life-cycle.

Chapter 3 identifies the role of insolvency law reform in reducing the number of zombie firms and the share of capital sunk in these firms. To identify key factors in this regard, the insolvency indicators of the OECD and their scoring is discussed as international best practices. In giving greater context to these principles of best practice, the UNCITRAL Legislative Guide on Insolvency Law is discussed as well. Following which, the insolvency reforms introduced by Portugal, which reduced their number of zombie firms, is unpacked and discussed.

Chapter 4 explains the insolvency procedures available in South Africa and what these entail. These procedures are compared with international best practices to ascertain to what extent these procedures align with international best practices. The chapter then compares the South African position with that of Portugal, and points out the successes of Portugal's insolvency reform while highlighting the failures of South Africa's insolvency regime.

Chapter 5 concludes the dissertation by providing an overview of all that has been discussed and discovered. The overview lays the foundation for the suggestions and recommendations that are put forward as to how South Africa can incorporate international best practices into its insolvency framework and learn from Portugal's reforms. These suggestions consider the principles that the legislature ought to take into account when introducing insolvency reforms, which would result in curbing zombie firms in South Africa.

Chapter 2: A framework of zombie firms

2.1. Introduction

As of July 2023, South African businesses are battling to stay afloat while grappling with high interest rates, rolling blackouts, and the ripple effects of the Covid-19 pandemic. On a global scale, governments provided funding and support to local firms during the pandemic to protect the country from incurring severe financial losses. Although this initial aid was integral to ensuring the negative shock on the economy was mitigated as much as possible, it created a breeding ground for zombie companies. Zombie companies are arguably not new to South Africa but the scarcity of scholarship on the topic shows that these companies have not been on the radar of researchers, policy-makers, and the South African legislature. However, the Covid-19 pandemic has brought the phenomenon to the foreground as it would have enabled existing zombies to survive and caused new ones to be created.

This chapter seeks to outline the history of zombie firms, particularly how the number of zombie firms increases following a large economic shock such as the GFC or Covid-19. Following this, various monetary policies introduced by the South African government during Covid-19 will be discussed. It will then be discussed how the resulting effects of these policies mirror previous economic shocks, and how these lead to an increase in zombie companies. This is particularly important as it emphasises how Covid-19 measures created a breeding ground for zombie companies. This phenomenon needs to be addressed as zombies inhibit the creation of healthy firms and has detrimental effects on the productivity, investment opportunities, and employment of the country.¹

After establishing that the responses to Covid-19 would enable the survival and creation of zombie firms, attention is turned towards finding a regulatory approach to target these firms in Chapter 3. However, as a point of departure, it is important to first determine exactly how a zombie firm can be identified and what distinguishes it from a viable firm. It is on this basis, that this chapter refers to the works of various international researchers to arrive at a concise criterion of zombie companies for purposes of this study.

¹ Albuquerque and Iyer “The Rise of the Walking Dead: Zombie Firms Around the World” 2023 *IMF Working Paper* 2023.

2.2. History of zombie companies

2.2.1. Japan

The term “zombie lending” was first used in investigations of Japan’s “lost decade” of the 1990s.² Later, the phenomenon was identified across the globe, particularly in Europe following the GFC and the sovereign debt crisis.³

Japan’s banking crisis in the 1990s unfolded as a result of the sharp decline in asset prices, more specifically, land and real estate.⁴ Real estate was often used as collateral. Financial institutions themselves held stocks in land, with loans granted to real estate representing a large portion of their balance sheet.⁵ Financial institutions as a result were placed under severe strain, and cut back lending, with firms cutting investment as a consequence.⁶

A further significant contributor was the misallocation of credit by the banks.⁷ At the time, there was very little regulatory oversight to keep the behaviour of banks in check. An exception to this was that banks were obliged to comply with the international Basel capital standards.⁸ The impact was that, if banks were to recognise their non-performing loans, they would have to write off existing capital. This would put banks at risk of falling below the minimum required capital levels.⁹ It was out of this fear that banks would continue to extend credit to defaulting firms, in the hope that they would either recover or be bailed out by government.¹⁰ As government bailouts entail the government of a country providing an injection of equity into the bank, the mechanism guarantees the debt of the banks.¹¹ This creates cause for concern as public funds are utilised to pay for the risk-taking behaviour of banks.¹²

² Caballero, Hoshi and Kashyap “Zombie Lending and Depressed Restructuring in Japan” 2008 *American Economic Review* 1943-1977.

³ Acharya *et al* “Zombie Lending: Theoretical, International and Historical Perspectives” 2022 *Annual Review of Financial Economics* 2.

⁴ Gianetti and Simonov “On the Real effects of Bank Bailouts: Micro Evidence from Japan” 2013 *American Economic Journal: Macroeconomics* 138.

⁵ Gianetti and Simonov 2013 *American Economic Journal: Macroeconomics* 138.

⁶ Gianetti and Simonov 2013 *American Economic Journal: Macroeconomics* 138.

⁷ Peek and Rosengren “Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan” 2005 *The American Economic Review* 1144.

⁸ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1944.

⁹ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1944.

¹⁰ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1944.

¹¹ Meehl “Bailouts, Bail-ins, and Banking Industry Dynamics” 2022 *The American Finance Association* 1.

¹² Meehl 2022 *The American Finance Association* 1.

Banks accordingly found their fates tied to that of the defaulting borrowers. If the banks did not provide their weakest borrowers with additional loans, the defaulting firms would be unable to make the necessary interest payments to keep the loans current.¹³ An alternative outcome could also see these defaulting firms going into liquidation.¹⁴ In both scenarios, banks would be required to report these non-performing loans, creating a self-preserving interest for banks to create a policy of forbearance.¹⁵ This would prevent banks from having to increase their own loan loss reserves, and impairing their reported capital.¹⁶ This approach saw banks evergreening loans to ensure that their own balance sheets looked better.¹⁷

However, the banks did not act alone in following this approach. The complicity of government both allowed and encouraged banks to continue their practice of extending additional loans to defaulting borrowers.¹⁸ This was encouraged to avoid failures of massive firms and banks, which would have large-scale repercussions from a financial and political perspective.¹⁹

For example, Shinsei Bank, a bank which took their credit risk analysis seriously in its evaluation of extending loans, was encouraged to extend loans to defaulting firms.²⁰ The Financial Services Agency Commissioner, Shoji Mori, remarked that “Shinsei should behave in line with other Japanese banks”.²¹ The role of government did not end there. Failed banks were depicted as purportedly cleaned-up, and the buyers of these banks purchased these institutions because the government prevented bidders from inspecting their books.²² This barring was in place to avoid the exposure of other banks with loans to the same firms from having to be recognised as non-performing.²³ Banks were placed in a precarious position, as the public perception would gravely decline if banks failed to aid in the recession by denying credit to firms in need.²⁴

Of the Japanese firms that had declared bankruptcy in 2000, 75% percent of the loans that had been extended to these firms had been labelled as sound or merely in need of monitoring.²⁵ Of

¹³ Peek and Rosengren 2005 *The American Economic Review* 1144.

¹⁴ Peek and Rosengren 2005 *The American Economic Review* 1144.

¹⁵ Peek and Rosengren 2005 *The American Economic Review* 1144.

¹⁶ Peek and Rosengren 2005 *The American Economic Review* 1144.

¹⁷ Peek and Rosengren 2005 *The American Economic Review* 1145.

¹⁸ Peek and Rosengren 2005 *The American Economic Review* 1145.

¹⁹ Peek and Rosengren 2005 *The American Economic Review* 1145.

²⁰ Peek and Rosengren 2005 *The American Economic Review* 1145.

²¹ Peek and Rosengren 2005 *The American Economic Review* 1145.

²² Peek and Rosengren 2005 *The American Economic Review* 1145.

²³ Peek and Rosengren 2005 *The American Economic Review* 1145.

²⁴ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1944.

²⁵ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1944.

a pool of firms comprised of those in publicly-traded manufacturing, construction, real estate, retail, wholesale and service sector firms, 30% were dependant on banks to survive with 15% of Japan's assets residing in those firms.²⁶

The ripple effect of sustaining unprofitable borrowers distorted competition throughout the economy.²⁷ This distortion came in many forms: depressing market prices for products; the increase of market wages by retaining employees whose productivity had declined; and congestion of the market.²⁸

Unsustainable firms continued to receive financial support from the banks and government. This prevented the regular competitive outcome, which would have seen their exit from the market. However, due to this aid, their market share was preserved.²⁹ The low prices of these firms' products, paired with their high wages, reduced the profit and collateral which was accessible to new, productive firms.³⁰ As a result, investment and entry into the market was thwarted.

2.2.2. Europe

In Europe, the phenomenon of zombie firms was brought to the forefront in the aftermath of the GFC of 2008 and the subsequent European sovereign debt crisis.³¹ The GFC was triggered by subprime lending in the United States, where mortgage loans were granted to clients with poor credit history and who struggled to maintain their repayment obligations.³² This dissertation will not go into depth regarding the causes of the GFC, save to mentioned that it was a combination of excessive leverage, poor lending practices, lack of regulatory supervision, and misaligned incentives.³³ The market turmoil during the crisis and the corresponding slow economic recovery encouraged central banks across the world to uphold low interest rates.³⁴ This encouraged institutional investors, such as pension funds, to utilize high-yield investments to meet their future obligations.³⁵ For asset managers, high-yield bonds

²⁶ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1994.

²⁷ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1994.

²⁸ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1994.

²⁹ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1994.

³⁰ Caballero, Hoshi and Kashyap 2008 *American Economic Review* 1994.

³¹ Havemeister and Horn "Fear the walking dead? Zombie Firms in the Euro Area and Their Effect on Healthy Firms' Credit Conditions" 2021 *European Systemic Risk Board Working Paper* 3.

³² Lastra *Cross-Border Bank Insolvency* (2011) 2.

³³ Lastra and Wood "The Crisis of 2007-2009: Nature, Causes, and Reactions" 2010 *Journal of International Economic Law* 531-550.

³⁴ Altman, Dai and Wang "Global Zombies" 2022 *SSRN* 18.

³⁵ Altman, Dai and Wang 2022 *SSRN* 19.

and leveraged loans were attractive options to boost their future returns.³⁶ The demand caused the fast growth of the high-yield bond markets globally.³⁷ Paired with low interest rates, this growth ensured that low-productivity businesses were able to survive and contributed to the growing number of zombie firms.³⁸

European banks were greatly exposed to the losses in the US market due to the asset-backed securities held and the dependence on the US money markets as a source of dollar finance.³⁹ As a result, some European governments provided guarantees to their banks as opposed to equity.⁴⁰ This led to banks being undercapitalized.⁴¹ These banks then relied on support from the European Central Bank, and increased their investments in risky domestic sovereign debt as well as their subsidized zombie lending practices.⁴²

2.2.3. Overview of economic shocks

It has been shown that, in advanced and emerging economies, it is a regular practice to extend credit to distressed borrowers.⁴³ Although the exact circumstances may differ in each case, several recurring themes have been identified: (1) the onset of large economic shocks, such as the GFC and the sovereign debt crisis, usually result in distressed firms avoiding default through the support of their lenders; (2) the act of forbearance in asset-quality recognition by banks enables and preserves the undercapitalization of banks; and (3) following the shock, long-term aggregate consequences ensue such as low economic growth.⁴⁴

Trends and commonalities which can be identified from the preceding discussions about Japan, the GFC and the sovereign debt crisis include the misallocation of credit; granting additional credit to defaulting borrowers; misaligned incentives (often due to governmental pressure); government bailouts; bank forbearance; the introduction of lax monetary policies; and long-term consequences such as decreased investment and productivity. These commonalities illustrate that certain behaviours on the part of governments, banks and financiers lead to zombie companies forming and continuing to survive. It is off this basis that the measures

³⁶ Altman, Dai and Wang 2022 *SSRN* 19.

³⁷ Altman, Dai and Wang 2022 *SSRN* 19.

³⁸ Altman, Dai and Wang 2022 *SSRN* 19.

³⁹ Lane “The European Sovereign Debt Crisis” 2012 *Journal of Economic Perspectives* 55.

⁴⁰ Acharya *et al* “Kicking the can down the road: government interventions in the European Banking sector” 2021 *The Review of Financial Studies* 11.

⁴¹ Acharya *et al* 2022 *Annual Review of Financial Economics* 8.

⁴² Acharya *et al* 2022 *Annual Review of Financial Economics* 8.

⁴³ Acharya *et al* 2022 *Annual Review of Financial Economics* 2.

⁴⁴ Acharya *et al* 2022 *Annual Review of Financial Economics* 2.

introduced by the South African government to alleviate the effects of the Covid-19 pandemic will be discussed in order to ascertain whether similar trends have been followed.

2.3. The South African landscape

2.3.1. South Africa's response to Covid-19

On 21 April 2020, South Africa's government introduced a R500 billion package to alleviate the effects of the pandemic being felt by individuals and businesses.⁴⁵ R200 billion of the package was allocated towards the Covid-19 Loan Guarantee Scheme, a credit scheme which came into operation on 12 May 2020.⁴⁶ The scheme was introduced to provide financial support to SMEs, which as at 2023, make up more than 90% of formal businesses in the country.⁴⁷

Initially the scheme was available to businesses with

- a turnover of less than R300 million;
- who were existing bank clients with good standing as of 29 February 2020; and
- that were financially distressed as a result of Covid-19 and were registered with the South African Revenue Service (SARS).⁴⁸

These loans could be used to cover operational expenses, such as salaries, rent, leases and supplier contracts.⁴⁹ As such, businesses could not use the funding to pay dividends, make investments, pay bonuses, or pay off other loans they may have.⁵⁰ The loan amount would be disbursed in up to three monthly instalments, following which no payment would be expected from the borrowers for a further three months.⁵¹

⁴⁵ SARB "Media statement: Loan Guarantee Scheme Opens" 2020, available at <https://www.resbank.co.za/content/dam/sarb/newsroom/Loan%20guarantee%20scheme%20opens.pdf> (last accessed 2023-05-12).

⁴⁶ SARB "Media statement: Loan Guarantee Scheme Opens" 2020.

⁴⁷ SARB "Quarterly Bulletin June 2023", available at <https://www.resbank.co.za/content/dam/sarb/publications/quarterly-bulletins/quarterly-bulletin-publications/2023/june/01Full%20Quarterly%20Bulletin.pdf> (last accessed 2023-05-12).

⁴⁸ Parliamentary Budget Office "Brief on Business Bounce-back Support and the Credit Loan Guarantee Schemes for Small, Micro and Medium Enterprises (SMMs)- June 2022", available at https://www.parliament.gov.za/storage/app/media/PBO/Analysis_and_Reports/2022/3-june/30-06-2022/PBO_Briefing_Business_Bounce_back_Support_and_the_Credit_Loan_Guarantee_Schemes_SMMs_1.pdf (last accessed 2023-05-12).

⁴⁹ National Treasury "Economic Measures for Covid-19" 2020, available at https://www.treasury.gov.za/comm_media/press/2020/20200428_COVID_Economic_Response_final.pdf (last accessed 2023-05-12); National Treasury "Answering your questions about the Covid-19 Loan Guarantee Scheme" 2020, available at https://www.treasury.gov.za/comm_media/press/2020/COVID-19%20loan%20guarantee%20scheme%20FAQs%2026%20July.pdf (last accessed 2023-05-12).

⁵⁰ National Treasury "Answering your questions about the Covid-19 Loan Guarantee Scheme" 2020.

⁵¹ National Treasury "Answering your questions about the Covid-19 Loan Guarantee Scheme" 2020.

These businesses were allowed to apply for one loan and they were then required to repay that loan over a five-year period.⁵² Banks were not obliged to extend the loans but if they so wished, they could do so according to their internal risk-evaluation and credit application processes.⁵³

Banks could also request that the owners of these businesses sign as sureties.⁵⁴ The loans extended would cover up to three months of operational expenses, and would be drawn down monthly.⁵⁵ The South African Reserve Bank lent money to the commercial banks at the repo rate of 3.5% with a 0.5% credit premium.⁵⁶ The banks would then disburse the money at the repo rate with an additional fixed spread of 3.5% (7.75% total).⁵⁷ This approach prevented and prohibited banks from making any profit from these loans, with the 3.5% acting as a buffer to absorb losses.⁵⁸ However, on 26 July 2020, two months after the scheme was introduced, it was reviewed and its entry requirements altered to make the fund more accessible.⁵⁹ The measures introduced to make the fund more accessible included:

- business restart loans were made available, to assist businesses that would be able to begin operating as soon as the economy opened up;
- the draw down period was extended from three months to a maximum of six months;
- the interest and capital repayment holidays were extended from three months to a maximum of six months;
- the turnover cap of R300 million was done away with, and replaced with a maximum loan amount of R100 million, with banks being able to provide syndicated loans for loans larger than R50 million;
- the test for good standing was made easier, with the test being moved back to 31 December 2019 to accommodate firms that were already struggling with their cash-flow in February;
- sole proprietors were previously not explicitly included, and salary-like payments to the owners were now allowed;

⁵² National Treasury “Answering your questions about the Covid-19 Loan Guarantee Scheme” 2020.

⁵³ National Treasury “Economic Measures for Covid-19” 2020.

⁵⁴ National Treasury “Economic Measures for Covid-19” 2020.

⁵⁵ National Treasury “Economic Measures for Covid-19” 2020.

⁵⁶ Parliamentary Budget Office “Brief on Business Bounce-back Support and the Credit Loan Guarantee Schemes for Small, Micro and Medium Enterprises (SMMEs)- June 2022”.

⁵⁷ Parliamentary Budget Office “Brief on Business Bounce-back Support and the Credit Loan Guarantee Schemes for Small, Micro and Medium Enterprises (SMMEs)- June 2022”.

⁵⁸ Parliamentary Budget Office “Brief on Business Bounce-back Support and the Credit Loan Guarantee Schemes for Small, Micro and Medium Enterprises (SMMEs)- June 2022”.

⁵⁹ National Treasury “Media Statement: Update on Covid-19 Loan Guarantee Scheme” 2020.

- no security, suretyships or guarantees were required;
- bank credit assessments and loan approvals were made more discretionary and less restrictive;
- banks could reconsider applications that had been previously declined; and
- loans under the Scheme as well as other loans could not trigger cross-default clauses and *vice versa*.⁶⁰

The Scheme stopped accepting new applications after 28 June 2021. As of 19 June 2021, R18.39 billion worth of loans had been extended to businesses under the Scheme.⁶¹ However, this does not encapsulate the entirety of the relief extended during Covid's period of turmoil. As of February 2021, banks had provided R293 billion worth of loans to their clients, with R165 billion being extended to the corporate sector and R128 billion to the retail sector.⁶²

Working alongside these forms of relief, policy measures were introduced relating to tax and monetary and financial regulation.⁶³ Although this dissertation will not discuss the intricacies of these relief measures in depth, the focus of the additional measures is mentioned for ease of reference:

- skill development levy holidays;
- tax deferrals;
- expansion of the employment tax incentive;
- a reduction of the repo rate to reduce short-term borrowing costs; and
- reduced capital requirements of financial institutions to support additional lending and the lowering of the liquidity coverage ratio requirement of financial institutions from 100% to 80% to support additional lending.

2.3.2. A review of the Covid-19 policy measures

It is difficult to ascertain the impact that these measures had, and whether their absence would have led to far greater economic devastation. Although it is beyond the scope of this

⁶⁰ National Treasury "Answering your questions about the Covid-19 Loan Guarantee Scheme" 2020.

⁶¹ The Banking Association of South Africa "2020 Annual Integrated Report" 2020, available at https://www.banking.org.za/wp-content/uploads/2021/02/JOB022770_BASA_AR_V5a_PP.pdf (last accessed 2023-05-12).

⁶² The Banking Association of South Africa "2020 Annual Integrated Report" 2020.

⁶³ National Treasury "Economic Measures for Covid-19" 2020.

dissertation, it may be useful for further research to be conducted which, through a comparative analysis of similar economies which adopted similar measures, the impact may be determined.

The measures discussed above – lowered interest rates, tax deferrals, reduced capital requirements, and government-backed schemes – are not viable in the long term, and can pose great dangers. The dangers arise due to the long-term negative impacts that these measures may have on the commercial banking sector and government debt.

As far as the commercial banking sector is concerned, non-performing loans reduced the profitability of the sector from R83,98 billion in 2019 to R34,84 billion in 2020.⁶⁴ The profitability of banks suffered further due to the lower interest rates and the decline in non-interest revenue which reduced alongside the decreased number of transactions that were carried out.⁶⁵

Government debt, as a percentage of GDP, increased to 68,9% in 2020, from 12,8% in 2019 and up to 23,7% from 2015 when the ratio was 45.2%.⁶⁶ In order to address Covid-19 and to introduce various policy measures, the government's revenue took severe blows. The R500 billion fiscal stimulus package saw more money spent on public health and social security, with tax revenues significantly reduced.⁶⁷ In its aim towards securing post-Covid recovery for the country, the government took on various loans including a \$4.3 billion loan from the IMF and a \$750 million loan from the World Bank Group.⁶⁸ As the government debt to GDP ratio increased, it placed the government at an increased risk of sovereign default. A sovereign debt default is a precarious position which can often lead to a banking crisis. When banks hold sovereign bonds, in the event of a sovereign default, it negatively impacts the banks' balance sheets, may cause a decrease in lending, a decline in economic activity, and an eventual banking crisis.⁶⁹

⁶⁴ Genesis Analytics and FSCA "2022 Financial Sector Outlook Study" 2022 *FSCA* 27.

⁶⁵ Genesis Analytics and FSCA "2022 Financial Sector Outlook Study" 2022 *FSCA* 28.

⁶⁶ IMF "General Government Gross Debt Percent of GDP South Africa", available at https://www.imf.org/external/datamapper/GGXWDG_NGDP@WEO/ZAF?zoom=ZAF&highlight=ZAF (last accessed 2023-10-31).

⁶⁷ De Swardt "Determining the Risks of a Sovereign Debt Default in South Africa and the Consequences Thereof: An International Overview" 2022 *Stellenbosch University* 1.

⁶⁸ IMF "IMF Executive Board Approves US\$4.3 Billion in Emergency Support to South Africa to Address the COVID-19 Pandemic" 2020, available at <https://www.imf.org/en/News/Articles/2020/07/27/pr20271-south-africa-imf-executive-board-approves-us-billion-emergency-support-covid-19-pandemic> (last accessed 2023-10-31); National Treasury "South Africa's Covid-19 Response Gets a \$750 Million Boost" 2022, available at https://www.treasury.gov.za/comm_media/press/2022/2022012101%20Media%20Statement%20-%20WORLD%20BANK%20LOAN%20TO%20SOUTH%20AFRICA.pdf (last accessed 2023-10-31).

⁶⁹ Martinez *et al* "Sovereign Debt" 2022 *IMF Working Paper* 14.

From the above discussion it is clear that, although the measures introduced sought to alleviate the negative impact of Covid-19, these measures are not viable in the long-term. In actuality, they pose great risk in the long term and may delay economic revival post Covid-19 due to their ripple effects.

A further unintended consequence of the implemented measures is the sustaining or creation of zombie companies. Amongst the pool of businesses afforded aid, a portion certainly would have been viable businesses. These may have been start-ups or those companies which were capable of turning their poor position around. However, lurking amongst those, would have been firms that were already unviable, under- or nonperforming, and incapable of turn-around even prior to Covid-19. The measures discussed above would have removed barriers that hindered these firms from accessing funding and delayed their payment obligations, enabling their prolonged survival.

2.3.3. South Africa's financial position post-Covid-19

As at May 2023, the total loans and advances extended by financial institutions in the form of instalment sale credit, leasing finance, mortgage advances, and other forms of loans and advances, amounted to four trillion one-hundred-and-twenty-four billion nine-hundred-and-nine million rand (R4 124 909 000 000).⁷⁰ Of that total amount, 50,4% was extended to households.⁷¹

In the same month, it was reported by the South African Reserve Bank that the ratio of non-performing loans had been trending upwards.⁷² Non-performing loans are calculated as loans which are overdue for more than 90 days as a percentage of on-balance-sheet exposures.⁷³ Non-performing loans are a particular concern as they can be an indicator of banking crises due to the impact it has on economic growth through decreasing credit development.⁷⁴ If non-performing loans continue to increase, it will first impact commercial banks, following which the financial position of the country's economy will deteriorate.⁷⁵ The increase in non-

⁷⁰ SARB "Monthly Release of Selected Data No 413 July 2023", available at <https://www.resbank.co.za/en/home/publications/publication-detail-pages/monthly-releases/monthly-release-of-selected-data/2023/MonthlyReleaseofSelectedDataNo413July2023> (last accessed 2023-05-12).

⁷¹ This was calculated from the amount given to households (R2 079 298) as a portion of total loans and advances, listed in SARB Monthly Release of Selected Data No 413 July 2023.

⁷² SARB "First Edition Financial Stability Review 2023" 15.

⁷³ SARB "First Edition Financial Stability Review 2023" 15.

⁷⁴ Khan, Siddique and Sarwar "Determinants of non-performing loans in the banking sector in developing state" 2020 *Asian Journal of Accounting Research* 136.

⁷⁵ Khan, Siddique and Sarwar 2020 *Asian Journal of Accounting Research* 136.

performing loans impedes the efficiency of banks and may result in a banking crisis. This arises as non-performing loans block interest revenue, reduce investment opportunities, and negatively deplete liquidity, which may result in a bankruptcy problem amongst banks and a weak economic system.⁷⁶

The South African Reserve Bank has presented the following data, as contained in Figure 1 below, to illustrate the non-performing loan ratios for major lending categories, against the long-term average.

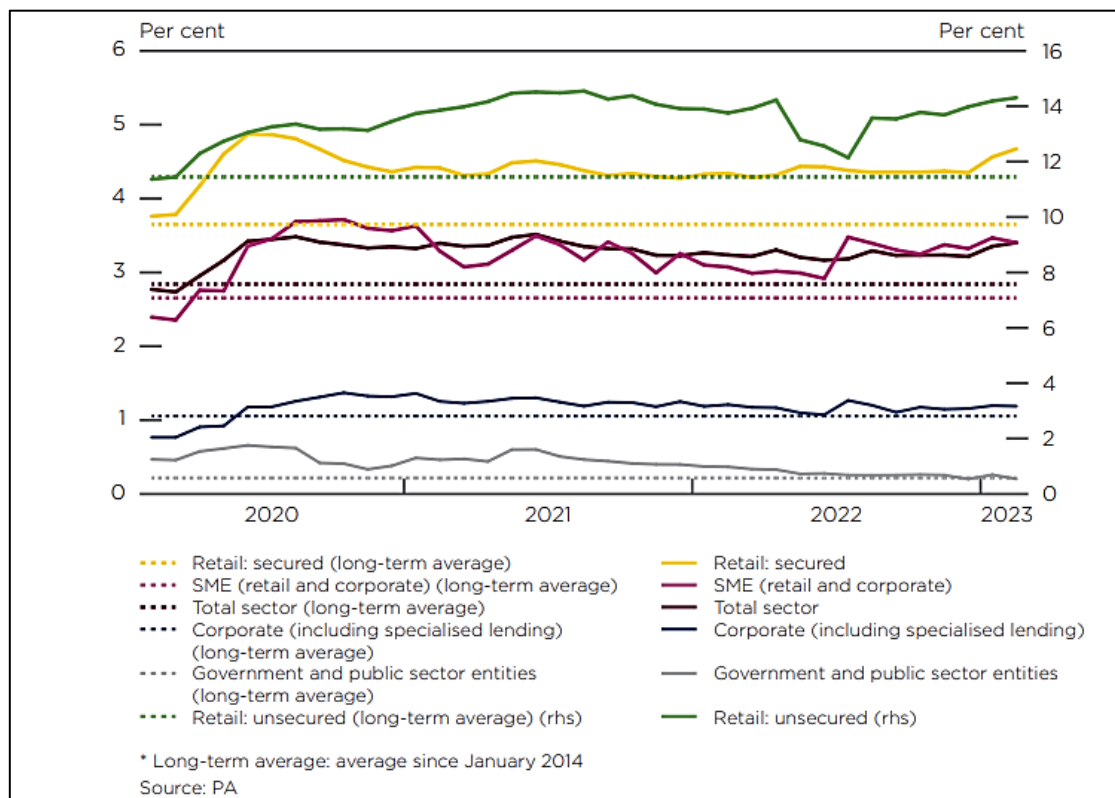


Figure 1: Current NPL ratios versus long-term average NPL ratios for major lending categories⁷⁷

The upward trend in non-performing loans depicts the struggle being faced by South African borrowers to repay their loans. The percentages are particularly high in the retail sector (both secured and unsecured) as well as for SMEs. As these reflect loans whereby the borrow has been in default for more than 90 days, it depicts borrowers who are unlikely to repay the bank the full amount owed.

⁷⁶ Khan, Siddique and Sarwar 2020 *Asian Journal of Accounting Research* 136.

⁷⁷ SARB “First Edition Financial Stability Review 2023” 16.

In its report on liquidations and insolvencies, Statistics SA reported that, as of May 2023, there have been 674 liquidations.⁷⁸ Of this number, 109 were compulsory liquidations and 565 were voluntary liquidations.⁷⁹ However, these statistics only report on companies and close corporations, and do not account for unincorporated SMEs. In most economies, SMEs form the backbone of the financial system as they account for 99% of all firms, more than 60% of jobs, and more than 50% of sales.⁸⁰ The failure to account for SMEs may be due to their small, informal and flexible nature. Many SMEs are sole-proprietorships or partnerships wherein the owner(s) takes on the loans and expenses of the business individually. As such, if the company becomes insolvent, the sole proprietor or partners becomes insolvent. In this regard, any insolvency proceedings are likely to be handled through the sequestration of the individual, as opposed to the liquidation of the company.

As has been seen in the graph presented in Figure 1, the ratio of non-performing loans is on the rise. Firms who cannot meet their repayment obligations are unable to keep their businesses afloat. In such a situation, incorporated businesses in South Africa have three formal processes available: compromises, business rescue, and liquidation. If companies fail to enter into the above processes and resolve their financial situation but continue to operate, they hinder other firms from accessing funding and entering the market. In this regard, the extension of additional credit and aid enables the survival of these companies who operate under insolvent circumstances. It is against this background that an investigation of the criteria for zombie companies is undertaken, whereby they may be readily identified.

2.4. Zombie companies

2.4.1. Definitions of zombie firms

In the existing literature on zombie firms, various definitions and criteria have been put forward as to what renders a firm a “zombie”. There are no uniform criteria as to when a firm is no longer viable and should exit the market. In this regard, various proposals have been made by authors depending on their particular research questions. Some of these definitions are broad

⁷⁸ Statistics SA “Statistics of Liquidations and Insolvencies November 2022”, available at <https://www.statssa.gov.za/publications/P0043/P0043November2022.pdf> (last accessed 2023-05-12).

⁷⁹ Statistics SA “Statistics of Liquidations and Insolvencies November 2022”.

⁸⁰ IMF “Insolvency Prospects Among Small and Medium Enterprises in Advanced Economies: Assessment and Policy Options” 2021 *IMF Staff Discussion Notes* 6.

in scope, with others are narrow for various reasons. A select few of these definitions will be considered prior to determining a framework for purposes of this study.

As a starting point, firms in the economic market may experience financial distress and lack profitability over an extended period of time.⁸¹ As a result, these firms may be unlikely to pay their debts as they fall due. However, when these firms are kept alive and granted aid which enables them to avoid exiting the market – either through bank loans, investor aid, government bailouts or continuing subsidies – they are considered to be zombie firms.⁸²

As part of their investigation into the economic stagnation of Japan in the 1990s, Caballero *et al* formulated criteria to identify zombie firms – based solely on interest rates and subsidized credit.⁸³ In their definition, considerations such as profitability and productivity were excluded.⁸⁴ The authors specifically identified zombie firms by comparing the interest rate that was paid by firms with AAA-ratings (high-quality borrowers) with that of the interest paid by other firms.⁸⁵ In this analysis, the authors categorised firms that paid an interest rate below that which the AAA-firms were paying as zombie firms.⁸⁶ The basis of this trait was that these firms were receiving subsidised credit. The need for subsidised credit was therefore used as an identifier in the study to identify unviable firms present in regular market conditions.⁸⁷

The authors' research focus was the role of misdirected bank lending in prolonging the stagnation of the Japanese economy of the 1990s.⁸⁸ The inclusion of subsidised credit as a factor to identify zombie firms nevertheless highlighted its failure to account for essential business practices.⁸⁹ The definition only considers firms that are kept afloat due to subsidised lending. It fails to consider that subsidised lending may be granted to firms who are still viable, but going through temporary financial distress, and that banks aid business clients with

⁸¹ Kane “Dangers of Capital Forebearance: The Case of the Fslc and Zombie S&Ls” 1987 *Contemporary Economic Policy* 77-83; Albuquerque and Iyer “The Rise of the Walking Dead: Zombie Firms Around the World” 2023 *IMF Working Paper* 10.

⁸² Kane 1987 *Contemporary Economic Policy* 77-83; Albuquerque and Iyer 2023 *IMF Working Paper* 10.

⁸³ Caballero *et al* 2008 *American Economic Review* 1947.

⁸⁴ Caballero *et al* 2008 *American Economic Review* 1947.

⁸⁵ Berling *Life Below Zero: Zombie Firms and Low Interest Rates* (Master's Thesis 2021 LUND University) 4.

⁸⁶ Caballero *et al* 2008 *American Economic Review* 1947.

⁸⁷ Caballero *et al* 2008 *American Economic Review* 1947.

⁸⁸ Caballero *et al* 2008 *American Economic Review* 1943.

⁸⁹ Albuquerque and Iyer 2023 *IMF Working Paper* 11.

recovery potential with the aim of preserving a good relationship between the bank and the firm.⁹⁰ The definition also does not consider profitability or productivity.⁹¹

Further challenges that arise with the use of the sole criterion of subsidised lending are founded in the volatility of interest rates. Instances may arise whereby healthy companies would be classified as zombie firms, notwithstanding that banks granted subsidised credit on the basis of a long-term relationship. The reverse is also plausible, whereby due to bank discretion or negotiations, zombie firms may have to pay higher interest rates due to the risk they pose.

Although this criterion is not extensive enough for a broad definition, subsidized credit and bank forbearance do contribute to the survival of zombie firms. Furthermore, the authors outlined congestion externalities caused by zombie firms, such as the tendency of healthy firms to reduce investment, employment and productivity.⁹² These effects represent the danger inherent to the prolonged survival of these types of firms, which prevents the normal “creative destruction” process that would see zombie firms exit the market with viable firms taking their place.⁹³

Contrary to the definition of Caballero *et al*, which focused on subsidized credit, McGowan *et al* centred their definition on profitability considerations.⁹⁴ In terms of their scholarship, a zombie firm is classified as such if its interest cover ratio is less than one for three consecutive years and the firm is 10 years or older.⁹⁵

A firm’s interest cover ratio is a good depiction of its current financial position. It is a debt and profitability ratio, which is used to determine if a company can pay interest on its outstanding debts while maintaining liquidity.⁹⁶ It is calculated by dividing a firm’s earnings before interest and taxes (EBIT) by its interest expense during a particular period.⁹⁷ The lower the ratio, the more burdened the company is by its debts, and the less capital it has available for alternative

⁹⁰ Albuquerque and Iyer “The Rise of the Walking Dead: Zombie Firms Around the World” 2023 *IMF Working Paper* 11.

⁹¹ Caballero *et al* 2008 *American Economic Review* 1947.

⁹² Acharya *et al* 2022 *Annual Review of Financial Economics* 3.

⁹³ Acharya *et al* 2022 *Annual Review of Financial Economics* 8.

⁹⁴ McGowan, Andrews and Millot “The Walking Dead? Zombie Firms and Productivity Performance in OECD Countries” 2017 *OECD Economics Department Working Papers* 6-45.

⁹⁵ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 16; McGowan, Andrews and Millot “Insolvency Regimes, Zombie Firms and Capital Reallocation” 2017 *OECD Economics Department Working Papers* 24.

⁹⁶ Investopedia “Interest Coverage Ratio: Formula, How it Works and Example” 2023, available at <https://www.investopedia.com/terms/i/interestcoverageratio.asp> (last accessed 2023-11-1).

⁹⁷ Investopedia “Interest Coverage Ratio: Formula, How it Works and Example” 2023.

purposes.⁹⁸ Firms need to have sufficient earnings to cover their interest payments, to ensure future survival, and to be prepared for unforeseen circumstances. As such, should a firm be unable to meet its interest payments, it is an identifiable red flag denoting a solvency issue. If a firm struggles to stay above water with these payments, it might need to borrow more money or resort to withdrawals from its cash reserves.

The rationale behind this criteria as a defining factor is that the survival of these firms may indicate that subsidies have been granted beyond explicit subsidised credit, and may capture non-performing loans, weak insolvency regimes, or government guarantees.⁹⁹ The requirement that the firms be 10 years in age or older, seeks to exclude young firms who are in their start-up phases from being seen as zombies, as they have long-term potential and expected upcoming profits.¹⁰⁰

However, a problem identified with this approach is that it fails to distinguish between zombie firms and vulnerable/distressed firms.¹⁰¹ Acharya *et al* emphasized that it is crucial to distinguish between firms who are distressed, and are zombie candidates, and those who actually receive loans due to their zombie nature.¹⁰² Alvarez *et al* provided a formula that differentiates between these two types of firms.¹⁰³ In their analysis, they defined financially distressed firms as firms who are at least 5 years old, with an interest cover ratio lower than 1, and negative equity for at least 3 consecutive years.¹⁰⁴ Importantly, only firms with debt can ever be distressed, as those without debt cannot default on debt payments. A zombie firm is defined as a firm that meets the above criteria and is a distressed firm which receives new credit from any bank or its main bank.¹⁰⁵

The definition of McGowan *et al*, with the age requirement of 10 years or older is also criticised as it does not account for why a young firm could not also be classified as a zombie.¹⁰⁶ A further critique of this definition is what is known as the “interest cover” critique.¹⁰⁷ This was first

⁹⁸ Investopedia “Interest Coverage Ratio: Formula, How it Works and Example” 2023.

⁹⁹ Mingarelli *et al* “Dawn of the (half) dead: the twisted world of zombie identification” 2022 *ECB Working Paper Series* 10.

¹⁰⁰ Mingarelli *et al* 2022 *ECB Working Paper Series* 10.

¹⁰¹ Mingarelli *et al* 2022 *ECB Working Paper Series* 10.

¹⁰² Acharya *et al* 2022 *Annual Review of Financial Economics* 11.

¹⁰³ Alvarez, Garcia-Posada, Mayordomo “Distressed firms, zombie firms and zombie lending: A taxonomy” 2023 *Journal of Banking and Finance* 2.

¹⁰⁴ Alvarez, Garcia-Posada, Mayordomo 2023 *Journal of Banking and Finance* 4.

¹⁰⁵ Alvarez, Garcia-Posada, Mayordomo 2023 *Journal of Banking and Finance* 5.

¹⁰⁶ Banjaree and Hoffman “Corporate Zombies: Anatomy and life cycle” 2022 *BIS Working Papers* 7.

¹⁰⁷ Mingarelli *et al* 2022 *ECB Working Paper Series* 10.

identified by Storz *et al*, whereby lower interest cover ratios could be attributed to higher interest payments as opposed to lower interest rates.¹⁰⁸ This means that using interest-coverage ratio as a tool of identification, may result in misclassifying zombie companies as healthy firms, due to these firms being highly subsidized. To remedy this, Storz *et al* define a zombie firm as a firm with negative net investments, with a debt servicing capacity (Earnings Before Interest Taxes and Depreciation and Amortization (EBITDA) to total financial debt) which is lower than 5% for two consecutive years.¹⁰⁹ This approach is profit-orientated. Zombie firms are identified as those which are unprofitable to the extent that they are unable to invest beyond their depreciation value.¹¹⁰ This method succeeds in excluding starts-ups, while the debt servicing capacity provides a more accurate indication of highly indebted firms than the interest cover ratio.¹¹¹ The two-year requirement further aids in ensuring that firms are not misclassified as a result of business fluctuations.¹¹²

Despite these critiques, the definition put forward by McGowan *et al* provides a foundation which has been widely utilized and built upon. This is due to the wide-spread accessibility of the data required by the definition, the capacity to measure and compare countries, and its ability to consider factors other than subsidized credit, such as misdirected loans.¹¹³

Banerjee and Hoffman built on this definition and based their definition on a consistent lack of profitability and low stock market valuation.¹¹⁴ The rationale behind this approach is that, if a firm is unable to generate a profit over an extended period, and its stock market valuation illustrates that this pattern is unlikely to change, the firm should exit the market.¹¹⁵ As such, the authors classify zombie firms as firms who meet the following criteria over two years: an interest rate coverage ratio (based on EBIT) which is below 1 with the ratio of its assets' market value to replacement costs (Tobin's Q) being below the median within its sector.¹¹⁶

In the converse, the authors provide a requirement for all firms to meet in order to exit their zombie status. The authors submit that a firm will need to have an interest rate coverage ratio

¹⁰⁸ Storz *et al* "Do we want these two to tango? On zombie firms and stressed banks in Europe" 2017 *ECB Working Paper Series* 15.

¹⁰⁹ Mingarelli *et al* 2022 *ECB Working Paper Series* 10.

¹¹⁰ Mingarelli *et al* 2022 *ECB Working Paper Series* 10.

¹¹¹ Mingarelli *et al* 2022 *ECB Working Paper Series* 11.

¹¹² Mingarelli *et al* 2022 *ECB Working Paper Series* 11.

¹¹³ Berling *Life Below Zero: Zombie Firms and Low Interest Rates* (Master's Thesis 2021 LUND University) 4.

¹¹⁴ Banerjee and Hoffman 2022 *BIS Working Papers* 6.

¹¹⁵ Banerjee and Hoffman 2022 *BIS Working Papers* 6.

¹¹⁶ Banerjee and Hoffman 2022 *BIS Working Papers* 7.

larger than 1 or a Tobin's Q above the median for two consecutive years before it is considered a revived firm.¹¹⁷ If this requirement is met, it would illustrate that the firm can service the interest on its debts using its earnings and can maintain its revenue at a consistent level.¹¹⁸ Alternatively, a higher Tobin's Q shows to investors that the business's assets hold high market value.¹¹⁹ The requirement of two years involves persistent and continuous increased performance prior to being declassified as a zombie firm.¹²⁰

This definition builds upon that of McGowan *et al* by adding the requirement of a low Tobin's Q.¹²¹ Tobin's Q, at the base level, reflects the relationship between market valuation and the intrinsic value of a firm and determines whether a firm is overvalued or undervalued.¹²² If a firm has a low Tobin's Q, investors view the firm as having low future profit potential.¹²³

This requirement replaces the age requirement of McGowan *et al*'s definition.¹²⁴ The Tobin's Q requirement seeks to ensure that young start-up firms, which are seen as holding profit potential, are not misclassified due to cyclical struggles.¹²⁵ This risk was previously addressed by limiting the application to older firms. However, the Tobin's Q requirement and the removal of the age criterion are preferred. This approach allows younger firms, who may actually be zombies, to meet the definition while providing for older firms who may also hold high growth potential.¹²⁶

Albuquerque and Iyer have defined zombie firms as firms which presented with an interest-cover ratio below one, a leverage ratio above the median firm in the same two-digit industry, and negative real sales growth, for at least two consecutive years.¹²⁷ A consistently low interest cover ratio reflects a higher risk of default, as the firm does not generate sufficient cash flow to cover its interest expenses.¹²⁸ Leverage ratios are used to identify how much of a firm's

¹¹⁷ Banjee and Hoffman 2022 *BIS Working Papers* 7.

¹¹⁸ Investopedia "Interest Coverage Ratio" 2023, available at [https://www.investopedia.com/terms/i/interestcoverageratio.asp#:~:text=A%20ratio%20above%20one%20indicates,preferred%20for%20analysts%20and%20investors.\(last%20accessed%202023-11-1\).](https://www.investopedia.com/terms/i/interestcoverageratio.asp#:~:text=A%20ratio%20above%20one%20indicates,preferred%20for%20analysts%20and%20investors.(last%20accessed%202023-11-1).)

¹¹⁹ Investopedia "Interest Coverage Ratio" 2023.

¹²⁰ Banjee and Hoffman 2022 *BIS Working Papers* 7.

¹²¹ Banjee and Hoffman 2022 *BIS Working Papers* 7.

¹²² Investopedia "Q Ratio or Tobin's Q: Definition, Formula, Uses and Examples" 2021, available at <https://www.investopedia.com/terms/q/qratio.asp> (last accessed 2023-11-1).

¹²³ Banjee and Hoffman 2022 *BIS Working Papers* 7.

¹²⁴ Banjee and Hoffman 2022 *BIS Working Papers* 7.

¹²⁵ Banjee and Hoffman 2022 *BIS Working Papers* 7.

¹²⁶ Banjee and Hoffman 2022 *BIS Working Papers* 7.

¹²⁷ Albuquerque and Iyer 2023 *IMF Working Paper* 10.

¹²⁸ Albuquerque and Iyer 2023 *IMF Working Paper* 11.

finances have been generated from incurring debt, and assesses the ability of the firm to meet its financial obligations.¹²⁹ It is particularly important as firms will utilize a combination of equity and debt to finance their operations.¹³⁰ Accordingly, understanding a firm's debt profile can assist in determining whether a firm is able to pay its debts as they become due. This ratio is calculated by taking the total amount of debt of a firm, both long-term and short-term, and dividing it by the total value of its assets.¹³¹ A high leverage ratio relative, when compared to other firms in the sector, indicates financial distress as these firms struggle to raise additional debt to finance new projects.¹³² The indicator of negative real sales growth has also been used as it is a strong predictor of the future productivity potential of firms.¹³³ This leverage ratio works alongside the two-year requirement to ensure that firms that meet the definition are those which are persistently unprofitable and not merely in cyclical fluctuations.¹³⁴

Albuquerque and Iyer follow the rationale of Banerjee and Hoffman, in that zombie firms do not arise overnight and can, accordingly, not be revived quickly.¹³⁵ This shows that there is a persistence to zombie firms. Accordingly, the authors submit that, for a zombie firm to exit its zombie status, it is required to record an interest coverage ratio above one, or a leverage ratio below the median firm in the industry, or positive sales growth, for two consecutive years.¹³⁶ This requirement precludes zombie firms from being misclassified as having exited their status due to cyclical fluctuations in between the two-year period.¹³⁷

Albuquerque and Iyer's approach identifies firms with continuous profitability issues, low growth potential, low investor promise, and over-indebtedness.¹³⁸ Their approach is also successful in excluding firms that are start-ups, or those who are facing periodical cash difficulties but still hold future growth potential.¹³⁹ This is achieved without utilizing the age criterion, which may have the negative consequence of failing to capture young zombie

¹²⁹ Investopedia "Leverage Ratio: What it is, What it tells you, How to calculate" 2023, available at <https://www.investopedia.com/terms/l/leverageratio.asp#:~:text=Key%20Takeaways-,A%20leverage%20ratio%20is%20any%20one%20of%20several%20financial%20measurements,output%20will%20affect%20operating%20income.> (last accessed 2023-11-1).

¹³⁰ Investopedia "Leverage Ratio: What it is, What it tells you, How to calculate" 2023.

¹³¹ Albuquerque and Iyer 2023 *IMF Working Paper* 11.

¹³² Albuquerque and Iyer 2023 *IMF Working Paper* 11.

¹³³ Whited and Wu "Financial Constraints Risk" 2006 *Review of Financial Studies* 539.

¹³⁴ Albuquerque and Iyer 2023 *IMF Working Paper* 11.

¹³⁵ Albuquerque and Iyer 2023 *IMF Working Paper* 11.

¹³⁶ Albuquerque and Iyer 2023 *IMF Working Paper* 11.

¹³⁷ Albuquerque and Iyer 2023 *IMF Working Paper* 11.

¹³⁸ Albuquerque and Iyer 2023 *IMF Working Paper* 37.

¹³⁹ Albuquerque and Iyer 2023 *IMF Working Paper* 11.

firms.¹⁴⁰ For these reasons, the definition brought forward by Albuquerque and Iyer, is the preferred definition for purposes of this study.

2.4.2. Characteristics of zombie firms

The definition chosen above provides factors to consider to establish whether a firm may be a zombie. However, beyond these criteria, studies have shown that zombie firms have certain characteristics and follow a general lifecycle. The following section will discuss each characteristic in more depth. As a point of departure, the main components discussed hereafter are listed. Zombie companies:

- increase following economic downturns such as the GFC;
- are mostly incorporated entities firms;
- can be large or small in size;
- have weaker balance-sheets and are more susceptible to default than its non-zombie counterparts;
- invest less in assets;
- have smaller and more leveraged net liquid asset holdings compared to non-zombie firms;
- are less productive and profitable;
- have low total factor productivity and return on assets;
- shrink down their operations through increased asset disposal and downsizing of employees;
- have lower operational efficiency and lower production;
- are susceptible to long-term losses;
- are highly dependent on bank loans;
- have negative cash flows;
- are unable to pay dividends;
- extend high amounts of equity; and
- are conservative in their investment and dividend policies but are aggressive in their leverage policies which make them riskier than non-zombie firms.

¹⁴⁰ Albuquerque and Iyer 2023 *IMF Working Paper* 24.

(i) The link between zombie firms and economic shocks

Over the past 20 years, zombie firms have steadily been increasing, particularly since the GFC.¹⁴¹ Albuquerque and Iyer found that upticks in the share of zombie firms arise following an economic downturns such as the GFC and Covid-19.¹⁴² In their research sample, 10% of all registered firms in 2021 were zombie firms, compared to 6% in 2000.¹⁴³ Of the private firms in the sample, the number arose from 1% in 1997 to 5.3% in 2020.¹⁴⁴ There was a temporary downward trend from 2016 to 2019, but zombie firms again began to increase during Covid-19.¹⁴⁵

As previously discussed, various measures such as relaxed monetary policy for extended periods of time have followed after economic shocks.¹⁴⁶ Zombie firms are those distressed firms which, under normal economic conditions, would promptly exit the market and enable new entrants to replace them.¹⁴⁷ However, following these economic shocks, normal economic conditions are altered through the relaxing of monetary policy and this enables zombie firms' survival.¹⁴⁸

(ii) Private vs public firms

Albuquerque and Iyer's research showed that the share of private zombie firms was lower than that of listed public firms.¹⁴⁹ The authors found that different factors may play a role to explain the larger presence of zombies amongst public firms. Larger public firms are more susceptible to becoming zombie firms as they are more likely to receive government subsidies in hopes of maintaining employment opportunities.¹⁵⁰ Due to the economic significance of these larger public firms, it is also more likely that these firms will have their loans evergreened.¹⁵¹ These firms may have political connections, which act as incentives to banks, investors and

¹⁴¹ Albuquerque and Iyer 2023 *IMF Working Paper* 12; Banjee and Hoffman 2022 *BIS Working Papers* 8.

¹⁴² Albuquerque and Iyer 2023 *IMF Working Paper* 12.

¹⁴³ Albuquerque and Iyer 2023 *IMF Working Paper* 12.

¹⁴⁴ Albuquerque and Iyer 2023 *IMF Working Paper* 12.

¹⁴⁵ Albuquerque and Iyer 2023 *IMF Working Paper* 12.

¹⁴⁶ Paras 1.2 and 2.2 above.

¹⁴⁷ De Martiis, Heil and Peter "Are you a zombie? A supervised learning method to classify unviable firms and identify the determinants" 2021 *SSRN* 10.

¹⁴⁸ Acharya *et al* 2022 *Annual Review of Financial Economics* 2.

¹⁴⁹ Albuquerque and Iyer 2023 *IMF Working Paper* 13.

¹⁵⁰ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 16.

¹⁵¹ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 16.

governments to bail these firms out when they are in distress.¹⁵² The same preferential treatments would not be as forthcoming for small private firms. As a result, if these private firms cannot source additional funding, they would have no other option than to default.¹⁵³

In this regard, Albuquerque and Iyer believe that there may be a lower number of zombie firms amongst private firms for the following reasons: (i) weaker private firms are more likely to exit the market than listed firms, and (ii) these private firms exit at a faster pace than listed zombie firms.¹⁵⁴ Furthermore, far less pressure is placed on banks to aid financially weak private firms.¹⁵⁵ This is due to the fact that the smaller the firm, the less likely the repercussions in terms of the costs of bankruptcy and loss of employment.¹⁵⁶

(iii) Firm size

Despite the significance of larger public firms, small firms are also susceptible to receiving subsidies. This is usually through incentives introduced by governments to boost economic and social prosperity in their country.¹⁵⁷ This incentive may extend to banks, whereby governments require banks to extend lower interest rates to smaller firms in hopes of diminishing firm defaults, lower unemployment rates, and appease the dissatisfaction of voters.¹⁵⁸ An example of such an incentive is the proposed South African Small, Micro and Medium Enterprises and Co-operatives Funding Policy.¹⁵⁹ This policy aims to ensure access to finance through the implementation of a new class of bank with limited functionality, and with lower Basel II compliance.¹⁶⁰ Basel II introduced requirements and standards relating to the treatment of interest rate risk; credit risk and operational risk.¹⁶¹ The relaxing of these standards may see

¹⁵² Faccio, Masulis and McConnell “Political Connections and Corporate Bailouts” 2006 *The Journal of Finance* 2598.

¹⁵³ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 16.

¹⁵⁴ Albuquerque and Iyer 2023 *IMF Working Paper* 14.

¹⁵⁵ Peek and Rosengren 2005 *The American Economic Review* 1157.

¹⁵⁶ Peek and Rosengren 2005 *The American Economic Review* 1157.

¹⁵⁷ Altman, Dai and Wang 2022 *SSRN* 17.

¹⁵⁸ Acharya *et al* “Whatever it takes: The real effects of unconventional monetary policy” 2019 *The Review of Financial Studies* 5.

¹⁵⁹ National Small Enterprise Amendment Act: South African SMMEs and Co-operatives Funding Policy, GN3353 in GG48483 of 28 April 2023.

¹⁶⁰ National Small Enterprise Amendment Act: South African SMMEs and Co-operatives Funding Policy, GN3353 in GG48483 of 28 April 2023.

¹⁶¹ Basel Committee on Banking Supervision “International convergence of Capital Measurement and Capital Standards: A Revised Framework” 2004 *BIS* 170.

the lowering of interest rates for small and medium enterprises and the forgoing of collateral requirements.¹⁶²

In South Africa, SMES make up 90% of formal businesses and it is envisaged by the National Development Plan that almost 10 million employment opportunities will be created by SMEs by 2030.¹⁶³ Banerjee and Hoffman find that zombie firms tend to be smaller than non-zombie firms and are likely to be less economically important.¹⁶⁴ However, the authors also found that SMEs were more likely to be zombie firms.¹⁶⁵ The authors submit that, in economies where unlisted, private, SMEs play an integral role, there may be more zombie firms present in the economy than those which are listed on the stock market.¹⁶⁶ In this same study, the authors found that zombie firms are much smaller than non-zombies in terms of assets, employees, and capital.¹⁶⁷

(iv) Balance-sheet considerations

Albuquerque and Iyer, expanding on their definition of zombie firms, unpack how zombie firms and non-zombie firms differ on their balance sheets.¹⁶⁸ They found that zombie firms have significantly weaker balance sheets than non-zombies and are at a greater risk of default.¹⁶⁹

Zombie firms invest far less in both tangible and intangible assets.¹⁷⁰ These firms are more affected by shocks, due to their net liquid asset holdings being substantially smaller and more leveraged than non-zombie firms.¹⁷¹ It was further found that zombie firms are less productive and profitable, which is depicted by low total factor productivity and return on assets.¹⁷² These

¹⁶² National Small Enterprise Amendment Act: South African SMMEs and Co-operatives Funding Policy, GN3353 in GG48483 of 28 April 2023.

¹⁶³ SARB “Quarterly Bulletin June 2023”, available at <https://www.resbank.co.za/content/dam/sarb/publications/quarterly-bulletins/quarterly-bulletin-publications/2023/june/01Full%20Quarterly%20Bulletin.pdf> (last accessed 2023-05-12); National Small Enterprise Amendment Act: South African SMMEs and Co-operatives Funding Policy, GN3353 in GG48483 of 28 April 2023.

¹⁶⁴ Banerjee and Hoffman 2022 *BIS Working Papers* 17.

¹⁶⁵ Banerjee and Hoffman 2022 *BIS Working Papers* 17.

¹⁶⁶ Banerjee and Hoffman 2022 *BIS Working Papers* 17.

¹⁶⁷ Banerjee and Hoffman 2022 *BIS Working Papers* 17.

¹⁶⁸ Banerjee and Hoffman 2022 *BIS Working Papers* 17.

¹⁶⁹ Banerjee and Hoffman 2022 *BIS Working Papers* 19.

¹⁷⁰ Albuquerque and Iyer 2023 *IMF Working Paper* 19; Banerjee and Hoffman 2022 *BIS Working Papers* 17.

¹⁷¹ Albuquerque and Iyer 2023 *IMF Working Paper* 19.

¹⁷² Albuquerque and Iyer 2023 *IMF Working Paper* 19.

firms shrink down their operations, which reflects in higher asset disposals and a declining number of employees.¹⁷³ These firms have lower operational efficiency coefficients and lower production rates, which render the firms more susceptible to long-term losses.¹⁷⁴ The research also showed that zombie firms are often smaller in size, with a lower asset value and a higher dependence on bank loans for survival.¹⁷⁵

The profitability of zombie firms, or the lack thereof, is also a distinguishing factor. Zombie firms experience negative cash flows and very few are able to pay dividends to shareholders.¹⁷⁶ It has also been found that zombie firms tend to extend significantly more equity than other firms.¹⁷⁷ Equity is issued through private placements, and the firms use this funding to cover their operating losses.¹⁷⁸

Ghoul, Fu and Guedhami assessed the corporate policies of zombie firms when it comes to cash, dividends, leverage, short-term debt, capital intensity, research and development, patents, and idiosyncratic risk.¹⁷⁹ It was found that zombie firms are conservative in their investments and dividends, but are aggressive in their leverage policies.¹⁸⁰ It was found that zombie firms take more risks than their non-zombie peers. In this regard, the aggressive leverage policies outweigh the conservative investment and dividends policies, and make zombie firms riskier options than non-zombie firms.¹⁸¹ It is interesting that there were no notable differences between zombies and non-zombies when it came to debt maturity, research and development expenditures, or patents.¹⁸²

2.4.3. The road to becoming a zombie firm

Banerjee and Hofmann investigated the life-cycle of zombie firms. They investigated the dynamics of zombie firm balance sheets from four years before reaching zombie status to four years after reaching zombie status.¹⁸³ It was found that zombie firm performance, in respect of

¹⁷³ Banerjee and Hoffman 2022 *BIS Working Papers* 17.

¹⁷⁴ Chen *et al* “The study of zombie firms in China using modified FN-CHK method” 2017 *IEIS* 3.

¹⁷⁵ Albuquerque and Iyer 2023 *IMF Working Paper* 19.

¹⁷⁶ Banerjee and Hoffman 2022 *BIS Working Papers* 18.

¹⁷⁷ Banerjee and Hoffman 2022 *BIS Working Papers* 18.

¹⁷⁸ Banerjee and Hoffman 2022 *BIS Working Papers* 18.

¹⁷⁹ Ghoul, Fu and Guedhami “Zombie firms: Prevalence, determinants, and corporate policies” 2020 *Finance Research Letters* 11.

¹⁸⁰ Ghoul, Fu and Guedhami 2020 *Finance Research Letters* 11.

¹⁸¹ Ghoul, Fu and Guedhami 2020 *Finance Research Letters* 11.

¹⁸² Ghoul, Fu and Guedhami 2020 *Finance Research Letters* 11.

¹⁸³ Banerjee and Hoffman 2022 *BIS Working Papers* 21.

profitability, productivity and business activity, ranked below that of non-zombie firms four years before being classified as a zombie.¹⁸⁴

As a zombie firm's productivity declines, assets, capital and intangible investment, and employment also decline.¹⁸⁵ It was found that, in the years before a firm is classified as a zombie, the firm disposes of assets at a much higher rate than its non-zombie peers.¹⁸⁶ This may be attributed to the need to source additional funding to stay afloat. It was further found that, two years before reaching zombie status, the indebtedness of the firm increased dramatically compared to that of non-zombie firms.¹⁸⁷

After becoming a zombie firm, the performance of the firm appears to improve slightly but still remains below that of a non-zombie firm.¹⁸⁸ The assets of the firm continue to decline as disposal increases but there is improvement in terms of capital expenses, intangible investments and employment growth.¹⁸⁹ During this time, their Tobin Q improves. This explains why investors reason that the firm has the potential to recover and it remains in the market.¹⁹⁰

2.5. Conclusion

The chapter highlighted that the share of zombie firms increases following economic shocks such as the GFC and, subsequently, Covid-19. Measures introduced to minimize the impact of the pandemic on the economy, although integral, fosters the growth and survival of zombie firms. South Africa introduced measures which have been shown to allow zombie firms to survive and prevent their exit from the market. The existence of zombie firms in economic markets has a congestive effect which lowers overall productivity, growth, investment, and employment.¹⁹¹ This congestion prevents more productive firms from entering the market.

Upon investigating various definitions developed by scholars worldwide, a definition of zombie firms for purposes of this study has been identified. Certain prevailing characteristics have also been identified. In this regard, a zombie firm is defined as a firm which has, for at least two consecutive years, had an interest-cover ratio below one, a leverage ratio above the

¹⁸⁴ Banjeree and Hoffman 2022 *BIS Working Papers* 21.

¹⁸⁵ Banjeree and Hoffman 2022 *BIS Working Papers* 21.

¹⁸⁶ Banjeree and Hoffman 2022 *BIS Working Papers* 21.

¹⁸⁷ Banjeree and Hoffman 2022 *BIS Working Papers* 22.

¹⁸⁸ Banjeree and Hoffman 2022 *BIS Working Papers* 22.

¹⁸⁹ Banjeree and Hoffman 2022 *BIS Working Papers* 22.

¹⁹⁰ Banjeree and Hoffman 2022 *BIS Working Papers* 22.

¹⁹¹ Purckhauer and Oberson "Where are the zombie companies? Analysis of zombie companies in France, Germany and Switzerland" 2021 *MSC International Finance* 8.

median firm in the same two-digit industry, and negative real sales growth. Zombie firms were found to be predominantly small, public firms. However, this is not absolute, and firms of various compositions may meet the zombie definition.

Prior to reaching zombie status, these firms tend to engage in similar behaviour. These include decreased profitability and performance, increased asset disposal and indebtedness, and increased leverage and issuing of equity. These firms are also very conservative regarding dividend and investment payments (if at all).

The proceeding chapter seeks to investigate the role that insolvency law reform has to play in curbing the rise and spread of zombie firms. This is done through investigating the international approach and best practice standards relating to insolvency regimes. Following which, the reforms of Portugal will be discussed to analyse and identify the impact of insolvency regimes on zombie firms.

Chapter 3: International best practices

3.1. Introduction

Chapter 2 arrived at a definition of zombie companies, and outlined their characteristics and life-cycle. Chapter 2 also illustrated the link between zombie companies and economic shocks such as Covid-19. This chapter investigates the role of insolvency law reform in curbing the creation and continued survival of zombie companies.

International best practices for insolvency law reform is discussed first. Reference is made to the OECD key indicators which are then expanded upon by referring to the recommendations brought forward by the UNCITRAL Legislative Guide on Insolvency Law. The OECD key indicators will serve as specific considerations necessary for insolvency reforms to address zombie companies. The UNCITRAL recommendations will then be discussed to supplement the indicators of the OECD. In this regard, the OECD key indicators will serve as a yardstick, whereby the efficiency and effectiveness of insolvency regimes may be tested.

After these criteria have been clearly explained, the chapter investigates how the implementation of these international best practices affects the share of zombie companies. This is depicted through a discussion of Portugal and its insolvency reforms. Following these reforms, the share of zombie companies continued to decline at a steady pace. The key reforms introduced by Portugal, which affected this change, are discussed and unpacked to ascertain what their key components are. These components are of particular importance as Chapter 4 will assess the extent to which South Africa is aligned with international best practices and whether South Africa could benefit from reforms such as those of Portugal.

3.2. The role of insolvency law

In the previous chapter, it was identified that the current literature finds that zombie firms arise due to support received either through additional lending or government funding. However, bank incentives and subsidized lending is only one side of the coin.

Following the GFC and the sovereign debt crisis, macroprudential regulatory oversight has been implemented on a global scale.¹ This ensures that the banking sector as a whole is

¹ South African National Treasury “A safer financial sector to serve South Africa better” 2011, available at <https://www.treasury.gov.za/twinpeaks/20131211%20-%20item%202%20a%20safer%20financial%20sector%20to%20serve%20south%20africa%20better.pdf> (last accessed 2023-11-2).

monitored and protected from unmanageable systemic risks.² As a result of this ongoing regulatory oversight and the implementation of international standards, banking sectors are maintaining stronger financial positions.³ Accordingly, if focus is centered solely on banks, it may mistakenly be believed that there is a low risk of zombie lending. However, another trend has emerged following the GFC. It has been found that countries with inefficient insolvency regimes, whereby insolvency is not promptly resolved through, for example debt restructuring, experience a larger number of zombie firms that arise following credit booms.⁴

If policy-makers and legislatures focus solely on the role of banks and the misallocation of credit, there is a risk that the role of ineffective insolvency regimes will be ignored.⁵ Bank incentives do not exist in isolation, but rather interact with insolvency resolutions. If the insolvency mechanisms available, such as restructuring and liquidation, are too costly or do not operate efficiently, lenders are unlikely to opt for these options and turn to zombie lending.⁶ Furthermore, the protection afforded to creditors and the debt-enforcement measures available are key considerations as to whether lenders will turn to liquidation.⁷ Therefore, it can be stated that, if creditor rights are weak and debt enforcement is inefficient, this leads to costly challenges which may increase zombie lending.⁸ Restructuring, if available but inefficient, will not be able to solve the problem.⁹

This highlights the link between the design of a country's insolvency regime and the motives of banks to evergreen loans. As previously discussed, banks are inclined to evergreen loans to avoid having to report their losses and increase their provisions. These provisions are allowances on the bank's balance sheet for uncollected loans and loan payments.¹⁰ It covers losses such as non-performing loans, bankruptcy of the customer, and loans that have been renegotiated to lower the repayment obligations of the lender.¹¹ In the event that the amount recoverable through liquidation is insufficient to cover the increase in provisions, or payment

² South African National Treasury "A safer financial sector to serve South Africa better" 2011.

³ Becker and Ivashina "Corporate Insolvency Rules and Zombie lending" 2021 *European Central Bank* 5.

⁴ Banjeree and Hoffman 2022 *BIS Working Papers* 12.

⁵ Becker and Ivashina 2021 *European Central Bank* 5.

⁶ Becker and Ivashina "Weak Corporate Insolvency Rules: The Missing Driver of Zombie Lending" 2022 *American Economic Association Papers and Proceedings* 516.

⁷ Djankov, McLiesh and Shleifer "Private Credit in 129 Countries" 2007 *Journal of Financial Economics* 316.

⁸ Ghoul, Fu and Guedhami "Zombie firms: Prevalence, Determinants and Corporate Policies" 2020 *SSRN* 3.

⁹ Becker and Ivashina 2022 *American Economic Association Papers and Proceedings* 517.

¹⁰ Investopedia "What is a loan loss provision? Definition and use in accounting" 2021, available at <https://www.investopedia.com/terms/l/loanlossprovision.asp> (last accessed 2023-11-2).

¹¹ Investopedia "What is a loan loss provision? Definition and use in accounting" 2021.

is delayed, the bank will be inclined to evergreen.¹² This indicates that, even if banks are healthy, these banks may be deterred from commencing restructuring or liquidation if the insolvency frameworks inhibit an efficient process of restructuring.¹³

It has further been found that, when investigating the differences in zombie firms across various countries, the share of capital sunk is higher in countries where the insolvency regimes delay both timely initiation and resolution of proceedings.¹⁴ This share of capital sunk may be reduced if insolvency regimes minimize the barriers to corporate structuring as well as the personal costs of entrepreneurial failure.¹⁵ In the converse, it can be said that, if insolvency regimes are appropriately reformed, this capital may be reallocated to productive firms.¹⁶

Similarly, a higher share of zombie capital exists when a country's insolvency regime lacks preventative measures and early warning mechanisms.¹⁷ If insolvency regimes lack preventative measures, such as early detection and the resolution of debt distress (firms who are in financial difficulty but not insolvent), it can have the negative effect of pushing viable firms into formal liquidation.¹⁸ The undesired consequence of this outcome is that it results in delays and expenses.¹⁹ This depletes the value of the firm and prevents the assets from being reallocated to more productive uses.²⁰ In turn, this removes the opportunity for entrepreneurs to start a new business, which throttles economic growth and productivity.²¹ Therefore, implementing insolvency reforms may boost productivity through

- reducing the share of capital sunk in zombie firms, so that capital may be reallocated to more productive firms;
- prompt and streamlined restructuring, in order to enable zombie firms to be revived in a sustainable manner and to ensure that distressed firms do not turn into zombies (which lifts aggregate productivity and lowers the social costs when compared to costs incurred if adjustments were only available through weak firms exiting the market); and

¹² Andrews and Petroulakis "Breaking the Shackles: Zombie firms, weak banks and depressed restructuring in Japan" 2017 *OECD Economics Working Papers* 11.

¹³ Andrews and Petroulakis 2017 *OECD Economics Working Papers* 6.

¹⁴ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 27.

¹⁵ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 27.

¹⁶ McGowan, Andrews and Millot 2017 *OECD Economics Department Working Papers* 27.

¹⁷ McGowan, Andrews and Millot "Insolvency regimes, zombie firms and capital reallocation" 2017 *OECD Economics Department Working Papers* 26.

¹⁸ Andrews, McGowan and Millot "Confronting the zombies: policies for productivity revival" 2017 *OECD Economic Policy Papers* 15.

¹⁹ Andrews, McGowan and Millot 2017 *OECD Economic Policy Papers* 16.

²⁰ Andrews, McGowan and Millot 2017 *OECD Economic Policy Papers* 16.

²¹ Andrews, McGowan and Millot 2017 *OECD Economic Policy Papers* 15.

- reform which, in today's fast-paced, technological landscape, may encourage technological diffusion by promoting experimentation with technological innovation, and by providing lagging firms with the opportunity to implement the necessary changes to bring their businesses up to speed with modern developments.²²

To determine which insolvency regime reforms are necessary, it must first be determined what the 'ideal' insolvency regime may look like. To determine this, the international best practices and key indicators of effective insolvency systems will be identified and discussed.

3.3. International best practices

3.3.1. Introduction

While considering these principles, it is worth reiterating the critical importance of insolvency law. Insolvency law provides the tools and mechanisms whereby the financial distress of the corporate sector can be resolved.²³ It does so by providing for the restructuring of firms which are facing financial challenges and enabling the exit of those which are no longer viable.²⁴ Furthermore, in the face of a recession and in the aftermath of a crisis, insolvency laws with strong restructuring frameworks can bolster the recovery of the economy and increase competitiveness.²⁵ In the interplay between insolvency law and the banking sector, insolvency frameworks can limit the losses felt by creditors of insolvent companies.²⁶ If insolvency frameworks are efficiently designed, non-performing loans can be reduced in the banking sector through the reduction of the price gap between banks selling these loans and investors purchasing them.²⁷

It is important to note that, although the international best practices to be discussed below reflect ideals to strive towards, there is no one-size-fits-all approach.²⁸ Each country has regulatory structures in place that intersect with insolvency law. As such, when considering reforms to insolvency law align with international best practices, such changes must be tailor-

²² Andre and Demmou "Enhancing insolvency frameworks to support economic renewal" 2022 *OECD Economics Department Working Papers* 6.

²³ Zoller "Corporate restructuring: Laws under stress: Policy-making in uncertain times" 2023 *Eur Bus Org Law Rev* 392.

²⁴ Zoller 2023 *Eur Bus Org Law Rev* 392.

²⁵ Gilson "Coming through in a crisis: how Chapter 11 and the Debt restructuring industry are helping to revive the U.S Economy" 2012 *Journal of Applied Corporate Finance* 35.

²⁶ Zoller 2023 *Eur Bus Org Law Rev* 392.

²⁷ Zoller 2023 *Eur Bus Org Law Rev* 392.

²⁸ McGowan and Andrews "Policies for Productivity: The design of insolvency regimes across countries" in *OECD Going For Growth* (2018) 91.

made to the particular jurisdiction. Any changes in this regard cannot follow a copy-paste exercise, whereby international best practice is inserted without an understanding of the current framework.

Ideally, bearing in mind international best practices, regimes should be structured to strike a balance between ex-ante efficiency and ex post efficiency.²⁹ What this means is that insolvency regimes need to provide for both creditors and debtors. In this regard, insolvency law should provide incentives for investors to extend credit to firms while incentivizing debtors to manage their businesses efficiently and transparently.³⁰ This may be accomplished through providing incentives in the relevant stages of a firm's life-cycle: (i) while the firm is healthy and prior to insolvency (ex-ante efficiency) and (ii) once the firm enters into insolvency due to being financially distressed (ex post efficiency).³¹

3.3.2. UNCITRAL's Legislative Guide on Insolvency Law

The UNCITRAL Legislative Guide on Insolvency Law ("the Legislative Guide") is a comprehensive statement of the key principles and objectives that should be reflected in the insolvency laws of a country.³² It comprises of five parts: part 1 deals with the key objectives of an insolvency law regime; part 2 deals with the core features of an effective insolvency law; part 3 addresses the treatment of enterprise groups in insolvency both nationally and internationally; part 4 focuses on obligations that might be imposed on decision makers of enterprises facing imminent insolvency; and part 5 deals with considerations specific to micro and small enterprises.³³

Due to the limitations imposed on this dissertation, as explained in chapter 1 above, not all of these principles will be discussed nor will those mentioned be discussed in-depth. These principles will be used to supplement the key indicators of the OECD, to expand on these principles as international best practice.

²⁹ McGowan and Andrews (2018) 91.

³⁰ McGowan and Andrews (2018) 91.

³¹ McGowan and Andrews (2018) 91.

³² UNCITRAL "UNCITRAL Legislative Guide on Insolvency Law", available at https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law (last accessed 2023-11-2).

³³ UNCITRAL "UNCITRAL Legislative Guide on Insolvency Law".

3.3.3. The OECD's Insolvency Indicators

The OECD first introduced insolvency indicators to summarise the key relevant features of insolvency frameworks necessary for resource allocation and productivity growth.³⁴ In 2022, the indicator's scope was broadened to include all OECD countries, as well as Bulgaria, Croatia, Cyprus, India, Malta, Romania and South Africa.³⁵

The indicators include thirteen key features. If these features are not present in an insolvency regime, it may delay productivity growth as initiation of processes are delayed and these proceedings are unnecessarily prolonged.³⁶ These indicators are therefore tools to assess the design of a country's insolvency regime. Countries are assessed using a questionnaire, and the responses are scaled on a value between 0 and 1. The closer to 1 a country's outcomes in respect of a particular criterion is, the more the regime delays the initiation and resolution of proceedings. As such, it can be said that the closer to 0 a country scores, the closer a country's insolvency regime is aligned with international best practices. On the contrary, the closer to 1, the more reform may be needed to bring the insolvency regime in line with international best practices.

These key features are grouped into three key sub-components followed by one miscellaneous grouping: (1) the treatment of failed entrepreneurs; (2) Prevention and streamlining; (3) Restructuring tools and (4) Other factors. These criteria and their components are illustrated in the diagram below.

³⁴ McGowan and Andrews "Policies for Productivity: The design of insolvency regimes across countries" in *OECD Going For Growth* (2018).

³⁵ Andre and Demmou 2022 *OECD Economics Department Working Papers* 7; OECD countries include: Australia; Austria; Belgium; Canada; Chile; Columbia; Costa Rica; Czech Republic; Denmark; Estonia; Finland; France; Germany; Greece; Hungary; Iceland; Ireland; Israel; Italy; Japan; Korea; Latvia; Lithuania; Luxembourg; Mexico; Netherlands; New Zealand; Norway; Poland; Portugal; Slovak Republic; Slovenia; Spain; Sweden; Switzerland; Türkiye; the United Kingdom and the United States.

³⁶ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

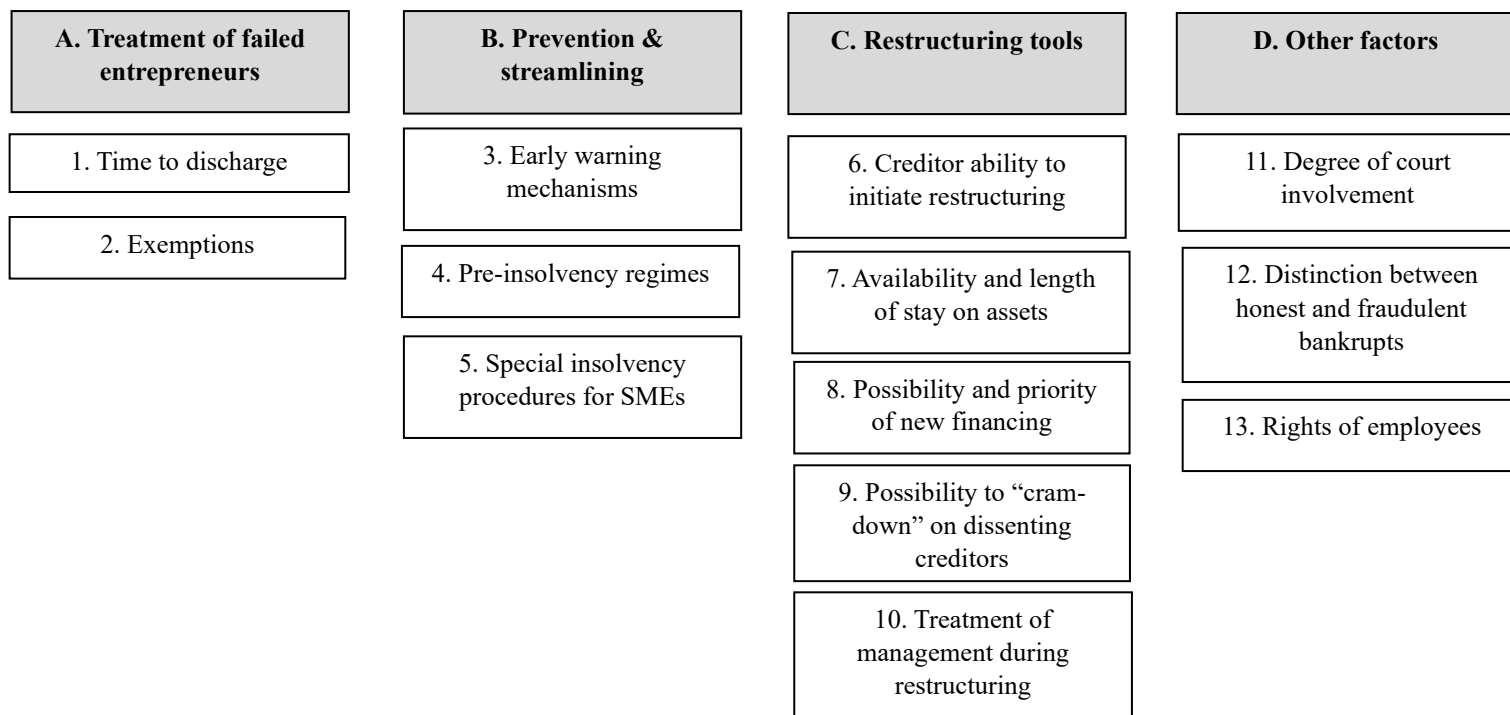


Figure 2: Overview of OECD Key Indicators³⁷

3.4. A brief guide to the worksheet and scoring

The diagram above illustrates the particular considerations and criteria which is considered, to ascertain whether an insolvency regime is in line with international best practices. To best understand what would denote ‘international best practices’, each sub-category’s scoring will be explained.

3.4.1. Treatment of failed entrepreneurs

The manner in which the entrepreneurs of failed business are treated affects whether they will be able to pursue other potentially successful endeavors in the future.³⁸ If entrepreneurs are granted a fresh start, and are able to acquire future earnings which are not too heavily burdened by obligations arising from past bankruptcy debt, productivity growth is boosted.³⁹ This is the case because the length of time to obtain discharge correlates with the costs and stigma of failure. If it takes overly long to obtain discharge, the costs and stigma attached increase in tandem.⁴⁰ This negatively impacts productivity growth as entrepreneurs are disincentivized

³⁷ This is a recreation of “The Structure of the OECD Insolvency Indicator” found in McGowan, Andrews and Millot “Insolvency Regimes, Zombie firms and Capital Reallocation” 2017 *OECD Economics Department Working Papers* 18.

³⁸ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

³⁹ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁴⁰ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

from entering the market and from taking on business risks.⁴¹ Furthermore, such time delays, prevent non-viable firms from promptly exiting the market.⁴²

(i) OECD scoring

In assessing the treatment of failed entrepreneurs, two components are considered: the time to discharge and the exemption of assets.⁴³ In assessing the time to discharge, the following index was used:

- if the time to discharge is less than or equal to one year, the value of 0 is given;
- if the time to discharge is between one and three years, the value of 0.5 is given; and
- if the time to discharge is greater than three years, the value of 1 is given.⁴⁴

In assessing exemption of assets, the following index was used:

- if the pre-bankruptcy assets exempted from the insolvent estate are more generous than modest personal and working items, for example the debtor's house is exempted, the value of 0 is given;
- if only modest personal items, such as the assets and income required to cover the debtor's subsistence, and working equipment is exempted, a value of 0.5 is given; and
- if the exemptions are less generous than modest personal items and working equipment, for example, where the assets of the spouse of the insolvent can be included in the insolvent estate, a value of 1 is given.⁴⁵

(ii) UNCITRAL principles regarding the treatment of failed entrepreneurs

The Legislative Guide does not speak to failed entrepreneurs specifically. However, it does refer to how debtors should be treated. Key considerations in this regard include the right to be heard, the right to participate and request information, and the right to retain property to preserve the personal well-being of the debtor.⁴⁶ It is important that these principles form the foundation of insolvency laws in order to ensure that the fundamental rights of the debtor are

⁴¹ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁴² Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁴³ OECD "The OECD Insolvency Indicator: Data 2022", 2022 available at <https://www.oecd.org/economy/growth/oecd-insolvency-indicator.htm> (last accessed 2023-11-2).

⁴⁴ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

⁴⁵ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

⁴⁶ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 206; 172.

protected, to ensure fair and impartial treatment, and to encourage debtor confidence in insolvency proceedings.⁴⁷ In this regard, it is important – particularly in reorganization – that the debtor has access to information relating to the progress of proceedings.⁴⁸ This is especially important where the debtor has been displaced from management and control of a business. An example of this involvement would be to afford the debtor an opportunity to express its opinion on a proposed business plan before it is adopted.⁴⁹ However, this right to be heard is not absolute.⁵⁰ Instances may arise where this right may be used to impede proceedings, for example where a debtor refuses to respond to attempts to establish contact. Thus, insolvency regimes require some flexibility whereby the requirement that the debtor be heard, be overruled where the right adversely affects proceedings.⁵¹ As far as the right to retain property to preserve the personal rights of the debtor is concerned, the insolvency law needs to explicitly outline which assets are to be excluded. At this point it is also important to note that the nature of debtors differ and the need for protection will also differ – corporate entities may not require the same exemption of assets as natural-person debtors.

3.4.2. Prevention and streamlining

Prevention and streamlining refers to available mechanisms which enable the early detection and prompt resolution of debtor distress.⁵² This refers to pre-insolvency regimes. These are preventative measures that aid firms in order to ultimately avoid the need to turn to formal insolvency proceedings. These preventative procedures ought to include quick and efficient resolution, through informal and flexible procedures that require minimal involvement of the courts or an administrative body.⁵³ Some examples of these types of procedures include out-of-court debt restructuring, mediation and conciliation, or a scheme of arrangement.⁵⁴

If a particular jurisdiction does not have these mechanisms in place, it may force firms that are still viable but facing financial distress into formal liquidation.⁵⁵ Pre-insolvency procedures

⁴⁷ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 166.

⁴⁸ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 166; 167.

⁴⁹ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 166; 167.

⁵⁰ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 167.

⁵¹ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 166 and 167.

⁵² Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁵³ Karapetian “The impact of emerging preventive restructuring mechanisms on Directors’ duties to creditors in the event of (Pre-) Insolvency in the UK and the Netherlands” 2022 *European Journal of Comparative Law and Governance* 188.

⁵⁴ Gurrea-Martinez “The future of reorganization procedures in the era of pre-insolvency law” 2020 *Ibero-American Institute for Law and Finance Working Paper Series* 7.

⁵⁵ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

play a pivotal role in distinguishing between firms who have no prospects of rehabilitation, and those facing temporary financial distress.⁵⁶ Particularly, following Covid-19, all firms faced financial difficulty and unforeseen difficulties, which renders distinguishing between the two particularly challenging.⁵⁷

If a firm is forced into formal liquidation, the firm is subjected to higher costs which erode the overall value of the firm.⁵⁸ Furthermore, a more cumbersome process is involved in distributing assets and resources.⁵⁹ As a result, the resources and assets of the firm remain in a state of flux and are unusable, rather than being distributed for more productive uses.⁶⁰ This limits the opportunity of entrepreneurs to enter the market and start new businesses, which consequently stifles productivity and business dynamism.⁶¹

On the contrary, if a firm is able to access pre-insolvency informal procedures, it reaps many benefits. Due to the informal nature, less costs are involved. If the involvement of the courts can be limited or exempted in its entirety, the process will be more flexible.⁶² Furthermore, due to the informal nature of the proceedings, the reputation of the company will be protected.⁶³ Accordingly, the firm will not be seen as a corporate failure, and the value of the assets will be protected.

(i) OECD scoring

This indicator is assessed on three components: early warning mechanisms; pre-insolvency regimes and special procedures for SMEs.⁶⁴ If a jurisdiction has early warning mechanisms in place, such as an online self-test or training, a value of 0 is given. If the jurisdiction does not have these in place, a value of 1 is given. If a jurisdiction has a pre-insolvency regime in place, a value of 0 is given. If there is no such regime, a value of 1 is given.

⁵⁶ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁵⁷ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁵⁸ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁵⁹ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁶⁰ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁶¹ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁶² Kastrinou and Jacobs “Pre-insolvency procedures: a United Kingdom and South African Perspective” 2016 *INSOL Europe* 2.

⁶³ Finch *Corporate Insolvency Law: Perspectives and Principles* (2009) 278.

⁶⁴ OECD “The OECD Insolvency Indicator: Data 2022” 2022.

If a jurisdiction has special insolvency procedures in place for SMEs, a value of 0 is given. If no such procedures exist, a value of 1 is given. An effective insolvency system for SMEs ought to:

- have removed barriers to access, and encourage the use of out-of-court restructuring procedures, hybrid procedures, and in-court simplified insolvency proceedings;
- have a streamlined regime that is simpler and more affordable than ordinary insolvency proceedings, which is expeditious and flexible enough to rehabilitate or reorganize firms which are still viable, and effectively liquidate those which are not;
- establish conditions and safeguards for the discharge of debt and to establish a fresh start for entrepreneurs;
- reduce the stigma attached to insolvency;
- promote entrepreneurship and access to credit;
- introduce and maintain safeguards that protect the rights of creditors, debtors and all stakeholders in SMEs insolvency;
- implement an effective regime which identifies, prevents and sanctions fraud or abuse of SMEs insolvency proceedings; and
- establish mechanisms which can assist SMEs in identifying early signals of financial distress and improve financial and business management literacy.⁶⁵

(ii) UNCITRAL principles on prevention and streamlining

The Legislative Guide is quiet on early warning mechanisms. However, it does provide guidelines regarding reorganization proceedings as a pre-insolvency procedure as well as special guidelines applicable to micro and small enterprises (SMEs). The recommendations regarding reorganization are discussed below, under the heading “restructuring tools”.

The recommendations relating to SMEs are too extensive for purposes of this dissertation. However, key recommendations regarding SMEs include developing a simplified insolvency regime specifically for SMEs; comprehensive treatment of all debts of individual entrepreneurs; default procedures and treatment; short time periods; and reduced formalities.⁶⁶ These recommendations echo the international realisation that SMEs are in a unique position

⁶⁵ The World Bank *Principles for Effective Insolvency and Creditor/Debtor Regimes Revised* (2021) 9.

⁶⁶ UNCITRAL *Legislative Guide on Insolvency Law: Part V* (2021) 5; 6; 8; 9.

compared to other business entities.⁶⁷ Due to the size of these operations, and the fact that full responsibility of the success of the entity rests on individual or a small group of entrepreneurs, simplified and cost-effective procedures are needed.⁶⁸ A simplified insolvency regime should make insolvency proceedings expeditious, flexible, low in costs, and easily accessible.⁶⁹ These types of proceedings would benefit economies as it creates certainty in the market, and allows fresh starts for debtors who are involved in unviable businesses.⁷⁰

3.4.3. Restructuring tools

Effective corporate restructuring mechanisms can encourage productivity growth in various manners.⁷¹ Corporate restructuring seeks to transform a firm into one that is of higher value or to enable its survival when its structure has become dysfunctional.⁷² This can be categorized as operational restructuring, financial restructuring, or investment restructuring – all of which can be applied in tandem.⁷³ Reforms, which resolve failing weak firms, play an integral role in reducing debt vulnerabilities, boosting productivity, and increasing long-term growth potential.⁷⁴ In particular, measures which reduce the debt burden of the firm, address redundant work forces, divest resources allocated to non-core business activities, and place greater focus on activities which contribute to the value proposition of the firm, have the highest chances of success when it comes to restoring the viability of weak firms.⁷⁵

In the alternate, if an insolvency regime inhibits corporate restructuring, productivity growth will be hampered.⁷⁶ As an example, if debtors are able to initiate restructuring procedures but these debtors' decisions can be obstructed by minority shareholders, it is unlikely that these firms will be restructured.⁷⁷ This results in resources remaining in these distressed firms, unable of being utilized in a more productive manner.

⁶⁷ UNCITRAL *Legislative Guide on Insolvency Law: Part V* (2021) 40.

⁶⁸ UNCITRAL *Legislative Guide on Insolvency Law: Part V* (2021) 9.

⁶⁹ UNCITRAL *Legislative Guide on Insolvency Law: Part V* (2021) 5.

⁷⁰ UNCITRAL *Legislative Guide on Insolvency Law: Part V* (2021) 5.

⁷¹ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁷² Shin "Corporate Restructuring and Its Macro Effects" 2017 *IMF Working Paper* 5.

⁷³ Shin 2017 *IMF Working Paper* 5.

⁷⁴ Lam *et al* "Resolving China's Zombies: Tackling Debt and Raising Productivity" 2017 *IMF Working Paper* 16.

⁷⁵ Lam *et al* 2017 *IMF Working Paper* 16.

⁷⁶ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁷⁷ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

(i) OECD scoring

In assessing a jurisdiction's restructuring tools, five components are considered: the initiation of restructuring by creditors; the length of the moratorium applicable to assets of the debtor whilst in restructuring; the possibility and priority-ranking of new financing; the possibility of cramming-down on dissenting creditors; and the dismissal of management during restructuring.⁷⁸

If creditors of a country have the choice to initiate either liquidation or restructuring, a value of 0 is given. If creditors may only initiate liquidation, a value of 1 is given.⁷⁹ If a country limits the application of the moratorium, a value of 0 is given. If the length of stay is indefinite, a value of 1 is given.⁸⁰

In respect of the possibility and priority of new financing: if the new financing only has priority over unsecured creditors, a value of 0 is given. If it has priority over both secured and unsecured creditors, a value of 0.5 is given and, if it has no priority, a value of 1 is given.⁸¹

In respect of the possibility of "cram-down" on dissenting creditors: if there is a cram-down, with the provision stating that dissenting creditors receive as much in restructuring as they would in liquidation, a score of 0 is given. If cram-down exists without this provision, a score of 0.5 is given and, if there is no cram-down options available, a score of 1 is given.⁸²

If management of the firm in question is not dismissed during the restructuring process, a score of 0 is given. If management is dismissed, a score of 1 is given.⁸³

(i) UNCITRAL principles on restructuring tools

The recommendations given on restructuring are too extensive to discuss in depth in this dissertation, however, the purpose behind reorganization laws being implemented in a country bear mentioning. These include to: facilitate business rescue, preserve employment and protect investments; identify businesses capable of reorganization; maximize the value of the estate; facilitate the negotiation and approval of a reorganization plan, and establish the effects of

⁷⁸ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

⁷⁹ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

⁸⁰ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

⁸¹ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

⁸² OECD "The OECD Insolvency Indicator: Data 2022" 2022.

⁸³ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

approval, including that the plan should bind the debtor, creditors and other interested parties; address the consequences of a failure to propose an acceptable reorganization plan, including converting the proceedings to liquidation proceedings in certain circumstances; and to provide for the implementation of the reorganization plan and the consequences of the failure to do so.⁸⁴ Implementation of such provisions acts as a lifeline for those businesses in financial distress, who may still have a chance to turn around. It is in the best interest of the economy that these businesses are able to be revived to preserve investment, employment and productivity. It also aids in discerning these firms from those which are unviable. In the event that the business is incapable of turning around, reorganization procedures seek to generate a greater return for creditors in subsequent liquidation.

3.4.4. Other factors

Other factors considered include the degree of court involvement; the distinction between honest and fraudulent bankrupts; and the rights of employees.⁸⁵

The degree of court involvement needs to be finely balanced as it may prolong the restructuring process or force weak firms to exit the market prematurely.⁸⁶ Necessitating the involvement of the courts, and subsequent judicial oversight, are nevertheless important to ensure that the rights of different parties are protected and that the proceedings are efficient.⁸⁷ However, court proceedings increase costs and takes time, which can become particularly burdensome for smaller firms.⁸⁸ Furthermore, the courts may become overburdened with insolvency matters, and insolvency practitioners may lack capacity and proper supervision to successfully steer firms towards rehabilitation.⁸⁹ As a result, if restructuring processes are too reliant on court involvement, it will limit the ability of viable firms to be restructured promptly and efficiently.⁹⁰ It will furthermore decelerate the rate at which unviable firms are liquidated, due to the court's resources being spread too thin.⁹¹

⁸⁴ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 233.

⁸⁵ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

⁸⁶ McGowan and Andrews (2018) 101.

⁸⁷ McGowan and Andrews (2018) 101.

⁸⁸ Bergthaler *et al* "Tackling small and medium sized enterprise problem loans in Europe" 2015 *IMF Staff Discussion Note* 9.

⁸⁹ Bergthaler *et al* 2015 *IMF Staff Discussion Note* 9.

⁹⁰ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 33-34.

⁹¹ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 34.

If some stages of the restructuring process, which do not require court involvement, can be simplified and handled out of court, the workload of the courts will reduce.⁹² This will enable the courts to focus their time and resources on difficult cases where the courts' attention is necessary.

The distinction between honest and fraudulent bankrupts is particularly important due to the negative stigma attached to insolvency. If an honest but unfortunate bankrupt is treated similar to a dishonest and fraudulent one, the negative social stigmatism of failure attached to them as well.⁹³ This creates the unfortunate perception that, if an entrepreneur faces liquidation or restructuring, it is due to dishonest behaviour. This is certainly not the case. In the majority of instances, external circumstances are the key contributors to the failure of a business.⁹⁴ However, most regimes do not distinguish between external causes of failures, and those which are caused by the personal actions of individuals.⁹⁵ In such instances, the fraudulent and honest bankrupt are subjected to the same discharge requirements and time period.⁹⁶ This stifles business productivity and ingenuity as the entrepreneur seeking to establish a new venture has to deal with the negative stigma.⁹⁷ When a bank is approached for a start-up loan, the bank often seeks personal guarantees to secure the loan and considers the credit record of the applicant.⁹⁸ If the honest entrepreneur has not been afforded the opportunity of a fresh start, it will inhibit the creation of new business due to the lack of collateral and the record reflecting the debtor's previous insolvency.⁹⁹

Due to this, it is less likely that weak firms will promptly exit the market in hopes of avoiding the attachment of this stigma and its negative consequences.¹⁰⁰ In addition, entrepreneurs who were involved in failed businesses would be hard-pressed to enter into a new venture.

⁹² McGowan and Andrews (2018) 101.

⁹³ The European Commission, Report of the Expert Group "A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start" 2011 10.

⁹⁴ The European Commission, Report of the Expert Group "A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start" 2011 10.

⁹⁵ The European Commission, Report of the Expert Group "A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start" 2011 10.

⁹⁶ The European Commission, Report of the Expert Group "A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start" 2011 10.

⁹⁷ The European Commission, Report of the Expert Group "A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start" 2011 10.

⁹⁸ The European Commission, Report of the Expert Group "A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start" 2011 10.

⁹⁹ The European Commission, Report of the Expert Group "A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start" 2011 10.

¹⁰⁰ McGowan and Andrews (2018) 101.

In respect of employee rights, if the restrictions on worker dismissals and collective dismissals cannot be negotiated, it may delay the exit or the downsizing of weak firms.¹⁰¹ Such restrictions may result in a bias against non-viable firms entering liquidation which, in turn, lowers productivity.¹⁰²

(i) OECD scoring

In assessing the above criteria, the following scoring system is used:¹⁰³

- court involvement: if the court is involved in the different stages of the liquidation and restructuring processes – such as the launch of the insolvency procedure, the appointment of the practitioner, voting on a restructuring plan by creditors, and confirmation of the restructuring plan, amongst others – a higher score is given for each stage of involvement. The number of stages for restructuring are assessed on a scale of 0 to 5, with each subsequent stage that requires the court to be involved increasing the overall score for this particular indicator. Similarly, the number of stages for liquidation are assessed on a scale of 0 to 5. In order to align the values with other indicators, this value is subsequently reworked to a value between 0 and 1.
- The distinction between honest and fraudulent bankrupts: a value of 0 is given if there is a distinction between honest and fraudulent bankrupts in the insolvency process, for example, a disqualification from discharge or debt write-off due to fraud.¹⁰⁴ A value of 1 is given if no such distinction exists.
- The rights of employees: the indicator will be constructed separately for liquidation and restructuring, following which the two will be summed and rescaled to a value between 0 and 1. A score of 0 is given if there are no restrictions on the ability to dismiss employees upon the initiation of insolvency proceedings and if it is possible to renegotiate collective dismissal agreements with employees. A score of 1 is given if there are no restrictions on the ability to dismiss employees upon the initiation of insolvency proceedings but it is not possible to renegotiate collective dismissal agreements with employees. A score of 1 is also given in the alternate, where there are restrictions on the ability to dismiss employees upon the initiation of insolvency

¹⁰¹ McGowan and Andrews (2018) 101.

¹⁰² McGowan and Andrews (2018) 101.

¹⁰³ OECD “The OECD Insolvency Indicator: Data 2022” 2022.

¹⁰⁴ OECD “The OECD Insolvency Indicator: Data 2022” 2022.

proceedings but it is possible to renegotiate collective dismissal agreements. A score of 2 (which is reworked to a value between 0 and 1) is given if there are restrictions on the ability to dismiss employees upon the initiation of insolvency proceedings and it is not possible to renegotiate collective dismissal agreements with employees.¹⁰⁵

(ii) UNCITRAL principles regarding “other factors”

The Legislative Guide does not deal explicitly with considerations regarding the involvement of courts. However, informal out-of-court proceedings are mentioned in voluntary restructuring negotiations.¹⁰⁶ These negotiations entail little to no court involvement, and is dependent on the agreement of the parties involved.¹⁰⁷ Out-of-court interaction is also mentioned with reference to the “competent authority” which oversees proceedings relevant to SMEs. The competent authority in this instance signals that a judicial officer need not oversee the proceedings to ensure cost-effective and expeditious proceedings.¹⁰⁸

The Legislative Guide does not explicitly contain recommendations on distinguishing between honest and fraudulent debtors. However, it does state that the punitive and deterrent aspects of insolvency laws will be less appropriate where the debtor is honest.¹⁰⁹ The principle does come up again in considerations regarding discharge. In this regard, it is emphasized that business failure is a natural occurrence in any economy and is not exclusively due to dishonest behaviour.¹¹⁰ As a result, conditions and restrictions imposed when it comes to the discharge of pre-insolvency debts may be more appropriate in cases where the debtor was dishonest or acted fraudulently.¹¹¹

The Legislative Guide does not explicitly deal with the rights of employees. However, it does draw attention to the fact that labour laws will impact insolvency proceedings. It emphasizes that certain labour laws may afford protections to employees, which may, for example, impact how restructuring plans are adopted.¹¹² In this regard, the relationship between insolvency law

¹⁰⁵ OECD “The OECD Insolvency Indicator: Data 2022” 2022.

¹⁰⁶ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 238.

¹⁰⁷ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 238.

¹⁰⁸ UNCITRAL *Legislative Guide on Insolvency Law: Part V* (2021) 54.

¹⁰⁹ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 62.

¹¹⁰ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 281.

¹¹¹ UNCITRAL *Legislative Guide on Insolvency Law: Part II* (2004) 283.

¹¹² UNCITRAL *Legislative Guide on Insolvency Law: Part I* (2004) 19.

and other laws should be clear and, where possible, these intersections should be regulated by the insolvency law framework.¹¹³

3.4.5. Summary of OECD insolvency indicators

The table below summarises the insolvency indicators discussed above. It must be reiterated that, the closer the score is to 0, the more the regime aligns with suggested international best practices. In the alternate, the closer a score is to 1, the less aligned the regime is with international best practices, and the more reform that is needed to bring it closer to the standard. Although these indicators need not necessarily be copy-pasted into a particular jurisdiction's insolvency regime, they should form part of the underlying principles of the framework.

<u>Insolvency indicator</u>	<u>Scoring</u>
<u>Treatment of failed entrepreneurs</u>	
<i>Time to discharge</i>	
If the time to discharge is less than or equal to one year	0
If the time to discharge is between 1 and 3 years	0.5
If the time to discharge is greater than 3 years	1
<i>Exemption of assets</i>	
If exemptions are more generous than modest personal items and working equipment (e.g. personal home excluded)	0
If exemptions are restricted to only modest personal items and working equipment (e.g. income needed for subsistence)	0.5
If exemptions are less generous than modest personal items and working equipment (e.g. the assets of the spouse of the debtor can be included in the bankrupt estate)	1
<u>Prevention and streamlining</u>	
<i>Early warning mechanisms</i>	
If countries have early warning mechanisms in place (e.g. Training and an online test)	0
If countries have no early warning mechanisms in place	1
<i>Pre-insolvency regimes</i>	
If pre-insolvency regimes exist	0
No pre-insolvency regime exists	1

¹¹³ UNCITRAL *Legislative Guide on Insolvency Law: Part I* (2004) 19.

<i>Special procedures for SMEs</i>	
If special procedures are in place for SMEs	0
If there are no special procedures in place for SMEs	1
<u>Restructuring tools</u>	
<i>Initiation of restructuring by creditors</i>	
If creditors can initiate both liquidation and restructuring	0
If creditors can only initiate liquidation	1
<i>Length of stay on assets in restructuring</i>	
If the length of stay has a limit	0
If the length of stay is indefinite	1
<i>Possibility and priority of new financing</i>	
If new financing has priority over only unsecured creditors	0
If new financing has priority over both secured and unsecured creditors	0.5
If new financing has no priority	1
<i>Possibility to “cram-down” on dissenting creditors</i>	
If there is cram-down with a provision stating that dissenting creditors receive as much under restructuring as they would in liquidation	0
If cram-down exists without the provision	0.5
If there is no cram-down	1
<i>Dismissal of management during restructuring</i>	
If management is not dismissed during the restructuring process	0
If management is dismissed during the restructuring process	1
<u>Other factors</u>	
<i>Degree of court involvement (rescaled to a value between 0 and 1)</i>	
Are courts involved in different stages of both liquidation and restructuring, determined on scale of 0 to 5	
Lowest amount of court involvement – only what is necessary	0
court involved in all stages	5
<i>Distinction between fraudulent and honest bankrupts</i>	
If there is a distinction between the treatment of honest and fraudulent entrepreneurs in the insolvency process (e.g. fraudulent entrepreneur may be ineligible for debt write-off or discharge from debt)	0
There is no distinction	1

<i>Rights of employees (reworked to a value between 0 and 1)</i>	
If there are no restrictions on the ability to dismiss employees upon the initiation of insolvency proceedings and it is possible to renegotiate dismissal agreements with employees	0
If there are no restrictions on the ability to dismiss employees upon the initiation of insolvency proceedings but it is not possible to renegotiate collective dismissal agreements with employees	1
If there are restrictions on the ability to dismiss employees upon the initiation of insolvency proceedings but it is possible to renegotiate collective dismissal agreements with employees	1
If there are restrictions on the ability to dismiss employees upon the initiation of insolvency and it is not possible to renegotiate collective dismissal agreements with employees	2

3.5. International best practices and zombie firms: Portugal

As previously discussed, the design of insolvency regimes has the potential to directly impact the number of zombie firms present in a particular jurisdiction. The reform of Portugal's insolvency law will be discussed in order to investigate the effects of insolvency reform on the number of zombie firms, and the mechanisms that either forcing their exit from the market or aid in their restoration as healthy going concerns. On this point, it must be noted that the OECD insolvency indicators highlighted the key reforms in Portugal's insolvency regime from 2010 to 2016, and the assessment showed that its scoring improved dramatically.¹¹⁴ These reforms have seen Portugal become one of the most improved countries among OECD countries.¹¹⁵ This change is illustrated in the graph below:

¹¹⁴ OECD "The OECD Insolvency Indicator: Data 2016" 2016, available at <https://www.oecd.org/economy/growth/OECD-Insolvency-indicators.xlsx> (last accessed 2023-11-3).

¹¹⁵ Gouveia and Osterhold "Fear the walking dead: zombie firms, spillovers and exit barriers" 2018 *Banco De Portugal Eurosystem Working Paper* 10.

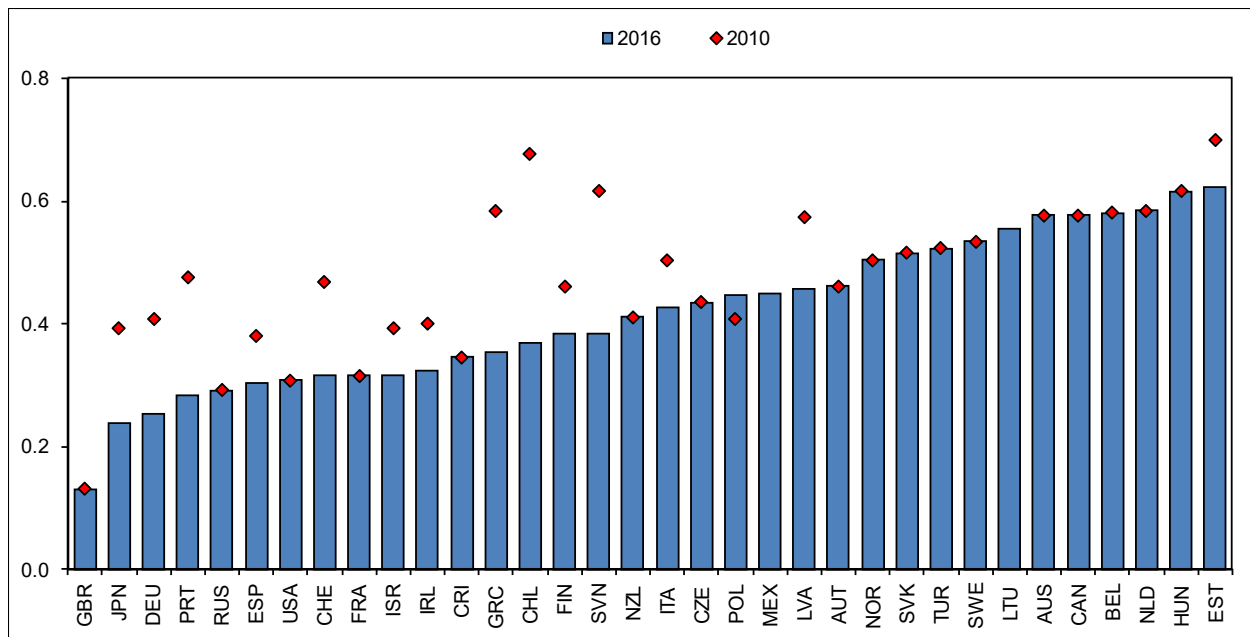


Figure 3: Portugal's OECD Scoring¹¹⁶

As the graph illustrates, the overall score of Portugal (shown as “PRT” on the graph) greatly decreased from 0.48 in 2010 to 0.28 in 2016. Each sub-component's change reflected as follows:¹¹⁷

Insolvency indicator	2010	2016	2022
<u>Treatment of failed entrepreneurs</u>			
Time to discharge	1	1	0.5
Exemption of assets	0.5	0.5	0.5
<u>Prevention and streamlining</u>			
Early warning mechanisms	1	0	0
Pre-insolvency regimes	1	0	0
Special procedures for SMEs	1	1	0
<u>Restructuring tools</u>			
Initiation of restructuring by creditors	0	0	0
Length of stay on assets	0	0	0
Possibility and priority of new financing	1	0.5	0.5
Possibility to “cram-down” on dissenting creditors	0	0	0

¹¹⁶ Source: OECD “The OECD Insolvency Indicator: Data 2022” 2022.

¹¹⁷ This table was created by inserting the data provided by the OECD in OECD “The OECD Insolvency Indicator: Data 2022” 2022.

Dismissal of management during restructuring	0	0	0
<u>Other factors</u>			
Degree of court involvement	0.7	0.7	0.4
Distinction between honest and fraudulent bankrupts	0	0	0
Rights of employees	0	0	0.5

From 2010 to 2016, Portugal improved its early warning mechanisms, pre-insolvency regimes, and the possibility and priority of new financing. From 2016 to 2022, Portugal retained its improved position and further improved on its time to discharge and special procedures for SMEs. However, in 2022, Portugal's scoring in respect of the indicator of rights of employees declined.

The greatest change took place between 2010 and 2016. These changes were attributed to major insolvency reforms that took place in 2012,¹¹⁸ against the background of the 2011-2014 Economic Adjustment Programme for Portugal.¹¹⁹ The reforms sought to foster the recovery of viable firms and the liquidation of those which were not viable. The changes introduced in 2012 included the amendment of the Code of Insolvency and Recovery of Companies (CIRE) in order to align it with international best practice; an in-court fast track procedure for pre-arranged restructuring plans (PER – *Programa a Especial de Revitalizacao*); and an out-of-court corporate recovery system which focused on smaller firms (SIREVE – *Sistema the Recuperacao de Empresas por Via Extra-Judicial*).¹²⁰ SIREVE was replaced by the Extrajudicial Business Recovery Scheme (RERE – *Regime Extrajudicial de Recuperação de Empresas*) in 2015. These mechanisms are discussed in more detail hereafter.

The Portuguese Competitiveness and Innovation Agency (IAPMEI) also offered various tools that were accessible and free-of-charge in order to assist debtors. These tools included a business valuation tool, a project assessment tool and, more relevant to zombie firm status, a financial self-diagnosis.¹²¹ The IAPMEI developed free training programmes for SMEs in the

¹¹⁸ Gouveia and Osterhold 2018 *Banco De Portugal Eurosystem Working Paper* 10.

¹¹⁹ The European Commission "The Economic Adjustment Programme for Portugal 2011-2014" 2014 *Occasional Papers* 202.

¹²⁰ Gouveia and Osterhold 2018 *Banco De Portugal Eurosystem Working Paper* 10.

¹²¹ Available on their website at [https://www.iapmei.pt/PRODUTOS-E-SERVICOS/Assistencia-Tecnica-e-Formacao/Ferramentas/Ferramenta-de-Avaliacao-de-Empresas-\(1\).aspx](https://www.iapmei.pt/PRODUTOS-E-SERVICOS/Assistencia-Tecnica-e-Formacao/Ferramentas/Ferramenta-de-Avaliacao-de-Empresas-(1).aspx).

form of their “SME Academy”. The academy sought to enable entrepreneurs to develop skills and good business practices.¹²² These reforms were subsequently retained.

Interestingly, when analysing the recovery and exit of zombie firms in Portugal, Carreira *et al* found that the share of zombie firms (as a percentage of the total number of firms) began to continuously decrease from 2012.¹²³ This is depicted in the graph below, illustrating the share of zombie firms in Portugal from 2005 until 2016:

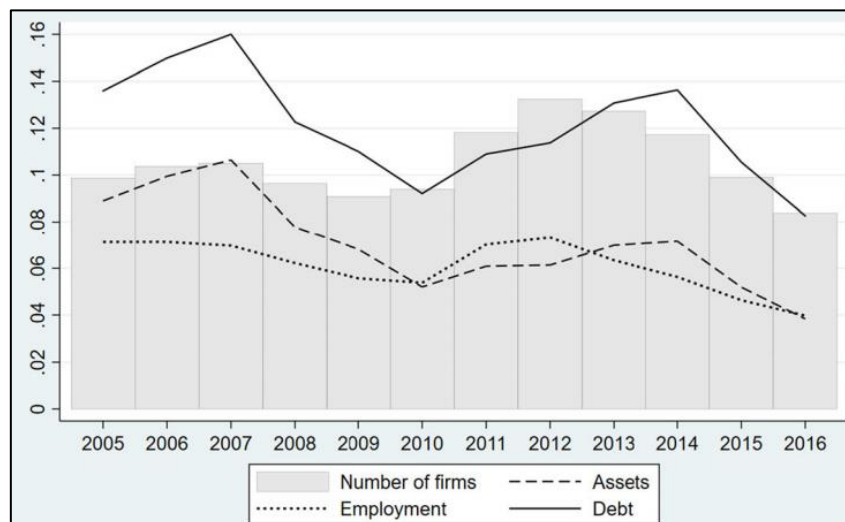


Figure 4: The Share of Zombie Firms in Portugal as illustrated by Carreira *et al*¹²⁴

As previously discussed, the higher the level of compliance with international best practice, the more barriers for firms to enter into liquidation or restructuring are reduced – which boosts productivity.¹²⁵ As far as zombie firms are concerned, when these barriers are reduced, the exit of firms which are no longer viable and the restructuring of firms that are viable (notwithstanding their zombie status) increase.¹²⁶

When Portugal implemented its insolvency reforms in 2012, it removed barriers to market departure and restructuring. Accordingly, it is no coincidence that the share of zombie firms in Portugal subsequently began to decline. Nieto-Carrillo *et al* analysed whether the reforms to Portugal’s insolvency law affected the reallocation of zombie firms, and how this impacted the

¹²² Available on their website at <https://www.iapmei.pt/PRODUTOS-E-SERVICOS/Assistencia-Tecnica-e-Formacao/Academia-de-PME.aspx>.

¹²³ Carreira, Teixeira and Nieto-Carrillo “Recovery and exit of zombie firms in Portugal” 2022 *Small Bus Econ* 497, 498.

¹²⁴ Carreira, Teixeira and Nieto-Carrillo 2022 *Small Bus Econ* 498.

¹²⁵ Andre and Demmou 2022 *OECD Economics Department Working Papers* 8.

¹²⁶ Gouveia and Osterhold 2018 *Banco De Portugal Eurosystem Working Paper* 27.

growth of aggregate productivity.¹²⁷ It was found that Portugal's reforms boosted business reorganization.¹²⁸ Following the implementation of these reforms, the "productive" zombie firms had an increased chance of recovering.¹²⁹ This was found to be true for small and large firms.¹³⁰ It was further found that, as reallocation barriers decrease, the adverse impact of these weaker firms on productivity-enhancing resource reallocation diminished in tandem.¹³¹

Although these reforms have focused mostly on restructuring and preventative measures, as opposed to exit mechanisms, it illustrated that not all zombie firms are unsustainable and doomed to exit the market.¹³² It shows that a thoughtfully-designed insolvency framework can increase the probability of these firms' recovery through reorganization.¹³³

The following section analyses some of these key reforms in order to determine what each reform entailed.

3.5.1. The Special Revitalization Plan: *Programa a Especial de Revitalizacao* (PER)

PER was introduced by Decree Law 16/2012 on 20 April 2012, which amended the Code of Insolvency and Recovery of Companies (CIRE). PER was introduced to allow debtor firms, who could demonstrate that they were in a difficult economic situation or facing imminent insolvency but who were still viable, the opportunity to enter into negotiations with their creditors and agree on a recovery plan to ensure the firm's revival.¹³⁴ A firm is considered to be in a difficult economic situation or facing imminent insolvency if the firm cannot fulfill its obligations, if it is facing illiquidity, or is unable to secure credit.¹³⁵

PER functions as a hybrid pre-insolvency judicial proceeding, whereby a debtor (the struggling firm) may work alongside at least one of its creditors and approach the court on an urgent basis to request that negotiations be initiated.¹³⁶ The process will begin when the debtor and creditor(s) declare their intent to begin negotiations in writing.¹³⁷ Once the written declaration

¹²⁷ Nieto-Carrillo, Carreira and Teixeira "Giving zombie firms a second chance: An assessment of the reform of the Portuguese insolvency framework" 2022 *Economic Analysis and Policy* 175.

¹²⁸ Nieto-Carrillo, Carreira and Teixeira 2022 *Economic Analysis and Policy* 175.

¹²⁹ Nieto-Carrillo, Carreira and Teixeira 2022 *Economic Analysis and Policy* 175.

¹³⁰ Nieto-Carrillo, Carreira and Teixeira 2022 *Economic Analysis and Policy* 175.

¹³¹ Nieto-Carrillo, Carreira and Teixeira 2022 *Economic Analysis and Policy* 175.

¹³² Nieto-Carrillo, Carreira and Teixeira 2022 *Economic Analysis and Policy* 176.

¹³³ Nieto-Carrillo, Carreira and Teixeira 2022 *Economic Analysis and Policy* 176.

¹³⁴ Article 17A(1) of the *Código Da Insolvência E Da Recuperação De Empresas* (CIRE) Decree Law 53/2004.

¹³⁵ Article 17B of CIRE Decree Law 53/2004.

¹³⁶ Article 17A(3) of CIRE Decree Law 53/2004.

¹³⁷ Article 17C(1) of CIRE Decree Law 53/2004.

of intent has been signed and dated by all declarants, the debtor and declaratory creditor/s must immediately approach the court with the aforementioned declaration.¹³⁸ In addition to the declaration, the debtor must file the following documents with the court:

- a list of all creditors of the firm, their domiciles, the amount of their claims, the nature of their claims and guarantees, and an indication as to whether any special relationships exist;
- a list of all pending actions and executions;
- a document explaining the activities of the firm over the last three years, including what the debtor understands to be the cause of the financial situation within which the firm has found itself;
- a document identifying those who are legally responsible for claims of insolvency;
- a list of all assets held by the debtor firm, including those under lease, and information pertaining to their location, identification and value;
- the annual accounts for the last three years; the management, inspection and audit reports; and information about the most significant changes to the assets which occurred since the last reports were drafted;
- a document identifying any commercial companies who are under the control of the debtor firm, or are considered associated companies; and
- a list identifying all employees of the firm.¹³⁹

Once these documents are presented together with the request, the court will appoint a judicial administrator.¹⁴⁰ Once this order is granted, the debtor must contact all creditors who did not partake in the declaration, and to invite them to participate in the ongoing negotiations.¹⁴¹ The debtor must further inform the creditors that the documents filed with the court are available for review at the office of the court.¹⁴² The order is also published on the Citius Portal.¹⁴³

It is important to note that, from the date that the order is granted, all pending debt recovery proceedings against the debtor are suspended.¹⁴⁴ In conjunction, from the date on which the order is published on the portal, any requests to place the debtor in liquidation is suspended,

¹³⁸ Article 17C(3) of CIRE Decree Law 53/2004.

¹³⁹ Article 17C(3)(b) and Article 24(1) of CIRE Decree Law 53/2004.

¹⁴⁰ Article 17C(3)(a) of CIRE Decree Law 53/2004.

¹⁴¹ Article 17D(1) of CIRE Decree Law 53/2004.

¹⁴² Article 17D(1) of CIRE Decree Law 53/2004.

¹⁴³ Accessible at <https://www.citius.mj.pt/portal/default.aspx>.

¹⁴⁴ Article 17E(1) of CIRE Decree Law 53/2004.

provided that an order for liquidation has not yet been granted.¹⁴⁵ The creditors have 20 business days, from the date on which the order is published on the portal, to lodge their claims.¹⁴⁶ Within 5 business days of the expiry of this period, the administrator must publish a provisory list of credits on the portal and present it to the court office.¹⁴⁷ After this publication, any creditor may challenge this list of credits, provided that the challenge is brought within 5 business days of publication.¹⁴⁸ If the list is challenged, the court will rule on the objections within 5 business days.¹⁴⁹ If no objection is made, the list becomes final.¹⁵⁰

Thereafter, the debtor and its creditors have two months to conclude their negotiations.¹⁵¹ This period can be extended by one month, if agreed upon in writing by the debtor and the administrator.¹⁵² During negotiations, the debtor must act in a transparent and equitable manner, and provide information that is complete and up to date.¹⁵³ If there is a lack of communication, or the information given is inaccurate, the debtor can be held personally liable for any losses incurred by the creditors as a result thereof.¹⁵⁴

During this period of negotiations, the management of the firm continues to run the firm. However, special permission from the administrator is required to perform acts of special importance.¹⁵⁵ Acts of special importance include the sale of the business or its shares, the disposal of assets, the acquisition of properties, the conclusion of new contracts, the creation of guarantees, and the assumption of third-party obligations.¹⁵⁶

The PER may end with or without the approval of a recovery plan.¹⁵⁷ A meeting will be held whereby a proposed recovery plan will be put to a vote.¹⁵⁸ Only credit holders with voting rights, who are present at the assembly or who are appropriately represented, can participate in the vote.¹⁵⁹ The vote must be in writing and indicate whether the creditor approves or rejects

¹⁴⁵ Article 17E(6) of CIRE Decree Law 53/2004.

¹⁴⁶ Article 17D(2) of CIRE Decree Law 53/2004.

¹⁴⁷ Article 17D(2) and (3) of CIRE Decree Law 53/2004.

¹⁴⁸ Article 17D(3) of CIRE Decree Law 53/2004.

¹⁴⁹ Article 17D(3) of CIRE Decree Law 53/2004.

¹⁵⁰ Article 17D(4) of CIRE Decree Law 53/2004.

¹⁵¹ Article 17D(5) of CIRE Decree Law 53/2004.

¹⁵² Article 17D(5) of CIRE Decree Law 53/2004.

¹⁵³ Article 17D(6) of CIRE Decree Law 53/2004.

¹⁵⁴ Article 17D(11) of CIRE Decree Law 53/2004.

¹⁵⁵ Article 17E(2) of CIRE Decree Law 53/2004.

¹⁵⁶ Article 161(3) of CIRE Decree Law 53/2004.

¹⁵⁷ Article 17F and 17G of CIRE Decree Law 53/2004.

¹⁵⁸ Article 17F(3) of CIRE Decree Law 53/2004.

¹⁵⁹ Article 211(1) of CIRE Decree Law 53/2004.

the plan.¹⁶⁰ Any proposed modifications must be noted and if the plan is rejected, the written document must contain the reasons for rejection.¹⁶¹

For the plan to be approved, the meeting must be attended by at least one third of the total creditors with voting rights and it must be approved by at least two thirds of the total creditors, with at least half being unsubordinated creditors.¹⁶²

Within 10 days after the voting has taken place, the court will choose to either approve the recovery plan or reject it.¹⁶³ This decision is binding on all creditors, including those who did not participate in the negotiations.¹⁶⁴

In the alternate, if negotiations end without the approval of a recovery plan or the court does not approve the plan, the court may issue an order of insolvency within 3 business days of the rejection or non-approval.¹⁶⁵ It is important to note that, if a company has partaken in a PER in the last two years, it cannot file a second PER.¹⁶⁶

As a summary of the above, this procedure is advantageous in that a stay of execution is granted; liquidation is avoided and the company is given time to restructure; the firm continues with its business and the directors retain their control during the process; it allows for the write-downs of debts; and leases are capable of being renegotiated. PER is thus a good option to completely restructure all liabilities. It provides for a cram-down, as it binds creditors even if they did not approve the recovery plan, and the plan is sanctioned by the court.

3.5.2. The Extrajudicial Business Recovery System – *Sistema the Recuperacao de Empresas por Via Extra-Judicial* (SIREVE)

SIREVE was introduced by Decree Law 178/2012 and was amended in 2015 by Decree Law 26/2015. It was created as an out-of-court pre-insolvency procedure to facilitate the recovery of companies through the conclusion of an agreement between the company and its creditors,

¹⁶⁰ Article 211(2) of CIRE Decree Law 53/2004.

¹⁶¹ Article 211(2) of CIRE Decree Law 53/2004.

¹⁶² Article 17F(3) and Article 212(1) of CIRE Decree Law 53/2004.

¹⁶³ Article 17F(5) of CIRE Decree Law 53/2004.

¹⁶⁴ Article 17F(6) of CIRE Decree Law 53/2004.

¹⁶⁵ Article 17G(3) and Article 17I(5) of CIRE Decree Law 53/2004.

¹⁶⁶ Article 17G(6) of CIRE Decree Law 53/2004.

mediated by IAPMEI.¹⁶⁷ A company seeking to recover through SIREVE would have to file an application with IAPMEI in this regard.¹⁶⁸

SIREVE could be accessed by companies that were in a difficult economic situation or facing imminent insolvency.¹⁶⁹ A company met the entry requirement if there were certain financial indicators present for at least three complete accounting periods at the date of submission of the application. These indicators were: (i) financial autonomy, which is measured as the ratio between the company's equity and its total net assets (indicator of difficulty if the ratio was more than 5%); (ii) the ratio between earnings before depreciation, interest and taxes and the value of interest and similar expenses (indicator of difficulty if the ratio was greater than 1.3) and (iii) the ratio between financial debt and earnings before depreciation, interest and taxes (indicator of difficulty if the ratio was equal to or greater than 0 and less than 10).¹⁷⁰ Before applying to partake in SIREVE, the firm's economic and financial position would be evaluated via an IT platform on IAPMEI's website.¹⁷¹ Although SIREVE was substituted with RERE, discussed hereafter, this service is still available free of charge and can be used by any firm who wishes to assess its own position.¹⁷²

An application to IAPMEI had to include information on the reasons why recourse was sought via SIREVE, and on the parties involved – including the details of the creditors with whom the company intended to negotiate with, who needed to be owed at least one third of the company's total debts.¹⁷³ In addition, the content of the agreement to be reached, the proposed business plan, a copy of the Simplified Business Information (IES) containing information on the last three economic years or two in the case of firms who have only completed two, a complete and detailed list of financial credits, a copy of a balance sheet which was less than three months old, and a list of all actions that had been brought against the company, had to be included in the application.¹⁷⁴ Within 15 days of submitting the application, the IAPMEI would issue an order either accepting or rejecting the application.¹⁷⁵ If accepted, the IAPMEI would take the necessary steps to establish communication between the debtor firm and the creditors identified

¹⁶⁷ Article 1 and 8(1) of Decree Law 178/2012.

¹⁶⁸ Article 3(1) of Decree Law 178/2012.

¹⁶⁹ Article 2 of Decree Law 178/2012.

¹⁷⁰ Article 2(2) of Decree Law 178/2012.

¹⁷¹ Article 2A(1) of Decree Law 178/2012.

¹⁷² Article 2A(3) of Decree Law 178/2012.

¹⁷³ Article 3(2) of Decree Law 178/2012.

¹⁷⁴ Article 3(2) of Decree Law 178/2012.

¹⁷⁵ Article 6(1) of Decree Law 178/2012.

in the application, and begin the process of implementing an agreement to restore the company to a going concern.¹⁷⁶ The proposed agreement and recovery plan would be forwarded to the identified creditors, who could make recommendations and further suggestions.¹⁷⁷

The IAPMEI would then monitor the negotiations and promote the participation of other entities in the process, beyond those who had been indicated by the company in the application.¹⁷⁸ This included creditors who had filed actions against the company for money lent and advanced, or who demanded specific performance from the company.¹⁷⁹ However, even if a creditor was not identified by the company or promoted by IAPMEI, the creditor could still request to be included in the proceedings.¹⁸⁰ These proceedings could not extend beyond three months from the date of the acceptance of the application.¹⁸¹ If necessary, it could be extended once, by one month, if so requested by the company or creditors, and approved by the IAPMEI.¹⁸²

Upon acceptance of the application all actions against the company were suspended, whether in relation to the payment of a debt or the fulfilling of an obligation by the company.¹⁸³ However, this protection was only against actions brought by creditors who participated in the SIREVE proceedings.¹⁸⁴ The company was also prevented from assigning, leasing, alienating, or in any way disposing of assets which could harm the interests of the creditors, until the proceedings had been terminated.¹⁸⁵ The company could furthermore not engage in any activity which would reduce, frustrate, hinder, endanger, or delay the satisfaction of the rights of the creditors.¹⁸⁶

During these proceedings, if creditors financed the debtor's activities by providing capital for its revitalization, they would enjoy general preferential claims which would have priority over the general preferential claims granted to employees.¹⁸⁷ Furthermore, if guarantees were agreed upon between the debtor and the creditors, in respect of which the firm was provided with the

¹⁷⁶ Article 6(5) of Decree Law 178/2012.

¹⁷⁷ Article 6(6) of Decree Law 178/2012.

¹⁷⁸ Article 8(1) of Decree Law 178/2012.

¹⁷⁹ Article 8(1) of Decree Law 178/2012.

¹⁸⁰ Article 10 of Decree Law 178/2012.

¹⁸¹ Article 15(1) of Decree Law 178/2012.

¹⁸² Article 15(2) of Decree Law 178/2012.

¹⁸³ Article 11(2) of Decree Law 178/2012.

¹⁸⁴ Article 11(3)(b) of Decree Law 178/2012.

¹⁸⁵ Article 11(5) of Decree Law 178/2012.

¹⁸⁶ Article 11(5) of Decree Law 178/2012.

¹⁸⁷ Article 11(8) of Decree Law 178/2012.

financial means to pursue its business activities, the guarantees would remain in place for 2 years.¹⁸⁸ This would remain even in the event of insolvency or the initiation of a new restructuring process.¹⁸⁹

The agreement containing the proposed recovery plan needed to be reduced to writing and signed by the company, as well as by the creditors who voted for its approval.¹⁹⁰ The recovery plan would be considered approved if it was voted on by creditors whose claims represented at least one third of the company's total debts.¹⁹¹ The plan could only be approved if it was favoured by more than two thirds of all the votes cast, and more than half of the votes needed to be non-subordinated claims.¹⁹² Alternatively, the plan would be approved if it was endorsed by creditors whose claims represented more than half of the company's total debts and more than half of these votes corresponded to non-subordinated claims.¹⁹³

If agreement was not reached, the IAPMEI would communicate this to the Tribunal via electronic means.¹⁹⁴ If no agreement was reached, the company was prevented from submitting a new application for two years.¹⁹⁵

If the plan was accepted and agreement was reached, the IAPMEI would communicate this electronically to the Tribunal, and provide the Tribunal with the terms agreed to in respect of the rights of the creditors seeking payment or specific performance.¹⁹⁶ If the company definitively failed to comply with the obligations of the agreement, or 30 days after being notified of its failure continued not to comply, the creditors could enforce the agreement individually.¹⁹⁷ In the alternate, the creditors could terminate the agreement and approach the court seeking to resume their actions against the company.¹⁹⁸

This procedure offered advantages such as tax benefits and confidentiality.¹⁹⁹ It also enabled companies to enter into negotiations with their creditors to settle disputes and avoid lengthy and costly court processes. However, this procedure was replaced by the Business

¹⁸⁸ Article 11(6) of Decree Law 178/2012.

¹⁸⁹ Article 11(6) of Decree Law 178/2012.

¹⁹⁰ Article 12(1) of Decree Law 178/2012.

¹⁹¹ Article 12(2)(a) and (b) of Decree Law 178/2012.

¹⁹² Article 12(2)(a) and (b) of Decree Law 178/2012.

¹⁹³ Article 12(2)(a) and (b) of Decree Law 178/2012.

¹⁹⁴ Article 16(3) of Decree Law 178/2012.

¹⁹⁵ Article 17 of Decree Law 178/2012.

¹⁹⁶ Article 13(3) of Decree Law 178/2012.

¹⁹⁷ Article 14(1) of Decree Law 178/2012.

¹⁹⁸ Article 14(3) and (4) of Decree Law 178/2012.

¹⁹⁹ Article 13(4) and 21B of Decree Law 178/2012.

Restructuring Extrajudicial Regime (RERE) on 2 March 2018 by Decree Law 8/2018. RERE is a completely extrajudicial procedure, and is based solely on negotiations between debtors and creditors without any intervention by the courts, tribunals or administrative bodies.²⁰⁰ In this regard, the mandatory involvement of the IAPMEI was replaced with the option of a business restructuring mediator, as discussed hereafter.

3.5.3. The Business Restructuring Extrajudicial Regime – “Regime Extrajudicial de Recuperação de Empresas” (RERE)

RERE is an out-of-court procedure which enables distressed firms to negotiate with one or more of their creditors and reach a restructuring agreement under confidential terms.²⁰¹ This differs from PER which is a hybrid-judicial procedure. Under PER proceedings the court plays a key role in: appointing a judicial administrator; deliberating on creditor claims which have been challenged; choosing whether to accept the restructuring plan and making an order of insolvency if the plan is rejected.²⁰² A “restructuring agreement” in terms of RERE, differs to the one in PER. Under RERE, the restructuring agreement is binding only upon certain creditors, upon which certain of the firm’s assets or liabilities are amended in terms of their composition, conditions or structure.²⁰³ Whereas under PER, the agreement is binding on all creditors, whether they participated in the negotiations or not.²⁰⁴ PER furthermore, is a public proceeding, wherein the list of creditors is published on the Citius Portal and available at the court office, whereas RERE is completely confidential.²⁰⁵

Similarly to PER, only businesses which are still viable, but are facing a difficult economic situation or are facing imminent insolvency, may enter into RERE proceedings.²⁰⁶ A firm is considered to be in a difficult economic situation or facing imminent insolvency, if the firm cannot fulfill all of its outstanding obligations that are due and payable, if it is facing illiquidity, or are unable to obtain credit.²⁰⁷

²⁰⁰ Conceicao and Cebola “Mediation as A Path to Business Restructuring – Contributions to the Portuguese Insolvency Framework” 2017 *TDM Special issue on Comparative and International Perspectives on Mediation in Insolvency Matters* 5.

²⁰¹ Article 2(1) of Decree Law 8/2018.

²⁰² See Article 17C(3)(a); 17D(3); 17F(5) ; 17G(3) and 17I(5) of CIRE Decree Law 53/2004.

²⁰³ Article 2(2) of Decree Law 8/2018.

²⁰⁴ See Article 17F(6) of CIRE Decree Law 53/2004.

²⁰⁵ See Article 17D(1) of CIRE Decree Law 53/2004.

²⁰⁶ Article 3(1) of Decree Law 8/2018; see also 17A(1) of CIRE Decree Law 53/2004.

²⁰⁷ Article 3(1) of Decree Law 8/2018 and Article 17B of CIRE Decree Law 53/2004.

Unlike PER, a judicial administrator is not appointed, nor is one required. However, if the debtor firm wishes to do so, they may appoint a business recovery mediator to assist in the negotiations with creditors.²⁰⁸ This highlights the difference between the aims of PER and RERE. Under PER proceedings, the appointment of the judicial administrator by the court, can be seen as an extension of the court's authority in overseeing proceedings. However, under RERE, the option to appoint a business rescue mediator, illustrates that RERE is intended to be driven entirely by the debtor company and its creditors, to set the terms of the negotiations as they see fit.

To initiate RERE, creditors which represent at least 15% of the total unsubordinated credits may, alongside the debtor firm, start negotiations and sign a memorandum of understanding (MOU) to be deposited with the Commercial Registry Office.²⁰⁹ This MOU needs to set out the key terms of a restructuring agreement to be negotiated and agreed upon, within a period of no more than three months from the deposit date unless another date is agreed upon.²¹⁰ The content of the MOU is determined by the parties, but must at least include the details of the debtor, the creditors participating, and any representatives for the debtor or creditors; the deadline for finalisation of negotiations; the total liabilities of the debtor; who will bear responsibility for the costs of negotiation, including costs for legal, financial or technical advice; an agreement that participating creditors will not initiate any proceedings against the debtor during negotiations, including proceedings which seek to deprive the debtor of assets or rights or to declare the debtor formally insolvency.²¹¹ The MOU must be dated and signed by all participants.²¹² Whereas in PER, the company may alongside any creditor, approach the court to enter into formal negotiations, RERE requires a certain value of creditor rights in favour of entering into negotiations, to begin the informal process. This may be in place to avoid abuse of the process between the company and a singular creditor.

Once the MOU is deposited with the Commercial Registry Office, pending attachments and enforcement proceedings filed by the creditors taking part in the RERE are suspended.²¹³ It is important to emphasize that unlike PER which is binding on all creditors, whether they participated in negotiations or not, this is only binding on creditors who are party to the

²⁰⁸ Article 14(1) of Decree Law 8/2018.

²⁰⁹ Article 6(1) of Decree Law 8/2018.

²¹⁰ Article 6(5) of Decree Law 8/2018.

²¹¹ Article 7(1) of Decree Law 8/2018.

²¹² Article 7(1) of Decree Law 8/2018.

²¹³ Article 11(2) of Decree Law 8/2018.

MOU.²¹⁴ RERE is therefore better suited for the partial restructuring of liabilities, as it is only binding on creditors who are parties to the restructuring agreement. The rights of other creditors to initiate claims will remain unchanged.²¹⁵ The exception is creditors who supply the debtor with utility services such as electricity, natural gas, water, or telecommunications – whether part of the MOU or not, these creditors may not suspend the supply of their services due to non-payment by the debtor.²¹⁶ This prohibition remains in place for three months, unless the providers are part of the MOU and have agreed to a longer period.²¹⁷

Under the provisions of CIRE, the debtor firm, and particularly the board members, are legally obligated to submit a claim to the court requesting a declaration of insolvency within 30 days of becoming aware of their insolvent situation.²¹⁸ This has a particular impact on the ability to enter into RERE proceedings. If a company is factually insolvent, wherein on their balance sheets, the liabilities exceed the assets, RERE cannot be initiated. However, if the debtor firm's financial position changes during the negotiation period of RERE, and the company becomes factually insolvent, the 30-day period will only start after the negotiations end.²¹⁹

Similarly, to PER, during the negotiations, the debtor firm will retain its business, but is prevented from performing acts of special importance unless otherwise stated in the MOU.²²⁰ However, as there is no judicial administrator to oversee the process, it may be difficult for creditors to become aware of special importance being undertaken.

Once the restructuring agreement is approved, it must be filed with the Commercial Registry Office following which:

- the debtor's credit rights and collaterals may only be modified under the restructuring agreement and to the extent that the holders are parties to the agreement;
- lawsuits relating to credit included in the restructuring agreement and insolvency proceedings (if insolvency has not been declared) brought by participating creditors are ended; and

²¹⁴ Article 17F(6) of CIRE Decree Law 53/2004 and Article 11(2) and (3) of Decree Law 8/2018.

²¹⁵ Article 11(3) of Decree Law 8/2018.

²¹⁶ Article 12(1) of Decree Law 8/2018.

²¹⁷ Article 12(3) of Decree Law 8/2018.

²¹⁸ Article 18(1) CIRE Decree Law 53/2004.

²¹⁹ Article 13 of Decree Law 8/2018.

²²⁰ Article 9(1), Article 161(2) and (3) of CIRE Decree Law 53/2004.

- any newly procured cash and attached guarantees provided for in the MOU or restructuring agreement are exempted from certain tax obligations.²²¹

However, the protection of attached guarantees is only effective if a declaration from a statutory auditor declares that the restructuring agreement includes credit corresponding to at least 30% of the total unsubordinated liabilities of the debtor, the financial situation of the debtor is more balanced due to a proportionate increase in assets over liabilities, and the debtor's equity capital is higher than the share capital.²²²

As a summary of the above, advantages of RERE proceedings include

- the write-down of certain debts;
- the suspension of seizure and enforcement proceedings filed by creditors taking part in the MOU, and after finalization of the restructuring agreement, the ending of lawsuits relating to credits contained in the agreement;
- it is not mandatory to appoint a third party; however, if the debtor so wishes, a mediator may be appointed to assist with negotiations;
- liquidation is avoided;
- due to the nature of the proceedings, it is completely confidential; and
- there is no court involvement.²²³

To highlight the difference in scope of application between RERE and PER, it can be summarized that PER is a formal negotiation process overseen by the courts and RERE is an informal negotiation between particular creditors. PER will find application in instances where the company's debts are of such a nature, that it is desirable to restructure the conditions and content of all creditor debts. Due to such a broad and severe impact, PER entrusts the courts to oversee the process. In this respect, the court has the final say regarding the judicial administrator who will oversee the proceedings on the court's behalf, as well as whether the proposed restructuring plan is accepted or rejected. If rejected, the court may also make an order that the company be placed into liquidation. It is important to note, that the court may reject the plan put forward by the company and the creditors, even if the plan was approved by the majority of creditors. This illustrates that the insolvency regime of Portugal places a

²²¹Article 19(5); Article 25(1) and Article 24 of Decree Law 8/2018; Article 27 and Articles 268-270 of CIRE Decree Law 53/2004.

²²²Article 27(1) and (3) of Decree Law 8/2018.

²²³Article 11(2); 14(1); 13; and 2(1) of Decree Law 8/2018.

responsibility on the judicial system, in cases of the restructuring of all the company's debts, to ensure that company's that are unviable and insolvent, are forced to enter into liquidation.

RERE, in the converse, does not involve the courts at all. It is an informal procedure that allows a company, alongside willing creditors, to restructure certain debts. As there is no judicial administrator, or court involvement, the plan reached in this procedure, is not binding on all creditors as it is in PER, it is only binding on those who participated in the agreement. Both PER and RERE are speedy proceedings, with PER to be completed in two months and RERE in three months. However, their goals are entirely different. If a company discovers that the restructuring of a particular debt, or a certain group of debts, would place the company in a better financial position and a secure position of solvency – RERE is the correct procedure to undertake. In the alternate, if a company upon evaluation of its position, discovers that it is in a position where all debts need to be restructured, and it is in a fragile position whereby all enforcement proceedings need to be suspended, PER is the correct procedure. However, a company looking to begin PER proceedings, needs to remember at the outset that the court has the final say and may grant an order of liquidation. Accordingly, if the company's financial position is such that there is no viability or chance of the company continuing on a solvent basis, PER is not appropriate.

3.6. Conclusion

This chapter dealt with the international best practices for insolvency regimes which is integral when it comes to decreasing the share of zombie firms in a given country. The insolvency indicators of the OECD were discussed and unpacked to illustrate international best practices when it comes to the design of insolvency regimes.

Portugal's score in relation to these best practices was discussed. Portugal improved greatly from 2010 to 2016, and managed to maintain its standing in the 2022 analysis. Portugal have reduced barriers for firms to enter into liquidation or restructuring and places a legislative duty on board members to approach the court for a declaration of insolvency when the firm becomes insolvent. The reforms introduced special pre-insolvency proceedings, namely PER and SIREVE in 2012 and RERE in 2018. The share of zombie firms in Portugal declined steadily from 2012 onwards.

The reforms implemented in Portugal encourage restructuring as opposed to swift exit but does not allow hopelessly insolvent firms to remain in the market as it places a time-limit on

negotiations for restructuring. This ensures that zombie firms which are still viable have an opportunity of being revived but that there are no unnecessary delays.

The ensuing chapter will depict South Africa's 2022 scoring of the OECD's insolvency indicators. Thereafter, the pre-insolvency and restructuring mechanisms currently available are assessed. It will then be discussed whether inspiration can be taken from Portugal and whether aspects of its reformative action are suitable for implementation in South Africa.

Chapter 4: The South African Position

4.1. Introduction

In the previous chapter, it was highlighted that South Africa is susceptible to being a breeding ground for zombie companies. In this regard, a definition of, and the criteria for, zombie companies were conceptualized. It is essential to identify these companies and develop appropriate insolvency reforms to address their prevalence. This chapter will investigate South Africa's legal framework for corporate insolvency to ascertain whether any criteria exists within the framework which may be applicable to the phenomenon of zombie companies, or whether the framework needs to be developed in order to deal with the occurrence of zombie companies. Specific reference is made to the mechanisms available to financially distressed companies, namely business rescue, liquidation (winding-up), and a compromise with creditors.

In Chapter 3, the key components essential to insolvency reforms which combat zombie companies were identified. This chapter seeks to compare the current regime of South Africa with these key components to ascertain whether it aligns with international best practices. This chapter is therefore separated into two parts. Part A deals with the available insolvency procedures in South Africa. Part B benchmarks these procedures against the OECD's key indicators, to ascertain to what extent South Africa's insolvency regime is in line with international best practices and the lessons that may be learned from the reforms effected by Portugal.

Part A: Background to South Africa's available mechanisms

In South African law, the following procedures are available to insolvent companies: winding-up, business rescue, and a compromise with creditors. The basic definition of a "company", for purposes of these procedures and this study, is a juristic entity which has been incorporated under either the Companies Act 61 of 1973 or the Companies Act 71 of 2008.¹ As this study is mostly concerned with South African companies, the scope of application of the procedures to foreign and external companies will not be discussed.²

¹ Section 1 of the Companies Act 71 of 2008.

² See Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 281 for the legal position in respect of the effect of the definitions of "company" in the Companies Acts 71 of 2008 and 61 of 1973 respectively.

To understand the legislative framework applicable to these proceedings, the interplay between different pieces of legislation must be explained. The winding-up of an insolvent company is governed by the Companies Act 61 of 1973 and the Insolvency Act 24 of 1936 (the Insolvency Act). This is the position even though the Companies Act 71 of 2008 has become law. Although the 2008 Act repeals the 1973 Act, the 2008 Act also provides for transitional arrangements. Item 9 of Schedule 5 of the 2008 Act, provides that despite the repeal of the 1973 Act, Chapter 14 of the 1973 Act will continue to apply until a date wherein the Minister states it is no longer of effect due to new efficient legislation having been introduced.³ The impact of this is that the provisions of Chapter 14, which deal with the winding-up of insolvent companies, will continue to apply to insolvent companies. However, the winding-up of solvent companies, will continue to be managed by the provisions found in the new 2008 Act. The provisions of the Insolvency Act are also important as they provide for certain circumstances not catered for in the 1973 Act. Section 339 of the 1973 Act provides that in the winding-up of a company which is unable to pay its debts, the provisions of the law relating to insolvency, must, in so far as it is applicable, be applied *mutatis mutandis* in respect of a matter not provided for in the 1973 Act. The 1973 Act furthermore, makes particular areas of insolvency law applicable to the winding-up of a company in respect of: voidable dispositions; the application of assets to costs and claims; the proof of claims; meetings; interrogations and inquiries.⁴ However, the provisions relating to voidable dispositions, interrogations and inquiries, only apply to the winding-up of a company who cannot pay its debts.⁵

4.2. Winding-up initiated by way of resolution

Voluntary winding-up is initiated through a special resolution of the company.⁶ It is important to note that solvent companies may also make use of the voluntary winding-up procedure when the company aims to exit the market. However, in such instances, the provisions of the Companies Act of 2008 will be applicable.⁷ A company that is insolvent may be wound-up either by the court or voluntarily by way of a shareholders' resolution.⁸

³ Item 9 of Schedule 5 of the Companies Act of 2008.

⁴ See sections 340; 342; 366; 412; 416 and 417 of the Companies Act of 2008.

⁵ Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 240.

⁶ Meskin *et al Meskin's Insolvency Law* (2023) 1.3; Sections 349; 350 and 351 of the Companies Act of 1973.

⁷ See sections 79 and 80 of the Companies Act of 2008.

⁸ Section 343(1) of the Companies Act of 2008.

Voluntary winding-up is either categorised as a creditors' winding-up or as a members' voluntary winding-up.⁹ A member's winding-up is the colloquial phrase for a company that is being wound-up as a solvent company, and a creditor's winding-up denotes the winding-up of an insolvent company.¹⁰ The grounds for winding-up a solvent company differs from those for an insolvent company as the Companies Act of 2008 determines the grounds for the winding-up of a solvent company and the Companies Act of 1973 determines the grounds for the winding-up of an insolvent company. The threshold for "insolvency" to determine winding-up as a solvent or insolvent company, is commercial insolvency.¹¹

4.2.1. Voluntary winding-up by members

A member's voluntary winding-up is initiated by the board of the company as the board requests shareholders to vote on whether the company should be wound-up. The resolution is approved if at least 75% of the voting rights exercised by shareholders are in favour of the resolution (hence the special resolution).¹² This kind of winding-up may only take place if the board has filed the resolution with the Companies and Intellectual Property Commission (CIPC) and has provided security to the Master for the payment of the debts of the company as they fall due within the next twelve months following the commencement of the winding-up of the company.¹³ Once the resolution has been registered with the CIPC, the winding-up process will have commenced.¹⁴

Although the company has entered the liquidation process, it will remain a corporate entity and retain all powers in this regard.¹⁵ However, it will cease business operations except to the extent that may be required for the beneficial winding-up of the company.¹⁶ The liquidator must take the company as he finds it and distribute the cash to creditors and shareholders – he cannot, by delaying realisation of assets, attempt to improve their value.¹⁷ Accordingly, to continue business operations for the beneficial winding-up of the company is not to increase return to creditors but may be applicable in instances where the company is to be sold as a going concern

⁹ Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 294.

¹⁰ Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 294.

¹¹ *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* 2013 3 All SA 303 (SCA) para 39.

¹² Section 80(1) of the Companies Act of 2008.

¹³ Section 80(2) and (3) of the Companies Act of 2008.

¹⁴ Section 80(6) of the Companies Act of 2008.

¹⁵ Section 80(8)(a) of the Companies Act of 2008.

¹⁶ Section 80(8)(b)(i) of the Companies Act of 2008.

¹⁷ *Thorne v The Master* 1964 3 SA 38 (N) para 50.

or taken over by another company.¹⁸ Furthermore, all the powers of the directors will cease except where they are enabled by the liquidator or the company, as decided in a general meeting.¹⁹ It is important to note that, due to the solvency of the company and the negligible risk that creditors will not be paid in full, the members (shareholders) of the company direct the liquidation process.²⁰

Within 28 days after the resolution has been filed (registered) with the CIPC, the company must provide the Master with a certified copy of the resolution and a resolution nominating a liquidator.²¹ The company will further give notice of the initiated winding-up through a publication in the Government Gazette.²² Although this procedure is initiated and monitored by the company, the court may, at any after winding-up commences, issue an order that the procedure be stayed or set aside on the terms and conditions it deems fit.²³ The court will only execute such as order if sufficient evidence is put forward to the satisfaction of the court that such interference is needed, and if so requested by a liquidator, creditor, or shareholder of the company.²⁴

Once winding-up commences, all civil proceedings by or against the company will be suspended until a liquidator is appointed.²⁵ Furthermore, any attachment or execution put in force against the estate of the company after winding-up commenced, will be void.²⁶ However, this applies to the attachment and execution of pre-liquidation debts, but it does not prevent attachment or execution against the company in respect of a judgement obtained for costs in post-liquidation proceedings.²⁷

Once the resolution has been registered, the Master will appoint the liquidator nominated by the company, provided that the Master is satisfied that the liquidator was properly nominated

¹⁸ See *Willis v Association of Universities of the British Commonwealth* 1965 1 QB 140 (CA) (note the application of the administrative processes of the 1973 Companies Act below).

¹⁹ Section 80(8)(b)(ii) of the Companies Act of 2008.

²⁰ Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 294.

²¹ The provisions of the 1973 Act become applicable when the administrative process begins in order to “give effect” to the provisions of the 2008 Act – see Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 290 read with the transitional provisions in schedule 9 of item 5 of the 2008 Act.

Section 356(2)(a)(i) of the Companies Act of 1973.

²² Section 356(2)(b) of the Companies Act of 1973.

²³ Section 354(1) of the Companies Act of 1973.

²⁴ Section 354(1) of the Companies Act of 1973.

²⁵ Section 359(1) of the Companies Act of 1973.

²⁶ Section 359(1) of the Companies Act of 1973.

²⁷ *Milne v Cassim* 1926 1 SA 775 (D) para 776.

and is not a disqualified person.²⁸ The liquidator occupies a position which in effect takes the place of the board of directors, to whom all the management powers of the directors have been given.²⁹ While performing this role, the liquidator also stands in a fiduciary relationship to the company, members and creditors.³⁰ The liquidator owes a duty to the company to ensure that its assets are realised and its liabilities minimised to the best advantage of the company.³¹ A similar principle arguably applies in the liquidation of solvent and insolvent companies: the liquidator owes a duty to the creditors to ensure that they suffer the least possible losses and receive the most advantageous dividend.³²

The appointed liquidator will have to supply the Master with security for the proper execution of his functions, unless the company resolved that this is not necessary.³³ The liquidator will be given a certificate of appointment and, subsequently, the liquidator will be entitled to act in terms of the Act.³⁴ The Master may remove the liquidator on the following grounds: he (the liquidator) is not qualified; he has become disqualified; his appointment was illegal; he failed to perform satisfactorily; his estate has become insolvent; he has become mentally or physically incapable of performing his duties; the majority of the members of the company have requested the Master in writing to do so; or, in the opinion of the Master, he is no longer suitable to be a liquidator of the company.³⁵ Should the Master fail to take action in any of these circumstances, the court may, upon an application by any interested person, remove a liquidator from office.³⁶

The liquidator, in any form of winding-up, has the following powers:

- to execute in the name of the company, all deeds, receipts and other documents;
- to prove a claim of any debtor of the company and receive payment in this regard;
- to draw, accept, make and endorse any bill of exchange or promissory note in the name of the company, however, the liquidator may not impose additional liabilities on the company without the leave of the court;

²⁸ Section 369(1); 370(1); 372 and 373 of the Companies Act of 1973.

²⁹ *Cf Howat Motors (Pty) Ltd v Waterson* 1963 3 SA 669 (T) para 673.

³⁰ *Carolina Trekkers & Implemente (Edms) Bpk v Venter* 1982 2 PH E9 (A); *In re Contract Corporation; Gooch's Case* 1872 7 Ch App 207 para 211.

³¹ *Cronje v Hillcrest Village (Pty) Ltd* 2009 6 SA 12 (SCA) para 25.

³² *Cronje v Hillcrest Village (Pty) Ltd* 2009 6 SA 12 (SCA) para 25.

³³ Section 375(1) of the Companies Act of 1973.

³⁴ Section 375(3) and (4) of the Companies Act of 1973.

³⁵ Section 379(1)(a)-(e) of the Companies Act of 1973.

³⁶ Section 379(2) of the Companies Act of 1973.

- to summon a general meeting of the company, creditors or contributories to obtain their authority where necessary; and
- to take measures for the protection and better administration of the affairs and property of the company, that a trustee of an insolvent estate may take without the authority of a resolution of creditors.³⁷

The liquidator may furthermore, and with the consent of the Master, terminate any lease wherein the company is the lessee of movable or immovable property.³⁸ Prior to calling a general meeting, the liquidator may also provide a reasoned recommendation to the Master that any movable or immovable property of the company be sold.³⁹ Following which, the Master may authorize that such property be sold on such conditions and in such manner that he may determine.⁴⁰

Further powers of the liquidator, which apply in winding-up by members', creditors' and the court, include:

- to bring or defend any action or legal proceeding of a civil nature in the name of the company;
- to agree to any reasonable offer of composition made to the company by any debtor and to accept payment of any part of a debt due in settlement thereof, or to grant an extension of time for the payment of the debt;
- to compromise or admit any claim or demand against the company;
- to arrange with creditors (except where the company is unable to pay its debts);
- to submit for arbitration any dispute concerning the company or any claim by or upon the company;
- to carry on or discontinue any part of the business of the company as may be necessary for the beneficial winding-up thereof;
- if the company is unable to pay its debts, to enforce or abandon a contract for the acquisition of immovable property in terms of section 35 of the Insolvency Act;
- to carry on or discontinue a lease in terms of section 37 of the Insolvency Act;

³⁷ Section 386(1)(a)-(e) of the Companies Act of 1973.

³⁸ Section 386(2) of the Companies Act of 1973.

³⁹ Section 386(2A) of the Companies Act of 1973.

⁴⁰ Section 386(2B) of the Companies Act of 1973.

- to sell any movable and immovable property of the company by public auction, public tender or private contract and to give delivery thereof; and
- to perform any act which does not required the leave of the court in terms of the Act.⁴¹

The liquidator will recover all the assets and property of the company, and use the proceeds of the property to pay the costs of the winding-up and the claims of creditors.⁴² Any remaining balance will then be distributed among the members of the company according to their rights and interests, unless the memorandum of incorporation provide otherwise.⁴³ The liquidation and distribution account determines the manner in which payments are made and must reflect an account of receipts and payments, a plan of distribution and a plan of contribution of creditors if applicable.⁴⁴ If this account is not the final account, the liquidator will be required to at least once in every six months, frame and lodge a further account with the Master.⁴⁵

The account will remain open for inspection for at least fourteen days at the office of the Master.⁴⁶ Any person with an interest in the company being wound-up may, at any time before the confirmation of the account, lodge an objection to such account with the Master stating their reasons therefore.⁴⁷ “Any person having an interest” in this respect refers to a legal interest, and includes a proprietary or financial interest.⁴⁸ The Master may then order the liquidator to amend the account or give other directions, if satisfied that the objection should be sustained.⁴⁹ The Master may order amendments and changes even if no objections have been lodged, if he is of the opinion that any improper charge has been made against the assets of the company or is otherwise incorrect.⁵⁰

After the account has laid open for inspection and either no objection has been lodged, the objection has been lodged and the account amended, or an objection has been withdrawn or rejected, the Master will confirm the account.⁵¹ This will have the effect of a final judgement and the liquidator will distribute the estate in accordance with the account, and collect

⁴¹ Section 386(4)(a)-(i) of the Companies Act of 1973.

⁴² Section 391 of the Companies Act of 1973.

⁴³ Section 391 of the Companies Act of 1973; *Commissioner for South African Revenue Service v Stand Two Nine Nought Wynberg (Pty) Ltd* 2005 JOL 14594 (SCA).

⁴⁴ Section 403(1)(a) of the Companies Act of 1973.

⁴⁵ Section 403(1)(b) of the Companies Act of 1973.

⁴⁶ Section 406(1)(a) of the Companies Act of 1973.

⁴⁷ Section 407(1) of the Companies Act of 1973.

⁴⁸ *Nieuwoudt v The Master* 1998 4 SA 513 (A) para 528.

⁴⁹ Section 407(2) of the Companies Act of 1973.

⁵⁰ Section 407(3) of the Companies Act of 1973.

⁵¹ Section 408 (a)-(c) of the Companies Act of 1973.

contributions from liable creditors and contributories.⁵² The “effect of a final judgement” means that, once the account has been confirmed by the Master and objections have been dealt with, the confirmation is final and cannot be reopened unless authorised by a court.⁵³

It is also important to note that directors and any person which has been involved in the promotion or formation of the company, and who has retained, misapplied or become liable for any money or property of the company or is guilty of any breach of trust, may be ordered by the court to repay or restore such property.⁵⁴ The court may also impose interest on this amount or may require the individual to pay compensation in respect of the retention, misapplication, or breach of trust.⁵⁵ If there were two or more delinquents jointly responsible for the loss suffered by the company, the court may apportion the liability between them as it sees fit.⁵⁶

Furthermore, if it is found that the business was being carried on recklessly, with gross negligence, with an intention to defraud, or for any fraudulent purpose, a director or prescribed officer may be held personally liable for any losses, damages or costs suffered by the company.⁵⁷ Carrying on business recklessly refers to carrying on a business in a manner that lacks any genuine concern for the prosperity of the company.⁵⁸ If a company continues carrying on business and incurring debts and, in the opinion of the reasonable man there is no reasonable prospect of the creditors receiving their payments when they become due, it will infer that the business is being carried on recklessly.⁵⁹ As to what constitutes an intention to defraud: if the company, while carrying on its business, incurs debts while its directors know there is no reasonable prospect of the creditors’ ever receiving payment, the trading has been done with intention to defraud.⁶⁰ However, this will not be the case if the directors honestly believe that the company will be able to pay, despite the reality being to the contrary.⁶¹

Once the affairs of the company have been wound-up, the Master will submit a certificate to this effect to the CIPC.⁶² The CIPC will then record the dissolution of the company and the

⁵² Section 408(c) and 409(1) of the Companies Act of 1973.

⁵³ *Kilroe-Daley v Barclays National Bank Ltd* 1984 4 SA 609 (A) para 627.

⁵⁴ Section 423(1) of the Companies Act of 1973.

⁵⁵ Section 423(1) of the Companies Act of 1973.

⁵⁶ *Cf Re Morecambe Bowling Ltd* 1969 1 All ER 753 (Ch) para 756.

⁵⁷ Sections 22 and 77(3)(b) of the Companies Act of 2008.

⁵⁸ *Anderson v Dickson (Intermedia (Pty) Ltd intervening)* 1985 1 SA 93 (N) para 110.

⁵⁹ *Ozinsky v Lloyd* 1992 3 SA 396 (C) paras 413-414.

⁶⁰ *Heneways Freight Services (Pty) Ltd v Grogor* 2007 2 SA 561 (SCA) para 4.

⁶¹ *Heneways Freight Services (Pty) Ltd v Grogor* 2007 2 SA 561 (SCA) para 8.

⁶² Section 82(1) of the Companies Act of 2008.

company's name will be removed from the register of companies.⁶³ The company will be considered dissolved on the date that the CIPC removes the name of the company from the register.⁶⁴

4.2.2. Voluntary winding-up by creditors

The procedural components of voluntary winding-up by members above apply *mutatis mutandis* to voluntary winding-up by creditors, except for a few differences which will be outlined here. The main conceptual difference is that creditor interests take preference due to the high probability that not all claims will be paid and hence the creditors play a central role in the process.⁶⁵

As is the case with members' voluntary winding-up, winding-up by creditors is initiated by a special resolution and this resolution has to be registered with the CIPC.⁶⁶ However, within 28 days after this registration, alongside having to advertise in the Government Gazette and provide a certified copy of the resolution, the company will have to provide the Master with two certified copies of the company's statement of affairs.⁶⁷

The company's statement of affairs is a document drafted by the directors of the company accompanied with by an affidavit verifying relevant information such as the particulars of the company's assets; debts; liabilities; any pending legal proceedings by or against it; the particulars of the company's creditors including their nature of business and the securities held by them.⁶⁸ This statement of affairs is presented by the directors at the meeting where the resolution to enter into a creditors' winding-up is voted on.⁶⁹

As soon as is practicable after this resolution has been passed, the Master will summon a meeting of the creditors of the company to consider the statement of affairs which was submitted to the Master, to prove claims against the company, and to nominate a liquidator.⁷⁰ Importantly, the creditors choose the liquidator in the case of a creditors' winding-up

⁶³ Section 82(2) of the Companies Act of 1973.

⁶⁴ Section 83(1) of the Companies Act of 1973.

⁶⁵ Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 294.

⁶⁶ Section 351(1) of the Companies Act of 1973.

⁶⁷ Section 356(2) of the Companies Act of 1973.

⁶⁸ Section 363(4) of the Companies Act of 1973.

⁶⁹ Section 363(1) of the Companies Act of 1973.

⁷⁰ Section 364(1)(a)(i)-(iii) of the Companies Act of 1973.

notwithstanding that the process was initiated by the shareholders.⁷¹ The liquidator in a members' winding-up is nominated in the resolution passed to liquidate the company.⁷²

When creditors prove their claims, it must be done at a meeting of creditors in the manner prescribed by the Insolvency Act.⁷³ This means that it must be done in accordance with the substantive and procedural requirements set out in these provisions.⁷⁴ In this regard, claims are proven by way of affidavit, at a meeting of creditors, wherein the liquidator will admit or reject the claim.⁷⁵ The liquidator is not required to adjudicate on the proof of the claim as if he is the court – he is required only to satisfy himself that based on the information provided, a prima facie claim exists.⁷⁶ However, only liquidated claims may be proved. A liquidated claim in this respect is one wherein the amount is certain due to being fixed by an agreement or by an order of court.⁷⁷ A creditor may bring forward an unliquidated claim at a meeting, however, it is not considered proven until the amount has been fixed by an order of court, by the liquidator under a creditor resolution, or by the admission or compromise of the Master.⁷⁸ If an unliquidated claim becomes liquidated and proof has been tendered, it will be deemed to have been proven and admitted.⁷⁹ However, if the creditor did not present proof at a meeting, the fact that a claim has been liquidated by a judgement will not automatically entitle the creditor to participate in any distribution. The creditor will first have to prove their claim to acquire this right.⁸⁰ Once the liquidator has admitted proof of a claim, he cannot subsequently reject it.⁸¹ If he does reject it, the creditor may institute action to establish the claim.⁸²

Furthermore, secured creditors will have the same obligations as they would have under Insolvency Act – they must set a value upon their security and the value of their vote will be calculated in the manner for which the Insolvency Act provides.⁸³ This entails the secured creditors stating the nature and particulars of their security and its value in an affidavit.⁸⁴ If the

⁷¹ Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 300.

⁷² Section 369(1) of the Companies Act of 1973; Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 300.

⁷³ Section 366(1)(a) of the Companies Act of 1973; see sections 44-48; 50-51; 78(3) and 104 of the Insolvency Act 24 of 1936.

⁷⁴ *Swaanswyk Investments (Pty) Ltd v The Master* 1978 2 SA 267 (C) para 270.

⁷⁵ Sections 44(3) and (4) of the Insolvency Act.

⁷⁶ *Cachalia v De Klerk* 1952 4 SA 675.

⁷⁷ *Cf Kleynhans v Van der Westhuizen* 1970 2 SA 742 (A) paras 749-750.

⁷⁸ Section 78(3) of the Insolvency Act.

⁷⁹ Section 78(3) of the Insolvency Act; *Taylor and Steyn v Koekemoer* 1982 1 SA 374 (T) paras 380-381.

⁸⁰ *Barlows Tractor Co (Pty) Ltd v Townsend* 1996 2 SA 869 (A) paras 881; 885.

⁸¹ *Ben Rossouw Motors v Druker* 1975 1 SA 821 (W) para 823.

⁸² Section 44(3) of the Insolvency Act.

⁸³ Section 366(1)(b) of the Companies Act of 1973.

⁸⁴ Section 44(4) of the Insolvency Act.

company is unable to pay its debts, the liquidator may take over the security of the creditor, as a trustee would under the Insolvency Act.⁸⁵ “Take over” in this regard refers to the liquidator purchasing the property from the creditor at a price equivalent to its value, thereby settling the claim of the creditor.⁸⁶

The liquidator has a duty to report to creditors and contributories within three months of his appointment.⁸⁷ The matters to be reported on at the general meeting include the following:

- the amount of capital issued by the company and the estimated amount of its assets and liabilities;
- if the company has failed, the causes of the failure;
- whether or not he intends to submit a report to the Master on contraventions or offences, or suspected contraventions or offences;
- whether any director, officer or former director appears to be personally liable for damages or compensation to the company for any debts or liabilities;
- any legal proceedings against or by the company which were pending at the date when winding-up commenced, or have since been instituted;
- whether further enquiry is needed into the promotion, failure, conduct or formation of the business;
- whether the company has kept appropriate accounting records, and if not, which requirements have not been met;
- the progress and prospects of the winding-up and
- any other matter the liquidator thinks fit.⁸⁸

It is the liquidator’s duty to thoroughly investigate the affairs of the company, especially in regards to whether directors or officers are liable for damages due to their reckless or fraudulent behaviour. This arises especially if a compromise or arrangement is proposed as it may protect some individuals from personal liability.⁸⁹ The counterpart to section 22 of the Companies Act of 2008 exists in section 424 of the Companies Act of 1973, however, the latter only becomes available as a recourse once the company has entered formal liquidation proceedings due to its

⁸⁵ Section 366(1)(c) of the Companies Act of 1973.

⁸⁶ *Kahan v Hydro Holdings (Pty) Ltd* 1980 3 SA 511 (T) para 513.

⁸⁷ Section 402 of the Companies Act of 1973.

⁸⁸ Section 402(a)-(i) of the Companies Act of 1973.

⁸⁹ See sections 311 and 424 of the Companies Act of 1973; *Ex Parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T) paras 116-117.

inability to pay debts (as per section 344(f) read with section 345 of the Companies Act of 1973, which is a ground to liquidate a company as an insolvent company in terms of the 1973 Act).

From the above, it is clear to see that the interests of the creditors are paramount in insolvency proceedings – when comparing voluntary winding-up by members’ and one by creditors’, the latter sees the liquidator exercising his duties subject to the directions of the creditors as opposed to the directions of the company.⁹⁰

4.3. Winding-up by way of court order

Compulsory winding-up is the winding-up of a company in compliance with a court order.⁹¹ A company may be wound-up by a court on the grounds specified in the 2008 or 1973 Act, depending on the solvency of the company as discussed above. The grounds listed in Section 81 of the 2008 Act prescribe the following scenarios whereby a solvent company may approach a court to be wound up:

- the company has resolved by special resolution that it be wound-up by the court;
- the company has applied to the court to have its voluntary winding-up continued by the court;
- a practitioner appointed during business rescue proceedings has applied for liquidation on the grounds that there is no reasonable prospect of the company being rescued;
- one or more of the company’s creditors have applied to the court for an order to wind up the company on the grounds that – the company’s business rescue proceedings have ended through the business rescue practitioner filing a notice of termination with the CIPC, or proceedings ended in a manner wherein the business rescue plan had been rejected and no affected person had acted to extend the proceedings; and it appears to the court that it is just and equitable in the circumstances for the company to be wound up; or it is otherwise just and equitable for the company to be wound up;
- the company, or one or more of its directors or shareholders, have applied to the court for an order to wind-up the company on the grounds that: (i) the directors are deadlocked in the management of the company and the shareholders are unable to break the deadlock, and (aa) irreparable injury to the company is resulting, or may

⁹⁰ Section 386(3)(b)-(c) of the Companies Act of 1973.

⁹¹ Section 343(1)(a) of the Companies Act of 1973.

result from the deadlock; or (bb) the company's business cannot be conducted to the advantage of shareholders generally, as a result of the deadlock; (ii) the shareholders are deadlocked in voting power, and have failed for a period that includes at least two consecutive annual general meeting dates, to elect successors to directors whose terms have expired; or (iii) it is otherwise just and equitable for the company to be wound up;

- a shareholder has applied with the leave of the court, for an order to wind up a company on the grounds that: (i) the directors, prescribed officers or other persons in control of the company are acting in a manner that is fraudulent or otherwise illegal; or (ii) the company's assets are being misapplied or wasted;
- the Commission or Panel has applied to the court for an order to wind-up the company on the grounds that the directors, prescribed officers, or other persons in control of the company are acting in a manner that is fraudulent or illegal, and the Commission or Panel has issued a compliance notice in respect of that conduct and the company has failed to comply with that notice; and within the previous five years, enforcement procedures in terms of the Act were taken against the company, its directors, prescribed officers or management, for substantially the same conduct, resulting in an administrative fine, or conviction for an offence; or
- in the case of a designated institution, defined in terms of the Financial Sector Regulation Act 9 of 2017, the Reserve Bank has applied for an order of court to wind-up the company on the grounds that the company has been placed in resolution and there are no reasonable prospects of that resolution ceasing.⁹²

In respect of an insolvent company the grounds in section 344 only apply insofar as the company is commercially insolvent:

- if a company has by special resolution resolved that it be wound-up by the court;
- the company has not commenced business within one year of its incorporation or has suspended its business for a whole year;
- seventy-five percent of the issued share capital of the company has been lost or become useless for the business of the company;
- the company is unable to pay its debts;

⁹² Section 81(1)(a)-(g) of the Companies Act of 2008.

- if the company is an external company and has been dissolved in its country of incorporation;
- it appears to the court that it is just and equitable that the company should be wound up.⁹³

The 2008 Act makes provision for the conversion of business rescue proceedings, or winding-up proceedings initiated for a solvent company, to liquidation proceedings pertaining to insolvent companies. For instance, section 81(1)(b) of the 2008 Act, enables the business rescue practitioner to apply for liquidation on the grounds that there is no reasonable prospect of the company being rescued. Similarly, section 81(1)(c)(i) of the 2008 Act enables a creditor or multiple creditors to apply to the court to wind-up the company due to business rescue proceedings having been terminated or a rescue plan not being adopted. Furthermore, during business rescue proceedings, one of the duties of the practitioner, is to investigate the affairs of the company.⁹⁴ Upon investigation of the affairs of the company, if at any time during proceedings, the practitioner concludes that there is no reasonable prospect for the company to be rescued, the practitioner must apply to the court for an order to discontinue business rescue proceedings and place the company into liquidation.⁹⁵

It is important to note, that irrespective of which ground the application is brought upon, the court has a discretionary power in granting a winding-up order.⁹⁶ The discretion must be exercised on judicial grounds, meaning that the court should have regard to the grounds and the reasons for the winding-up being sought.⁹⁷ The court will look at the circumstances surrounding the specific case brought before it, and the circumstances of previous cases will not be binding but serve as guidelines.⁹⁸ The court may also consider the wishes of the creditors, and direct that a meeting be held to ascertain these wishes.⁹⁹ However, the court will not be bound by these wishes, as the consideration of their wishes is in itself discretionary.¹⁰⁰

⁹³ Section 344(a)-(h) of the Companies Act of 1973. Smith *et al Hockly's Law of Insolvency Winding-up and Business Rescue* (2022) 283.

⁹⁴ Section 141 of the Companies Act of 2008.

⁹⁵ Section 141(2)(a)(ii) of the Companies Act of 2008.

⁹⁶ *F & C Building Construction Co (Pty) Ltd v Macsheil Investments (Pty) Ltd* 1959 3 SA 841 (D) para 844.

⁹⁷ *Irvin & Johnson Ltd v Oelofse Fisheries Ltd* 1954 (1) SA 231 (E) para 244; *Leca Investments (Pty) Ltd v Shiers* 1978 4 SA 703 (W) para 705.

⁹⁸ *Kyle v Maritz & Pieterse Inc* 2002 3 All SA 223 (T) para 225.

⁹⁹ Section 413(b) of the Companies Act of 1973.

¹⁰⁰ *SAA Distributions (Pty) Ltd v Sport en Spel Oelofse Fisheries Ltd* 1954 1 SA 231 (E) paras 374-375.

Of particular relevance for purposes of this dissertation is in instances where the company is unable to pay its debts. A company is deemed unable to pay its debts under the following circumstances:

- if a creditor who the company owes at least R100.00 has served on the company a demand requiring the company to pay the sum due and the company has for three weeks thereafter failed to pay the sum or secure or compound it to the satisfaction of the creditor; or
- a judgement, decree or order of court in favour of a creditor is returned by the sheriff with an endorsement that there is insufficient disposable property to satisfy the judgement; or
- it is proved to the satisfaction of the court that the company is unable to pay its debts.¹⁰¹

When considering whether the company can pay its debts, the court will also consider the contingent and prospective liabilities of the company.¹⁰² It has been implied that, when considered by our courts, the situations listed above comprise an exhaustive list of scenarios, when ascertaining whether a company can pay its debts for purposes of compulsory winding-up.¹⁰³

In respect of the scenario where a creditor is owed at least R100.00, this refers to amounts that are due and payable at the date of application.¹⁰⁴ Any debt which can be utilized for purposes of compulsory winding-up, needs to be payable without further ado and without needing to undergo any further processing.¹⁰⁵ It is important to note that an application on this ground will fail if payment has not been made due to a *bona fide* dispute, based on reasonable grounds. An example of this is where the company reasonably and on substantive grounds challenges its liability for the debt. In such an instance, the company cannot be said to have neglected payment and the section will not be applicable.¹⁰⁶ However, if the company admits liability and only the amount thereof is in dispute, winding-up may still ensue.¹⁰⁷

¹⁰¹ Section 345(1)(a)-(b) of the Companies Act of 1973.

¹⁰² Section 345(2) of the Companies Act of 1973.

¹⁰³ *Taylor and Steyn v Koekemoer* 1982 1 SA 374 (T).

¹⁰⁴ *Barclays Bank (DC&O) v Riverside Dried Fruit Co (Pty) Ltd* 1949 1 SA 937 (C) para 948.

¹⁰⁵ *Kowarski v Time Clothing (Pty) Ltd* 2010 JDR 1178 (ECG) para 31.

¹⁰⁶ *Re Lympne Investments Ltd* 1972 2 All ER 385 (Ch) para 389.

¹⁰⁷ *Body Corporate of Fish Eagle v Group Twelve Investments (Pty) Ltd* 2003 5 SA 414 (W) para 428.

In respect of the scenario where the sheriff has indicated that there is insufficient disposable property available, reference must be made to immovable and movable property. If the assessment is based solely on the fact that the sheriff did not find sufficient movable property, it would be insufficient to satisfy the requirement as it does not consider all kinds of property.¹⁰⁸ In this regard, if the endorsement stated that the sheriff has not found “any money, property or assets to satisfy the judgement” it will be sufficient to meet the requirements set out in the 1973 Act.¹⁰⁹

The company’s inability to pay its debts can be proved in a variety of ways. These include:

- the company has failed on demand to pay a debt, it is *prima facie* proof of an inability to pay its debts as a company not facing financial difficulty ought to be able to pay from its current revenue or resources;¹¹⁰
- a number of creditors have sued the company for debts owed and assets have been sold in execution;¹¹¹
- the company has admitted to its creditors that it could not pay its debts, has failed to adhere to an instalment agreement, or failed to pay interest due, and there was no explanation for these failures;¹¹²
- that the company is actually insolvent, in that its liabilities exceed its assets and although is not a ground per se, it is a material factor to be considered by a court in ascertaining whether a company is unable to pay its debts.¹¹³

An application can be brought to the court for the winding-up of a company by the company itself; one or more of the company’s creditors; one or more of the company’s members (shareholders); jointly by all of the parties mentioned above; or, in the case of a voluntary winding-up in progress, by the Master or any creditor or member of that company.¹¹⁴ This shows that the categories of persons with *locus standi* are much broader than for voluntary measures.

¹⁰⁸ See *Richard Goldman Finance (Pty) Ltd v Elmtree Finance & Investment Co (Pty) Ltd* 1977 2 SA 624 (W) para 627; *Cornelissen v Welkom Tractors & Auto’s (Pty) Ltd* 1971 3 SA 114 (O) paras 116-117.

¹⁰⁹ Cf *Amalgamated Hardware and Timber (Pty) Ltd v Wimmers* 1964 2 SA 542 (T) paras 544F-G.

¹¹⁰ *Rosenbach & Co (Pty) Ltd v Singh’s Bazaars (Pty) Ltd* 1962 4 SA 593 (D) para 597.

¹¹¹ See *In re Globe New Patent Iron & Steel Co* 1875 LR 20 Eq 337.

¹¹² *Kalk Bay Fisheries Ltd v United Restaurants Ltd* 1905 TH 22.

¹¹³ *Johnson v Hirotec (Pty) Ltd* 2000 4 SA 930 (SCA) paras 933-934.

¹¹⁴ Section 346(1)(a)-(e) of the Companies Act of 1973.

The court may decide to grant a winding-up order, dismiss the application, adjourn the hearing conditionally or unconditionally, make an interim order, or any other order the court deems just.¹¹⁵ The winding-up is deemed to have commenced under this procedure, at the time the application has been duly lodged with the Registrar of the Court.¹¹⁶ At any time after the application has been presented, but before an order has been made, the company, any creditor or member, may approach the court for a stay of proceedings of commenced actions and the restraint of further actions.¹¹⁷ The court may then stay or restrain the proceedings as it sees fit, however, the discretion is narrow and should only be granted in special circumstances.¹¹⁸ In making its decision, the court will consider the legal rights of the parties and the interests of each class of creditors who may be impacted by the decision, as well as the likelihood of the company being wound-up.¹¹⁹ It will not necessarily be considered a special circumstance if one creditor continues with a sale-in-execution of the company's property, as other creditors seeking the winding-up of the company will be afforded a stay on proceedings if the order is granted.¹²⁰

After granting an order of winding-up, the property of the company will vest in the Master until a provisional liquidator is appointed.¹²¹ The court may also order any director, member, trustee, banker, agent or officer of the company to pay, deliver, surrender or transfer any money, property, or books and papers that the company is *prima facie* entitled to, to the liquidator in a time frame stipulated by the court.¹²²

It is important to note that the following provisions discussed under voluntary winding-up, apply *mutatis mutandis* to companies wound-up by the court: legal proceedings being suspended and attachments being void;¹²³ the duty of directors to submit a statement of affairs;¹²⁴ the first meeting of creditors convened by the Master to consider the statement of affairs, nominate a liquidator and prove claims;¹²⁵ how claims are proven;¹²⁶ the appointment,

¹¹⁵ Section 347(1) of the Companies Act of 1973.

¹¹⁶ Section 348 of the Companies Act of 1973; *Wolhuter Steel (Welkom) (Pty) Ltd v Jatu Construction (Pty) Ltd* 1983 3 SA 815 (O) para 816.

¹¹⁷ Section 358 of the Companies Act of 1973.

¹¹⁸ *Venner's Electrical Cooking & Heating Appliances Ltd v Thorpe* 1915 2 Ch 404 (CA) paras 407-408.

¹¹⁹ *The Great Ship Co Ltd; Parry's Case* 1863 46 ER 839 (Ch) para 841.

¹²⁰ Section 359(1) of the Companies Act of 1973.

¹²¹ Section 361(1) of the Companies Act of 1973.

¹²² Section 362(1) of the Companies Act of 1973.

¹²³ Section 359 of the Companies Act of 1973.

¹²⁴ Section 363 of the Companies Act of 1973.

¹²⁵ Section 364 of the Companies Act of 1973.

¹²⁶ Section 366 of the Companies Act of 1973.

determination, role and removal of a liquidator;¹²⁷ the general powers and duties of liquidators;¹²⁸ the inspection and objections of the account;¹²⁹ the confirmation of the account;¹³⁰ the distribution of the estate¹³¹; the dissolution of the company;¹³² and the liability of delinquent and fraudulent directors.¹³³

Liquidators, in the winding-up by a court specifically, will have regard to any directions that may be given by resolution of the creditors or members of the company at any general meeting when it comes to the administration of the assets of the company.¹³⁴ If the liquidator submits a matter for consideration by creditors and members, but no directions have been given or there are different instructions received from creditors and members, the liquidator may apply to the Master for directions.¹³⁵ The Master may give or refuse to give directions. If the Master refuses, the liquidator may approach the court for further instructions.¹³⁶ The court may give directions in relation to any matter arising from the winding-up, as well as any questions of law. Although the court would prefer to avoid stepping into the shoes of the liquidator, it will advise the liquidator on matters of law or principle to protect the liquidator from being accused of acting unreasonably.¹³⁷

Furthermore, if any person has been aggrieved by an act or decision of the liquidator may apply to the court for an order the court deems fit after giving notice to the liquidator.¹³⁸ “Any person” in this regard refers to a person with a genuine grievance because an order has been made which prejudicially affects his or her or its interests.¹³⁹

4.4. Compromise with creditors

The formal compromise with creditors is governed by the 2008 Companies Act. A company that is in financial difficulty, but not partaking in business rescue proceedings, may enter into

¹²⁷ Section 367; 369; 370; 372; 375; 379 of the Companies Act of 1973.

¹²⁸ Section 386; 391; 402; 403 of the Companies Act of 1973.

¹²⁹ Section 406; 407 of the Companies Act of 1973.

¹³⁰ Section 408 of the Companies Act of 1973.

¹³¹ Section 409 of the Companies Act of 1973.

¹³² Section 419 of the Companies Act of 1973.

¹³³ Section 423; 424 of the Companies Act of 1973.

¹³⁴ Section 387(1) of the Companies Act of 1973.

¹³⁵ Section 387(2) of the Companies Act of 1973.

¹³⁶ Section 387(3) of the Companies Act of 1973.

¹³⁷ *Ex Parte Liquidator Varachia Stores (Pty) Ltd* 1940 TPD 17 para 20; and Australian Case *Sanderson v Classic Car Insurance Pty Ltd* 1986 10 ACLR 115 (SC NSW) paras 117-118.

¹³⁸ Section 387(4) of the Companies Act of 1973.

¹³⁹ *LL Mining Corporation Ltd v Namco (Pty) Ltd (in liquidation)* 2004 3 SA 407 (C) para 414.

a compromise with its creditors.¹⁴⁰ The board, or the liquidator if it is being wound-up, may propose a compromise of its financial obligations to all of its creditors, or any class of its creditors, by delivering a copy of this proposal and a notice of a meeting to consider it to the creditors and the CIPC.¹⁴¹ This compromise can be sought with any class of creditors, irrespective of the nature of their claims against the company.¹⁴²

Although the 2008 Companies Act repealed the compromise in section 311 of the 1973 Companies Act, some of the basic principles relating to compromises remain. The proposal must contain all information necessary to aid creditors in deciding whether or not to accept the proposal.¹⁴³ It is important that creditors are sufficiently informed. The proposal must be sent to the creditors before the meeting, so that the creditors may prepare themselves for the meeting if attending personally, or to instruct someone else how to cast their vote by proxy.¹⁴⁴ Although the circumstances of each compromise will require different information, the basic information required remain the same.¹⁴⁵ As such, the 2008 Companies Act regulates the information that must be included in a compromise. This proposal should be comprised of three parts: Part A (the background); Part B (proposals) and Part C (assumptions and conditions).¹⁴⁶ The background should include (as a minimum):

- a complete list of all the material assets of the company and which are held as security by creditors;
- a complete list of the creditors of the company and an indication of which would qualify as secured, statutory preferent, and concurrent in terms of the Insolvency Act, and which creditors have proved their claims;
- the probable dividend that would be received by creditors in their specific classes in the event that the company would be placed in formal liquidation;
- a complete list of the holders of the company's issued securities and the impact the proposal would have on them if any; and

¹⁴⁰ Section 155(1) of the Companies Act of 2008.

¹⁴¹ Section 155(2) of the Companies Act of 2008.

¹⁴² *In re Empire Mining Co* (1890) 44 Ch 402 para 409.

¹⁴³ Section 155(3) of the Companies Act of 2008.

¹⁴⁴ Section 155(2) and (3) of the Companies Act of 2008. See also the principles established in *Ensor v South Pine Properties (Pty) Ltd* 1978 2 SA 755 (N) 760.

¹⁴⁵ *Ensor v South Pine Properties (Pty) Ltd* 1978 2 SA 755 (N) 760.

¹⁴⁶ Section 155(3) of the Companies Act of 2008.

- whether the proposal includes a proposal made informally by a creditor of the company.¹⁴⁷

The proposals should include (as a minimum):

- the nature and duration of any proposed debt moratorium;
- the extent to which the company is to be released from the payment of its debts, and the extent of any debt proposed to be converted into equity;
- the treatment of contracts and the ongoing role of the company;
- the property of the company that is proposed to be available to pay the claims of creditors;
- the order of preference in which the proceeds of the property of the company will be applied to pay creditors if the proposal is adopted; and
- the benefits of adopting the proposal as opposed to the benefits that would have been received in liquidation.¹⁴⁸

The assumptions and conditions should include (as a minimum):

- a statement of the conditions that must be satisfied for the proposal to come into operation and be fully implemented;
- the effect, if any, that the plan will have on the number of employees and their conditions of employment; and
- a projected balance sheet for the company and a statement of income and expenses for the ensuing three years, prepared on the assumption that the proposal is accepted.¹⁴⁹

An authorised director or officer of the company must provide a certificate with the proposal, stipulating that the factual information provided appears to be accurate, complete, and up to date; and that the projections made therein were made in good faith on the basis of factual information and assumptions.¹⁵⁰ The proposal will be adopted by the creditors if it is supported by a majority representing at least seventy-five percent in value of the creditors or class who voted at a meeting called for that purpose.¹⁵¹

¹⁴⁷ Section 155(3)(a)(i)-(v) of the Companies Act of 2008.

¹⁴⁸ Section 155(3)(b)(i)-(vi) of the Companies Act of 2008.

¹⁴⁹ Section 155(3)(c) of the Companies Act of 2008.

¹⁵⁰ Section 155(5) of the Companies Act of 2008.

¹⁵¹ Section 155(6) of the Companies Act of 2008.

If the proposal is adopted, the company may apply to the court to approve the proposal.¹⁵² The court, on application, may sanction the compromise contained in the proposal if it considers it to be just and equitable, taking into account the number of creditors of any affected class who were present or represented at the meeting, and who voted in favour of the proposal; and the report of the Master in instances where the company is being wound-up.¹⁵³ Following the sanctioning of the court, a copy must be filed with the CIPC within five business days and the company's memorandum of incorporation must be attached.¹⁵⁴ The compromise is only final and binding on all creditors or the relevant class of members once the court sanctions it and on the date on which it is filed.¹⁵⁵

4.5. Business rescue

Business rescue proceedings are governed by the provisions of Chapter 6 of the 2008 Companies Act. There are some key definitions which need to be explained first, in order for the discussion of the provisions to be fully comprehended.

4.5.1. Key definitions

An *affected person* refers to a shareholder or creditor of the company; any registered trade union representing the employees of the company; and the employees which are not represented by a trade union.¹⁵⁶ The term “creditor” is not defined by the Act, but it is understood as someone to whom money is owed.¹⁵⁷ However, in the recent case of *Wescoal Mining (Pty) Ltd v Mkhombho* [2023] ZAGPJHC 1097, the Court considered the meaning of a “creditor” for purposes of business rescue. The Court found that where “creditor” appears in Chapter 6 of the 2008 Act, it is referring to a creditor of the company that existed as the time business rescue commenced.¹⁵⁸ However, this definition creates confusion regarding whether post-commencement financiers may be deemed creditors with rights to vote on the business plan. According to the Court in *Wescoal*, creditors with a voting interest to vote at a meeting to approve a proposed business plan, must be pre-commencement creditors.¹⁵⁹ In this respect, the Court was of the view that post-commencement financiers do not vote on the approval of the

¹⁵² Section 155(7)(a) of the Companies Act of 2008.

¹⁵³ Section 155(7)(b)(i)-(ii) of the Companies Act of 2008.

¹⁵⁴ Section 155(8)(a)-(c) of the Companies Act of 2008.

¹⁵⁵ Section 155(8)(a)-(c) of the Companies Act of 2008.

¹⁵⁶ Section 128(1)(a)(i)-(iii) of the Companies Act of 2008.

¹⁵⁷ Levenstein *South African Business Rescue Procedure* (2022) 7.2.1.1.

¹⁵⁸ *Wescoal Mining (Pty) Ltd v Mkhombho* para 20.

¹⁵⁹ *Wescoal Mining (Pty) Ltd v Mkhombho* para 27.

business rescue plan, but are rewarded and taken care of through their enhanced security (which is discussed below).¹⁶⁰ It is uncertain whether this definition will stand, as the Court itself mentioned that the case before it was an application for final relief, and that the Court “will leave it to others to assess my diligence.”¹⁶¹ Nonetheless, this dissertation refers to “creditors” as those who are pre-commencement creditors, and those of whom extended credit to the company post-commencement, as “post-commencement financiers”.

Business rescue refers to the process of facilitating the rehabilitation of a company that is financially distressed by providing for:

- “the temporary supervision of the company and the management of its affairs, business and property;
- a temporary moratorium on the rights of claimants against the company or property in its possession; and
- the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing to exist on a solvent basis or, if not possible to continue existing, to result in a better return for the company’s creditors or shareholders than would have resulted from the immediate liquidation of the company.”¹⁶²

In the case of Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) Pty Ltd 2013 4 SA 539 (SCA) , the Supreme Court of Appeal interpreted the meaning of “business rescue” to “facilitate rehabilitation” to mean the achievement of one of two goals, either (a) to return the company to a state of solvency; or (b) to provide a better deal for creditors and shareholders than what they would have received through liquidation.¹⁶³ , From the above it can be seen that business rescue accordingly has two goals: the implementation and development of a business rescue plan; and securing a better return for creditors than what would have been obtained in liquidation. However, it is also important to note that, in the listed purposes of the Act, the Companies Act seeks to provide for the efficient rescue and recovery of financially distressed companies in a manner that balances the rights and interests of all

¹⁶⁰ *Wescoal Mining (Pty) Ltd v Mkhombho* para 24; see paragraph 4.5.8

¹⁶¹ *Wescoal Mining (Pty) Ltd v Mkhombho* para 27.

¹⁶² Section 128(1)(b) of the Companies Act of 2008.

¹⁶³ *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) Pty Ltd* para 26.

relevant stakeholders.¹⁶⁴ Thus, business rescue cannot be in the interest of only some shareholders or creditors.

Although *rehabilitation* is not defined in the Act, based on the definition of business rescue above, a company will be considered rehabilitated if it returns to a sustainable state of solvency. However, O'Brien and Calitz in their discussion of the meaning of "rescuing a company" and "rehabilitation", highlight the decision of the Supreme Court of Appeal in *Oakdene*.¹⁶⁵ As discussed above, *Oakdene* confirmed the two goals of business rescue to be: to return the company to existing on a solvent basis or if the company does not continue to exist, the business rescue proceedings must result in a better return for creditors or shareholders than what would have resulted from immediate liquidation.¹⁶⁶ O'Brien and Calitz submit that a company will not be rehabilitated on the sole basis that it has returned to a state of solvency, it also has to be able to continue operations under solvent circumstances.¹⁶⁷ However, beyond this, business rescue also acts, in respect of the second goal, as a procedure to liquidate the company over time through enabling business operations for a particular period, to result in a better return for creditors or shareholders.¹⁶⁸

In the case of *Welman v Marcelle Props 193 CC* [2012] ZAGPJHC (24 February 2012), the Court emphasized that business rescue proceedings are not appropriate for firms which can be considered chronically or terminally ill.¹⁶⁹ The Court stated that these proceedings are in actuality for ailing corporations, that upon being given time, will be rescued and continue to operate in solvency.¹⁷⁰ O'Brien and Calitz in their discussion of the suitability of business rescue proceedings to certain corporations, retain the use of medical metaphors mentioned in *Welman*.¹⁷¹ For purposes of this discussion, the struggling company is compared to a patient, and the business rescue practitioner is compared to the medical practitioner. A medical practitioner cannot do anything to help or save patients that are already dead.¹⁷² Similarly, a medical practitioner in triage, may face patients who are still alive, but have life-threatening

¹⁶⁴ Section 7(k) of the Companies Act of 2008; *Welman v Marcelle Props 193 CC* 2012 JOL 28714 (GSJ) paras 16; 25.

¹⁶⁵ O'Brien and Calitz "A reasonable prospect for rescuing a company as a requirement for business rescue: a decade later" 2021 TSAR 695.

¹⁶⁶ *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) Pty Ltd* para 26.

¹⁶⁷ O'Brien and Calitz 2021 TSAR 695.

¹⁶⁸ O'Brien and Calitz 2021 TSAR 695.

¹⁶⁹ *Welman v Marcelle Props 193 CC* para 28.

¹⁷⁰ *Welman v Marcelle Props 193 CC* para 28.

¹⁷¹ O'Brien and Calitz "Considerations that inform the view of whether there is a reasonable prospect of rescuing a company: A decade of legal precedent" 2022 TSAR 27-28.

¹⁷² O'Brien and Calitz 2022 TSAR 27.

wounds that place them beyond saving.¹⁷³ Furthermore, when medical practitioners consult their patients, it is essential to take the medical history of the patient, to inform a diagnosis and treatment plan alongside an examination.¹⁷⁴ As a medical history reflects what treatment the patient was exposed to in the past which was unsuccessful, it is essential that business rescue proceedings do not continue on the basis of a previously unsuccessful treatment plan.¹⁷⁵ Similarly, a medical practitioner will consider how long the symptoms of the patient have ensued to determine whether treatment will be successful. This same principle applies to business rescue.¹⁷⁶ A key consideration amongst medical patients and their treatment, is the availability of support structures.¹⁷⁷ This same consideration bears weight in business rescue proceedings, if the support of the relevant stakeholders is absent, it renders the proceedings difficult, and possibly redundant entirely.¹⁷⁸ In the case of medical patients, the sad reality is that the medical treatments are too expensive to be accessible, likewise in business rescue, it may be too costly to be a viable option for certain companies.¹⁷⁹ In medical cases, medical practitioners face the harsh reality of some patients' conditions being beyond treatment, wherein the life-support system should be turned off.¹⁸⁰ This same reality is present in business rescue. If a company cannot be rescued, it is the duty of the practitioner to apply for the liquidation of the company.¹⁸¹ Unlike in cases of medical care where a long-term treatment plan may be provided to better the life of the patient with an incurable condition, business rescue is not designed to fulfil this function.¹⁸² The purpose of this analogy has been to highlight that business rescue, as far as the first goal is concerned at least, is to operate as a special remedy limited to companies facing a temporary distress, which are capable of being remedied. It is not an alternative to liquidation, if the company is insolvent, it must enter into liquidation.

The analogy given above may seem contradictory and confusing in relation to the second goal of business rescue, as it provides for a better return in liquidation. In terms of the second goal, this does not denote rehabilitation per se, but presents an alternative through quasi-liquidation

¹⁷³ O'Brien and Calitz 2022 TSAR 27.

¹⁷⁴ O'Brien and Calitz 2022 TSAR 27.

¹⁷⁵ O'Brien and Calitz 2022 TSAR 27.

¹⁷⁶ O'Brien and Calitz 2022 TSAR 27.

¹⁷⁷ O'Brien and Calitz 2022 TSAR 27.

¹⁷⁸ O'Brien and Calitz 2022 TSAR 27.

¹⁷⁹ O'Brien and Calitz 2022 TSAR 27.

¹⁸⁰ O'Brien and Calitz 2022 TSAR 27.

¹⁸¹ O'Brien and Calitz 2022 TSAR 27.

¹⁸² O'Brien and Calitz 2022 TSAR 27.

which, through the sale of the assets or business of the company, results in a better return for creditors than they would have received under liquidation.¹⁸³ However, as it results in a higher dividend, it is still continued a “rescue”.¹⁸⁴

These goals are commendable; however, the provisions are not always clearly drafted. This gives rise to confusion and enables litigious parties to exploit these inconsistencies and bring forward arguments which stifles the process and secures advantages which were not intended by the Act.¹⁸⁵

In the definition of business rescue above, it was highlighted that business rescue is only for companies which are *financially distressed*. A company is considered financially distressed if it appears to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months (cash-flow test); or it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months (balance sheet test).¹⁸⁶

A problem with this definition lies in the fact that the Act does not define “insolvent”. This is problematic as a company can be factually or commercially insolvent. A company is factually insolvent if its liabilities exceed its assets, and commercially insolvent when unable to pay its debts even though its assets exceed its liabilities.¹⁸⁷ It may be inferred that the first part of the definition refers to the company becoming commercially insolvent as it refers to the inability of the company to pay its debts as they become due (a cash test) which illustrates that even if the assets exceed the liabilities, the company does not have the cash/liquidity to settle its debts. Regarding the second component, it refers to factual insolvency as it refers to the company’s liabilities exceeding its assets. This six-month period caveat intends to separate financially distressed companies from those which are insolvent to the point of no return, as those in distress are companies which are still viable and are capable of being rescued.¹⁸⁸

¹⁸³ Levenstein (2022) 7.2.1.2.

¹⁸⁴ *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* 2013 3 All SA 303 (SCA) paras 26; 28.

¹⁸⁵ *Panamo Properties (Pty) Ltd v Nel* 2015 5 SA 63 (SCA) para 1.

¹⁸⁶ Section 128(1)(f)(i)-(ii) of the Companies Act of 2008.

¹⁸⁷ *Boschpoort Ondernemings (Pty) Ltd v Absa Bank Ltd* 2014 2 SA 518 (SCA) paras 14-16.

¹⁸⁸ Levenstein (2022) 7.2.1.4.

4.5.2. The commencement of business rescue

Business rescue can be commenced in two ways: voluntarily through a company resolution or through an order of court (compulsory).¹⁸⁹

(i) Voluntary commencement

A company may voluntarily begin business rescue and be placed under supervision through a resolution, if the board has reasonable grounds to believe that the company is financially distressed and there appears to be a reasonable prospect of rescuing the company.¹⁹⁰ The rationale behind voluntary proceedings is that the board is in the best position to determine whether a company is financially distressed.¹⁹¹ Subsequently, the sooner a company can enter into business rescue, the better its chances of being rehabilitated. The resolution required is that of a simple majority, which is taken in good faith.¹⁹²

The Act does not define the term “reasonable grounds to believe”, however, it is understood to be based on the company’s specific circumstances at the time, which is a subjective test (belief) based on objective facts (the company’s financial position) and an objective belief that there is a reasonable prospect.¹⁹³ If the circumstances of the company are looked at objectively, and the company cannot be said to be financially distressed, a resolution to enter business rescue could be seen as being executed in bad faith.¹⁹⁴ Similarly, the Act does not define “a reasonable prospect”. This has been left to our courts to determine. The principle was summarized and explained as requiring less than a “reasonable probability”, but more than a mere *prima facie* case or arguable possibility.¹⁹⁵ Particular emphasis is placed on the “reasonable” requirement, which means that it must be a prospect that has been based on reasonable grounds.¹⁹⁶ In this regard, a mere speculative suggestion is insufficient.¹⁹⁷

The resolution discussed above cannot be adopted if liquidation proceedings have been initiated by or against the company and will have no effect until it is filed with the CIPC.¹⁹⁸

¹⁸⁹ Section 129 and 131 of the Companies Act of 2008.

¹⁹⁰ Section 129(1)(a)-(b) of the Companies Act of 2008.

¹⁹¹ *Lazenby v Lazenby Vervoer VV* 2014 ZANWHC 41 para 23.

¹⁹² Levenstein (2022) 8.2.2 footnote 2; *Griessel v Lizemore* 2015 4 All SA 433 (GJ) para 82.

¹⁹³ *ABSA Bank Ltd v Golden Dividend 339 (Pty) Ltd* 2015 5 SA 272 (GP) paras 58-61.

¹⁹⁴ *Griessel v Lizemore* 2015 4 All SA 433 (GJ) para 83.

¹⁹⁵ *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* para 29.

¹⁹⁶ *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* para 29.

¹⁹⁷ *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* para 29.

¹⁹⁸ Section 129(2)(a)-(b) of the Companies Act of 2008.

The reason for this is that all legal proceedings against the company, including liquidation proceedings, will be subject to a moratorium, and the filing requirements seek to avoid the board using a business rescue resolution to thwart a liquidation application with no intention of filing it.¹⁹⁹

Within five business days after a company has adopted and filed a resolution (or as long as the CIPC may allow on application), it must:

- publish a notice of the resolution, its effective date, in the prescribed manner to every affected person, accompanied by a sworn statement of the facts relevant to the grounds on which the board resolution was founded;
- and appoint a business rescue practitioner who satisfies the requirements of the Act and has consented in writing to the appointment.²⁰⁰

After appointing a business rescue practitioner, the company must file a notice of the appointment of the practitioner within two business days after making the appointment; and publish a copy of the notice of appointment to each affected person within five business days after the notice was filed.²⁰¹

If a company fails to undertake the requirements listed above, the resolution will lapse and become a nullity.²⁰² The company will also not be able to file another resolution for a period of three months from the date on which the previous resolution was adopted.²⁰³ If a company has adopted a business rescue resolution, it cannot adopt another to enter into liquidation unless the business rescue resolution has lapsed, or business rescue proceedings have ended.²⁰⁴

If the board had reasonable grounds to believe that the company is financially distressed but did not adopt a resolution to enter into business rescue, the company must send a written notice

¹⁹⁹ See section 133 of the Companies Act of 2008; *Sulzer Pumps (South Africa) (Pty) Ltd v O & M Engineering CC* 2015 JOL 32825 (GP) para 28.

²⁰⁰ Section 129(3)(a)-(b) of the Companies Act of 2008.

²⁰¹ Section 129(4)(a)-(b) of the Companies Act of 2008.

²⁰² Section 129(5)(a)-(b) of the Companies Act of 2008.

²⁰³ Section 129(5)(b) of the Companies Act of 2008.

²⁰⁴ Section 129(6) of the Companies Act of 2008.

to each affected person setting out its reasons for not doing so.²⁰⁵ However, such notice may encourage an affected person to bring an application for compulsory business rescue.²⁰⁶

At any time after the resolution has been adopted, until a business rescue plan has been adopted, an affected person may apply for a court order:

- setting aside the resolution on the grounds that there is no reasonable basis for believing that the company is financially distressed, there is no reasonable prospect of rescuing the company, or the company has failed to follow the procedural requirements (discussed above);
- setting aside the appointment of a practitioner on the grounds that the practitioner does not satisfy the requirements of the Act, is not independent of the company or its management, or lacks the necessary skills having regard to the company's circumstances; or
- requiring the practitioner to provide security to secure the interests of the company and its shareholders.²⁰⁷

A person who applies to court must serve a copy of the application on the company, CIPC, and notify each affected person.²⁰⁸ Each affected person will have the right to participate in the hearing of the matter.²⁰⁹ When considering setting aside the resolution or if considered just and equitable, the court may decide to afford the practitioner sufficient time to form an opinion whether or not the company appears to be financially distressed and whether there is a reasonable prospect of rescuing the company.²¹⁰ Following a report from the practitioner, the court will then decide if the resolution should be set aside.²¹¹ If it sets aside the company's resolution, the court may take further steps and place the company in liquidation.²¹² If there were no reasonable grounds to believe that the company would be unlikely to pay its debts, an order of costs may be awarded against any director who voted in favour of the business rescue resolution, unless the court is satisfied it was done in good faith.²¹³ If the court sets aside the

²⁰⁵ Section 129(7) of the Companies Act of 2008.

²⁰⁶ See section 131 of the Companies Act of 2008; *Lazenby v Lazenby Vervoer VV* 2014 ZANWHC 41 para 21.

²⁰⁷ Section 130(1) of the Companies Act of 2008.

²⁰⁸ Section 130(3) of the Companies Act of 2008.

²⁰⁹ Section 130(4) of the Companies Act of 2008.

²¹⁰ Section 130(5) of the Companies Act of 2008.

²¹¹ Section 130(5) of the Companies Act of 2008.

²¹² Section 130(5) of the Companies Act of 2008.

²¹³ Section 130(5) of the Companies Act of 2008.

appointment of a practitioner, the court must appoint an alternate practitioner, recommended or accepted by the holders of a majority of the independent creditors' voting interests.²¹⁴

Under this method of commencement, business rescue is deemed to have commenced when the company filed a resolution to place itself under supervision; or applied to the court for consent to file a resolution.²¹⁵

(ii) Compulsory commencement

Unless a company has adopted a resolution as discussed above, any affected person may apply to a court for an order placing the company in business rescue.²¹⁶ The applicant must serve a copy of this application on the company and the CIPC, and notify each affected person as these persons will have the right to participate in the hearing.²¹⁷ The court may make an order placing the company under business rescue and supervision if it is satisfied that the company is financially distressed; the company has failed to pay an amount in terms of an obligation in terms of public regulation, or employment contracts; or it is otherwise just and equitable to do so for financial reasons; and there is a reasonable prospect of rescuing the company.²¹⁸ Alternatively, the court may dismiss the application and give a different order, such as placing the company in liquidation.²¹⁹

This application should not be an abuse of process and should be brought in good faith and for the proper purpose of rescuing the company – not for ulterior motives, such as suspending liquidation for a personal benefit.²²⁰ This is important because if liquidation proceedings have already commenced when this application is brought, it will suspend the liquidation proceedings until the court has adjudicated on the matter or business rescue proceedings have ended.²²¹ A company which has been placed under supervision must also notify each affected person of the business rescue order within five business days of the order being given.²²²

²¹⁴ Section 130(6) of the Companies Act of 2008.

²¹⁵ Section 132(1)(a)(i)-(ii) of the Companies Act of 2008.

²¹⁶ Section 131(1) of the Companies Act of 2008.

²¹⁷ Section 131(2) and (3) of the Companies Act of 2008.

²¹⁸ Section 131(4) of the Companies Act of 2008.

²¹⁹ Section 131(4)(b) of the Companies Act of 2008.

²²⁰ *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 (Pty) Ltd* 2012 2 SA 423 (WCC) para 3.

²²¹ Section 131(6) of the Companies Act of 2008.

²²² Section 131(8) of the Companies Act of 2008.; see *Mouton v Park 2000 Development 11 (Pty) Ltd* 2019 4 All SA 133 (WCC) para 65.

Under this form of commencement, business rescue is deemed to have commenced when an affected person applied to the court for an order placing the company under supervision or when a court made an order placing the company under supervision during liquidation proceedings.²²³

4.5.3. The business rescue timeline

Once business rescue has commenced, the Act prescribes certain milestones to be completed within certain timeframes. These are outlined below.²²⁴

- Directors' duties: the directors must provide the business rescue practitioner with all books and records of the company as soon as is practicable after business rescue has commenced.²²⁵ The directors are then required to provide a statement of affairs to the business rescue practitioner within five business days of the commencement of business rescue.²²⁶
- The business rescue practitioner: as soon as possible after his appointment, the practitioner must inform all regulatory authorities of the commencement of business rescue.²²⁷ The practitioner also begins to execute his duties in accordance with the timelines discussed below.
- Creditors and employees' meetings: within ten business days after being appointed, the business rescue practitioner must give notice of, convene and preside over, separate meetings of the creditors and employees of the company.²²⁸
- Meeting to consider the plan: within ten business days after publishing a business rescue plan in terms of section 150, the business rescue practitioner must convene and preside over a meeting of creditors, and any other holders of a voting interest, for the purpose of considering the plan.²²⁹ At least five business days before the meeting, the practitioner must deliver a notice of the meeting to all affected persons setting out the details of the meeting, the agenda, and a summary of the rights of affected persons to

²²³ Section 132(1)(b)-(c) of the Companies Act of 2008.

²²⁴ Levenstein (2022) 9.1.

²²⁵ Section 142(1) of the Companies Act of 2008.

²²⁶ Section 142(3) of the Companies Act of 2008.

²²⁷ Section 140(1A) of the Companies Act of 2008.

²²⁸ Sections 147 and 148 of the Companies Act of 2008.

²²⁹ Section 151(1) of the Companies Act of 2008.

vote and participate in the meeting.²³⁰ The meeting may be adjourned from time to time, as is necessary or expedient, until a decision regarding the company's future has been taken.²³¹

- The end of business rescue: within three months after the start of proceedings, or such longer time as the court allows, business rescue will end either through the court setting aside the resolution; the court converting the proceedings into liquidation; the practitioner filing a notice with the CIPC that business rescue proceedings have terminated; a business rescue plan has been rejected and no further steps have been taken; or a business rescue plan has been adopted and implemented.²³²

4.5.4. The business practitioner's powers and duties

During business rescue, the practitioner:

- has full management control of the company in substitution for its board and pre-existing management, which entails the practitioner being more than a figurehead responsible for the rehabilitation of the company;²³³
- may delegate any power or function of the practitioner to a person who was part of the board or pre-existing management of the company;²³⁴
- may remove from office any person who forms part of the pre-existing management of the company or appoint a person as part of the management of a company, whether to fill a vacancy or not;²³⁵
- must investigate the affairs, business, property financial position of the company, to determine whether there is a reasonable prospect of the company being rescued;²³⁶ and
- is responsible for developing a business rescue plan to be considered by affected persons, and implementing a business rescue plan which has been adopted.²³⁷

²³⁰ Section 151(2) of the Companies Act of 2008.

²³¹ Section 151(3) of the Companies Act of 2008.

²³² Section 132(2) and (3) of the Companies Act of 2008.

²³³ Section 140(1)(a) of the Companies Act of 2008; *Booyesen v Jonkheer Boerewynmakery (Pty) Ltd (in Business Rescue)* 2017 4 SA 51 (WCC) para 68.

²³⁴ Section 140(1)(b) of the Companies Act of 2008; *Murgatroyd v Van den Heever* NO 2014 4 All SA 89 (GJ) para 16.

²³⁵ Section 140(1)(c) of the Companies Act of 2008.

²³⁶ Section 141(1) of the Companies Act of 2008.

²³⁷ Section 140(1)(d) of the Companies Act of 2008.

4.5.5. First meeting of creditors and employees

At the first meeting of creditors, the practitioner will inform the creditors whether he is of the opinion that there is a reasonable prospect of rescuing the company and creditors may prove their claims.²³⁸ The creditors may also decide whether they wish to establish a creditor committee.²³⁹ At the employees' meeting, the practitioner will also inform the representatives whether there is a reasonable prospect of rescuing the company and it may be determined whether an employees' committee will be established.²⁴⁰

4.5.6. The business rescue plan and proposal

The practitioner must prepare a business rescue plan after consulting with creditors, affected persons, and the management of the company.²⁴¹ This rescue plan must be aimed at rescuing the company. Any plan that is aimed at controlled liquidation or the winding-down of the company will not comply with the requirements of the Act.²⁴² The Act contains a framework outlining the information that must be included in the proposal in order to assist creditors in deciding whether or not to accept or reject the plan. This is divided into three parts and is outlined below.

The background forms part A and must include (as a minimum):

- a complete list of all the material assets of the company and an indication as to which assets were held as security when business rescue began;
- a complete list of the creditors of the company when business rescue began and an indication as to which creditors would qualify as secured, statutory preferent, and concurrent in terms of insolvency law, and an indication of which creditors have proved their claims;
- the probable dividend that would be received by creditors, in their specific classes, if the company were to be placed in liquidation;
- a complete list of the holders of the company's issued securities;
- a copy of the written agreement concerning the practitioner's remuneration; and

²³⁸ Section 147(1)(a) of the Companies Act of 2008.

²³⁹ Section 147(1)(b) of the Companies Act of 2008.

²⁴⁰ Section 148(1) of the Companies Act of 2008.

²⁴¹ Section 150(1) of the Companies Act of 2008.

²⁴² *National Union of Metalworkers of SA v VR Laser Services (Pty) Ltd* 2020 2 All SA 536 (GJ) para 16.

- a statement whether the business rescue plan includes a proposal made informally by a creditor of the company.²⁴³

The proposal part forms part B and must include (as a minimum):

- the nature and duration of any moratorium for which the business rescue plan makes provision;
- the extent to which the company is to be released from its debts, and the extent to which any debt is proposed to be converted into equity in the company;
- the ongoing role of the company, and the treatment of any existing agreements;
- the property of the company that is to be available to pay creditors' claims in terms of the business rescue plan;
- the order of preference in which the proceeds of property will be applied to pay creditors if the business rescue plan is adopted;
- the benefits of adopting the business rescue plan as opposed to the benefits that would be received by creditors if the company were in liquidation; and
- the effect that the business rescue plan will have on the holders of each class of the company's issued securities.²⁴⁴

Part C contains information about the assumptions and conditions relevant to the plan, including (as a minimum):

- a statement of conditions that must be satisfied, if any, for the business rescue plan to come into operation and be fully implemented;
- the foreseen effect, if any, on the number of employees and their terms and conditions of employment;
- the circumstances under which the business rescue plan will end; and
- a projected balance sheet for the company and statement of income and expenses for the ensuing three years, prepared on the assumption that the proposed business plan is adopted.²⁴⁵

²⁴³ Section 150(2)(a)(i)-(vi) of the Companies Act of 2008.

²⁴⁴ Section 150(2)(b) of the Companies Act of 2008.

²⁴⁵ Section 150(2)(c) of the Companies Act of 2008.

4.5.7. Meeting to consider the plan

At a meeting called to consider the proposed plan, the practitioner will introduce the plan to the creditors for consideration and, if applicable, the shareholders; inform the attendees as to whether he is of the opinion that there is still a reasonable prospect of the company being rescued; provide an opportunity for the employees' representatives to address the meeting; invite discussions; conduct a vote on any motions to amend the proposed plan or motions to direct the practitioner to adjourn the meeting to revise the plan for further consideration; and call for a vote for preliminary approval of the proposed plan, if the meeting was not adjourned.²⁴⁶

The plan will be preliminarily approved if it was supported by the holders of more than 75% of the creditors' voting interests that were voted, and the votes in support of the plan included at least 50% of the independent creditors' voting interests.²⁴⁷ If the plan did not comply with the requirements of a business rescue plan, it cannot be approved, and any approval voted upon will be null and void.²⁴⁸ A business rescue plan which has been adopted will be binding on the company, each creditor, and every holder of securities, even if these individuals were not present at the meeting.²⁴⁹

If the business rescue plan was rejected, the practitioner may seek a vote of approval from the holders of voting interests to prepare and publish a revised plan; or advise the meeting that the company will apply to the court to set aside the result of the vote on the grounds that it was inappropriate.²⁵⁰ A vote may be considered inappropriate if the court considers it just and reasonable to set it aside, having regard to the interests of the persons who voted against the proposed plan; the provision, if any, made in the plan for the interests of these persons; and the fair and reasonable estimate of the return to these persons if the company were to be liquidated.²⁵¹ If the practitioner does not take such steps, an affected person may take these steps.²⁵²

²⁴⁶ Section 152(1) of the Companies Act of 2008.

²⁴⁷ Section 152(2) of the Companies Act of 2008.

²⁴⁸ *National Union of Metalworkers of SA v VR Laser Services (Pty) Ltd* 2020 2 All SA 536 (GJ) para 17.

²⁴⁹ Section 152(4)(a) of the Companies Act of 2008.

²⁵⁰ Section 153(1)(a) of the Companies Act of 2008.

²⁵¹ Section 153(7) of the Companies Act of 2008; *Shoprite Checkers (Pty) Ltd v Berryplum and Others* 2015 ZAGPPHC para 40.

²⁵² Section 153(1)(b) of the Companies Act of 2008.

4.5.8. Effect of business rescue proceedings

The commencement of business proceedings has certain effects on legal proceedings, property interests, post-commencement finance, employees and contracts, shareholders and directors. Each of these will be briefly discussed.

During business rescue, there will be a general moratorium on legal proceedings against the company, including enforcement actions.²⁵³ The legal proceedings in this regard, or those in relation to property belonging to the company, may be commenced if the written consent of the practitioner is given or with the leave of the court.²⁵⁴ This moratorium is not meant to serve as an absolute bar on proceedings, but serves as a procedural limitation on the party's right of action.²⁵⁵ However, this does not apply to criminal proceedings against the company or its directors.²⁵⁶

During business rescue, the company may dispose of property only in the ordinary course of business; in a *bona fide* transaction at arm's length for fair value approved in advance and in writing by the practitioner; or in a transaction undertaken as part of the implementation of an approved business plan.²⁵⁷ "Property" in this regard refers to real rights, personal rights, immaterial property rights, and patrimonial objects.²⁵⁸

Post-commencement finance is defined as two transactions that take place during business rescue. The first is any payment owed to an employee for services rendered during business rescue which has not yet been paid.²⁵⁹ The second is any other additional financing obtained during business rescue.²⁶⁰ The second type of financing may be essential in providing working capital to enable the company to continue operations.²⁶¹ These financiers, due to the nature of the firm being under business rescue, takes on considerable risk in their financing. To compensate these financiers for this risk, the Act affords them a preferent claim in business rescue.²⁶² The order of preference will then be: (1) remuneration, expenses and claims of the

²⁵³ Section 133(1) of the Companies Act of 2008.

²⁵⁴ Section 133(1)(a)-(b) of the Companies Act of 2008.

²⁵⁵ *Commissioner for the South African Revenue Service v Louis Pasteur Investments (Pty) Ltd (in provisional liquidation)* 2022 (5) SA 179 (GP) paras 54-56.

²⁵⁶ Section 133(1)(d) of the Companies Act of 2008.

²⁵⁷ Section 134(1)(a) of the Companies Act of 2008.

²⁵⁸ Muller *et al* *Silberberg and Schoeman's: The Law of Property* (2019) 2.5.

²⁵⁹ Section 135(1) of the Companies Act of 2008.

²⁶⁰ Section 135(2) of the Companies Act of 2008.

²⁶¹ Loubser "Post-commencement financing and the ranking of claims: A South African Perspective" in Perry (ed) *European Insolvency Law: Current Issues and Prospects for Reform* (2014) 29.

²⁶² Section 135(3) of the Companies Act of 2008.

business rescue practitioner during business rescue proceedings;²⁶³ (2) employee remuneration from the date business rescue commenced;²⁶⁴ (3) secured post-commencement finance; (4) unsecured post-commencement finance; (5) secured creditors for transactions that took place before business rescue commenced (pre-commencement); (6) employee remuneration that became due and payable before business rescue commenced; and (7) unsecured pre-commencement finance.²⁶⁵

During business rescue, the contracts of employees that were employed immediately before proceedings commenced will continue under the same conditions except to the extent that changes occur in the ordinary course of attrition; or the employees and the company agree different terms and conditions in accordance with labour law; and any entrenchment of employees contemplated in the plan takes the considerations of section 189 and 189A of the Labour Relations Act 66 of 1995 into account.²⁶⁶ What this means is not that the continuity of employment is guaranteed, but rather that the current conditions of employment will be preserved.²⁶⁷ If employees are to be retrenched in terms of the plan, they can only be retrenched in accordance with section 189 and 189A of the Labour Relations Act.

During business rescue, shareholders may not alter their issued securities other than transferring them in the ordinary course of business.²⁶⁸ Any other alteration will be invalid unless the court directs otherwise, or if it has been stipulated in an approved plan.²⁶⁹ During these proceedings, the directors will continue with their functions subject to the authority given to them by the practitioner and have a duty to exercise the management of the company in accordance with the direction of the practitioner.²⁷⁰ It is important to note, that this applies to individual directors and not the board of directors.²⁷¹

²⁶³ Section 143 of the Companies Act of 2008.

²⁶⁴ Section 135(3) of the Companies Act of 2008.

²⁶⁵ This ranking was confirmed in the case of *Merchant West Working Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company (Pty) Ltd* 2013 ZAGPJHC 109 para 21.

²⁶⁶ Section 136(1) of the Companies Act of 2008.

²⁶⁷ *Solidarity obo BD Fourie v Vanchem Vanadium Products (Pty) Ltd; In re: National Union of Metalworkers (NUMSA) obo Members v Vanchem Vanadium Products (Pty) Ltd* 2016 ZALCJHB 106 para 35.

²⁶⁸ Section 137(1) of the Companies Act of 2008.

²⁶⁹ Section 137(1) of the Companies Act of 2008.

²⁷⁰ Section 137(2)(a)-(c) of the Companies Act of 2008.

²⁷¹ *Caratco (Pty) Ltd v Independent Advisory (Pty) Ltd* 2020 5 SA 35 (SCA) para 16.

4.5.9. The end of business rescue

Business rescue proceedings will end under the following circumstances: when the court sets aside the resolution; when the court converts the proceedings into liquidation; when the practitioner has filed with the CIPC that business rescue proceedings have terminated; when a business rescue plan has been rejected and no further steps have been taken; or when a business rescue plan has been adopted and implemented.²⁷²

Part B: How South Africa's mechanisms align with international best practice

4.6. A definition of zombie companies

As a point of departure regarding South Africa's alignment with international best practice, it needs to be mentioned that South Africa does not have a definition of zombie companies in its legal frameworks. South Africa also does not have any legislation or mechanisms in place, designed particularly for zombie companies. The discussion of Part A illustrated the available mechanisms in South African law for companies in financial difficulty. From these mechanisms, a definition that has a bearing on zombie companies is the definition of "financially distressed" companies for purposes of business rescue.²⁷³ As these companies are unlikely to be able to pay all their debts as they become due and payable within the next six months or will become insolvent in the next six months, it is similar to the balance sheet characteristics of zombie companies defined in Chapter 2. However, it is not a perfect fit as zombie companies have already reached the point of no return. Accordingly, it is preferred that a definition and criterion of zombie companies be developed to identify these companies in a South African context.

4.7. South Africa's scoring of OECD key indicators

This section seeks to unpack South Africa's scoring on the OECD key indicators identified in Chapter 3. This scoring was captured in 2022, and assessed South Africa's insolvency regime on its treatment of failed entrepreneurs; prevention and streamlining; restructuring tools; and other factors such as the degree of court involvement, the distinction between fraudulent and honest bankrupts and the rights of employees.

²⁷² Section 132(2) and (3) of the Companies Act of 2008.

²⁷³ Section 128(1)(f) of the Companies Act of 2008.

South Africa's scoring will be summarised below whereafter each criterion will be discussed. The scoring system is calculated as is outlined in Chapter 3. As a reminder of the scoring system, the closer a scoring is to 0, the closer it is to suggested international best practice.

Insolvency indicator	2022
<u>Treatment of failed entrepreneurs</u>	
Time to discharge	1
Exemption of assets	0.5
<u>Prevention and streamlining</u>	
Early warning mechanisms	1
Pre-insolvency regimes	0
Special procedures for SMEs	1
<u>Restructuring tools</u>	
Initiation of restructuring by creditors	0
Length of stay on assets	1
Possibility and priority of new financing	1
Possibility to "cram-down" on dissenting creditors	0
Dismissal of management during restructuring	1
<u>Other factors</u>	
Degree of court involvement	0.1
Distinction between honest and fraudulent bankrupts	0
Rights of employees	1

4.7.1. The treatment of failed entrepreneurs

(i) The time to discharge

International best practice in this regard, that would garner a score of 0, is if the time to discharge is less than or equal to one year.²⁷⁴ South Africa scored 1, which represents a time to discharge being greater than three years.²⁷⁵ In respect of personal insolvency, which applies in cases of entrepreneurs such as sole proprietors and partnerships, South African law provides

²⁷⁴ OECD "The OECD Insolvency Indicator: Data 2022" 2022, available at <https://www.oecd.org/economy/growth/oecd-insolvency-indicator.htm> (last accessed 2023-11-2).

²⁷⁵ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

for discharge if the entrepreneur is rehabilitated.²⁷⁶ When a debtor is rehabilitated, one of the effects is that all the debts of the debtor which were due or had arisen before the sequestration, and which did not arise due to fraud, will be discharged.²⁷⁷ Rehabilitation can take place in two ways: automatically after ten years or by an order of court within the 10-year period. A debtor will be automatically rehabilitated at the expiry of 10 years from the date of sequestration.²⁷⁸ This period begins to run from the date of provisional sequestration.²⁷⁹

There are certain circumstances whereby a debtor may approach the court for earlier rehabilitation. However, even if the particular provisions have been complied with, the court is not obliged to grant this rehabilitation order, nor is an insolvent entitled to rehabilitation.²⁸⁰ Rehabilitation may be sought from the court under the following circumstances:

Composition of not less than 50 cents in the rand: An insolvent may apply for rehabilitation, if he or she has obtained a certificate from the Master stating that the creditors have accepted an offer of composition, in which payment has been made or security has been given, and every concurrent claim proven has received at least 50 cents in the rand.²⁸¹ However, this application will only be considered if three weeks prior to the application, notice was posted in the Government Gazette publishing the intention of the insolvent to apply for rehabilitation and the trustee of his estate was given a copy of that notice.²⁸²

Lapse of the prescribed period – an insolvent may apply to be rehabilitated:

- after 6 months have elapsed from the date of sequestration if no claim has been proven against the estate, the insolvent has not been convicted of any fraudulent act in relation to his insolvency, and has not been sequestrated before;²⁸³
- after 12 months have elapsed since the trustee's account of his estate has been confirmed by the Master;²⁸⁴
- after 3 years have elapsed since the account was confirmed, if the insolvent has been previously sequestrated;²⁸⁵

²⁷⁶ Section 129(1)(b) of the Insolvency Act.

²⁷⁷ Section 129(1)(b) of the Insolvency Act.

²⁷⁸ Section 127A(1) of the Insolvency Act.

²⁷⁹ *Grevler v Landsdown en 'n ander* 1991 3 SA 175 (T).

²⁸⁰ *Cf Ex Parte Woolf* 1958 4 SA 190 (N); *Ex Parte Hittersay* 1974 4 SA 326 (SWA).

²⁸¹ Section 124(1) of the Insolvency Act.

²⁸² Section 124(1) of the Insolvency Act.

²⁸³ Section 124(3) of the Insolvency Act.

²⁸⁴ Section 124(2)(a) of the Insolvency Act.

²⁸⁵ Section 124(2)(b) of the Insolvency Act.

- after 5 years have elapsed from the date of the conviction of the insolvent, where the insolvent has been convicted of a fraudulent act in relation to his insolvency;²⁸⁶ or
- after 4 years have elapsed from the date of sequestration, if the Master has recommended that the insolvent be rehabilitated.²⁸⁷

Payment of all claims: If the Master confirms a plan of distribution which provides for the payment in full of all claims proved against the estate, with interest and the costs of sequestration settled, the insolvent may apply to be rehabilitated.²⁸⁸

Unfortunately, rehabilitation in the sense described above does not apply to corporate entities. In addition, section 128 of the Insolvency Act determines that a partnership cannot be rehabilitated. Companies or close corporations are deregistered at the end of the formal liquidation process, which means that business entities are not rehabilitated and do not obtain a discharge of debt and a subsequent fresh start in the market.

(ii) The exemption of assets

International best practice in this regard provides that pre-bankruptcy assets exempted from the insolvent estate should be more generous than modest personal and working items and, for instance, the debtor's house is excluded.²⁸⁹ South Africa was awarded a score of 0.5, to reflect that only modest personal items and working equipment are exempted, such as the assets and income required to cover the subsistence of the debtor.²⁹⁰ The insolvent may also recover remuneration for work done after sequestration, to the extent that is necessary for the support of the insolvent and their dependants.²⁹¹

Under South African insolvency law, the wearing apparel, bedding, whole or part of the insolvent's household furniture, and tools and other essential means of subsistence, as the creditors may determine, will be exempted from the insolvent estate.²⁹² Interestingly, South African insolvency law does not provide any protection for the primary residence of the debtor. As the home falls part of the estate, the trustee may, in principle, order that the debtor and his

²⁸⁶ Section 124(2)(c) of the Insolvency Act.

²⁸⁷ Section 124(2) proviso of the Insolvency Act.

²⁸⁸ Section 124(5) of the Insolvency Act.

²⁸⁹ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

²⁹⁰ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

²⁹¹ Section 23(9) read with Section 23(5) of the Insolvency Act.

²⁹² Section 82(6) of the Insolvency Act.

family vacate the premises.²⁹³ However, certain debtors have used the Prevention of Illegal Eviction From and Unlawful Occupation of Land Act 19 of 1998, to aid them in these situations.²⁹⁴ However, this Act only ensures that a particular process is followed before individuals are evicted, and does not protect debtors from this eviction in entirety, nor can it prevent it if the correct process is followed.²⁹⁵

Insofar as corporate entities are concerned, the concept of excluded and exempted assets does not apply because these entities cease to exist after completion of the formal liquidation process.

4.7.2. Prevention and streamlining

(i) Early warning mechanisms

International best practices require that an insolvency regime should provide for early warning mechanisms, such as an online self-test or training.²⁹⁶ South Africa scored a 1 in this regard, as its insolvency regimes do not have early warning mechanisms in place to aid debtors in identifying whether they are entering into a precarious financial position.²⁹⁷ The closest mechanism akin to an early warning mechanism is the components of “financial distress” in business rescue. In terms of section 129(7) of the 2008 Companies Act, the board of a company in financial distress, which does not choose to enter business rescue proceedings voluntarily, must inform affected persons of the state of the company and the reasons for not opting for business rescue. Should an affected person wish to do so, an application can be brought to court to initiation proceedings in accordance with section 131. Although this arguably protects affected persons, it does not provide director *per se* with an accessible, early warning mechanism created specifically for the purpose of enabling the company to seek assistance. It merely reiterates that directors who have a reasonable suspicion of distress to consider business rescue and inform affected persons accordingly.

²⁹³ Boraine “Does the prevention of illegal eviction from and unlawful occupation of Land Act of 1988 provide adequate family home protection to insolvent debtors or is it still pie in the sky? (Part 1) 2020 *OBITER* 223.

²⁹⁴ See *ABSA Bank v Murray* 2004 2 SA 15 (CPD); *Mayekiso v Patel* 2019 2 SA 522 (WCC).

²⁹⁵ Boraine “Does the prevention of illegal eviction from and unlawful occupation of Land Act of 1988 provide adequate family home protection to insolvent debtors or is it still pie in the sky? (Part 2)” 2020 *OBITER* 902

²⁹⁶ OECD “The OECD Insolvency Indicator: Data 2022” 2022.

²⁹⁷ OECD “The OECD Insolvency Indicator: Data 2022” 2022.

(ii) Pre-insolvency regimes

A country which scored a 0, is arguably in line with international best practice if it has pre-insolvency regimes in place. South Africa scored a 0 with its pre-insolvency regimes of business rescue and compromise with creditors, which was discussed in Part A. Unfortunately, it is unclear whether the assessors considered the fact that companies that are already insolvent and in liquidation may still seek business rescue and an order to this effect will suspend liquidation proceedings in accordance with section 131(6) of the 2008 Companies Act. In addition, the second outcome of business rescue articulated in section 128(1)(b) (iii) of the Companies Act is essentially an orderly winding-down of the company, which makes it difficult to view business rescue solely as a ‘pre-insolvency’ procedure.²⁹⁸

(iii) Special procedures in place for SMEs

If a country has special procedures in place for SMEs, a score of 0 is given, and a score of 1 is given if there is none.²⁹⁹ South Africa was scored a 1, as South Africa’s insolvency framework does not provide a comprehensive and specialised process for SMEs in financial distress.³⁰⁰

4.7.3. Restructuring tools

(i) Initiation of restructuring by creditors

If a creditor can initiate both liquidation and restructuring proceedings, a value of 0 is given. South Africa scored a 0 as creditors can initiate both liquidation and business rescue. Creditors can initiate liquidation proceedings by approaching the court for an order that the company be placed under compulsory winding-up, as discussed in Part A.³⁰¹ Creditors may also initiate business rescue proceedings, as affected persons, by approaching the court for an order to place the company under supervision, as discussed in Part A.³⁰²

²⁹⁸ O’Brien and Calitz 2021 *TSAR* 695.

²⁹⁹ OECD “The OECD Insolvency Indicator: Data 2022” 2022.

³⁰⁰ OECD “The OECD Insolvency Indicator: Data 2022” 2022; Boraine and Van Wyk 2016 *International Insolvency Review* 4.

³⁰¹ Section 343(1)(a); 344(f) of the Companies Act of 1973.

³⁰² Section 131 of the Companies Act of 2008.

(ii) Length of stay on assets

If a country limits the duration of the moratorium, a value of 0 is given and if the stay is indefinite, a value of 1 is given.³⁰³ South Africa was awarded a 1. South Africa's business rescue provisions, throughout the entire process of business rescue, provides for a general moratorium on legal proceedings against the company and the protection of property interests, as discussed in Part A.³⁰⁴ This moratorium remains in place if business rescue proceedings are extended as described in Part A above.

(iii) Possibility and priority of new financing

If new financing only has priority over unsecured creditors, a value of 0 is given. If it has priority over both secured and unsecured creditors, a value of 0.5 is given and if it has no priority, a value of 1 is given. In this regard, South Africa was scored a 1.³⁰⁵ However, it is submitted that this is an incorrect score. Post-commencement financing is provided for in business rescue, and is afforded a preferential ranking. In terms of this ranking, post-commencement financiers are given priority ranking over unsecured pre-commencement creditors and may become secured creditors due to the ability to take on unencumbered assets as collateral for providing post-commencement financing, as explained in Part A.³⁰⁶ Accordingly, the correct score in this regard would be a 0.

(iv) The possibility of cram-down on dissenting creditors

If there is a cram-down provision, coupled with a provision stating that the dissenting creditors receive as much in restructuring as they would in liquidation, a score of 0 is given. South Africa was scored a 0.³⁰⁷ In terms of South Africa's business rescue provisions, when a business plan is adopted, dissenting creditors will be bound to it.³⁰⁸ Although this has the effect of cramming-down on dissenting creditors, there is no provision stipulating that dissenting creditors will receive what they would in liquidation. Accordingly, the incorrect score was given, and the correct score would be a 0.5.

³⁰³ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

³⁰⁴ Section 133 and 134 of the Companies Act of 2008.

³⁰⁵ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

³⁰⁶ Section 135(3) of the Companies Act 2008; *Merchant West Working Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company (Pty) Ltd* 2013 ZAGPJHC 109 para 21.

³⁰⁷ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

³⁰⁸ Section 152(4)(b) of the Companies Act of 2008.

(v) Dismissal of management during restructuring

The dismissal of management under this criterion does not refer to actually dismissing management, but concerns whether management retains control of the firm during restructuring.³⁰⁹ If management retains control of the firm, a score of 0 is given as it incentivises early filing.³¹⁰ A score of 1 is given if management does not retain this control. South Africa was given a score of 1. Under South Africa's business rescue provisions, the business rescue practitioner has full management control of the company in substitution for its board and pre-existing management.³¹¹

4.7.4. Other factors

(i) The degree of court involvement

In assessing the degree of involvement, the score is based on the number of stages the court is involved in when it comes to liquidation and restructuring. These two scores are reworked to a single score between 0 and 1. South Africa scored 0.1. This is a good score which illustrates that court involvement is limited. This can be attributed to the key roles that the liquidator and business rescue practitioner play as supervisors and key decision-makers in these proceedings.

(ii) The distinction between honest and fraudulent bankrupts

A score of 0 is given if there is a distinction between honest and fraudulent bankrupts in the insolvency process. South Africa scored 0. A distinction is made between honest and fraudulent insolvents as was seen in the discussion above, regarding the rehabilitation and discharge of individual debtors. Where honest debtors can apply for rehabilitation 12 months after the account is confirmed, fraudulent bankrupts may only do so after 5 years.³¹²

When it comes to business rescue, no distinction is made between companies whose distress is due to poor management and those whose distress was due to no fault of their own. However, the 2008 Companies Act provides for directors and prescribed officers to be held to account for non-compliance with their duties in terms of sections 22 (reckless trading), 76 (fiduciary

³⁰⁹ Andre and Demmou 2022 *OECD Economics Department Working Papers* 12.

³¹⁰ Andre and Demmou 2022 *OECD Economics Department Working Papers* 12; OECD "The OECD Insolvency Indicator: Data 2022" 2022.

³¹¹ Section 140(1)(a) of the Companies Act of 2008.

³¹² Section 124(2)(a) and (c) of the Insolvency Act.

duty and duty of care and skill) and 77 (specific provisions that impose personal liability on directors and prescribed officers).

(iii) Rights of employees

In assessing the rights of employees, the scoring is conducted for restructuring and liquidation, and then reworked to a value between 0 and 1. South Africa scored 1. A score of 1 is given in two scenarios: if there are no restrictions on the ability to dismiss employees upon the initiation of insolvency proceedings but it is not possible to renegotiate collective dismissal agreements with employees; or there are restrictions on the ability to dismiss employees upon the initiation of insolvency proceedings, but it is possible to renegotiate collective dismissal agreements.³¹³

In terms of liquidation, the 1973 Companies Act, which provides for the winding-up of insolvent companies, states that the provisions of the Insolvency Act will apply *mutatis mutandis* in respect of any matter not regulated by the 1973 Companies Act.³¹⁴ Accordingly, the provisions of the Insolvency Act relating to employees will apply. According to the Insolvency Act, contracts of employment will be suspended from the date on which an order of winding-up is granted.³¹⁵ During this suspension, the employees do not have to perform work for the company nor are they entitled to wages.³¹⁶ However, before a liquidator may terminate a contract of employment, there are certain requirements that must be met.³¹⁷ One of these requirements, is that the liquidator must consult in terms of a collective agreement or with employees' representatives on measures to save part or whole of the business.³¹⁸ In these discussions, it may be agreed that employment be continued.³¹⁹ In this agreement, this continuance may be in whole or in part. Accordingly, under liquidation, a score of 1 is given as there are restrictions on the ability to dismiss employees, but it is possible to renegotiate collective dismissal agreements.

In respect of business rescue, any retrenchment of employees is subject to section 189 and 189A of the Labour Relations Act.³²⁰ In terms of these provisions, prior to dismissing employees, the liquidator will have to consult in terms of a collective agreement, or with the

³¹³ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

³¹⁴ Section 339 of the Companies Act of 1973.

³¹⁵ Section 38(1) of the Insolvency Act.

³¹⁶ Section 38(2) of the Insolvency Act.

³¹⁷ See section 38(5)(a)-(d) of the Insolvency Act.

³¹⁸ Section 38(5); 35(6) of the Insolvency Act.

³¹⁹ Section 38(9) of the Insolvency Act.

³²⁰ Section 136 of the Companies Act of 2008.

employees' representatives.³²¹ During this consultation, negotiation will take place regarding various considerations, including how to minimise the number of dismissals and the method of selecting the employees to be dismissed.³²² Accordingly, South Africa is given a score of 1 under business rescue, as there are restrictions on the ability to dismiss employees, but it is possible to renegotiate collective dismissal agreements.

4.8. Summary of South Africa's alignment with international best practices

The overall score for South Africa, for all thirteen key indicators, was a score of 0.58 in 2022.³²³ This places South Africa 42nd out of 45 countries.

South Africa is in line with international best practice in respect of pre-insolvency procedures; a system which enables creditors to initiate liquidation and business rescue proceedings; new financing is given preference over secured and unsecured creditors; dissenting creditors may be crammed down subjected to a business rescue plan notwithstanding that they did not approve of the plan; the court is not involved in all stages of liquidation and restructuring; and that there is a distinction between honest and fraudulent bankrupts, albeit only insofar as natural person debtors are concerned. Although South Africa has scored well in these criteria, it is worth mentioning that some of these scores are subject to critique, and may require further improvement. For instance, the best score given for pre-insolvency, requires only that there is a pre-insolvency procedure. This does not go deeper into what kind of pre-insolvency procedures are most effective or how these should be optimally administered. Thus, a good scoring should be viewed with scepticism as it does not necessarily reflect that this aspect of the regime is perfect. Rather, it reflects that this part of the regime has succeeded in meeting the bare minimum requirement.

The South African insolvency regime is not aligned with international best practice in respect of its treatment of failed entrepreneurs, namely, the time to discharge and the exemption of assets; early warning mechanisms; special procedures for SMEs; the length of stay on assets; the dismissal of management during business rescue; and the rights of employees.

³²¹ Section 189(1)(a)-(b) of the Labour Relations Act.

³²² Section 189(2)(a) of the Labour Relations Act.

³²³ OECD "The OECD Insolvency Indicator: Data 2022" 2022.

4.9. Conclusion

Overall, South Africa's insolvency procedures of liquidation and restructuring fall short of key components that international best practices deem essential. The failure to have these key components, leads to a weaker insolvency regime. As was discussed in Chapter 3, if insolvency frameworks are efficiently designed, it may limit the loss felt by creditors during insolvencies and can reduce non-performing loans through a reduction of the price gap between banks and investors.³²⁴ The most important consideration for purposes of this dissertation, is that efficient and effective insolvency frameworks reduce the share of capital sunk in zombie firms, and may revive zombie companies that are capable of rehabilitation.³²⁵ Based off the indicators and discussion above, South Africa's insolvency frameworks are not operating as optimally and effectively as they could. This in turn, stifles the removal of zombie companies and enables their prolonged survival.

Portugal found itself in a similar position to South Africa. However, following insolvency reforms, they have become one of the countries best aligned with international best practices and have seen the share of zombie companies in their country decline. In Chapter 5, key differences will be identified between the reforms of Portugal and South Africa's current insolvency framework. With reference to these differences, the study will conclude by recommending steps to be taken in order for South Africa to benefit from reforms such as those of Portugal, in order to address zombie companies in the country.

³²⁴ Zoller 2023 *Eur Bus Org Law Rev* 392.

³²⁵ Andre and Demmou 2022 *OECD Economics Department Working Papers* 6.

Chapter 5: Conclusion and recommendations

5.1. Introduction

In 2020, South Africa fell victim to the clutches of Covid-19, alongside its global counterparts. To curb its effect, various economic policies were introduced. These policies had the unintended consequence of throwing a lifeline to zombie companies.¹ Zombie companies are not a new phenomenon to the global market, but have received little attention in South Africa.²

It is important to understand the nature of these companies, so that their swift exit from the market, or alternatively revival, may be effected and monitored.³ This is important as the continued survival of these firms hampers the growth of the economy by stifling productivity, investment and employment.⁴

5.2. The framework for zombie companies

The history of zombie companies depicts a link between zombie companies and large economic shocks such as the GFC or the sovereign debt crisis.⁵ Following these events, the economies are in a fragile state and additional credit is afforded to firms in hopes of economic recovery.⁶ This, however, creates a difficult position whereby defaulting companies that should have exited the market are able to survive due to being extended extra credit.⁷

The extension of credit to defaulting borrowers can be attributed to the incentives of different parties. Banks, through their practices of evergreening loans and forbearance, seek to protect their own balance sheets.⁸ This occurs because, if banks have to report their non-performing loans, it reflects poorly on them reputationally and they would have to increase their loan loss reserves and impair their reported capital.⁹ Accordingly, if banks extend additional credit to these defaulting companies or alter the terms of their loan agreements, they can better determine how they appear on paper. Further incentives to extend credit arise on the part of governments. Due to societal pressure, particularly following an economic shock where

¹ See paragraph 1.2.

² See paragraph 1.5.

³ See paragraph 1.3.

⁴ See paragraph 2.1.

⁵ See paragraph 2.2.3.

⁶ See paragraph 2.2.3.

⁷ See paragraph 1.2.

⁸ See paragraph 2.2.1.

⁹ See paragraph 2.2.1.

households and business struggle to discharge their debts, governments may incentivize banks to extend credit to put the minds of the people at ease.¹⁰ Although the reasons behind the credit extension may vary depending on the circumstances, there are certain trends that have been identified in previous economic shocks, which have preceded an increase in zombie companies. The identified trends include the introduction of relaxed monetary policy, bank forbearance, low economic growth following the shock, and the misallocation of credit.¹¹

As South Africa has just experienced a large economic shock following Covid-19, the policies introduced were unpacked to determine whether there are correlations between the circumstances of South Africa and the identified trends that cause an increase in zombie companies. It was found that the policies introduced during Covid-19, including deferred loan repayments, tax deferrals, and the reduced capital requirements of banks, paired with a large increase in non-performing loans, created a breeding ground for zombie companies elsewhere.¹² As South Africa has continued to face low economic growth since the pandemic, the threat of zombie companies and their impact on the economy remain.

In order to address zombie companies, the first step is to be able to readily identify them. In order to identify these companies, a definition was chosen to distinguish these companies from those that are in temporary financial distress. In this regard, a zombie company is defined as a company which has, for at least two consecutive years, had an interest-cover ratio below one, a leverage ratio above the median firm in the same industry, and negative real sales growth.¹³ This identifies zombie companies as those which have insufficient cash flows to cover their interest expenses, are unable to pay their debts as they become due, and are persistently unprofitable.¹⁴ Other characteristics identified amongst zombie firms include that they have weaker balance sheets than their counterparts, invest less in assets, have negative cash flows, extend high amounts of equity, are highly dependent on bank loans, and have lower operational efficiency, amongst others.¹⁵ Yet these companies avoid exiting the market. Thus, attention was drawn to possible solutions rooted in insolvency law.

¹⁰ See paragraphs 2.2.1; 2.2.3; 2.4.2 (ii) and (iii).

¹¹ See paragraph 2.2.3.

¹² See paragraphs 2.2.1; 2.2.2; 2.3.1; 2.3.2; 2.3.4

¹³ See paragraph 2.4.1,

¹⁴ See paragraph 2.4.1.

¹⁵ See paragraph 2.4.2.

5.3. International best practices

The design of a country's insolvency regime has a key role to play in the share of zombie firms in a country.¹⁶ It has been found that, if a country has an insolvency regime which delays the timely initiation and resolution of proceedings, a higher share of capital is sunk in zombie companies.¹⁷ Alternatively, insolvency reforms which minimize the barriers to corporate restructuring and enable the swift exit of unviable companies, may reduce this capital share sunk and reallocate it to more productive firms, and revive businesses who are not too far gone.¹⁸

In ascertaining what the ideal design of an insolvency framework entails, the OECD key indicators were referred to, alongside commentary of UNCITRAL regarding these key indicators.¹⁹ It is found that an efficient, optimal insolvency regime is based on considerations regarding the treatment of failed entrepreneurs; prevention and streamlining; restructuring tools; and other factors such as court involvement, the distinction between honest and fraudulent bankrupts, and the rights of employees.²⁰ These considerations determine the alignment scoring that a country's insolvency regime will receive.²¹

Portugal had one of the worst scores in 2010, but managed to turn this position around when reassessed in 2016.²² This change is attributed to insolvency reforms introduced in the country, which addressed restructuring and out-of-court creditor negotiations.²³ Interestingly, from the date of these reforms, the share of zombie companies in the country has continued to decrease.²⁴ This confirms a correlation between the international best practices regarding the design of insolvency regimes and the share of zombie companies in a country. It is off this basis that the current framework of South Africa was analysed in order to determine the extent to which the regime aligns with international best practices.

¹⁶ See paragraph 3.2.

¹⁷ See paragraph 3.2.

¹⁸ See paragraph 3.2.

¹⁹ See paragraphs 3.3.2; 3.3.2; 3.3.3.

²⁰ See paragraph 3.3.3.

²¹ See paragraph 3.3.3.

²² See paragraph 3.5.

²³ See paragraphs 3.5; 3.5.1; 3.5.2; 3.5.3.

²⁴ See Paragraph 3.5.

5.4. The South African position

The procedures available to distressed companies in South Africa include liquidation (winding-up), a compromise with creditors, and business rescue.²⁵ Once the key features of these procedures were highlighted, they were then assessed against the key indicators of the OECD to determine their alignment with international best practices. In this regard, South Africa placed 42nd out of 45 countries.²⁶ It is submitted that even in the areas where South Africa has passed the test threshold, this is often in cases where very little is required. As highlighted in Chapter 4, in order for South Africa to meet the requirements for a positive score on pre-insolvency, it needed only to have pre-insolvency procedures in place.²⁷ In this regard, the scoring system of the OECD can be considered as reflecting the minimum requirements that a country's insolvency system should meet.²⁸

South Africa failed to meet these requirements in respect of its treatment of failed entrepreneurs, namely, the time to discharge and the exemption of assets; early warning mechanisms; special procedures for SMEs; the length of stay on assets; the dismissal of management during business rescue; and the rights of employees.²⁹

Of particular interest for consideration of zombie companies is lessons that can be learned from Portugal's insolvency regime which inform the recommendations given below.

5.5. Lessons from Portugal

Portugal has seen significant improvement in its share of zombie companies since introducing reforms to its insolvency framework.³⁰ The main differences between South Africa's regime and that of Portugal is in its preventative, streamlining and restructuring tools.

In respect of prevention and streamlining, Portugal succeeds in having early warning mechanisms in place and having special procedures for SMEs.³¹ What bears particular mention is the free and accessible online tools provided on the IAPMEI website.³² These tools include

²⁵ See paragraphs 4.1; 4.2; 4.3; 4.4 and 4.5.

²⁶ See paragraph 4.8.

²⁷ See paragraph 4.7.2.

²⁸ See paragraph 4.8.

²⁹ See paragraph 4.8.

³⁰ See paragraph 3.5.

³¹ See paragraph 3.5.

³² See paragraph 3.5.

a business valuation tool, a project assessment tool, and a financial self-diagnosis.³³ The fact that these tools are easily accessible and free of charge, enables firms to regularly and consistently check their financial viability. These tools assist businesses with decision-making and enable them to accurately predict whether they will no longer be viable in the upcoming months. Such a forecast provides three beneficial results: it may incentivise a company to initiate negotiations with its creditors, to enter into a revitalisation plan with creditors, or it may force a company into liquidation if entirely unviable. Portugal further places a legal obligation on board members to request a declaration of insolvency from the court within 30 days of becoming aware of their insolvency situation.³⁴ Thus, if these tools illustrate that a company's position may be so dire that liquidation is the only option, these companies are legally obligated to file for liquidation. Alternatively, the tools will provide the company with a purview of its true position, and it will enable these companies to seek assistance sooner rather than later. As this can be quickly sought, the likelihood of success increases.

A further advantage of these tools is that they enable business owners who may lack the required expertise, or who cannot afford to seek financial expertise, with an in-depth explanation of their businesses' financial positions. This is particularly beneficial to SMEs. SME owners are also afforded free training by the IAPMEI.³⁵ This training in an "SME Academy" enables entrepreneurs to develop skills and good business practices.³⁶ This type of training teaches business owners invaluable skills which, in turn, increase the likelihood of successful businesses operations.

In respect of restructuring tools, the key reforms introduced were the procedures of PER, SIREVE and RERE.³⁷ Even though SIREVE was introduced in 2015, it was replaced by RERE in 2018.³⁸ RERE is the preferred procedure as it is a complete out-of-court procedure. Due to this, in the proceeding discussion comparing these procedures with that of South Africa, only PER and RERE will be considered.

PER is a hybrid pre-insolvency judicial proceeding in respect of which a company may restructure all its liabilities through negotiations with creditors.³⁹ PER is similar to business

³³ See paragraph 3.5.

³⁴ See paragraph 3.5.3

³⁵ See paragraph 3.5.

³⁶ See paragraph 3.5.

³⁷ See paragraph 3.5.

³⁸ See paragraph 3.5.3.

³⁹ See paragraph 3.5.1.

rescue. The negotiations are intended to arrive at an approved recovery plan to revitalise the company.⁴⁰ However, some key differences between the procedures include the following:

- in order to initiate PER, the debtor company approaches the court alongside at least one debtor to request that negotiations be initiated;⁴¹
- all documentation will be submitted to the court, following which the court will appoint a judicial administrator;⁴²
- the management bodies of the firm continue with their duties, with special permission from the administrator required for acts of special importance;⁴³ and
- the approved plan will be considered by the court who will then approve the plan or reject it.⁴⁴

One of the key differences which should be highlighted is that management continues to run the business, and only needs permission from the administrator regarding acts of special importance.⁴⁵ This approach is preferred as it acts as an incentive for these businesses to seek early intervention.⁴⁶ If a board knows that it will lose all control of the management of the company, which is the case in business rescue wherein the practitioner steps into their position, they may leave restructuring until it is too late. This would stifle economic growth and hinder more productive firms from entering the market due to the assets sunk in the failing firm.

Furthermore, the involvement of the court in appointing a practitioner and deciding on the plan, boost efficiency. Although this takes away from the flexibility of these proceedings, it does address a problem presented by South Africa's business rescue proceedings. There are not mechanisms in South Africa to oversee the day-to-day conduct of the business rescue practitioner. The CIPC licenses practitioners but does not provide consistent oversight. This may negatively impact the quality of practitioners appointed in certain cases. Even though affected persons may approach the court to remove a practitioner, this delays proceedings and defeats the purpose of business rescue as a swift procedure.⁴⁷ It also places a burden on the applicant to prove that the practitioner is ill-suited on the grounds provided in the Act.⁴⁸ It is

⁴⁰ See paragraph 3.5.1.

⁴¹ See paragraph 3.5.1.

⁴² See paragraph 3.5.1.

⁴³ See paragraph 3.5.1.

⁴⁴ See paragraph 3.5.1.

⁴⁵ See paragraph 3.5.1.

⁴⁶ Andre and Demmou 2022 *OECD Economics Department Working Papers 12*.

⁴⁷ See section 139(2) of the Companies Act of 2008.

⁴⁸ Section 139(2) of the Companies Act of 2008.

submitted that if the appointment of the practitioner is a matter to be considered by the court at the outset, it may enhance the efficiency of business rescue proceedings as the appropriate orchestrator of the proceedings is elected from the beginning. This will also prevent the stakeholders from incurring further expenses and experiencing time delays in seeking the removal of the practitioner.

RERE is an entirely out-of-court procedure which enables companies to negotiate with one or more of their creditors to reach a restructuring agreement under confidential terms.⁴⁹ It is similar to the compromise procedure under South African law, with some key differences: only business which are still viable but facing a difficult economic situation may enter into these proceedings;⁵⁰ the company may appoint a business recovery mediator to assist in the negotiations;⁵¹ and there is no court involvement.

A key difference between RERE and South Africa's compromise procedure, is that RERE is an informal, flexible procedure. For a compromise under South African law to be enforceable against dissenting creditors, the court must approve the proposal and it must be filed.⁵² South Africa's insolvency framework does not provide for informal procedures, whereby companies and creditors may seek to remedy their financial position on their own terms and only seek aid if needed.

5.6. Conclusion and recommendations

Key differences between Portugal's insolvency framework and South Africa's are:

- the existence of free and accessible early-warning mechanisms;
- free training for SMEs;
- a restructuring procedure which enables management to retain their control of the business and only require consent regarding certain transactions;
- a system whereby the Court approves the plan and the restructuring practitioner; and
- an outlined procedure for informal restructuring.

In respect of early warning mechanisms, South Africa could benefit from implementing free online tools such as that of Portugal. Literature focuses on zombie companies which are listed

⁴⁹ See paragraph 3.5.3.

⁵⁰ See paragraph 3.5.3.

⁵¹ See paragraph 3.5.3.

⁵² See paragraph 4.4.

companies. It is a general assumption that these types of companies should have the expertise and mechanisms in place to realize when they are financially distressed or heading towards insolvency. While this is true, early warning mechanisms would be equally beneficial for all types of businesses. The reason for this is that it may be too expensive, considering the state of the company's finances, to seek an expert assessment each time the possibility of distress arises.

The company may also have been misled by previous board members in a takeover; by fraudulent auditors; or other circumstances may have led to an incorrect assessment. If a company's decision-makers may freely garner an assessment of their financial position, it may enable them to access mechanisms such as compromise or business rescue while they are still viable. This is particularly important for businesses who may lack the expertise or resources to understand their financial position. In this respect, the training provided to SMEs in Portugal, would also be of incredible value in a country like South Africa where 90% of the formal businesses are SMEs.⁵³

Key components, which bear consideration in respect of restructuring, is the implementation of provisions in the business rescue process which allow for management to retain control of operations, albeit only to a limited extent. This would increase the likelihood of early filing, which is an essential consideration as to whether business rescue will be successful. Furthermore, inspiration can be drawn from the role that the court plays in appointing the business rescue practitioner and approving the plan. It is not suggested that the court become intricately involved in South Africa, but rather that an independent authority be established to oversee business rescue proceedings in respect of the company-specific qualifying criteria of practitioners, the appointment of practitioners with the necessary expertise to a specific company, and final approval of the plan. This would ensure that business rescue runs as efficiently as possible and any incompetent practitioners or misaligned incentives can be avoided. This would aid affected persons as it would remove the burden placed on them to prove that the practitioner is ill-suited due to incompetence, failure to exercise the required degree of care and skill, engaging in illegal conduct, a conflict of interest, or being incapacitated.⁵⁴ Considering the fact that these companies are in financial distress, to place further time delays and expenses on affected persons will certainly dissuade these parties from seeing business rescue as an effective rescue mechanism.

⁵³ See paragraph 2.3.1.

⁵⁴ Section 139(2) of the Companies Act of 2008.

In South Africa's insolvency framework, there is no provision made for informal restructuring agreements between a company and its creditors. Although a compromise with creditors does provide for restructuring agreements, it requires confirmation by the court.⁵⁵ It is submitted that South Africa would greatly benefit from an informal, out-of-court procedure in this regard that would still allow some form of moratorium or protection against creditor claims while the process is on-going. The provisions of Portugal's RERE are also beneficial to the extent that they provide for an optional business restructuring mediator to assist in the process. This type of procedure would give creditors and companies the opportunity to manage how they wish to remedy their own debt, without incurring the expenses and timely delays associated with court intervention. It also enables the company to manage certain aspects of their debt with certain creditors, to possibly return the company to a more viable financial position that avoids insolvency later on. In the context of zombie companies, this would enable the transition to a sustainable enterprise.

It is submitted that inspiration may be taken from these procedures of Portugal's insolvency framework. If implemented in South Africa, the early-warning mechanisms and restructuring tools may avoid companies falling into zombie status in the first place, and may aid those who have a chance of turning around. However, it is submitted that in order for zombie companies to be fully understood and addressed in South Africa, further study is required to understand how these firms operate in the South African landscape. Upon this further investigation, it is suggested that these companies must be regulated by a legislative framework over and above the general provisions applicable to companies, which provides for a definition and mechanisms to aid or address zombie companies that do not take steps to recover or exit the market. Although the notion of zombie companies may sound like a mythological phenomenon, it is a very real threat to economic prosperity and growth. Accordingly, it is submitted, that should these companies be appropriately addressed, South Africa may survive its "long-night".

⁵⁵ See paragraph 4.4.

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