

# The case for business rescue

THE PENALTY FOR DECLARING BANKRUPTCY IN ANCIENT ROME WAS SLAVERY OR BEING CUT TO PIECES. THE CHOICE WAS LEFT TO THE CREDITOR. BY THE MIDDLE AGES, THE TREATMENT OF INSOLVENT DEBTORS HAD SOFTENED CONSIDERABLY. IN NORTHERN ITALY, BANKRUPT DEBTORS HIT THEIR NAKED BACKSIDES AGAINST A ROCK THREE TIMES BEFORE A JEERING CROWD AND CRIED OUT, "I DECLARE BANKRUPTCY". IN FRENCH MEDIEVAL CITIES, BANKRUPTS WERE REQUIRED TO WEAR A GREEN CAP AT ALL TIMES, AND ANYONE COULD THROW STONES AT THEM (*WORLD BANK, DOING BUSINESS IN 2004*).

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Since those days, almost all modern democracies have established statutory corporate rescue procedures with the purpose of providing protection for insolvent corporate businesses. South Africa introduced its corporate rescue procedures, labelled as judicial management, in the Companies Act 46 of 1926. The problem was that, until recently, this mechanism to assist businesses in cases where it is better to continue operations, did not work. It led to many businesses in financial distress immediately being liquidated without any rescue attempt. Research published over the past two decades has indicated these problems and deficiencies, and called for a reform of corporate rescue legislation (Lamprecht, 2008).

This article aims to provide background information on the events and thought that have led to the new business rescue framework, as well as its place in the current socio-economic and business environments. A brief overview and discussion of the business rescue proceedings, benefits and concerns are also given.

## The move to business rescue

In 2004, Department of Trade and Industry (the dti) published a policy document dealing with guidelines for corporate law reform. One of the areas for review focused on the current system of judicial management, and acknowledged that it appeared that judicial management was rarely used, even more rarely led to a successful conclusion, and gone almost unchanged since 1926. The document further mentioned that, by contrast, a number of countries had introduced new systems for business rescue over the past decade (Department of Trade and Industry, 2004).

These new systems recognised business rescue as a necessary alternative to liquidation, and operated on the basis that the value of the company is greater if it, or its business, is preserved as a going concern, as opposed to the assets being sold off on a piecemeal basis (Parry, 2006, p. 2).

This worldwide tendency to preserve value by providing formal corporate rescue procedures to businesses in distress, together

with the fact that the creditor-friendly judicial management regime has failed as a corporate rescue regime, laid the foundation for a new debtor-friendly business rescue regime. This regime crystallised in February 2007 with the dti publishing its first draft Companies Bill, detailing the new business rescue provisions in Chapter 6. The chapter saw various versions as consultation with stakeholders and the public took place. The final Companies Bill was issued late in 2008 and subsequently assented to by the President on 8 April 2009 as the Companies Act, 71 of 2008.

The new business rescue model emerged at a time when the South African business environment found itself in a recession with liquidation statistics increasing every month. Some industries and labour unions have approached the government for bail-outs of struggling companies. President Jacob Zuma recently stated that the productive capacity of our economy should be kept intact to respond to the revival in demand as the global economy recovers. The President added that we must do our absolute best to retain skills and labour (SAPA, 2009).

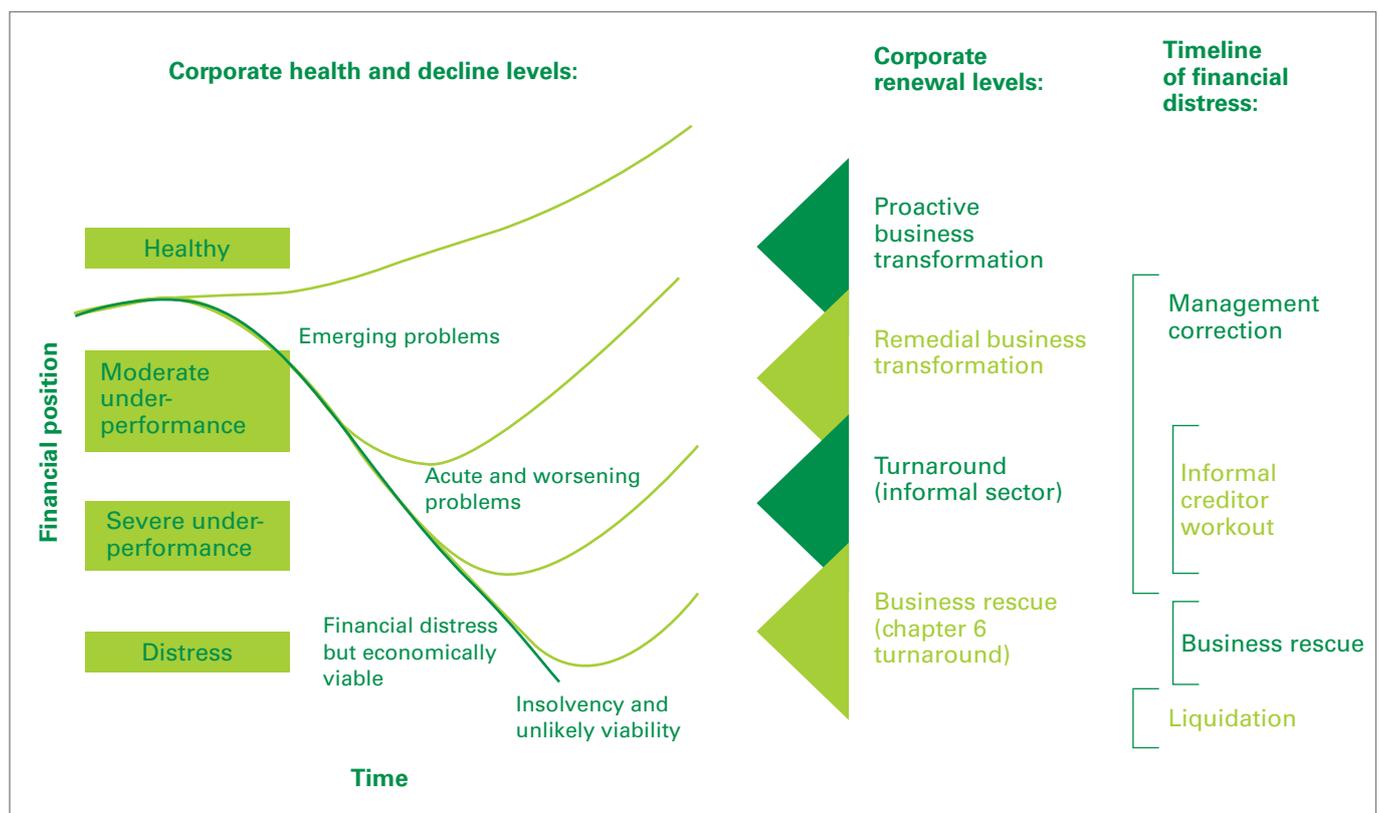
## Benefits of tailored corporate rescue laws

Tailored, well-functioning, corporate rescue laws can preserve value to benefit a range of stakeholders: investors' investments may be preserved; managers and employees may retain their jobs; creditors may receive a greater portion of what they are owed than would be the case under liquidation; clients may see a satisfactorily completion of work in progress; the public may benefit from the debtors still being in business, and taxes may be paid to the government. Balancing the interests of these different groups in a political, social, cultural and economic environment presents a challenge, which necessitates a diversity of approaches. Therefore, a business rescue regime suitable for one country may not be suitable in another country (Parry, 2006, p. 2; Corporate Renewal Solutions, 2009a).

In designing a tailor-made South African business rescue model, the dti had the benefit of hindsight and the example of a number of working business rescue models worldwide. However, it is unclear if



**Diagram 1. Restoration of corporate value**



our provisions were based on a single existing model or drawn from various systems currently in place worldwide. The 2004 corporate reform policy document only indicated that the provisions of the US Chapter 11 bankruptcy-protection measure would be considered.

**The South African Business Rescue model**

Our new South African model defines business rescue as proceedings to facilitate the rehabilitation of a company that is *financially distressed* (see below) by providing for:

- the temporary supervision and management of the company by a business rescue practitioner;
- 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, other liabilities and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis, or provides a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.

A company is *financially distressed* when it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing

six months, or it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months.

Business rescue is one of a number of procedures to save financially distressed but economically viable companies. It is important to note that business rescue, as a formal process within the legislative framework, follows failed management-led correction and failed informal creditor workout. If business rescue is successful, liquidation is avoided. Diagram 1 above, shows the different levels of corporate health decline and the level where the business rescue and liquidation legislation is applicable (Corporate Renewal Solutions, 2009b).

**How does the business rescue model work?**

**Initiating the proceedings**

There are two ways of initiating business rescue proceedings: Firstly, such proceedings may be initiated by the company when the board resolves that the company voluntarily begins business rescue proceedings and is placed under supervision. This will happen if the board has reason to believe that the company is financially distressed and there appears to be a reasonable prospect of rescuing the company. Such a resolution may not be adopted if liquidation proceedings have already been initiated by or against the company and takes effect only when it is filed with the Companies

and Intellectual Property Commission (hereafter referred to as the “Commission”). Liquidation proceedings, if still necessary, may commence only when business rescue proceedings have ended or lapsed (when the company failed to comply with any provision). After adoption of the resolution, the company must publish a notice of the resolution in the prescribed manner to every affected person (shareholders, creditors and all employees, whether represented by a registered trade union or not), appoint a business rescue practitioner and notify the Commission and those affected of the appointment.

Secondly, such proceedings may be initiated by an affected person by application to the court for an order to place the company under supervision and to commence business rescue proceedings. The court will make such an order if it is satisfied that the company is financially distressed; if the company has failed to pay over any amount in terms of an obligation under a public regulation or employment-related contract; or if it is otherwise just and equitable to do so for financial reasons and where there is a reasonable prospect of rescuing the company. The court (and not the company) may make a further order appointing an interim practitioner (nominated by the affected person who brought the application) subject to ratification by the creditors at a later stage. It is interesting to note that if liquidation proceedings have already been commenced by or against the company, this application (if granted) suspends such liquidation proceedings until the court adjudicates on the application or until the business rescue proceedings end. A court may place the company under supervision and initiate business rescue proceedings at any time during the course of liquidation proceedings or proceedings to enforce any security against the company.

#### During the proceedings

During the proceedings a specific person is responsible for performing the business rescue. This person, the “business rescue practitioner” has specific powers and duties laid out in part B of chapter 6. The business rescue practitioner has *full* management control of the company in place of its board and pre-existing management, although the practitioner may delegate any power or function to a person that was part of the board or pre-existing management of the company. The practitioner may remove from office any person that formed part of the pre-existing management of the company or appoint a person as part of the management of a company. The practitioner is the one responsible for the development of a business rescue plan to be considered by affected persons, and the implementation thereof once it has been adopted. During a company’s business rescue proceedings, the practitioner is also an officer of the court, whilst having the responsibilities, duties and liabilities of a director of the company.

The legislation has strict provisions with regard to the general moratorium on legal proceedings against the company and the protection of its property interests. The interest of providers of the necessary post-commencement finance needed for the turnaround, and the order of preference of claims to be paid out, are further dealt with in section 135.

#### End of proceedings

The proceedings end when

- the court sets aside the resolution or order that began the proceedings or has converted those proceedings into liquidation proceedings;
- the practitioner has filed a notice of termination with the Commission;
- a business rescue plan has been proposed and rejected; or
- a business rescue plan has been adopted and the practitioner has subsequently filed a notice of substantial implementation of that plan.

If a company’s business rescue proceedings have not ended within three months after the start of the proceedings, the practitioner must prepare a report on the progress of the business rescue proceedings and update it monthly until the end of the proceedings. The court may extend the three month deadline on application by the practitioner.

#### Conclusion

In summary, the new business rescue model should have many benefits. In particular, although it allows the intervention of affected parties by application to the court, it is a substantively non-judicial, commercial process, which regulates interaction between the company, the business rescue practitioner and affected parties in devising a business rescue plan. The process is also consultative and inclusive as each of the stakeholders (or affected parties) is afforded an opportunity to participate and be consulted (Moosa, 2009). The temporary general moratorium against liquidation and legal proceedings may provide the necessary breathing space to effect a successful turnaround. Further, the outcome sought by the legislation, namely the continued existence of the company on a solvent basis or, if this is not possible, a better return for the company’s creditors or shareholders than would result from the immediate liquidation of the company, has a reasonable prospect of success. There should be more business rescue attempts, and fewer business liquidations.

Despite the many benefits, there are also new concerns. Not all businesses are viable, and judging by international experience with modern business rescue regimes, it can be expected that business rescue attempts using the new legislation will have a success rate of less than 50%. Local commentators have also raised concerns regarding the competing interests between the different affected persons. Parry (2006) noted that one crude measure of the relative success of corporate rescue laws is the way in which different interest groups are treated, since this is largely a reflection of differing social and economic values in the countries concerned. Research indicates that business rescue is also more expensive than an informal creditor workout: business rescue costs are shared between the shareholders, creditors (in the case of forgiveness) and the taxpayer in the case of a court application. The new legislation is not the answer for South Africa’s unemployment and liquidation problems, but it has the potential to be a successful mechanism for economically viable businesses in financial distress.

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