Judicial management as a technique for corporate rescue. A comparison with English and Australian law.

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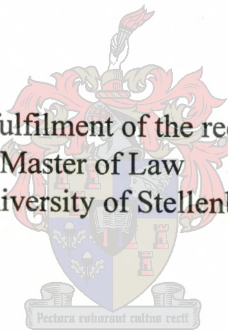

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Declaration

I, the undersigned, hereby declare that the work contained in this thesis is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

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Summary

Judicial management has been part of South African company law since 1926. It was introduced as a procedure to provide for a corporate rescue. Judicial management has changed little since its introduction. This is in stark contrast with the position in other jurisdictions where the need for improved corporate or business rescue procedures has received considerable attention in the last few decades.

This thesis examines the suitability of judicial management as a business rescue procedure for the current South African circumstances and compares it to similar mechanisms in England and Australia.

The modern economy relies on credit. Furthermore the globalisation of markets and the increase in competition between enterprises add to the unpredictability of an enterprise's economic circumstances. Thus, one of the important objectives of a corporate insolvency regime is the preservation of viable economic enterprises. A business rescue procedure such as judicial management is therefore an essential component of a corporate insolvency regime.

However, judicial management needs reform. The existing shortcomings of judicial management include its high cost, the appointment of professional liquidators as business rescuers, the lack of a business rescue culture, the absence of an approved rescue plan, the treatment of judicial management as an extraordinary measure in corporate insolvency and the use of section 311 of the Companies Act as a corporate rescue mechanism.

This thesis proposes that judicial management should commence with a mere resolution by the directors. This is less cumbersome than the existing procedure to commence judicial management comprising a court order. Judicial management triggers a stay of limited duration on legal proceedings that provides an essential breathing space to devise and implement a rescue plan.

Once judicial management commences the creditors should hold the power to decide on the future of the company. They can therefore accept or reject a rescue plan (prepared by the judicial manager) for the restructuring of current rights and obligations and for the future management of the company.

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During judicial management and the execution of the rescue plan, control of the company's assets vests in the judicial manager and directors lose their powers of management. Judicial managers should be encouraged to make a success of judicial management by providing that the judicial manager cannot be appointed as the liquidator in a subsequent liquidation. Furthermore, the burden of the costs of judicial management could be eased by providing a more flexible system for the remuneration of the judicial manager.

A statutory business rescue procedure interacts with other components of an insolvency regime and other areas of law. In order to optimise the positive effects of a business rescue procedure certain changes are proposed regarding statutory provisions on insolvent trading, the phenomenon of phoenix companies, section 311 of the Companies Act and tax legislation. The thesis also proposes a smooth transition from judicial management to voluntary liquidation.

The thesis has an annexure with draft legislation to give effect to the principal changes proposed by it for the Companies Act.

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Opsomming

Geregtelike bestuur is reeds sedert 1926 deel van die Suid-Afrikaanse maatskappyereg. Dit is ingestel as 'n prosedure om maatskappye van ondergang te red. Geregtelike bestuur het sedertdien min verander. Dit is in skerp teenstelling met ander jurisdiksies wat die afgelope paar dekades toegewy gewerk het aan prosedures om korporasies en besighede te red.

Hierdie tesis ondersoek die toepaslikheid van geregtelike bestuur as 'n prosedure om in die huidige Suid-Afrikaanse omstandighede besighede van ondergang te red en vergelyk dit met soortgelyke prosedures in Engeland en Australië.

Moderne ekonomieë se afhanklikheid van krediet, die globalisering van markte en die toename in mededinging tussen ondernemings dra by tot die wisselvallige ekonomiese omstandighede van 'n onderneming. Die redding van lewensvatbare ondernemings is gevolglik 'n belangrike doelstelling van korporatiewe insolvensiereg. Daarom is 'n prosedure soos geregtelike bestuur om ondernemings te red 'n onontbeerlike element van korporatiewe insolvensiereg.

Geregtelike bestuur moet egter hervorm word. Geregtelike bestuur het verskeie tekortkominge waaronder hoë regskoste, die aanstelling van professionele likwidateurs as persone om ondernemings te red, die gebrek aan 'n kultuur om ondernemings te red, die afwesigheid van 'n goedgekeurde reddingsplan, die hantering van geregtelike bestuur as 'n buitengewone remedie in korporatiewe insolvensiereg en die gebruik van artikel 311 van die Maatskappywet as 'n meganisme om maatskappye van likwidasie te red.

Die tesis stel voor dat geregtelike bestuur met 'n blote direksiebesluit in werking gestel word. Dit is minder belemmerend as die hofbevel waarmee geregtelike bestuur tans begin word. Geregtelike bestuur stel 'n moratorium van beperkte duur in werking waartydens geen geregtelike prosesse teen die maatskappy aanhangig gemaak of voortgesit kan word nie. Dit gee die maatskappy die nodige grasie om 'n reddingsplan uit te werk en te implementeer.

Nadat geregtelike bestuur in aanvang geneem het behoort die krediteure die mag te hê om oor die toekoms van die maatskappy te besluit. Krediteure sou 'n reddingsplan

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(voorberei deur die geregtelike bestuurder) wat vir die herstrukturering van die regte en verpligtinge van die maatskappy en vir sy toekomstige bestuur voorsiening maak kon aanvaar of verwerp.

Gedurende geregtelike bestuur en die uitvoering van die reddingsplan vestig die beheer oor die bates van die maatskappy in die geregtelike bestuurder. Die direksie verloor terselfdertyd alle bestuursbevoegdhede. Geregtelike bestuurders behoort aangemoedig te word om 'n sukses van die geregtelike bestuur te maak deur te bepaal dat 'n geregtelike bestuurder nie as likwidateur aangestel kan word indien die maatskappy uiteindelik gelikwideer word nie. Die las van hoë koste kan verlig word deur 'n buigsame stelsel van vergoeding vir die geregtelike bestuurder in te stel.

'n Statutêre reddingsprosedure vir ondernemings staan in wisselwerking met ander elemente van korporatiewe insolvensiereg en ander regsgebiede. Ten einde die positiewe uitwerking van 'n reddingsprosedure vir ondernemings te optimaliseer word sekere veranderinge ten opsigte van die wetgewing met betrekking tot handeldryf in insolvente omstandighede, die verskynsel van "phoenix" maatskappye, artikel 311 van die Maatskappywet en belastingwetgewing voorgestel. Die tesis stel ook 'n gladde oorskakeling van geregtelike bestuur na vrywillige likwidasie voor.

Die tesis sluit ook 'n aanhangsel met voorgestelde wetgewing in om uitvoering te gee aan die belangrikste veranderinge aan die Maatskappywet wat in die tesis voorgestel word.

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CHAPTER 1

Introduction

1 1 Judicial management and corporate rescue

Judicial management has been part of South African company law for a long time. It was first introduced by the Companies Act of 1926.[1] At that time it was considered necessary to assist "factories manufacturing articles". It was widely considered that these firms helped the country in the circumstances of the day and judicial management was thought of as a tool to provide a corporate rescue. That meant that instead of liquidating the company (or factory) some means for the survival of the company or its business was provided.[2]

Although judicial management was never extensively used in the South African context, the idea of a corporate rescue was not abandoned. In fact it has become a world-wide phenomenon. Considerable thought, effort and legislative energy have been poured into similar arrangements elsewhere.

It can be said from the outset that there are quite a few indications that the idea of a corporate rescue is not nearly as unpopular as the use of judicial management might indicate. An example is the frequent use in South Africa of the scheme of arrangement in terms of section 311 of the Companies Act[3] in what has been termed the "arrangement industry"[4] to keep companies that are unable to pay their debts alive.

The need for a corporate rescue scheme is echoed by the words of the Australian Law Reform Commission:

> "The Commission is concerned that apart from conclusions that might be suggested by statistical evidence, the legislative approach to corporate insolvency in Australia is largely negative. There is very little emphasis upon or encouragement of a constructive approach to corporate insolvency, for example,

[1] Act 46 of 1926, ss 195-198. See the text at n 8 *infra* for the definition of judicial management.
[2] Hansard "House of Assembly Debates" vol 6 25 Feb 1926 col 996-7.
[3] Act 61 of 1973. Its frequent use might however be curbed by recent developments. The *dictum* in *Commissioner for Inland Revenue v Datakor Engineering (Pty) Ltd* 1998 4 SA 1050 (A), has the effect that the preserved tax loss of the company may not be utilised by the offeror company in a section 311 scheme of arrangement. Anonymous "Income Tax – Assessed loss – Arrangement under section 311 of the Companies Act" 1999 *The Taxpayer* 34; Anonymous "Arrangements under section 311 of the Companies Act with a view to preserving the company's assessed losses: Are they worthwhile? 1999 *The Taxpayer* 105. See also 5 4 *infra.*

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the possibility of saving a business (as distinct from the company itself) and preserving employment prospects."[5]

In Singapore a judicial management regime was introduced in 1987. Apparently it draws on the idea of judicial management in South Africa.[6] It was incorporated into Singaporean law after a crisis in the local financial markets that followed the financial failure of important companies.

The object was that creditors should not force companies that are essentially viable into liquidation before they have first had an opportunity to reorganise their affairs. This reflected the opinion that had there been a suitable mechanism "fundamentally sound companies (which have now gone under) would have been saved with the passage of time and the general improvement of the economy."[7]

This is part of the evidence that in several parts of the world the need for corporate rescue mechanisms was recognised and the necessary legislation has indeed been introduced.

The South African law knows judicial management as a corporate rescue procedure. A judicial manager may be provisionally appointed when a company is unable to pay its debts or is probably unable to meet its obligations.[8]

The provisional judicial manager takes over the management of the company from the incumbent directors. He then has to do certain investigations and organise meetings with creditors and members. He then reports back to the court on the prospect of the company being able to become a successful concern or to pay its debts within a reasonable time. The meetings of creditors and members are to consider the desirability of placing the company under final judicial management. There is no provision that the judicial manager takes any active role in formulating a corporate rescue plan resembling the deed of company arrangement of Australian law[9] or the proposals of the administrator under English law.[10]

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[4] *Ex Parte NBSA Centre Ltd* 1987 2 SA 783 (T) 796; *Ex Parte Kaplan and Others NNO: In Re Robinson Consolidated Industries Ltd* 1987 3 SA 413 (W) 422, 424.

[5] Australia Law Reform Commission *General Insolvency Inquiry* Discussion Paper no 32 (1987) 20.

[6] Tomasic, Little, Francis, Kamarul & Wang "Insolvency Law Administration and Culture in Six Asian Legal Systems" 1996 *Australian Journal of Corporate Law* 249 258-259. See however Brown *Corporate Rescue* 824 who says that it is closely modelled on the English administration procedure.

[7] Tomasic *et al* 1996 *Australian Journal of Corporate Law* 260.

[8] Companies Act 61 of 1973 ss 427-440.

[9] See 3 5 3 *infra*.

[10] See 3 5 2 *infra*.

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Once the provisional judicial manager has reported to the court and the court decides to make a final order the judicial manager runs the company under the supervision of the Master. The aim is to restore the company to a successful concern.

The courts[11] have treated judicial management as a "special dispensation which can be granted to a company only in exceptional circumstances."[12] Olver amplifies this view[13] when he asks:

> "Why should a special system be set up by the Legislature to bail out shareholders and creditors who may have made unwise investments? There is surely a further requirement - further special circumstances which should be present before an order is granted."[14]

He submits that the effect on the whole economy and the community should be a factor to be considered and not only the benefit of a few creditors. In his view it is in the nature of business for creditors to take commercial risks and he is of the view that the same argument applies to shareholders.

It appears that this view also underlies the approach of the courts. It is submitted that this view is too narrow in its understanding of the economy and the community. The question can rather be posed in answer to Olver's question, "Why should the legislature not set up a special system to bail out shareholders and creditors?"

There are good reasons for such a question and such a system. An understanding of modern economic circumstances[15] and the redefinition of the community as the sum of small parts and not only as a large organism without regard to the need for small healthy components sheds a completely different light on judicial management.

1 2 Definition of corporate rescue

The terms "corporate rescue" and "business rescue" are often used interchangeably. It is a fact that very often businesses are conducted in one or other corporate form. Therefore references to corporations are often used to mean businesses in a wider sense than corporations or companies alone. The corporate form is characterised by

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[11] *Silverman v Doornhoek Mines Ltd* 1935 TPD 349 353; *Bahnemann v Fritzmore Exploration (Pty) Ltd* 1963 2 SA 249 (T) 250-1; *Tenowitz v Tenny Investments (Pty) Ltd* 1979 2 SA 680 (E) 684, see also the *obiter* endorsement in *Sammel v President Brand Gold Mining Co Ltd* 1969 3 SA 629 (A) 663.
[12] Meskin *Henochsberg on the Companies Act I* 5th ed 923
[13] Olver *Judicial Management in South Africa* LLD thesis UCT (1980).
[14] Olver *Judicial Management in SA* 37.
[15] See further 1 3 *infra*.

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juristic or legal personality and nearly always by limited liability of the members as well. As a result the insolvency measures for juristic persons were dealt with separately from those for unincorporated businesses and natural persons.[16]

Rescue measures have been introduced for juristic persons that were not available to unincorporated businesses such as partnerships. South African judicial management is a prime example. However, there is a world-wide trend towards replacing the distinction between incorporated and unincorporated businesses by a distinction between business debtors and consumer debtors.[17] The separate treatment of juristic persons and non-juristic persons does not correspond exactly with the distinction between business debtors and consumer debtors. This gives rise to the two terms "business rescue" and "corporate rescue", which then for obvious reasons are used interchangeably, whereas the term "business rescue" will however include business debtors other than corporations or companies. Although judicial management refers to companies only, "business rescue" will be used henceforth as a more inclusive term that includes the rescue regimes for companies. This is often the most important application for such rescue regimes.

Corporate rescue is crisply defined by Paul Omar:

> "Corporate rescue is now associated with what is termed the revival of companies on the brink of economic collapse and the salvage of economically viable units to restore production capacity, employment and the continued rewarding of capital and investment."[18]

It must also be said that the survival of the juristic person is not important as a goal in itself; it is the survival of the enterprise and the real business carried on by the juristic person, in whole or in part, which is the actual goal.[19]

The emphasis on business rescue has come about partly because insolvency law started to take into account the large-scale rise in corporate insolvencies in the last

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[16] For example see chapter XIV of the Companies Act 61 of 1973 and Part IX of the Close Corporations Act 69 of 1984.

[17] Rajak "Business Rescue for South Africa - A Report Submitted to the Department of Trade and Industry" (1998) 10 and Rajak & Henning "Business Rescue for South Africa" 1999 *SALJ* 262 270.

[18] Omar "Thoughts on the Purpose of Corporate Rescue" 1997 *The Company Lawyer* 127. See also Belcher *Corporate Rescue* 11-13 who defines corporate rescue as: "a major intervention necessary to avert eventual failure of the company". Brown *Corporate Rescue* 3 defines it simply as: "the survival of the company or a substantial part of its business".

[19] Belcher *Corporate Rescue* 24; Brown *Corporate Rescue* 2 and Goode *"Principles of Corporate Insolvency Law"* (1997) 26, 275.

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few decades. This trend might largely be a result of the increasing interdependence of all national economies and the effects of the rise and fall of economies in the international arena.

This development started to change perceptions on insolvency. The idea that fault should be attributed to those who are responsible for financial failure and that they should be punished, slowly made room for the idea that fault is not always present and the realisation that if a company has some breathing space to reorganise before facing the storm following the public knowledge of its financial difficulties, it would probably survive the storm. A further development has been that the survival of the company has become a desirable objective from the perspective of the broader community. Insolvency and the consequent business failure are not only felt by the company itself, but also affect society at large.[20] The idea that company failure is simply a market mechanism to get rid of inefficiency no longer receives unqualified acceptance.[21]

1 3 **Modern economic circumstances**

What are the circumstances of modern-day commerce and living to be taken into account when decisions are to be made as to the insolvency regime that should exist?

One must first realise that the modern world is a world of credit. This is true to an extent, which was unthinkable in terms of the situation that prevailed a mere 100 years ago. This reality is quite evident from the reports on the inquiries into insolvency law in the United Kingdom[22] and Australia.[23] The economy of the world (including that of South Africa) runs on credit. It is the fuel that keeps economic activity going in a modern industrialised world. The most significant extenders of credit are the banks and other similar financial lending institutions. Furthermore manufacturers extend credit to their customers, trade suppliers extend credit to their customers and retailers extend credit to their customers, the consumers.

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[20] In fact, the recognition of this led to the introduction of judicial management in South Africa in the first place. See the reference to Hansard in n 2 *supra.*
[21] Delaney "Power, Intercorporate Networks and Strategic Bankruptcy" 1989 *Law and Society Review* 643 663. See also Tomasic *Australian Corporate Insolvency Law* (1993) 6.
[22] Sir Kenneth Cork *Insolvency Law and Practice* Report of the Review Committee (1982) (hereafter "Cork Report").
[23] Harmer RW (Commissioner in Charge) *General Insolvency Inquiry,* Report no 45, Summary of Report 2 (hereafter "Harmer Report").

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Consumerism, economic growth and the consequent employment opportunities and social stability are all based on credit. The response to the need for more credit has been enormous. The credit card, personal loans and large-scale "in house" finance schemes by manufactures and retailers are just part of the stream of credit supply that is available today.

It is also true that a mere wage earner can obtain credit on a scale that was unthinkable in the past. This is evident in such advertising slogans as "buy now pay later". There are some theologians, who say that the consumer ethic has even crept into the spirituality of modern humanity to the extent that, the good and virtuous person is the one who buys and buys.[24] It is easy to predict that in circumstances like these the risks of the consumer not being able to meet his obligations are greatly increased and this event might often happen without any fault on his side. What is even more evident is that the modern economy needs buyers and buyers need credit. It then becomes in society's interest to give people fresh starts, to let them start over again because, without buyers, there is no future for the sellers.[25]

The risks of insolvency greatly increase with globalisation and international trade and increasing competition. It is quite evident that global events and events in foreign countries can have a severe impact on traders and businesses everywhere. Often businesses cannot respond in such a short time, or the resultant default in obligations has a domino effect that leaves many businesses exposed.

A good example of such an event is the economic crisis that hit the Far East in late 1997 and early 1998. This crisis suddenly spilled over into the South African economy in June 1998. Under pressure from a wave of reported speculative dealing the South African currency devalued sharply against major foreign currencies. It caused immediate upward pressure on interest rates that rose sharply at a time when it

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[24] The Canadian Catholic theologian Gregory Baum says that there are four forms of spirituality present in the western world. The first is the work ethic which stems from Calvin and which contributed enormously towards the modern industrialised economies. Knowledge of your calling and hard work are the best virtues and laziness is the worst of all sins. This led to an overproduction of goods, which resulted in the second form of spirituality, the consumer ethic. The virtues in this form are pleasure, comfort, expensive hobbies and luxurious lifestyles. The buyers are the virtuous. "Tweede Lydensondag, Markus 9: 2 - 9" Smit *Woord teen die Lig* vol I (6) 106 115 - 116.

[25] Professor Harry Rajak (professor of law, University of Sussex) shares the anecdote about when he played the game Monopoly with his son. At one stage his son was completely insolvent and the game was actually over, but both of them wanted to continue. His son asked him: "What now, what do we do if I still want to play?" At that point he realised that it was in his playing interest to extend his son further credit and to come to his rescue for the game to continue.

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was widely expected that interest rates would fall. Such a sharp rise in interest rates causes a sudden slowdown in the economy and curtails the spending power of the consumer public. It is easy to understand that such sudden changes can have a dramatic impact on a business in South Africa and might even catch the prudent businessman unawares.

In addition, a world-wide trend to lower trade tariffs[26] leaves businesses open to more direct competition. These factors explain why virtually all countries with modern industrialised economies saw a sharp rise in insolvencies in the last two decades. The response of countries to these circumstances was to take a look at their insolvency regimes and many of them introduced new insolvency legislation.

The United Kingdom had a commission of inquiry into their insolvency law and followed it up with a new Insolvency Act in 1986.[27] Australia did likewise with new insolvency legislation in the 1990's. New legislation was also introduced in Canada, Singapore and a host of other countries.

In South Africa there is presently research being done by the Law Commission on the insolvency of individuals. The position with regard to the liquidation of companies is currently under review by the Standing Advisory Committee on Company Law.[28]

The response to business failure or insolvency in modern economic circumstances has been divergent, but many of the countries that revised their insolvency law in the last few decades included a business rescue system in their insolvency law.[29] To understand fully the role of a business rescue system one needs to understand insolvency and its relevance to the modern economic circumstances which currently exist. Once the problems of insolvency are evident one needs to consider the response to the problems created by insolvency. Society should respond to these problems by

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[26] The policy of the World Trade Organisation, which South Africa joined in 1995, prescribes the lowering of tariffs over a period of 5 years for all signatory states. This organisation replaced the General Agreement on Tariffs and Trade, more commonly known as GATT.

[27] The Act applies to England, Wales and Scotland as far as corporate insolvency is concerned and to England and Wales as far as the bankruptcy of individuals is concerned. See Sealy & Milman *Annotated Guide to the Insolvency Legislation* (1994) 4th ed 5. See 1 4 *infra* on the Cork Report which preceded the new Act.

[28] Conference on a unified Insolvency Act 6 October 1999 *Draft Insolvency and Business Recovery Bill* (1999) Discussion Document vol 1.

[29] Countries that introduced business rescue regimes include the United States (1978), Italy (1979), Luxenborg (1984), France (1985), the United Kingdom (1986), Singapore (1987), Sweden (1987), Netherlands (1988), Ireland (1990), Denmark (1991), Portugal (1992), Australia (1992) Switzerland (1994) and Belgium (1998). See also Rajak, Horrocks, Bannister *European Corporate Insolvency* (1995).

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creating an appropriate business rescue system in the light of the objects of insolvency law.

1 4 **Insolvency and the economy**

Insolvency law has received very little attention in the form of in depth research and an investigation into the principles that should underlie the law in the light of the practical effect of the measures of existing insolvency law. In England the position changed when the then English government had to consider the bankruptcy proposals of the European Economic Union in the early 1970's. At roughly the same time the English economy suffered an increased incidence of corporate and individual financial failures because of a prolonged recession and high levels of inflation. The English public was not satisfied with the results of the insolvency law in those circumstances. This led the English government to appoint a committee, the Cork Committee, which was instructed to investigate the English insolvency law and to make recommendations.[30]

The Cork Committee's investigation was the first comprehensive review of the insolvency law in England for more than a century. The final report of the Cork Committee that appeared in 1984 has been described as "a voluminous and epochmaking document, which will continue to provide a major point of reference for years to come."[31] The Cork Report remains an important source of reference also for the South African scholar, because the South African insolvency law is under the influence of past English law.[32]

It is possible to regard insolvency as a state of affairs where the debtor can no longer meet all his obligations. Something has happened to put him in a position where his assets are at present not enough to pay all his creditors, present and future. There is a lack of monetary value in the estate of the debtor. This is a very clinical approach that does not explain the damage that insolvencies inflict on an economy.

Another way of approaching insolvency would be to say that the debtor finds himself in a position where he has started to dishonour the most important principle in

[30] In general on the history and the effect of the Cork Report see Fletcher *The Law of Insolvency* (1996) 13-21. See also Goode *Principles of Corporate Insolvency Law* (1997) 8.
[31] Fletcher *Law of Insolvency* 17.
[32] Rajak *"Business Rescue for SA"* 1 and Rajak & Henning "Business Rescue for South Africa" 1999 *SALJ* 262.

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commerce and trade, namely *pacta sunt servanda.*[33] This principle is the cornerstone of transactions and the trust that makes it possible for the economy to function. Without the legitimate and realistic expectation that the other party will keep to his agreement there would not be sufficient trust to enter into transactions and thus no economy to speak of.

Without looking at the harm and destruction of a particular insolvency it could be said that in general insolvency corrupts the trust that oils the wheels of the economy.[34] It often leads to the removal of a participant from the economy, which has a ripple effect on the other participants in the economy. Insolvency law should provide a response to the situations where the trust is adversely affected.

Agreements should be kept, but what happens when it is no longer possible for a party to comply with its agreements? The response to insolvency situations is rooted in the culture, including the business culture, of a society. Often insolvency law is guided by a particular society's perception as to the cause of insolvency and society's wish as to how to treat the debtor in the future.

As set out in the Cork Report, the response of society in England was for a very long time rooted in the circumstances that prevailed more than a hundred years ago. The economy then was largely a cash economy. Goods were paid for in cash. For the individual, insolvency was unthinkable in a commercial sense and occurred mainly where an unforeseen event bestowed an unforeseen obligation on the individual.

> "Traders, on the other hand, by virtue of their profession needed to give and receive credit. The capital or available assets of the trader largely consisted of moveable property of the type 'generally unknown, always uncertain, and perpetually fluctuating' ".[35]

In a world where credit exists and is extended for substantial amounts there is always the possibility of the absconding trader. He was the one who:

> "craftily obtaining into their hands great substance of other men's goods, do suddenly flee to parts unknown, or keep their houses, not minding to pay or

[33] Agreements must be honoured.

[34] See further Tomasic *Australian Corporate Insolvency Law* 1-19 on the principles underlying insolvency law.

[35] Christian *The Origin, Progress and Present Practice of Bankrupt*[cy] *Law,* 1818 as quoted in the Cork Report 15 para 33.

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restore to any of their creditors their duties, but at their own wills and pleasures consume debts and the substance obtained by credit of other men, for their own pleasure and delicate living, against all reason, equity and good conscience."[36]

The society described above is concerned about the mistakes made that led to insolvency and its aversion of the absconding trader. Curing these problems was at the heart of much of the early insolvency legislation. Therefore up to this day there exists in insolvency law the need to find who was at fault.

The need to establish if someone was at fault speaks for itself. It was however for a long time, and to some extent still is, an overriding objective of society's response to situations of insolvency. As a result the insolvent was treated as a virtual criminal, but without the necessity of a conviction. It was possible to jail one's debtor if his debts remained unpaid, on account of the debts alone, without any criminal conviction. This situation gives rise to the following question: What good is it to jail someone for not paying his debts, thereby preventing him from earning the means to pay his creditors?[37]

In South Africa a defaulting debtor could still be sent to jail for not paying his debts until the Constitutional Court's decision in *Coetzee v Government of the Republic of South Africa*.[38] The reason why the debtor would have found himself in jail was for contempt of court, but in essence it would have been contempt for not paying while a court order ordering the debtor to pay was in force. However the Constitutional Court has now decided that a process which jails a defaulting debtor because of non-payment is unconstitutional. The court found that although the objective of provisions for imprisonment of civil debtors is a legitimate and reasonable governmental objective, the question is whether the means to achieve the goal are reasonable. The court found the means to achieve the goal are not reasonable. The fundamental reason why the means are not reasonable is because the provisions are overbroad. The sanction of imprisonment is clearly aimed at the debtor who will not pay. But it is unreasonable in that it also strikes at those who cannot pay and simply fail to prove

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[36] Quotation from the first English Bankruptcy Act passed in 1542 as quoted in the Cork Report 16 para 35.
[37] Surely the question attempts a very shallow analysis of the whole aspect as to how to deal with a defaulting debtor and does not take the unwilling debtor into account. Nevertheless the whole idea is somewhat paradoxical.
[38] 1995 (10) BCLR 1382 (CC), 1995 4 SA 631 (CC).

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this at a hearing, often due to negative circumstances created by the provisions themselves.[39]

Even though much of the insolvency law was based on fault it was also soon recognised that someone could land in financial difficulties through no fault of his own. A businessman in a world of credit, and especially in a world where great sums of credit are extended, can, owing to the risks inherent to trade, still be ruined while acting most diligently and honourably. For someone that found himself in such a predicament it was considered proper and justified that his creditors should release him from a strict adherence to all his commitments. That meant he deserved a "fresh start"[40] if he was honest and frank towards his creditors, made full disclosure and delivered all of his property to be divided among his creditors in satisfaction of their claims to the extent that his assets would permit.[41]

The question is whether finding fault, providing for the orderly distribution of remaining assets and providing for a fresh start are adequate to deal with modern-day insolvency situations. As explained above, modern economic circumstances are very different from those prevailing when insolvency law first came to the fore. The idea of giving someone that was not at fault a chance to start afresh was an innovative idea that contributed to the solution of complex situations, which could not be allowed to continue indefinitely. This idea of a fresh start has been refined in the development of current business rescue regimes. Instead of a fresh start, the business rescue measures, including those contained in modern insolvency law, are based on a "second chance" or "further chance". This has been done because it is a remedy that a modern economic society needs.

On the one hand, the modern economy needs debtors and entrepreneurs to oil its wheels. Society on the other hand loses much more that a few unpaid debts when a business is liquidated. The innovation of a fresh start for those who justified it because of their misfortunes not of their own making and subsequent proper conduct towards their creditors needs to be extended to a "second chance" for the business debtor, including corporate debtors, in similar circumstances and with similar proper conduct.

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[39] *Coetzee v Government of the Republic of South Africa* 1995 4 SA 631 (CC) 643.

[40] If the debtor concerned is a corporate debtor a fresh start would mean that the members of the corporate debtor are not disqualified from starting a new corporation.

[41] Cork Report 15 par 34.

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As argued above this response is not based on the deserved behaviour of the business debtor, but it is an answer to the needs of the modern economy and a modern society that depends on the modern economy. However, the response of a particular society to insolvency situations depends not only on the needs of the economy and society, but is influenced to a large extent by the culture of the country, which in this context includes its business culture. As stated above, a general trend has developed to make a distinction between business debtors and consumer debtors.[42] The procedures and mechanisms for the treatment of business debtors differ from the measures for consumer debtors. Business rescue concerns the business debtor.

Regimes classified as pro-debtor have a different cultural response to insolvency from those classified as pro-creditor.[43] Some countries like France have a predominantly pro-debtor regime while other countries like the United Kingdom and countries influenced by the United Kingdom have a predominantly pro-creditor insolvency regime. South Africa also falls in the pro-creditor category.[44]

The Cork Report maintains that the response of insolvency law to an insolvent debtor, is guided by four questions:[45]

> "(a) How, in what circumstances and to what extent are the debtor's assets to be made available for the benefit of his creditors?
>
> (b) Are his creditors to be dealt with on the basis of 'share and share alike' or in accordance with some other method of distribution?
>
> (c) How is the debtor himself to be treated or, if the debtor is a company, how should its officers, managers and other agents be treated?
>
> (d) What does society need and demand in these potentially conflicting situations?"

In an attempt to answer these questions in a meaningful way, one has to consider the economic circumstances prevailing, the historical background to insolvency law and the law and practice of the individual country and then provide for different

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[42] See text at n 17 *supra.*

[43] There are also those countries that make no provision for the treatment of insolvency. These countries are some former communist countries and some Muslim countries.

[44] A pro-creditor regime is characterised by laws giving creditors maximum security through an assurance that the contracts they make will be upheld. The courts will thus enforce priorities strictly. See Belcher *Corporate Rescue* 87-88.

[45] Cork Report 10.

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responses. It is also important to keep in mind that with the rapid integration of the world economy considerable thought should also be given to international synchronisation of insolvency law.

1 5 **Aims of this thesis**

Economic circumstances in South Africa and the world have undergone huge changes since judicial management was introduced in 1926. This thesis aims to examine judicial management in the light of these changed economic circumstances and the development of business rescue regimes elsewhere, especially in England and Australia, and to suggest changes to judicial management where it is considered necessary.

For this purpose, the objectives of insolvency law will first be identified. In doing this special attention will be given to business rescue as an objective of insolvency law. The components of insolvency law will then be discussed. The components of insolvency law should lead to the fulfilment of the objectives of insolvency law. The role of business rescue measures as one of the components of insolvency law will receive special emphasis. Judicial management will be discussed as one of the alternative techniques for achieving a business rescue. Judicial management as a corporate rescue method[46] will be compared with similar business rescue regimes in English and Australian law. This comparison will form the background to suggested amendments to the legislation on judicial management.

The English and Australian models were a logical choice for comparison for several reasons. First, both England and Australia have had recent official inquiries into their insolvency regimes which subsequently led to new legislation. The legislation in both these instances included a new business rescue regime. Secondly, both of these countries share the Commonwealth heritage with South Africa. Thirdly, South Africa shares a long commercial relationship with England and it is beyond doubt that English law has had an important influence on South African law, especially in the field of company law. Consequently English law also influenced South African law regarding the liquidation of companies. Australia on the other hand is also of

[46] Judicial management is only available to companies.

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importance because it followed the South African example of judicial management[47] by introducing official management in 1961-1962. The recent amendments to its insolvency regime and the introduction of its new business rescue measure should logically shed useful light on the South African model of judicial management and the possible need for amendments.

The thesis will discuss the different aspects of business rescue procedures separately, starting with the commencement procedures.[48] Thereafter this thesis will discuss the moratorium associated with business rescues,[49] the effect of business rescues on company directors and officials,[50] the rescue plan,[51] the transition to voluntary winding-up,[52] the powers and duties of the person who administers the company in a business rescue,[53] his qualifications,[54] remuneration[55] and his removal.[56]

Separate discussion of each aspect makes the comparison of the different jurisdictions easier and more understandable. The discussion of each aspect of a business rescue will start with judicial management reflecting the current South African position. This will be followed by an examination of the English procedure of administration that was introduced in 1986. The discussion of English law precedes that of Australian law, because the English position corresponds more closely to the South African procedure, in that the English procedure of administration also commences with a court order. It is also older than the Australian procedure. The Australian procedure of voluntary administration will also be discussed last in each instance as this procedure was only introduced in the 1990's and had the benefit of an investigation into the English position before it was implemented. The discussion will thus follow the chronological order of the statutory implementation of the three business rescue schemes.

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[47] There is little doubt that the Australian system followed the South African remedy of judicial management. See Paterson, Ednie & Ford *Australian Company Law* 3rd ed par [333/1]; *Re Testro Bros. Consolidated Ltd* 1965 VR 18.
[48] See 3 3 *infra.*
[49] See 3 4 *infra.*
[50] See 3 4 2 *infra.*
[51] See 3 5 *infra.*
[52] See 3 6 *infra.*
[53] See 4 3 *infra.*
[54] See 4 4 *infra.*
[55] See 4 5 *infra.*
[56] See 4 6 *infra.*

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At the end of the discussion of each of the aspects an evaluation will be made. This will be followed, rather boldly perhaps, by suggested changes to the existing South African legislation to give effect to the proposals.

From the outset it is clear that the provision of an effective statutory business rescue regime is not a cure-all to the problems of business insolvency. It is merely one of the components of an insolvency regime. Other crucial components must also be in place. It is submitted that an insolvency regime that responds well to the needs of a modern economy and society is one that achieves the right balance between the different components.

In the last chapter[57] specific reference will be made to other aspects of insolvency law in the wide sense that have an influence on the effective use of judicial management in the South African context. Certain recommendations will be made for possible legislative changes to achieve a better balance between the different components of insolvency law to serve the present needs more effectively.

1 6 **The parties affected by an insolvency**

As a prelude to the discussion of the objectives of insolvency law, it is first necessary to consider the interested parties affected by an insolvency.[58]

One of the parties is the debtor. There is the honest debtor, the unfortunate character who at one stage saw Lady Luck turning her back on him. There is also the dishonest or downright unscrupulous debtor. He is the one described as the absconding debtor.[59] This character appears in varying degrees of honesty and dishonesty. His blameworthiness may relate to blatantly dishonest dealings or may only be found in his tardiness in coming to the point where he accepts that he is insolvent and informs his creditors. The position is more complicated if the debtor is a juristic person. The managers of such a debtor have some protection against their own folly and failure at the risk of the creditors.

On the other hand there are the creditors. They are potentially the real victims who stand to lose a lot because the debtor can no longer perform according to his promises. Creditors also come in different classes. They vary from the several classes of secured creditor through to the most unfortunate, the unsecured creditor. A society with a pro-

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[57] See 5 *infra*.
[58] See Cork Report 53 par 192.

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creditor insolvency regime treats creditors as close family and gives them the most sympathy and protection.

Society itself is part of the cast. It determines the rules on how to resolve a situation of broken agreements like insolvency. It wants to give creditors maximum support, but also wants to treat debtors as somewhat more distant relatives who should be given a second chance. Society also wants to punish unacceptable behaviour. It acts as moral guide and judge. However, society cannot afford to cast out failing debtors in all circumstances. Society needs both creditors and debtors to go on performing their economic functions in order for society to be healthy (and wealthy).

The rules of society have to deal with totally different aspects. While some rules punish and restrict blameworthy debtors, other rules aim to admit insolvent debtors into the mainstream of economic activity once again.

In this process it would be wrong to view creditors as neutral observers whose actions are predictable. Economic activity is not only a theatre of neutral monetary or economic relationships. It is also an arena in which persons do not always act rationally. Creditors often enjoy exercising power over their debtors. This leads to behaviour that cannot be explained by rational economic and market behaviour. Such creditors may, for no good economic reason, deliberately cause the sequestration of a debtor's estate.

A good example of such an event in a South African context is the famous Tollgate saga.[60] Tollgate Holdings (Tollgate) was a company with diverse interests. It owned businesses in the textiles, communications, tourism, sport promotions, property and food sectors of the economy. Besides all these assets it also had enormous debts. Its debts owed to banks totalled approximately R600 million. These debts were owed mainly to a single commercial bank. Tollgate was presumably insolvent or at least commercially insolvent. Tollgate realised its predicament and started to put a plan together to save itself from financial collapse. By June 1992 the bank debt had been

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[59] See 1 4 n 36 *supra.*

[60] The whole affair has been described in various issues of *Millennium*, especially October 1995, Feb-Mar, Apr, Oct-Nov 1996. See also *Noseweek* issue 14. The liquidation inquiry under the Companies Act that has been continuing for more than three years is not conducted publicly and information from the inquiry is not freely available. In addition to this anecdotal evidence see Belcher *Corporate Rescue* 95-98 for a discussion on the predictability of corporate decision-making in times of adversity and the problems attached to such predictability.

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halved.[61] Up to this point it appeared that Tollgate was recovering from its financial woes. This should have been a great relief to any creditor to see his exposure to a potential disastrously default diminish.

In spite of this performance from Tollgate the commercial bank became less friendly towards Tollgate. This less friendly and later hostile attitude to Tollgate was allegedly motivated by considerations other than pure economic and business motives. Towards the end of 1992 the bank decided to liquidate Tollgate and was only frustrated in doing so by Tollgate's application for its own liquidation when it learned of the bank's imminent court action.

This attitude of the bank is not entirely explicable in terms of commercial and economic considerations. In the two years up to the decision to liquidate, Tollgate reduced its bank debts substantially and even paid R160 million in interest payments as well. It is also alleged that the commercial bank could not have afforded to make a decision to liquidate without the considerable financial help it received from the Reserve Bank of South Africa.[62]

This liquidation affair has led to the longest and most expensive liquidation proceedings in South Africa and furthermore the demise of a huge business which could still have played an important part in the economy. The example illustrates the interests of society in the insolvency of a large company. These interests cannot necessarily be subordinated to the rights of a particular creditor, particularly if that creditor has an ulterior motive.

It is against the background of debtors, creditors, society and the present economic realities that one needs to look at the objectives of insolvency law. These objectives are sometimes opposing with the result that choices have to be made. The objective of removing delinquent debtors from economic activity requires a different approach to the objective of preserving viable economic enterprises. The rules that are made cannot provide for all the subtle differences in situations which arise in practice. The rules also cannot possibly give equal weight to all the conflicting wishes of creditors and debtors and society. Some form of voluntary arrangement is notionally the ideal way to solve insolvency situations, to provide for maximum flexibility, creativity and

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[61] *Millenium* Oct (1995) 48-49.

[62] This help was apparently given for bad debts in general and not specifically in connection with the Tollgate account.

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ingenuity. To the South African scholar a system based primarily on a voluntary arrangement seems impossible. Nevertheless, the rules of insolvency law should provide for such a possibility to some extent.[63]

1 7 **Objectives of insolvency law**

In order to identify the objectives of insolvency law in England and Australia, it is helpful to consider the objectives of insolvency law as formulated by Goode,[64] the Cork Report[65] and the Harmer Report.[66] Goode listed ten objectives of corporate insolvency in his 1990 edition but reduced the list to four in his 1997 edition. On the other hand the Cork and Harmer Reports refer to the objectives of insolvency, which covers both individual and corporate insolvency.

From an analysis of these sources it is suggested that the following are or at least should be the major objectives of a modern insolvency regime.

1 7 1 Recognition of modern economic processes

First, the circumstances and the economic processes of the modern world must be recognised and insolvency law should align its response to insolvency with the needs and processes of the modern world.

This objective is mentioned by the Cork Report as its first objective. It is definitely an indication of the importance of the need to realise that insolvency law is, as far as practically possible, an instrument to facilitate the commercial and economic processes of the community. The measures of the insolvency law should thus have a broader perspective than merely dealing with the defaulting debtor and his creditors.

The Cork Report stresses the importance of recognising that the effects of insolvency are not only limited to the private interests of the insolvent and his creditors, but it

[63] Although it might seem an outrageous idea to propose a voluntary regime to handle insolvency, one can look at the example of Taiwan. It is said that the Confucian ethic of settling disputes by relying on personal relationships rather than the law influences the way insolvency is handled in Taiwan.
"The Chinese people have long been accustomed to settle their differences and difficulties in an amicable manner; and great leniency is generally shown to a bona fide insolvent debtor. Bankruptcy is not regarded, as it is done in Europe, as a semi-criminal offence. A debtor, be he a merchant or not, is usually permitted to settle his debts by all manner of means. When he has failed in his own effort, he will request some third party to mediate." See Tomasic et al 1996 *Australian Journal of Corporate Law* 258. In practice under this system, a merchant will ask for the assistance of the local chamber of commerce to bring about an amicable settlement of a debt related dispute.

[64] Goode *Principles of Corporate Insolvency Law* (1990) 17-23 and *Principles of Corporate Insolvency Law* (1997) 24 - 29.

[65] Cork Report 53-55 para 191-199.

[66] Harmer Report no 45 2 para 5.

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also has a vital effect on other interests of society or groups in society. This is also among the objectives identified by the Harmer Report.[67]

1 7 2 Preservation of viable economic enterprises

The first objective leads directly to the second, namely the provision of means for the preservation of viable commercial enterprises that might usefully contribute to the economic life of a community. It can also be regarded as the business rescue objective. It is the first objective of Goode (both in 1990 and 1997) and one of the distinct objectives of the Cork Report.[68] However, it is not directly addressed by the Harmer Report, which presumably sees it as following so logically from the first objective above that it does not even need further discussion. This one can deduce from the fact that although it is not stated as a separate objective, the Harmer Report nevertheless proposed the introduction of a new business rescue measure as part of its response to insolvency.

In this respect the South African regime of judicial management preceded the modern wave of business rescue schemes recently introduced in many other jurisdictions by several decades.

As said before, the viewpoint that insolvency weeds out the inefficient firms and leaves the economy more healthy and efficient is no longer accepted unequivocally.

Business enterprises are not merely financial units.[69] Businesses may also have wide networks of contacts and expertise built up over many years. All these cannot be replaced easily. Furthermore businesses play an essential role in communities and sometimes the well-being of an entire community depends on a single business enterprise.

As an example of such a business one only needs to look at the central role played by a motor car manufacturer such as Mercedes in the economy of a city like East London. If such a business should collapse, and not be afforded the chance to reorganise itself, it would devastate the economy of that region.[70] The Cork Report stated in this regard:

[67] *Cf* the Harmer Report objectives six and seven.
[68] Cork Report 55 para 198(j).
[69] See Tomasic *Australian Corporate Insolvency Law* 14-17; Warren "Bankruptcy Policy" 1987 vol 54 no 3 *The University of Chicago Law Review* as cited by Wheeler *Company Law* (1993) 775.
[70] See also *Sammel & Others v President Brand Gold Mining Co. Ltd* 1969 3 SA 629 (A) 662H where the trial judge Nicholas, J is quoted as saying "nobody would lightly allow Saaiplaas to go into

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> "We believe that a concern for the livelihood and well-being of those dependent upon an enterprise which may well be the lifeblood of a whole town or even a region, is a legitimate factor to which a modern law of insolvency must have regard. The chain reaction consequent upon any given failure can potentially be so disastrous to creditors, employees and the community that it must not be overlooked."[71]

The circumstances of the restructuring of the John Mansville Corporation in the early 1980's in the United States of America serve as an example. John Mansville applied for restructuring in terms of Chapter 11 of the Federal Bankruptcy Act of 1978; the United States' business rescue provision. John Mansville was an "economically robust" corporation that specialised in asbestos products. At some stage John Mansville became the defendant in a number of lawsuits in which persons who fell ill because of contact with asbestos claimed damages. By 1982 an average of 425 new plaintiffs per month commenced actions against John Mansville.

A study indicated that these claims would escalate in the future. This left the management of John Mansville with a predicament. They knew that future claims would devastate the corporation and at the same time it would be improper to go on doing business without giving proper attention to this inevitable insolvency, although it was not possible to say exactly when the corporation would become insolvent.

The future claims became the focal point as to why the corporation had to be reorganised. The other option would have been to liquidate the corporation. Of this possibility the court said:

> "The liquidation of this substantial corporation would be economically inefficient in not only leaving many asbestos claimants uncompensated, but also in eliminating needed jobs and the productivity emanating from a going concern. It fosters the key aims of Chapter 11 to avoid liquidation at all costs."[72]

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liquidation"; "it would be a very painful process and would never be done lightly"; and "it would be painful to the community of the Orange Free State gold fields, the State, the investing public, the mining house, all shareholders, creditors, everybody."
However painful liquidation would have been, it was unavoidable in the absence of some alternative.

[71] Cork Report 56 para 204.

[72] *In re: John Mansville Corporation* 36 Bankr 743 (SDNY 1984).

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It is thus clear that circumstances may evolve where it is practically impossible for a business enterprise to enter into a voluntary arrangement with its creditors but where the survival of the business enterprise is desirable. It is also abundantly clear that it is to the benefit of creditors that measures exist where the business can sometimes be kept going so as to sell it as a going concern and thus provide for a bigger dividend than would be obtained by merely liquidating the business.

It is not difficult to convince oneself of the merits of preserving viable commercial enterprises. The South African legislature recognised this when judicial management was introduced. A proper business rescue measure and culture will do a lot to oil the wheels of the economy and will have beneficial social advantages.[73] The use of section 311 of the Companies Act in the so-called arrangement industry shows that such a need exists. A proper business rescue measure would also be able to alleviate some of the problems experienced with standard schemes under section 311.[74]

However, it is important to keep in mind that statutory business rescue provisions will not be used merely because they exist. The procedure and its aims need to answer to the prevailing business realities. The other insolvency provisions should encourage the use of this measure. The persons implementing the business rescue should be competent and readily available and the business and legal cultures of the community should embrace it as a viable remedy.

At the same time it should be acknowledged that it is very difficult to measure the success of a business rescue regime. Success means different things to different people. If only a part of the business was rescued it might be a success to the management and directors, but a failure for the employees who lost their employment.[75]

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[73] Not everyone agrees. See Robinson "Statutory moratorium on proceedings against a company" 1996 *Australian Business Law Review* 429 at 430 who states:

> "The Cork Report likewise agreed that society has a legitimate concern in the preservation of the commercial enterprise even if it had no interest in the rehabilitation of the company as such. It is submitted that this view is fundamentally flawed. In reality it is usually the case that by the time insolvency surfaces a company is truly in its death throes and well on its way to liquidation. Any prospect of a rehabilitation at this stage is less than slim. Even if 'successful' reorganisation eventuates, the presumption is that the creditors will be required to compromise their debts. The philosophical question that emerges is why corporate rescue is favoured and how much should be given up to facilitate such a scheme."

[74] For a discussion of s 311 and its effect on judicial management see 5 4 *infra*.

[75] For a discussion on what constitutes a successful rescue see Belcher *Corporate Rescue* 22–24. See also Brown *Corporate Rescue* 2–3.

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1 7 3 Maximising returns to creditors

This third objective is of the utmost importance to insolvency law. Insolvency law substitutes individual enforcement procedures with a collective procedure. As a trade-off to the alteration of their rights, the creditors are entitled to expect that their interests should be served in maximising the returns to creditors.

Goode (1997) mentions this objective as the second of four objectives of corporate insolvency law.[76] However, it is noteworthy that neither the Cork Report, the Harmer Report nor Goode (1990) mentioned the maximising of returns to creditors as an objective of insolvency law. It is submitted that this objective is so trite, given the pro-creditor bias of traditional insolvency law, that the authors did not think that it even merited noting.

1 7 4 Orderly, fair and equal process

The fourth objective has to do with the process of insolvency. It is quite clear from the analysis of the abovementioned sources that this process should be orderly, fair and equal amongst creditors.[77]

This is the cornerstone of any insolvency regime. If there is no provision for a fair and orderly process, few if any of the other objectives of insolvency law will be met. Once insolvency occurs it is no longer possible or desirable that every creditor engages in his own enforcement procedure. Such a state of affairs would mean that the bulk of the assets would go to the creditor who moves fastest and it would open up virtually unlimited possibilities for improper practices and conflict between creditors. This has been recognised for a very long time and therefore it has been a long established procedure to stop individual proceedings once insolvency occurs and to appoint a liquidator or insolvency practitioner to step in to manage a collective process on behalf of all creditors.

Orderly insolvency proceedings would not achieve much without the equal treatment of creditors. Although there are creditors with stronger rights than others, most notably secured creditors, it should be an objective of insolvency law to strengthen the

[76] Goode *Principles of Corporate Insolvency Law* (1997) 26.

[77] Cork Report 54 para 198(d) & (f), Harmer Report 2 and Goode *Principles of Corporate Insolvency Law* (1997) 27.

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equality of all creditors as a general principle.[78] In practice there should be little room for promoting certain creditors above others as preferent creditors.[79] Included in the equal treatment of creditors is the setting aside of certain transactions that took place before the commencement of formal insolvency proceedings.

1 7 5 Honest, competent, impartial, efficient and expeditious administration

Fifthly, the administration of the insolvency should be done in a manner that is honest, competent, impartial, efficient and expeditious. This objective recognises that the success of an insolvency regime depends on its administration. The administrators should act in a manner that installs confidence in the insolvency regime. Ways of encouraging those that stand to gain as administrators or managers of the process to act in such a manner should receive careful consideration. The administrator does not carry the risk associated with a business or participation in the economy, therefore the constraints of normal participation do not apply. Some control needs to be in place to regulate the actions of insolvency practitioners.

The administration of the insolvency should also be expeditious. The process of law is notoriously slow. However, the slow enforcement procedures available to a creditor recognise the creditor's contractual rights. When formal insolvency commences it changes the rights of the creditor: enforcement, set-off and other remedies are no longer available. This is all the more reason for the process to be expeditious.

1 7 6 Regulation of behaviour of participants in a credit economy

In the sixth place, the writers on English law believe that the insolvency regime should also regulate the behaviour of participants in the economy. Goode (1990) refers to the need for the proper investigation into the causes of the company's failure and the imposition of responsibility for culpable management by the directors and officers and the protection of the public against future improper trading by delinquent

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.[78] Harmer Report 46 - 48. The report even recommended that the priority over other creditors enjoyed by the Commissioner of Taxation should no longer apply. This recommendation was accepted by the Australian legislature in 1993 when the priority of the Commissioner of Taxation in respect of unpaid taxes was abolished by the Insolvency (Tax Priorities) Legislation Amendment Act 1993.

[79] See Bennetts "Inequality is Fairness: Reviewing the decision in *Lam Soon Australia Pty Ltd (administrator appointed) v Molit (No 55) Pty Ltd,* unreported Federal Court (Full Court), No S632 of 1996, 18 October 1996" 1997 *Company and Securities Law Journal* 52 54. The court approved a deed of arrangement discriminating between unsecured creditors by paying most in full but paying the lessor only one cent more than he would have received in liquidation. Bennetts rightly criticises the decision saying that it might lead to all kinds of discrimination: between old suppliers and continuing suppliers, or between creditors whose votes are needed and those whose votes are not needed. Discrimination should not be applied lightly.

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directors. The Cork Report also refers to the desirability of an investigation into the conduct of officers or agents, which merits criticism or punishment.

The Harmer Report on the other hand largely rejected the idea that insolvency law should be "the guardian of values that seem appropriate in the conduct of the credit economy".[80] The Harmer Report nevertheless mentions two instances where insolvency law should act in a regulatory manner. The provisions for insolvent trading should regulate the role of directors of private or proprietary companies and should determine to what extent they should be liable for the unpaid debts and liabilities of an insolvent company. The other instance where the commission felt that the insolvency law should play a regulating role is in connection with individuals who conduct their commercial activities in an "unscrupulous manner".

Thus even the Harmer Report agrees that there should be some regulation of conduct through insolvency law. Although the insolvent trading provisions can be seen as a measure to avoid unscrupulous conduct by directors of companies, their value to the business rescue objective (discussed above) should not be forgotten. If the insolvency measures strike the optimal balance as to their treatment of insolvency, the insolvent trading provisions may result in directors seeking timeous relief. The earlier this relief is sought, the greater the potential for the business being rescued or at least for the creditors getting a fairer deal on insolvency.[81] Potential future creditors might then be spared the ordeal of a defaulting debtor. The Cork Report also mentions the early rather than late diagnosis and treatment of insolvency as one of its objectives. Proper regulatory measures in insolvency law, where needed, would help the early treatment of insolvency.[82]

1 7 7 Other objectives

Goode (1990)[83] also mentions an objective that is not mentioned by the other two sources. It concerns the removal of the management powers from the present management. It has always been part of English, Australian and South African law that the management of the insolvent's assets should be taken out of the hands of the

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[80] Harmer Report no 32 at 6.
[81] See 5 2 *infra*.
[82] The measures need not be always part of an insolvency statute. Accounting practice can be influenced to draw the attention of the directors to the possible consideration of a business rescue option, similar to the requirement of the going concern judgment which accountants have to make when auditing a business.
[83] Goode *Principles of Corporate Insolvency Law* (1990) 6.

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defaulting debtor. However, it is not unanimously accepted that this approach should be followed. There are certain insolvency measures that allow for a different approach. The Chapter 11 procedure of the United States' insolvency law is a business rescue regime where the debtor stays in control of the assets. On the other hand the Australian and English regimes for business rescue are different. They do not go as far as placing creditors in control but put a neutral administrator in control. Nevertheless, the receiver who is appointed by a creditor who holds a floating charge over the whole or a substantial part of the property of the company is, *de facto,* a creditor in control.[84]

Once it has been decided to vest control in a neutral third party, careful consideration should be given to the qualifications and remuneration of such party. The desirability of impartial and expert management of the debtor's assets may in practice conflict with the desired end result of maximum dividends to the creditors as it often results in most of the assets in an already depleted estate going to the insolvency practitioner.

Other objectives of insolvency law that are of lesser importance to the present research, are the international harmonisation of the different national insolvency regimes as well as their mutual recognition of each other. These objectives are important where the insolvent debtor has been conducting business and has incurred debts in more than one jurisdiction.

International harmonisation in this context is the ideal of having a single insolvency administration "in which the claims of all creditors are marshalled and all the property of the insolvent, wherever situated, is dealt with and distributed by the one administrator".[85] This would avoid the cost and inefficiency of two or more conflicting administrations where the insolvent debtor has assets in more than one country.

The recognition of different insolvency regimes internationally is the alternative to international harmonisation. While the ideal of a single insolvency administration eludes the commercial world, the second best alternative is procedures where countries recognise each other's insolvency proceedings. This supports the administration of an insolvency where the insolvent debtor has assets in more than

[84] See also 2 3 2 *infra.*
[85] Harmer Report 61.

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one country or where some of the creditors of the debtor are not from the country where the insolvency proceedings are taking place.[86]

1 8 **Conclusion**

Although the above discussion of the objectives of insolvency law referred to the English and Australian law, the objectives are universal. It is therefore safe to say that the objectives identified above are applicable in the South African context as well.

From the discussion[87] it is clear that the preservation of viable economic enterprises is an important objective of insolvency law. A business rescue regime should thus be one of the components of insolvency law which are necessary to achieve the objectives of insolvency law.

The next chapter will identify and briefly discuss the different components of insolvency law as found in South Africa, England and Australia.

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[86] At present the South African Law Commission is contemplating the introduction of the UNCITRAL Model Law on Cross-Border Insolvency. See SA Law Commission *Interim Report on Review of the Law of Insolvency: The Enactment in South Africa of UNCITRAL's Model Law on Cross-Border Insolvency* Project 63 (1999) and Cronje "The UNCITRAL Model Law on Cross-Border Insolvency: Perspectives from the South African Law Commission" Paper delivered at conference on UNCITRAL Instruments in Southern Africa May 1999.
[87] See 1 7 2 *supra.*

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CHAPTER 2

Components and potential components of an insolvency regime

2 1 Introduction

The objectives of insolvency law are diverse and cannot be achieved without a variety of measures. It is necessary to identify the different measures or components of insolvency law and their relation to each other in order to understand their significance and the role that each could play in meeting the objectives of insolvency law. The success of an insolvency regime in meeting the objectives of insolvency law lies not only in providing the necessary components, but also in achieving the correct balance between them.

This chapter will identify the possible components of a modern insolvency regime necessary to meet the objectives of insolvency law. It will use the existing measures found in South Africa, England and Australia as the basis for the discussion. The possible components will be discussed briefly and those that could be used to rescue businesses from insolvency will be identified and discussed separately from the other components.

The discussion aims to facilitate an understanding of the role of each component in meeting the objectives of insolvency law and the extent of interaction between the components and objectives. When this is done it will be possible to evaluate judicial management as a specific measure of insolvency law, in the context of its role in the present and future insolvency regime of South Africa.

The discussion will focus on the components of modern corporate insolvency law. The components of insolvency law exclusively for consumer debtors fall outside the scope of the discussion.

2 2 **Components and potential components of insolvency law**

The measures that exist in South Africa, England and Australia to achieve the divergent aims of insolvency law in relation to business debtors are:[1]

(a) winding-up provisions;

(b) voluntary arrangements with creditors;

(c) schemes of arrangement;

(d) administration procedures (similar to judicial management);

(e) receiverships;[2]

(f) avoidance of antecedent transactions;

(g) provisions regarding wrongful or fraudulent trading; and

(h) provisions for the disqualification of directors in certain circumstances.

The different components of an insolvency regime as set out above respond to different objectives of insolvency. For instance, winding-up responds to the need for an orderly, fair and equal process and the maximising of returns to creditors. Avoidance of antecedent transactions aims to promote the equal treatment of creditors and provisions for wrongful or fraudulent trading and disqualification of creditors aim to regulate the behaviour of participants in a credit economy. Some of the components are aimed at helping a business debtor overcome his financial woes without the business being wound up. They are voluntary arrangements with creditors, schemes of arrangement, administration procedures (similar to judicial management) and receiverships. All of the last-mentioned group of components can be used as alternative techniques to bring about a business rescue.

The different components of the insolvency regime that do not present themselves as alternative techniques for business rescues will first be discussed briefly and then the alternative techniques for business rescues will be discussed in more detail. It is important to understand the components that cannot be seen as business rescue techniques, as they form part of a comprehensive response to the problems of insolvency. It is submitted that the success of some of these measures impact directly on the success of the different business rescue techniques. For example, it is clear that if the managers of a business debtor have no difficulty in trading unscrupulously whilst protected by limited liability and are then able to set up a new company to escape any difficulty in honouring their agreements the unscrupulous managers would

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[1] See Milman & Durrant *Corporate Insolvency: Law and Practice* (1994) 2nd ed 3-7 and Goode *Principles of Corporate Insolvency Law* (1997) 14.

[2] Receivership is not known in South African law. It flows from the "floating charge" and is a creature of the principles of equity. Although it is a common-law measure it is included as part of the discussion of insolvency law because of its widespread use in situations where companies suffer financial difficulties, with the result that in the common law receivership has developed into a corporate rescue procedure. See further 2 3 2 *infra*.

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have little incentive to make use of any business rescue measure. It would be far easier to abandon a failed business and start a new or "phoenix" company, instead of being burdened by having to negotiate some arrangement with creditors in an effort to escape the possible consequences of failure.[3]

2 2 1 Winding-up

Winding-up or liquidation of a company is the statutory process of bringing the operations of a company to a close. The liquidator collects the assets of the company, realises them, ascertains the claims of creditors and, only after he has paid the costs of liquidation, distributes the net proceeds to creditors by way of dividend. This distribution is in order of priority as laid down by the law of insolvency.[4]

Winding-up is not only available in cases of insolvency, but in general it is also the mechanism to close down a company which has achieved its purposes or which has outlived its usefulness.[5] Where the company is wound up because of inability to pay its debts, the liquidator also has the duty to investigate the causes of the company's failure and to report on them. Once this has been done and the reports have been made, the company is dissolved.[6] The liquidator has no power to carry on the business of the company other than to the extent it is necessary for its beneficial winding-up.[7]

A winding-up can be effected by means of a voluntary or a compulsory winding-up procedure. Of these two procedures the compulsory winding-up is the one most resorted to in case of insolvency of the company and it is a process strictly controlled by the court.[8]

2 2 2 Setting aside of antecedent transactions

The setting aside of transactions undertaken shortly before formal insolvency that favour some creditors above others has always been part of insolvency law.[9] It serves to ensure equality between creditors and to avoid scams where assets and value are

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[3] See Cork Report 391 para 1739–1744 and the discussion of phoenix companies at 5 3 2 2 *infra.*
[4] Cilliers, Benade, Henning, Du Plessis & Delport *Corporate Law* (1992) 2nd ed 490; Goode *Principles of Corporate Insolvency Law* (1997) 18 – 20.
[5] Cilliers & Benade *et al Corporate Law* 490.
[6] Cilliers & Benade *et al Corporate Law* 520.
[7] Companies Act 61 of 1973 s 384(f). see also the (English) Insolvency Act 1986 sch 4 para 5 and Goode *Principles of Corporate Insolvency Law* (1997) 18.
[8] Cilliers & Benade *et al Corporate Law* ch 28 and Goode *Principles of Corporate Insolvency Law* (1997) 19.
[9] See for example regarding South Africa the Companies Act 61 of 1973 s 339 and s 340 applying the Insolvency Act ss 26, 29-34 to insolvent companies.

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siphoned off from the estate of the company without adequate compensation, shortly before its insolvency.

The extent to which the liquidator is able to undo transactions entered into before formal insolvency differs from jurisdiction to jurisdiction, but it is clearly an important part of any insolvency regime and serves to eliminate the possible abuse of a system which affords defaulting debtors a fresh start.

If these measures for setting aside antecedent transactions are successful, they prevent a business debtor from channelling the assets of the business to a friendly or related creditor so that he will be able to use the assets again while his creditors have to look to an empty shell in a futile attempt to satisfy their claims. The measures stop schemes or shams that are merely crude survival schemes and which at the same time defraud the creditors of the business debtor. Although the survival of viable business entities is an important objective of insolvency law, it does not follow that any method to achieve this end is acceptable and desirable.[10]

2 2 3 Provisions on wrongful trading, insolvent trading and disqualification of directors

Provisions against fraudulent and wrongful trading (insolvent trading provisions)[11] aim to regulate the behaviour of those that conduct the affairs of companies whose members enjoy limited liability and to curb some of the ailments and abuses of limited liability.

The company is undoubtedly the success story of the modern industrialised economy. In fact, it has made it all possible. The legal structure of the company brought together managers and entrepreneurs on the one hand and surplus capital without managerial and entrepreneurial capacity on the other. This provided the engine for economic growth. Especially in the smaller business limited liability was the catalyst to stimulate the entrepreneurial culture. However, limited liability presents its own problems especially as far as creditors are concerned in circumstances where the company becomes insolvent and is liquidated.

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[10] In general see Milman "Curbing the phoenix syndrome" 1997 *Journal of Business Law* 224.

[11] See for example s 424 of the Companies Act 61 of 1973 which empowers the court to impose personal liability for the obligations of the company on those who have been party to conducting its business in a fraudulent or reckless manner. See also 5 2 *infra*.

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The community clearly has an interest in insolvency law and insolvency can never be treated as an exclusively private matter between creditor and debtor. Although the Greene Committee[12] described limited liability as "part of the price the community has to pay"[13] the general dissatisfaction about the opportunities it provides for abuse by the unscrupulous remains.

> "The doctrine of limited liability may have its good points, but it also leads to some indifference and lack of concern when company officials know that if the company goes down, they will not have any financial liability... .
>
> There are many fraudulent practices concerned with the formation and liquidation of companies. Companies are formed, debts run up, the assets milked and the company put into liquidation. Immediately a new company is formed and the process is repeated *ad infinitum.* Associated with the basic fraud is the practice of new companies buying the remaining stock of the old company [from the liquidator] at give away prices, taking on the premises complete with fittings which are unpaid for, again at nominal prices."[14]

The insolvent trading provisions encourage debtor companies to make timeous use of other insolvency law measures such as winding-up or some business rescue provision.[15] If the debtor companies indulge in fraudulent, reckless or wrongful trading, the directors or persons party to such trading run the risk of personal liability for the debts of the company. In an attempt to strengthen the impact of the insolvent trading provisions, some jurisdictions, for example England, make use of "shadow director" provisions.[16]

A person who is not a director can be regarded a shadow director if the company is accustomed to act on his advice. A shadow director has to comply with *all* the duties of a director.

The disqualification of directors is a further attempt to regulate the behaviour of those that conduct their business affairs through companies.[17] Persons that abuse the limited

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[12] The Company Law Amendment Committee chaired by Wilfred Greene (the Greene Committee) held an inquiry into English company law in 1925 - 1926.
[13] Company Law Amendment Committee *Report* (1925-26) par 8 and 9.
[14] Written evidence submitted to the Cork Committee by a Divisional Consumer Protection Officer of the South Yorkshire County Council. See the Cork Report 391 para 1741.
[15] Belcher *Corporate Rescue* 51.
[16] See further the discussion at 5 2 *infra.*
[17] See for example the Companies Act 61 of 1973 s 218 and s 219.

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liability of companies are prohibited from serving as directors of companies in the future. In this way the public is protected from abuse of limited liability by unscrupulous characters.[18]

As can be seen the different provisions interact to achieve the objectives of insolvency law.

2 3 **Alternative techniques to rescue businesses**

There are different alternatives to deal with insolvency of a company without resorting to liquidation of the company and a consequent sale of all of its assets. These alternatives are components of the insolvency regimes of South Africa, England and Australia.

2 3 1 Voluntary arrangements with creditors and schemes of arrangement

It is always possible that a debtor company can come to some voluntary arrangement with its creditors. Such an arrangement will nearly always provide for the payment of a portion of the creditors' claims as settlement in full. The arrangement may be concluded within or outside a statutory framework.[19]

The exact structure of such an arrangement differs from situation to situation and it is this flexibility which makes it an attractive facility to deal with problems of insolvency. The reason why creditors may be disposed to accept such a procedure lies in its flexibility and the speed with which matters can be brought to a conclusion once the arrangement has been accepted.

The South African, English and Australian systems know the informal arrangement where it is purely a contractual arrangement between the debtor and his creditors. This arrangement binds only those creditors who consent to the arrangement.[20] The difficulty is that those creditors who do not consent can always upset the whole arrangement.

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[18] In general see the discussion at 5 3 *infra*.

[19] For a discussion of various voluntary arrangements outside a statutory framework see Belcher *Corporate Rescue* 24–34. See also Brown *Corporate Rescue* 545–554.

[20] Creditors' claims against a company that arise from contract may be altered by the parties to the contract, however only those parties that agree to the variation of their contractual rights will be bound by the variation.

On the other hand the law also provides for statutory schemes of arrangement where it is possible to bind dissenting creditors. English law knows such statutory arrangements in four different forms.

First, section 425 of the Companies Act[21] involves the court's approval for a scheme approved by a prescribed majority of creditors of each class, obtained at separately convened meetings. It can be used irrespective of whether the company is in liquidation.

Secondly, there is the company voluntary arrangement. This is the arrangement procedure provided by Part I of the Insolvency Act.[22] However, this procedure lacks the possibility of a moratorium while the arrangement is worked out. Furthermore, the arrangement only binds consenting creditors.

Thirdly, section 110 of the Insolvency Act[23] operates during a voluntary winding-up where the liquidator may with the approval of the court dispose of the company's business to another company in exchange for shares, policies or other like interests in the transferee company.[24]

Finally, sections 165-167 of the Insolvency Act[25] make it possible for the liquidator in a winding-up to make compromises or arrangements with creditors.

These different procedures are mutually exclusive with their respective advantages and disadvantages. Section 425 of the Companies Act is cumbersome and does not have a moratorium period in which to put the arrangement together.[26] Part I of the

[21] 1985.

[22] 1986. Part I "Company voluntary arrangements" comprises ss 1-7.

[23] 1986.

[24] This section deals with a corporate reconstruction where the whole or part of the company in liquidation is sold by the liquidator to another company in exchange for shares or securities. The members of the company in liquidation must consent to accept shares or securities in the purchasing company instead of the cash to which they would normally be entitled. Provided that the required sanction of the court (s 110(3)) is obtained, the scheme is binding on all members except those who dissent in writing (s 111(1)).

[25] Insolvency Act 1986.

[26] Prentice, Oditah & Segal "Administration: The Insolvency Act 1986, Part II" 1994 *Lloyd's Maritime and Commercial Law Quarterly* 487 list the disadvantages of s 425 as the lack of the power to enforce an informal moratorium during the time needed to put the scheme together; the lack of the power to prevent legal actions, the seizure of assets, the exercise of various real rights vested in lessors and security holders or the presentation of a winding-up petition during the time when the scheme is being discussed; the fact that cooperation of management is essential but may not be forthcoming because of demoralisation (it was their mismanagement that led to the precarious position) or because of unwillingness to cooperate; and because of the definition of class in section 425 which leads to the possibility that a class of creditors can block the whole scheme.

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Insolvency Act only binds consenting creditors and the other two arrangements are only available where the company is already in liquidation.

Section 411 of the Australian Corporations Law provides a procedure similar to the one in section 425 of the English Companies Act. The South African counterpart is section 311 of the Companies Act. In the South African context it is extensively used to keep the company shell alive once the company has gone into liquidation. The main purpose for a scheme of arrangement in terms of section 311 is the utilisation of the tax benefits of the assessed loss of the company in liquidation. It is so widely used that the whole procedure is carried out according to a "standard scheme".[27]

When successful, the section 311 scheme nearly always results in the company being rescued from liquidation. However, at this point there is usually not much left of the business of the company. The provision is however a common device to keep the company alive and it can safely be said that this is presently by far the most popular measure in South Africa for rescuing companies. However, this method has to be contrasted with a business rescue where the primary focus is not on saving the company itself, but rather on keeping its business going.

In the words of the Cork Report:

> "In the case of an insolvent company, society has no interest in the preservation or rehabilitation of the company as such, though it may have a legitimate concern in the preservation of the commercial enterprise."[28]

2 3 2 Receiverships

Receivership is actually an enforcement procedure where the holder of a "floating charge"[29] over the whole or substantially the whole of a debtor company's property can appoint a receiver over the property of the company covered by the floating charge. The receiver concerns himself with the realisation of the company's assets that are subject to the floating charge and the payment of the proceeds to the holder of the charge in or towards discharge of his claim. It is a form of security for credit extended. Receivership was a creation of the English courts, but since 1986 it has

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[27] See the discussion at 5 3 1 *infra*.
[28] Cork Report 53 para 193.
[29] The floating charge is something akin to the South African notarial bond over movable property, but it originates from equity and has principles of ownership and control totally foreign to South African law.

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enjoyed statutory recognition. Receivership in this form has no South African counterpart.

Secured creditors who resort to the appointment of a receiver have the advantage that the receiver is usually free to realise the assets concerned outside and independently of the winding-up, and without regard to the effect upon the unsecured creditors.

The floating charge is limited to companies in its use. It has three distinct characteristics. First, it is a charge on both present and future designated assets of the company. Secondly, the assets are of the kind that in the ordinary course of business would change from time to time. And, thirdly the company may carry on its business unhindered by the floating charge and may dispose of all or any of the assets in the ordinary course of business. This position continues until the creditor takes some step to set the floating charge in operation.[30]

A floating charge is a creature of equity. It is commonly given over the whole of the undertaking of the borrowing company. As such it is usually the lender bank which holds the floating charge on the debtor company's property. The floating charge is created by contract. Upon the happening of an event set out in the contract, or on the appointment of a receiver or on the winding-up of the company the floating charge becomes operative. It is said to "crystallise". The appointment of the receiver can be either by the court or by the creditor.

Once the floating charge has crystallised the company can no longer freely deal with the property. The receiver has control over the assets to deal with them as described above.

> "The floating charge possesses great advantages, and it was quickly adopted by the financial community. It permits the easy creation of security upon the entire undertaking of the borrowing company, thus conferring the maximum security upon the lender, while at the same time permitting the borrowing company complete freedom to deal with and dispose of its assets in the ordinary course of business. So widespread has the use of the floating charge become, that today it is thought that the greater part of the loan finance obtained by the corporate sector, particularly in the case of the finance

[30] Fletcher *Law of Insolvency* 361. See also Cork Report 31 para 102 and *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284 at 294.

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obtained from the banking community, is raised upon the security of such charges; and that the greater part of the materials in course of processing and of the ordinary stock in trade of the corporate sector is subject to them."[31]

The receivership has evolved to its present form where a receiver and manager will be appointed in terms of the floating charge. The receiver and manager has extensive authority to get in the assets, run the company's business and dispose of the assets either piecemeal or as the sale of a going concern. These extensive powers have led to receivership evolving into a form of business rescue regime. The receiver can sell the property of the company as soon as possible or run the business of the company so that it can produce a better price when it is sold as a going concern.

It is this characteristic of receivership which makes it necessary to include it in a discussion of insolvency measures, although it is actually a procedure to enforce a creditor's security. South African law does not know such a measure or its equivalent. Where receivership serves the purpose of sometimes prolonging the life of the business of the company, and not necessarily the life of the company itself, it answers an economic need. South African law is poorer for not having such a procedure and in fact for not even having such a business rescue culture.[32] At the same time it must be conceded that it is impossible to conceptualise a floating charge in terms of South African law.

However, it has to be said that the floating charge and the resultant receivership have serious disadvantages. The Cork Report[33] refers to three such disadvantages. First, it enables a company to obtain credit from suppliers and others on the strength of its appearance as a company of great wealth. All the while, the semblance of wealth on which the credit is obtained is falsified by the existence of the charge. And the floating charge is capable of being enforced at any moment. Secondly, there is scope for the dishonest director. He is often the principal shareholder in a small trading company and he is in the best position to determine the true financial position of the company. This puts him in a position to avoid the loss of the capital invested by him

[31] Cork Report 32 para 104.

[32] See *Tenowitz and Another v Tenny Investments (Pty) Ltd; Spur Steak Ranches (Pty) Ltd v Tenny Investments (Pty) Ltd* 1979 SA 680 (E) 684D, where the court observed that it is not a ground for judicial management that the proceeds of the company will be more if the business is given more time to be sold as a going concern.

[33] No changes appear to have been made to the law on receiverships, in spite of the criticisms in the Cork Report 32 para 105.

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in the venture by way of loans. He simply obtains a floating charge in his own favour and thus gains priority over the unsecured and often unsuspecting trade creditors who trade with the company. Thirdly, the common practice of giving a floating charge over the whole undertaking of the company means that in the event of the company going insolvent, the whole of the assets will be dealt with and realised outside the winding-up.

Therefore, although South Africa needs to develop a business rescue culture receivership does not appear to be an appropriate vehicle.

2 3 3 Administration

Administration is the business rescue provision of English law. Voluntary administration is its Australian counterpart. As such, they correspond to the South African procedure of judicial management. Administration and voluntary administration involve the appointment of an administrator to manage the company for the benefit of the creditors in general with the aim of also securing the survival of the company or its business as a going concern.

Although business rescue procedures in the three jurisdictions differ in important aspects they have certain characteristics in common. The procedure commences when the company is insolvent or on the verge of insolvency. Subsequent to commencement the company is allowed some breathing space in that a moratorium is placed on enforcement procedures by creditors. The administrator or judicial manager of the company has to use the time provided by the moratorium to formulate a plan to restore the company to financial success.

The plan has to be accepted as required by the various statutory provisions and if it is accepted, the company will be managed according to the terms of the plan. If the plan is rejected the company will often proceed to liquidation.

The following chapters will compare the different procedures in the three jurisdictions and propose changes to judicial management in South Africa based on the comparison.

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3 3 1 Judicial management (South Africa)

Judicial management is a corporate rescue mechanism, initiated by a court order. In this respect it is similar to the English administration order.

On application to the high court[38] a provisional judicial management order may be made, if it appears just and equitable, when a company by reason of mismanagement or any other reason:

> "(a) is unable to pay its debts or is probably unable to meet its obligations; and
>
> (b) has not become or is prevented from becoming a successful concern,
>
> and there is a reasonable probability that, if it is placed under judicial management, it will be enabled to pay its debts or to meet its obligations and become a successful concern".[39]

The application may be made by the company, one or more creditors (including contingent or prospective creditors), one or more members of the company or any or all of them acting together or, in the case of a company being wound up voluntarily, the Master.[40] Although there is no statutory provision for this, the liquidator[41] and the provisional liquidator[42] have been allowed to apply for judicial management.

In South African law judicial management is seen as an extraordinary[43] measure because a creditor of a company that is unable to pay its debts is primarily entitled to liquidation as a means of recovering his claims. This right of the creditor has been referred to as a right *ex debito justitiae* to liquidate the company.[44]

The court normally does not make a final order, but makes a provisional order and appoints a provisional judicial manager.[45] The provisional judicial manager assumes

[38] Companies Act 61 of 1973 s 427.
[39] Companies Act 61 of 1973 s 427.
[40] Companies Act 61 of 1973 s 427(2) read with s 346.
[41] *In Re AH Olver NO: Intafine Leasing and Finance (Pty) Ltd* unreported case no M 1830/76 CPD dated 16 Feb 1977, see Olver *Judicial Management in SA* Annexure IV.
[42] *Common Fund Investment Soc Ltd v COC Trust Co Ltd* 1968 4 SA 137 (C).
[43] There is a line of decisions that supports this view. It starts with *Silverman v Doornhoek Mines Ltd* 1935 TPD 349 at 353, was subsequently echoed by Trollip JA in *Sammel & Others v President Brand Gold Mining Co Ltd* 1969 3 SA 629 (A) at 663 and followed in *Tenowitz v Tenny Investments (Pty) Ltd* 1979 2 SA 680 (E) at 683. This is one of the reasons why judicial management is uncommon. Courts do not view it as a normal measure that might help a company in financial trouble and a natural alternative to liquidation.
[44] *Tenowitz v Tenny Investments (Pty) Ltd* 1979 2 SA 680 (E) 683.
[45] Companies Act 61 of 1973 s 428(1).

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the management of the company and takes possession of all assets of the company.[46] Furthermore, the provisional judicial manager has the duty to prepare a report and lay the report before separate meetings of members, creditors and debenture holders.[47] The purposes of the meetings are to consider the report of the judicial manager on the desirability of a final judicial management order, to decide on nominees for appointment as final judicial manager, to prove the claims of creditors and to consider the passing of a resolution giving preference to the claims of creditors that arise during judicial management above those of pre-judicial management creditors.[48]

The meetings should be held before the return day of the provisional order. The return day must not be more than 60 days after the provisional order unless the court extends this period on good cause shown.[49]

There is some difference of opinion among both the courts and academics on whether the test to be satisfied on granting the final order is more stringent than the test to be satisfied when a provisional order is sought. Although it was held in *Tenowitz v Tenny Investments (Pty) Ltd*[50] that more than a reasonable probability that the company will become a successful concern should exist on the return day before a final judicial management order can be made, the court in *Ex Parte Onus*[51] was of the opinion that the test is exactly the same on the return day as for a provisional order. Judge Steyn found no reason in the wording of the Companies Act to support a more stringent test for a final judicial management order. The court found support for its conclusion in the judgments in *Kotzé v Tulryk Bpk en Andere*[52] and *Ladybrand Hotel (Pty) Ltd v Segal and Another*.[53] It is submitted that the latter opinion is the correct one. This view is also supported by Meskin,[54] but is opposed by Cilliers and Benade[55] and Olver who hold the view that a stricter test is intended.[56] However, considering that Cilliers and Benade do not refer to *Ex Parte Onus* at all and that Olver submitted his thesis

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[46] Companies Act 61 of 1973 s 430(a).
[47] Companies Act 61 of 1973 s 430(c).
[48] Companies Act 61 of 1973 s 431.
[49] Companies Act 61 of 1973 s 432.
[50] *Supra* 683E.
[51] 1980 4 SA 63 (O) 66C-D.
[52] 1977 3 SA 118 (T).
[53] 1975 2 SA 357 (O).
[54] Meskin *Henochsberg I* 926.
[55] Cilliers & Benade *et al Corporate Law* 477.
[56] Olver *Judicial Management in SA* 43.

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before this judgment, it can be safely assumed that their views on the stringency of the test on the return day will not be followed by the courts in future.

It is implicit in the requirement that there must be a reasonable probability that the company will again become a successful concern that the company will be able to meet all its debts and obligations in full.[57] This requirement of a reasonable probability that the company will recover to the extent that it is able to repay its debts in full is criticised by Rajak as being outdated, unrealistic and often contrary to the wishes of creditors.[58]

3 3 2 Administration (England)

This procedure starts with a petition to the court for a court order to place the company under administration.[59] The company, its directors, a creditor or creditors, including any contingent or prospective creditor or creditors may lodge the petition.[60] The supervisor under a company voluntary arrangement may also lodge a petition to place the company under administration.[61]

Where the applicant is the company, Pennington[62] argues that a petition should be presented in the name of the company only if a general meeting of members or shareholders has so resolved. Alternatively, the company's articles of association should expressly delegate the power to petition in the company's name to its board of directors and the board should then resolve to do so. According to his view, which finds support in the wording of the relevant provision of the Insolvency Act, individual members or shareholders cannot petition for an administration order in that capacity, irrespective of their shareholding.

The "directors" as applicants for the order means the board of directors acting unanimously or by a resolution duly approved by a majority, taken at a properly constituted board meeting.

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[57] *Cf* Companies Act 61 of 1973 s 427(1) and (3).

[58] The debtor is seen more and more as a potential business unit that should be nursed back to financial health. As such the debtor would once more resume his place in the market for the benefit of both past and future creditors. A reduction in the amount received in satisfaction of his claim is the price a modern creditor is willing to pay for the debtor to be restored to commercial effectiveness. See Rajak "*Business Rescue for SA*" 7; Rajak & Henning 1999 *SALJ* 267.

[59] Insolvency Act 1986, s 9(1).

[60] Insolvency Act 1986, s 9(1).

[61] Insolvency Act 1986, s 7(4)(b). In special cases a self-regulating organisation or professional body or the Secretary of State may also lodge the petition. Financial Services Act s 74.

[62] Pennington *Corporate Insolvency Law* (1997) 2nd ed 336.

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Creditors are defined as including contingent or prospective creditors. Contingent creditors are those whose claims give rise to a contingent liability for the company. A contingent liability is a liability that may arise out of a legal commitment that exists already, such as possible liability as surety or the possible liability of an insurer under a policy of indemnity insurance.[63] A prospective liability is one that will certainly arise, but it is not due at the present moment and is not yet finally established or quantified such as a liability for work in progress.[64]

There are five conditions to be satisfied before the court order can be made. Two can be seen as the main conditions, whereas the other three are disqualifying rather than qualifying conditions.

First the court needs to be satisfied that the company is or is likely to become unable to pay its debts. Inability to pay its debts is to be read within the meaning of section 123 of the Insolvency Act.[65] Section 123(1) is the equivalent of section 345 of the South African Companies Act, the section that provides when a company will be deemed unable to pay its debts.[66] The standard of proof to be applied to the requirement that the company is unable to pay its debts or is likely to become unable to do so, is the normal standard of proof in civil cases. It must therefore be more probable than not that the company is or is likely to become insolvent.[67] Brown nevertheless suggests that this standard of proof is too high and that an even chance of the company becoming unable to pay its debts should suffice.[68]

If the presumptions created in section 123(1) cannot be used to prove inability to pay debts, the section also provides for the "cash flow"[69] test and the "balance sheet"[70] test. The cash flow test enables the applicant to prove that factually the company

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[63] Goode *Principles of Corporate Insolvency Law* (1990) 35.
[64] Goode *Principles of Corporate Insolvency Law* (1990) 36.
[65] See Insolvency Act 1986, s 8(1)(a).
[66] These grounds include a written demand by a creditor for an amount in excess of £750 which amount remained unpaid for three weeks and no security to the satisfaction of the creditor was given in that time; a wholly or partially unsatisfied judgment debt on which execution or some other court process was issued; if some other evidence satisfies the court that the company is unable to pay its debts; and where the court is satisfied that the value of the assets is less than that of the liabilities, taking into account contingent and prospective liabilities.
[67] Pennington *Corporate Insolvency Law* (1997) 342. See also the remarks of Hoffman J in *Re Harris Simons Construction Ltd* (1988) 5 BCC 11 and Brown *Corporate Rescue* 58.
[68] Brown *Corporate Rescue* 59.
[69] Insolvency Act 1986, s 123(1)(e).
[70] Insolvency Act 1986, s 123(3).

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cannot now meet its existing debts. The company is thus commercially insolvent.[71] The balance sheet test is an alternative test of insolvency. The company will be deemed to be insolvent if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities.[72]

Secondly the court has to consider whether the making of an order would be likely to achieve one of the following purposes:[73]

> "(a) the survival of the company, and the whole or any part of its undertaking, as a going concern;
>
> (b) the approval of a voluntary arrangement under Part 1;
>
> (c) the sanctioning under section 425 of the Companies Act of a compromise or arrangement between the company and any such persons as are mentioned in that section; and
>
> (d) a more advantageous realisation of the company's assets than would be effected on a winding-up."[74]

The court order has to specify the purpose or purposes for which the order is made. The four purposes of administration are not susceptible to proof as a matter of fact. The second requirement therefore involves a forecast as to the company's prospects in the light of what is already known. The meaning of "likely" in the second requirement has been held to mean that it must be more probable than not[75] that the purposes of administration will be achieved by the making of the administration order. However in other instances it was held that "likely" in this context means that the probability that the purpose will be achieved need not be higher than an even chance and that a probability of an even chance is therefore enough.[76] This is slightly less stringent than

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[71] Brown *Corporate Rescue* 55; Fletcher *Law of Insolvency* 422 and Goode *Principles of Corporate Insolvency Law* (1997) 68.

[72] Brown *Corporate Rescue* 56; Fletcher *Law of Insolvency* 422 and Goode *Principles of Corporate Insolvency Law* (1997) 69.

[73] Insolvency Act 1986, s 8(1)(b) and (3).

[74] It seems that the purpose referred to in subpar (d) is met by the Australian deed of arrangement procedure. It is estimated that unsecured creditors in the deed of arrangement procedure receive on average 21.5 cents/dollar compared with 7.32 cents/dollar in a liquidation. Lessing & Corkey *Corporate Insolvency Law* (1995) 52.

[75] *Re Consumer & Industrial Press* (1988) 4 BCC 68.

[76] *Re Harris Simons Construction Ltd* [1989] 1 WLR 368, [1989] BCLC 202; *RE SCL Building Services LTD* [1990] BCLC 98, 5 BCC 746 and *Re Rowbotham Baxter Ltd* [1990] BCLC 397, [1990] BCC 133.

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the "more probable than not" test. The "even chance" test has now been accepted as the governing test.[77]

Several writers perceive the main entry conditions of the administration procedure as being generally too strict. As such they impede the usefulness of the administration procedure as they discourage early use of the procedure which would result in a higher likelihood of success.[78]

The three disqualifying conditions are that the company must not have gone into liquidation; an administrative receiver must not have been appointed or if he has, his appointer must consent to the order;[79] and the company must not be an insurance company within the meaning of the Insurance Companies Act 1982 or a recognised bank or licensed institution within the meaning of the Banking Act 1979.[80]

The making of the order remains in the discretion of the court even if all the conditions are met. The court may take into consideration any additional factors it considers to be relevant. These include the consequences of making an administration order instead of a winding-up order. The court will usually also give more weight to the position of unsecured creditors because secured creditors have less to lose.[81]

Notice of the petition must be given. Because the English law favours the administrative receiver[82] appointed under a crystallised floating charge, the Insolvency Act requires that prior notice be given to any person who has appointed, or is or may be entitled to appoint, an administrative receiver of the company.[83] As soon as practicable after filing the petition, the petitioner must also give notice of its presentation to any sheriff or other officer who, to his knowledge, is charged with an execution or other legal process against the company or its property.[84]

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[77] Brown *Corporate Rescue* 68; Fletcher *Law of Insolvency* 424; Goode *Principles of Corporate Insolvency Law* (1997) 285-287 and Belcher *Corporate Rescue* 100-101.
[78] Brown *Corporate Rescue* 657; Fletcher *Law of Insolvency* 479; Goode *Principles of Corporate Insolvency Law* (1997) 323.
[79] Insolvency Act 1986, s 9(3). Or the charge under which he was appointed is vulnerable under ss 238-240 or 245 of the Insolvency Act.
[80] Insolvency Act 1986, s 8 (4).
[81] Goode *Principles of Corporate Insolvency Law* (1997) 284.
[82] See the Insolvency Act 1986, s 9(2)(a). The administrative receiver is the person appointed to give effect to the floating charge. The name "administrative receiver" was introduced by the 1986 Insolvency Act.
[83] Insolvency Act 1986, s 9(2)(a).
[84] Insolvency Rule 1986, r 2.6A.

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3 3 3 Voluntary administration (Australia)

The Australian procedure does not start with a court order. Under the voluntary administration procedure an administrator may be appointed by the directors of the company, its liquidator or by a chargee.[85]

The board of directors may resolve to appoint an administrator, except where the company is already being wound up, if they are of the opinion that the company is insolvent or likely to become insolvent and that an administrator should be appointed. The appointment should be in writing using the common seal of the company.[86]

The liquidator or provisional liquidator may appoint an administrator in writing, where he is of the opinion that the company is insolvent or likely[87] to become insolvent. Where the liquidator or the provisional liquidator is appointed as administrator, the court must approve the appointment.[88]

Lastly, a chargee who holds a charge over all or a substantial part of the company's property may appoint an administrator where the charge has become enforceable and remains enforceable.[89] This appointment cannot be made if the company is already being wound up. The appointment should, as in the other instances, be in writing.

Only one appointment of an administrator can be made. Thus, if an administrator has already been appointed by the directors neither the liquidator nor the chargee can appoint an administrator.[90] This means that he who acts first can appoint the administrator of his choice. It is however possible to appoint more than one administrator when the decision is made to appoint. The functions and powers may then be exercised by any one acting alone or by two or more of them acting together unless the instrument of appointment otherwise provides.[91]

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[85] Corporations Law, ss 436A-436C. A chargee is the holder of a charge over the property of the company. It may be over the immovable or movable property or both. A charge is a form of security for the repayment of debts owed to the chargee. It can be in the form of a charge or a floating charge. See Corporations Law, s 9.
[86] Corporations Law s 436A.
[87] As to the meaning of likely there has not been any Australian judgment on this, but the word was considered in similar circumstances in the English courts. See discussion at 3 3 2, n 75 *supra*.
[88] Corporations Law, s 436B. See Crutchfield *Corporate Voluntary Administration Law* 2ed (1997) 69 for a discussion on when the court will approve the appointment of the liquidator of an insolvent company by himself as its administrator.
[89] Corporations Law, s 436C.
[90] Corporations Law, s 436D.
[91] Corporations Law, s 451A(2).

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Upon appointment the administrator must act quickly, extremely quickly when measured by South African standards.[92] He must lodge a notice of appointment with the Australian Securities Commission ("ASC") before the end of the next business day. Notice of such appointment must also be published within three business days after appointment in a national newspaper or in a newspaper in each jurisdiction in which the company has its registered office or carries on business. Notice of appointment should be given by the administrator, to the company and to holders of charges over all or a substantial part of the property of the company. Notice need not however be given to the person who made the appointment.[93]

Failure to give the required notice does not invalidate what was done in terms of the administration. However the court may order otherwise.[94]

3 3 4 Evaluation

All three jurisdictions described above have a business rescue procedure exclusively for juristic persons in the form of companies. If such a procedure is only available to companies it is a major shortcoming in terms of the role that business rescue procedures could play in the economy of a country.[95] If the business rescue procedure is intended to play a significant role in the economy there is no logical reason to restrict its application to companies.[96]

The distinction to be drawn should be that between business debtors and consumer debtors. Thus the business rescue scheme should be available for partnerships, close corporations, individual businesspersons and business trusts.[97] The treatment of close corporations is a case in point. It is a legal person to the same extent as a company. However, there is no measure similar to judicial management to restore a financially ailing close corporation. If an all-inclusive business rescue system is to be introduced it should be included as part of an Insolvency Act dealing with trade or business

[92] See 3 5 3 4 *infra.*
[93] Corporations Law, s 450A.
[94] Corporations Law, s 450F.
[95] Rajak "*Business Rescue for SA*" 10-13; Rajak & Henning 1999 *SALJ* 270-273.
[96] In South Africa it was for a long time uncertain whether s 311 of the Companies Act as a procedure to accomplish a scheme of arrangement was also available for close corporations. This was settled when a revised compromise procedure was introduced by means of s 72 of the Close Corporations Act 69 of 1984. See also s 66(1) of the Close Corporations Act which now makes it clear that s 311 of the Companies Act cannot be applied to a close corporation.
[97] Although the rescue procedure should be available to all businesses there are certain businesses such as banking institutions and insurance companies that could have special requirements for a business

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debtors as a group. It would be inappropriate to deal with such a business rescue procedure in the Companies Act.[98]

The Chapter 11 scheme of the USA Bankruptcy Code makes no distinction between debtors who may use it. There is thus no artificial distinction drawn between companies as business debtors and other business debtors. However the system is so completely foreign to the South African experience, that it is almost impossible to envisage such an all-inclusive business rescue scheme in South Africa.

It is nevertheless possible to have different business rescue provisions that could apply to different business debtors. The distinction should recognise that some trade debtors are bigger than others. A scheme that involves high costs will not be suitable for smaller business debtors. Rajak, in his report,[99] suggests a different business rescue procedure for different business debtors in South Africa, based on the difference in size of business debtors.[100] This is a very sensible suggestion that should be implemented if at all possible. Possible bases for such distinction are the number of members of the business entity or the size of the business in monetary terms.

There are existing distinctions between the different forms of business debtors based on the number of participants in the different forms. The close corporation is limited to ten natural persons, the partnership to twenty persons (natural or legal), the private company to fifty members and the individual business debtor is of course a single person. On the other hand the public company requires at least seven members, but that is no restriction on the maximum number of members that a public company may have. A proposal for some distinction in terms of size based on the number of participants in the business entity may be meaningless because the type of entity is not necessarily an accurate indication of size.

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rescue. See their exclusion from the administration procedure of the English Insolvency Act 1986 by s 8(4)(a) and (b). A discussion of this aspect is however beyond the scope of this thesis.

[98] See however the critisism of the fact that business rescue procedures are included in an insolvency statute in Brown *Corporate Rescue* 654. See also Olver "Judicial Management - a Case for Law Reform" 1986 *THRHR* 84 who regards the inclusion of judicial management in the chapter on winding-up of the company under the previous Companies Act 46 of 1926 as a reason why the judicial management procedure never achieved much success.

[99] Rajak "*Business Rescue for SA*" 9; Rajak & Henning 1999 *SALJ* 269.

[100] *Cf* the remarks of Olver 1986 *THRHR* 86 submitting that it is unlikely that any small company can bear the burden of a judicial manager's fees under the present judicial management procedure and become a successful concern.

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A distinction could more sensibly be made on the basis of the size of business transactions.[101] Such a distinction is already made in the Income Tax Act[102] where some small businesses are allowed to be taxed on a cash flow basis.[103] The Value Added Tax Act[104] also distinguishes between businesses that are obliged to register as registered vendors and those that do not. At present the distinction is drawn between businesses with a turnover of R150 000 or more per year and those with a turnover of less than that. The same Act also draws distinctions between businesses that have to report to the tax authorities on either a six monthly or two monthly basis, and this distinction is also based on the size of the business's yearly turnover. It will therefore not be something completely new to distinguish between business debtors on the basis of size in monetary terms.

The point of distinguishing between big and small business debtors would be to devise a more flexible and less costly business rescue scheme for the smaller business regardless of the business form. For example, the Close Corporations Act[105] contains a provision that aims to achieve much the same as the Companies Act, but which is more flexible and involves less costs. The composition[106] available to close corporations under liquidation enables close corporations to form schemes of arrangement similar to the section 311 schemes of the Companies Act without approaching the court once,[107] whereas a section 311 procedure needs two court applications.[108]

Having pointed out the need for a two-tier business rescue scheme, one for small and one for bigger businesses and the desirability of including all business debtors, this thesis will concentrate on a scheme suitable for the needs of bigger business debtors. Bigger businesses traditionally find themselves in the form of companies and judicial

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[101] A distinction based on the size of business transactions is supported by Goldin J in *Tobacco Auctioneers Ltd v A W Hamilton (Pvt) Ltd* 1966 2 SA 451 (R) and *Olver Judicial Management in SA* 36-37. However their distinction is not to differentiate between different business rescue schemes, but to determine whether the company is sizeable enough to qualify for judicial management. Both are of the opinion judicial management was not intended for smaller companies.

[102] Act 58 of 1962.

[103] Income Tax Act, 58 of 1962, s 37G.

[104] Act 89 of 1991 s 23.

[105] Act 69 of 1984.

[106] Close Corporations Act 69 of 1984 s 72.

[107] It will however be necessary to approach the court if the composition involves the setting aside of the winding-up order. See the Close Corporations Act 69 of 1984 s 72(11).

[108] However if the company was placed under final liquidation and thereafter a scheme of arrangement in terms of s 311 resulted in the setting aside of the winding-up order it will take five court applications to effect the scheme of arrangement.

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management itself is a mechanism only available to companies, as is voluntary administration in Australia and administration of companies in the England.

One of the important factors to consider at the outset is the costs involved in a business rescue scheme. The rescue is necessary because of a lack of funds. The creditors and the courts will not be persuaded to embrace a scheme where it will only result in the available assets being depleted and another "creditor" being introduced in the form of the administration costs of the business rescue scheme.

On the one hand, voluntary administration in Australia is initiated merely by decision of the relevant party. This method is virtually without cost and extremely quick. It only needs a decision in writing under the common seal of the company where the administrator is appointed by the directors and notice of administration in the prescribed manner. On the other hand, the English scheme is initiated by petition to the court and by court order. Likewise, judicial management in South Africa requires a court order, but needs applications for both a provisional order and a final order. It is clear that the English and South African schemes are comparatively cumbersome and much more expensive to set in motion. They require much greater involvement and preparation by legal practitioners.

The high costs involved in the implementation of administration schemes are arguably the Achilles heel of the English system. One of the five reasons advanced by the Insolvency Service for the lack of enthusiasm in practice for the administration order procedure is the time and costs involved.[109] Grier and Floyd note this as one of the two main reasons why administration orders lack popularity.[110] Goode agrees that the high costs is one of the important factors impeding the use of the administration procedure.[111] At the same time he also identifies the inevitable delay involved with court applications as a further shortcoming of the procedure.[112]

[109] Consultative Document *Company Voluntary Arrangements and Administration Orders* Insolvency Service publication 1993.

[110] Grier and Floyd *Corporate Recovery; Administrations and Voluntary Arrangements* (1995) 215.

[111] Goode *Principles of Corporate Insolvency Law* (1997) 323 is supported by Fletcher *Law of Insolvency* 479. Milman *Corporate Insolvency: Law and Practice* 2nd ed (1994) 46 agrees that it is prohibitively expensive for the small private company and says £2000 has been cited as a minimum starting cost. Brown *Corporate Rescue* 655 says that a figure of between £1500 - £2000 is more realistic for smaller companies, but agrees that the costs of administration orders is the overwhelming reason cited for their relatively low use.

[112] Goode *Principles of Corporate Insolvency Law* (1997) 323. See also Rajak "*Business Rescue for SA*" 8 who identifies the heavy reliance of judicial management on court procedures as one of the shortcomings of judicial management. See also Rajak & Henning 1999 *SALJ* 268.

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On the basis of costs and ease of implementation the Australian system is clearly superior.[113] However, to balance the ease of initiation, an extremely short period is allowed for the implementation of a deed of arrangement to safeguard the interests of the creditors, who are only subjected to a moratorium for a very short period. The idea of the application to court is to obtain an independent and impartial decision after any possible objections have been heard. The creditors would be more satisfied and have more trust in the whole process if they were given the opportunity to be heard and if a court made the order. However, this consideration is counterbalanced by the cost and delay inherent in court applications.

The choice between the two approaches involves more than a business decision on the costs. There is a policy decision to be taken. Does the legislature want to encourage the entrepreneurial spirit and to what extent is it prepared to encourage such a spirit in the national economy? The greater the emphasis on an entrepreneurial culture, the greater the desirability that the decision-making power should lie in the hands of the business debtor. If the power to initiate a business rescue is placed in the hands of the business debtor, possible abuses can be countered by a stricter monitoring of the process that follows.[114]

The existing requirement of a court application for both provisional and final judicial management appears to be a legacy of indecisiveness stemming from the adversarial nature of our courts and the role of the judge as a neutral adjudicator without any prior knowledge of the issues for decision. There is a lot to be said for simplifying the commencement of judicial management.

Another aspect of the commencement process that needs amplification in the legislation is the grounds on which the business rescue scheme can be implemented and its purpose. There have been concerns in the past that judicial management was abused. The response of the Van Wyk de Vries Commission was to recommend that a judicial management order should only be granted if there is a reasonable probability

[113] Before the voluntary administration procedure became operational it was generally thought that the procedure would only be employed in relation to small to medium size companies. See Keay "Corporate Governance during Administration and Reconstruction under part 5.3A of the Corporations Law" 1997 *Company and Securities Law Journal* 145 146. Routledge "An exploratory empirical analysis of part 5.3A of the Corporations law" 1998 *Company and Securities Law Journal* 4 11 concludes however that size does matter and that the larger companies might have a better chance to succeed with a business rescue under the Australian procedure, due to the costs of voluntary administrations.

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that all debts will be paid and that the company will become a successful concern. The legislature agreed and retained this requirement for judicial management.[115] With hindsight, this is the wrong approach. Virtually nowhere in other business rescue schemes is this seen as a qualifying requirement. In the prevalent credit economies of today it is widely accepted that the creditors would usually accept a reduction of their claims and rather reap the longer term benefits of having a viable debtor to do business with.[116]

The English system is a good example in this respect: it specifies a variety of purposes for which administration is available.[117] The emphasis may be on the survival of the business or any part of it; the opportunity to effect some voluntary arrangement between those concerned or even the more beneficial realisation of the assets of the company.

The more beneficial realisation of assets as a purpose of administration is in stark contrast to the judgment in *Tenny v Tenowitz*[118] which declares that judicial management is not available in circumstances where it is sought to achieve a more beneficial realisation of the business assets as a going concern as opposed to the survival of the company itself.

Whereas both the South African and English systems emphasise the desired outcome, the Australian system is less specific in this respect, but focuses instead on the process that it initiates. The Australian system only defines the circumstances in which the business rescue scheme is available, and the process to be followed. It is left to the participants to decide what the process should deliver. There is thus neither a judicial discretion involved in the implementation, nor an expression by the legislature of the aims of every specific administration.[119] It is nevertheless a question of the trust present in debtors' and creditors' relations. It is beyond doubt that creditors would be wary of the implementation of a business rescue scheme without a stated aim. This is especially so given the powerful position creditors particularly the big lending

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[114] See Crutchfield *Corporate Voluntary Administration Law* 26-27 for a discussion of the safeguards against abuse of voluntary administration in Australian law.
[115] See the Companies Act 61 of 1973 s 427 and s 432 and compare the Companies Act 96 of 1926 s 195.
[116] Rajak "*Business Rescue for SA*" 7; Rajak & Henning 1999 *SALJ* 267.
[117] Insolvency Act 1986, s 8(3).
[118] *Supra* 684. See also Van Wyk De Vries *Commission of enquiry into the Companies Act Main Report* 145-147.
[119] The court in the English scheme has to state the purposes for which the administration is given.

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institutions are in *vis-a-vis* debtors. If business debtors can easily implement the business rescue scheme and a resultant moratorium on enforcement follows, that will lead to a loss of power by the creditors. It is suggested however that this problem of a loss of power by the creditors, leading to distrust of and a resultant lack of faith in a business rescue system should receive attention elsewhere in the business rescue mechanism, and not in the context of the procedure for commencement.

It would be beneficial for judicial management to ease its requirement of full payment of all the debtor's debts[120] and to adopt a mechanism less formal than the applications for provisional and final judicial management that are currently required. It must be remembered that the appointment of a receiver[121] or administrative receiver[122] is a very simple procedure that needs no application to a court and is only a decision taken by the person entitled to make the appointment. In that sense a completely informal mechanism for commencement is widely accepted in Australia and England. It must, however, be said that this is a power exercised by the secured creditor to strengthen its own position and is as such far less controversial than an easy mechanism for implementing judicial management in the hands of the debtor, or for that matter, a smaller less powerful, or even friendly creditor.

The question also remains as to whether a company should be insolvent before it should be able to apply for judicial management. It is submitted that it should not be a strict requirement that a company is unable to pay its debts.[123] The earlier a company recognises that it should reorganise itself because of looming financial disaster the better the chances of avoiding eventual liquidation and the greater the possibility of successful reorganisation.[124]

It is noted above that some writers regard the criteria for the commencement of the administration procedure in England as a barrier to the use of administration.[125]

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[120] Rajak "*Business Rescue for SA*" 7 states: "[t]he requirement that to be eligible for protection a debtor must be seen to be one capable of recovery to the point where it is able to repay all its debts in full is outdated, unrealistic and often contrary to the wishes and interests of both debtor and creditors." See also Rajak & Henning 1999 *SALJ* 268.

[121] For the appointment of a receiver in Australia see Tomasic *Australian Corporate Insolvency Law* 25 *supra*.

[122] Insolvency Act 1986, s 29.

[123] Compare s 427(1)(a) of the Companies Act with the less stringent requirement of s 8 of the English Insolvency Act and s 436A of the Australian Corporations Law.

[124] The Law Reform Commission of Hong Kong *Report on Corporate Rescue and Insolvent Trading* (1996) 27 submits that likely insolvency should not be a precondition. See also Belcher *Corporate Rescue* 19.

[125] *Cf* the text at 3 3 2 n 78 *supra*.

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Making insolvency or near insolvency a condition for the commencement of the administration procedure is in sharp contrast with the Chapter 11 process in the United States. In terms of the Chapter 11 process no conditions for entry are set and the management of the company is entitled to use the business rescue provisions as "a matter of right".[126]

It is submitted that Australian approach is a good example to follow. Although conditions for entry are required, the directors of the company may commence the business rescue procedure without the intervention of the court. Where however the procedure is to be initiated without the consent of the directors the intervention of the court is still necessary.

If the directors were given the opportunity to place a company under judicial management without the intervention of the court, it would encourage them to do so when the need arises although the company might still be solvent. If their actions are disputed the court will have to determine whether the company was likely to become unable to pay its debts. In this regard the court would not easily reject the opinion of the directors especially where the conditions for commencement do not require an imminent probability of inability to pay debts. In this way the company would still be able to enter the business rescue procedure early and the court would not apply "unduly exacting standards"[127] and impede the use of judicial management.

It is further submitted that it could be useful to add a technical ground when a company may be placed under judicial management. Where a company's financial statements are not up to date[128] it should be possible for one of the members or a creditor to place the company under judicial management. It is a serious problem that a company on its way to insolvency often neglects to comply with the necessary requirement of having up to date financial statements. When such a company finally goes into judicial management or liquidation it is very difficult for the judicial manager or liquidator to establish the reasons for insolvency without proper financial records. It is thus submitted that failure to provide audited financial statements timeously should be a ground for placing a company under judicial management. One possibility would be to deem a company likely to become unable to pay its debts

[126] Belcher *Corporate Rescue* 17.
[127] Fletcher *Law of Insolvency* 479. See also Crutchfield *Corporate Voluntary Administration Law* 68.
[128] *Cf* proposed s 1(5) at 3 3 5 *infra.*

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where audited financial statements are in arrears for more than fifteen months from the end of the financial year of the company.[129] It could however alternatively be treated as a separate ground for placing a company under judicial management.

The purpose of judicial management could be amplified to include the survival of the company, its business or any part of it and the possibility of a more advantageous realisation of the company's assets than would be effected on a winding-up.

The Hong Kong Law Reform Commission identifies purposes to be achieved in a judicial management as an extension of time for the payment of debts; the variation or the re-ordering of the ranking for payment of the company's debts or any class of its debts or the conversion of its debts in whole or in part into shares or other securities to be issued by the company.[130]

All the purposes mentioned above could be achieved under a deed of company arrangement as conceived by the Australian procedure. However it is still desirable to state the more common and important purposes in legislation. On the other hand it is also advisable not to limit the purposes to be achieved by judicial management unnecessarily. This balance could be achieved by incorporating a purpose similar to that of the deed of company arrangement as one of the purposes of judicial management, namely the approval of a plan of future conduct.[131] The legislation would thus provide important guidelines as to the purposes for which judicial management is intended and at the same time the legislation would not restrict the application of judicial management.

An aspect that restricts the use of judicial management as a measure to rescue companies is the attitude of the South African courts of treating judicial management as a remedy that should only be allowed in exceptional circumstances.[132] The courts are also of the view that it would seldom, if ever, be just and equitable to grant a judicial management order against the wishes of a creditor unless the court is

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[129] Ss 179 and 286 of the Companies Act 61 of 1973 read together require a company to lay its audited financial statements before the annual general meeting at a time not exceeding nine months after the end of the financial year. Fifteen months would extend a further grace period of six months in which audited financial statements should be produced before the possibility to place a company under judicial management for this reason arises. See text at 5 2 4 at n 55 *infra*.

[130] Law Reform Commission of Hong Kong *Report on Corporate Rescue and Insolvent Trading* (1996) 26.

[131] See proposed s 1(3)(b) at 3 3 5 *supra*.

[132] See 1 1, n 11 and 12 *supra*.

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persuaded that it will probably be in the interests of all creditors and of the shareholders to grant the order.[133]

It is submitted that there is no compelling reason why the courts should view judicial management as an extraordinary measure. There is certainly nothing in the legislation that merits its treatment as such. It would however be more difficult for the courts to treat judicial management as an equally appropriate alternative to liquidation in the light of past decisions and it will probably need a change in legislation before they will do so.

The creation of a business rescue culture in South Africa also requires a change of attitude from the banks. Banks have a lot of power in insolvency situations. Even where the other creditors may be willing to extend some leniency towards a business in order to sell it as a going concern it would be in the hands of the major creditor, with the overwhelming majority of votes, to decide between the possibility of a business rescue and the otherwise inevitable liquidation. Sometimes banks can be rather merciless in their attempt to recover their loans even in situations where there is no actual insolvency but only commercial insolvency:

> "Mr Hodes submitted, in the second place, that this was a case where the Court ought to exercise its discretion against the grant of a final order. In this regard he referred to the manner in which ABSA had conducted its relationship with Key and with the company and in the light thereof contended that it would not be fair nor just nor equitable to grant ABSA a final winding-up order. Mr Hodes' criticism of ABSA's conduct is perhaps not without some justification - it was an exercise in cynicism on its part to expect repayment of several million rand over little more than a week-end, but its right to have done so is beyond dispute."[134]

It is strongly arguable that the change in attitudes necessary to foster a culture of business rescue will best be achieved by using the Australian model to commence a business rescue.

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[133] *De Jager v Karoo Koeldranke & Roomys (Edms) Bpk* 1956 3 SA 594 (C) 602D-E; *Guttman v Sunlands Township (Pty) Ltd (In Liq)* 1962 2 SA 348 (C) 351-352 and 354-355; *Tobacco Auctions Ltd v AW Hamilton* (Pvt) Ltd 1966 2 SA 451 (R) 453B.

[134] *ABSA Bank Ltd v Rhebokskloof (Pty) Ltd and Others* 1993 4 SA 436 (C) 441F-G.

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3 3 5 Draft legislation to give effect to the proposals

Draft legislation to give effect to these proposals in South Africa could read as follows:

Section 1[135](Circumstances in which company may be placed under judicial management)

(1) When any company is or is likely to become unable to pay its debts and there is a probability that if it is placed under judicial management it would achieve one or more of the purposes referred to in subsection (3), it may be placed under judicial management.

(2)(a) The company may be placed under judicial management by:

(i) a special resolution of the company or a resolution of its directors. This resolution must be lodged by the end of the next business day with the Master, who must approve the appointment of the judicial manager nominated by the company, its directors or its members.

(ii) an application to court by a member or a creditor or creditors or any prospective or contingent creditor or creditors or the provisional liquidator.[136]

2(b) Before an application for judicial management is presented to the Court, a copy of the application and of every affidavit confirming the facts stated therein shall be lodged with the Master at the seat of the Court.

2(c) Despite the provisions of section 203(1) of the Companies Act a special resolution referred to in subsection 2(a)(i) takes effect when it is lodged with the Master.

(3) The purposes for which a company may be placed under judicial management are:

(a) the survival of the company, and the whole or any part of its undertaking, as a going concern;

(b) the approval of a plan of future conduct;[137]

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[135] Based on the Companies Act 61 of 1973 s 427; the English Insolvency Act 1986, s 8(3) and the Australian Corporations Law, s 436 A.
[136] *Cf* 3 3 1 *supra.*
[137] See 3 5 5 *infra.*

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(c) the sanctioning under section 311 of the Companies Act of a compromise or arrangement; and

(d) a more advantageous realisation of the company's assets than would be effected by a winding-up.

(4) Judicial management commences when the Master approves the appointment of the judicial manager after the resolution referred to in subsection 2(a)(i) is lodged with the Master or when the court makes an order for judicial management in terms of subsection 2(a)(ii).

(5) A company is deemed to be likely to become unable to pay its debts if it fails to provide audited financial statements as required by section 286 of the Companies Act within fifteen months after the end of its financial year.

(6) The fact that an application for judicial management is opposed by a creditor seeking winding-up on one of the grounds in section 344 of the Companies Act will not by itself justify the refusal of a judicial management order if one or more of the purposes in subsection (3) are proved.

3 4 **Consequences of commencement of business rescue procedure**

The two most important consequences of the commencement of a business rescue procedure is that it is usually accompanied by a moratorium on existing debts and its effect on the management powers of the incumbent directors.

3 4 1 Moratorium on payment of existing debts

The most important effect of the commencement of a business rescue regime is that it provides some breathing space where the debtor is protected from enforcement procedures from creditors to enable him to reorganise his affairs. This breathing space is created by a placing a moratorium on all enforcement procedures.

> "A judicial manager is appointed because the Court thinks that the company, if it has a sort of moratorium - that is what a judicial management amounts to - will pull through and will be able to go on."[138]

The extent and the effect of this stay of enforcement procedures as it is applied in the different jurisdictions will now be discussed.

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[138] *Estate Loock v Graaf-Reinet Board of Executors* 1935 CPD 117. See also Belcher *Corporate Rescue* 17 and Lessing & Corkery *Corporate Insolvency Law* 79.

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3 4 1 1 *Judicial management (South Africa)*

3 4 1 1 1 *The general effect of the moratorium*

Where the court grants a provisional judicial management order it does not automatically result in a moratorium on any legal proceedings. The granting of a moratorium is in the discretion of the court. The provisional judicial management order must contain certain directions[139] with regard to the directors of the company and its management and the appointment of a provisional judicial manager. Furthermore, the order may include a possible moratorium on all actions, proceedings, the execution of all writs, summonses and other processes against the company.[140] Most provisional judicial management orders contain such a provision in practice.[141]

The effect of the moratorium is that the company enjoys a reprieve from actions against the company, but it does not mean that a company is free to delay performance of its contractual obligations.[142] A creditor would thus be able to refuse performance that is tendered after the due date by a debtor company under judicial management and would not be under legal obligation to carry on with the contract if the debtor company under judicial management does not perform as agreed.

The moratorium lasts for a period determined by the court. It is important to note that the moratorium only extends to procedural measures and the court cannot prevent set-off from operating.[143]

Upon the making of the provisional order the property of the company is deemed to be in the custody of the Master, but as soon as the provisional judicial manager is appointed he becomes custodian of the property.[144]

Even if the judicial management order does not provide for a moratorium, Olver[145] submits that the effect of section 434(2)[146] in reality results in a factual moratorium. This section requires the judicial manager to pay the costs of judicial management and debts incurred by him in the conduct of the company's business first and only if

[139] Companies Act 61 of 1973 s 428(2)(a).
[140] Companies Act 61 of 1973 s 428(2). It must also contain the directions referred to in s 428(c).
[141] Olver *Judicial management in SA* 66 and Meskin *Henochsberg I* 931.
[142] *New Union Goldfields Ltd v Cohen and Others* 1954 2 SA 397 (A) 403.
[143] *Transkei Development Corporation Ltd v Oshkosh Africa (Pty) Ltd* 1986 1 SA 150 (C) 153J-154A and 154D.
[144] Companies Act 61 of 1973 s 429(a).
[145] Olver *Judicial management in SA* 109.
[146] Companies Act 61 of 1973.

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circumstances permit, to pay the claims of pre-judicial management creditors. However, section 434(2) by itself does not prevent pre-judicial management creditors from instituting actions and leving execution to enforce their claims. Nevertheless, the provisional judicial management order normally includes a moratorium and judicial managers do not have to resort to section 434(2).

3 4 1 1 2 *The effect on secured creditors*

If a moratorium is granted, the secured creditors enjoy no privilege in comparison to unsecured creditors. They are also subject to the same restrictions as the unsecured creditors with regard to the stay of actions and enforcement procedures. There is nothing in the Companies Act which makes any distinction between the treatment of secured or unsecured creditors in judicial management. Thus if they want to realise their security the secured creditors would require the leave of the court to institute proceedings.

3 4 1 1 3 *The effect on owners and lessors of property*

In *New Union Goldfields Ltd v Cohen and Others*[147] it was decided that even though a creditor is not entitled by action to enforce a right because the debtor is under judicial management, it does not follow that the debtor is lawfully entitled to delay performance of the corresponding obligation. It would mean for example that a lessee company under judicial management is not entitled to withhold payments in terms of a lease agreement. If the lease provides for forfeiture on breach by the lessee, the lessor would be entitled to cancel the lease on breach by the lessee. Even though the lessor needs the permission of the court to proceed with eviction proceedings the lessee will nevertheless be a trespasser.

However, in *Western Bank Ltd v Laurie Fossati Plant Hire (under judicial management)*[148] the court was reluctant to grant permission for an action to cancel a lease, as it would have destroyed the whole purpose of judicial management.

3 4 1 1 4 *The court's discretion*

The moratorium can only be breached with the permission of the court.[149] In order to obtain permission of the court the creditor will need to make an application to court. In this regard the court may give leave to sue, but refuse leave to enforce.[150]

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[147] 1954 2 SA 397 (A) 403A.
[148] 1974 4 SA 607 (E) 613B.

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The exercise of the court's discretion in permitting an action against the company in judicial management was considered in *Western Bank Ltd v Laurie Fossati Plant Hire (under judicial management)*.[151] The court resolved that its discretion to allow an action to proceed or an interdict to issue must be exercised judicially and not arbitrarily or capriciously. The court must have regard to all the salient and material features of the case in the light of the tenor and policy of judicial management in the Companies Act. The court then found that the tenor and policy of judicial management is to preserve and not to destroy a company that is capable of rehabilitation.

Consequently the court refused to grant leave to Western Bank to institute action against Laurie Fossati Plant Hire for the confirmation of the cancellation of certain agreements of lease of road-making machinery. The court came to the conclusion that Western Bank might well suffer no prejudice and that the granting of such leave would assist in the destruction of Laurie Fossati Plant Hire. Such destruction would deny some 150 creditors any possibility of a dividend or perhaps even eventual payment in full.

Another material consideration which the court will consider when deciding if it should give leave to institute action is whether the court in doing so would be countenancing or aiding illegality.[152]

3 4 1 2 *Administration (England)*

In the English procedure there are two important moments with regard to the effect of the moratorium that applies to the administration order procedure.[153] The first moment is when the petition is presented to the court. The second is when the administration order is made by the court.

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[149] See further the discussion in Meskin *Henochsberg I* 932-933.
[150] *Ross v Northen Machinery and Irrigation (Pty) Ltd* 1940 TPD 119 120. The court gave two reasons. It would create a preference in favour of the applicant and it would embarrass the judicial manager and might prove prejudicial to the conduct of the business of the company under judicial management.
[151] 1974 4 SA 607 (E) 611A. Western Bank entered into certain agreements of lease of road making machinery with the respondent company. The rentals had to be paid on the first day of each month in terms of the agreement. The rentals were paid monthly, but rarely on due date. After the respondent company was placed under judicial management Western Bank sought leave from the court to cancel the lease agreements because the payment of rentals were late. Western bank had to apply for leave to cancel as the judicial management order made provision for the stay of all proceedings against the respondent company.
[152] *Samuel Osborn (SA) (Pty) Ltd v United Stone Crushing Co (Pty) Ltd* 1938 WLD 229 236.
[153] For a general discussion see Brown *Corporate Rescue* 99-176; Fletcher *Law of Insolvency* 443-460 and Goode *Principles of Corporate Insolvency Law* (1997) 295-309.

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3 4 1 2 1 *The general effect of the moratorium*

The moratorium affects the unsecured and secured creditors as well as the owners and lessors of property.

The moratorium comes into effect immediately on the presentation of the petition. Once the presentation of the petition for an administration order is made all proceedings leading to a winding-up are stayed. No resolution may be passed or order made for the winding-up of the company.[154]

This precludes a voluntary winding-up, but it does not prevent the presentation of an application for winding-up of the company. However, such an application will not be dealt with until the administration petition is dismissed or the administration order discharged. The court may restrict any advertisement of the winding-up order for the time being. This prevents adverse publicity that might jeopardise the very purpose of the administration sought.[155]

Once the administration order is made any petition for the winding-up of the company must be dismissed.[156]

On the presentation of the petition for an administration order no other proceedings and no execution or other legal process may be commenced or continued, and no distress may be levied,[157] against the company or its property except with the leave of the court and only subject to such terms as the court may impose.[158]

On the administration order being granted this moratorium is confirmed.[159] However although the court may still consent to the commencement or continuation of other proceedings, execution or to distress being levied, this consent may now also be given by the administrator once he is appointed.

It is suggested that the term "proceedings" is limited to legal or quasi-legal proceedings. Among the latter would be arbitration and proceedings before an

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[154] Insolvency Act, 1986 s 10(1)(a).
[155] Brown *Corporate Rescue* 79.
[156] Insolvency Act, 1986 s 11(1)(a).
[157] "A distress is one of the most ancient and effectual remedies for the recovery of rent. It is the taking, without legal process, cattle or goods as a pledge to compel the satisfaction of a demand, the performance of a duty, or the redress of an injury." James *Stroud's Judicial Dictionary of Words and Phrases* 5th ed (1986) 749.
[158] Insolvency Act, 1986 s 10(1)(c).
[159] Insolvency Act, 1986 s 11(3)(d).

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industrial tribunal.[160] An example of proceedings which are excluded is the revocation of a license, as happened in *Air Ecosse Ltd v Civil Aviation Authority*[161] where British Airways applied to the Civil Aviation Authority for the revocation of the air transport license of Air Ecosse Ltd once it went into administration. It was decided that the application for a revocation of the air transport license does not fall under the moratorium.

The Insolvency Act does not specifically exclude criminal proceedings from the moratorium as does its Australian counterpart. According to Fletcher[162] the legislature intends to include in this context only proceedings which are: "similar to those which bring about the winding-up of a company, the appointment of an administrative receiver, or the enforcement of a security."[163]

It should be noted that there is no provision in the Insolvency Act to the effect that all dispositions of property of the company which were made after the date when the petition was presented, shall be void unless approved by the court.[164] Thus between the time that the petition is presented and the administration order is made, the creditors are subject to a moratorium with no reciprocal limitation on the powers of the directors. During this time the directors are therefore free to exercise their powers and they may dispose of the company's property by selling, leasing, mortgaging or charging it or by dealing with it in any other way. Normally the time span between the presentation of the petition and the hearing is short.[165] There is thus no great danger that the directors may dissipate the assets.[166]

The moratorium also applies to other legal process. The meaning of "other legal process" in this context is unclear. Following the Australian example it would most

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[160] Robinson *Australian Business Law Review* (1996) 429 436.
[161] [1987] 3 BCC 492.
[162] Fletcher *Law of Insolvency* 436. See also Milman & Durrant *Corporate Insolvency* 34-35 and Brown *Corporate Rescue* 141-154.
[163] For a judicial analysis of proceedings that are not affected see *Re Paramount Airways Ltd, Bristol Airport v Powdrill* [1990] 2 WLR 1362 (the exercise of a lien by an unpaid creditor), *Re Atlantic Computers plc* [1992] 2 WLR 367 (a head lease allowed to be cancelled and the head lessor allowed to repossess goods from the sub-lessees) and *Royal Bank v Buchler* [1989] BCLC 130 (where a creditor wanted to sell an office block over which it had a security and the court effectively put a deadline on the administration).
[164] There is such a provision when a petition to liquidate a company is granted. See the Insolvency Act 1986, s 127.
[165] A minimum of 5 days according to the Insolvency Rules, 1986 r 2.7.
[166] Where directors' actions threatened to diminish the value of fishing vessels by selling the fishing licences separately, the court abridged the period for service of the petition. This will mainly happen where a creditor presents the petition. *Cf Re Gallidoro Trawlers Ltd* [1991] BCLC 856.

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probably mean a process involving the court.[167] Thus it would not affect a notice given to make time of the essence.

The "property" of the company which is subject to the moratorium is statutorily defined.[168] Property is widely defined. It includes: "money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property."

3 4 1 2 2 *The effect on secured creditors*

The moratorium also affects secured creditors as it is provided that upon presentation of the petition and upon the making of the final order, no other steps may be taken to enforce any security over the company's property.[169] However, the administrator, once he is appointed, may consent and the court may grant leave to take such steps, subject to the terms that the court may impose.

Security is defined[170] as any mortgage, charge, lien or other security. This is a definition that leaves less doubt than the Australian Act which uses the word charge.[171]

The meaning of "taking steps" is somewhat uncertain. It is submitted that it should be limited to those actions that would have the legal effect of preventing the administrator from doing something with the property subject to the security that he would otherwise have been entitled to do. This would not include giving notice of a kind that does not interfere with the administrator's ability to deal with the property. In *Re Olympia & York Canary Wharf Ltd*[172] it was held that the moratorium applicable to secured creditors is not intended to interfere with the rights of creditors any more than is required to enable the administrators to carry out their functions.

The holder of a floating charge, however, receives preferential treatment. Before the administration order may be made the holder of the floating charge has the opportunity to appoint an administrative receiver. Such an appointment may be made

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[167] See the discussion at 3 4 1 3 1 *infra*.
[168] Insolvency Act, 1986 s 436.
[169] Insolvency Act, 1986 s 10(1)(c) and s 11(3)(c). The only difference between the two sections is that s 10, which operates from the presentation of the petition, refers to "no steps" and s 11, which operates once the order is made, refers to "no other steps".
[170] Insolvency Act, 1986 s 248(b)(i).
[171] See 3 4 1 3 2 *infra*.

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without the need for leave from the court and once made, the appointment would prevent the court from making an administration order without the consent of the person who appointed the administrative receiver.[173] This preference is accomplished by the requirement that the holder of the floating charge is entitled to at least five days' notice before the administration order is made.[174] He thus has five days in which to decide to appoint an administrative receiver.[175]

3 4 1 2 3 *The effect on owners and lessors of property*

The Insolvency Act also makes it clear that no steps may be taken to repossess goods in the company's possession under any hire-purchase agreement[176] while the moratorium is in force except with the consent of the administrator or the leave of the court subject to such terms as the court may impose. It is thus clear that the English law makes no special arrangement for the lessors of property. They are treated the same as all other creditors.

The moratorium does not affect the rights of the parties concerned; it merely suspends the enforcement procedure. Thus if an application is made to the court for leave to enforce and it is granted, the rights have remained vested in the party concerned and he may act to enforce them.

Goods will still be considered to be in a company's possession even though they were handed over for repair to someone else or sublet to someone else.[177]

3 4 1 2 4 *The exercise of the court's discretion*

The court in *Atlantic Computers*[178] gave guidance on the exercise of the court's power to grant leave for the moratorium to be lifted. The principles laid down by the court include:

[172] [1993] BCLC 453 457. See also Goode *Principles of Corporate Insolvency Law* (1997) 301 – 303.
[173] Insolvency Act, 1986 s 9(3).
[174] Insolvency Act, 1986 s 9(2)(a) and Insolvency Rules, 1986 r 2.7.
[175] Fletcher *The Law of Insolvency* (1996) 438; *Re A Company (No. 00175 of 1987)* [1987] BCLC 467.
[176] Hire purchase agreements include conditional sale agreements, chattel leasing agreements, and retention of title agreements. See s 10(4) of the Insolvency Act 1986. A chattel leasing agreement is an agreement for the bailment, or in Scotland, the hiring of goods, which is capable of subsisting for more than three months. See s 251 of the Insolvency Act 1986.
[177] *Re Atlantic Computer Systems plc* [1992] 1 All ER 476 at 492d-g. See Goode *Principles of Corporate Insolvency Law* (1997) 308 – 309 and also Brown *Corporate Rescue* 158 – 163. Although the guidance was given in the context of leased equipment it is capable of general application.
[178] [1992] 1 All ER 476 at 500-503.

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The person who applies for leave for the lifting of the moratorium should make out a case for leave to be given.

When an owner of land or goods who, as lessor, wants to repossess his property, applies for leave from the court or consent from the administrator for the lifting of the moratorium, it should normally be given if it is unlikely to impede the achievement of the purpose of administration.

In other cases where a lessor wants to repossess, the court should weigh the interests of the lessor against those of the other creditors.

In the weighing of interests great weight should be given to a lessor's ownership rights. An administration for the benefit of unsecured creditors should not be conducted at the expense of those with ownership rights. The court needs to weigh the loss that would be caused to either party.

The result of the weighing of the different interests might lead the court to impose certain terms on which leave is granted. Alternatively the court may decide to refuse leave to repossess but at the same time give directions to the administrator on how to treat the property.

The court will apply broadly the same principles upon granting leave to enforce security.

When the court hears an application to grant leave to enforce security the court will normally not seek to resolve disputes over the existence, validity or nature of the security.

3 4 1 3 *Voluntary administration (Australia)*

The moratorium on proceedings against the company's property that takes effect upon the commencement of voluntary administration[179] is of vital importance to the whole procedure. This moratorium lasts for the duration of the administration.[180]

Similar to the position in English law, the moratorium affects unsecured and secured creditors and the owners or lessors of property being used by or in possession of the company. In general, the moratorium purports to stay all legal and enforcement proceedings against the company. A person would, however be able to escape the

[179] Corporations Law, s 440D.

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effects of the moratorium, either with the written permission of the administrator or with leave from the court. The court may impose such restrictions, as it deems fit, when it grants leave to a person to escape from the effect of the moratorium.[181]

3 4 1 3 1 *The general effect of the moratorium*

The moratorium prevents the company from being wound up whilst under administration. The company cannot be wound up voluntarily and where an application has been made for the winding-up of the company, the court will adjourn the hearing of the application for winding-up if the court is satisfied that the continuation of administration, rather than winding-up is in the interests of the company's creditors.[182]

Similarly the court will not appoint a provisional liquidator where it is satisfied that it is in the interests of the company's creditors for the company to continue under administration.[183] Any application to wind-up the company under administration is deemed to be a pending suit while the company is under administration.[184]

Another important element of the moratorium is the stay of proceedings against the company or its property[185] and the suspension of any enforcement process in relation to the company's property.[186]

"Proceedings" in this context must be restrictively interpreted as the prohibition refers expressly to court proceedings. Other proceedings for example the revocation of a license without resort to the court, as happened in the *Air Ecosse Ltd* case[187] would therefore clearly fall outside the moratorium. The Act further specifically excludes criminal and prescribed proceedings against the company or its property.[188] The reason why criminal proceedings are allowed to go ahead is perfectly clear. It would be against public policy for a company to be able to stay criminal proceedings against itself by appointing an administrator. Regarding prescribed proceedings it seems that

[180] For a general discussion see Lessing & Corkery *Corporate Insolvency Law* 79 – 83; Tomasic *Australian Corporate Insolvency Law* 147 – 151 and Brown *Corporate Rescue* 799 – 805.
[181] See Lessing & Corkery *Corporate Insolvency Law* 79.
[182] Corporations Law, s 440A(1) and (2). See Crutchfield *Corporate Voluntary Administration Law* 106.
[183] Corporations Law, s 440A(3).
[184] Corporations Law, s 440H.
[185] Corporations Law, s 440D.
[186] Corporations Law, s 440F.
[187] [1987] 3 BCC 492.
[188] Corporations Law, s 440D(2). In general see also Tomasic *Australian Corporate Insolvency Law* 147.

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the legislature also had public policy considerations in mind. The Explanatory Memorandum to the 1992 Reform Act[189] refers to an action to prevent imminent environmental damage as a possible example of prescribed proceedings.[190]

The moratorium on court proceedings can only be overcome with the written consent of the administrator or with leave from the court.[191] The moratorium on enforcement processes, however, may only be lifted by the court on such conditions as it may impose.[192] It is somewhat strange that the administrator cannot consent to the lifting of the moratorium in this case as well.

The administrator is further protected against any claim for damages resulting from a refusal by him to grant permission for the lifting of the stay of legal proceedings.[193]

As stated above, no enforcement process[194] may be commenced or proceeded with except with the leave of the court on such terms as it may impose. Where a court officer such as a sheriff or a registrar receives written notice of the administration, he cannot proceed and sell any property of the company in a process of execution or pay any monetary proceeds from such an action to anyone other than the administrator.[195] The court officer must also return all property of the company that is in his possession under a process of execution.[196] Where someone bought the property in good faith when it was sold in execution in contravention of the above provisions he will nevertheless become and remain the owner with good title against the administrator.[197]

As in the English statute "property" is statutorily defined, and means "any legal or equitable estate or interest (whether present or future and whether vested or

[189] Para 521.
[190] Crutchfield *Corporate Voluntary Administration Law* 111 states that no proceedings have yet been prescribed under Corporations Law s 440D(2)(b).
[191] Corporations Law, s 440D(1). In *Foxcroft v The Ink Group Pty Ltd* (1994) 15 ACSR 203 a former employee was not granted leave by the court to continue with proceedings for reinstatement or compensatory or exemplary damages against the company in administration in the Industrial Relations Court. The proceedings were commenced before the commencement of administration and were fixed to be heard after the administrator was appointed. See also Crutchfield *Corporate Voluntary Administration Law* 111.
[192] Corporations Law, s 440F.
[193] Corporations Law, s 440E.
[194] Defined by s 9 of Corporations Law as execution against any property, or any other enforcement process in relation to that property that involves a court or a sheriff.
[195] Corporations Law, s 440G(1), (2) and (4). The costs of the execution are deemed to be a first charge on the property or money delivered by the Court officer to the administrator. That means that the court officer may retain part of the proceeds of a sale to cover costs of the execution or attachment.
[196] Corporations Law, s 440G(3).
[197] Corporations Law, s 440G(8).

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contingent) in real or personal property of any description and includes a thing in action."[198]

The moratorium does not prevent the creditor from taking those steps that do not involve the court, such as giving notice of the acceptance of repudiation of a contract on the strength of non-compliance with its terms by the company under administration.

The moratorium might seem severe from a creditor's perspective. However there are clear exceptions to the moratorium. As in the case of the English law and unlike the South African law it is the secured creditor that is exempted from the strict application of the moratorium, as appears from the discussion below.

3 4 1 3 2 *The effect on secured creditors*

In general the moratorium also affects the rights of secured creditors.[199] During administration a person cannot enforce a charge on property of the company unless the administrator gives his written consent or the court grants leave.[200] However there are three important exceptions:

First, the holder of a charge over all or a substantial part of the property of the company may enforce his charge and appoint a receiver to control the property under the charge or enter into possession of the property of the company. Such a creditor may do so at any time before the appointment of the administrator and within a period of ten business days after the appointment of the administrator.[201]

The Explanatory Memorandum to the 1992 Reform Act[202] states the reason for this exception is that a person who has security over the whole, or substantially the whole, of the property of the company deserves special consideration when solvency problems need to be resolved.

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[198] Corporations Law, s 9.
[199] Lessing & Corkery *Corporate Insolvency Law* 99 are of the opinion that the moratorium can also work to the advantage of secured creditors in certain circumstances. The moratorium prevents the repossession of goods to which retention of title clauses apply. This ensures that the company can continue with its business. In comparison a company in receivership would not be able to stop repossession of similar goods, which would cripple the business. For a secured creditor with a fixed or floating charge the continuation of the business may be helpful.
[200] Corporations Law, s 440B.
[201] Corporations Law, s 441A read with the definition of "decision period" in s 9 as ten business days. See also Lessing & Corkery *Corporate Insolvency Law* 80.
[202] Para 532 and 533.

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Secondly, creditors, who have enforced other charges (other than the one referred to in the first exception), before the beginning of administration are not subject to the moratorium. However the court may on application of the administrator order the chargee not to perform certain functions or exercise specified powers except to the extent that the court permits.[203] The court may only make such order if it is satisfied that what the administrator proposes to do during administration will "adequately protect"[204] the chargee's interest.

Thirdly, creditors who have charges over perishable property are not affected by the moratorium and may act on those charges.[205] This exception is also subject to restriction by the court on application of the administrator to the same extent as the second exception mentioned above. The reason for this provision is quite clear. In the case of perishable property any delay would severely affect the value of the charge.[206] However, there is no statutory definition of "perishable property" which may cause difficulties in the application of this section in practice.

Creditors secured by a personal guarantee from the directors for the debts of the company are also affected. Any action on a guarantee given by a director that will become enforceable on the appointment of an administrator is also stayed.[207] The term "guarantee" has a wide interpretation. It includes any agreement whereby a director or relative incurred or may incur a liability in respect of a debt, liability or other obligation of the company.[208]

The Explanatory Memorandum explains that directors who are subject to such guarantees will be discouraged from appointing an administrator to the company if, on appointment, the guarantee would immediately become enforceable. A creditor can, however, apply to the court for leave to enforce the guarantee.

3 4 1 3 3 *The effect on owners and lessors of property*

The moratorium also applies to the owner or lessor of property that is used or occupied by or in the possession of the company. The owner or lessor may not, during

[203] Corporations Law, s 441B and D.
[204] Corporations Law, s 441D(3). This concept is not defined and it is left to the court to decide what constitutes adequate protection.
[205] Corporations Law, s 441G.
[206] "[I]t is hard to conceive of a situation where the retention of title claims will apply to perishable property" (Mansueto "Retention of Title claims in the context of Voluntary Administration" 1996 *Company and Securities Law Journal* Vol 14 36 at 41).
[207] Corporations Law, s 440J.

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administration, take possession of the property or otherwise recover it, unless the administrator gives his written consent or the lessor or owner obtains leave from the court to do so.[209]

Subject to these two exceptions, the moratorium prevents suppliers from repossessing their property. However it does not prevent an owner or lessor from giving relevant notices during the administration to the company under administration. This would allow all contractual steps to be taken so that when administration is lifted, the owner would be able to repossess the property immediately.

It should however be noticed that the administrator has a personal liability for the rent of property in the possession or occupancy of the company unless the court otherwise directs. This liability commences from the eighth day of the administration if the company stays in possession or occupation of the property.[210]

Where, before the commencement of administration, the owner or lessor entered into possession, assumed control of the property, or exercised any other power in relation to the property for the purpose of enforcing a right as owner or lessor, the continuance of that action will not be affected by the moratorium.[211] Thus by way of explanation, if the applicant in *Western Bank v Laurie Fossati Plant Hire (under judicial management)*[212] cancelled the lease agreement before the company was put under administration, the repossession of the road-making equipment pursuant to the cancellation would have proceeded uninterrupted by the administration.

In these circumstances the court may however, on application from the administrator, restrict the owner or lessor from performing certain functions or exercising specified powers in relation to the property. The court must however be satisfied that the owner or lessor will be adequately protected by the proposals of the administrator.[213] Thus, again by way of explanation, if the applicant in *Western Bank v Laurie Fossati* took steps to cancel the lease and repossess the road-making equipment before the company was placed in administration, the administrator may after his appointment apply to the court to stop the repossession. The administrator must, however, satisfy

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[208] Corporations Law, s 440J(4) read with the definition of "relevant agreement" in s 9.
[209] Corporations Law, s 440C.
[210] Corporations Law, s 443B(1), (2) and (8). See also s 443A regarding the personal liability of the administrator.
[211] Corporations Law, s 441F.
[212] See 3 4 1 1 4 n 151 for the facts of the case.
[213] Corporations Law, s 441H.

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the court that *Western Bank* will be adequately protected. The administrator may for instance offer *Western Bank* security over some asset or set aside certain income for the specific purpose of paying *Western Bank*.[214]

3 4 1 3 4 *Exercise of the court's discretion to grant exemption from the moratorium*

The court in Australia has in general been reluctant to use its power to grant exemption from the moratorium. In *Foxcroft v The Ink Group Pty Ltd*[215] the judge remarked:

> "To allow one creditor or potential creditor to proceed would not only take the administrator's attention from what he needs to do under the division in a relatively short period of time, but it would also involve cost in running the legal action on behalf of the administration, as well as perhaps giving the claimant some advantage over the other creditors or potential creditors."[216]

Not only has the court been reluctant to grant exemption from the moratorium in cases where a creditor wanted to institute action against the company, but it has also been reluctant to give leave to a creditor who sought to repossess his property pursuant to a retention of title clause. The court generally refuses leave to repossess goods until the creditors have had time to vote on the proposed deed of company arrangement at least in cases where the administrator takes care to arrange the business in such a way that the owner of the goods is adequately protected. In *Osborne Computer Corporation Pty Ltd v Riddel*[217] the administrator wanted to continue manufacturing which involved including in the end product goods belonging to a creditor under a retention of title clause. The administrator undertook to keep the proceeds of the eventual sale separate from other assets for the purpose of paying the debts of the creditor owner. The creditor sought leave to repossess. The court refused saying that it was the purpose of voluntary administration to promote the continuance of the company's business and furthermore the creditor's interest was protected to the satisfaction of the court.[218]

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[214] See also para 543 of the Explanatory memorandum of the Reform Act 1992.

[215] (1994) 12 ACLC 1063.

[216] At 1065. See also Crutchfield *Corporate Voluntary Administration Law* 111.

[217] (1995) 17 ACSR 606.

[218] For a full discussion of the effect of voluntary administration on the position of creditors with retention of title clauses see Mansueto 1996 *Company and Securities Law Journal* 36. Note that the situation changes when the deed of company arrangement is executed and that administrators need to take this seriously as they may find themselves personally liable if they refuse repossession without good cause once the deed of company arrangement has been executed.

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3 4 1 4 *Evaluation*

The moratorium granted to the company under administration is undoubtedly the most important instrument in making any business rescue scheme possible. It aims to preserve the assets of the company and to suspend the rights of the creditors to enforce their claims, providing the necessary breathing space for the debtor company and its creditors to reorganise their rights and interests. In the moratorium period the law should strive to balance the rights, duties and obligations of the various interested parties.

The importance of the moratorium is illustrated by the lack of use of the company voluntary arrangement[219] in England, the counterpart of the far more popular individual voluntary arrangement[220] in the same country. The Insolvency Service[221] regards the lack of a moratorium as one of the important shortcomings of the company voluntary arrangement.[222]

However the effectiveness of the moratorium granted by the Australian system seems to be considerably diluted by the exceptions.[223] The best way to go about the procedure would be to give a blanket moratorium with no general exceptions to either secured or unsecured creditors, but to move the process along to a speedy conclusion. Any exceptions to the moratorium should be agreed to by the administrator/judicial manager or upon his refusal should be sought from the court by application.

The success of the business rescue mechanism depends on the one hand upon the application of the moratorium without exceptions and on the other hand upon the limitation of possible damage that might accrue to creditors who are delayed in the enforcement of their claims. The shorter the period of the moratorium the better the chances of limiting possible damage that may accrue to the creditors.

In this regard the Law Reform Commission of Hong Kong[224] initially favoured a finite availability of the moratorium, for a maximum period of six months. However, the commission ultimately decided not to recommend a limit of six months to the

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[219] The company voluntary arrangement is an alternative business rescue procedure governed by part I of the Insolvency Act of 1986.

[220] Governed by Part VIII of the Insolvency Act of 1986 and available to both individual business debtors and individual consumer debtors. S 252 of the Insolvency Act 1986 extends a moratorium to the individual debtor.

[221] Consultative Document (1993) *supra.* See also Brown *Corporate Rescue* 653.

[222] See also the same criticism from Brown *Corporate Rescue* 653.

[223] See the discussion in 3 4 1 3 *supra.*

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moratorium. It was feared that such an approach would lead to a situation where a success in the business rescue could be imminent, but is then prevented by the expiry of the six month time-limit. It would mean that all the hard work of the previous six months would be futile just when it was about to achieve its object.

Instead, the commission proposed an initial moratorium of 30 days which, based on the Canadian example,[225] could be extended by the court on good cause shown for further periods of 30 days each. The court's powers to extend will expire after six months and any further extensions must be approved by the creditors in a creditors' meeting. This approach of limiting the duration of the moratorium is in keeping with the Australian example, which strives to limit the period of administration to a period of not more than four months.

The limitation of the period that the moratorium is in force is an important factor in the South African context. A short duration for the moratorium will be necessary to win the trust of creditors and to safeguard their interests. This is especially important because secured creditors in South Africa do not have the option of appointing a receiver and thus do not have the chance to opt out of judicial management. In contrast, the Australian or English creditor who respectively holds a charge or a floating charge over the whole or substantially the whole of the property of the company does have the option of opting out of administration.

The possibility of abusing of the moratorium needs to be considered as well. The repeated use of the moratorium could be prevented by a stipulation in the Act prohibiting the application of the moratorium if it has been used by the company concerned in the preceding twelve months. The abuse of the moratorium to delay enforcement measures or to defraud creditors could be countered by making directors personally liable for damages wrongfully caused by the delay.

It would also be useful to require the directors to lodge an affidavit together with their written resolution with the master when they place the company in judicial management. In the affidavit they should at least state the reasons why the company is in the position where it needs to be placed in judicial management and the purposes for which it is placed in judicial management. This would ensure better information

[224] *Report on Corporate Rescue and Insolvent Trading* (1996) 34-35 para 5.7 – 5.16.
[225] See Companies' Creditors Arrangement Act 1985, s 11.

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from the start and untruthful statements could activate the disqualification provisions of the Companies Act.[226]

3 4 1 4 1 *The general effect of the moratorium*

It is notable that judicial management does not grant an automatic stay of enforcement proceedings but leaves it up to the court to determine its applicability and its extent. It is submitted that the moratorium should be dealt with in detail in the legislation, for two reasons. First, detailed treatment promotes legal certainty for members of the business community. Secondly, commencement without a court order is proposed so it cannot simply be left to the court to regulate the moratorium in its order.

In the first place, the moratorium provided by judicial management should normally prevent any winding-up proceedings from continuing or being instituted. A company should therefore not be able to take any steps for its voluntary winding-up while it is under judicial management. It might be advisable however to have an exception by allowing a creditor to proceed with the initial steps for a winding-up which would in the end save some time when the judicial management order is discharged. This will balance interests in so far a creditor loses less time should the judicial management fail to achieve its purpose.

It is understood that the practice in the Western Cape[227] is that nearly all applications for a provisional winding-up of a company are heard by the court within a day or two of the filing of the petition. This amounts to treating such applications as urgent. If the application is defended, it is then set down for a date some three to four months in the future.

The practice in the courts of Gauteng, however, is somewhat different. There the applicant for the winding-up of a company has to make out a strong case for urgency before the court will hear the application on the same short notice as the courts in the Western Cape. In the Gauteng courts it may take up to six weeks for a defended winding-up application to be heard by the court. However, thereafter the procedure is much faster that the procedure in the Western Cape.

The moratorium should have the consequence that once judicial management has commenced an application for the winding-up of a company should not be treated as

[226] Companies Act 61 of 1973 s 218.

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urgent. The creditor should, however, be allowed to proceed in such a manner that upon judicial management being unsuccessful and terminated, he should be able to enforce his rights with minimum delay. As such the detrimental effect of the moratorium on the rights of creditors will be limited.

If legislation provides for such a course its only function may be a symbolic appeasement of creditors, because judicial management should in any event provide for a transition from judicial management to a creditors' voluntary winding-up. This would then offset the time lost in intiating the winding-up of a company in the event of judicial management being unsuccessful.

Allowing a creditor to take some steps towards the winding-up of the company should naturally not jeopardise the chances of success of the judicial management. The legislation could therefore provide that the application for the winding-up should not be published in any way.

Secondly, the moratorium should entail that no enforcement proceedings against the company or its property are possible. Without such a provision there would in effect be no moratorium. The court and the judicial manager should have the power to give leave to continue with proceedings. The continiuation of the proceedings may be required in certain circumstances, for example where concerns regarding the outcome of a pending court case were the reason for the company being placed under judicial management.

Proceedings of a criminal nature should as a matter of public policy not be stayed by the commencement of judicial management. This reduces the danger of abuse of judicial management.

Initially, at least, it does not appear to be necessary to provide that proceedings similar to the prescribed proceedings of the Australian voluntary administration procedure should escape the moratorium.[228] The courts would be able to deal with these situations under their discretionary power to give leave to sue a company under judicial management. If this approach does not work satisfactorily in practice, the legislature can easily amend the procedure at a later stage to provide for the exclusion of specified proceedings from the moratorium.

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[227] The information about the practice in the Western Cape and Gauteng was obtained from an interview with an attorney Robert Bricout of a prominent legal firm, Hofmeyers.

[228] See the text at 3 4 1 3 1 n 190 *supra*.

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Thirdly, the limitation on the rights of creditors should at least mean that the completion of prescription be delayed for the duration of the moratorium. This would be contrary to the decision in *Union Goldfields (Ltd)* [229] which was decided before the present Prescription Act.[230] It is submitted that under the present law judicial management would be seen as "any order of court" delaying the completion of prescription where the creditor is prevented by a court order from instituting court proceedings to interrupt the running of prescription.[231] If as suggested however, judicial management commences with a resolution by the company or its directors then the effect on the running of prescription is at best uncertain. It is submitted that judicial management can hardly be regarded as an order of court preventing the creditor from interrupting the running of prescription when judicial management commences with a resolution of the company or its directors. It would be desirable to clarify the position in legislation. It should also be made clear that set-off should still be allowed to operate even though the company is under judicial management.[232]

Fourthly, the variation or termination of contracts should also be considered. It is to be expected that upon the implementation of a new judicial management procedure, future contracts with companies will continue to provide for their termination should the company go into judicial management. This reflects the current position. The question is whether the moratorium should extend to the point where contracts may not be terminated or varied because of the company being placed in judicial management. On the one hand, the termination of contracts could, in certain circumstances, lead to the purpose of judicial management being thwarted. If a franchise agreement were to end in the event of the franchise holder, if a company, being placed under judicial management, there would be little sense in placing that company under judicial management. On the other hand, anomalies might arise if contracts should remain unchanged. For instance, should a bank not be able to cancel the unused portion of an agreed overdraft facility?

The solution to this lies in giving the judicial manager an election whether or not to continue with contracts that have variation or termination clauses when the company

[229] See 3 4 1 1 3 *supra*.
[230] Act 68 of 1969 which replaced the Prescription Act 18 of 1943.
[231] Prescription Act 68 of 1969 s 13(1)(a). See also Meskin *Henochsberg I* 932; *LAWSA* IV part 3 472 at n19.

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is placed under judicial management. Should the judicial manager elect to continue, the "fresh debts" should either be an expense of the judicial management or should have a preference upon liquidation. For example, a company could have been granted an overdraft facility before it was placed under judicial management. If the company is placed under judicial management before the overdraft facility has been used to its maximum and the judicial manager elects to make use of the full overdraft facility, the previously unused portion of the overdraft facility would have a preference.

Fifthly, the Canadian law makes provision for "eligible financial contracts" to be exempted from the moratorium.[233] These contracts occur in certain closed markets. The imposition of a moratorium on such contracts would result in the unravelling of numerous other contracts that could cause severe disruption in those markets. Transactions on the Johannesburg Stock Exchange and related markets are examples of such contracts. Contracts envisaged by the Canadian legislature include futures, derivatives and forward foreign exchange agreements.[234] The moratorium should in no way restrict their operation or the possibility of proceedings to enforce the rights flowing from these contracts. In such a case the judicial manager or his counterpart would have to allow those contracts to continue until their stipulated termination date and then to accept their "net termination value" (the final outcome, whether a gain or a loss) at the end of the period. Such a procedure is worth considering. It would not cause much disruption of judicial management in general as such contracts will not be encountered all that often in judicial management.

In the sixth place, the state and the tax authorities should also be bound by the moratorium and by the eventual plan of future conduct. This is in keeping with the decision in *Namex (Edms) Bpk v Kommissaris van Binnelandse Inkomste*[235] where the

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[232] This is the present position in South Africa. See *Transkei Development Corporation Ltd v Oshkosh Africa (Pty) Ltd* 1986 1 SA 150 (C) 153-155. *Ruskin NO v Amalgamated Minerals Ltd* 1951 1 PH E15 W; *re Trans-African Insurance Co Ltd* 1958 4 SA 324 (W).

[233] Companies' Creditors Arrangement Act 1985, s 11.1(1).

[234] The Canadian legislation lists the following: a currency or interest rate swap agreement; a basis swap agreement; a spot, future, forward or other foreign exchange agreement; a cap, collar or floor transaction; a commodity swap; a forward rate agreement; a repurchase or reverse repurchase agreement; a spot, future, forward or other commodity agreement; an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities; any derivative, combination or option in respect of, or agreement similar to a currency or interest rate swap agreement; any master agreement in respect of any of the above agreements or contracts; a guarantee of the liabilities under any of the above agreements; or any prescribed agreement. See the Companies' Creditors Arrangement Act 1985, s 11.1(1). See Brown *Corporate Rescue* 516-526 for the treatment of similar contracts in England.

[235] 1994 2 SA 265 (A) 286A-E.

court decided that the tax authorities are also bound by a section 311 scheme of arrangement.

3 4 1 4 2 *The effect on secured creditors*

A much criticised aspect of the English and Australian business rescue procedures is that they notably favour secured creditors over unsecured creditors, especially those secured creditors entitled to appoint a receiver.[236] The Australian measure allows the secured creditor the opportunity to appoint a receiver for ten business days after the decision to appoint the administrator. The English measure entitles the relevant creditor to make the appointment at any time prior to the granting of the administration order. In both instances the receiver, once appointed, gets preference over the administrator. It gives a *de facto* veto right to the creditor entitled to appoint a receiver and it enables the big lending institutions to protect their interests.[237] They would have no problem in accepting the administration regime if they still have a veto right on its implementation.

However, the South African secured creditor has no option comparable to the appointment of a receiver. There is no doubt that the secured creditors should also be restrained by the moratorium. As secured creditors in South Africa never had the remedy of receivership, no exception from the moratorium on the same grounds as in Australian or English law is required. However to limit the adverse effect of the moratorium on secured creditors it is suggested that the process of judicial management leading to the acceptance of a plan of future conduct should be as swift as possible. When a plan of future conduct is accepted judicial management will cease and the company will be managed according to the plan of future conduct. The discharge of judicial management will free the secured creditor from the moratorium. Naturally, one would expect that the secured creditors will be consulted on the composition of a plan of future conduct and if they give their approval to the formulated plan, they should be bound by it. Thus a secured creditor will be free to act upon his security immediately after the termination of judicial management to the extent that he is not curtailed by the plan of future conduct.

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[236] Brown *Corporate Rescue* 656, 801; Lessing & Corkery *Corporate Insolvency Law* 99; Goode *Principles of Corporate Insolvency Law* (1997) 337; Fletcher *Law of Insolvency* 479 and Grier & Floyd *Corporate Recovery* 213.

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If the period of the moratorium is limited in order to expedite the judicial management process, the moratorium will not affect the secured creditors' position very much. Their position would be even less affected if they are allowed to take all preparatory steps for enforcing their security during judicial management. Such steps would include the issuing and serving of a summons and the pleadings stage. But enforcement of the security should be stayed in that the court should not be allowed to make a judgment. In that way the secured creditors would lose less time once the period of the moratorium has expired on the termination of an unsuccessful judicial management process. The secured creditors should be able to place themselves in a position enabling them to obtain judgment with minimum delay once the moratorium is lifted.

3 4 1 4 3 *The effect on owners and lessors of property*

Owners and lessors of property should be bound by the moratorium and prevented from repossessing property used or occupied by the company or in the company's possession. This would of course be subject to the contractual remedies such as set-off and combination of accounts.[238] If the owner or lessor of property seeks a remedy enforceable in a court of law such as an order for eviction the owner or lessor must seek consent from the judicial manager or the court.[239] Thus the lessor would be able to give notice of acceptance of repudiation of a contract. What should not be possible is for the company to be able to use the property of the owner or lessor without due performance on behalf of the company. Once again this problem can be overcome by giving the judicial manager an election similar to the liquidator or provisional liquidator and for the "fresh debts" to have a preference over pre-judicial management debts and treated as part of the costs of judicial management. For example it would result in the protection of post judicial management rental. The rentals in arrears would be governed by the plan of future conduct.

3 4 1 4 4 *The discretion to grant exemption from moratorium*

The judicial manager should have the power to consent to the exemption of a creditor from the moratorium and if he refuses, the creditor, owner or lessor should be able to

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[237] The Cork Report in para 437-439 on 105 notes that an important criticism against receivers is that they do not have a lot of concern for the interests of creditors other than the creditor who appointed them.
[238] *Cf* Crutchfield *Corporate Voluntary Administration Law* 109.
[239] See 3 4 1 4 4 *infra*.

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approach the court. It is a fundamental principle that any creditor, owner or lessor should be able to seek redress from the court if the judicial manager does not consent to an exemption from the moratorium.

The court in *Atlantic*[240] has shown that judicial precedent can be very helpful in these circumstances. However, litigation in the High Court is always excessively expensive, more so where the company is under judicial management.

There are other possibilities for resolving this kind of dispute. It could be left to the High Court to formulate suitable principles or conditions when it will exercise its discretion to lift the moratorium. Judicial managers would be well advised to heed those principles and conditions.[241] Another possibility would be to follow the example of the Income Tax Act in creating a special tribunal or a special court where the parties pay their own costs, appear in person and accept the ruling of the special court. If they appeal to the High Court the loser will be faced by a costs order.

Such special courts would follow the example of the bankruptcy courts in the United States. The expertise in the field of insolvency built up by these courts would be an asset for the business environment as a whole. Such a special court would have the advantage of the appointment of persons specially suited for this role. However, it might not be practical to implement it on a national scale as it might prove to be a costly exercise. This solution is therefore unlikely to be affordable given the demands currently made on the budget of the Department of Justice.

Another possibility would be to allow the Master to issue policy statements as to when, in his opinion, judicial managers should grant exemption from the moratorium and to allow for an application for leave to be heard by the Master himself. In such a way a body of practical solutions will become available quite quickly. Guidelines when it will be appropriate for the judicial manager to exercise his discretion to lift the moratorium could also be laid down in the Act or regulations to the Act.

Another possibility would be the availability of arbitration upon the judicial manager refusing consent to the lifting of the moratorium and the creditor, owner or lessor not being satisfied. In such a case the powers of the judicial manager should expressly include the power to consent to arbitration. Unless the parties agree on an arbitrator,

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[240] See the discussion at 3 4 1 2 4 *supra*.

[241] Judicial managers run the risk of a *de bonis propriis* costs order if they do not follow the principles laid down by the court.

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the arbitrator should be appointed by the Master and both parties should consent to the arbitrator's decision being final. However, arbitration also often involves high costs and thus such a procedure would not necessarily add economic benefits to the corporate rescue procedure.

It is therefore submitted that the judicial manager should in the appropriate circumstances be able to consent to exemption from the moratorium always upon the written application of a creditor, owner or lessor. If the judicial manager refuses the application, the creditor should be free to seek relief from the court. However the judicial manager should have the power to refer such a matter to arbitration as this might it some cases be beneficial to the corporate rescue procedure. The Master should also be required by legislation to give guidelines to judicial managers. The guidelines of the Master should, however, not bind the judicial managers in the exercise of their discretion.

If such an approach is followed there would be no need for exceptions to the moratorium akin to the Australian charge on perishable products[242] or the "significant financial hardship" exception proposed by the Law Reform Commission of Hong Kong.[243]

3 4 1 5 *Draft legislation to give effect to the proposals*

Section 2[244] (Effect of judicial management)

(1) While the company is under judicial management all actions, proceedings the execution of all writs, summonses and other processes against the company are stayed and must not be proceeded with without the written consent of the judicial manager, or without the leave of the Court and on such terms and conditions as the Court may impose.

(2) Other processes in subsection (1) include the repossession without court intervention of or other steps by the owner or lessor of property to take control of property used by, in possession of or occupied by the company.

[242] See 3 4 1 3 2 n 205 *supra*.
[243] *Report on Corporate Rescue and Insolvent trading* (1996) 40 para 5.36. "If the court was satisfied that the moratorium was causing significant financial hardship to the creditor, the court could exempt that creditor from the moratorium... we cannot justify a company finding sanctuary in [judicial management] that would result in significant hardship to another person or business and may even put that business in jeopardy."
[244] Based on Companies Act 61 of 1973 s 428 (2) and Corporations Law s 440C.

(3) Nothing in subsection (1) requires the leave of the court for the initial steps to bring an application for the winding-up of the company or the initial steps to obtain a judgment to enforce a security over the property of the company.

(4) Subject to subsection (5), if a contract to which the company is a party contains a clause that purports to vary the terms of the contract or to terminate the contract upon the company being placed under judicial management, such clause has no effect on the commencement of judicial management.

(5) The judicial manager has an election to continue with a contract referred to in subsection (4) without the clause becoming operative or to accept the variation or termination of the contract, provided that if the judicial manager elects to continue with the contract without the clause becoming operative the further obligations flowing from that contract must be complied with and must be treated as part of the costs of judicial management.

(6) Subsection (1) does not apply to prescribed financial contracts.[245]

(7) The Master must issue guidelines to judicial managers how to exercise their discretion in subsection (1).[246]

3 4 2 Directors and company officials

The placing of a company under judicial management is bound to affect the directors of the company, as the persons responsible for its management. This is particularly so in jurisdictions that are pro-creditor in their approach to insolvency matters.

3 4 2 1 *Judicial management (South Africa)*

Under South African law the directors are, as is to be expected, divested of their powers from the date of the provisional order for judicial management and the company is placed under the management of the provisional judicial manager. The legislation is quite clear on this point: it provides that the provisional judicial management order shall contain directions that the company is henceforth under the management of a provisional judicial manager and that all those vested with management powers are divested of those powers.[247] The provisional manager

[245] For a definition of prescribed financial contracts see section 0 in the annexure.

[246] Alternatively basic guidelines could be provided in the statute and the Master must then issue supplementary guidelines.

[247] Companies Act 61 of 1973 s 428(2)(a).

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operates under the supervision of the court.[248] This position is confirmed when the final judicial management order is made.[249]

In *Alpha Bank v Registrateur van Banke*[250] it was decided that the management powers of the company are transferred to the judicial manager[251] and no residual management powers or powers of control remain with the directors.

There is no express provision that the directors will also be removed from their office of directors. However it is provided that in cancelling a judicial management order the court must, among other things, give directions "for the convening of a general meeting of members for the purpose of electing directors of the company". This suggests that the directors cease to hold office when a final judicial management order is made.[252] This is unfortunate as it leaves the directors with less reason to cooperate towards effecting a successful rescue and without any continuing fiduciary duty towards the company.

The position on provisional judicial management is however uncertain. It is submitted that directors do not lose office when a provisional judicial management order is made. In this case section 432 is applicable to the discharge of the provisional judicial management order[253] and the section does not contain a similar provision for the court to give directions for the election of directors.

3 4 2 2 Administration (England)

Under English law the creditors are faced with a moratorium on enforcing their rights from the moment of presentation of the petition for an administration order to the court.[254] However, there are no restrictions on the directors until the administration order is actually granted by the court. The directors continue to exercise their powers[255] and may dispose of the company's property by selling, leasing, mortgaging or charging it or by dealing with it in any other way.[256] In this respect the English law

[248] The court that made the provisional order is the court with jurisdiction. See *Ex Parte Pan-African Tanneries Ltd (Under Judicial Management)* 1950 4 SA 321 (O).
[249] Companies Act 61 of 1973 s 432(3)(a).
[250] 1996 1 SA 330 (A) 352.
[251] The case dealt with the appointment of a curator of a bank, but on this point there is no material distinction between a curator of the bank and a judicial manager of a company.
[252] Meskin *Henochsberg I* 957.
[253] Meskin *Henochsberg I* 957.
[254] Insolvency Act 1986, s 10(1), see also the discussion at 3 4 1 2 4.
[255] Goode *Principles of Corporate Insolvency Law* (1997) 290.
[256] Compare the Insolvency Act 1986, s 10 and s 14. It is exactly this feature which has made a presentation to the court for an administration order a valuable tool to buy time to enter into some

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differs from the South African law because the English law does not provide for a provisional order.

Once the order is made and an administrator is appointed the power to manage the company's affairs, business and property rests with the administrator.[257] Any other powers conferred on the company or its officers in terms of the company's constitution or the Companies Act which could be exercised in such a way as to interfere with the administrator's powers are not exercisable without the administrator's consent.[258]

The directors still hold office, although the administrator may remove any director and may appoint new directors.[259] They cannot exercise any of their powers to deal with company assets. However, they must still exercise their statutory duties. The directors may without the consent of the administrator exercise powers conferred on them that cannot be exercised in such a way as to interfere with administrator exercising his powers. The directors may, for example, call and hold meetings, such as the annual general meeting, and they are still responsible for the filing of proper financial statements.[260]

3 4 2 3 *Voluntary administration (Australia)*

The Australian law makes more provision for the co-operation between the directors and the administrator than South African and English law. This is perhaps no surprise considering that voluntary administration commences with a resolution by the directors. Although voluntary administration may commence by other methods they are less common.[261]

The powers of the directors and company officers are suspended for the duration of administration and the administrator is able to exercise all the powers previously

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arrangement with creditors. This was not possible before because once the company started to seek an arrangement it led to a uncontrollable situation where creditors moved in to be first to secure a benefit for themselves. Millman & Durrant *Corporate Insolvency: Law and Practice* 2nd ed 47.

[257] Insolvency Act 1986, s 14(1)(a). This divesting of the directors of their management powers is criticised. It contrasts with the Chapter 11 model which leaves the "debtor-in-possession". The directors thus remains in control of day to day management.

[258] Insolvency Act 1986, s 14(4).

[259] Insolvency Act 1986, s 14(2)(a). When read with s 14(4) it also means that the company's power to remove directors by resolution ceases. Where the director has a service contract the contract determines the conditions of employment. Consequently removal of such director may expose the company to a claim for damages for a breach of contract. Brown *Corporate Rescue* 365 – 366.

[260] Brown *Corporate Rescue* 370 – 371.

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exercisable by them. Company officers include directors, a receiver, a receiver and manager and the liquidator. They will only be able to exercise any of their pre-administration powers with written permission from the administrator.[262]

The power to deal with the property of the company is expressly conferred on the administrator.[263] If the directors purport to deal with the property the transaction is void,[264] the directors are guilty of an offence and they may be liable to pay compensation.[265]

The administrator furthermore, has the power to remove a director of the company from office and to appoint a person as director.[266] In practice the administrator would try to distance himself from day to day control of the business. He would most probably refrain from taking "shop floor" decisions in a business in relation to which he has no general expertise. The day to day control of the business would usually be handed back to the directors now acting under the supervision of the administrator. However the administrator may decide to hand the control to a particular director or group of directors, especially where his investigations show that the involvement of certain directors led to the company's financial troubles. In larger companies the administrator would often need to establish new or reaffirm old lines of authority.[267]

The outcome of administration relies on the continued cooperation of directors in providing necessary information to the administrator. This includes the current financial information of the company as well as personal financial information of the directors. The quality of this information will often help to win the confidence of the creditors who must eventually approve the deed of company arrangement. The loss of power by the directors does not make them passive participants in the administration.

It is the directors who appoint the administrator and this leaves the possibility that he may be manipulated by the directors. To prevent the directors from manipulating the administrator, the legislation makes provision that once an appointment of the administrator has been made it cannot be revoked.[268]

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[261] Lessing & Corkery *Corporate Insolvency Law* 54 found that 92% of administrations commences with a resolution by directors.
[262] Corporations Law, s 437C.
[263] Corporations Law, s 437D.
[264] Corporations Law, s 437D(2).
[265] Corporations Law, s 437D(5) and 437E(1).
[266] Corporations Law, s 442A.
[267] Lessing & Corkey *Corporate Insolvency Law* 98.
[268] Corporations Law, s 449A. See also Tomasic *Australian Corporate Insolvency law* 159.

The directors' powers are restored upon the acceptance and execution of the deed of company arrangement, but their powers are then defined and controlled by the deed of company arrangement. Once the deed of company arrangement is in place and operating the administrator will still play a role as the administrator of the deed of company arrangement. His role will then also be defined by the deed of company arrangement. In general, the deed of company arrangement should strive to ascribe a mere supervisory role to the administrator. This makes his participation more affordable by keeping costs down.[269]

3 4 2 4 *Evaluation*

From the discussion of the three jurisdictions above it is clear that the Australian example provides and expects cooperation between the administrator and the directors of the company. As stated above, this is not surprising given the fact that the process is such that the company is usually placed under administration by a mere directors' resolution. Nevertheless, there is no doubt that the administrator is in full control and that the directors play a secondary role from the commencement of voluntary administration.

The English procedure makes provision for the necessary powers to pass to the administrator while the directors still remain responsible for certain statutory duties. The legislation clearly sets out the relation between the administrator and the directors. It is clear that despite the administration order, the directors will still be in office, may exercise certain powers, are still responsible for certain statutory duties and carry the responsibilities accompanying the office of director such as fiduciary duties.

This divesting of directors of their management powers has received some criticism.[270] It contrasts with the Chapter 11 model in the United States that leaves the "debtor-in-possession", thus leaving the directors in control of the day-to-day management. The early passing of control of the company to an outsider, albeit a professional, leads to a stigma being attached to the company. In addition, it leads to unnecessary costs of outside professionals, whilst the directors with inside knowledge of the company are on the side-lines. It arguably deters directors from seeking an early administration order as they not only lose their function and powers, but are also

[269] Keay 1997 *Company and Securities Law Journal* vol 15 145 154.

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faced with a report on their prior conduct filed with the Department of Trade and Industry.[271]

The present South African position is even less satisfactory and the decision in *Alpha Bank* is of no great help. It is now clear that the directors do not have any management powers or other powers of control whilst the company is under judicial management. In fact they lose office altogether when the company is placed under final judicial management. However, there is no clarity on matters such as the directors' common-law duties when the company is under provisional judicial management. The purpose of judicial management is the eventual return to a successful business and that is all the more reason why the directors should still be obliged to comply with their duties and able to perform those functions which do not interfere in any way with the judicial manager exercising his powers. The legislation should make it clear that it is possible for the judicial manager to delegate some of his management powers to the directors. It should also be made clear that the directors are still in office and subject to their statutory and common-law duties.

There exists an anomaly in South African law between the position of directors of a company under judicial management and their position where the company is in liquidation. In the latter instance the position of directors is determined by whether the winding-up of the company is voluntary or compulsory. In the case of a voluntary winding-up by creditors, the directors' powers cease except insofar as the liquidator or the creditors sanction their retention.[272] In a voluntary winding-up by members the powers of the directors also cease, but their continuation may be sanctioned by the liquidator or a general meeting of members.[273] In a compulsory winding-up however "the directors cease to be directors functionally, officially and nominally and their powers and duties cease, and they are deprived of their control of the company's property."[274]

Surely in a judicial management which has the eventual rescue of the business as its aim the position of the directors should be more akin to their present position in a voluntary winding-up and not more similar to that in a compulsory winding-up. It is

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[270] Brown *Corporate Rescue* 364 and Goode *Principles of Corporate insolvency Law* (1997) 323.
[271] Brown *Corporate Rescue* 364.
[272] Companies Act 61 of 1973 s 353(2)(a).
[273] Companies Act 61 of 1973 s 353(2)(b).
[274] *LAWSA* IV part 3 260.

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submitted that judicial management needs a structure where there is more cooperation between the directors and the judicial manager.

The Law Reform Commission of Hong Kong has concluded[275] that as far as the relationship between the judicial manager and the directors is concerned it will be very beneficial to the judicial manager if the directors participate in a spirit of cooperation with the judicial manager and if the relationship between the judicial manager and the directors is clearly understood. This spirit of cooperation will usually be facilitated where the directors appointed the judicial manager.

It is thus submitted, along the lines of the recommendations by the Law Reform Commission of Hong Kong[276] that directors should be involved in the running of the company, but only to the extent that the judicial manager delegates powers to them, remembering that all powers of control should now vest in the judicial manager.[277]

The involvement of directors has the advantage of using their knowledge of the business and their drive and commitment to save the company. This advantage comes without involving the costs of outsiders to do the same work. The directors often have a vested interest in the company and they would often stand to lose much more than anybody else does.

On the other hand it might be because of the lack of skill and experience of the directors that the company is in its present difficulties. Then it would be up to the judicial manager to use his envisaged powers to dismiss a director or all the directors.

The judicial manager should not only have the power to dismiss, but he should also have the power to renegotiate the directors' remuneration, as directors. After all, they do not have the same powers as before. It is submitted that he would be able to this in any event if he has the power to dismiss. It is submitted further that in the case of dismissal of a director by the judicial manager, the director should not have the normal contractual remedy of damages for breach of contract by the company.[278]

Although this would be the ideal position it is unlikely that it will be attainable under the present labour-law regime in South Africa. Although removal from office as

[275] Hong Kong Law Reform Commission *Report on Corporate Rescue and Insolvent Trading* 54 para 8.9.
[276] *Report on Corporate Rescue and Insolvent Trading* (1996) 56.
[277] See also the discussion at 4 1 4 *infra*.
[278] Nor should it be possible to use the provisions of labour law to prevent the judicial manager from dismissing a director.

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director would present no problems any termination of employment in terms of a service contract would have to answer to the provisions of labour law.

3 4 2 5 *Draft legislation to give effect to the proposals*

Section 3[279]

(1) While a company is under judicial management, a person (other than the judicial manager) cannot perform or exercise, and must not purport to perform or exercise, a function or power as an officer or director of the company, except with the written approval of the judicial manager.[280]

(2) Subsection (1) does not remove an officer or director of the company from office.

(3) The judicial manager has the power to remove any director of the company and/or to appoint any person not disqualified in terms of the Companies Act to be a director of it, whether to fill a vacancy or otherwise.

(4) A director removed from office in terms of subsection (3) will have not have any claims against the company or the judicial manager because of his removal.

3 5 **Proposals, deed of company arrangement and procedures**

In order to rescue a business which is performing badly and to restore it to success a new strategy needs to be devised. The responsibility to take such an initiative lies with the directors and management of the company. If no such plan is devised and implemented the only hope for the company is a sudden change of fortune which lies beyond the control of anyone involved with the company. Therefore statutory business rescue regimes normally provide the procedures for the formulation of a rescue plan.

However, when the company has entered the business rescue procedure the responsibility for the formulation of a business rescue plan may no longer be the responsibility of the directors. In jurisdictions with a pro-creditor orientation towards

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[279] Based on Insolvency Act 1986, s 14 and Corporations Law, s 437C.

[280] An alternative to subsection 1 could read:
(1) Any power conferred on the company or its directors, whether by the Companies Act or by the memorandum or articles of association or the common law, which could be exercised in such a way as to interfere with the exercise by the judicial manager of his powers is not exercisable except with the written consent of the judicial manager, which may be given either generally or in relation to particular cases.

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insolvency matters one would expect the responsibility to be transferred from those controlling the debtor company to some person primarily concerned with looking after the interests of creditors. The creditors would most probably play an important role in such a process.

At the stage where the company finds itself engaged in a business rescue procedure, the plan to lead the company to becoming a successful business or to some other goal will need to be something more formal than a corporate business strategy formulated by the directors, if the plan is to win the trust and support of creditors who were denied the enforcement of their creditor rights by the commencement of the business rescue procedure.

This part of the thesis will discuss the formulation and acceptance of such a business rescue plan.

3 5 1 Judicial management (South Africa)

Bearing in mind that any business in trouble needs to establish a plan or strategy to emerge from its troubles it is surprising that the existing judicial management procedure does not provide expressly for the formulation of a plan or blueprint for future conduct of the company. This is in contrast with its Australian and English counterparts. However, it is not possible for the court to make a final judicial management order if on the return day there is nothing before the court to suggest that the company will, if placed under judicial management, be enabled to become a successful concern.[281] The court thus has to be satisfied that the future operations of the company will result in it being successful.[282] It is submitted that the court will only be in a position to reach this conclusion if the provisional judicial manager gives an indication as to how the company's future operations will be conducted.[283]

This implied requirement represents judicial management's comparatively nebulous equivalent to a plan of future conduct.

The alternative subsection leaves less certainty as to the functions and powers of the directors, because the written consent of the judicial manager will be necessary for only some of the powers and functions that a director can exercise.

[281] Companies Act 61 of 1973 s 432(2).

[282] See *Tenowitz v Tenny Investments (Pty) Ltd supra* 685H.

[283] See also Meskin *Henochsberg I* 937.

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3 5 1 1 *The process leading to the formulation of a possible plan of future conduct*

The first indication that such a plan has to be formulated comes from the duties of the provisional judicial manager. The provisional judicial manager must prepare and lay before separate meetings[284] of the creditors, members and debenture-holders a report dealing with the following matters: an account of the general state of affairs of the company; a statement of reasons why the company is in financial difficulties and the reasons preventing it from becoming a successful concern; a statement of the assets and liabilities of the company; a complete list of the creditors of the company; particulars as to the source or sources from which money has been or is to be raised for purposes of carrying on the business of the company; and the considered opinion of the provisional judicial manager as to the prospects of the company becoming a successful concern and of the removal of the facts or circumstances which prevent the company from becoming a successful concern.[285]

The provisional judicial manager must form his considered opinion on the best information which he can reasonably obtain and then formulate some future course for the company. If this opinion turns out to be that the provisional judicial management order should be made final he should be able to defend it from the searching questions of creditors, members and debenture-holders at the different meetings. The reason for laying before the meetings an account of the general state of affairs of the company and the statement of reasons why the company has failed is obviously to enable the different meetings to enlighten the provisional judicial manager on shortcomings in the information that he used in coming to his considered opinion and to enable them to evaluate his recommendations.[286]

At the meetings referred to above the provisional judicial manager is not the chairperson.[287] This removes any possible control over the proceedings that the provisional judicial manager could have as a means of imposing his opinion on the meetings. He thus has to convince the meetings on the strength of an objective assessment of the company's present problems and a realistic plan of future conduct.

[284] These meetings must be convened by the Master. (See the Companies Act 61 of 1973 s 429(b)(ii).)
[285] Companies Act 61 of 1973 s 430(c) read with s 429(b)(ii).
[286] See also Meskin *Henochsberg I* 937.
[287] Companies Act 61 of 1973 s 431(1).

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The purpose of the meetings referred to above is to consider the report of the provisional judicial manager and the desirability of placing the company under final judicial management, taking into account the prospects of the company becoming a successful concern.[288] The meeting of creditors should also consider the passing of a resolution conferring preference for payment for liabilities incurred or to be incurred by the provisional judicial manager or judicial manager.[289] (This preference will be in relation to all the other unsecured liabilities not already discharged, excluding the costs of judicial management.)

The chairperson of the meeting then prepares a report on the meeting that must be laid before the court on the return day when the court decides whether to make a final judicial management order or whether to discharge the provisional judicial management order. This report should include the chairperson's own summary of the reasons for any conclusion reached at the meeting on the desirability of placing the company under final judicial management.[290]

Upon conclusion of the meetings of creditors, members and debenture-holders the plan regarding the envisaged future conduct of the company has been proposed by the provisional judicial manager, considered and commented upon by the creditors, the members and the debenture-holders and a conclusion noted by the chairperson of the meetings. This however does not give this plan of future conduct any legal status. The court still has to decide whether to make a final judicial management order, thereby indirectly approving the "plan".

The court makes its decision on the return day of the provisional judicial management order after consideration of the opinion and wishes of creditors and members of the company; the report of the provisional judicial manager;[291] the number of creditors who did not prove claims at the first meeting of creditors and the amounts and nature[292] of their claims; the report of the Master; and the report of the Registrar.[293] The court also considers the report of the chairperson of the meetings of creditors, members and debenture holders.

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[288] Companies Act 61 of 1973 s 431(2)(a).
[289] Companies Act 61 of 1973 s 431(2)(d) and s 435(1)(a).
[290] Companies Act 61 of 1973 s 431(3); Meskin *Henochsberg I* 938.
[291] The report laid before the meetings of the creditors, members and debenture holders convened in terms of Companies Act 61 of 1973 s 429(b)(ii).
[292] The nature of the claim probably refers to whether it is secured, unsecured, liquidated, unliquidated, disputed, undisputed, due and payable, due but not yet payable, contingent or prospective.

The court then makes a decision on whether a final order should be made. The plan regarding future conduct has been considered by various parties by this stage, but nobody is bound by any decision taken at any meetings and opposing views as to the possibility of the company becoming a successful concern may be submitted to the court. Once the court has made the final judicial management order it represents the court's view on the prospects of the company becoming a successful concern and thus indirectly endorses the plan. It does not however necessarily confirm the plan of future conduct, in a way which binds the judicial manager and the company to a specific course of action in the future.

As part of the final judicial management order the court gives directions for the vesting of the management of the company in the final judicial manager, subject to the supervision of the court.[294] The court, as part of the final judicial management order, may also make such other directions as to the management of the company, or any matter incidental thereto, including the power to raise money in any way without the authority of the shareholders, as the court may consider necessary. In exercising this power the court may elevate the status of the plan of future conduct to something more formal and binding.[295]

It is the process described above, together with the powers of the court on granting a final judicial management order that lead to the formulation and acceptance of judicial management's comparatively nebulous equivalent to a plan of future conduct found in the other jurisdictions considered.

From a survey of decided cases it is obvious that a compromise with creditors and a reorganisation of rights may form part of the process of steering a company through judicial management. In a majority of the reported cases such a scheme of arrangement was ventured upon only once the company was in final judicial management. This is the reason why the application for the meetings of creditors in the equivalent of the current section 311 scheme was done by the judicial manager.[296] Thus it does not constitute a true plan of future conduct to establish whether judicial

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[293] Companies Act 61 of 1973 s 432(2).

[294] The final judicial management order must also contain provisions for the handing over of all matters and the accounting to the final judicial manager by the provisional judicial manager and the discharge of the provisional judicial manager where necessary. See the Companies Act 61 of 1973 s 432(3)(a).

[295] Companies Act 61 of 1973 s 432(3)(c).

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management is the right course for the company to follow. The scheme of arrangement follows once the order to put the company in final judicial management was already made. It therefore seems that the scheme of arrangement was not part of a definite plan for future conduct presented to the court on the return day of the provisional judicial management order.

However in *Williams v Sandy's Confectionery (Pty)Ltd; Ex Parte Muller NO*[297] it was decided that the section 311 scheme meetings should be held first and that the decision whether or not to put the company into final judicial management would be deferred until the date when the court was asked to sanction the anticipated compromise in terms of the section 311 scheme proposed by the provisional judicial manager. This represents a formulation of a plan where the creditors contributed to the process. It is not clear from the judgment whether the scheme aimed to reach a compromise with creditors whereby they would not be paid in full. If this were indeed the case, it would serve as an indication that the judicial management process can still be useful even though the aim of full payment as envisaged by the Companies Act[298] is not possible.

The court in the *Williams* case however decided that a section 311 scheme does not fall under the provisions of section 428(2)(c) of the Companies Act regarding the management of the company under provisional judicial management. The subsection provides that the court may make such directions as to the management of the company or any other matters incidental thereto, as the court may consider necessary. The court reasoned that a compromise scheme has nothing whatsoever to do with the management of the company.[299] This attitude highlights the difficulty that a company has in restructuring itself with a plan of future conduct under the present provisions for judicial management. The court nevertheless resolved the difficulty by deciding that the reference in section 311(1) of the Companies Act to a "judicial manager" as an applicant for a section 311 scheme must of necessity include a provisional judicial manager.[300]

[296] See *Ex Parte Botha: In re Public Utility Transport Corporation Ltd* 1952 4 SA 244 (W); *Ex Parte Cornell, N.O.: In re Khadaan Drive-in Cinema (Pty) Ltd* 1959 1 SA 13 (D); *Ex Parte Power and Others, NN.O.:In re Natal Oil Products Ltd* 1959 1 SA 7 (D).
[297] 1976 2 SA 355 (D) 355H.
[298] Companies Act 61 of 1973 s 427(1).
[299] *Williams v Sandy's Confectionery (Pty) Ltd* 1976 (2) SA 355 (D) 356B.
[300] At 356H.

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3 5 1 2 *Variation and termination of the judicial management order*

The court which granted the final judicial management order may vary the terms of the order at any time and in any manner on application of the Master; the final judicial manager or a representative of the body of creditors of the company concerned. The representative of the creditors should be mandated by a resolution passed by the majority in value and number of the creditors at a meeting of the creditors.[301]

The judicial manager[302] or any person having an interest in the company may at any time apply to the court for the cancellation of the judicial management order. The court may do so if it appears to the court that the purpose of the judicial management order has been fulfilled or that it has failed to fulfil its purpose or that for any reason it is undesirable that the order should remain in force.[303]

3 5 1 3 *The role of creditors and members*

The creditors and members pronounce their views on the future conduct of the company under provisional judicial management at the meetings convened to consider the report of the provisional judicial manager. There their views are noted by the chairperson of the meeting and laid before the court in his report.[304]

Upon the return day of the provisional judicial management order the creditors are also able to address the court on grounds supporting or opposing the making of a final judicial management order.

As stated above, once the final judicial management order is made the creditors may approach the court in order to vary the terms of the order.[305] A creditor or member as a person having an interest in the company may at any time apply to the court for the cancellation of the judicial management order.[306]

3 5 1 4 *Liabilities incurred by the judicial manager*

One aspect that will definitely be considered as part of a possible plan of future conduct is the decision by creditors whose claims arose before the granting of a judicial management order whether or not to give preference for the payment of

[301] Companies Act 61 of 1973 s 432(4).
[302] The judicial manager is under a duty to do so if he is of the opinion that the judicial management will not achieve its purpose. (See the Companies Act 61 of 1973 s 433(1)).
[303] Companies Act 61 of 1973 s 440(1).
[304] *LAWSA* IV part 3 467-468.
[305] Companies Act 61 of 1973 s 432(4).

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liabilities incurred or to be incurred by the provisional judicial manager or judicial manager over all unsecured claims against the company.[307]

This may be problematic for the judicial manager. He has to keep the business of the company running at least until the meeting of the creditors where this matter is decided without knowing whether the creditors will grant such a preference. He might find himself incurring necessary and reasonable liabilities that might not be paid in full.[308]

3 5 2 Administration (England)

Unlike the South African judicial management procedure, the English administration order has the acceptance of a plan of future conduct, referred to in the legislation as "administrator's proposals", at the heart of its process. The administrator's proposals need to be approved even though the purposes of the administration order do not include a business rescue as such.[309]

3 5 2 1 *Acceptance of the administrator's proposals*

The aim of the administration order is the approval by the company's creditors of the administrator's proposals for achieving the purposes specified in the administration order. A copy of these proposals must be sent to the Registrar of Companies and to all the creditors (insofar as the administrator is aware of their addresses) and it must be laid before a meeting of creditors of the company for approval. This the administrator must do within three months from the granting of the order or within such longer period as the court allows.[310]

In order to prepare his proposals, the administrator will need to assess the affairs of the company. In helping him to do so he has certain powers to investigate and to require persons to cooperate in submitting statements as to the affairs of the company to him in the prescribed form. In fact the administrator has a statutory duty to do the investigations.[311]

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[306] Companies Act 61 of 1973 s 440(1).
[307] Companies Act 61 of 1973 s 435(1). See also LAWSA IV part 3 479.
[308] Meskin *Henochsberg I* 953.
[309] One of the purposes for which an administration order may be granted is a more advantageous realisation of the company's assets than would be effected on a winding-up. See the Insolvency Act 1986, s 8(d).
[310] Insolvency Act 1986, s 23(1); Insolvency Rules, r 2.17.
[311] Insolvency Act 1986 s 22(1) and (3); Insolvency Rules 1986, r 2.11. For a discussion of the administrator's investigative powers and duties see 4 3 2 3 *infra*.

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The administrator's proposals should set out the way in which the administrator proposes to conduct the administration to achieve the purpose or purposes for which the administration order was made.[312] According to Pennington the proposal should include details such as the assets to be sold and those to be retained; the parts of the business undertaking that will continue, if any; the way in which the future undertaking will be financed; and how creditors will be treated. Pennington is also of the opinion that the proposals may specify that debts may be deferred and only become due and payable at a later date; that the creditors might compromise to forfeit some or part of their claims; and that securities may be released.[313]

The nature of the proposals may vary from trading to success or deferment of payment of debts to the winding-up of the company's business over a lengthy period and even the dividing of the company's business activities and the transfer of viable parts to newly formed subsidiary companies and the selling of the viable parts in newly formed subsidiary companies and the winding-up of the rest.[314]

If the proposals involve the alteration or modification of rights of shareholders or secured creditors, the administrator will prepare a scheme of arrangement. Where it is only the creditors' rights which are affected the administrator may proceed with a company voluntary arrangement.

The proposals must be set out in the prescribed form and this must be accompanied by a statement of the administrator that contains details of his appointment and the purposes of the administration order. The statement must also include names of the directors and the secretary of the company; a brief history of the company leading to the administration order; the statement of affairs or details of the company's financial position at the latest practicable date; a statement of the manner in which the company was run since the administration order and the manner in which it will be run in the future; and such other information as the administrator considers necessary to enable the company's creditors to decide whether or not to vote for the adoption of the administrator's proposals.[315]

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[312] Insolvency Act 1986, s 23.
[313] Pennington *Corporate Insolvency Law* (1997) 380.
[314] This is also known as the hiving down of companies. Belcher *Corproate Rescue* 27.
[315] Insolvency Act 1986, s 23(1); Insolvency Rules 1986, r 2.16(1). See also Brown *Corporate Rescue* 318 – 319.

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The practice of administrators has evolved whereby the administrators will seek the approval of creditors to their proposals in general terms only. The creditors might find themselves asked to approve proposals that simply authorise the administrator to:[316]

> continue to manage the affairs of the company in order to achieve one or more of the purposes set out in the administration order;
>
> to sell all or any of the assets of the company, as and when offers that are suitable are received, for the benefit of creditors in general;
>
> to refer to the creditors' committee on a regular basis and to ask for their approval for significant disposals where the administrator considers it appropriate; and
>
> upon achieving one or more of the stated purposes of the administration order to apply to the court for its discharge on the basis that either a voluntary arrangement under part I of the Insolvency Act will be implemented or a creditors' voluntary winding-up or a compulsory winding-up order will follow the discharge.

Once the proposals are prepared the administrator must call a meeting of the creditors of the company to consider the proposals. He should give at least 14 days' notice to creditors[317] and to the directors and officers of the company who must attend the meeting.[318]

The Insolvency Rules deal with such aspects as creditors eligible to attend and to vote; the chairperson's right to accept and reject claims; the procedures to resolve disputes by application to court; the nullifying of resolutions taken; and, the ordering of other meetings.[319] The Insolvency Rules also provide that creditors may appoint

[316] This is different from the expectations at the time when the Insolvency Act was enacted. Some then thought that the proposals should be set out in great detail. However, given the nature of business a detailed proposal might soon need modifications because of economic developments. See Fletcher, Higman, Trower *The Law and Practice of Corporate Administrations* (1994) 44.

[317] Those identified in the statement of affairs or known to the administrator to have claims against the company at the date of administration. See the Insolvency Act 1986, s 23(1) and s 24(1); Insolvency Rules 1986, r 2.18(1).

[318] The rules also deal with the situation where no one attends and give the chairman, normally the administrator himself, the power to adjourn the meeting for not more than 14 days. Insolvency Rules 1986, r 2.19.

[319] Insolvency Rules 1986, r 2.22 and r 2.23.

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proxies to vote on their behalf and that the notice of the meeting must make provision for this.[320]

There are two requirements for calculating the majority of creditors who must approve the plan.[321] First a majority in value of the creditors present and voting in person or by proxy must approve the proposals. Secondly, this majority should be achieved by not taking into account the claims of creditors who are persons connected to the company. Persons connected to the company include directors or shadow directors and persons associated with them or the company.[322] The value of the debts is the nominal value, that is the value without allowing for discounting due to the debts only being due and payable in the future. The value of the debts is the sum of the nominal value at the date of the administration order plus interest capitalised to that date less any subsequent payments.[323]

The secured creditors or any creditors holding some security on debts[324] due to them are only allowed to vote to the value of their claims exceeding the value of their security.[325] Creditors for goods sold in terms of a hire-purchase or similar agreement are only entitled to vote to the value of the unpaid instalments as at the date of the administration order and the result of any acceleration clause is not included in the value of their vote.[326]

The creditors' meeting may approve the proposals of the administrator as they stand or with modifications.[327] The modifications will however be subject to the approval of the administrator. If he finds them unacceptable the court can discharge the administration order or make an interim order to enable the administrator to convene another meeting and to present revised proposals.[328] The court has no power to make or to consent to any modifications as a substitute for the consent of the administrator or creditors. If the administrator consents to the modifications, each modification

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[320] Insolvency Rules 1986, r 19(5).
[321] In general on the voting of creditors see Brown *Corporate Rescue* 321 – 325.
[322] Insolvency Rules 1986, r 2.28 and 1(A).
[323] Insolvency Rules 1986, r 2.22(4); Pennington *Corporate Insolvency Law* (1997) 385.
[324] This includes for example the seller of goods who retained title on the goods sold till the purchase price is paid.
[325] Insolvency Rules 1986, r 2.24.
[326] Insolvency Rules 1986, r 2.27(1) and (2).
[327] The creditors should not be able to force modifications upon the administrator, which he may not view, as desirable, workable or compatible with the original proposals, given that the administrator is under a duty to act in accordance with the proposals. Brown *Corporate Rescue* 325.
[328] Insolvency Act 1986, s 24(2) and (5).

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needs to be consented to by the meeting and in the end a resolution approving of the modified proposals in their entirety needs to be taken.

The administrator must report to the court setting out the result of the creditors' meeting and must also notify the Registrar of Companies and each creditor who received notice of the meeting or of whom the administrator afterwards became aware. This notice to the relevant parties should include the details of the proposals and of any revisions or modifications that were approved by the meeting.[329]

3 5 2 2 *Effect of the approval of the proposals*

The approval of the proposals by the creditors' meeting signifies a further step in the administration process and the approved proposals lay down the rules which the administrator must follow in the future whilst conducting the affairs of the company. The acceptance does not bring administration to an end. In this respect it differs from the Australian procedure where voluntary administration ends once the deed of company arrangement is executed.[330]

3 5 2 3 *Variation and termination*

Once the proposals are approved, the administrator should conduct the administration in accordance with the approved proposals. If the approved proposals need modification due to a change in circumstances or merely because the provisions of the proposals turn out to be impractical, the administrator may make changes unilaterally if these modifications are not substantial. If the changes are substantial the administrator must have them approved by a creditors' meeting convened and conducted much in the same way as the original meeting for approving the proposals was convened and conducted.[331]

However, when the administrator for some reason would like to alter the purpose for which the administration order was made, he should apply to court. When the court approves this new purpose or purposes the administrator should put new proposals to

[329] Insolvency Act 1986, s 24 and Insolvency Rule 2.30. Apparently the court has no further role in giving legal effect to the proposals. Once the proposals of the administrator are approved by the meeting of creditors they have legal effect. See also Fletcher & Grabb *Insolvency Act 1986* 45-48.
[330] See 3 4 3 2 *infra.*
[331] Insolvency Act 1986, s 25(1) and (2); Insolvency Rules 1986, Sch 4, Form 2.22.

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a creditors' meeting for their approval.[332] In such a case the original proposals will cease to have any effect.[333]

Administration proceedings may be brought to an end by a successful appeal against the making of the order, the rescission of the order by the court[334] or its discharge by the court. The order may be discharged by the court on the application of the administrator. The administrator has a duty to apply if it appears to him that the purposes set out in the administration order have been achieved or are incapable of achievement, in which case he can also apply for the variation of the order.[335] The administrator also has a duty to apply if required by a meeting of the company's creditors summoned for this purpose in accordance with the rules.[336]

3 5 2 4 *The role of creditors and members during administration*

The administrator is responsible for conducting the administration and there is no provision that he should have regard to the wishes of the creditors. If in doubt as to the validity of any act he may ask the court for directions.[337] The administrator may however convene meetings of creditors in order to ascertain their wishes. The court may also direct the administrator to hold a meeting, and the administrator must hold a meeting of creditors if requested by creditors with claims to the value of one tenth of the claims.[338] It is doubtful if the creditors would make use of this avenue as there is precious little for them to gain out of a meeting that might further drain the resources of the company and where they cannot give any directions to the administrator. However if the creditors' meeting resolves that the administrator should apply to court for a discharge of the company from administration he is obliged to do so.[339]

The creditors may decide to establish a creditors' committee. The decision and election will take place at the meeting where the original proposals are approved.[340] This committee consists of a minimum of three and a maximum of five creditors.[341] The committee must assist the administrator in carrying out his functions. The

[332] *Re St Ives Windings Ltd* (1987) 3 BCC 634.
[333] Pennington *Corporate Insolvency Law* (1997) 389.
[334] *Cornhill Insurance plc v Cornhill Financial Services Ltd* [1992] BCC 818.
[335] Insolvency Act 1986, s 18(2)(a).
[336] Insolvency Act 1986, s 18(2)(b).
[337] Insolvency Act 1986, s 14(3).
[338] Brown *Corporate Rescue* 320.
[339] Insolvency Act 1986, s 18(2)(b).
[340] Insolvency Act 1986, s 26(1).
[341] Insolvency Rules 1986, r 2.32(1).

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administrator and the creditors' committee must establish the scope of the committee's activities by agreement.[342] The creditors' committee may require the presence of the administrator at any of their meetings, where he must provide the committee with such information as it may reasonably require on matters relating to his carrying out of his functions as administrator.[343]

The Insolvency Rules also regulate the notice periods of creditors' committee meetings, filling of vacancies, quorums, voting, proxies and written consent outside a formal meeting.[344]

The administrator must also provide the members of the creditors' committee with a report of receipts and payments of the company. The reports are six-monthly and must be made within two months after the ending of each six-month period from the date of his appointment.[345]

The administrator has the power to call meetings of members of the company.[346] The need will not however arise often unless the administration leads to a voluntary arrangement under Part I of the Insolvency Act or a scheme of arrangement under section 425 of the Companies Act.[347] In these circumstances a meeting of creditors will need to sanction the arrangement or the scheme.

3 5 2 5 *Liabilities incurred by the administrator*

The administrator in exercising his functions is deemed to act as the agent of the company.[348] Thus he does not incur any personal liability for any new contracts that he enters into on behalf of the company, nor for any old contracts of the company that he continues with.[349]

Furthermore, the claims of creditors under contracts concluded after the administration order was granted, and contracts of employees that he adopted, are a first charge on the company's property in the custody or control of the administrator.

[342] Insolvency Rules 1986, r 2.34(1).
[343] Insolvency Act 1986, s 26(2); Insolvency Rules 1986, r 2.44(1).
[344] Insolvency Rules 1986, rr 2.34-2.43.
[345] Insolvency Rules 1986, r 2 52(1) and (3) and Sch 4, Form 2.15.
[346] Insolvency Act 1986, s 14(2)(b).
[347] 1985.
[348] Insolvency Act 1986, s 14(5). See also Goode *Principles of Corporate Insolvency Law* (1997) 314.
[349] Brown *Corporate Rescue* 267.

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This charge even ranks ahead of the administrator's own remuneration and expenses.[350]

3 5 3 Voluntary administration (Australia)

The Australian procedure is similar to the English procedure in that the approval of a plan of future conduct, referred to in the legislation as the deed of company arrangement is very much the focal point of the procedure.[351] Its importance can hardly be exaggerated. There are three possible normal outcomes of the Australian administration. First, a deed of company arrangement may be executed; secondly the company's creditors may resolve that the administration should end and thirdly the company's creditors may resolve that the company be wound up.[352] The anticipated outcome is the execution of a deed of company arrangement.[353]

3 5 3 1 *Execution of the deed of company arrangement*

The aim of voluntary administration is to lead to a deed of company arrangement that will govern the way in which the affairs of the company will be run in the future. However from a survey conducted among insolvency practitioners it is evident that voluntary administration is often used instead to put the company into liquidation.[354] Nevertheless, the rest of the discussion will focus on the position where a deed of company arrangement is executed.

The specific contents of the deed will vary greatly depending on the circumstances of each administration. To provide the required flexibility, the Act does not in any way limit the scope for the company and its creditors to reach an agreement nor does it limit the use of voluntary administration to certain purposes.[355]

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[350] Insolvency Act 1986, s 19(4), (5). See also Brown *Corporate Rescue* 466.
[351] See Explanatory Memorandum to the Corporate Law Reform Act 1992 para 444; Tomasic *Australian Corporate Law* 137.
[352] Corporations Law, s 435C(2). See also s 435C(3) for other ways in which the administration may end.
[353] Corporations Law, s 439C(a). See also Tomasic *Australian Corporate Insolvency Law* 154.
[354] Lessing and Corkey *Corporate Insolvency Law* 70. The authors did a survey in which 56% of the respondents saw the administration procedure as a suitable way of placing a company into liquidation. They felt it was quicker and easier than the normal creditors' voluntary winding-up or court process, and it enabled quicker, more effective protection of the assets.
Those who opposed this view cited possible abuse of the intention of the administration procedure; the fact that nothing was wrong with the present liquidation procedures and the fact that the director's nominee usually gets appointed as liquidator as reasons for their dissent.
See also 3 6.
[355] Explanatory Memorandum to the 1992 Corporate Law Reform Act para 577. See also Tomasic *Australian Corporate Insolvency Law* 154.

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As soon as practical after the administration of the company begins, the administrator must investigate the business, property, affairs and financial circumstances of the company.[356] This investigation should enable the administrator to determine the true position of the company and assist him in forming an opinion, as he must, whether it would be in the interests of the company's creditors to execute a deed of company arrangement or whether the administration should end or whether the company should be wound up.[357]

After having done his investigation and formed his opinion on the action that should be taken regarding the company's future the administrator must convene a meeting of creditors to decide upon the future of the company. This must be convened within either 21 or 28 days from the beginning of administration and five business days' notice of the meeting must be given.[358] If the administrator is of the opinion that it is in the interests of the company's creditors that the company should execute a deed of company arrangement the notice of the meeting should include a statement setting out details of the proposed deed.[359] If the meeting of creditors resolves that a deed of company arrangement should be executed by the company the administrator of the deed[360] must prepare an instrument setting out the terms of the deed. The company[361] must execute this instrument prepared by the administrator of the deed within 21 days after the end of the meeting of creditors[362] and the administrator of the deed must execute the instrument before the company does or as soon as practicable thereafter.[363]

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[356] Corporations Law, s 438A.

[357] Corporations Law, s 438A(b). To assist the administrator in his investigations to ascertain the true position of the company, he has certain powers to compel persons to make certain statements of affairs and to make relevant books and documents available to him. See Corporations Law, s 438 and also 4 3 3 3.

[358] Corporations Law 439A. As elsewhere business in Australia is also affected by summer and taking of decisions slows down. According to s 439A(5) if the administration starts on a day in December or a day that is less than 28 days before Good Friday the convening period shall be 28 days. At other times the convening period is 21 days.

[359] Corporations Law, s 439A(4)(c). In practice many administrations provide complete details of the proposal before the second meeting and increasingly provided a draft of the proposed deed of company arrangement itself. Lessing & Corkery *Corporate Insolvency Law* 97.

[360] This is the term used by the Corporations Law s 444A(3) to distinguish the administrator appointed to administer the company under the deed of company arrangement from the administrator appointed on administration. Normally the administrator of the deed will be the same person as the administrator appointed on administration, unless the creditors resolve to appoint someone else as administrator of the deed. See the Corporations Law s 444A(2).

[361] A resolution of the board of directors is required. See the Corporations Law s 444B(3).

[362] If the company fails to execute the deed or decides not to, the administration order will be transformed into a creditors' voluntary winding-up and the administrator will become the liquidator. See the Corporations Law, s 446A(2)(b).

[363] Corporations Law, s 444B.

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When the instrument is executed by both the company and the administrator of the deed the instrument becomes a deed of company arrangement.[364]

Although the specific contents of the deed will vary greatly depending on the circumstances the terms of the deed must be specified in the instrument prepared for execution by the administrator of the deed. This requirement is imposed in recognition of the importance of the arrangement.[365]

The instrument must also specify the administrator of the deed of company arrangement; the property available to pay the claims of the creditors; the nature and duration of any moratorium provided for by the deed; the extent to which the company will be relieved from its debts; the conditions which may be set for the deed to come into and to continue in operation; the circumstances in which the deed is to terminate; the order in which the proceeds of the property of the company are to distributed amongst creditors; and the date by which claims must have arisen if they are to be admissible under the deed.[366] This date may not be later than the day on which administration began.[367]

The creditors are however generally more interested in the details of the reorganisation of the company affairs such as: the amounts of the dividends to be paid and the timing of the payments; how the necessary funds to keep the business going will be obtained and whether there will be a sale of assets or loans from related parties; whether related parties will refrain from participating in the deed of company arrangement dividends and whether related parties will give extra security to secured creditors or to the administrator to secure dividend payments; and the extent of the administrator of the deed's exercise of day to day control during the period of the moratorium.[368]

The administrator of the deed must at once notify all creditors and the ASC of the execution of the deed of company arrangement and must lodge a copy with the ASC.[369]

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[364] Corporations Law s 444B(6).
[365] Corporations aw s 444A(3). Explanatory Memorandum to the 1992 Corporate Law Reform Act para 577. See also Tomasic *Australian Corporate Insolvency Law* 154.
[366] Corporations Law, s 444A(4).
[367] Corporations Law, s 444A(4)(i).
[368] Lessing & Corkery *Corporate Insolvency Law* 98.
[369] Corporations Law, s 450B.

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3 5 3 2 *Effect of the deed of company arrangement*

Administration comes to an end upon the execution of the deed of company arrangement. This also means that the moratorium imposed by the administration on enforcement procedures is lifted.[370] This does not result in a return to the pre-administration position. The relationship between creditors[371] (even dissenting creditors) and the company is now governed by the deed of company arrangement. The deed of company arrangement may include a postponement of payment or a release of debts or a continued moratorium.[372]

Secured creditors and owners or lessors of property occupied, used or in possession of the company may again freely exercise their rights except in so far as the secured creditor, owner or lessor voted in favour of the deed and the deed provides otherwise.[373] If the deed does not provide for the restriction of the enforcement of their rights by the secured creditors, owners or lessors, mentioned above, the court may nevertheless make an order restricting them in their actions towards the company.[374]

The company is also protected during the 21 day period it has to consider the execution of the deed. No one is allowed to act in a way he would not have been able to act if the deed had already been executed, unless the court directs otherwise.[375]

Furthermore, no one bound by the deed may, until its termination, make or continue with an application for winding-up or begin or continue with proceedings against the company or an enforcement procedure against its property. The court however may give permission to begin or continue with proceedings against the company or an enforcement process against its property on such terms as the court may impose.[376]

[370] *Supra* 3 4 1 3.
[371] To the extent that their claims arose on or before the date specified in the deed of company arrangement (Corporations Law, s 444D(1)).
[372] Corporations Law, s 444A(4)(c) and (d).
[373] Corporations Law, s 444D. See also the discussion at 3 4 1 3 2 *supra*.
[374] The court is however limited in the exercise of this power by the Corporations Law, s 444F.
[375] Corporations Law, s 444C.
[376] Corporations Law, s 444E. See also Hannan "Shutting the door: Voluntary administration and contingent liabilities." 1995 *Law Institute Journal* 1007 on the effects of the acceptance of a deed of company arrangement on contingent creditors who might not even be aware of their possible claims at the date of approval of the deed.

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The deed of company arrangement binds the company, its officers and members and the deed's administrator as well as the creditors of the company with claims arising on or before the date specified in the deed.[377]

Whilst under administration a company is required to set out in every public document[378] and negotiable instrument behind its name where it first appears "under administration" and until the deed of company arrangement terminates "subject to deed of company arrangement".[379]

3 5 3 3 *Variation and termination of the deed of company arrangement*

The creditors have certain rights to require the convening of a creditors' meeting and may resolve to vary the deed at such a meeting but only if the variation does not differ materially from that proposed in the notice of the meeting.[380] The court on application by a creditor of the company may cancel the variation or confirm it wholly or in part and may add conditions to the order.[381]

The deed will terminate when the court so orders;[382] if the company's creditors so resolve at a meeting specially convened for the purpose; or if the conditions or circumstances specified in the deed for its termination are fulfilled or come into existence.[383]

3 5 3 4 *The role of creditors and members*

Creditors have an important role to play during the administration and subsequent deed of company arrangement phase. The first time creditors are called into action is at the first creditors' meeting. This should take place within five business days from the commencement of administration, on at least two business days' notice to creditors. This first meeting will decide whether a committee of creditors will be

[377] Corporations Law, s 444G and 444D(1).
[378] A public document in this sense refers to documents that will be seen and read by the public and it includes business letters, invoices, receipts, orders for goods and the like. Corporations Law, s 88A.
[379] Corporations Law, s 450E.
[380] Corporations Law, s 445A and F. See the text at n 389 *infra* as to the required majority.
[381] Corporations Law, s 445B.
[382] The court may terminate the deed if it is satisfied that the deed was executed on false or misleading information, or if a material contravention of the deed took place, or if the deed will lead to injustice or undue delay, or if would be oppressive or unfairly prejudicial to a creditor, or if the deed should be terminated for some other reason (see the Corporations Law, s 445D).
[383] Corporations Law, s 445C.

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formed. The meeting may also resolve to remove the administrator and to replace him with another.[384]

The committee of creditors cannot give directions to the administrator, but it may require the administrator to report to the committee about matters relating to the administration.[385]

At the second meeting of creditors the future of the company is decided. At this meeting the creditors may decide that the company should execute a deed of arrangement or that administration should end or that the company should be wound up. The meeting can also potpone taking a decision as more time is needed to prepare for a proper decision. The meeting may then be adjourned from time to time but not for more than 60 days from the first day on which the meeting was held.[386] If no resolution has been passed by the sixtieth day then administration ceases automatically.[387]

The creditors of the company are in a strong position whilst the company is governed by the deed of company arrangement. They may call a creditors' meeting either to vary the deed or to end it and place the company in a voluntary creditors' winding-up.[388] Resolutions at a creditors' meeting are carried when the majority in number (present and voting in person or by proxy) and in value of claims against the company (present and voting in person or by proxy) vote in favour of the resolution.[389] The dual requirement does give the smaller creditors some protection against complete domination by a few large creditors, without the necessity of seeking protection from the court. It is submitted that a higher majority by value should be required to ensure that adequate weight is given to the wishes of major creditors.

The members have to adhere to the deed of company arrangement and assist in the operation of the company to the point where it is a successful concern once more. Only when the deed of company arrangement is terminated and the administrator no longer holds office will the members control the company again. It is however

[384] Corporations law, s 436E.
[385] Corporations Law, s 436E and F.
[386] Corporations Law, s 439B(2).
[387] Corporations Law, s 435(c).
[388] Corporations Law, s 445A and s 445C(b).
[389] Regulations to the Corporations Law 5.6.11 to 5.6.36A.

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conceivable that the administrator will delegate his powers to the directors and officers of the company and leave most of the day to day decisions to them.[390]

Any transfer of shares or an alteration of the status of members made during the administration of the company is void unless the court orders otherwise.[391]

3 5 3 5 *Liabilities incurred by the administrator*

In general the Australian administrator is made liable for the debts that he incurs in the exercise or performance of his functions as administrator. This includes liabilities for services rendered or goods bought or property hired, leased, used or occupied.[392] He is also personally liable for the continued use or occupancy or possession of property of which someone else is the owner or lessor. This liability starts on the eighth day after administration began.[393] The logic behind this provision is that the administrator has seven days in which to make a preliminary assessment of the financial position of the company and to decide whether administration will continue and also whether to continue with the lease of the property.

The administrator is indemnified for his liabilities from the assets of the company and this is indemnification has priority over all unsecured debts of the company and in certain instances over debts secured by a floating charge.[394]

The position of post-deed creditors is not all that certain. If the deed of company arrangement does not make provision for the preferential treatment of post-deed creditors a distinction is drawn between post-deed creditors whose claims arose from transactions with the administrator and those whose claims arose from transactions with the directors. The latter will have less protection than the former.[395]

[390] Lessing & Corkery *Corporate Insolvency Law* 98.
[391] Corporations Law, s 437F.
[392] Corporations Law, s 443A.
[393] Corporations Law, s 443B.
[394] Corporations Law, s 443D and E.
[395] O'Donovan "Which claims are Admissible under Deeds of Company Arrangement" *The Australian Law Journal* (1995) 905. O'Donovan maintains that because of an oversight in the legislation the post-deed creditors whose claims arose from transactions with the directors will have no preference over creditors who are bound by the deed. On the other hand the creditors who dealt directly with the administrator will have a preferential claim in the case of a subsequent winding-up. He finds support for his view in an unreported case *Re Crawford House Press Pty Ltd* [13 June 1995 No 1801/1995 Supreme Court of New South Wales]. This oversight needs attention, otherwise creditors may not extend any credit to companies under a deed of arrangement and thus jeopardise the business rescue. O'Donovan also suggests that the deed of company arrangement should be allowed to specify the date of approval thereof as the admissible claim date, thus it would also be binding on creditors whose claims arose after the date of administration. It is submitted that this approach would be beneficial to the rescue process.

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3 5 4 Evaluation and proposals

The formulation of a plan to lead the company from its financial woes to a successful concern is an important part of the recovery of the company. This is recognised by the Australian and English procedures.[396] However, it is not an express feature of judicial management prescribed by the Companies Act in South Africa. It is submitted that this gives the impression that judicial management supports the view that if you can only identify the mistakes made and who was at fault, this achievement by itself would lead the company back to being a successful concern. Such a view contrasts sharply with a view that a successful rescue needs investigating, planning and hard work. Nevertheless it is acknowledged that the provisional judicial manager in practice has to formulate a plan of future conduct in order to convince the court and the creditors of the desirability of a final judicial management order.

It is submitted that the judicial management procedure should be amended to include provisions for the formulation and acceptance of such a plan. This would make it possible to eliminate the involvement of the court altogether if the commencement procedure proposed in this thesis is accepted.[397] Even if the alternative procedure is followed the involvement of the court is reduced to a single occasion as opposed to the two hearings presently required.[398] This will lead to a saving of costs. It is recognised that it is controversial to alter the contractual rights of creditors without their consent without the intervention of the court.[399]

3 5 4 1 *Acceptance of a plan of future conduct*

The judicial manager should compile the plan and essentially the creditors of the company should accept it. Upon acceptance by the required majority of creditors it should bind all creditors whether they voted in favour of the plan or not. The ideal would be for the judicial manager to formulate such a plan with the help of the

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[396] It is also a feature of most of the other corporate rescue regimes including the USA Chapter 11 procedure, the Hong Kong procedure and the procedure adopted recently by the Belgium legislature (as described in Wetsontwerp betreffende gerechtelijk akkoord (1998)).

[397] If the proposal is accepted that the directors may appoint a judicial manager without the intervention of the court it would have the result that the court is not approached at all. See s 1(2)(a)(i) of proposed legislation 3 3 5 *supra*.

[398] Currently a provisional order is made with a return day when the court will decide whether to make a final order. If the proposal is accepted to incorporate the plan of future conduct as part of judicial management a second appearance would be avoided in the case where the company was placed under judicial management in accordance with s 1(2)(a)(ii) of the proposed legislation in 3 3 5 *supra*.

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directors and members as well as the creditors of the company. This retains the whole-hearted support of the shareholders and directors for the judicial management process and improves the likelihood of eventual acceptance by the creditors.[400] Any existing or previous significant association of the judicial manager with the directors and members might lead the creditors to perceive the judicial manager as too close to the directors and shareholders of the company. The creditors might then have less confidence in the judicial manager conducting his investigation into the failure of the company in an impartial and diligent manner.[401]

A possible solution to this problem would be to entrust another person to investigate the prior conduct of directors. The logical choice is Master. One of his officials would have to be appointed to do the investigation in the case of a company, which has gone into judicial management. Considering the fact that only a few companies make use of judicial management at present it would not be impossible to implement this proposal. Alternatively, creditors could be given the option, to be exercised at the meeting where the proposals of the judicial manager regarding the future conduct of the business are considered, whether they want someone other than the judicial manager to investigate the prior conduct of directors.

The judicial manager must lay his proposals regarding the plan of future conduct before a meeting of creditors convened to approve the plan. If any amendments to the plan are made it should be with the consent of the judicial manager.

The majority needed to accept the proposal for a plan of future conduct should at least be a majority in number and in value of the creditors present in person or proxy and voting. Secured creditors should only have a vote in value equal to the amount of their claims exceeding their security. The plan of future conduct should not vary the extent of the security of secured creditors without their consent. The principle of equality should also be adhered to.[402] Dissenting creditors of the same class should not be unfairly discriminated against without the opportunity to apply to the court to

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[399] "It is, of course , difficult to envisage a system in terms of which a creditor is barred from the enforcement of a fundamental commercial right which does not depend for its validity on the sanction of a court order." Rajak "*Business Rescue for SA*" 8; Rajak & Henning 1999 *SALJ* 269.
[400] Brown *Corporate Rescue* 319.
[401] See in general the discussion on the position of the administrator in Australian voluntary administration and the creditors' concern that he might not be sufficiently independent. Keay 1997 *Company and Security Law Journal* 155 *et seq.*
[402] See 1 7 4 *supra* n 77.

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intervene. Furthermore, the creditors voting should not include either directors who are creditors or creditors connected to the directors of the company.[403]

Irrespective of whether the members participate in the formulation of the plan of future conduct, they should have the opportunity to express their approval or disapproval of the plan as accepted by the creditors. After all, such a plan might involve the further financial commitment of the members. Thus once the creditors have accepted the plan of future conduct, the shareholders should ideally decide whether to accept the plan as well. Nevertheless, to require the consent of the shareholders may only be feasible where the company does not have many shareholders or members. However, where the company has a large number of shareholders the necessary approval might take a lot of time and may also be very costly. It is therefore submitted that the Australian requirement of a resolution from the board of directors should suffice. The directors should be able to give an indication to the creditors whether the board of directors will accept the plan at the meeting where the creditors are to decide on the plan put forward by the judicial manager. In the event of the plan as approved by the creditors differing substantially from the plan proposed by the judicial manager, the board of directors should give their consent to the amended plan within seven days of the creditors' meeting. If the directors decide not to give their consent the company should immediately be placed in liquidation.[404]

3 5 4 2 *The effect of the acceptance of the plan for future conduct*

The Australian procedure makes provision for the end of administration and the operation of the company in terms of the deed of company arrangement under the supervision of the administrator. The company is thus once again part of the economy without the protection of a moratorium on all enforcement procedures, except insofar as the enforcement of debts are governed by the deed of company arrangement.

The English procedure does not make provision to end administration upon the acceptance of the administrator's proposals. The company remains under the protection of the order until it has become a successful concern or the purpose for

[403] Creditors connected to the directors should include the director or his or her spouse or any juristic person in which the director or his spouse holds a controlling interest, whether alone or jointly, a partnership of which the director or his or her spouse is a partner or a trust of which the director or his or her spouse is a trustee or a major beneficiary, or a person declared a creditor connected to the director by the court.

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which the administration order was given is achieved or the administration order is discharged because it is clear that the intended purposes will not be achieved.

Both approaches have merit. The Australian approach will lead to more confidence from future trade creditors in that they would be able to enforce their rights against the company without impediment. The English system on the other hand keeps the company under protection of the court order.

It is submitted that it would be better for South Africa to follow the Australian example. Once the company has had a breathing space and come to an agreement with its creditors, it should be subjected to full participation in the commercial world. The confidence of the future trade creditors is important for the survival and future success of the company. It would also help to quell fears that judicial management would be abused to avoid payment to present and future creditors. Thus once the plan of future conduct is accepted by the creditors, members and the judicial manager, it should govern the running of the company henceforth much in the same manner as the Australian deed of company arrangement.

The future role of the judicial manager should be defined by the plan of future conduct, but this should at least involve some degree of supervision by him of those undertaking the day to day management. Full control of the company should only revert to the members and the directors of the company once the goals set by the plan of future conduct have been achieved.

In appropriate circumstances the judicial manager could permit the management of the company to implement the reconstruction of the company according to the plan of future conduct while the judicial manager takes a back seat. Where the creditors however have more serious misgivings about the directors' competence and good faith the judicial manager may have greater involvement in the management of the company.[405]

3 5 4 3 *Variation and termination of the plan of future conduct*

The plan should not be required to be excessively detailed, because that would only lead to frustration in having to amend minor details because of changed or unforeseen

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[404] For a discussion of the procedure to be followed in these circumstances see 3 6 *infra*.
[405] Keay 1997 *Company and Securities law Journal* 145 160.

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circumstances even though the alteration would not be a departure from the substance of the original plan.

Variations to the plan of future conduct that are not substantial should be within the power of the judicial manager. When the judicial manager wants to make a substantial change to the plan he should ask the approval of a creditors' meeting.

If the purpose of judicial management can no longer be met or it is clear that the goals set by the plan of future conduct can no longer be achieved, any of the creditors should be able to require the judicial manager to convene a meeting of creditors. The creditors' meeting may then resolve to terminate the plan of future conduct and to put the company into liquidation.

3 5 4 4 *The role of members and creditors*

As already discussed the creditors and members should approve the plan of future conduct. The creditors should not only be able to approve the plan, but should have the right to request a meeting to consider the variation or the termination of the plan.

The establishment of committees of creditors to oversee the judicial management merits consideration. Their powers should be limited to requesting information from the judicial manager on aspects of the judicial management, similar to the position in the English law.

The extent of creditors' power depends on the acceptance of the proposal that they should have the ultimate decision about the future of the company when they meet to decide whether to accept the plan of future conduct. Furthermore they should have the power to decide on who the judicial manager of the company will be for the purposes of implementing the plan of future conduct.

3 5 4 5 *The liability of the judicial manager*

The liability of the judicial manager will be discussed in greater detail below.[406] It is be sufficient for present purposes to say that it would be better to deal with the preference of company liabilities incurred by the judicial manager in legislation rather than to leave it to the creditors to decide whether or not to grant a preference, as is the case at present.

[406] For a discussion see 4 2 4 4 *infra*.

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3 5 5 Draft legislation to give effect to the proposals

Section 4

(1) The judicial manager must within 60 days of appointment (or such longer period as the court may allow):

(a) send to the Master and to creditors proposals for a plan of future conduct for the company for achieving the purpose or purposes of judicial management; and

(b) submit the proposals for a plan of future conduct to a meeting of the company's creditors convened for the purpose on not less than 10 days' notice.

(2)(a) The meeting of creditors referred to in subsection (1)(b) above may resolve, by a majority in number and a majority of sixty percent in value of claims:

(i) to accept the proposals for a plan of future conduct with or without modifications, but must not do so unless the judicial manager consents to each modification; or

(ii) that judicial management should end; or

(iii) that the company be wound up.

2(b) (i) Creditors eligible to vote at the meeting referred to in subsection (1)(b) are creditors with proven claims against the company and such creditors allowed to vote by the judicial manager, but excluding all creditors who are also directors of the company or any creditor who are persons connected to such directors.

(ii) A secured creditor is allowed to vote at the meeting to the value of the unsecured portion of his or her claim against the company or to the full value of his or her claim if the creditor agree to forfeit his or her security.

(3)(a) If the proposals for a plan of future conduct are accepted in accordance with subsection (2)(a)(i) the directors of the company must within 7 days approve the proposals for a plan of future conduct in writing.

(b) In the event of the directors failing to accept the proposals within the period referred to in paragraph (a) the company is automatically under a creditors' voluntary winding-up, on the expiry of that period.

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(c) Once the plan of future conduct becomes operative it binds the company and all creditors of the company whose claims against the company arose before or on the date agreed upon in the plan of future conduct, which date must not be later than the date on which the company was placed under judicial management.

(d) Secured creditors are bound by the plan of future conduct to the extent that they participated in the vote for its approval.

(e) The plan of future conduct has no effect in so far as it discriminates unfairly against a dissenting creditor or future creditor.

(4) Once the proposals for a plan of future conduct have been approved by the creditors and directors the judicial manager must forthwith file a copy of the accepted plan of future conduct with the Master and the Registrar of Companies and send a notice setting out the details of the plan of future conduct to all the creditors of the company.

(5) Upon the filing of the plan of future conduct with the Master the company is released from judicial management and the affairs of the company must be conducted according to the plan of future conduct.

(6) The judicial manager is responsible for the execution of the plan of future conduct according to the role assigned to him or her in the plan of future conduct, provided that the plan of future conduct must not restrict any of the statutory powers of the judicial manager.

(7) The judicial manager may and must, if required by any creditor or creditors who alone or together hold ten percent or more of the value of the proven claims against the company, convene a meeting of creditors and at the meeting the creditors may resolve, with a majority in number and a majority of seventy-five percent in value to amend the plan of future conduct or to terminate the plan of future conduct and that the company be wound up.

(8) The judicial manager must apply to the court for the termination of the plan of future conduct where the judicial manager is of the opinion that it is no longer possible to achieve the goals of the plan of future conduct and that because of the urgency of the matter or otherwise it is not appropriate to convene a meeting under subsection (7) above. He or she may at the same time apply for the winding-up of the company.

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(9) If the judicial manager is of the opinion that it is necessary to amend the plan of future conduct he may amend it by giving notice of the amendment to the Master where the amendment is not substantial, but if the amendment or amendments are substantial the administrator must obtain the approval of the creditors at a meeting of creditors convened for the purpose in accordance with subsection (7).

3 6 **Transition to voluntary winding-up**

The possibility that a business rescue procedure will not lead to the eventual restoration of the company to a successful concern is a risk inherent to the business rescue procedure from its outset. It is thus necessary to provide for a smooth transition from the business rescue procedure to the winding-up of the company in circumstances where this is required.

3 6 1 Judicial management (South Africa)

The present statutory provisions on judicial management do not provide measures for an automatic transition from judicial management to the liquidation of the company. The provisional judicial management or final judicial management order must first be discharged by the court. Once this is done a separate application should be made for the winding-up of the company.

> "To discharge [a judicial management order] is one thing. To replace it with an order for liquidation is quite another. The two are separate steps, and no less so because the second is often the purpose of the first, because the first is frequently taken so that the second may in turn ensue. The second need not follow, after all, and it does not always do so."[407]

The court which granted the provisional judicial management order may discharge it at any time on application of the original applicant,[408] a creditor, a member, the provisional judicial manager or the Master.[409] The court on application from the judicial manager may cancel a final judicial management order. The judicial manager should bring this application if at any time the judicial manager is of the opinion that the continuation of judicial management will not enable the company to become a

[407] *In re Hlobane Building and Mining Supplies (Pty) Ltd* 1984 3 SA 270 (N) 273A.
[408] *Turner v VL Brink Ltd* 1959 (SA 328 (C).
[409] Companies Act 61 of 1973 s 428(3).

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successful concern.[410] The judicial manager may at the same time bring an application for the winding-up of the company.[411]

3 6 2 Administration (England)

The discharge of an administration order restores the status of the company to the position immediately before the order was made. The restrictions on creditors are lifted and they can pursue their normal legal remedies against the company.

Administration orders are most frequently discharged in order to wind-up the company. This may be because either the proposals of the administrator are impracticable or the creditors of the company are in any event not prepared to approve the proposals or because the purposes of the administration could not be achieved. The court cannot make a winding-up order on the discharge of the administration order. A winding-up petition must be presented in separate proceedings.[412] The court may however give directions to the administrator to present a petition for the winding-up of the company. If the administrator is directed by the court to petition for the winding-up of the company it may also direct that he shall be the liquidator of the company. In this way continuity in terms of the possession and control of the assets will be achieved.[413]

English and South African law are similar in that the discharge of the business rescue procedure and the winding-up of the company are separate issues that need different applications to the court.

3 6 3 Voluntary administration (Australia)

The Australian position differs from that in South Africa and England in that it provides measures for a direct transition to the winding-up of the company. The company under administration converts from being in administration to a voluntary winding-up in three situations.[414] These are where the creditors at the meeting to decide upon the future of the company resolve that the company should be wound up; where the company has failed to execute the deed of arrangement within 21 days of

[410] Companies Act 61 of 1973 s 433(l).
[411] Companies Act 61 of 1973 s 433(l).
[412] Insolvency Act 1986, 18(3), see also Pennington *Corporate Insolvency Law* (1997) 401, Brown *Corporate Rescue* 448 and also *re Brook Marine Ltd* [1988] BCLC 546.
[413] Brown *Corporate Rescue* 448.
[414] Corporations Law, s 446A(1).

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the deed being agreed upon by the creditors; and where the creditors terminate the deed of company arrangement and resolve that the company should be wound up.

The company will also pass from administration to a voluntary winding up where the court makes an order to terminate the deed of company arrangement pursuant to section 445D of the Corporations Law[415] or if the deed specifies circumstances when the deed will terminate and the company will pass into voluntary liquidation and those circumstances have arisen.[416]

The company will in these circumstances be in a creditors' voluntary winding up and the necessary special resolution needed to put the company in a creditors' voluntary winding-up will be deemed to have been passed.[417] In these situations the administrator is also deemed to be appointed as the liquidator.[418]

3 5 4 Evaluation

It is submitted that the Australian procedure offers the best solution regarding the transition from judicial management to the winding-up of the company. This may partially explain why this procedure is used more frequently than its English counterpart.[419] It may also partly explain why the dividend yield is higher where winding-up follows directly on administration in comparison to the winding-up of a company that follows the traditional procedure.[420]

It is submitted that judicial management should lead automatically to a creditors' voluntary winding-up where the creditors so resolve at the meeting to decide whether to accept the proposals of the judicial manager for a plan of future conduct; where the directors do not accept the proposals for a plan of future conduct of the company approved by the creditors and where the creditors resolve to terminate the operation of the plan of future conduct and to liquidate the company. In normal circumstances a

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[415] This section gives the court the power to terminate a deed of company arrangement where the deed was agreed to by creditors on false and misleading information about the company's business, property, affairs or financial circumstances.

[416] Corporations Law, s 446B, see also *Australian Corporations and Securities Law Reporter* par 138-040.

[417] Corporations Law, division 12 and s 446A.

[418] Corporations Law, s 446A.

[419] From June 1993 to March 1995 the number of Australian companies entering into administration has shown a steady growth rate with a resulting fall in the number of creditors' voluntary liquidations. In 1994 there were 901 administrations compared to 393 creditors' voluntary liquidations. In England there were 196 administrations and 7875 creditors' voluntary liquidations in 1997. See Lessing & Corkey *Corporate Insolvency Law* 50-51; Insolvency Service (England) "Insolvency General Annual Report" (1997).

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creditors' voluntary winding-up must be initiated by a special resolution of the company in general meeting.[421] The proposal gives the required majority of creditors the power to iniate even if this is opposed by the members. Where the proposals for future conduct envisage the eventual liquidation of the company in certain circumstances and those circumstances occur the judicial manager should also apply to court for the liquidation of the company.

It is a bit more contentious who the liquidator should be in such circumstances. On the one hand, it would be logical to suggest that the judicial manager should be the liquidator. This will facilitate winding-up as he would be well acquainted with the affairs of the company. On the other hand if it has to be a person other than the judicial manager it would encourage the judicial manager to make a success of judicial management. Olver also recommends that the judicial manager should not be the liquidator if the company is subsequently wound up. Nor should the partner, business associate, employer or employee of the judicial manager be the liquidator in these circumstances. He also recommends that the same restriction should apply to any other company within a group of companies that is under judicial management.[422]

Appointing the judicial manager as liquidator could also lead to abuse of the procedure by the directors of the company in order to achieve the appointment of a friendly liquidator. This problem could be rectified by giving the creditors the option to change the judicial manager or the liquidator at different stages of the process.

3 6 5 Draft legislation to give effect to the proposals

Section 5[423] (Transition to voluntary winding-up)

(1) The company is deemed passed a special resolution that the company be wound up voluntarily if:

> (a) the directors of the company do not approve the proposals for future conduct within seven days after the creditors approved them at a creditors' meeting; or
>
> (b) the creditors of a company under judicial management resolve that the company be wound up in terms of section 4(2)(a)(iii); or

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[420] See 3 3 2, n 74.
[421] Companies Act 61 of 1973 s 349.
[422] Olver 1986 *THRHR* 87. He is also supported by Lessing & Corkery *Corporate Insolvency Law* 105.

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(c) the creditors of a company governed by a plan of future conduct resolve to terminate the plan of future conduct and to put the company into liquidation in terms of section 4(7); or

(d) if the plan of future conduct specifies circumstances in which the plan of future conduct is to terminate and the company is to be wound up and those circumstances have arisen.

(2) The judicial manager, his or her partner, business associate, employer or employee is disqualified from being appointed as liquidator of a company of which he or her was the judicial manager.

[423] Based on Corporations Law, s 446A.

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CHAPTER 4

The judicial manager: powers and duties and appointment

4 1 Introduction

The previous chapter examined the mechanism of the business rescue procedure. This chapter discusses the position of the judicial manager. The judicial manager has a vital role. The eventual success of a business rescue will be determined by the way in which the judicial manager manages the process. This applies not only to the success of any individual business rescue but also to the successful establishment of a culture of business rescues in South Africa.

Before the decision can be made as to who is the most appropriate person for appointment as judicial manager, it is necessary to look at the precise role that he is to play in the judicial management process. Therefore this chapter first examines the powers and duties of the judicial manager and then considers the necessary qualities for appointment as judicial manager. The chapter concludes with a discussion of the remuneration of the judicial manager and the circumstances in which he can be removed from office.

4 2 The role of the judicial manager

It can be safely assumed that the task awaiting the judicial manager in a modern business rescue procedure in South Africa will be very similar to the role of the administrator in English law.

The administrator in English law is faced with a two-fold task, namely, the formulation of a plan of future conduct acceptable to the creditors and the successful management of the company while this plan is drawn up and approved. Successful management in the interim will preserve the company and protect the interests of creditors.[1]

The first step of the administrator will be to acquire as much information as possible on the financial, trading and market position of the company. The financial information, however, will seldom reflect the current position precisely, because it will normally be at least a few weeks old. He will need to know which of the current

[1] See generally Fletcher *et al Law and Practice of Corporate Administrations* (1994) 152 *et seq*.

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liabilities need to be paid for the company to stay viable. He will need to identify goods bought under reservation of title and goods on lease.

The administrator also needs to look at contracts that may terminate because of the company being under administration such as leases of land and buildings, ship charters, licenses to use patented processes or trade marks, franchise agreements, permission to use copyright material, and insurance. His negotiating skills will be tested in making arrangements with the parties concerned in order to continue to utilise these rights.

The administrator then needs to decide how to provide an adequate cash flow to keep the company's business going. Often this will come from outstanding debt receivable, but not where it has already been factored. The book debts may also be part of the security of a secured creditor, so that it will not be possible for the administrator to utilise payment of these debts to fund the business.

After considering these matters, the administrator needs to draw up a cash-flow projection for the next few months. This will enable him to establish the amount that is needed to finance any shortfall in cash flow. These financial projections will enable him to make a decision on whether it is financially possible to continue the business. This is an important decision. Even in cases where the administrator hopes to sell the assets more advantageously (as a going concern) the business needs to continue.

The administrator also needs to determine the causes of past losses. The reasons may not always be easy to identify. Few failures will be caused by a sudden and unique trading disaster.[2] More common causes of losses are through diversifying into fields where the management of the company lacks expertise, or a premature or ill-conceived introduction of a new product line by the company, or the stubborn clinging to an unprofitable product line by the company, or attempts by the company to make extraordinary profits through deals which have not gone as expected. Sometimes detailed research will be necessary to establish the causes of poor performance.

The administrator will however have to contend with more than financial matters. The administrator will need to make other strategic decisions. He will have to decide

[2] Such as the PanAm Flight 103 that exploded above the Scottish town of Lockerbie in 1988 or the decision by Sanmed, the operator of a medical scheme, who installed a new computer programme which created such administrative chaos that the medical scheme found itself in deep trouble.

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whether the production line should be made more efficient; whether the company has the right staff to continue the business and whether the company will be able to keep them. If the administrator decides to make staff redundant he will have to do this in accordance with the relevant provisions of labour law.[3] But the administrator will need to play more roles than those of investigator and business strategist, he should also be a motivator and skilled negotiator. The administrator will have to assure the staff of the future of the company and secure the supply of raw materials.

The administrator also becomes the one responsible for the operating procedures of the company and must take care that safety and other regulations are adhered to.

The day to day affairs of the company may be run by the administrator himself as he may often elect to oust the directors from control of the company's business and to work directly with the senior staff. On the other hand, he may prefer to leave the general management structure in place subject to his general supervision. In addition to changes to the management structure, he may find it necessary to change the management information systems of the company.

Having done all of the above, the administrator still needs to formulate his plan for the future conduct of the business for the approval by the creditors. Besides taking these steps to restore the business to success, the judicial manager will also have to investigate and report on the past conduct of the directors.

4 3 **Powers and duties of judicial manager**

From the above description of the practical steps that the judicial manager needs to take, it is quite clear that he will need wide-ranging powers. The judicial manager will at least need general management powers, certain specific powers such as the power to dismiss directors and the power to investigate the affairs of the company. The powers of the judicial manager must also be sufficiently wide to enable the judicial manager to perform the duties entrusted to him by the legislature. It is therefore appropriate to consider the judicial manager's powers and duties together.

[3] In South Africa, the most important provisions are contained in the Labour Relations Act s185 – s 197.

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4 3 1 Judicial management (South Africa)

4 3 1 1 *General powers and duties*

On his appointment the provisional judicial manager has the duty to assume the management of the company and to recover and reduce into possession all the assets of the company.[4] Thus the provisional judicial manager has all the powers necessary to manage the company until an order is made to discharge the provisional judicial management order or to make a final judicial management order. These powers would include the powers necessary to keep the business going and to raise the necessary funds to do so. The Companies Act does not however expressly confer any general powers on the provisional judicial manager for this purpose.

The final judicial manager on his appointment takes over from the provisional judicial manager and assumes the management of the company. He must manage the company, subject to the orders of the court, in such a manner as he deems most economic and most promotive of the interests of the members and creditors of the company.[5] This implies that if some plan of future conduct was in fact laid before the court the court may have given directions based on it. The management task of the judicial manager differs from that of the directors to the extent that the judicial manager is expressly required to take into consideration the interests of the creditors as well.[6] This is to be expected in the light of the financial situation that led to judicial management.

In exercising this management task, both the provisional and final judicial manager are subject to the supervision of the court.[7] The judicial manager is appointed by the Master,[8] his remuneration is determined by the Master[9] and he may be removed by the court.[10] In exercising his powers and executing his duties the judicial manager, whether provisional or final, is not an officer of the company, but an officer of the court.[11]

[4] Companies Act 61 of 1973 s 430(a).
[5] Companies Act 61 of 1973 s 433(a) and (b).
[6] Companies Act 61 of 1973 s 433(b). see also Meskin *Henochsberg I* 944 and Cilliers & Benade *et al Corporate Law* 483.
[7] Companies Act 61 of 1973 s 428(2)(a) and s 432(3)(a).
[8] Companies Act 61 of 1973 s 429(b)(i) and s 431(4).
[9] Companies Act 61 of 1973 s 434A. See also Cilliers & Benade *et al Corporate Law* 482.
[10] The court has an inherent power to remove a judicial manager. See *The Master of the Supreme Court v Bell* 1954 2 PH E21 (T) and *The Master v Bell* 1955 3 SA 100 (T). See also *LAWSA* IV part 3 477.
[11] *Rennie NO v Holzman and Others* 1987 4 SA 938 (C); 1989 3 SA 706 (A).

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4 3 1 2 *Specific powers and duties*

The Companies Act does not expressly provide any specific powers for the provisional and final judicial managers. Such powers must be deduced from the statutory duties assigned to the provisional and final judicial manager respectively.

The judicial manager has the specific duty to convene general meetings of the company, including the annual general meeting, and meetings of creditors.[12] The judicial manager has the duty to apply to court for the cancellation of the judicial management order, if at any time he is of the opinion that the continuation of the judicial management will not enable the company to become a successful concern.[13]

The judicial manager does not have the power to sell or otherwise dispose of any of the assets of the company save in the ordinary course of business.[14] Therefore, if the need arises to sell assets in order to restructure the business or to save costs or for any other reason to dispose of them in a manner inconsistent with how a business of that kind would normally be conducted, the permission of the court should be sought.[15]

The judicial manager also has the power to ask the court to set aside transactions that amount to voidable or undue preferences under the applicable provisions of insolvency law.[16]

4 3 1 3 *Power and duty to investigate affairs*

The provisional judicial manager has the implied power to investigate the affairs of the company in order to comply with the statutory duty to report to the meetings of creditors, members and debenture-holders convened by the Master. The investigation should provide the judicial manager with enough information to prepare and lay before the meetings a report on the general state of the affairs of the company, the reasons why the company is unable to pay its debts and why it is unsuccessful, a list of the creditors, particulars as to the possible sources of income and a considered opinion as to the prospects of the company becoming a successful concern.[17]

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[12] Companies Act 61 of 1973 s 433(g). See also *LAWSA* IV part 3 par 378.
[13] Companies Act 61 of 1973 s 433 (l). See also Meskin *Henochsberg I* 946.
[14] Companies Act 61 of 1973 s 434(1).
[15] Companies Act 61 of 1973 s 434(1).
[16] Companies Act 61 of 1973 s 436(1). Meskin *Henochsberg I* 954 submits that a provisional judicial manager cannot exercise the powers under this section unless empowered accordingly by the court.
[17] Companies Act 61 of 1973 s 430(c).

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The provisional judicial manager in investigating the company should rely on the cooperation of the directors and other people involved with the company to obtain the necessary information. It could also be argued that the fact that the Companies Act assigns these duties to a provisional judicial manager implies that he at least has the power to ask for the necessary information and demand that it should be handed to him. He, however, does not appear to be in the same position as the final judicial manager who may be given certain investigative powers by the court and can be assisted in the inquiry by the court and the Master exercising their own powers of investigation in terms of section 417 of the Companies Act.[18]

The judicial manager has more investigative duties than the provisional judicial manager. The judicial manager must examine the affairs and transactions of the company prior to the judicial management order in order to form an opinion whether any director (past or present) or officer (past or present) of the company has contravened any provision of the Companies Act or committed an offence. His findings should be in the form of a report to the Master.[19]

As stated above the judicial manager has the support of the court and the Master in that they may use their powers in terms of section 417 of the Companies Act to conduct an investigation and to force persons to cooperate.[20] The court, in the judicial management order, may also direct that certain provisions concerning the winding-up of a company apply. Such provisions would give the judicial manager powers to examine any persons relevant to the judicial management and the judicial manager would thus have the same powers of summoning and examination as the Master or court who appointed him.[21]

4 3 1 4 *Liability of the judicial manager*

Once the judicial management order is made any moneys of the company becoming available to the judicial manager shall be applied by him in paying the costs of the judicial management and in the conduct of the company's business in accordance with the judicial management order.[22] The costs in the conduct of the company's business

[18] Companies Act 61 of 1973 s 439(2) and 417.
[19] Companies Act 61 of 1973 s 433(j).
[20] For the constitutionality of s 417 of the Companies Act 61 of 1973 see *Ferreira v Levin NO* 1996 1 SA 984 (CC); 1996 1 BCLR 1 (CC) and *Bernstein v Bester NO* 1996 2 SA 751 (CC), 1996 4 BCLR 449 (CC).
[21] Companies Act 61 of 1973 s 439(2), read with ss 414, 415, 416, 417 and 418(2).
[22] Companies Act 61 of 1973 s 434(2).

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include the expenditure incurred to continue the operations of the company, such as salaries and wages, water and electricity, licensing fees, insurance premiums, raw materials, rent and instalments under instalment sale transactions.[23] Thus the costs involved in keeping the company's business going are given preference over the pre-judicial management debts. This preference however lasts only for the duration of judicial management. Should judicial management end in liquidation debts incurred during judicial management will only have preference in the liquidation if the creditors adopted a resolution to this effect in terms of section 435(1) of the Companies Act.[24]

The judicial manager thus has a real dilemma in terms of the costs of conduct of the business during judicial management. If he fails to obtain a resolution of the creditors resulting in the preference for the judicial management debts, he may in effect be incurring debts which will fall with all the other unsecured debts and which could yield very little if the company is subsequently liquidated.

The result is that the judicial manager might find himself in a situation similar to that of the liquidator in *Kerbels Flooring and Carpeting (Pty) Ltd v Shorsbee.*[25] In this case the liquidator was held personally liable for negligence. The liquidator elected to continue with a contract in terms of which Kerbels as subcontractor would complete the tiling of school premises that were being built by the liquidated company. His negligence arose from his failure to ensure that the liquidated company had enough money to pay the resultant obligation. The judicial manager may become similarly liable when he incurs costs in the conduct of the company's business during judicial management and in the end finds that those creditors remain unpaid because they have no preference in a subsequent liquidation.

Even if the circumstances are different and negligence may be more difficult to prove, the judicial manager will nevertheless have a moral dilemma whether to continue with business in the face of a possibility that the creditors may only have a concurrent claim with the expectation of a very small dividend. It could tarnish his integrity and reputation in such a way that his professional future may be adversely affected.

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[23] Meskin *Henochsberg I* 950.
[24] See further Meskin *Henochsberg I* 953.
[25] 1994 (1) SA 655 (SE).

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4 3 2 Administration (England)

4 3 2 1 *General powers*

The general powers of the administrator include the power to "do all things necessary for the management of the affairs, business and property of the company".[26] These powers are necessary to enable the administrator to take control of and manage the company and its business effectively.

On his appointment the administrator takes all the property of the company, or to which the company appears to be entitled, into his custody. The primary functions of the administrator are to manage the affairs, business and property of the company and to prepare proposals to achieve the purpose or purposes set out in the administration order. The administrator must manage the affairs of the company and he has the power to do so until his proposals are approved. In exercising these powers the administrator is deemed to act as the company's agent.[27]

Contracts entered into before administration do not terminate except where the contract in question so provides.[28] Such provisions are often encountered in practice.[29]

In the time between the granting of the administration order and the approval of the administrator's proposals, the administrator manages the business on his own initiative. Although there are as yet no guidelines from the still to be accepted proposals to regulate the administrator's actions, he does not need the approval of the court for each transaction.[30] At this point he must be guided by the purposes set out in the administration order as those which his administration is intended to achieve.[31] The administrator may however refer for guidance to the independent report on the financial position of the company.[32] These sources provide only broad and vague

[26] Insolvency Act 1986, s 14(1)(a).
[27] Insolvency Act 1986, s 14(5).
[28] Goode *Principles of Corporate Insolvency Law* (1997) 317.
[29] The common practice of inserting into contracts provisions terminating the contract or rendering it terminable upon the company going into administration is a cause for concern, see Goode *Principles of Corporate Insolvency Law* (1997) 323.
[30] See the text at n 35 *infra* as to when the administrator in his discretion may nevertheless approach the court for guidance.
[31] As the administrator acts as agent of the company it is clear that he cannot enter into any transactions which the company, as his principal, cannot enter into. Thus he cannot enter into transactions *ultra vires* the company. Such transactions would be a breach of duty. The company would however still be bound because of the provisions of the Companies Act 1985. See Fletcher *et al Law and Practice of Corporate Administrators* (1994) 68 and also Brown *Corporate Rescue* 279.
[32] This report was filed with the petition for the administration order and was accepted by the court.

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guidelines. Nevertheless they guide the administrator in his decisions on whether or not to dispose of assets, enter into new contracts, and terminate, renew or continue with existing contracts.

The administrator should not do anything that would seriously and adversely affect the achievement of the proposals which he intends to submit to the company's creditors, or anything that will prevent any such proposals being prepared.[33]

Once the administrator's proposals have been prepared and accepted, in accordance with the purposes set out in the administration order, the administrator must manage the affairs of the company in accordance with those proposals. These proposals may be revised from time to time by the administrator with the approval of meetings of creditors.[34]

The administrator may apply to the court for directions in relation to a particular matter arising in connection with the carrying out of his functions.[35] This the administrator may do regardless of whether it relates to the period before his proposals were accepted or thereafter.

4 3 2 2 *Specific powers*

Added to the general powers of the administrator is a long and comprehensive list of specific powers described in Schedule 1 to the Insolvency Act, 1986. It corresponds quite closely to the list of common powers of a company contained in schedule 2 to the South African Companies Act, 61 of 1973.[36]

Over and above his general and specific management powers the administrator also has certain other powers.[37] The administrator has the power to remove a director from office. He also has the power to appoint a person to be a director of the company, whether to fill a vacancy or otherwise. He may also call any meeting of members or creditors.[38]

As explained above,[39] the directors of the company may still exercise certain powers. However, any power conferred on the company or its officers, by the Act or the

[33] *Re Charnley Davies Ltd* [1988] BCLC 243.
[34] Insolvency Act 1986, s 17(2)(b) read with s 25.
[35] Insolvency Act 1986, s 14(3).
[36] See the discussion in Brown *Corporate Rescue* 294 - 303.
[37] Insolvency Act 1986, s 14(2).
[38] See also 4 3 2 1*supra* and Brown *Corporate Rescue* 303 - 305.
[39] See 3 4 2 2 *supra.*

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company's constitution, which could interfere with the functions of the administrator and the exercise of his powers may not be exercised except with the permission of the administrator. The administrator can give this permission in either general terms or in a specific instance.[40]

Similar to the position in Australia, the administrator has the power to deal with property subject to a floating charge even though the floating charge may have become operative.[41] In fact, he may even dispose of such property. The administrator may also, with the leave of the court, dispose of property subject to a fixed charge or to a hire-purchase agreement (reserving title to the seller). The proceeds of all such disposals are however earmarked for the purposes of paying those secured creditors' debts.[42]

The administrator also has the power to ensure the continuation of supplies of gas, water, electricity and telecommunication services, the so-called essential supplies by utilities. When the administrator makes a request for the continuation of the supply of essential utilities, the relevant supplier is prevented from threatening to cut off supplies to compel preferential payment of outstanding arrears. Prior to the Insolvency Act of 1986 this practice was permissible. The supplier may, however, make it a condition of supply that the administrator personally guarantees the payment of the charges for further supplies.[43]

The administrator may also apply to the court to set aside "under value" transactions to which the company was a party.[44]

4 3 2 3 Powers of investigation

The administrator has to investigate the affairs of the company for different purposes. In the first place he needs to have the best possible information to enable him to prepare his proposals to effect a business rescue. He also needs to establish what led the company to its present problems. On the other hand he has a duty to report on the conduct of the directors. The administrator thus needs various powers to solicit information from people connected with the company and its operations as well as

[40] Insolvency Act 1986, s 14(4).
[41] Insolvency Act 1986, s 15.
[42] Insolvency Act 1986, s 15.
[43] Insolvency Act 1986, s 233. The purpose of this provision is to ensure that the public utilities are not able to exploit the advantage resulting from the essential nature of the services which they are legally obliged to provide, Fletcher *Law of Insolvency* 460.

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powers to obtain control or possession of property or records belonging to the company.

In order to obtain the necessary information to establish the state of the affairs of the company the administrator has the power and the duty to require certain persons to furnish him with a statement of affairs of the company.[45] This statement of affairs must be verified by an affidavit from the person making the statement. The administrator may also require concurring affidavits from others to verify the statement of affairs. The concurring affidavit should indicate where the person making it disagrees with the statement of affairs.[46]

The statement of affairs should include particulars of the assets of the company, its debts and liabilities, names and addresses of creditors, securities held by creditors and the date on which they were created, the preferential debts and liabilities in the case of a winding-up and the estimated shortfall or excess of company assets after satisfying its debts.[47]

This statement of affairs and accompanying affidavits should then be filed in court, where they are open to inspection by the public.[48] If the administrator considers this to be undesirable in the context of the administration he may apply to court for permission not to file the statement at all or to file different sections separately and to allow access thereto only with leave of the court.[49]

Further to the statement of affairs the administrator also has powers similar to those of a liquidator in a winding-up to require any persons to deliver to him any property, books, papers or records of the company in his possession or under his control. The administrator may apply summarily to the court for an order to compel anyone to comply with his request to deliver these items.[50] The court also has certain powers of examination, similar to those in a liquidation, which it may use to help the

[44] Insolvency Act 1986, s 238. This is the equivalent of an undue preference in South African Law.

[45] Insolvency Act 1986, s 22(1). The persons referred to are those who are or have been officers of the company; those who have taken part in the company's formation at any time within one year before the date of the administration order; those who are in the company's employment or have been in its employment within that year and are in the administrator's opinion capable of giving the information required; and those who are or have been within that year officers or employees of a company which is, or within that year was, an officer of the company under administration. (See the Insolvency Act 1986, s 22(3).)

[46] Insolvency Act 1986, s 22(2); Insolvency Rules 1986, r 2.12 and Sch 4, form 2.9.

[47] Insolvency Act 1986, s 22(2); Insolvency Rules 1986, r 2.12 and Sch 4 form 2.9.

[48] Insolvency Rules 1986, r 2.12(6).

[49] Insolvency Rules 1986, r 2.13.

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administrator to ascertain the company's assets and liabilities, the nature and effect of the transactions entered into by the company and the possibility of invalidating them, and to enable the administrator to decide whether to litigate in the company's name or to make any relevant applications in the administration proceedings.[51]

If it appears to the administrator that the conduct of a director or former director of the company makes him unfit to be concerned with the management of a company the administrator must report this to the Secretary of State. Moreover the Secretary of State has certain powers to require the administrator to furnish him with information with respect to any person's conduct as a director of the company.[52]

4 3 2 4 *Duties of the administrator*

The duties of the administrator include taking custody or control of the property of the company, including property to which it appears to be entitled[53] and the carrying on of the business of the company.[54] The administrator must also convene a meeting of creditors if he is requested to do so.[55] He is obliged to make an application to the court for the administration order to be discharged if each of the purposes in the administration order has been achieved or has become impossible, or if he is required by a creditors' meeting to do so.[56]

The administrator under English law needs to give notification of his appointment. Notice should be given to the company, any person who has appointed or is entitled to appoint an administrative receiver of the company, the administrative receiver of the company, any petitioner of a pending petition for winding-up of the company, other creditors whose addresses are known and to the Registrar of Companies.[57] These notices have to be followed by an advertisement in the Gazette, and once in such newspaper as the administrator thinks would be appropriate for bringing the administration to the attention of the creditors of the company.

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[50] Insolvency Act 1986, s 234(1) and (2).
[51] Insolvency Act,1986, s 236.
[52] Company Directors Disqualification Act 1986, s 7(3). The duty of the administrator to report on the prior conduct of the directors is criticised as one of the reasons for the lack of popularity of the administration order procedure. Fletcher *Law of Insolvency* 479 and Grier & Floyd *Corporate Recovery* 214.
[53] Insolvency Act 1986, s 17(1).
[54] Insolvency Act 1986, s 17 (2).
[55] Insolvency Act 1986, s 17(3).
[56] Insolvency Act 1986, Insolvency Act 1986, s18.
[57] Insolvency Act 1986, s 21, read with Insolvency Rules 2.10.

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4 3 2 5 *Liability of the administrator*

Unlike the position in Australian law, the administrator incurs no personal responsibility on any new contracts entered into on behalf of the company. The only exception is where he agrees to such personal liability. However any sums of money payable because of contracts entered into by him or a predecessor are charged on the property of the company in his possession or under his control and he has a duty to see that these get paid in priority to his own remuneration and expenses.[58]

4 3 3 Voluntary administration (Australia)

Once the administrator is appointed he has to give the necessary notices to the ASC, to the creditors and in the prescribed newspapers.[59] He then has to convene the first meeting of the creditors, manage and investigate the company's affairs, make reports to the ASC where necessary, prepare proposals for the eventual deed of company arrangement, convene and conduct the creditors' meeting to decide on the future of the company, and in his capacity as administrator of the deed of company arrangement execute the deed and conduct the company's affairs in accordance with the deed.

4 3 3 1 *General powers*

As one would expect and similar to the position in South Africa and England, the administrator must take control of the business, property and affairs of the company upon the commencement of administration.

He may carry on the business and manage the property of the company; terminate or dispose of all or part of the company's business or property; and perform any function and exercise any power that the corporation or any of its officers could perform or exercise if it were not under administration.[60]

The powers of all the company's officers are suspended for the duration of the administration and the administrator is able to exercise all the powers previously held by the officers. Similar to the position in English law the administrator is taken to be

[58] Insolvency Act 1986, s 19(5).
[59] Corporations Law s 450A.
[60] Corporations Law, s 437A.

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acting as the agent of the company when he performs a function or exercises a power as administrator of the company under administration.[61]

4 3 3 2 *Specific powers*

In addition to the general powers described above, the administrator also has a number of specific powers. These are to ensure " that the administrator has sufficient powers to adequately control the company during the administration and to put forward recommendations to the meeting of creditors at the end of administration based on a full understanding of the company's financial position."[62] The powers are as drastic as those under English law in that the administrator has the power to remove from office and appoint directors of the company.[63] The exercise of this power to remove directors that are perceived as being part of the cause of the company's problems may help the administrator to gain the trust of the creditors.[64]

He also has the power to execute documents on behalf of the company, to bring and defend legal proceedings or to do anything else in the name of or on behalf of the company. Leaving nothing to chance the Australian legislature also added a catch-all power, the power to do anything else that is necessary for the purposes of administration.[65]

Similar to the English position, the administrator in Australia also has the power to deal with property that is the subject of a floating charge even though the floating charge has become operative when the company was placed in administration. It gives the administrator the right to treat that property as if the floating charge has not come into operation yet. This power is important otherwise the administrator would be virtually powerless to deal with virtually any of the assets of the company, as the vast majority of the assets may be subject to the floating charge.[66]

4 3 3 3 *Powers of investigation*

The administrator in his attempt to get a full understanding of the financial and other affairs of the company must investigate the affairs of the company. In order for him to

[61] Corporations Law, s 437B.
[62] Explanatory Paper to the Corporate Law reform Bill 1992. See also Crutchfield *Corporate Voluntary Administration Law* 137-145.
[63] Corporations Law, s 442A.
[64] Keay 1997 *Company and Securities Law Journal* 150.
[65] Corporations Law, s 442A.
[66] Corporations Law, s 442B, s 442C, s 442D.

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do so effectively the law requires directors to hand over any books relating to the company, to notify the administrator of the whereabouts of any books and to give to the administrator a statement about the company's business, property, affairs and financial circumstances.[67] The administrator also has the right to require other persons to hand over the books of the company or to make the books available for inspection.[68]

The administrator is obliged to lodge a report with the ASC when it appears to him in the course of the administration of the company that a past or present officer or a member of the company may have been guilty of an offence against the company. This duty to report to the ASC also extends to the case where a person who took part in the formation, promotion, administration, management or winding-up of the company may have misapplied, retained, or became accountable for money or property of the company, or may have been guilty of negligence, default, breach of duty or breach of trust in relation to the company.[69] Even if the administrator does not lodge a report the court may require him to do so if circumstances exist from which it appears that he is under a duty to lodge a report.[70]

When investigating or making these reports the administrator is protected by a qualified privilege from claims in respect of all statements made during the course of performing any of his functions and powers as administrator.[71] This is to ensure that the administrator can be frank and direct in his investigations and reports.

4 3 3 4 *Liability of the administrator*

The liability of the administrator in Australia is one of the aspects that a person should seriously consider before accepting an appointment as administrator. Investigation of this aspect indicates that some do consider this as a deterrent, but more often than not it does not deter them from accepting office.[72]

The administrator of a company under administration is liable for all the debts that he incurs during administration. Moreover the administrator cannot by contract relieve

[67] Corporations Law, s 438B. See also Tomasic *Australian Corporate Insolvency Law* 145.
[68] Corporations Law, s 438C. An example of such a person is someone who has possession of the books by virtue of a lien.
[69] Corporations Law, s 438D(1) and (2).
[70] Corporations Law, s 438D(3).
[71] Corporations Law, s 442E.
[72] Lessing & Corkery *Corporate Insolvency Law* 53, 69.

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himself of this liability.[73] If at the time when administration commences the company is the lessee of property, the administrator has seven days to inform himself of the financial position of the company and to decide whether or not to give notice to the lessor that the company will no longer exercise its rights in terms of the existing agreement. If the administrator does not give such notice the administrator will also become liable for the rental payments.[74] The administrator is however entitled to be indemnified out of the property of the company for such debts and liabilities.[75] The administrator is of course also liable for the payment of taxes.[76]

4 3 4 Evaluation

4 3 4 1 *Duties of the judicial manager*

It is clear from the discussion above that a judicial manager in a corporate rescue regime should at least have the following duties:

He should accept his appointment, take control of the property, management and affairs of the company and notify the appropriate people.

He should assess the financial and market position of the company.

He should decide whether any of the purposes of judicial management can be attained and form an opinion on the future course of the company.

He should formulate his proposals for a plan of future conduct to achieve the purpose or purposes of judicial management.

He should submit his proposals and his opinion to a meeting of creditors who must decide upon the future of the company.

He should implement the decision of the company's creditors, whether that decision be for the winding-up of the company, the discharge of judicial management or the acceptance of a plan of future conduct.

In the interim he should also protect the assets and manage the affairs of the company, including the appointment and dismissal of officers and the decisions on whether or not to continue with existing contracts.

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[73] Corporations Law, s 443A. See generally Crutchfield *Corporate Voluntary Administration Law* 148-149.
[74] Corporations Law, s 443B.
[75] Corporations Law, s 443D.
[76] Corporations Law, s 443BA.

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He should do all this in the best interests of the company and its creditors.

Lastly, he should make the necessary reports on the conduct of the directors.

4 3 4 2 General powers

It is clear that the judicial manager has to do a lot of work within tight time constraints. His responsibilities on two fronts should be considered. One the one hand there is his responsibility to formulate some plan or proposal for the future conduct of the affairs of the company. On the other hand the level of his control over the company and his involvement with the day to day running of the business operations should be considered.

Concentrating on the formulation of a plan for future conduct whilst leaving the administration in the hands of the existing management presents certain dangers. The judicial manager in such circumstances may fail to win the trust of the creditors, both generally in terms of the business culture of insolvency in South Africa, being a country with a pro-creditor insolvency regime, and in actual circumstances of a particular case. In the business rescue procedure of Ireland, these two functions are split between the examiner (judicial manager) and the incumbent management. The examiner has to formulate a plan of future conduct while the incumbent management manages the company.[77] It has however been said of this approach that it is impossible for the judicial manager to sit removed from the action busy formulating his proposals when elsewhere creditors demand their goods back or refuse to supply further goods no matter what legal priority they are offered.[78]

A further danger through the lack of control by the judicial manager is the possibility of assets being dissipated by unscrupulous directors. This might result in the whole procedure being perceived as a way of avoiding legal obligations and an avenue to dissipate assets.

It is thus not advisable to leave the control of the assets in the hands of the management. This has clearly been recognised by all three jurisdictions discussed above. It is important for the creditors to know that in return for a stay of their rights of enforcement, the judicial manager and not the directors will have full control of the assets.

[77] For a brief overview of the Irish law see Rajak *et al European Corporate Insolvency* 311 - 322.

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There will, however, be a price to be paid for such a provision. The judicial manager may need to bring in his own staff to run the company, which could be such a costly exercise that it would in effect be a dissipating of assets by the judicial manager. There therefore needs to be a balance between handing full control to the judicial manager and the continued involvement of the present management. After all, it is the incumbent management who may stand to benefit the most if the business is preserved. The involvement of a party with a considerable personal stake may strengthen the judicial management process.[79]

4 3 4 3 *Specific powers*

The specific powers of the administrators provided for in the English and Australian law cover all possibilities and end with a catch-all provision.[80] Most notably and necessary is the power to dismiss and appoint directors.[81] This should be complemented by the power to adjust the remuneration of existing directors who remain in office, although this might not be feasible within the provisions of labour law.[82]

The specific powers of the judicial manager could easily be dealt with in legislation. It is also submitted that the general powers of the judicial manager should be included in the relevant legislation. This would remove the necessity to deduce the extent of the powers of the judicial manager indirectly by examining the duties assigned to him. Nevertheless it does not appear that the present position in South Africa has led to any serious problems.

4 3 4 4 *Power of investigation*

The investigation of the company's affairs is of the outmost importance. Any of the decisions and proposals made by the judicial manager will only be as good as the information they are based on. In this regard it is important for the judicial manager to have the power to oblige certain persons to provide him with a statement of affairs. The directors should always give a statement of affairs to the judicial manager. After

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[78] *Report on Corporate rescue and insolvent trading* (1996) Law reform Commission of Hong Kong 52.

[79] For a discussion of the relationship between the judicial manager and the directors see 3 4 2 4 *supra*.

[80] See the English Insolvency Act sch 1 par 23 and also Brown *Corporate Rescue* 320; see also the Australian Corporations Law s 437A(1)(d) and (2).

[81] Whether the director can be dismissed depends on the *de facto* situation. The director can be dismissed from office without regard to labour law. If however the director is dismissed as employee the labour law applies. *Oakland Industries (SA) (Pty) Ltd v John NO and another* 1987 4 SA 702 (N).

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all they are responsible for the management of the company and its is to be presumed that they would have access to the best information. Furthermore the judicial manager should be able to call for information from all officers of the company,[83] and where the secretary of the company is a body corporate, the directors and officers of that body corporate, any person who may have taken part in the formation of the company if such involvement was less than a year before the company was placed under judicial management and current company employees or anyone who was an employee within the year before the company was placed under judicial management.[84]

It is submitted that it is quite obvious that the judicial manager should be empowered to solicit information from officers of the company. They would or at least should have an intimate knowledge of the property, business and affairs of the company. The same justification applies to certain employees of the company. It is also conceivable that former employees of the company would be in possession of valuable information and insight into the business and affairs of the company.

The statement made by the directors should be verified by an affidavit. This should ensure information of better quality. In would also benefit subsequent investigations by the judicial manager into the prior conduct of directors. In the event of false information being submitted on affidavit it may lead to the perpetrator's disqualification as a director.[85]

The statement of affairs should include: particulars of the company's assets, debts and liabilities (provisional and contingent); names and addresses of creditors; details of security held by creditors and the date that the security was given; the reasons in the opinion of the person making the statement why the company is in its present state of affairs; and, any other information that the judicial manager may reasonably require.

Preferably the process of assessing the company's present state should start even before the commencement of judicial management, and it is conceivable that directors

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[82] For a discussion about the remuneration of the judicial manager see 4 5.
[83] The Companies Act 61 of 1973 s 1 defines a officer as the managing director, manager or secretary of the company but excludes a secretary which is a body corporate.
[84] See 4 3 2 3 *supra* for the position in the English law and 4 3 3 3 *supra* for the position in the Australian law.
[85] A person who at any time has been convicted of perjury and has been sentenced to imprisonment without the option of a fine or to a fine exceeding one hunderd rand shall be disqualified from being appointed or acting as a director of the company unless the court gives permission. (Companies Act 61 of 1973 s 218(1)(d)(iii)).

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would be in contact with potential judicial managers for some time before their appointment, especially if, as seems logical, the judicial managers' consent to their appointment is required.

To facilitate this process and to guard against the abuse of judicial management by directors wishing to free their company or themselves from their lawful liabilities it should be made a requirement that judicial management will only commence if the directors also file supporting affidavits with their decision to place the company in judicial management. These affidavits would need to confirm the reasons for the decision and the purpose of judicial management.

These proposals would need an amendment to the current legislation in South Africa where the powers of the judicial manager to investigate are derived from the possibility of the court or the Master summonning persons to appear before them.[86] The judicial manager only has the power to compel certain persons to attend meetings or to summon them to appear before him if the court makes that part of the judicial management order.[87] This approach is clumsy and should be streamlined by giving the judicial manager the power to demand information supported by affidavit (if the judicial manager so requires) in addition to those powers that he already has in terms of the Companies Act.

4 3 4 5 *Liability of the judicial manager*

With reference to the liability of judicial managers, it is a difficult question whether the judicial manager should be liable for any debts of the company during the judicial management. English law addresses this problem by designating the administrator as the agent of the company under administration. He thus never incurs personal liability for debts contracted on behalf of the company unless he agrees to it. The Australian law makes the administrator personally liable for debts incurred during the period of administration with a corresponding indemnity for those debts out of the property of the company under administration as a first charge even before the remuneration of the administrator. This is a way of circumventing the existing problem in judicial management in South Africa where the meeting of creditors can decide whether or not preference should be given to all new debts incurred while the company is under judicial management.

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[86] Companies Act 61 of 1973 s 417 read with s 439(2).

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An attorney with experience of judicial management indicated that this is a major obstacle in the present judicial management process.[88] The creditors often refuse to consent to such a proposal. The English answer to the problem is that an automatic statutory preference is given even above the remuneration of the administrator. The Australian method of making the administrator personally liable in effect results in such an automatic statutory preference being given. It should be noted that both the English and Australian approaches also go a step further than the possible South African preference in that the new debts are preferred even above the remuneration of the administrator. In South African law the preference consented to by the creditors would not affect the payment of the costs of judicial management which includes the remuneration of the judicial manager.[89]

The current dilemma of the South African judicial manager in not knowing whether the creditors will consent to a preference for new debts, with the resultant danger of personal liability in certain circumstances was discussed above.[90] It is clear that this situation should be resolved by removing the power to consent to the preference for new debts from the creditors and by making statutory provision for it.

It has never been the intention that the judicial manager should be personally liable for the debts of the company and the Australian position is a rather artificial arrangement. There is no reason why there should not be a statutory preference for the payment debts and liabilities incurred by the judicial manager out of the assets of the company, especially where the creditors play a far more active role in the business rescue, as proposed in this thesis.[91] A judicial manager should only be liable for damages due to his negligence in relation to the performance of his functions and the exercise of his powers.

The question that remains is whether the judicial manager should have the power to terminate existing contracts. The election that the Australian administrator has in terms of lease agreements is a case in point.

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[87] See 4 3 1 3 *supra.*
[88] Interview with attorney Robert Bricout of Hofmeyers, Cape Town in May 1998.
[89] Companies Act 61 of 1973 s 435(1).
[90] See 4 3 1 4 *supra.*
[91] Such a statutory preference facilitates the possibility of the company being rescued. It ensures suppliers that they will be paid for supplies to the company in judicial management whilst the judicial manager is formulating a plan of future conduct.

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Unless the judicial manager has the statutory power to cancel existing and continuing contracts, a purported cancellation would more often than not be a breach of contract. Moreover, the creditor cannot lightly be denied his contractual rights or the contractual remedies that flow from a breach of contract. If that were allowed to happen, judicial management may develop into an easy way to escape unwanted contractual obligations.

What is certain however is that such a claim for breach of contract should not be regarded as a liability incurred by the judicial manager in the course of judicial management with the resultant statutory preference. It is submitted that it would be pointless giving the judicial manager the opportunity to cancel the agreement and then to treat the damages arising from the cancellation as preferent debts arising after the commencement of the judicial management.

The suggested solution is to give the judicial manager an election whether to continue with certain contracts or not and then to treat any damages resulting from premature termination as debts arising before the commencement of judicial management.[92] Where the judicial manager decides to continue with the contract the resultant liabilities arising after the commencement of judicial management would qualify for the statutory preference. It should be kept in mind that it would only be those contracts that are onerous to the company that would be cancelled. The whole idea of judicial management is that the company should become a successful concern again. In that sense ordinary business agreements would normally not be affected at all. The kind of contract that springs to mind is the long term lease of property.

4 3 5 Draft legislation to give effect to the proposals

Section 6[93](Duties of the judicial manager)

(1) A judicial manager must:

> (a) on appointment forthwith assume the management of the affairs, business and property of the company and recover and take possession of all the assets of the company;

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[92] See also the election given to the judicial manager discussed in 3 4 1 4 1 *supra* and the proposed legislation s 2 (4) in 3 4 1 5 *supra*.
[93] Based on Companies Act 61 of 1973 s 430 and s 433.

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(b) conduct such management, subject to the supervision of the Master, in such a manner as he or she may deem most economic and most promotive of the interests of the members and creditors of the company;

(c) lodge with the Registrar of Companies

(i) within 7 days after his or her appointment a copy of the letter of appointment as judicial manager;

(ii) in the event of the judicial management or the operation of the plan of future conduct being terminated, a notice of such termination;

(d) prepare and lay before the meeting convened in terms of section 4(2) a report containing

(i) an account of the business, property, affairs and financial circumstances of the company;

(ii) a statement of the reasons why the company is unable to pay its debts or is probably unable to meet its obligations;

(iii) a complete list of creditors of the company (including contingent and prospective creditors), specifying the amount and nature of the claim of each creditor;

(iv) the considered opinion of the judicial manager whether it would be in the interests of the creditors to accept the plan of future conduct; or for judicial management to end; or for the company to be wound up; and

(v) proposals for the plan of future conduct;

(e) convene and conduct all meetings of members and creditors required by this Act or requested in terms of this Act;

(f) keep such accounting records and prepare such annual financial statements as the company or its directors would have been obliged to keep or prepare if the company was not placed under judicial management;

(g) lodge with the Master copies of all such documents as prescribed or requested;

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(h) examine the affairs of the company before the commencement of the judicial management order in order to ascertain whether any director, or past director, officer or past officer of the company has contravened or appears to have contravened any provision of this Act or has committed any other offence, and submit to the Master such reports as are in terms of section 400 of the Companies Act required to be submitted by a liquidator;

(i) examine the affairs of the company before the commencement of the judicial management order in order to ascertain whether any director, or past director, officer or past officer of the company is or appears to be personally liable to the company for damages or compensation to the company or for any debts or liabilities of the company, and to report to the Master and to the members and creditors the full particulars of any such liability;

(j) apply to the court for any order in terms of section 4(8).

Section 7[94] (General powers)

(1) The judicial manager of a company:

(a) may do all such things as may be necessary for the management of the affairs, business and property of the company, and

(b) without prejudice to the generality of paragraph (a) has the powers specified in the Schedule.

(2) The judicial manager also has power to call a meeting of the members or creditors of the company.

(3) The judicial manager has the power to cancel onerous contracts provided that the cancellation thereof will be deemed to have occurred before the company was placed in judicial management.

(4) The judicial manager may apply to the court for directions in relation to any particular matter arising in connection with the carrying out of his or her functions.

(5) In exercising his or her powers the judicial manager is deemed to act as the company's agent.

Section 8[95] (Powers of investigation)

[94] Based on the English Insolvency Act 1986, s 14.

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(1) Within 5 days of the company being placed in judicial management the directors must give a statement about the company's business, property, affairs and financial circumstances to the judicial manager.

(2) A director of a company under judicial management must attend on the judicial manager at such times; and give the judicial manager such information about the company's business, property, affairs and financial circumstances as the judicial manager may reasonably require.

(3) When a company is placed in judicial management the judicial manager may forthwith require some or all of the persons referred to in subsection (4) to furnish a statement of affairs of the company within such a period as the judicial manager reasonably requires.

(4) The persons for purposes of subsection (3) are:

(a) those who are or who have been officers of the company;

(b) directors and officers of an officer referred to in subsection (4)(a) who is a juristic person;

(c) those who at any time within one year before the company was placed under judicial management have taken part in the formation of the company; and

(d) company employees or anyone who was a company employee within one year before the company was placed in judicial management;

(5) The judicial manager may require any person to support any of the information given in terms of this section with an affidavit.

Section 9[96] (Preference to post-judicial management creditors)

(1) All liabilities incurred by the judicial manager in the conduct of the company's business must be paid in preference to all other liabilities not already discharged exclusive of the costs of judicial management, and thereupon all claims based upon such first-mentioned liabilities have preference in the order in which they were

[95] Section 7 should not replace the existing avenues and powers of investigation that the judicial manager has in terms of Companies Act 61 of 1973 ss 439, 417, 414, 415, 416 and 418(2), but should complement those powers. Section 7 is based on the Australian Corporations Law, s 438B(2) and (3) and the English Insolvency Act 1986, s 22.

[96] Based on the Companies Act 61 of 1973 s 435(1).

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incurred over all unsecured claims against the company except claims relating to the costs of the judicial management.

(2) If the judicial management is superseded by a winding-up of the company the preference conferred to in subsection (1) shall remain in force except in so far as claims relating to the costs of the winding-up are concerned.

Schedule to the Act[97]

Specific powers of the judicial manager referred to in section 7.

The judicial manager has the power:

(a) to appoint and dismiss professionally qualified legal representatives and accountants to assist the judicial manager in the performance of his or her duties;

(b) to appoint and dismiss an agent or to employ a person to do any business which he or she is unable to do;

(c) to do all acts and execute documents in the name of the company;

(d) to make payments incidental to the performance of his or her functions;

(e) to draw, accept, make and endorse negotiable instruments in the name of and on behalf of the company;

(f) to raise loans or borrow money and grant security therefor over the property of the company;

(g) to make any arrangement or compromise on behalf of the company;

(h) to call meetings of the members or creditors of the company;

(i) to form a committee of creditors;

(j) to do all other things incidental to his or her functions.[98]

4 4 Who should be the judicial manager?

If a viable business rescue procedure is to be implemented in South Africa, its success will largely depend on to the calibre and competence of the judicial managers. In the words of the Cork Report:[99]

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[97] Based on sch 1 to the English Insolvency Act 1986.
[98] The customary catch-all.
[99] 175.

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"The success of any insolvency system, however, is very largely dependent upon those who administer it."

The best-designed system would still fail if those responsible for its successful implementation fail or are unable to do so. In a system such as judicial management this is of crucial concern. The drafters of any insolvency regime should carefully consider the identity of those who will be allowed to become the managers of its business rescue procedures.

The practical steps that the judicial manager has to take and his powers and duties were discussed above. From this discussion it is obvious that the judicial manager needs a wide variety of knowledge and skills.

The Cork Report concluded that the administrator would need knowledge and experience in the fields of :

> "the law regulating the relations of debtor and creditor; the organisation of courts dealing with insolvency matters and the proceedings in connection therewith; the investigation of the business dealings and transactions of an insolvent debtor; the pursuit and recovery of assets fraudulently disposed of in order to defeat creditors; the rescission of voluntary conveyances and other transactions amounting to voidable preferences; and the rules relating to the distribution of the insolvent debtor's assets among his creditors. In addition, he must be capable of taking complete control of a business, sometimes of enormous size or complexity, or even both, and of carrying it on with a view either to selling it as a going concern or to making some other proposals for its continuance as an economic unit."

This knowledge and experience must be complemented by independence, impartiality and a sense of good judgment and a commitment to work towards the rescue of the business in judicial management. In many instances it may be easier just to accept business failure and appoint a liquidator to dispose of the business or the assets in the easiest possible way. The skills required of a successful judicial manager are therefore arguably of a higher degree and greater variety than those required of a liquidator.

In light of the above considerations, the requirements for judicial managers and administrators in the different jurisdictions are somewhat surprising.

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4 4 1 Judicial management (South Africa)

The Companies Act does not give a positive direction regarding the determination of who should be appointed as judicial manager, whether provisional or final. There is no requirement that a judicial manager should be an insolvency practitioner or should belong to a profession as is provided in English and Australian law. The Companies Act merely provides for the Master to appoint a provisional or a final judicial manager and then disqualifies certain persons from being a judicial manager.[100]

South African law makes provision for a neutral third party to take control of the company in judicial management. This is not surprising considering the pro-creditor orientation of South African insolvency law. Apart from the disqualification in terms of the Companies Act the court has ruled that

> "Nobody should be appointed as a judicial manager, provisional or otherwise, unless he is disinterested and free to act independently and impartially."[101]

Subject to these limitations the position is thus that the Master may appoint any person that he deems to be fit to act as a judicial manager, provisional or final. In the appointment of the final judicial manager the Master will usually appoint the nominee(s) of creditors and members agreed to at their meetings.[102] This clearly shows the legislature's appreciation that judicial management will have a better chance of approval if the creditors have some faith in the person administering the process.

The provisional judicial manager may be required by the Master to give such security for the proper performance of his duties as provisional judicial manager as the Master may determine.[103]

4 4 2 Administration (England)

Unlike the position in South Africa, English statutory law prescribes certain positive requirements before a person may act as an administrator. An administrator of a

[100] Companies Act 61 of 1973 s 429(b)(i) and s 431(2)(b). The persons disqualified are the auditors of the company or any person disqualified from being appointed as liquidator in a winding-up. Regarding persons disqualified for appointment as liquidator see Companies Act 61 of 1973 ss 372 and 373.
[100] *Theron v Natal Markagente (Edms) Bpk* 1978 4 SA 898 (N) 900D, where the court also held that the attorney of the applicant for a judicial management order should be disqualified from acting as the judicial manager at least on his own (at 900H - 901A).
[101] *Theron v Natal Markagente (Edms) Bpk* 1978 4 SA 898 (N) 900D, where the court also held that the attorney of the applicant for a judicial management order should be disqualified from acting as the judicial manager at least on his own (at 900H - 901A).
[102] Companies Act 61 of 1973 s 431(2)(b).

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company in administration must be an insolvency practitioner.[104] The term "insolvency practitioner" is used by the Insolvency Act to describe all those persons that may be appointed as administrators, liquidators, provisional liquidators or administrative receivers.

There are general requirements to qualify as an insolvency practitioner.[105] In general, to qualify as an insolvency practitioner a person needs to belong to a recognised professional body and should be permitted by the rules of that body so to act; or the person should be specifically authorised to act as an insolvency practitioner.[106]

The recognised professional bodies include those for charted accountants, certified accountants, insolvency practitioners and the Law Society. Membership of one of these bodies will not in itself be sufficient, the rules of the body must also specifically permit the person to act as an insolvency practitioner.[107] This gives the body room to prescribe examinations and experience as further criteria.

Further requirements to be met are that he should be a natural person,[108] that he must have given adequate security (be adequately bonded)[109] and that he must be fit and proper person[110] for his duties as insolvency practitioner.

Reasons why a person would in general be disqualified to act as an insolvency practitioner would relate to personal insolvency, a disqualification order in terms of the Company Directors Disqualification Act,[111] or through being a patient under the Mental Health Act.[112]

In a particular case the insolvency practitioner should have no conflict of interest and should not have been previously involved with the company, for example as its auditor.[113]

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[103] Companies Act 61 of 1973 s 429 (b)(i).
[104] Insolvency Act 1986, Part XIII, ss 388-398.
[105] Insolvency Act 1986, s 390.
[106] Insolvency Act 1986, s 390(2)(b).
[107] Insolvency Act, s 391(1). See also Brown *Corporate Rescue* 180 n 23.
[108] Insolvency Act 1986, s 390(1).
[109] Insolvency Act 1986, s 390(3).
[110] Insolvency Act 1986, s 393(2)(a).
[111] 1986.
[112] 1983.
[113] These provisions stem from the rules of the professional bodies themselves and from the Insolvency Rules 1986. See also Lange & Hartwig *The Law and Practice of Administrative Receivership and Associated Remedies* (1989) 42.

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4 4 3 Voluntary administration (Australia)

To act as an administrator in Australia a person needs to be a registered liquidator.[114] As the name suggests, such a person must be appropriately registered, he must then consent to his appointment and must not be disqualified from acting as a liquidator. The disqualification can be in general or may relate to the particular circumstances.

To obtain registration the applicant must be a natural person and should satisfy further requirements. He must belong to a specified professional body[115] or must have an accountancy degree from a university or must have other equivalent qualifications and experience that the Commissioner judges to be sufficient. Furthermore the Commissioner must be satisfied that the applicant has the necessary experience, is capable of performing the duties and is a fit and proper person to be registered as a liquidator.[116]

A person will be regarded as having the necessary experience for registration as a liquidator if that person has been:

> five years in a public practice;
>
> has worked in a wide range of corporate insolvency administrations under the direction of an official liquidator for a continuous period of three years; and
>
> has spent at least two continuous years, during the last five years, on the supervision of corporate insolvency administrations.[117]

The general disqualification is that the liquidator should not be an insolvent under administration.[118]

Not surprisingly the Australian law is similar to the other two jurisdictions in its approach of appointing an impartial third party as the administrator. In relation to the particular company a person cannot act as a liquidator if he or a body corporate of which he is a member is either a creditor or a debtor of the relevant company to the value of at least $5000 (Australian) or more. Also excluded are a person who has any interest through a mortgage in the company, or who is the auditor or an officer of the

[114] Corporations Law, s 448.
[115] The Institute of Chartered Accountants in Australia, the Australian Society of Certified Practising Accountants or any other prescribed body. See Corporations Law, s 1282 (2)(a)(I).
[116] Corporations Law, s 1282. Various other qualifications such as being a resident in Australia are also imposed. See Crutchfield *Corporate Voluntary Administration Law* 218-219.
[117] Policy Statement 40 of the ASC, see also Tomasic *Australian Corporate Insolvency Law* 323.

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company or who has any connections through partnership or employment by the auditor or officer of the company.[119]

4 4 4 Evaluation

It was mentioned in the introduction to this section that the ideal judicial manager should have a wide knowledge and experience coupled with a firm commitment to make a success of the business rescue. It is difficult to see how these qualities will often be present in any one person. Although the practice in England and Australia has been to qualify persons on a professional level before they may act in insolvency related matters it is debatable whether the business rescuer and the liquidator come from the same mould even though the professional and other statutory qualifications for both are the same. There is evidence to suggest that the business rescuer and the liquidator differ fundamentally in their approach. This is so because a liquidator is best equipped to liquidate and his tendency will be to treat a judicial management in much the same way.

> "One IP *(Insolvency Practitioner)* put the point very starkly. He said: 'IP's are the wrong persons to do corporate rescue. They aren't trained to do it. They only know how to kill companies.' The essential nature of an insolvency practitioner was counterproductive because even the name emphasised the ideals of insolvency and undertaking rather than rescue."[120]

The judicial manager (business rescuer) needs a different approach. His skill is not primarily to dissect, but ultimately to revive.[121] The qualities required are fundamentally different from those of the liquidator. The need is to make it possible for those who possess the requisite qualities to become judicial managers.

Traditionally professional liquidators were appointed as judicial managers of companies in spite of the opposing objectives and duties of the two categories of persons. This resulted from the inclusion of judicial management at the end of the chapter on winding-up in the 1926 Companies Act. It was only in the 1973

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[118] This administration refers to a process concerned with individual insolvency.

[119] Corporations Law, s 532(2).

[120] Flood, Abbey, Skordaki & Aber *The Professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach* (1995) Research Report no 45 17.

[121] "The insolvency profession is more familiar with burial rites than with rescue procedures. Rescue always implies risk and courage." Mark Goldstein as reported in Flood *et al Research Report 45* 17. See also the criticism of Olver 1986 *THRHR* 88 who describes the essential qualification of the judicial manager as a "good on-going business manager".

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Companies Act that judicial management was placed in a separate chapter on its own.[122]

The type of business rescuer needed could be drawn from the ranks of experienced business people either retired from or tired of their present employment, who would respond to the challenge of rescuing businesses in financial trouble. To regulate their conduct may need detailed legislation or regulations, but a licensing scheme by the Master could accommodate this possibility. At present judicial managers, like liquidators only need the approval of the Master.

It is envisaged that the South African liquidators will have to belong to a professional body in the future, thus coming in line with the position in Australia and England.[123]

If the South African legislature were to go the way of its Australian and English counterparts then only those belonging to a profession will be eligible as judicial managers. In this case an exception should be considered. Take for example the case where someone was a successful manager of a company, but subsequently retired or left the company and the company now goes into judicial management. If the former successful manager still possess the necessary health and energy, it is probable that he will be the most appropriate business rescuer.

It is thus submitted that the South African legislation at least as far as judicial management is concerned should leave the possibility open, as is currently the case, that a suitable person within the discretion of the Master can be appointed as judicial manager.

It should also be possible to appoint jointly as judicial managers someone with professional qualifications together with someone with entrepreneurial skill and relevant business experience. Indeed in view of the wide range of skills and experience required, joint appointments should be encouraged.

Other possible solutions would be to change the rules of the professional bodies regarding fee sharing to allow, in the case of fees earned through judicial management, the sharing of those fees with a joint judicial manager who is not a qualified professional in that field. If the rules of professional bodies are not changed

[122] Olver 1986 *THRHR* 86.
[123] South African Law Commission *Review of the Law of Insolvency* Discussion Paper 66 162.

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some other way should be found to make it possible to use persons with special skills in the context of judicial management.

Accounting firms who expect to generate some work in this field, as the Australian experience indicates is possible, could then form separate companies much on the lines of their existing consulting companies, to enable them to share the fees generated with non-professionals.

Creditors are concerned whether the judicial manager is sufficiently independent from the directors and management of the company and that he is adequately skilled in the areas of insolvency and company rescue. This concern will be even greater where, as is proposed, the directors have a role to play in the appointment of the judicial manager or where the judicial manager is a former manager.

Independence in the mind of the creditors will probably be achieved by appointing judicial managers from one of the traditional professions, that is the legal and accounting professions. As already explained those with the credentials to manage a business and the insight to draw up proposals to rescue it will most likely not come from the traditional professions, nor from the traditional liquidators. The advantage of using those that belong to professions is that their conduct and independence can be regulated by their different professional bodies.

The suggestions above of either licensing specific individuals by the Master or the development of business rescue consultants used by professionals appointed as judicial managers will hopefully convince creditors that even those that do not belong to traditional professions will be sufficiently independent. After all the creditors are interested in competence and above all a judicial manager that they can trust.

> "To some creditors money isn't important. I've seen them turn down 90p in the pound because they did not like the directors. Personalities are important."[124]

The question as to who should qualify for appointment as judicial managers is of fundamental importance if South Africa is to implement a successful business rescue procedure. Therefore sufficient flexibility to develop a culture and profession of corporate rescuers is necessary in order to resuscitate judicial management from its present moribund state.

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[124] Flood *et al Research Report no 45* 20 illustrate the difficulty of establishing trust as reported by an insolvency practitioner.

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At present the number of companies under judicial management is small and the number of people skilled in corporate or business rescue is even smaller. However if the issue of qualifications of judicial managers is managed carefully by the Master during the implementation of an improved judicial management regime it should be possible to foster a new business rescue culture. At the same time the qualifications for judicial managers may likewise be developed as the culture grows and more persons develop as judicial managers. Thus it would be possible to have a new standard of qualifications applying especially to judicial managers after a number of years. This could be achieved by giving the Minister after consultation with interested parties, the power to make regulations on qualifications and experience required for appointment to the position of judicial manager.

4 4 5 Draft legislation to give effect to the proposals

Section 10[125] (Appointment of the judicial manager)

(1) Upon the company being placed under judicial management

(a) all the property of the company concerned shall be deemed to be in the custody of the Master until a judicial manager has been appointed and has assumed office;

(b) the Master shall without delay appoint a natural person whom the Master regards as having the necessary qualifications, experience and skill as a judicial manager (who shall not be the auditor of the company or any person disqualified by the Companies Act from being appointed as liquidator in a winding-up) who shall give such security for the proper performance of the duties of judicial manager, as the Master may direct.

(c) the Master may appoint two or more persons jointly as judicial manager in terms of subsection (1)(b).

(2) The Master shall from time to time issue rules with regard to the qualifications and experience for judicial managers which the Master considers appropriate.

(3) Where a judicial manager is appointed in terms of subsection (1), the court may, on the application of a judicial manager or member or creditor or officer of the company, review the appointment of the judicial manager.

[125] Based on Companies Act 61 of 1973 s 429.

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4 5 **Remuneration of the judicial manager**

The issue of the remuneration of the judicial manager is contentious. His remuneration is undoubtedly a drain on the assets of the company and high professional fees can be detrimental to the whole cause of judicial management, especially where the judicial manager needs to appoint other persons to help him in his tasks. Although this may seem a minor issue in the context of the whole business rescue procedure it plays an important role, because of its potential to motivate or demotivate the judicial manager. The judicial manager will have to put considerable time, effort and emotional energy into a business rescue in order to make it work. The financial resources to reward him adequately are however scarce. It is therefore necessary to examine critically the approaches of the different jurisdictions to this important issue.

4 5 1 Judicial management (South Africa)

The remuneration of the judicial manager and provisional judicial manager is governed by a special section of the Companies Act.[126] It is provided that the judicial manager and the provisional judicial manager shall be entitled to such remuneration for their services as may be fixed from time to time by the Master.[127] In fixing the remuneration the Master must take into account the manner in which the judicial manager has performed his functions and any recommendation by the members or creditors of the company relating to such remuneration.[128]

This is a change from the situation that existed before 1980 where the court had the authority to fix the remuneration of the judicial manager[129] and gave directions in this regard to the Master. The Master now determines the remuneration on his own, subject to review by the court.[130]

In practice the Master has certain tables of tariffs which he uses.[131] These are detailed tariffs based on tariff scales of government pay. The judicial manager is required to keep detailed timesheets of work done and time spent by everybody in his employ who did any work in relation to the judicial management. When the Master receives

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[126] Companies Act 61 of 1973 s 434A. See Meskin *Henochsberg I* 951-952.
[127] Companies Act 61 of 1973 s 434A(1).
[128] Companies Act 61 of 1973 s 434A(2).
[129] Companies Act 61 of 1973 s 428(2)(b); now deleted.
[130] Meskin *Henochsberg I* 952.

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the timesheets of all the work done he calculates the remuneration according to the timesheets and the classification of the persons involved and the time spent by them. Thus he would apply different tariffs for different employees making such distinctions as professional, secretarial and clerical at different levels.

Apparently this system involves long delays in payments to the judicial manager and the remuneration is low in comparison with the earnings of a liquidator for the same amount of work.

The remuneration of the judicial manager is payable from the assets of the company and enjoys preference over other debts.[132]

4 5 2 Administration (England)

In England the remuneration of the administrator is determined either as a percentage of the value of the property which he administers or on the basis of a tariff for the time spent on the administration. The decision as to which of these methods should apply is made by the creditors' committee or where there is no creditors' committee, by a meeting of the creditors.[133]

In fixing the fee of the administrator the creditors' committee should have regard to the complexity of the case, any exceptional responsibilities that may fall on the administrator, the effectiveness with which he carries out his duties and the value and the nature of the property he has to deal with.[134]

The Insolvency Rules also make provision for an application to the court or a request to the creditors' committee by the administrator to increase his fee, or for the creditors to apply to the court for the reduction of the administrator's fee on the grounds that it is excessive.[135]

The administrator's remuneration and expenses are payable out of the assets of the company. This payment has priority over any sums secured at the time of payment by a security which when it was originally created, was a floating charge.[136] However the

[131] This information was supplied by Eileen Fey a charted accountant who is an experienced judicial manager.
[132] Companies Act 61 of 1973 s 435(1) and (2).
[133] Insolvency Rules 1986, r 2.47.
[134] Insolvency Rules 1986, r 2.47(4).
[135] Insolvency Rules 1986, rr 2.48 - 2.50.
[136] Insolvency Act 1986, s 19(4).

payment ranks after debts or liabilities incurred by the administrator and arising from the administration.[137]

4 5 3 Voluntary administration (Australia)

Similar to the position in English law and contrary to the position in South African law, it is the creditors that determine and fix the remuneration of the Australian administrator. The company's creditors determine the remuneration of the administrator, by way of resolution passed at a creditors' meeting. If the creditors fail to fix the remuneration, the court will determine the remuneration on application by the administrator.[138]

Where the creditors decided upon the remuneration, the administrator, an officer, a member or a creditor of the company may apply to the court to have the remuneration reviewed. The court may then confirm, increase or reduce the remuneration.[139]

The remuneration of the administrator is payable from the assets of the company under administration. However, similar to English law, but in contrast to the position in South Africa, the other liabilities incurred by the administrator have preference in payment from those assets. The payment of the administrator's remuneration has preference over unsecured debts and secured debts resulting from a floating charge has not yet been activated.[140]

4 5 4 Evaluation

The judicial manager is appointed by the Master and manages the company. By reason of the fact that he administers the company under judicial management his remuneration cannot be determined by the company. It is submitted that in general the remuneration of the judicial manager should be agreed to between the judicial manager and the Master taking into account the opinion of the creditors.

The present position in South Africa does not provide enough encouragement to judicial managers to make a success of judicial management and to restore the company to successful trading. Whereas a judicial manager is remunerated by a tariff

[137] Insolvency Act 1986, s 19(5).
[138] Corporations Law, s 449E(1).
[139] Corporations Law, s 449E(2).
[140] Corporations Law, s 443D-F.

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system, a liquidator is remunerated by a percentage of the assets and income of the company in liquidation.[141]

The alternative fee structure of English law may add more flexibility and may leave more room for a remuneration structure that would be able to motivate the judicial manager to make a success of the judicial management.

The example of the Australian and English law should not be followed in allowing the judicial manager to go to court on the matter of remuneration. The established practice of the South African experience of letting the Master decide the fees in the first instance the fees, with only a review jurisdiction for the courts, should be adhered to. The Master has enough experience to hear the appeal of the judicial manager or the creditors in this matter. The court would ask for his opinion anyway.

The costs of a judicial management might mean the difference between a successful rescue and an inevitable liquidation.[142] The suggestions put forward in this thesis are also aimed at keeping the costs of judicial management down. In this regard, it is especially medium-sized companies that will suffer because of costly procedures. Small businesses should in any event have a different and even less cumbersome business rescue procedure.[143] Large companies however will have enough assets to relegate the costs of judicial management to a small percentage of the available assets.

The costs of judicial management including the remuneration of the judicial manager discriminate against smaller companies as they may not have enough assets to accommodate the fees of the judicial manager and the cash flow for recovery. The discrimination in the commercial world against such smaller companies is further highlighted by the fact that big lending institutions would often be much more supportive of big companies in such circumstances than of smaller companies. This is because they often stand to lose much more when big companies are liquidated.

[141] Liquidations are thus more lucrative than judicial managements for those professionals involved in insolvency.

[142] The direct cost of voluntary administration is a decreasing function of company size. Routledge 1998 *Company and Securities Law Journal* 10, 11 shows that the average cost as a percentage of total assets differs from 21,5% for small companies to between 4% and 8% for bigger companies. See also Olver 1986 *THRHR* 87 who argues that the burden of a judicial manager's fees on a small company is such that the costs might exceed the value of the assets by quite some margin..

[143] *Cf* the discussion at 3 3 4 *supra*.

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This is illustrated by the existence of an informal rescue procedure that is used for big companies in England, the so-called London approach.[144] It is an informal procedure for multi-bank support for big companies with financial problems and looming insolvency. These big companies would almost always be in debt at various banks. One of these creditor banks takes the lead in getting all the creditor banks together with the debtor company and then the banks work together to reach a collective view on whether and how the company should be given financial support. Often the Bank of England will play a role in convincing all the creditor banks to accept the rescue plan.

When the banks learn about the financial troubles of the company they refrain from taking immediate steps to act upon their security and call in their loans. They maintain their support pending further examination. This amounts to a voluntary moratorium. The banks amongst themselves appoint a lead bank with sufficient staff and experience to manage relationships between the creditor group and the company and to ensure a proper flow of information to facilitate the process.

The banks share the relevant financial information of the debtor company freely between themselves and use it to make their decisions about the future of the company. A precondition is that the information shared must be reliable.

During the voluntary moratorium the banks and other creditors work together to reach a collective view on whether and how the company should be given financial support. The success of the approach is that loss is shared on an equitable basis between the banks and with the view to ensuring the maximum value for creditors.

In terms of the London approach the whole rescue is done without the costs of an administrator being borne by the company being rescued. It does not seem likely that the banks would go to the same lengths to rescue even medium sized businesses as the incentive to do so is much less.

This raises the possibility of an incentive-based remuneration, something that none of the three jurisdictions under consideration apparently utilise at present. The possibility of having an incentive-based remuneration should not however be summarily discarded. The work involved in restoring a company to successful trading differs

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[144] Goode *Principles of Corporate Insolvency Law* (1997) 338; Flood, Abbey, Skordaki, Aber *The Professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach.*

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considerably from that involved in the liquidation of a company. Employees have to be motivated, deals have to be negotiated and creditors must be convinced of the possible success and plans formulated must be implemented successfully. It is thus submitted that it should be possible, with the approval of the creditors, that the judicial manager should receive some form of equity payment. The provision of an option to buy shares in the future at the price of the shares at the commencement of judicial management is one possibility.

This possibility would encourage the judicial manager to put in more work than he would be prepared to in the existing circumstances. It would also assist in obtaining access to new sources of funding for the ailing company. This possibility could conceivably bring venture capital and judicial managers together and greatly improve the chances of successful judicial management and the fostering of a business rescue culture.

However, the remuneration of the judicial manager should always be subject to full and timely disclosure and should not become an opportunity for the practitioners to benefit unreasonably to the detriment of creditors.

4 5 5 Draft Legislation to give effect to the proposals

Section 11[145] (Remuneration of the judicial manager)

(1) The judicial manager is entitled to such remuneration for his or her services as may be fixed by the Master from time to time.

(2) The remuneration must be fixed either

(a) as a percentage of the value of the property with which the judicial manager has to deal, or

(b) by reference to the time properly given by the judicial manager and his or her staff in attending to matters arising in the judicial management, or

(c) based on an incentive scheme agreed to by the members and creditors, or

(d) any combination of the above, and

in fixing the remuneration the Master shall take into account the manner in which the judicial manager has performed his or her functions and any

[145] Based Companies Act 61 of 1973 s 434A and s 384(2) and Insolvency Rules 1986, r 2.47.

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recommendation by the members or creditors of the company relating to such remuneration.

(3) The Master may reduce or increase the such remuneration if the Master is of the opinion that there is good cause for doing so, and may disallow such remuneration either wholly or in part on account of any failure or delay by the judicial manager in the discharge of his or her duties.

(4) Where remuneration of the judicial manager is fixed by the Master in terms of this section, the court may, on the application of the judicial manager or of an officer, member or creditor of the company, review the remuneration and confirm, increase or reduce the remuneration.

4 6 **Removal of the judicial manager**

The possibility to remove a judicial manager should always exist. The twists and turns of commercial life can always be more than what may be foreseen by any person, however imaginative he may be. Therefore a mechanism should exist to remove a judicial manager. At the same time the mechanism should be such that it does not turn the judicial manager into a lame duck. The mechanisms for the removal of a judicial manager will also depend to some extent on the mechanisms for his appointment.

4 6 1 Judicial management (South Africa)

In South African law, the provisional judicial manager and final judicial manager are appointed by the Master.[146] Although there is no specific statutory provision for the removal of the judicial manager,[147] the court has an inherent power to remove a judicial manager.[148] Thus any party with an interest may apply to court for the removal of the judicial manager. The Master presumably has the authority to appoint a judicial manager to fill the resulting vacancy.

4 6 2 Administration (England)

In English law the administrator is appointed by the court[149] and as one would expect his removal and the filling of the vacancy also lie with the court. The administrator

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[146]Companies Act 61 of 1973 s 429(b) and s 431(4) respectively.
[147] *Cf* Companies Act 61 of 1973 s 379 regarding the statutory powers of the master and the court to remove a liquidator.
[148] *The Master of the Supreme Court v Bell* 1954 2 PH E21 (T); *The Master v Bell* 1955 3 SA 100 (T); *LAWSA* IV part 3 477.
[149] Insolvency Act 1986, s 13.

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may be removed from office by an order of court or he may resign. He must vacate the office if he ceases to be qualified as an insolvency practitioner in relation to the company or upon the discharge of the administration order.[150]

The court will fill the vacancy on application of any joint administrator or where there is no such joint administrator on application of the creditors' committee. Where there is neither a joint administrator nor a creditors' committee, the application should be made by the company, its directors or any creditor or creditors.[151]

4 6 3 Voluntary administration (Australia)

Unlike the position under South African and English law, the Australian administrator is appointed by the directors, liquidators or chargee of the company.[152] Once the administrator is appointed the appointment cannot be revoked.[153] This removes the possibility that the administrator may be manipulated by those who appointed him.[154] The court may, however, remove the administrator from his position on the application of the ASC or of a creditor and appoint a new administrator.[155]

The administrator's office will become vacant on the administrator's death, disqualification or resignation. In such a case a new administrator may be appointed by those who were originally responsible for the appointment of the administrator.[156] However, the danger of the appointment of an administrator who is too friendly towards the directors is counterbalanced by the provision that such a new appointee has five business days in which to convene a meeting of the company's creditors so that they may determine whether to remove the appointee from his position and appoint someone else as the administrator of the company.[157]

4 6 4 Evaluation

It is desirable that a judicial manager should have the assurance that he will not be easily removed from his position. This is important in terms of his independence to investigate the necessary matters freely and in terms of the commitment needed to be successful as a judicial manager. It might however happen that if the judicial manager

[150] Insolvency Act 1986, s 19(1) and (2).
[151] Insolvency Act 1986, s 13.
[152] Corporations Law, s 436A, B and C.
[153] Corporations Law, s 449A.
[154] Keay 1997 *Company and Securities Law Journal* 153.
[155] Corporations Law, s 449B.
[156] Corporations Law, s 449C(1).

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is appointed by the directors of the company or its shareholders, then the creditors will have no trust in the judicial manager.[158] It may also lead to situations where only favourably disposed judicial managers are appointed to ensure that the investigation into the prior conduct of the company officials is less thorough.

It is submitted that the answer to these problems is to leave the power of appointment to the Master, who is preferred to the court with a view to saving time and costs. This is the option adopted in this thesis. [159]The Master would in all circumstances take into consideration the person nominated by those that placed the company under judicial management. If the Master is obliged to follow the recommendation of those that initiated judicial management it would be prudent to follow the Australian example of giving the creditors the chance to remove such a judicial manager and replace him with someone else.

It will always be healthy from a policy perspective if the Master has a strong beneficial influence on the conduct of the judicial managers. This influence will be strengthened, if he has the power to fix the remuneration of the judicial manager and the same power of removal which he has in the case of a liquidator.[160]

The inherent power of the court to remove a judicial manager should not be tampered with.

The office of judicial manager will also become vacant upon the death or resignation of the judicial manager and the Master should have the same powers to fill a vacancy, however it occurred.

4 4 5 Draft legislation to give effect to the proposals

Section 12[161] (Vacation of office)

(1) The judicial manager of a company may at any time be removed from office by order of court and may in prescribed circumstances resign his or her office by giving notice of such resignation to the Master.

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[157] Corporations Law, s 449C(4).
[158] See also the argument in favour of a system of appointing administrators from a panel on a roster basis to ensure independence. Such a measure was not adopted in Australia as it was thought that this would detract from the voluntary nature of the voluntary administration procedure from the company's perspective. Keay 1997 *Company and Securities Law Journal* 156.
[159] See proposed legislation section 10 (1)(b).
[160] Companies Act 61 of 1973 s 379.
[161] Based on the Insolvency Act 1986, s 19 and the Companies Act 61 of 1973 s 379 and s 381.

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(2) Sections 379 and 381 of the Companies Act relating to the removal of the liquidator by the Master and the control of the Master over liquidators apply to judicial managers, with the changes required by the context.

(3) The Master may remove a judicial manager of a company and replace him or her by another person if so requested by a meeting of creditors.

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CHAPTER 5

Other statutory provisions that have an influence on judicial management

5 1 Introduction

In this chapter the other statutory provisions outside the chapter of the Companies Act on judicial management that have a significant influence on the use of judicial management as a corporate rescue measure in practice will be discussed. There are different ills that afflict a society because of insolvency. To cure those ills it is not enough merely to add to the list of remedies. Achieving the right balance through the effective interaction between those remedies is also important.

As far as judicial management as a corporate or business rescue procedure is concerned, there are various other statutory provisions that will have a substantial impact on its use. Of these the provisions on insolvent trading, the disqualification of directors, the current use of section 311 of the Companies Act and the treatment of possible assessed tax losses of the company in judicial management will be discussed.

5 2 **Insolvent trading provisions**

The so-called insolvent trading provisions are a convenient label for the category of statutory provisions that provide for the personal liability of a director of a company in certain circumstances where creditors did not receive full payment for the debts that the company owed them. The liability may be criminal or civil or possibility both. In the South African context such liability is imposed by section 424 of the Companies Act, 61 of 1973.

The insolvency of companies often has for those directors and shareholders who ran the business far less serious financial consequences than for an individual who has been declared insolvent. Instead, the burden of the adverse financial effects of failure is transferred to the unsecured or concurrent creditors of the company. This is of course one of the intended consequences of juristic personality. However it was also intended that those who obtain the privilege of juristic personality use it in a responsible manner and should not unscrupulously abuse this privilege to defraud creditors or other members of the community. However, if limited liability for directors and shareholders is not available, then it is not worth using a business entity with juristic personality.

The community has always taken an interest in insolvency. In this context, insolvency is not merely a private matter between the company and its creditors. The community is interested in whether the conduct of the insolvent was blameworthy. In the case of an insolvent company the community is interested in the conduct of those who conducted the affairs of the insolvent company. The community is also interested to know whether the conduct of the individual insolvent or of the managers of an insolvent company merits suitable punishment and whether the individual's or managers' opportunity to repeat such conduct in the future should be curtailed altogether or at least be restricted to protect the community.[1]

These questions need to be addressed not only where the company is finally liquidated, but also in the circumstances where the company is rescued and allowed to recover through a process of judicial management.

The provisions of insolvent trading are also important for two altogether different reasons. If there is a sufficient risk that the company director could lose his protection against personal financial consequences in the case of business failure he should be much more circumspect in the way he conducts the affairs of the company. One of the more prudent things that he may do is to put the company into judicial management in order to run an open and participatory process of rescuing the company, rather than letting it trade in insolvent circumstances. In such a way he may possibly escape the consequences of falling foul of insolvent trading provisions. In this regard insolvent trading provisions act as encouragement for the use of judicial management.

However, encouragement alone would not be enough to render the use of judicial management attractive if a much easier "private" method to rescue the business is at hand. If insolvent trading provisions did not exist, it would be far easier for the director of the company to liquidate a company at any sign of trouble, form a new company and carry on with a clean slate having rid the business of outstanding debts, unwanted contractual obligations and other liabilities.[2]

The insolvent trading provisions of South Africa, England and Australia will now be briefly discussed without any attempt being made to provide exhaustive evaluation. Each of these jurisdictions would merit a discussion on insolvent trading provisions

[1] Cork Report 390 para 1734 - 1735.

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far beyond the scope of this thesis. However an attempt will be made to get a basic understanding of the provisions and how they should effectively interact with the provisions on judicial management to encourage its use.

5 2 1 South African insolvent trading provisions

The South African insolvent trading provisions are found in section 424 of the Companies Act. This section purports to discourage fraudulent behaviour as well as reckless behaviour in the conduct of the company's business.

5 2 1 1 *Establishing liability*

Under section 424 a person can incur personal responsibility, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct. This may happen if that person was knowingly a party to the carrying on of the business of the company in a reckless manner, or with the intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose.[3]

To establish liability in terms of this provision it is necessary to prove that the person or persons, who would often be a director or the directors of the company, were reckless or fraudulent in carrying on the business of the company.[4]

To prove recklessness is easier than to prove a fraudulent intent. In order to prove someone was reckless in terms of this provision it is necessary to prove that the person's action was less than a certain standard of behaviour. This standard is that of a reasonable businessperson belonging to the same group or class as the person whose behaviour is judged and moving in the same spheres and having the same knowledge or means to knowledge as the relevant person.[5] As this is a civil remedy the standard of proof is on a balance of probabilities.

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[2] For a vivid description see 2 2 3 *supra* n 14 regarding the submission by a Divisional Consumer Protection Officer of the South Yorkshire County Council. There is no reason to believe that the situation in South Africa differs to any extent from the remarks made in the submission.

[3] Companies Act 61 of 1973 s 424(1).

[4] The legislative intention of including recklessness in this provision was to broaden the scope of the earlier provision, which did not include recklessness, to provide a remedy which could serve as a restraining influence on "over-sanguine directors". See *Gordon NO and Rennie NO v Standard Merchant Bank Ltd and Others* 1984 2 SA 519 (C) 527A-B; *Philotex (Pty) Ltd and Others v Snyman and Others* 1998 2 SA 138 (A) 142G-H. See also Fourie "Limited liability and insolvent trading" 1994 *Stellenbosch Law Review* 148.

[5] *Philotex (Pty) Ltd and Others v Snyman and Others supra* 143G-H.

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The proof of recklessness thus involves an objective test, the test of the reasonable businessperson, and a subjective test, the knowledge and circumstances of the person in question. It is not enough to disprove recklessness by showing that a director honestly believed that the company would be able to pay its debts when they fall due.[6] Such a defence would clearly be sufficient against a claim based on fraudulent trading where it will be necessary to prove intent on the part of the director.[7]

Philotex (Pty) Ltd and Others v Snyman and Others brought clarity to the application of section 424 after the uncertainty left by the "silver lining"[8] test of *Ex Parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (in Liquidation)*.[9] *Philotex* explains the standard of conduct which would make a person liable for reckless trading in terms of section 424 of the Companies Act. *Ex Parte De Villiers* dealt with the requirements for fraudulent trading and did not discuss the requirements for reckless trading.[10]

Philotex clearly explains when liability will be established in terms of section 424:[11]

> "Participation in business necessarily involves taking entrepeneurial risks but s 424 only penalises the subjection of third parties to risk where (apart from the case of fraudulent trading) it is grossly unreasonable. If, therefore, in a given case there is some ground for thinking that creditors will be paid but a reasonable businessman would nonetheless, because of circumstances creating a material but not high risk of non-payment, refrain from running that risk, the director who does run that risk by incurring credit, and thus falls short of the standard of conduct of the reasonable businessman, trades unreasonably and therefore negligently *vis-a-vis* creditors. That departure from the reasonable standard could not fairly be described as gross, however, and the director concerned would not be hit by the section. By contrast, an instance that manifestly would fall foul of the section is where the reasonable businessman

[6] *Philotex (Pty) Ltd and Others v Snyman and Others supra* 147D-E.
[7] *Ex Parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (in Liquidation)* 1993 1 SA 493 (A) 504.
[8] See Goode *Principles of Corporate Insolvency Law* 457.
[9] *Supra* 504 A-B. See 5 2 2 1 n 20 *supra.* Criticism is also directed to earlier statement of the silver lining test to the effect that it is too widely stated. *Philotex (Pty) Ltd and Others v Snyman and Others supra* 148A.
[10] It is noteworthy that the "silver lining test" endorsed in *Ex Parte De Villiers* was not followed even for fraudulent trading in its country of origin. See *Philotex (Pty) Ltd and Others v Snyman and Others* 1998 2 SA 138 (A) 147G-148D.
[11] 1998 2 SA 138 146H-147C.

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would realise that in all the circumstances payment would not be made when due. To incur credit in that situation would, as a matter of degree, be so plainly more serious a departure from the required standard than the conduct in the first example that one has no difficulty categorising it as grossly unreasonable and therefore grossly negligent. This second example, one must emphasise, is an extreme one and it would, in my view, impose an unduly heavy burden on a plaintiff in s 424 proceedings to require proof of circumstances in which a reasonable businessman would assess non-payment as a virtual certainty. So, if a plaintiff were to present evidence warranting the conclusion that when credit was incurred there was, objectively regarded, a very strong chance, falling short of a virtual certainty, that creditors would not be paid, that case would, I think, also involve the mischief which the section was intended to combat. It is not possible to attempt to draw the line between negligence and recklessness more exactly. Each case must turn on its own facts and involve a value judgment on those facts."

The liability in terms of section 424 is not limited to instances where the company is wound up. Section 424 will be applicable when it appears, whether in a winding-up, judicial management or otherwise that the business of the company was carried on in contravention of section 424.

5 2 1 2 *Extent of liability*

The person who falls foul of the provision can be held personally responsible, without any limitation of liability, for all or any of the debts of the company as the court may direct.

This is a very extensive liability and may well be a deterrent to insolvent trading, particularly since the *Philotex* ruling. It is not only the directors that are at risk of a section 424 ruling. It applies to any person who was knowingly a party to carrying on business in the prohibited manner.[12] This at least includes senior management and in appropriate circumstances the auditor of the company. A "shadow director" can also clearly fall foul of the provisions. A shadow director is a person who is not actually a director but the one on whose instructions one or more of the directors are accustomed to act. It would thus not be possible for a person to escape liability by organising the

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affairs of the company so that his or her spouse is the director, but the former is the actual driving force behind the scenes. Such a person would satisfy the requirement of being knowingly a party to the carrying on of the business of the company.

A creditor may claim the damages that he suffered directly from the person who carried on the business of the company recklessly or with an intent to defraud the creditors.[13]

5 2 1 3 *Escaping of liability*

Possible defences available to the defendants in a section 424 claim would be to establish either that they acted reasonably or that their conduct was not negligent to the extent of being reckless.

It may also be useful to a director subject to a claim under section 424 to be able to show that he proposed that the company should be put in judicial management, but was outvoted by the majority of directors. The strength of this argument would however depend on the circumstances of the relevant case.

5 2 2 English insolvent trading provisions

The Insolvency Act[14] distinguishes between fraudulent trading[15] and wrongful trading.[16] The former determines criminal and civil liability whilst the latter only determines civil liability. The Cork Report considered the former legislation in this part of the law inadequate and it was as a result of the Cork Report that the current division between the criminal and civil liability was introduced. Fraudulent trading deals with criminal liability, while civil liability is dealt with as wrongful trading.

5 2 2 1 *Establishing liability for fraudulent trading*

As far as fraudulent trading is concerned, the court on application of the liquidator may declare any persons who were knowingly party to carrying on of fraudulent

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[12] Meskin *Henochsberg on the Companies Act I* 912. See also Goode *Principles of Corporate Insolvency Law* (1997) 456 on similar wording in the English Companies Act 1985, s 425.
[13] Meskin *Henochsberg on the Companies Act I* 915-916. This is contrary to the position in the English law where only the liquidator may apply to court in similar circumstances. See 5 2 2 4 *infra.*
[14] 1986.
[15] Insolvency Act 1986, s 213. See generally Goode *Principles of Corporate Insolvency Law* (1997) 456-458.
[16] Insolvency Act 1986, s 214. See generally Goode *Principles of Corporate Insolvency Law* (1997) 458-473.

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trading by the company to be liable to make such contributions to the company's assets as the court thinks proper.[17]

This will happen when it appears in the course of the winding-up of the company that any business of the company was carried on with the intent to defraud creditors of the company (or any other person), or for any fraudulent purpose. [18]

To establish fraudulent trading there has to be actual dishonesty, involving real moral blame. It is not enough to show that the company continued to run up debts even though they knew that the company was insolvent.[19] What is wrong is to allow a company to incur debts when it was clear that it would never be able to satisfy its creditors. It has been decided that directors would not be guilty of fraudulent trading if they incurred credit while they:[20]

> "genuinely believe that the clouds will role away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression".

This test was, however, subsequently disapproved of in *R v Grantham.*[21] The court held that the test was not whether the directors thought that the company would be able to pay its way at some indeterminate time in the future but whether they thought that the company, in incurring further credit, could pay its debts as they fall due or shortly thereafter. If they realised that the company would not be able to do so they would be guilty of fraudulent trading even if they had some expectation that some day all debts will be paid.

This provision for criminal and civil liability, however, applies only in a winding-up of the company and it is only the liquidator that may apply to the court. Furthermore, it is clear that any contributions to be made should only be made to the company's assets and will thus benefit the body of creditors as a whole. This limitation is reasonable where it is the liquidator that brings the application and thus exposes the assets of the company to an order for costs.

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[17] Insolvency Act 1986, s 213(2).
[18] Insolvency Act 1986, s 213(1).
[19] Sealy & Milman *Annotated Guide to the Insolvency Legislation* 251 and also Goode *Principles of Corporate Insolvency* (1997) 457.
[20] *Re White & Osmond (Parkstone) Ltd* unreported but referred to in *R v Grantham* [1984] 2 All E R 166. See also Goode *Principles of Corporate Insolvency Law* (1997) 457.
[21] [1984] 2 All E R 166.

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Before the present provisions were enacted it was still possible for an individual creditor to invoke the corresponding section and the court could then order a payment in favour of the creditor. In this way the general body of creditors received no benefit at all.

5 2 2 2 *Extent of the liability of fraudulent trading.*

The court is permitted to declare the wrongdoers liable to make such contributions to the company's assets as the court deems fit. The wording is so wide that the court would be able to include a punitive amount if it deems fit. In addition to the payment of compensation a person who is guilty of fraudulent trading may also be subject to criminal sanctions and possible disqualification as director.[22]

5 2 2 3 *Establishing liability for wrongful trading*

Wrongful trading is aimed at compensation for the benefit of the company creditors in the case of mismanagement of the company.

To hold a person liable for wrongful trading the company must have gone into insolvent liquidation. The person, at some time before the commencement of the winding-up, must have known or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. And the person should have been a director at the time. If these requirements are to be met the court must also be satisfied that the person did not take every step with a view to minimising the potential loss to creditors he ought to have taken.[23]

The requirement of an insolvent liquidation illustrates the interaction between wrongful trading and administration. If administration is successful insolvent liquidation would be avoided and so too liability for wrongful trading.

Goode[24] makes an important point when he shows that the liability for wrongful trading does not follow on mismanagement that takes the company to the brink of insolvency. It is what happens from that point onwards that is decisive. The director must then take steps to minimise the potential loss to creditors. A cessation of trading activities is not an automatic escape as that would not by itself necessarily minimise the loss to creditors. The director will have to analyse the company's situation and

[22] See s 458 of the English Companies Act 1985 and the Company Directors Disqualifications Act 1986, s 4 and s 10.
[23] Insolvency Act 1986, s 214(2) and (3).

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carefully decide what steps to take. This may involve the help of outside professionals.

For the purposes of this provision the term "director" also includes a shadow director. A shadow director means a person in accordance with whose directions or instructions the directors of the company are accustomed to act, but not if the advice was given in a professional capacity.[25] Practically speaking this could include, depending on the particular circumstances, a controlling shareholder, even a parent company, "company doctors"[26] and in some instances also a lending bank exercising control for the protection of its loan and security. Examples of professional advisers who are excluded as shadow directors are solicitors, bankers or accountants, an administrative receiver and administrator.

The requirement that the director must have known or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation includes both an objective and a subjective element. The director will be measured against a reasonably diligent person having both the general knowledge, skill and experience that may be reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company and the general knowledge and experience that the relevant director has.

In this English law corresponds closely to Australian law and the recent developments in South African law.[27]

However, it is not enough to establish wrongful trading where the director knew that the company will not be able to pay its debts as they fall due. His knowledge should also extend to the fact the company's assets when sold would not meet the liabilities. Thus knowledge or deemed knowledge of commercial insolvency is not enough to trigger the wrongful trading provisions. It should be established that the director knew or ought to have known that the company was factually insolvent.[28]

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[24] *Principles of Corporate Insolvency* (1997) 465-466.
[25] Insolvency Act 1986, s 214(7) and s 251.
[26] See Goode *Principles of Corporate Insolvency Law* (1997) 466.
[27] South African law, however, uses this test in connection with recklessness, which requires worse behaviour than the English law's wrongful trading where the standard of behaviour is even higher than is required to avoid liability for mere negligence, because of the subjective element.
[28] Goode *Principles of Corporate Insolvency Law* (1997) 469 and Fletcher *The Law of Insolvency* 662.

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5 2 2 4 *Extent of the liability for wrongful trading*

The court may declare that the person liable for wrongful trading must make such contribution to the assets of the company as the court thinks fit.

Again it is noticeable that the contribution should go to the company's assets and that the liquidator is the only person who can apply for the imposition of liability for wrongful trading.

5 2 2 5 *Escaping liability for wrongful trading*

Once the liquidator has proved the necessary requirements to trigger liability for wrongful trading the director can defend himself by proving that he took every reasonable step with a view to minimising the potential loss to the creditors. "Every step he ought to have taken" refers to those which would be known or ascertained or reached or taken by a reasonably diligent person. The reasonably diligent person is one having both the general knowledge, skill and experience reasonably expected of a person in the same role as the director and the actual general knowledge, skill and experience that the relevant director has.

Goode[29] gives some practical advice to directors on how to avoid liability for wrongful trading. He lists twelve points which can be summarised as follows:

Do not assume that to stop trading is the easiest way out, it might not minimise the potential loss to creditors. Consider the viability of the business carefully, insisting on a programme to reduce expenditure, increase income and improve cash flow. Ensure proper books are kept; hold frequent board meetings; evaluate performance against budgets; get appropriate outside help; keep major creditors informed and ensure that you are properly informed. Consider the appointment of an administrator or administrative receiver and if your contributions are regularly rejected, resign and record your reasons in a letter.

5 2 3 Australian insolvent trading provisions

5 2 3 1 *Establishing liability*

The provisions in the Australian legislation[30] establish a duty on the director of a company to prevent a company from incurring debts while insolvent. It also sets forth the liability if this duty is breached and the defences available to the director.

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Most importantly it is only directors which may fall foul of these provisions. However, "director" is defined to include a person occupying the position of director, irrespective of his actual designation and whether or not he has been validly appointed or duly authorised to act in that capacity and a person in accordance with whose directions or instructions the directors are accustomed to act.[31] The latter is also known as the "shadow director" provision.

This would leave consultants and auditors outside the ambit of the insolvent trading provisions especially when they only give advice in their professional capacity.

The second part of the insolvent trading provision is the insolvency requirement. For the purposes of this provision insolvency may be proved with the help of certain presumptions. If a company is being wound up because of insolvency and it can be proved that it was insolvent on any date in the twelve months preceding the presentation of the petition, then it will be presumed that it was insolvent from that date to the date of presentation of the petition of its winding-up.[32] A company will be insolvent if it is not able to pay its debts as they fall due.[33]

The liquidator wishing to claim from the director in terms of the insolvent trading provisions does not have to prove that the company was insolvent on the day that the relevant debts were incurred, but may make use of the presumption of insolvency for this purpose. It will then be up to the director to prove that the company was not insolvent at the relevant time.

Before any duty or liability of the company director can arise the company must have incurred a debt. It is thus important to establish the precise moment that the debt was incurred. This moment is determined by focusing on the circumstances of each case.[34]

For the insolvent trading provision to become operative against the director of the company there must also be "reasonable grounds" for suspecting that the company is insolvent or by incurring the debt and other debts at the same time as the debt in question, the company will become insolvent. The use of the words "reasonable grounds" introduces an objective test and it would not be possible for the director to

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[29] *Principles of Corporate Insolvency* (1997) 472.
[30] Corporations Law s 588G and H.
[31] Corporations Law, s 60.
[32] Corporations Law, s 588E(3).
[33] Corporations Law, s 95A.

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claim that he did not actually know.[35] However it has also been held that to determine whether reasonable grounds existed the court should not only look to the facts that the director ought to have known, but the court should also consider the facts that he indeed knew.[36] This extends the ambit of reasonableness to the circumstances where the director was, whether by chance or otherwise, better informed than he ought to have been.

This approach is sensible and in keeping with the trend to require greater responsibility from directors. It is no longer possible to escape liability where a passive director was so inactive as not to have taken part in the business of the company at all. In this way enough pressure is put on directors not to close their eyes to reality and so be able to escape any responsibility.

In the case of a director the standard to judge reasonableness is by the standard appropriate to a director or manager of ordinary competence.[37]

5 2 3 2 *Extent of liability*

A breach of his duty in terms of the insolvent trading provisions exposes a director to an order for the payment of compensation to the company and the possibility of payment towards a creditor. Furthermore the statute also refers to the possibility of a civil or a criminal penalty.[38]

5 2 3 3 *Escaping liability*

The director who finds himself subjected to a claim in terms of the insolvent trading provisions has some statutory defences.[39] The director will escape liability if he can prove that at the time of the company incurring the debt, he had reasonable grounds to expect and did expect the company to be solvent at the time and that it would remain

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[34] For a full discussion on when a debt will be incurred see Australian Corporations & Securities Reporter par 166-500.

[35] *Commonwealth Bank of Australia v Friedrich & Others* (1991) 9 ACLC 946; *Group Four Industries Pty Ltd v Brosnan & Anor* (1991) 9 ACLC 1 181 see also *Australian Corporations & Securities Reporter* par 166-265.

[36] *Standard Charted Bank of Australia Ltd v Antico & Ors* (1995) 13 ACLC 1 381; see also *Australian Corporations & Securities Reporter* par 166-265.

[37] *3M Australia Pty Ltd v Kemish* (1986) 4 ACLC 185, *Rema Industries and Services Pty Ltd v Coal 5&Ors* (1992) 10 ACLC 530, see also *Australian Corporations & Securities Reporter* par 166-500.

[38] Crutchfield *Corporate Voluntary Administration Law* 24-25.

[39] Corporations Law, s 588H.

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solvent even if it incurred that debt and any other contemplated debts at the same time.[40]

Another possible defence is if the director can successfully prove that he relied on the information of a reliable person. This defence recognises that directors of ordinary competence who are actively part of the running of the company do rely on the information supplied to directors by senior and experienced executives and employees of the company. The director should prove that at the time that the relevant debt was incurred he had reasonable grounds to believe and did believe that a competent and reliable person (who was responsible to provide adequate information to him about the solvency of the company) expected the company to be solvent and to remain solvent. The provision of the information should have been in the fulfilling of the reliable person's responsibility.[41]

A third defence is for the director to prove that due to illness or some other good reason the director did not take part in the management of the company at the time.[42] And lastly, the director will also escape liability if he can prove that he took all reasonable steps to prevent the company from incurring the debt.[43]

In determining whether a director has proved the last defence above, the court should specifically have regard to the fact whether the director took any action with a view of appointing an administrator, when that action was taken and the results of that action. However, the court is in no way limited to looking only at those facts.[44] In providing this guidance to the court the legislature is clearly indicating that it wants to encourage the use of administration through the insolvent trading provisions.

5 2 4 Evaluation

The insolvent trading provisions are an answer to one of the major objectives of corporate insolvency namely the regulation of behaviour of participants in a credit economy.[45] However, the provisions that exist are not really effective in practice.[46] Goode[47] identifies the heavy burden of proof, the complicated financial evidence, the

[40] Corporations Law, s 588H(2).
[41] Corporations Law, s 588H(3).
[42] Corporations Law, s 588H(4).
[43] Corporations Law, s 588H(5).
[44] Corporations Law, s 588H(6).
[45] *Cf* 1 7 6 *supra*.
[46] See 1 7 5.
[47] Goode *Principles of Corporate Insolvency Law* (1997) 28-29.

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time-consuming and expensive preparation and the reluctance of liquidators and creditors to throw good money after bad as the practical obstacles. These contribute to the low level of use of the insolvent trading provisions. He contends that there is a growing use in England of the proceedings leading to the disqualification of directors instead.

The observations of Goode regarding the practical reasons for the low utilisation of the insolvent trading provisions are no doubt also applicable to the South African situation. This is not altogether difficult to understand in the light of the decision of *Ex parte De Villiers*. The grounds for taking a director to court and establishing his liability under section 424 of the Companies Act are difficult to prove. The effects of *Philotex* however could be that creditors will now be more inclined to go to the court in an attempt to hold the directors liable for the debts of the company. And such trend would encourage directors to put the company in judicial management as a way of escaping liability under section 424. The directors could then argue that they acted reasonably in the circumstances by putting the company in judicial management.

When the current provisions are considered it becomes clear that the South African insolvent trading provisions combine a criminal sanction with a provision for personal liability in section 424 of the Companies Act.[48] It is thus no surprise that fraudulent trading or recklessness are required before the insolvent trading provisions become operative.

This contrasts with the position in English law where the criminal sanction and the sanction for personal liability are separated. The criminal sanction requires fraudulent behaviour, whilst the standard of behaviour required to avoid civil liability for wrongful trading is even higher than that needed to avoid liability for negligence. Hence the wrongful trading provision imposes a positive duty on a director in certain circumstances to take every step with a view to minimising the potential loss to creditors as the director ought to have taken.[49]

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[48] Act 61 of 1973.
[49] See 5 2 2 3 *supra*.

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The provision for personal liability in the Australian law becomes operative in the case of mere negligence.[50] This contrasts sharply with the South African position where at least gross negligence is required.[51]

It is submitted that the proposal of De Koker should be followed and that the criminal sanction and the provision for personal liabilty should be separated. Fraudulent trading should remain as the prerequisite for criminal sanction. The provision for personal liability for debts incurred while the company is trading in insolvent circumstances should be based on mere negligence.

In its current form South African law makes a specific provision for shadow directors unnecessary. Section 424 is formulated widely enough to include the person who acts as a director, the power behind the throne, without being formally appointed as a director of the company.[52]

In terms of the South African legislation an application for the imposition of personal liability under section 424 may be brought by the Master, the liquidator, the judicial manager and any creditor, member or contributor to the company. It is not suggested that this should be changed to the restrictive English position where the liquidator is the only person who may institute proceedings for fraudulent or wrongful trading.

It would, however, encourage appropriate use of judicial management if the South African legislature expressly provides that putting a company into judicial management will be a relevant factor in an application for the imposition of personal liability when the court has to decide whether or not the director acted reasonably. The Australian legislation has such a provision.[53] This would give a clear indication that the legislature encourages company managers to seek early help.

Another strong encouragement to put a company into judicial management early enough to rescue the business would be provided if it were to be regarded as *prima facie* proof of reckless trading[54] if the company does not produce audited financial

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[50] De Koker "Personal liability and disqualification - sanctioning insolvent trading by companies" Paper delivered at Symposium on Corporate Insolvency Law Reform 23 October 1998, Pretoria 4 proposes that criminal liability should only follow fraudulent and reckless trading.

[51] *Philotex (Pty) Ltd v Snyman* 1998 2 SA 138 (A) 144A and also De Koker "Personal liability and Disqualification" 4.

[52] See 5 2 1 2 *supra.*

[53] See Corporations Law, s 588(6).

[54] Or negligence if the proposal of De Koker is accepted to make separate provision for personal liability on the grounds of negligence. See De Koker "Personal liability and disqualification" 12-16 for draft legislation of these provisions.

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statements within fifteen months after the end of the financial year. This submission is linked to the proposal that a company would be deemed probably unable to meet its obligations when the company has not produced audited financial statements within fifteen months after the end of its financial year as proposed above.[55]

5 2 5 Draft legislation to give effect to the proposals

De Koker's proposal requires amendments to a section of the Companies Act falling outside the chapter on judicial management. The draft legislation in this thesis is restricted to provisions on judicial management. However, regardless of whether new insolvent trading provisions are introduced or not, the two subsections suggested below should be incorporated into the existed or any revised provisions.

On the assumption that the present legislation is not changed it is suggested that the following subsections should be added to section 424 of the Companies Act, 61 of 1973.

Subsection (5):

> Where the court has to decide whether a person recklessly carried on the business of the company for the purposes of subsection (1) the court must take into consideration whether that person endeavoured to place the company in judicial management, when the person endeavoured to place the company in judicial management and the result of his or her actions to do so.

Subsection (6):

> Where the court has to decide whether a person or persons recklessly carried on the business of the company for the purposes of subsection (1) the fact that the company has no audited financial statements within fifteen months after its year end is *prima facie* proof of recklessness.

5 3 **Disqualification of company directors**

The insolvent trading provisions discussed above may and should be an important incentive to the director to act early on the financial woes of the company and place it in judicial management. The disqualification of directors may play a similar role. Whether this is possible and indeed the case will discussed after a brief explanation of the relevant disqualification provisions in the three jurisdictions.

[55] See 3 3 5 *supra*, proposed s 1(5).

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5 3 1 Disqualification of directors (South Africa)

Provisions on the disqualification of directors are to be found in the Companies Act.[56] These provisions in their current form do little to encourage the use of the judicial management procedure.

The Companies Act[57] provides for the automatic disqualification of the following persons from being directors of a company, namely: a body corporate; a minor or other person under legal disability; and any person who is the subject of any order under the Companies Act[58] or the repealed Companies Act[59] disqualifying him from being a director. The following are automatically disqualified from the office of director except with the consent of the court, namely an unrehabilitated insolvent; a person removed from an office of trust on account of misconduct; and, a person who has at any time been convicted of one or more of a series of offences[60] and who has been sentenced as a result to imprisonment without the option of a fine or to a fine exceeding 100 rand.[61]

The Companies Act also provides for disqualification by the court[62] when a person has been convicted of an offence in connection with the promotion, formation or management of any company; or the court has made an order for the winding-up of a company and the Master has made a report under the Companies Act stating that in his opinion a fraud has been committed by the person in connection with the promotion or formation of the company; or by any director or officer of the company in relation to the company since its formation; or in the course of the winding-up or judicial management of a company it appears that any such person has been guilty of an offence referred to in section 424 (whether or not he has been convicted of that offence); or, has otherwise been guilty while an officer of the company of any fraud in relation to the company or of any breach of his duty to the company.

[56] Companies Act 1973 61 of 1973 s 218 and s 219.
[57] Companies Act 61 of 1973 s 218.
[58] Act 61 of 1973.
[59] Act 46 of 1926.
[60] Offences including theft, fraud, forgery or uttering a forged document, perjury, an offence under the Prevention of Corruption Act, 1985, or any offence involving dishonesty or in connection with promotion, formation or management of a company. Companies Act 61 of 1973 s 218(d)(iii).
[61] See regarding the exercise of the court's discretion *Ex parte Barron* 1977 3 SA 1099 (C); *Von Steen v Von Steen en 'n ander* 1984 2 SA 251 (T); *Ex parte Tayob and Another* 1989 2 SA 282 (T) and *Nusca v Da Ponte and others* 1994 3 SA 251 (B).
[62] Companies Act 61 of 1973 s 219.

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There is however no reported case of the disqualification of a director by the court in terms of section 219. It is thus safe to conclude that the latter provision at least does little to encourage directors to put companies in judicial management.

5 3 2 Disqualification of directors (England)

5 3 2 1 *Company Directors Disqualification Act*[63]

An order for the disqualification of a director in terms of the Act means that the person concerned may not without the permission of the court be a director, liquidator or administrator of a company, or be a receiver or manager of a person's property, or in any way, directly or indirectly, be concerned or take part in the promotion, formation or management of a company.[64] The disqualification thus effectively prohibits a person to act as a director or a *de facto* director or a shadow director for the period determined by the court.

The disqualification can be directed against any person as the Act only prescribes the grounds for disqualification and the disqualification from acting as a director. Thus it does not only apply to persons who have previously acted as directors and are thus disqualified because of their actions as directors.

The Act provides for grounds for a discretionary, mandatory and automatic disqualification. The maximum period of disqualification varies between five years and fifteen years depending on the ground for disqualification.

The grounds upon which the court has a discretion to order disqualification are:

> conviction for an indictable offence in connection with the promotion, formation, management or liquidation of a company, or with the receivership or the management of a company's property;[65]
>
> persistent default in relation to provisions of the companies legislation requiring any return, account, notice or other document to be filed with or delivered to the Registrar of Companies;[66]

[63] See generally Goode *Principles of Corporate Insolvency Law* (1997) 477-493 and Fletcher *The Law of Insolvency* 668-670.
[64] Company Directors Disqualification Act 1986, s 1.
[65] Company Directors Disqualification Act 1986, s 2.
[66] Company Directors Disqualification Act 1986, s 3 and s 5. Persistent default will be proved if the person was found guilty in relation to any of the above offences three or more times in the five years preceding the application. A disqualification may also be made if the person was summarily convicted of any of the offences mentioned above.

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fraudulent trading or any other fraud in relation to the company or breach of duty as officer, liquidator, receiver, or manager; and [67]

a finding, following a statutory investigation, that the person is unfit to be concerned with the management of a company,[68] or has participated in wrongful trading.[69]

The court has no discretion and must make a mandatory disqualification in the case where a director is found to be unfit to act as director. This arises in cases where the person was a director of a company which has become insolvent and the conduct of the director (including a *de facto* and shadow director) makes him unfit to be concerned in the management of a company.[70]

A person will be automatically disqualified to act as a director, without the leave of the court, where he is an undischarged bankrupt, or where upon his default in payment of a county court administration order the court revokes that order.[71]

5 3 2 2 *Curbing the Phoenix syndrome*[72]

The Phoenix syndrome is the phenomenon where a company goes into liquidation and soon after another company under the same management and with the same or a similar name appears doing the same business. Although a company goes into liquidation the name of the company may still have a great deal of goodwill attached to it or may still have a high market recognition which still leaves the company name as a valuable asset.

In order to curb this practice the English Insolvency Act provides that a director of a company that has gone into insolvent liquidation cannot be a director (or a shadow director) of a second company using the same (or a similar) name to that of the failed company.[73] This prohibition lasts for five years.

[67] Company Directors Disqualification Act 1986, s 4.
[68] Company Directors Disqualification Act 1986, s 8.
[69] Company Directors Disqualification Act 1986, s 10.
[70] Company Directors Disqualification Act 1986, s 6.
[71] Company Directors Disqualification Act 1986, s 12.
[72] Milman "Curbing the Phoenix syndrome" 1997 *The Journal of Business Law* 224 used this expression. See also Coburn "The Phoenix Reexamined" 1998 *Australian Journal of Corporate Law* 321.
[73] Insolvency Act 1986, s 216.

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The Insolvency Rules provides for three exceptions.[74] The first is where the successor company buys the whole or substantially the whole business from the insolvency practitioner acting in respect of the first liquidated company. Proper notice of this must however be given to the creditors of the first company. Secondly, leave from the court may be sought to act as director provided that the application was brought within seven days after the liquidation of the first company.[75] The court when considering whether to give leave under this exception will often make use of its power to require the liquidator to furnish a report on the conduct of the director. The third exception applies when the company was known by the relevant name for the whole of the twelve months prior to the liquidation of the first company and it was not dormant for any portion of those twelve months.

This section is very helpful in curbing the undesirable practice of unscrupulous businesspersons reinventing themselves while leaving a mass of unpaid debts in their wake. This prohibition applies automatically and independently of guilt or blameworthy conduct on the part of the director.

If a person falls foul of this provision in the Act he is liable to a fine or imprisonment or both.[76]

5 3 3 Disqualification of directors (Australia)

Unlike the situation in England, but similar to the position in South Africa there is not a separate statute to deal with the disqualification of directors. The relevant provisions are found in the Corporations Law.

An insolvent under administration is prohibited from managing a corporation without the leave of the court.[77] The rationale for this prohibition is to prevent a person who has a history of insolvency from taking part in commercial activities in a managerial capacity in connection with a company.[78]

If a person has repeatedly breached the Corporations Law, failed to prevent the company from repeatedly breaching the Corporations Law, or has acted dishonestly or

[74] Insolvency Rules 1986, rr 4.228-4.230.
[75] Insolvency Act 1986, s 216(3), Insolvency Rules 1986, r 4.229.
[76] Insolvency Act 1986, s 216(4).
[77] Corporations Law, s 229(1).
[78] *Re Altim Pty Ltd* [1968] 2 NSWR 762, see also Cassidy "Disqualification of Directors Under the Corporations Law" 1995 *Company and Securities Law Journal* Vol 13 221.

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failed to exercise a reasonable degree of care and diligence, the prescribed applicants may apply to the court to make a disqualification order against that person.[79]

The ASC may also apply to the court for the disqualification of a person where the person was part of the management of a corporation and the management was wholly or partly responsibly for the failure of the corporation, resulting in its insolvent winding-up, its official management, insolvency, its inability to satisfy a levy of execution, or the appointment of a receiver, or where the management entered into a compromise or arrangement with the corporation's creditors.[80]

The ASC moreover has the power, without the intervention of the court, to disqualify a person from taking part in the management of the company.[81] The ASC can exercise this power where the person was a director of two or more companies during the twelve months prior to the winding-up of those companies; those companies were wound up within seven years of each other; the liquidator has lodged a report regarding the conduct of persons involved in the management of the company; and the liquidation dividend was less than 50 cents in the dollar.

Persons disqualified from management of a company may not be a director, a promoter, or in any way be concerned in or take part in the management of a corporation whether directly or indirectly.

The Australian law does not seem to attach much importance to the disqualification of directors. The grounds for disqualification are not as numerous as one would expect, but there has nevertheless been a slight increase in the number of disqualifications in recent years.[82] It is thus clear that official encouragement to make use of administration stems from other sources and not from the statutory provisions for disqualification of directors.[83]

5 3 4 Evaluation

The disqualification procedures are important in any insolvency regime. However they will not easily encourage the incumbent management to put a company into judicial management, unless they are vigorously enforced. Enforcement should not

[79] Corporations Law, s 230.
[80] Corporations Law, s 599.
[81] Corporations Law, s 600.
[82] Cassidy *Disqualification of directors* [1995] 239.
[83] See insolvent trading provisions and taxation.

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depend on the eager participation of the company's creditors. By the time that a liquidation procedure is in full swing, creditors are often reluctant to put a lot of energy into such procedures.

De Koker proposes that South African law should add personal liability for insolvent and fraudulent trading to the grounds for the disqualification of a director in terms of section 218 of the Companies Act.[84]

The South African law is however also lacking in not having provisions similar to those in England to curb the phoenix syndrome.[85] These provisions would not only put a stop to undesireable phoenix companies, but would encourage a director rather to put a company into judicial management in order to save the company instead of liquidating it and losing a valuable asset like the company name.

Coburn, however, warns that voluntary administration may actually assist those responsible for phoenix company activity. This tendency flows from the possible appointment of an administrator who is too friendly towards the directors of the company in a situation where creditors are just interested in writing off their losses and putting the matter behind them.[86]

This problem is less of a threat where the judicial manager would be able to recover assets by the avoidance of antecedent transactions.

5 4 The use of section 311 of the Companies Act as a corporate rescue measure

In the South African context section 311 of the Companies Act is often employed as a corporate rescue mechanism. It is submitted that the current use of this provision undermines the use of judicial management.

Section 311 plays an important role in company law. It provides the machinery whereby a compromise or arrangement can be made between a company and its creditors (or any class of them) or between a company and its members (or any class of them). It is intended that section 311 may be used where a company needs to negotiate with persons, such as creditors or members, who have claims against it with a view to altering those claims in the common interest. Claims against a company often vest in large groups or classes of persons. It might therefore be impossible for

[84] De Koker "Personal liability and disqualification." 17.
[85] See 6 3 2 2.
[86] Coburn 1998 *Australian Journal of Corporate Law* 325.

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the company to negotiate with these persons individually. The company thus needs a procedure to negotiate with them collectively. The procedure should also enable the company to bind all the persons of a group or a class to the agreement reached with the required majority. Section 311 is the legislature's answer to this need.

5 4 1 Scheme of arrangement section 311

The commercial world has enthusiastically utilised section 311 in a slightly different role, as indicated above. It has become the main tool for rescuing the corporate cadaver where the company is insolvent or has already gone into liquidation. For this purpose a "standard scheme", which is briefly explained below was developed to bring the whole "corporate rescue" within the ambit of section 311.

There is little doubt that the development and continued use of the standard scheme in terms of section 311 is driven by a desire to gain tax benefits rather than to achieve a proper business rescue.[87] The whole arrangement and its terms are thus geared to preserving an assessed loss for taxation purposes and very little or no attempt is made to incorporate any of the provisions to be found in a proper business rescue.

> "What is not always readily appreciated is that the terms of the scheme of arrangement with which these decisions are overtly concerned are to a significant extent dictated by a *deus ex machina,* namely, section 20(1)(a)(ii) of the Income Tax Act, 58 of 1962."[88]

It is clear that the standard scheme in terms of section 311 shows no concern for the creditors of the company.

> "The most expeditious and economic means of acquiring a company in financial difficulties and, at the same time, ridding a company of its existing creditors is through the mechanism of section 311 of the Companies Act."[89]

The standard scheme is mostly employed where someone wants to acquire a company which enjoys an assessed loss for income tax purposes. The target company is nearly always in provisional or final liquidation.[90]

[87] Delport "Die Appèlhof en Standaardskemas in die Maatskappyereg" 1996 *SA Merc LJ* 377 385; Anonymous "Company Schemes of Arrangement: preserving the Assessed Loss" 1989 *The Taxpayer* 26; RDJ "Schemes of Arrangement - a new Development" 1989 *Income Tax Reporter* 7; Getz & Jooste "Section 311 of the Companies Act: Preserving the Assessed Loss" 1995 *Acta Juridica* 56.
[88] Anonymous "Company Schemes of Arrangement: preserving the Assessed Loss" 1989 *The Taxpayer* 26. Section 20(1)(a)(ii) of the Income Tax Act is the provision which determines that an assessed loss will be reduced by the amount of a compromise between the taxpayer and any of his creditors.

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In terms of the standard scheme, the would-be acquirer offers to make an amount of money available. This money is meant to be distributed amongst the creditors of the target company. Normally, secured and preferent creditors would be paid to the extent of the value of their security or preference. The concurrent creditors however only receive a dividend which is a percentage of their claims against the company.

Only creditors who prove their claims in terms of a prescribed procedure, generally at a creditors' meeting, will be paid. This payment will be done once the scheme is approved by the court.

On the occurrence of a predetermined event the creditors are deemed to have ceded their claims against the company to another, normally the would-be acquirer or his nominee. This predetermined event is mostly the approval of the scheme. The amount ceded would normally be a fraction less than the full claim against the company. In most instances the amount deemed to be ceded would be 1% less than the full amount.

On the approval of the scheme the company is released from liquidation.

The advantages of the standard scheme to the acquirer are that the tax loss of the company is preserved and the company has got rid of its creditors. The acquirer can use the preserved assessed loss to diminish the tax liability of his own profitable business and furthermore the new acquirer is in a strong position towards the company in that he is now the major creditor of the company.

This standard scheme raises different issues to be addressed in order to comply with the law and commercial needs and in the interests of greater commercial morality. It also points to shortcomings in the present companies and tax legislation.

The different issues that are raised by the standard scheme include whether the standard scheme really falls within the provisions of section 311 of the Companies Act; the treatment of creditors of the target company; the overpowering importance of preserving the assessed loss for taxation purposes; and several issues with regard to the continued insolvency of the company.

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[89] RDJ "Schemes of Arrangement - a new Development" 1989 *Income Tax Reporter* 7.
[90] *Namex (Edms) Bpk v Kommissaris van Binnelandse Inkomste* 1994 2 SA 265 278C-D.

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5 4 1 1 *Does the standard scheme fall within the provisions of section 311*

It is not the object of this thesis to resolve the issue of the legality of the standard scheme. This has been the subject of numerous court cases and articles.[91] For the purposes of this thesis it is enough to accept that the standard scheme will be allowed in terms of section 311 especially since its *obiter* approval by the former Appelate Division in *Namex (Edms) Bpk v Kommissaris van Binnelandse Inkomste.*[92]

5 4 1 2 *Treatment of the creditors*

The treatment of the unsecured creditors in the standard scheme leaves much to be desired. The issue was addressed in *Ex Parte Kaplan & others NNO: In re Robin Consolidated Industries Ltd.*[93] The judge pointed to the shortcomings in the proof of claims, the acceptance of late claims and related matters. To counter these the courts developed guidelines to be included in standard schemes to ensure the fair treatment of creditors.

It is clear that creditors are not part of the future of the company as they are seen as a mere irritant from which the company should be rid.[94] It is understandable that the creditors are so treated, because the company is often in such dire financial circumstances that the creditors have lost hope of recovering much. The company is most probably in provisional liquidation already and the creditors are not part of any plan of future conduct for the company. The creditors are merely left with the choice to accept a dividend now or risk receiving less later.

> "In these circumstances the creditors of the company are very likely to be amenable to an offer of a reduced pay-out to their claims. They will be persuaded that if liquidation runs its often lengthy course, accompanied by its

[91] See *Ex Parte Kaplan & others NNO: In re Robin Consolidated Industries Ltd* 1987 3 SA 413 (T); *Ex Parte Millman &Others NNO: In re Multi-Bou (Pty) Ltd & others* 1987 4 SA 405 (K); *Ex Parte Strydom NO: In re Central Plumbing Works (Natal) (Pty) Ltd; Ex Parte Spendiff NO: In re Candida Footwear Manufacturers (Pty) Ltd; Ex Parte Spendiff NO: In re Jerseytex (Pty) Ltd* 1988 1 SA 616 (D); *Sackstein v Bolstone (Free State) (Pty) Ltd (In Liquidation) & others* 1988 4 SA 556 (O) and *Namex (Edms) Bpk v Kommissaris van Binnelandse Inkomste* 1994 2 SA 265 (A); see also Delport "Die Appèlhof en Standaardskemas in die Maatskappyereg" 1996 *SA Merc LJ* 377.

[92] 1994 2 SA 265 (A).

[93] 1987 3 SA 413 (W) 429-434.

[94] RDJ "Schemes of Arrangement - a new Development" 1989 *Income Tax Reporter* 7 quoted in 5 4 1 *supra* n 88.

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attendant costs and the merciless ravages of inflation, they will receive even less than what is offered to them."[95]

From a policy point of view it would be much better if the company were to be placed in judicial management before the stage of provisional liquidation is reached and that the treatment of creditors were to be regulated by legislation. The problem of the treatment of creditors can be better understood when one takes into consideration that the acquirer in the standard scheme "[is] more often than not ... an insider".[96]

The creditors cannot be assured treatment equal to that which they would receive in judicial management or liquidation. The procedure would neither secure future business relations, business trust, a continuation of the business or parts thereof nor preserve employment, all of which are some of the positive aspects which a proper business rescue procedure is intended to achieve.

5 4 1 3 *Preserving the assessed loss*

As pointed out above, the overwhelming desire driving the standard scheme is the desire to preserve the assessed tax loss of the company. This indicates that judicial management should at least leave the company no worse off as regards tax implications than the standard scheme. The tax implications of judicial management are discussed below.[97]

Suffice to say is that the preserving of the tax loss in judicial management would do much for the company's cash flow position once it starts trading profitably again. This has been recognised in both Australia and England.[98] If judicial management is at a tax disadvantage, the standard scheme will be preferred to judicial management regardless of the other benefits associated with a proper business rescue mechanism.

It is a somewhat more complex question as to whether or not the court should be party to an agreement or scheme of arrangement which intends to circumvent the Receiver of Revenue. It is a more difficult question, because everybody has the right to arrange his affairs in order to pay the minimum tax. However, even if the schemes are legitimate it is not an open door for minimising future tax liabilities. If the parties to

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[95] Getz & Jooste "Section 311 of the Companies Act: Preserving the Assessed Loss" 1995 *Acta Juridica* 56.
[96] *Ex Parte Kaplan & others NNO: In re Robin Consolidated Industries Ltd* 1987 3 SA 413 (T) 424.
[97] See 5 5 *infra*.
[98] See 5 5 *infra*.

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the standard scheme were to explain in their submissions to the court that their intention is to acquire an assessed loss the Receiver may disallow the application of the assessed loss in the post-scheme company in terms of the anti-avoidance provisions of the Income Tax Act.[99]

The court without actually ordering an illegal act may be in the position where it is used to present a carefully distorted picture to the Receiver. The court is thus in effect being made a party to misleading the Receiver.

5 4 1 4 *The continued insolvency of the company*

The standard scheme upon its implementation often leaves the company still insolvent despite the fact that the company was released from liquidation. This is due to the claims of the pre-scheme creditors of the company having been ceded to the acquirer which is now the major creditor of the company. The public policy ramifications of this and whether the court should approve such schemes have received much attention.[100]

In *Ex parte Lebowa Development Corporation Ltd*[101] the court was concerned about the phoenix character of the standard scheme of arrangement. The court eloquently describes the sequence of events which "has actually occurred so many times in the past as to be very familiar, and the repetition of which is placed in prospect by the present proposal".[102]

The company, having just been given a new lease on life after the section 311 scheme, puts on a new face with a name change, new premises, new letterheads and attractive signwriting. The company appears prosperous and this misleads

> "many smaller suppliers of goods and services in the market-place, sometimes one-man concerns, whose only real knowledge and ability relate to the particular service or product which they supply, and who have little knowledge or experience of company law or company financial statements.

[99] Income Tax Act, 58 of 1962, s 103.
[100] See *Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T); *Ex parte De Villiers NO: In re MSL Publications (Pty) Ltd (In Liquidation)* 1990 4 SA 59 (W); *Cooper v A & G Fashions (Pty) Ltd* 1991 4 SA 204 (K); *Ex parte De Villiers & another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation)* 1993 1 SA 493 (A); Willimse "Het die klokke Gelui vir Skikkings Ingevolge a 311 van die Maatskappywet?" 1989 *De Rebus* 205; Getz & Jooste "Section 311 of the Companies Act: Preserving the Assessed Loss" 1995 *Acta Juridica* 56.
[101] 1989 3 SA 71 (T).
[102] 98C.

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For a variety of reasons such smaller suppliers, when approached on behalf of an apparently prosperous company to supply goods or services on such usual terms as payment 30 days after invoice, readily do so without making further enquiries as to the company's ability to pay."

The court then gives various reasons why the supplier does not make further enquiries. However it is clear that the court is justly concerned about the unsuspecting future creditor of the company who does not know that this company was the subject of a standard scheme in terms of section 311 and rescued from liquidation without restoring the company to complete solvency.[103]

The court in *Ex Parte Strydom NO: In re Central Plumbing Works (Natal) (Pty) Ltd*[104] answered the concerns raised in *Ex Parte Lebowa* by saying:

"There are, for example, very many companies that commence business with a negligible share capital and can purchase the assets necessary for it to carry on its business only by means of its shareholders lending or advancing to it the funds required for this purpose. All of this is well known in the commercial world and persons who supply goods to companies have regard to the realities of the situation in considering whether or not to grant credit to the company. If they are not satisfied with the company's creditworthiness they may insist upon being paid in cash or refuse to supply. That is their prerogative. The Courts do not make their decision for them. And it is difficult to see why creditors or rather future creditors should enjoy any greater protection in cases where companies are released from liquidation following upon the sanction of a scheme of arrangement."

This view was largely endorsed by the former Appellate Division in *Ex parte De Villiers & another NNO: In re Carbon Developments*:[105]

"It is a common occurrence for a private company to embark on trading with a nominal paid-up share capital and to finance its business operations by way of

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[103] For an understanding of the possible damages done by such a phoenix character of the current application of section 311, see Coburn *Australian Journal of Corporate Law* 322 - 323.

[104] *Ex Parte Strydom NO: In re Central Plumbing Works (Natal) (Pty) Ltd; Ex Parte Spendiff NO: In re Candida Footwear Manufacturers (Pty) Ltd; Ex Parte Spendiff NO: In re Jerseytex (Pty) Ltd* 1988 1 SA 616 (D) 623.

[105] 1993 1 SA 493 (A) 503.

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> members' loans. Frequently, those loans are treated as if they were part of the capital of the company."

These remarks of the courts though conflicting show the concerns for creditors and the danger to creditors especially in a jurisdiction such as South Africa, which does not prescribe a statutory minimum capital. The remarks of the court in *Ex parte De Villiers* are only partly true. It may be a common occurrence for companies to be undercapitalised and financed by members' loans, but those loans are not treated as capital in the event of the liquidation of the company. In a liquidation those loans compete for the available assets with at least the concurrent creditors.

This problem of under-capitalisation of the company upon the approval of the scheme of arrangement has received attention and it is at present solved by the use of a so-called "subordination agreement". The subordination agreement purports to subordinate the claims ceded to the acquirer in the standard scheme to the claims of new creditors. Although subordination agreements were not always received enthusiastically, it is now widely accepted that a well-drawn subordination agreement will satisfy the conscience of the court regarding the need to promote commercial morality, causing it to sanction the standard scheme.[106]

A solution would be to change the order of preference on insolvency by legislation with the introduction of a statutory subordination of creditor rights of shareholders in their capacity as creditors to the claims of concurrent creditors.

5 4 2 <u>Changes to legislation</u>

In order to remedy the ailments of the standard scheme in terms of section 311, it is important not to make section 311 impossible to use as it plays an important role.[107]

The following suggestions are made to remedy some aspects of the standard scheme of arrangement in terms of section 311 without changing either its usefulness or its essence.

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[106] *Cf Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T); *Cooper v A & G Fashions (Pty) Ltd* 1991 4 SA 204 (K); *Ex Parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (in Liquidation)* 1993 1 SA 493 (A) 504 and Luiz & Van der Linde "Subordination Agreements - Are They Worth the Paper They Are Written On?" 1993 *SA Merc LJ* 100.
[107] *Namex (Edms) Bpk v Kommissaris van Binnelandse Inkomste* 1994 2 SA 265 (A) 294.

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5 4 2 1 *Change of company name*

Where a company has undergone a scheme of arrangement whilst in liquidation or provisional liquidation, the company should upon approval of the scheme and release from liquidation or provisional liquidation add to its name in brackets the words: "reorganised in terms of section 311". This could be abbreviated to (reorg sec 311). This name change should last for at least eighteen months or for such longer period as the court may determine.

This would warn future creditors of the possible dangers of which they would be otherwise unaware and which rightly concerned the court in *Ex parte Lebowa.* It would give a similar warning to outsiders as is intended by the compulsory use of "limited" at the end of the name of a company. It would moreover alert outsiders that the company had already experienced severe difficulties in the past and thus carries a slightly higher risk than even a newly formed company.

It would also alert the Receiver of Revenue to the immediate past of the company and would enable the Receiver to ask the necessary questions to determine whether to apply the discretionary power to attack the application of the assessed loss under the anti-avoidance provisions of the Income Tax Act.

5 4 2 2 *Introduction of a statutory subordination*

The problems of continued insolvency of the company emerging from the standard scheme in terms of section 311 can be solved by a statutory subordination of the claims of shareholders of the company who are at the same time shareholders or directors of the company. This could be done by changing the statutory ranking of claims of a company that was the subject of a scheme of arrangement in terms of section 311 of the Companies Act while it was in liquidation or provisional liquidation. The claims against the target company of shareholders or directors of such a company in their capacity as creditors would, from the approval of such a scheme of arrangement and the subsequent release from liquidation or provisional liquidation, statutorily rank below the claims of other creditors in a subsequent liquidation.

Such a change in legislation would solve any moral dilemmas of the court regarding continued insolvency. It would, together with the suggested name change of the company, be an answer to the issues raised in the *Lebowa* case and protect

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unsuspecting future creditors.[108] It would not interfere with the long-standing practice of private companies being under-capitalised and then funded by members' loans. The other benefits of having a member's loan against the company would be preserved and at the same time it would correspond with the views of the court in *Ex parte de Villiers* that such loans are often treated as capital.[109]

In the existing procedure of judicial management there is also a provision for a change in the statutory ranking of claims. The pre-judicial management creditors may consent to the preferent payment of claims that arise in judicial management. The subordination of claims of the shareholders and directors in their capacity as creditors would correspond with the current consent to preference in judicial management. The claims as creditors of the shareholders and directors arise from pre-scheme of arrangement transactions. They are included in the claims ceded to the acquirer under the standard section 311scheme.

A similar precedent in the form of equitable subordination exists in the United States of America.[110] There the bankruptcy courts, due to their equitable jurisdiction, are able to subordinate the claims of certain creditors in a winding-up. They used this power to evolve the practice of equitable subordination in corporate insolvencies.

The doctrine is especially applied in parent subsidiary relations in groups of corporations. The parent corporation might be ordered to subordinate its claims against a subsidiary when the subsidiary is liquidated.

The change should be introduced by the legislature and declare the circumstances where subordination of claims as creditors of shareholders or directors should take effect.

The changes to legislation proposed above would not significantly affect the usefulness of section 311 of the Companies Act. Where it is not used to preserve tax losses they would not make any difference. However, where section 311 is used as a corporate rescue procedure to preserve effectively the assessed tax loss, the proposed changes remove the unfavourable aspects of the current standard scheme. If this is done, the business community may acquire a new enthusiasm for a revitalised judicial

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[108] See 5 4 2 1 *supra*.
[109] See 5 4 1 *supra*.
[110] Schulte "Corporate groups and the equitable subordination of claims on insolvency" 1997 *The Company Lawyer* vol 18 no 1 2.

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management procedure. The proposed changes in legislation would only remedy those aspects of the section 311 standard scheme that cause problems.

5 5 **Assessed losses for taxation purposes**

The advent of the business rescue procedures and company voluntary arrangements brought with them certain problems relating to taxation. The solution to these problems have a significant impact on the decision of creditors in deciding upon the outcome of administration as well as on the prospects of survival of the company in administration.

For example, for the plan of future conduct to be accepted it will nearly always result in a compromise where creditors surrender part of their claims. The creditors may be faced with tax laws that do not treat such a reduction in a claim against the debtor as a deductible expense or bad debt. On the other hand the tax laws may treat the release from debt as a taxable income in the hands of the debtor company or the tax laws may reduce any assessed loss of the debtor company by the amount of the compromise agreed to by the creditors. The treatment of the compromise with creditors by the tax laws affects the future viability of the company undergoing a business rescue.

An important question is whether or not the company undergoing a business rescue will be able to continue to utilise the full value of an assessed loss accumulated in its favour. If the company is allowed to utilise the full value of its assessed loss it will enhance the possibility of a successful business rescue. It will mean that the tax liability of the company in its first years of recovery is less and that will in turn mean a much better cash flow.

England and Australia both realised the importance of the treatment of the assessed loss in a business rescue and both jurisdictions made policy decisions on the matter. Their policy is to enhance business rescue.

5 5 1 South Africa

The treatment of assessed losses in South Africa has not yet been properly considered in the context of judicial management. With the current requirement that a judicial management order will only be made if there is a reasonable probability that the company will be able to pay all its debts or meet all its obligations, the company will be allowed to utilise any assessed loss in its entirety.

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If however, the proposals in this thesis are accepted and a company is allowed to enter judicial management without the purpose of paying all of its debts or meeting all of its obligations, the treatment of the assessed tax loss will be affected by section 20 of the Income Tax Act.[111] If the company will not pay all its debts or meet all of its obligations it will invariably have to enter into a compromise with its creditors. The result of this compromise with creditors will be that they agree to accept a reduced amount in full settlement of their claims. The Income Tax Act stipulates that the assessed loss of the company in such circumstances will be reduced by the amount of the benefit to the company debtor.

Thus if the assessed tax loss of the company was valued at R1000, the company had debts of R1000 and the company reaches a compromise with its creditors whereby it will pay them 45 cents in the rand, the assessed tax loss will be reduced by R550 to R450.

The position is different under the standard scheme of arrangement in terms of section 311 of the Companies Act. Under the standard scheme the debts owed to the creditors are ceded and not diminished. The assessed tax loss is thus unaffected by the compromise provisions of section 20 of the Income Tax Act. This would represent a significant difference in the result reached through judicial management compared to that under a section 311 standard scheme of arrangement.

5 5 2 England

The problems described in the introduction to this section were also experienced in England with the introduction of the administration order procedure and company voluntary arrangements. These problems were clarified by the English Inland Revenue which made it clear that a deduction will still be allowed to the company under administration in respect of a debt or part of a debt released by the creditor as part of a voluntary arrangement or compromise, provided that the release was wholly and exclusively for the purposes of the debtor's trade, profession or vocation. This provision applies both for the benefit of debtor and creditor. Thus the deduction for the debtor company is not diminished by the amount released and at the same time the

[111] Act no 58 of 1962.

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creditor will be allowed to treat the released part of the debt as bad debts or debts estimated to be bad.[112]

These decisions and clarification were in response to the possible adverse effects of taxation on administration and as a gesture of support for the culture of business rescue.[113] Another interesting aspect was the clarification of the Inland Revenue's response as to how it would vote on proposals by the administrator, as the Inland Revenue would often be a substantial creditor, entitled to vote at meetings of creditors.

> "When deciding how to vote, the Revenue give consideration to, amongst other things, the way in which the taxpayer has attended to his tax obligations, the level of uncertainty over assets and liabilities and whether a voluntary arrangement is the appropriate course for the Revenue to approve as a creditor. The Revenue are also very much aware of the interests of other parties and of the purpose of the voluntary arrangement procedure."[114]

As to the liability for tax the administrator will not be personally liable for tax payments. Tax remains the liability of the company. The administrator can discharge that liability under his general powers and he is liable to account for the payment of PAYE and National Insurance Contributions deductions.

The appointment of a administrator does not mean the end of the accounting period of a company and group relations are not disturbed because of the administration order.[115]

5 5 3 Australia

There is nothing in the mere act of execution of a deed of company arrangement which brings about any change in the tax status of the company concerned.[116] This has the potential benefit that the company can preserve any assessed tax loss that it may have at that stage which would in turn be very beneficial for the company once it has completed its operational restructuring and is able to trade again. The cash-flow

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[112] *British Tax Reporter* par 171-500.
[113] See Institute of Charted Accountants in England and Wales (ICAEW) Technical Release 799, see also *British Tax Reporter* par 171-500.
[114] Institute of Charted Accountants in England and Wales (ICAEW) Technical Release 799 as reported in *British Tax Reporter* par 171-500.
[115] Brown *Corporate Rescue* 354 and 355.

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position of the company would be greatly enhanced if it does not have to make provision for any tax payments in the first year following the deed of company arrangement.

As Shtein[117] indicates the Commissioner of Taxation indicated that he does not consider the release of debt as a capital gain assessable in the hands of the debtor. Neither does such an amount released by the creditor amount to income in the hands of the debtor according to the ordinary principles and nor may the debtor's accounts be re-opened to make an adjustment to reduce the previous deductions as a result of the compromise.

It can however reduce the deductions allowed if the compromise refers to debts in the current tax year.[118] Thus where an Australian company has an assessed loss for taxation purposes that refers to taxation periods before the taxation period when the company was put into voluntary administration a compromise with creditors will not affect the amount of that assessed loss. Where the claims arose in the same taxation period as the taxattion period when the company was placed under voluntary administration the compromise will result in a reduced deduction from taxable income.

5 5 4 Evaluation

In order to promote the use of a revitalised judicial management procedure some reform of section 20 of the Income Tax Act is necessary. In this respect, England and Australia are useful examples. The Australian approach allows the assessed tax loss brought forward from previous years to remain unaffected by a compromise with creditors reached through voluntary administration. However, the debts of the current financial year affected by the compromise will only be allowed as a tax deduction to the extent of their after compromise value. It is submitted that South Africa should follow this approach. Such an approach would do much to foster a much needed business rescue culture and would promote the use of a reformed judicial management procedure. The business rescue culture would benefit even more if a similar

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[116] Shtein "The acquisition of reconstructed tax loss companies and trusts" 1995 *Australian Business Law Review* 411 at 420.

[117] Shtein "The acquisition of reconstructed tax loss companies and trusts" 1995 *Australian Business Law Review* 411 at 421.

[118] A further unknown factor is the effect of the proposed legislation in respect of "commercial debt forgiveness." It seems unlikely that the introduction of this legislation will alter the position of companies under administration or deed of company arrangement.

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concession does not apply to the assessed loss in a scheme of arrangement in terms of section 311.[119]

If such reform is not undertaken it will have a considerable effect on the use of judicial management as the section 311 standard scheme procedure will often be preferred. This will simply be because there would not be tax neutrality between the two options. As a result all the mechanisms for creditor participation and the rescue of the business undertaking instead of the corporate shell would be neglected.

[119] There is doubt whether the practice of keeping the assessed loss in a s 311 scheme of arrangement will continue after the decision in *The Commissioner for Inland Revenue v Datakor Engineering (Pty) Ltd* 1998 4 SA 1050 A. See Anonymous 1999 *The Taxpayer* 34 and Anonymous 1999 *The Taxpayer* 105.

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ANNEXURE

Section 0

(1) In this chapter, unless the context otherwise indicates-

'creditor connected to a director' means a director or his or her spouse or any juristic person in which a director or his or her spouse holds a controlling interest, whether alone or together, a partnership of which a director or his or her spouse is a partner, or a trust of which a director or his or her spouse is a trustee or a major beneficiary, or a person declared a creditor connected to a director by the court.

'prescribed financial contract' means a currency or interest rate swap agreement; a basis swap agreemnent; a spot, future, forward or other foreign exchange agreement; a cap, collar or floor transaction; a commodity swap; a forward rate agreement; a repurchase or reverse repurchase agreement; a spot, future, forward or other commodity agreement; an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities; any derivative, combination or option in respect of, or agreement similar to a currency or interest rate swap agreement; any master agreement in respect of any of the above agreements or contracts; a guarantee of the liabilities under any of the above agreements; or any prescribed agreement.

Section 1[1](Circumstances in which company may be placed under judicial management)

(1) When any company is or is likely to become unable to pay its debts and there is a probability that if it is placed under judicial management it would achieve one or more of the purposes referred to in subsection (3), it may be placed under judicial management.

(2)(a) The company may be placed under judicial management by:

(i) a special resolution of the company or a resolution of its directors. This resolution must be lodged by the end of the next business day with the Master, who must approve the appointment of the judicial manager nominated by the company, its directors or its members.

[1] Based on the Companies Act 61 of 1973 s 427; the (English) Insolvency Act 1986, s 8(3) and the (Australian) Corporations Law, s 436 A.

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(ii) an application to court by a member or a creditor or creditors or any prospective or contingent creditor or creditors or the provisional liquidator.

2(b) Before an application for judicial management is presented to the Court, a copy of the application and of every affidavit confirming the facts stated therein shall be lodged with the Master at the seat of the Court.

2(c) Despite the provisions of section 203(1) of the Companies Act a special resolution referred to in subsection 2(a)(i) takes effect when it is lodged with the Master.

(3) The purposes for which a company may be placed under judicial management are:

(a) the survival of the company, and the whole or any part of its undertaking, as a going concern;

(b) the approval of a plan of future conduct;

(c) the sanctioning under section 311 of the Companies Act of a compromise or arrangement; and

(d) a more advantageous realisation of the company's assets than would be effected by a winding-up.

(4) Judicial management commences when the Master approves the appointment of the judicial manager after the resolution referred to in subsection 2(a)(i) is lodged with the Master or when the court makes an order for judicial management in terms of subsection 2(a)(ii).

(5) A company is deemed to be likely to become unable to pay its debts if it fails to provide audited financial statements as required by s 286 of the Companies Act within fifteen months after the end of its financial year.

(6) The fact that an application for judicial management is opposed by a creditor seeking winding-up on one of the grounds in section 344 of the Companies Act will not by itself justify the refusal of a judicial management order if one or more of the purposes in subsection (3) are proved.

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Section 2[2] (Effect of judicial management)

(1) While the company is under judicial management all actions, proceedings the execution of all writs, summonses and other processes against the company are stayed and must not be proceeded with without the written consent of the judicial manager, or without the leave of the Court and on such terms and conditions as the Court may impose.

(2) Other processes in subsection (1) include the repossession without court intervention of or other steps by the owner or lessor of property to take control of property used by, in possession of or occupied by the company.

(3) Nothing in subsection (1) requires the leave of the court for the initial steps to bring an application for the winding-up of the company or the initial steps to obtain a judgment to enforce a security over the property of the company.

(4) Subject to subsection (5), if a contract to which the company is a party contains a clause that purports to vary the terms of the contract or to terminate the contract upon the company being placed under judicial management, such clause has no effect on the commencement of judicial management.

(5) The judicial manager has an election to continue with a contract referred to in subsection (4) without the clause becoming operative or to accept the variation or termination of the contract, provided that if the judicial manager elects to continue with the contract without the clause becoming operative the further obligations flowing from that contract must be complied with and must be treated as part of the costs of judicial management.

(6) Subsection (1) does not apply to prescribed financial contracts.

(7) The Master must issue guidelines to judicial managers how to exercise their discretion in subsection (1).[3]

Section 3[4]

(1) While a company is under judicial management, a person (other than the judicial manager) cannot perform or exercise, and must not purport to perform or exercise, a

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[2] Based on Companies Act 61 of 1973 s 428 (2) and Corporations Law s 440C.
[3] Alternatively basic guidelines could be provided for in statute and the Master must then issue supplementary guidelines.
[4] Based on Insolvency Act 1986, s 14 and Corporations Law, s 437C.

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function or power as an officer or director of the company, except with the written approval of the judicial manager. [5]

(2) Subsection (1) does not remove an officer or director of the company from office.

(3) The judicial manager has the power to remove any director of the company and/or to appoint any person not disqualified in terms of the Companies Act to be a director of it, whether to fill a vacancy or otherwise.

(4) A director removed from office in terms of subsection (3) will have not have any claims against the company or the judicial manager because of his removal.

Section 4

(1) The judicial manager must within 60 days of appointment (or such longer period as the court may allow):

(a) send to the Master and to creditors proposals for a plan of future conduct for the company for achieving the purpose or purposes of judicial management; and

(b) submit the proposals for a plan of future conduct to a meeting of the company's creditors convened for the purpose on not less than 10 days' notice.

(2)(a) The meeting of creditors referred to in subsection (1)(b) above may resolve, by a majority in number and a majority of sixty percent in value of claims:

(i) to accept the proposals for a plan of future conduct with or without modifications, but must not do so unless the judicial manager consents to each modification; or

(ii) that judicial management should end; or

(iii) that the company be wound up.

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[5] An alternative to subsection 1 could read:
(1) Any power conferred on the company or its directors, whether by the Companies Act or by memorandum or articles of association or common law, which could be exercised in such a way as to interfere with the exercise by the judicial manager of his powers is not exercisable except with the written consent of the judicial manager, which may be given either generally or in relation to particular cases.
The alternative subsection leaves less certainty as to the functions and powers of the directors, because the written consent of the judicial manager will be necessary for only some of the powers and functions that a director can exercise.

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2(b) (i) Creditors eligible to vote at the meeting referred to in subsection (1)(b) are creditors with proven claims against the company and such creditors allowed to vote by the judicial manager, but excluding all creditors who are also directors of the company or any creditor who are persons connected to such directors.

(ii) A secured creditor is allowed to vote at the meeting to the value of the unsecured portion of his or her claim against the company or to the full value of his or her claim if the creditor agree to forfeit his or her security.

(3)(a) If the proposals for a plan of future conduct are accepted in accordance with subsection (2)(a)(i) the directors of the company must within 7 days approve the proposals for a plan of future conduct in writing.

(b) In the event of the directors failing to accept the proposals within the period referred to in paragraph (a) the company is automatically under a creditors' voluntary winding-up, on the expiry of that period.

(c) Once the plan of future conduct becomes operative it binds the company and all creditors of the company whose claims against the company arose before or on the date agreed upon in the plan of future conduct, which date must not be later than the date on which the company was placed under judicial management.

(d) Secured creditors are bound by the plan of future conduct to the extent that they participated in the vote for the its approval.

(e) The plan of future conduct has no effect in so far as it discriminates unfairly against a dissenting creditor or future creditor.

(4) Once the proposals for a plan of future conduct have been approved by the creditors and directors the judicial manager must forthwith file a copy of the accepted plan of future conduct with the master and the registrar of companies and send a notice setting out the details of the plan of future conduct to all the creditors of the company.

(5) Upon the filing of the plan of future conduct with the Master the company is released from judicial management and the affairs of the company must be conducted according to the plan of future conduct.

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(6) The judicial manager is responsible for the execution of the plan of future conduct according to the role assigned to him or her in the plan of future conduct, provided that the plan of future conduct must not restrict any of the statutory powers of the judicial manager.

(7) The judicial manager may and must, if required by any creditor or creditors who alone or together hold ten percent or more of the value of the proven claims against the company, convene a meeting of creditors and at the meeting the creditors may resolve, with a majority in number and a majority of seventy-five percent in value to amend the plan of future conduct or to terminate the plan of future conduct and that the company be wound up.

(8) The judicial manager must apply to the court for the termination of the plan of future conduct where the judicial manager is of the opinion that it is no longer possible to achieve the goals of the plan of future conduct and that because of the urgency of the matter or otherwise it is not appropriate to convene a meeting under subsection (7) above. He or she may at the same time apply for the winding-up of the company.

(9) If the judicial manager is of the opinion that it is necessary to amend the plan of future conduct he may amend it by giving notice of the amendment to the Master where the amendment is not substantial, but if the amendment or amendments are substantial the administrator must obtain the approval of the creditors at a meeting of creditors convened for the purpose in accordance with subsection (7).

Section 5[6] (Transition to voluntary winding-up)

(1) The company is deemed to have passed a special resolution that the company be wound up voluntarily if:

(a) the directors of the company do not approve the proposals for future conduct within seven days after the creditors approved them at a creditors' meeting; or

(b) the creditors of a company under judicial management resolve that the company be wound up in terms of section 4(2)(a)(iii); or

[6] Based on Corporations Law, s 446A.

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(c) the creditors of a company governed by a plan of future conduct resolve to terminate the plan of future conduct and to put the company into liquidation in terms of section 4(7); or

(d) the circumstances for the winding-up of the company envisaged in the plan of future conduct have arisen.

(2) The judicial manager, his or her partner, business associate, employer or employee is disqualified from being appointed as liquidator of a company of which he or her was the judicial manager.

Section 6[7](Duties of the judicial manager)

(1) A judicial manager must:

(a) on appointment forthwith assume the management of the affairs, business and property of the company and recover and take possession of all the assets of the company;

(b) conduct such management, subject to the supervision of the Master, in such a manner as he or she may deem most economic and most promotive of the interests of the members and creditors of the company;

(c) lodge with the Registrar of Companies

(i) within 7 days after his or her appointment a copy of the letter of appointment as judicial manager;

(ii) in the event of the judicial management or the operation of the plan of future conduct being terminated, a notice of such termination;

(d) prepare and lay before the meeting convened in terms of section 4(2) a report containing

(i) an account of the business, property, affairs and financial circumstances of the company;

(ii) a statement of the reasons why the company is unable to pay its debts or is probably unable to meet its obligations;

[7] Based on Companies Act 61 of 1973 s 430 and s 433.

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(iii) a complete list of creditors of the company (including contingent and prospective creditors), specifying the amount and nature of the claim of each creditor;

(iv) the considered opinion of the judicial manager whether it would be in the interests of the creditors to accept the plan of future conduct; or for judicial management to end; or for the company to be wound up; and

(v) proposals for the plan of future conduct;

(e) convene and conduct all meetings of members and creditors required by this Act or requested in terms of this Act;

(f) keep such accounting records and prepare such annual financial statements as the company or its directors would have been obliged to keep or prepare if the company was not placed under judicial management;

(g) lodge with the Master copies of all such documents as prescribed or requested;

(h) examine the affairs of the company before the commencement of the judicial management order in order to ascertain whether any director, or past director, officer or past officer of the company has contravened or appears to have contravened any provision of this Act or has committed any other offence, and submit to the Master such reports as are in terms of section 400 of the Companies Act required to be submitted by a liquidator;

(i) examine the affairs of the company before the commencement of the judicial management order in order to ascertain whether any director, or past director, officer or past officer of the company is or appears to be personally liable to the company for damages or compensation to the company or for any debts or liabilities of the company, and to report to the Master and to the members and creditors the full particulars of any such liability;

(j) apply to the court for any order in terms of section 4(8).

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Section 7[8] (General powers)

(1) The judicial manager of a company:

(a) may do all such things as may be necessary for the management of the affairs, business and property of the company, and

(b) without prejudice to the generality of paragraph (a) has the powers specified in the Schedule.

(2) The judicial manager also has power to call a meeting of the members or creditors of the company.

(3) The judicial manager has the power to cancel onerous contracts provided that the cancellation thereof will be deemed to have occurred before the company was placed in judicial management.

(4) The judicial manager may apply to the court for directions in relation to any particular matter arising in connection with the carrying out of his or her functions.

(5) In exercising his or her powers the judicial manager is deemed to act as the company's agent.

Section 8[9] (Powers of investigation)

(1) Within 5 days of the company being placed in judicial management the directors must give a statement about the company's business, property, affairs and financial circumstances to the judicial manager.

(2) A director of a company under judicial management must attend on the judicial manager at such times; and give the judicial manager such information about the company's business, property, affairs and financial circumstances as the judicial manager may reasonably require.

(3) When a company is placed in judicial management the judicial manager may forthwith require some or all of the persons referred to in subsection (4) to furnish a statement of affairs of the company within such a period as the judicial manager reasonably requires.

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[8] Based on the English Insolvency Act 1986, s 14.

[9] Section 7 should not replace the existing avenues and powers of investigation that the judicial manager has in terms of Companies Act 61 of 1973 ss 439, 417, 414, 415, 416 and 418(2), but should

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(4) The persons for purposes of subsection (3) are:

(a) those who are or who have been officers of the company;

(b) directors and officers of an officer referred to in subsection (4)(a) who is a juristic person;

(c) those who at any time within one year before the company was placed under judicial management have taken part in the formation of the company; and

(d) company employees or anyone who was a company employee within one year before the company was placed in judicial management;

(5) The judicial manager may require any person to support any of the information given in terms of this section with an affidavit.

Section 9[10] (Preference to post-judicial management creditors)

(1) All liabilities incurred by the judicial manager in the conduct of the company's business must be paid in preference to all other liabilities not already discharged exclusive of the costs of judicial management, and thereupon all claims based upon such first-mentioned liabilities have preference in the order in which they were incurred over all unsecured claims against the company except claims relating to the costs of the judicial management.

(2) If the judicial management is superseded by a winding-up of the company the preference conferred to in subsection (1) shall remain in force except in so far as claims relating to the costs of the winding-up are concerned.

Section 10[11] (Appointment of the judicial manager)

(1) Upon the company being placed under judicial management

(a) all the property of the company concerned shall be deemed to be in the custody of the Master until a judicial manager has been appointed and has assumed office;

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complement those powers. Section 7 is based on the Australian Corporations Law, s 438B(2) and (3) and the English Insolvency Act 1986, s 22.

[10] Based on the Companies Act 61 of 1973 s 435(1).

[11] Based on Companies Act 61 of 1973 s 429.

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(b) the Master shall without delay appoint a natural person whom the Master regards as having the necessary qualifications, experience and skill as a judicial manager (who shall not be the auditor of the company or any person disqualified by the Companies Act from being appointed as liquidator in a winding-up) who shall give such security for the proper performance of the duties of judicial manager, as the Master may direct.

(c) the Master may appoint two or more persons jointly as judicial manager in terms of subsection (1)(b).

(2) The Master shall from time to time issue rules with regard to the qualifications and experience for judicial managers which the Master considers appropriate.

(3) Where a judicial manager is appointed in terms of subsection (1), the court may, on the application of a judicial manager or member or creditor or officer of the company, review the appointment of the judicial manager.

Section 11[12] (Remuneration of the judicial manager)

(1) The judicial manager is entitled to such remuneration for his or her services as may be fixed by the Master from time to time.

(2) The remuneration must be fixed either

(a) as a percentage of the value of the property with which the judicial manager has to deal, or

(b) by reference to the time properly given by the judicial manager and his or her staff in attending to matters arising in the judicial management, or

(c) based on an incentive scheme agreed to by the members and creditors, or

(d) any combination of the above, and

in fixing the remuneration the Master shall take into account the manner in which the judicial manager has performed his or her functions and any recommendation by the members or creditors of the company relating to such remuneration.

(3) The Master may reduce or increase the such remuneration if the Master is of the opinion that there is good cause for doing so, and may disallow such remuneration

[12] Based Companies Act 61 of 1973 s 434A and s 384(2) and Insolvency Rules 1986, r 2.47.

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either wholly or in part on account of any failure or delay by the judicial manager in the discharge of his or her duties.

(4) Where remuneration of the judicial manager is fixed by the Master in terms of this section, the court may, on the application of the judicial manager or of an officer, member or creditor of the company, review the remuneration and confirm, increase or reduce the remuneration.

Section 12[13] (Vacation of office)

(1) The judicial manager of a company may at any time be removed from office by order of court and may in prescribed circumstances resign his or her office by giving notice of such resignation to the Master.

(2) Sections 379 and 381 of the Companies Act relating to the removal of the liquidator by the Master and the control of the Master over liquidators apply to judicial managers, with the changes required by the context.

(3) The Master may remove a judicial manager of a company and replace him or her by another person if so requested by a meeting of creditors.

Schedule to the Act[14]

Specific powers of the judicial manager referred to in section 7.

The judicial manager has the power:

(a) to appoint and dismiss professionally qualified legal representatives and accountants to assist the judicial manager in the performance of his or her duties;

(b) to appoint and dismiss an agent or to employ a person to do any business which he or she is unable to do;

(c) to do all acts and execute documents in the name of the company;

(d) to make payments incidental to the performance of his or her functions;

(e) to draw, accept, make and endorse negotiable instruments in the name of and on behalf of the company;

(f) to raise loans or borrow money and grant security therefor over the property of the company;

[13] Based on the Insolvency Act 1986, s 19 and the Companies Act 61 of 1973 s 379 and s 381.

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(g) to make any arrangement or compromise on behalf of the company;

(h) to call meetings of the members or creditors of the company;

(i) to form a committee of creditors;

(j) to do all other things incidental to his or her functions.[15]

[14] Based on sch 1 to the English Insolvency Act 1986.

[15] The customary catch all.

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