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Business Rescue Feature

A DODGE FOR DIRECTORS

It has already been five years since the South African legislature introduced business rescue, a corporate restructuring procedure that, given the current economic climate, is a concept with which most corporates should now be familiar. Despite its progressive intentions and increasing popularity, business rescue is often abused, usually by directors and stakeholders who have in-depth knowledge of the affairs of the company, the causes and consequences of the financial demise of the company, and who are often the initiators of the process.

Business Rescue is designed to encourage recovery so that the business continues trading but the secondary object is to obtain the best possible result for creditors when recovery of the business is not possible. A loophole exists in this secondary object and this loophole is at the start of the business rescue process because it must be initiated before the company becomes insolvent. In other words, when the company is financially distressed. The first persons who would have knowledge of the affairs of the business would be the directors and stakeholders. Directors are (and rightly so) entitled (and in certain instances obliged) to initiate business rescue by filing a resolution contemplated in s129 and, following that, to appoint a business rescue practitioner (generally someone of their choice as long as they meet the requirements for appointment). Once the appointment is made, the business rescue practitioner, who assumes various powers and duties under the Companies Act, is obliged to carry out the process without interference. However, directors of the company must co-operate with and assist the business rescue practitioner.

The general moratorium on legal proceedings is essential to achieving the goals of business rescue and therefore, when a company is in business rescue, all legal proceedings against the company, including arbitration proceedings, are prohibited (unless one of the exceptions apply) or are suspended for the duration. However, the effect of the moratorium, coupled with the cumbersome requirement of being able to justify the "rescue" of a company through the secondary goal, opens the business rescue process to abuse. By filing a resolution for business rescue, directors will be able to use the process to strategically avoid paying the creditors of the company (for a protracted period at least) and prevent the liquidation of the company and the consequences which flow from it including insolvency enquiries, setting aside of voidable dispositions and directors attracting personal liability.

More often than not, business rescue practitioners advertise business rescue by playing on the moratorium, which is an attractive mechanism to fend off creditors and, in some instances, to fend off a formal enquiry by a creditor who wants to delve into the affairs of the company and the actions of its directors and officers. Directors, with full knowledge of their indiscretions and dealings in the business, possibly in contravention of legalisation (particularly the Insolvency Act and the Companies Act – which would invoke the sanctions mentioned and which might put them in the uncomfortable situation of having to explain themselves in insolvency enquiries) are incentivised to avoid the sanctions provided by such legislation and to pursue business rescue. The achievement of the secondary purpose of business rescue, given the South African Revenue Service's concurrent ranking (as opposed to preferent in liquidation proceedings) and the lack of judicial oversight of the business rescue process, coupled with the fact that the Companies Act provides no sanction for non-compliance by a business rescue practitioner with s141 of the Companies Act, creates the ideal mechanism for directors to abuse the business rescue process in what purports to be a legitimate manner.

Section 141 (1) of the Companies Act places an obligation on a business rescue practitioner to investigate the affairs of the company, its business, property and financial situation. In terms of ss141(2)(c), if the business rescue practitioner concludes that there is evidence of voidable transactions, reckless trading, contravention of law or fraud, he or she is then limited to directing management to take appropriate steps or (in the case of fraud, reckless trading or contraventions of law) report any such activity to the appropriate authorities. However, in the absence of clear direction as to what steps management should take in such circumstances, including what the sanctions are for non-compliance with these subsections, s141 is rendered toothless. Moreover, it is difficult to envisage how management (whilst a company is in business rescue) would take any necessary or appropriate steps to remedy situations where the behaviour described in these subsections is evident. In most instances the management of smaller companies will be undertaken by the directors and stakeholders, who may be responsible for the conduct. A further difficulty is that there is no obligation on the business rescue practitioner to bring any of these unlawful activities to the attention of the affected persons to the business rescue proceedings.

Business rescue has been a process of trial and error, and South African courts have the daunting task of interpreting the provisions of Chapter 6 of the Companies Act to give effect to the business rescue process. It was held in the case of *Sulzer Pumps (South Africa) (Pty) Ltd vs. O & M Engineering CC* that no court can allow business rescue to be used as an abuse of the court process. Courts, therefore, have a duty to ensure that the entry into business rescue is not feigned.

How does one then go about protecting the sanctity of the business rescue process without losing sight of its purpose? In our view, it would be prudent for the legislature to take cognisance of the practical difficulties and potential avenues of abuse which have occurred since the introduction of the concept of Business Rescue, with a view to formulating regulations and or amendments to Chapter 6 whereby:

- a form of judicial oversight over the business rescue process is introduced;
- business rescue practitioners are properly mandated and regulated in the manner in which they are to assess whether business rescue is appropriate after having had regard to the facts and circumstances in which business rescue is sought, including the reasons behind the directors passing a resolution contemplated in s129;
- section 141 is revisited and amended in such a manner to properly safeguard creditors and other affected persons' rights, including bringing to book persons who ought to be held responsible for the illicit behaviour described and allowing for any such evidence to be published, and brought to the affected person's attention;
- proper sanctions and remedies are introduced against business rescue practitioners, directors and affected persons who abuse business rescue proceedings.

It might also be necessary for courts to revisit the criticism levelled by the SCA in the matter of *Oakdene Square Properties and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd* in respect of the Western Cape High Court judgement in *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd*. In this regard, the SCA considered the test laid down in the *Southern Palace* judgement relating to when the requirement of a reasonable prospect of success is met as *"too stringent"*, and that there should not be general minimum criterion of what would constitute a reasonable prospect of success.

Business rescue is no doubt a process that is here to stay. It plays, and will continue to play an important part in the insolvency and restructuring space. However, in order for it to be regarded as a trustworthy and sustainable manner of restructuring, and a suitable alternative to the mere winding up a company, it is crucial that statutory safeguards are introduced to protect the rights of creditors and other affected persons who might not have the financial means to resort to litigation for purposes of highlighting and preventing abuse of the business rescue process.

Bell is a partner and Barnett an associate, Dispute Resolution practice with Baker & McKenzie.

Article by JOHN BELL AND JENNIFER BARNETT