A PRIVATE EQUITY STRUCTURE TO FACILITATE THE EFFECTIVE
POST-COMMENCEMENT FINANCING OF BUSINESS RESCUE

BY

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I declare that this dissertation is my own work. It is being submitted for the degree of Master of Laws at the University of Cape Town. It has not been submitted before for any degree or examination at any other University.

JUAN-PIERRE REINECK            FEBRUARY 2015
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‘If I have seen further it is by standing on the shoulders of giants’

– Sir Isaac Newton

This dissertation combines two comparatively new concepts in South African corporate law, being business rescue from the Companies Act 71 of 2008 and the financing of venture capital companies in the Income Tax Act 58 of 1962. The formulation of the tax efficient financial structure for post-commencement financing of business rescue as proposed in this dissertation would not have been possible without the guidance, insight and support of a number of people.

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ABSTRACT

Business rescue is a process through which a financially distressed company can be rehabilitated by providing for the temporary supervision of the company, the management of its affairs, business and property. Focused research indicates that one of the main reasons that business rescues in South Africa have failed is due to the lack of post-commencement rescue finance.

This dissertation puts forward a researched and suggested financial structure solution that combines two comparatively new concepts in South African corporate law, being business rescue from the Companies Act 71 of 2008 and the financing of venture capital companies in the Income Tax Act 58 of 1962.

The outcome of the suggested post-commencement finance structure is that the investors investing in this structured solution would receive an immediate benefit in the form of a tax deduction and a reduction in the financial risk exposure of the investment. In turn, the company in business rescue receiving the investment funds from this finance structure would also benefit from fewer cost burdens associated with traditional debt financing (i.e. servicing of the debt) and thereby increase the probability of a successful business rescue, concomitantly resulting in the improvement in economic activity and importantly, the retention of jobs in South Africa that it so desperately needs.
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A PRIVATE EQUITY STRUCTURE TO FACILITATE THE EFFECTIVE POST-COMMENCEMENT FINANCING OF BUSINESS RESCUE.

1. Introduction

1.1. The Challenge

The Companies Act 71 of 2008 (hereafter ‘Companies Act’) came into effect on 1 May 2011 and with it, Chapter 6, which has the completely new provision in South African corporate law for business rescue.

Business rescue is a process through which a financially distressed company can be rehabilitated by providing for the temporary supervision of the company, the management of its affairs, business and property. One of the effects of a company going into business rescue is that a temporary moratorium is introduced to protect the company from any possible adverse actions by its creditors. When a company is placed in business rescue by the court, a qualified business rescue practitioner is appointed and tasked with the development and implementation of a business rescue plan (if approved by creditors and/or securities holders) to rescue the company by restructuring its affairs - being the business activities, its property, debt, other liabilities and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis. If it is not possible for the company to continue on a solvent basis, the plan (if approved) should result in a better

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2 Section 128(1)(b)(i). Also see Welman v Marcelle Props 193 CC and Another [ZAGPJHC] 32 at para [28] - "In my view, business rescue proceedings are not for the terminally ill close corporations. Nor are they for the chronically ill. They are for ailing corporations, which, given time, will be rescued and become solvent."
3 Section 128(1)(b)(ii)
return for the company’s creditors or shareholders than would result from the immediate liquidation of the company.\textsuperscript{4}

Since May 2011, 1338 business rescue notices have been filed with the Companies and Intellectual Property Commission (CIPC). Of the 1338 notices filed, 1121 business rescue proceedings have started, of which 129 were substantially implemented. This gives business rescue a success rate of slightly less than 12 per cent since May 2011.\textsuperscript{5}

Focused research indicates that one of the main reasons that business rescues in South Africa have failed is due to the lack of post-commencement rescue finance.\textsuperscript{6} The current extent of post-commencement financing for business rescue in South Africa is little to non-existent.\textsuperscript{7} According to Du Preez there are eleven key reasons for financiers disinterest in post-commencement finance. In summary they are:

1. The impact of the profile and actions of the business rescue practitioner.
2. Business rescue filing by distressed businesses for the wrong purpose and filing too late.
4. Concerns and uncertainty regarding the priority ranking of post-commencement finance.


\textsuperscript{5} Annual report 2013/2014 (Companies and Intellectual Property Commission)


5. Banks are conservative and risk averse due to regulations such as Basel.²
6. The financier risks losing money.
7. Lack of cooperation by banks during business rescue proceedings.
8. Distressed business do not readily involve and engage with financiers upfront prior to filing for business rescue.
10. The availability of security.
11. Financiers do not have comfort in the business rescue plan based on a viable business.

Many of the reasons put forward by Du Preez for the lack of post-commencement financing have also been confirmed in a recent South African survey.⁹

This dissertation seeks to put forward a researched, suggested financial structure solution that will assist in the facilitation of effective post-commencement financing of business rescue in terms of section 135 of the Companies Act while, importantly, and at the same time, reducing the financial risk exposure to the investor providing finance.

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Reasons for lack of funding by distressed lenders has been confirmed as: “Timing” – businesses file for rescue too late and don’t bring their financial situation to the relevant stakeholders early enough; “Uncertainty of lack of knowledge” – general lack of knowledge and experience in the industry, and uncertainty around interpretation of the Act; “Risk and reward” – by virtue of the company being in distress, any funding advanced to it is at a higher risk and therefore requires a higher return; “Security” – the availability of adequate security is a critical determinant of the ability to obtain financing; “Post-commencement finance” – uncertainty around the legal ranking and priority of post-commencement financing.
1.2. Parameters of Study

Chapter 2 will briefly discuss the history of the South African corporate rescue\textsuperscript{10} legislation, and then analyse South African legislation on post-commencement finance in terms of section 135 of the Companies Act.

As this dissertation is focused on post-commencement finance, chapter 3 will only discuss foreign comparative law from the perspective of post-commencement finance. The foreign jurisdictions that will be examined include the United States of America, the United Kingdom, Australia, Canada, and China. In addition, the principles for effective insolvency and creditor rights systems of the World Bank will be considered, as well as the United Nations Commission on International Trade Law (UNCITRAL) recommendations for post-commencement finance.

Chapter 4 will examine private equity involvement in distressed debt investing and turnaround management of companies that are distressed.

Chapter 5 introduces the venture capital company in terms of section 12J of the Income Tax Act 58 of 1962 (hereafter ‘ITA’) and both the benefits and implication of these provisions, while chapter 6 suggests a proposed company structure for a venture capital company to utilise the ITA’s provisions.

Chapter 7 seeks to marry the section 12J venture capital company with the provisions of business rescue in order to facilitate effective post-commencement financing.

\textsuperscript{10} A Loubser “Some Comparative Aspects of Corporate Rescue in South African Company Law” (2010) UNISA LLD Dissertation
I hope that this research will be grasped and serve as a stepping stone to more successful business rescue post-commencement finance provision, concomitantly resulting in an improvement in economic activity and importantly, the retention of jobs that South Africa so desperately needs.

2.1. Introduction

Judicial management of a company was introduced by the Companies Act 46 of 1926. Judicial management underwent a few changes when the Companies Act 46 of 1926 was replaced by the Companies Act 61 of 1973, and has largely remained the same until the introduction of the Companies act 71 of 2008.\(^{11}\)

The Companies Act that became effective from 1 May 2011 introduced a new concept of business rescue in South African company law. Prior to the introduction of Chapter 6 of the Act that provides for business rescue, companies facing difficulty either needed to find a 'white knight'\(^{12}\) or faced liquidation.

Even though business rescue is to be welcomed, it goes without saying that a company finding itself in financial difficulty is going to be even further challenged in raising appropriate finance to continue trading. The provision for post-commencement financing, to assist a company in business rescue with finance, has been inserted into Chapter 6 of the Companies Act under section 135.

This chapter will briefly discuss the history of the South African corporate rescue\(^{13}\) legislation, and conclude with a brief analysis of South Africa’s post-

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\(^{13}\) Loubser op cit (n10)
commencement finance provisions in terms of section 135 of the Companies Act.

2.2. Judicial Management

Judicial management of a company was introduced by the Companies Act 46 of 1926 and underwent some changes when the Companies Act 61 of 1973 was introduced. The purpose of judicial management is to enable companies in financial trouble, as a result of mismanagement or any other cause, to once again become profitable going concerns.

The judicial management procedure entails an application by an interested party to the High Court for an order to have the company placed under judicial management. In order to obtain this court order, the applicant must prove that:

1. the company is unable to pay its debts or is probably unable to meet its obligations,
2. it has not become or is prevented from becoming a successful concern, and
3. there is a reasonable probability that if the company is placed under judicial management, it will be enabled to pay its debts or meet its obligations and thereby to become a successful concern.

In addition, section 427(1) also requires that it must appear just and equitable to the court to grant a judicial management order.

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14 Loubser op cit (n11) 153
15 Silverman v Doormdoek Mines Ltd 1935 TPD 349
16 A list of the interested parties that may apply to the High Court to have the company placed under judicial management can be found in section 346(1) of the Companies Act 61 of 1973
17 Section 427(2)
If the court is satisfied that the requirements in terms of section 427(1) have been met, a provisional judicial management order may be granted\textsuperscript{18} and that the return date, stated on the order, may not be more than sixty days.\textsuperscript{19}

After the provisional judicial management order has been granted, the Master of the High Court, of the particular provincial division of the court where the provisional judicial management order was granted, will appoint a provisional judicial manager.\textsuperscript{20} The provisional judicial manager takes over the management of the company\textsuperscript{21} and must prepare a report containing an account of the general state of affairs of the company\textsuperscript{22} and what the prospects are of the company becoming a successful concern again.\textsuperscript{23}

At the meeting of creditors, members and debenture-holders (if any), convened by the Master,\textsuperscript{24} the provisional judicial manager reports on the financial situation and prospects of the company. The meeting considers the report and indicates whether they regard it as desirable, and also if the provisional judicial management order should be made a final judicial management order. If they do, then they also nominate a candidate for the appointment as the final judicial manager, and the creditors are required to prove their claims.\textsuperscript{25}

On the return day of the provisional judicial management order, a final judgement order may be granted by the court if, after considering the provisional judicial manager report, Masters report, and view of the creditors, it is satisfied that the company will be able to become a successful going concern again and that it is just and equitable for the company to be placed

\begin{flushleft}
\textsuperscript{18} Section 428(1)  \\
\textsuperscript{19} Section 432(1)  \\
\textsuperscript{20} Section 429(b); see also Loubser op cit (11) 155  \\
\textsuperscript{21} Section 430(a)  \\
\textsuperscript{22} Section 430(c)(i)  \\
\textsuperscript{23} Section 430(c)(vi)  \\
\textsuperscript{24} Section 429(b)(ii)  \\
\textsuperscript{25} Section 431(2)
\end{flushleft}
under judicial management.\textsuperscript{26} If a final judicial management order is granted, the management of the company will vest with the final judicial manager that was appointed by the Master.\textsuperscript{27}

The Companies Act 61 of 1973 did not prescribe a specific term for judicial management, and the order was usually granted for an indefinite period.\textsuperscript{26} Judicial management could only be terminated by an order of the court which granted the final judicial management order by way of application by either the final judicial manager, or any person having an interest in the company.\textsuperscript{29}

\subsection*{2.3. Business Rescue}

One of the purposes of the Companies Act is to provide for the efficient rescue and recovery of financially distressed companies in a manner that balances the rights and interests of all relevant stakeholders.\textsuperscript{30} The Companies Act introduces the completely new provision of business rescue to South African corporate law. Bradstreet\textsuperscript{31} mentions that ‘the new business rescue provisions promote economic development in South Africa by nurturing the growth of emerging commercial endeavours and protecting companies in general from being effectively ‘axed’ by liquidation…’

Business rescue proceedings may be initiated and commenced in one of two ways – either by the company itself by way of a resolution by the board of directors of the company, or, by an order of court.\textsuperscript{32} The board of a company

\begin{itemize}
\item \textsuperscript{26} Section 432(2)
\item \textsuperscript{27} Section 432(3)
\item \textsuperscript{28} Loubser op cit (11) 155
\item \textsuperscript{29} Section 440(1)
\item \textsuperscript{30} R Bradstreet, \textit{“The Leak in the Chapter 6 Lifeboat: Inadequate Regulation of Business Rescue Practitioners May Adversely Affect Lenders’ Willingness and the Growth of the Economy”} (2010) 22 South African Mercantile Law Journal 195-213
\item \textsuperscript{31} Section 132(1). See also \textit{Investec Bank Ltd v Bruyns} 2012 (5) SA 430 (WCC) at para 12; \textit{Taboo Trading 232 (Pty) Ltd v Pro Wreck Scrap Metal CC} 2013 (6) SA 141 (KZP); Joubert v Pro Wreck Scrap Metal CC and others 2013 (6) SA 141 (KZP) at para 11.4; \textit{African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd and Others} [2013] 4 All SA 432 (GNP) at para 5.
\end{itemize}
may resolve that the company voluntarily begin business rescue proceedings and place the company under supervision, if the board has reasonable grounds to believe that the company is financially distressed and there appears to be a reasonable prospect\textsuperscript{33} of rescuing the company.\textsuperscript{34} Similarly, in respect of a court application, the court may make an order placing the company under supervision and commencing business rescue proceedings, if the court is satisfied that the company is financially distressed; or the company has failed to pay over any amount in terms of an obligation under or in terms of a public regulation, or contract, with respect to employment-related matters; or it is otherwise just and equitable to do so for financial reasons, and there is a reasonable prospect for rescuing the company.\textsuperscript{35} The court may also dismiss the application, together with any further necessary and appropriate order, including an order placing the company under liquidation.\textsuperscript{36}

Business rescue proceedings end when:\textsuperscript{37}

1. the court sets aside the resolution or order that began the business rescue proceedings, or has converted the proceedings to liquidation proceedings; or

2. the practitioner has filed with the Commission\textsuperscript{38} a notice of the termination of business rescue proceedings; or

\textsuperscript{33} In \textit{Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 (Pty) Ltd} 2012 (2) SA 423 (WCC), Eloff AJ stated “\textit{section 131(4) of the new Act uses the phrase “reasonable prospect” in respect of the recovery requirement. The use of different language in this latter provision indicates that something less is required than that the recovery should be a reasonable probability…The approach to business rescue in the new Act is the opposite [to the old Act] - business rescue is preferred to liquidation.}” See also \textit{Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami)(Pty) Ltd} supra (n4) at para 29.

\textsuperscript{34} Section 131(1)

\textsuperscript{35} Section 131(4)(a)

\textsuperscript{36} Section 131(4)(b). See \textit{CSARS v Beginsel NO and Others} 2013 (1) SA 307 (WCC) at para 57 where the court accepted, without deciding, that it has the power to intervene where it is shown that the business rescue practitioners have committed a material mistake in concluding that the continued implementation of the business rescue plan would result in a better return for the creditors of the company.

\textsuperscript{37} Section 132(2). See also \textit{African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd and Others} supra (n32) at para 5.

\textsuperscript{38} Companies and Intellectual Property Commission (CIPC)
3. a business rescue plan has been proposed and rejected, and no affected person has acted to extend the proceedings in any manner contemplated in section 153 of the Companies Act; or

4. alternatively, a business rescue plan has been adopted, and the practitioner has subsequently filed a notice of substantial implementation of that plan.

During business rescue proceedings, there is a general moratorium on legal proceedings against the company, as well as protection against its property interests. Only in certain instances may legal proceedings be commenced with against the company and the disposal of property by a company during business rescue proceedings may only be done in certain circumstances. The requirements found in section 112 and 115 of the Companies Act for the disposal by the company of all or a greater part of its assets or undertaking will have to be met, unless the disposal of such property forms part of an approved business rescue plan.

If, during a company’s business rescue proceedings, the company wishes to dispose of any property over which another person has any security or title interest (i.e. secured creditors), the company must obtain the prior consent of that other person, unless the proceeds of the disposal would be sufficient to fully discharge the indebtedness protected by that person’s security or title interest, and to promptly pay to that other person the sale proceeds attributable to that property up to the amount of the company’s indebtedness.

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39 Section 133. See also Investec Bank Ltd v Bruyns supra (n32) at para 16; African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd and Others supra (n32) at para 5; Blue Star Holdings (Pty) Ltd v West Coast Oyster Growers CC 2013 (6) SA 540 (WCC) at para 13 and 14.

40 Section 134. See also Madodza (Pty) Ltd v Absa Bank Ltd and Others (38906/2012) [2012] ZAGPPHC 165 (15 August 2012) at para 12 states: “It is to be noted that this provision does not only prohibit legal proceedings and enforcement action against the company itself, but also in relation to specific property belonging to the company, or property that is lawfully in its possession”

41 Section 133(1)

42 Section 134(1)

43 Section 112(1)(a)
to that other person, or to provide security for the amount of those proceeds to the reasonable satisfaction of that other person.\textsuperscript{44}

A very important feature of a company placed in business rescue is that the contracts of employ that the company has with its employees\textsuperscript{45} are not terminated, as would be the case if a company was placed in liquidation.\textsuperscript{46} Business rescue does therefore not contribute to unemployment, and an opportunity is created for the creditors to be paid in full, albeit somewhat delayed. The employees and the company may however, in accordance with applicable labour laws, agree to different terms and conditions of employment.\textsuperscript{47} Any retrenchments in terms of a business rescue plan would also have to comply with the relevant labour laws.\textsuperscript{48}

In terms of section 38 of the Insolvency Act,\textsuperscript{49} if a company is placed into liquidation, all contracts of employment will be suspended and then, after 45 days (after the appointment of a liquidator), the employment contracts will be terminated. The only time that the contracts of employment will not be terminated is if the contracts pass onto the purchaser of the business\textsuperscript{50} in the context of a sale of the business as a going concern.\textsuperscript{51}

In addition to the contracts of the employees not being terminated during business rescue proceedings, employees will also have a priority claim for any unpaid remuneration owed by the company to the employees during business rescue proceedings.\textsuperscript{52} The ranking of claims for any unpaid remuneration owed by the company to the employees will rank after payment

\textsuperscript{44} Section 134(3)
\textsuperscript{45} A requirement of the Basic Conditions of Employment Act 75 of 1997
\textsuperscript{46} D Davis et al, \textit{Company Law and Other Business Structures in South Africa} 2\textsuperscript{nd} ed. (2010) 237; Loubser op cit (n10)
\textsuperscript{47} Section 136(1)(a)
\textsuperscript{48} Section 136(1)(b)
\textsuperscript{49} 24 of 1936
\textsuperscript{50} In terms of section 197 of the Labour Relations Act 66 of 1995
\textsuperscript{51} Davis op cit (46)
\textsuperscript{52} Section 135(1)
of the business rescue practitioner’s remuneration and expenses, and other costs of the business rescue proceedings.53

A business rescue practitioner may, during business rescue proceedings, entirely, partially or conditionally suspend, for the duration of the business rescue proceedings, any obligation of the company that arises under an agreement to which the company was a party at the commencement of the business rescue proceedings, and that will become due during the business rescue proceedings.54 Alternatively, the business rescue practitioner may apply urgently to a court to entirely, partially or conditionally cancel, on any terms that are just and reasonable in the circumstances, any obligation of the company.55 However, neither the business rescue practitioner, nor the court, may suspend or terminate any provision of an employment contract, or an agreement to which section 35A of 35B of the Insolvency Act would have applied had the company been liquidated.56

A business rescue practitioner is appointed in terms of the Companies Act57 and has full managerial control of the company and may delegate any power or function to a person who was part of the board or pre-existing management of the company.58 As soon as possible after his/her appointment, the business rescue practitioner must investigate the company’s affairs and consider whether there is any reasonable prospect (as opposed to the judicial management test of reasonable probability) of the company being rescued.59

53 Section 135(3)
54 Section 136(2)(a)
55 Section 136(2)(b)
56 Section 136(2A)
57 See sections 129(3), 131(5) and 147(1), read with section 138.
58 Section 140. Also see Murgatroyd v Van den Heever NO and others [2014] 4 All SA 89 (GJ) at para 16 and 17.
59 Section 141
The business rescue practitioner, after consulting the creditors, other affected persons, and the management of the company, must prepare a business rescue plan for consideration and possible adoption at a meeting held in terms of section 151 of the Companies Act.\textsuperscript{60}

At a meeting held in terms of section 151 of the Companies Act, the practitioner must call for a vote for preliminary approval of the proposed plan, as amended if applicable, unless the meeting has first been adjourned.\textsuperscript{61}

The proposed business rescue plan will be approved on a preliminary basis if it was supported by the holders of more than 75 percent of the creditors’ voting interests that were voted and also by at least 50 percent of the independent creditors’ voting interests, if any, which were voted.\textsuperscript{62} If a proposed business rescue plan does not alter the rights of the holders of any class of the company’s securities, approval of that plan on a preliminary basis also constitutes the final adoption of that plan.\textsuperscript{63}

If a proposed business rescue plan does alter the rights of any class of holders of the company’s securities, the practitioner must immediately hold a meeting of holders of the class of securities who rights would be altered by the proposed plan, and call for a vote by them to approve the adoption of the proposed business rescue plan. If, in the vote contemplated, a majority of the voting rights that were exercised support adoption of the plan, it will have been finally adopted. If, in the vote contemplated, a majority of the voting rights that were exercised oppose adoption of the plan, the plan is rejected, and may be considered further only in terms of section 153 of the Companies Act.\textsuperscript{64}

\textsuperscript{60} Section 150(1). See also \textit{CSARS v Beginsel NO and Others} supra (n36) at para 38, where it was said that the business rescue plan must provide sufficient information for an interested person to make an informed decision so that he/she can vote to either accept or reject the plan.
\textsuperscript{61} Section 152(1)
\textsuperscript{62} Section 152(2)
\textsuperscript{63} Section 152(3)(b)
\textsuperscript{64} Section 152(3)(c)
A business rescue plan that has been adopted is binding on the company, and on each of the creditors of the company and every holder of the company’s securities.65 This is known as a ‘cramdown’.66

If a business rescue plan has been rejected, the practitioner may seek a vote of approval from the holders of voting interests to prepare and publish a revised plan; or advise the meeting that the company will apply to a court to set aside the result of the vote by the holders of voting interests or shareholders, as the case may be, on the grounds that it was inappropriate.67

In the recent unreported case of Copper Sunset Trading 220 (Pty) Ltd, t/a Build It Lephalale (under business rescue) v Spar Group Ltd and Another (case number 365/2014), an application was brought to the High Court in Polokwane by the business rescue practitioner of the Applicant seeking to have the votes of two creditors, who voted against the adoption of a business rescue plan, set aside in terms of section 153(1)(a)(ii) of the Companies Act 71 of 2008 on the grounds that it was inappropriate. Makgoba J stated, at para 37, that ‘…the attitude of the First Respondent gunning for liquidation is self-serving and, with respect, unreasonable regard being had to the fact that it is the only creditor likely to gain…’. He went further to state that the Second Respondent’s vote against the business rescue plan was irrational as in absence of such a plan it would receive no dividend on liquidation. Consequently, Makgoba J ruled the votes as inappropriate and set them aside. The business rescue plan was subsequently adopted.

67 Section 153(1)
2.4. A Brief Analysis of Section 135 of the Companies Act 71 of 2008.

Post-commencement financing is the provision of financial resources to a company that has formally been put in business rescue. In terms of section 135, irrespective of whether the financial resources received by the company after it has been placed in business rescue is obtained from a new creditor or an existing creditor, it is all termed post-commencement financing.

Section 135 makes provision for instances where a company has already been formally placed in business rescue and is unable to pay operational expenses; the finance provided to meet these expenses is considered post-commencement financing. Generally speaking, post-commencement financing will be used to pay the business rescue practitioner’s remuneration and expenses, and other claims arising out of the costs of the business rescue proceedings. The repayment of the employees’ post-commencement finance will be treated equally among the employees, and will have preference over all other post-commencement finance claims, irrespective of whether or not they are secured, and will also have preference over all other unsecured claims against the company.

During its business rescue proceedings, a company may obtain financing, and such financing may be secured to the lender by utilising any asset of the company to the extent that it is not already encumbered. Such post-commencement financing repayment will rank after the business rescue practitioner’s remuneration and expenses, and other claims arising out of the

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68 Remuneration, reimbursement for expenses or other amount of money relating to employment, such monies that are due and payable but that are not paid to the employee.
69 Section 135(1)
70 In Cape Point Vineyards (Pty) Ltd v Pinnacle Point Group Ltd 2011 (5) SA 600 (WCC), the Court held that although Chapter 6 does not specifically provide for the payment of the costs incurred by an applicant in proceedings under section 131, the costs of the business rescue application will qualify as costs “arising out of the costs of the business rescue proceedings” under section 135(3) (at paras 3-10).
71 Any money due to employees after the commencement of business rescue that has not been paid.
72 Section 135(3)(a)
73 Section 135(2)
costs of the business rescue proceedings, as well as post-commencement financing claims in respect of employment related matters.\textsuperscript{74} The repayment of the financier’s post-commencement finance will have preference in the order in which they were incurred and will have preference over all other unsecured claims against the company.\textsuperscript{75}

If business rescue proceedings are unsuccessful and are superseded by a liquidation order, the preference conferred in terms of section 135 will remain in force for any post-commencement finance provided, except to the extent of any claims arising out of the costs of liquidation.\textsuperscript{76}

There has been some debate over the order of preference of claims in terms of section 135, especially since section 135 does not specifically mention the way in which secured creditors (pre-business rescue) would rank.\textsuperscript{77}

In the case of \textit{Merchant West Working Capital Solutions (Pty) LTD v Advanced Technologies and Engineering Company (Pty) Ltd and Another},\textsuperscript{78} Kgomo J. clarified the order of ranking of claims.\textsuperscript{79} According to Kgomo J.’s

\begin{itemize}
  \item[1.] The practitioner, for remuneration and expenses, and other persons (including legal and other professionals) for costs of business rescue proceedings.
  \item[2.] Employees for any remuneration which became due and payable after business rescue proceedings began.
  \item[3.] Secured lenders or other creditors for any loan or supply made after business rescue proceedings began, i.e. post-commencement finance.
  \item[4.] Unsecured lenders or other creditors for any loan or supply made after business rescue proceedings began, i.e. post-commencement finance.
  \item[5.] Secured lenders or other creditors for any loan or supply made before business rescue proceedings began.
  \item[6.] Employees for any remuneration which became due and payable before business rescue proceedings began.
\end{itemize}


“The prioritisation of the claims of employee creditors is important in ensuring that a struggling business is not faced with the extra burden of potential resignations and desperate employees who have no motivation to work. A guarantee of preference in payment will provide such motivation to employees who may otherwise feel financially pressed to cut their losses and find alternative employment.”

\textsuperscript{75} Section 135(3)(b)

\textsuperscript{76} Section 135(4)

\textsuperscript{77} Du Preez op cit (n7); See also Deloitte op cit (n9)

\textsuperscript{78} [2013] ZAGPJHC 109

\textsuperscript{79} At para [21] Claims rank in the following order of preference:
judgement, it is clear that the ranking of claims for secured lenders prior to the commencement of business rescue will rank after the claims of both secured and unsecured post-commencement financiers.

In *Redpath Mining South Africa (Pty) Ltd v Marsden No and Others*, Kgomo J again ranked the claims in the same order of preference as he did in the *Merchant West Working Capital Solutions (Pty) LTD v Advanced Technologies and Engineering Company (Pty) Ltd and Another*. The Court in this case also made mention of the rights of secured creditors and the protection afforded to them under section 134(3) of the Companies Act.

### 2.5. Finance, and the Different Mechanisms Used to Fund the Provision of Post-Commencement Financing in South Africa

While section 135 of the Companies Act makes provision for the post-commencement financing of a company in business rescue, the term “financing” is undefined by the Companies Act.

According to the Concise Oxford English Dictionary (2006), the word “finance (v)” means - *to provide funding for (a person or enterprise)*. Furthermore, there are three sources of enterprise funding, namely debt financing; equity financing; and a combination of both debt and equity financing (hybrid).

There are numerous ways in which to fund post-commencement financing in South Africa. Du Preez puts forward the following examples currently used:

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7. *Unsecured lenders or other creditors for any loan or supply made before business rescue proceedings began.*

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80 [2013] ZAGPJHC 148 at para [60]
81 [2013] ZAGPJHC 109
82 [2013] ZAGPJHC 148 at para [66]
84 Du Preez op cit (n7)
1. *Asset Based Lending based on receivables and stock*

2. *Lending against any unsecured asset*

3. *Buy out the bank’s debt at a discount*

4. *Buying equity in the business*

5. *Debt to equity swap and thereby effectively writing off the debt*

6. *Recapitalisation through a compromise with the creditors to inject additional funding*

7. *Buy up dissenting creditors voting rights, thereby offering them what they would get in a liquidation and then pushing the business rescue plan through (“Binding offer”)*

8. *Shareholders put additional money in*

9. *A new entity buys out the existing debt and/or equity through acquisition*

10. *Sell some assets to raise capital*

11. *Additional overdraft funding*

### 2.6. Conclusion

Continuing finance is fundamental to any corporate rescue plan as well as a hindrance when it is in short supply.\(^{85}\) According to Qi,\(^{86}\) without an established provision which clearly outlines prospective post-commencement financing, efforts to effectively rescue a distressed company may be an exercise in futility. Research has shown that obtaining financing during the rescue process had a correlative effect on reducing the possibility of liquidation.\(^{87}\)

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The provisions of section 135 of the Companies Act makes it possible for financiers to supply much needed post-commencement finance to companies which are in business rescue. As a consequence of such advancement of funds, if the judgement of *Merchant West Working Capital Solutions (Pty) LTD v Advanced Technologies and Engineering Company (Pty) Ltd and Another*\(^{88}\) is correct, these financiers will rank, irrespective of whether they are secured or not, ahead of pre-business rescue secured and unsecure creditors, in terms of their ranking of claims.\(^{89}\) Pre-business rescue secured creditors will however be protected in terms of section 134(3) of the Companies Act.\(^{90}\)

While there are many mechanisms used to fund post-commencement financing in South Africa, essentially their source is found in either the form of debt financing or equity financing, or a combination of both debt and equity financing (hybrid).\(^{91}\)

\(^{88}\) [2013] ZAGPJHC 109
\(^{89}\) *Merchant West Working Capital Solutions (Pty) LTD v Advanced Technologies and Engineering Company (Pty) Ltd and Another* supra (n78); see also *Redpath Mining South Africa (Pty) Ltd v Marsden No and Others* supra (n80) at para [66]
\(^{90}\) *Redpath Mining South Africa (Pty) Ltd v Marsden No and Others* supra (n80)
\(^{91}\) Ward op cit (n83); see also Damodaran op cit (n83)
3. International Comparative of Post-Commencement Finance

3.1. Introduction

As this dissertation is focused on post-commencement finance, this chapter will only discuss foreign comparative law from the perspective of post-commencement finance. The foreign jurisdictions that will be examined include the United States of America, United Kingdom, Australia, Canada, and China. In addition, the principles for effective insolvency and creditor rights systems of the World Bank will be considered, as well as the United Nations Commission on International Trade Law (UNCITRAL) recommendations for post-commencement finance.

3.2. Foreign Comparative

3.2.1. United States of America

Chapter 11 of the Bankruptcy Reform Act of 1978 is the principle piece of legislation that deals with corporate bankruptcy. Section 364 of the Bankruptcy Reform Act of 1978 affords the company in distress a number of mechanisms to restructure its business by encouraging post-commencement financing of the company in distress.

In terms of section 364(a) of the Bankruptcy Reform Act of 1978, the company in distress may obtain unsecured credit and incur unsecured debt,

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92 Referred to in America as ‘debtor’ or ‘debtor-in-possession’.

93 Referred to in America as “post-petition financing”.

provided that such credit and debt are obtained in the ordinary course of business. However, in terms of section 364(b), if the company in distress wants to obtain unsecured credit and incur unsecured debt outside of the ordinary course of business, he may do so only once a court has authorise this after notice and a hearing.

If the company in distress is unable to obtain unsecured credit solely based upon the award of an administrative expense under section 503(b)(1), the court, after notice and a hearing, may authorize the company in distress to obtain credit or to incur debt that has priority over administrative expenses of the kind specified in sections 503(b) or 507(b). This debt may be secured on property of the estate that is not otherwise encumbered.

The court, after notice and a hearing, may authorise obtaining credit or incurring debt by way of a senior security on property of the estate, if the company in distress is unable to obtain such credit otherwise, and ‘there is adequate protection of the interest of the holder of the security on the property of the estate on which such senior security is proposed to be granted’.

Generally, senior security will not be granted unless the court determines that there is adequate value in the collateral to fully protect the old and new lender. The most common way to establish adequate protection is to demonstrate the existence of an ‘equity cushion’. The equity cushion refers to the excess in value of the secured property over the secured debt.

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95 Section 364(c)(1) of the Bankruptcy Reform Act of 1978  
96 Section 364(c)(2)&(3) of the Bankruptcy Reform Act of 1978  
97 Referred to in America as “priming lien”. There is no equivalent South African term for “priming lien”.  
98 McCormack op cit (n92) 185.  
99 Section 364(d)(1) of the Bankruptcy Reform Act of 1978  
100 In re C.B.G Ltd., 150 B.R. 570, 572-73; In re Plabell Rubber Products, Inc., 137 B.R. 897, 899-901  
101 McCormack op cit (n92) 185.  
In re Dunes Casino Hotel, 69 B.R. 784, the debtor proposed to incur $700,000 in priming indebtedness, whereas the prepetition debt against the subject property was $17.5 million and the property was valued at $26.2 million. The bankruptcy court found the equity cushion adequate under the circumstances.
The hierarchy of claims under Chapter 11 of the Bankruptcy Reform Act of 1978:102

1. Secured claims
2. Super-priority claims (e.g. debtor-in-possession financing)
3. Priority claims
   3a. Administrative expenses (including legal and professional fees incurred in the case)
   3b. Wages, salaries, or commissions
   3c. Employee benefit claims
   3d. Claims against facilities that store grain or fish produce
   3e. Consumer deposits
   3f. Alimony and child support
   3g. Tax claims
   3h. Unsecured claims based on commitment to a federal depository institutions regulatory agency
4. General unsecured claims
5. Preferred stock
6. Common stock

Chapter 11 of the Bankruptcy Reform Act of 1978 provides substantial flexibility in its provisions for the facilitation of post-commencement finance. It contains provisions that encourage financiers to provide post-commencement finance and enable them to have access security.

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3.2.2. United Kingdom

In the United Kingdom, corporate insolvency is regulated by two pieces of legislation, namely the Insolvency Act of 1986 and the Enterprises Act of 2002. While the Enterprises Act does not specifically mention the financing of a company in financial distress, it has been argued by writers that it has done so by implication.

The administration of a financially distressed company entails the appointment of an outside insolvency practitioner as the administrator, tasked with the responsibility of running the company's affairs. The Administrator has the power to raise or borrow money and grant security over the property of the company. He also has the power to dispose of property which is subject to a floating charge, as if it were not subject to the charge, however, if the assets are subject to a fixed charge, the administrator may apply to court for an order authorizing the disposal of the asset. The administrator may not dispose of any fixed asset unless he has approval from the courts. These two provisions are very similar to sections 364 (a) and (b) of Chapter 11 of the Bankruptcy Reform Act of 1978.

An administrator's remuneration and expenses shall be 'charged on and payable out of property of which he had custody or control immediately before cessation, and payable in priority to any security to which paragraph 70 applies.' Any debt or liability arising as a consequence of a of a contract entered into by the administrator shall be 'charged on and payable out of

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104 McCormack op cit (n92), 195 - 200
106 A floating charge constitutes a charge over all assets of the borrower company, as acquired from time to time, and the company remains free to deal with its assets in the ordinary course of business.
107 Insolvency Act 1986, Schedule B1 para 70
108 A fixed charge is security over a particular asset.
109 Insolvency Act 1986, Schedule B1 para 71
110 Insolvency Act 1986, Schedule B1 para 99(3)
property of which the former administrator had custody or control immediately before cessation, and payable in priority to any charge arising under sub-paragraph (3)." 111 In the case of Centre Reinsurance International Co v Freakley 112 Lord Hoffmann explained, that this provision was concerned with debts and liabilities incurred under the contracts that were entered into by the administrator, which have not been discharged. He further said that the administrator, under the Insolvency Act, has the power to decide what expenditure ‘is necessary for the purposes of the administration and should therefore receive priority. But there is no reason to extend that priority to expenditure which neither the administrator nor the court has specifically approved.’

On a broad interpretation of paragraph 99(3) of Schedule B1, it has been said that, in its ordinary meaning, the wording would encompass liabilities under contracts of loan entered into by the administrator on behalf of the company. 113

As mentioned by McCormack, 114 ‘Interest and capital payments under a loan can be classified as liabilities arising out of a contract. Such liabilities are stated to be "(a) charged on and payable out of property which the former administrator had custody or control immediately before cessation, and (b) payable in priority to any charge arising under sub-paragraph (3)."’

The case of Bibby Trade Finance Ltd v McKay 115 serves as a good example of where an administrator borrowed money from an existing creditor to fund the completion of a profitable contract. The repayment of the loan, by virtue of the contract entered into by the administrator, was a legitimate payment in

111 Insolvency Act 1986, Schedule B1 para 99(4)
113 McCormack op cit (n92) 198
114 McCormack op cit (n92) 199
115 ([2006] All ER (D) 266)
the course of the administration. It therefore qualified for ‘super priority’ in the administration.\textsuperscript{116}

3.2.3. Australia

Business rescue\textsuperscript{117} in Australia is contained in Part 5.3A of the Australian Corporations Act 50 of 2001 (hereafter ‘Australian Corporations Act’). These provisions, with the exception of only a few, appear for the most part to be identical to the provisions of Chapter 6 of the South African Companies Act.\textsuperscript{118} Australian court cases have also been cited in South African cases that deal with business rescue.\textsuperscript{119}

While section 135 of the Companies Act makes provision for post-commencement financing, no similar provision has been specifically provided for in the Australian Corporations Act. There are, however, sections in the Australian Corporations Act that, if interpreted broadly, could encompass post-commencement financing. Section 437A(1)(d) of the Australian Corporations Act states that while a company is under administration, the administrator may perform any function, and exercise any power, that the company (or any of its officials) could perform or exercise if the company were not under administration.\textsuperscript{120} This provision would thus enable the business rescue administrator to arrange finance after their appointment.

\textsuperscript{116} A Keay and P Walton, \textit{Insolvency Law: Corporate and Personal}, 2nd Ed, Jordan (2008) p132. See also R Goode, \textit{Principles of Corporate Insolvency Law}, 4\textsuperscript{th} Ed, Sweet and Maxwell (2011) p458. \textsuperscript{117} Referred to in Australia as "Corporate rehabilitation" \textsuperscript{118} C Anderson, “Viewing the Proposed South African Business Rescue Provisions from an Australian Perspective” (2008) 1 PER 1. \textsuperscript{119} In \textit{Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami)(Pty) Ltd} supra (n4) at para 24, the Court referred to the Australian case of \textit{Dallinger v Halcha Holdings (Pty) Ltd} [1995] FCA, when considering the secondary objective of business rescue contained in section 128(1)(b)(ii). \textsuperscript{120} The administrator has no greater right to use the company’s property than the company itself had. The administrator’s control of the company’s property is subject to pre-existing rights affecting it — \textit{Hyatt of Australia Ltd v Coolum Report Pty Ltd} [2012] QSC 49, [69].
Furthermore, section 443A of the Australian Corporations Act states that the administrator of a company under administration is liable for the debt he/she incurs in the performance or exercise of any of his/her functions and powers as administrator. However, in terms of section 443D of the Australian Corporations Act, the administrator of a company under administration is entitled to be indemnified out of the company’s property for the debts for which the administrator is liable under section 443A of the Australian Corporations Act.

Therefore, it could be argued that while no specific provision is mentioned in the Australian Corporations Act for the funding of post-commencement financing, by virtue of the provisions of section 437A, 443A, and 443D broadly interpreted, the administrator may enter into a loan agreement or rearrange the share structure of the company on behalf of the company under administration. The debt of the loan agreement, which the administrator is liable for, will be indemnified by the company under administration.

In addition, section 443E of the Australian Corporations Act provides that the administrator’s right of indemnity, in terms of section 443D of the Australian Corporations Act, has priority over all the company’s unsecured debts. If the company in administration does proceed to liquidation, the administrators expenses are generally entitled to a priority under section 556(1)(c) of the Australian Corporations Act.

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121 A form of post-commencement finance.
122 Section 437A(1)(d) of the Australian Corporations Act
123 Section 443A of the Australian Corporations Act
124 Section 443D of the Australian Corporations Act
125 Re Robinson; Darrell Lea Chocolate Shops Pty Ltd [2012] FCA 833.
126 M Murray and J Harris Key’s Insolvency: Personal and Corporate Law and Practice (8th ed, Thomson Reuters Lawbook Co. 2014) 639
3.2.4. Canada

Corporate restructurings in Canada are generally governed by either the Bankruptcy and Insolvency Act (BIA),\(^\text{127}\) or the Companies’ Creditors Arrangement Act (CCAA).\(^\text{128}\) The provisions of the CCAA are only available to distressed companies with total assets of more than $5 million,\(^\text{129}\) while the provisions of the BIA are available to all corporate distressed companies.

Prior to the authorisation of post-commencement financing\(^\text{130}\) in Canada, companies undergoing reorganisation were essentially governed and addressed through a Court process.\(^\text{131}\) If funding was required, application would need to be made to Court, and the Court would authorise the post-commencement financing by virtue of its so-called inherent jurisdiction in terms of the CCAA.\(^\text{132}\) As a result, guidelines have emerged from the Canadian CCAA cases. Briefly, they are:\(^\text{133}\)

1. A company with a viable basis for restructuring will be permitted to borrow funds for working capital and to grant security for such borrowings that rank ahead of the claims of unsecured creditors:

   *Westar Mining Ltd. (Re);\(^\text{134}\)*

   *T Eaton Co. (Re).*\(^\text{135}\)

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\(^{127}\) Bankruptcy and Insolvency Act, RSC 1985, c B-3

\(^{128}\) Companies’ Creditors Arrangement Act, RSC 1985, c C-36

\(^{129}\) Section 5.3 of the Companies’ Creditors Arrangement Act, RSC 1985, c C-36

\(^{130}\) Referred to in Canada as “debtor-in-possession (DIP) financing”.

\(^{131}\) This was the position prior to 18 September 2009, when the court’s authority to authorise post-commencement financing\(^\text{131}\) was codified by the amendments of the Canadian legislation of both the Bankruptcy and Insolvency Act (BIA) RSC 1985, c B-3 and the Companies’ Creditors Arrangement Act (CCAA) RSC 1985, c C-36.

\(^{132}\) McCormack op cit (n92) 200


\(^{135}\) (1997), 46 C.B.R. (3d) 293 (Ont. Ct. (Gen. Div.).)
2. Super-priority DIP financing\textsuperscript{136} will be approved where all or substantially all the existing secured creditors acquiesce or consent: \textit{Willann Investments Ltd. v. Bank of America Canada.}\textsuperscript{137}

3. Super-priority for DIP financing will be granted where existing secured creditors will not be adversely affected thereby because the financing results in the creation of new collateral assisting in repaying the DIP financing, specifically new receivables: \textit{Dylex Ltd. (Re).}\textsuperscript{138}

4. Super-priority DIP financing will generally be approved by the court where the funds are used to pay essential expenditures which have priority in any event over existing secured lenders: \textit{SkyDome Corp. (Re).}\textsuperscript{139}

5. In initial CCAA orders, which are usually granted on very short notice, extraordinary relief such as super-priority financing should be restricted to what is necessary to meet urgent short-term needs: \textit{Royal Oak Mines Inc. (Re).}\textsuperscript{140}

6. The court's inherent jurisdiction to grant super-priority financing does not extend so as to permit it to grant DIP financing super-priority over security, which by statute is afforded priority over all other interests: \textit{Royal Oak Mines Inc. (Re).}\textsuperscript{141}

7. Deciding whether to grant super-priority DIP financing is an exercise of balancing the interests of the debtor and its stakeholders. The court

\textsuperscript{136} There is no equivalent South African term.

\textsuperscript{137} [1991] O.J. 721 (QL) (Ont. Ct. (Gen. Div.)).

\textsuperscript{138} (Unreported endorsement, January 23, 1995, Ontario Court (General Division), Court File No. B-4/95, Houlden J.A.).

\textsuperscript{139} (Unreported endorsement, November 27, 1998, Ontario Court (General Division), Court File No. 98-CL-3179, Blair J.).

\textsuperscript{140} (1999), 6 C.B.R. (4th) 314 (Ont. Ct. (Gen. Div.)).

\textsuperscript{141} (1999), 7 C.B.R. (4th) 293 (Ont. Ct. (Gen. Div.)).
should not permit super-priority DIP financing unless there is ‘cogent
evidence that the benefit of DIP financing clearly outweighs the
potential prejudice to the lenders whose security is being
subordinated’: United Used Auto & Truck Parts Ltd. (Re) (‘United’);\textsuperscript{142}
applied in Sharp-Rite Technologies Ltd. (Re).\textsuperscript{143}

8. The interests of existing secured creditors can be prejudiced by the
granting of super-priority financing only if the court is satisfied this is
justified in the circumstances of the case: General Electric Capital
Canada Inc. v. Euro United Corp.\textsuperscript{144}

With the amendments to the Canadian legislation, which became effective on
18 September 2009, the court’s authority to authorise post-commencement
financing was codified by both the Bankruptcy and Insolvency Act (BIA)\textsuperscript{145}
and the Companies’ Creditors Arrangement Act (CCAA),\textsuperscript{146} taking the
foregoing into account.

The factors that the court now has to consider for the purpose of authorising
post-commencement financing include, but are not limited to, consideration of:\textsuperscript{147}

1. the period during which the company is expected to be subject to
restructuring proceedings;
2. how the business is to be managed during the proceedings;
3. whether management has the confidence of the company’s major
creditors;
4. whether the loan would enhance the prospects of a viable compromise
or arrangement being made;

\textsuperscript{144} (Unreported endorsement, December 24, 1999, Ontario Superior Court of Justice, Court File No. 99-CL-3592, Blair J.).
\textsuperscript{145} Section 50.6 of the Bankruptcy and Insolvency Act, RSC 1985, c B-3
\textsuperscript{146} Section 11.2 of the Companies’ Creditors Arrangement Act, RSC 1985, c C-36
\textsuperscript{147} Section 11.2(4) of the Companies’ Creditors Arrangement Act, RSC 1985, c C-36
5. the nature and value of the company’s property;
6. whether any creditor would be materially prejudiced as a result of the charge; and
7. the monitor’s views.

The court is not limited to the consideration of only these factors. In addition, the court is not required to give these factors equal weight and consideration. The court has also held that even if certain creditors are materially affected by the post-commencement financing, the court must look to the broader picture. A compromise that the creditor may have to accept may be outweighed by the positive effects of the financing on the total business of the company being restructured.

3.2.5. China

The Enterprise Bankruptcy Law of the People’s Republic of China (the ‘EBL’), which was passed on 27 August 2006 and took effect on 1 June 2007, governs bankruptcy proceedings in China. Chapter 8 of the EBL, entitled ‘Reorganisation’, contains rules governing the corporate bankruptcy reorganisation proceedings.

In respect of post-commencement financing, unlike Chapter 11 of the US Bankruptcy Reform Act of 1978, the EBL does not contain any provisions

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150 *Ibid*
154 Referred to as “post-petition finance” in China.
which grant ‘super-administrative-expense.priority’ to post-commencement financiers.155

The debts that the company bears during its reorganisation in order to continue business operations are debts of common benefits, and are paid by the company’s assets before the pre-commencement unsecured debts of the company.156 This is similar to the administrative priority prescribed in Section 364(a) and (b) of the US Bankruptcy Reform Act of 1978.157

The EBL provides that the company158 or the administrator may obtain a post-commencement loan in order to continue the company’s business and may provide security to the post-commencement finance lender on unencumbered assets.159 This provision is similar to the provision of Section 364(c)(2) of the US Bankruptcy Reform Act of 1978.160

An EBL post-commencement finance lender cannot get ‘super-administrative-expense.priority’ on encumbered assets unless the pre-commencement security holder voluntarily abandons his priority right and agrees to give the post-commencement finance lender special benefits.161

Due to the numerous similarities, it would appear that the Chinese provisions are based on the American legislation.

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155 Ren op cit (n153) 160
156 Article 42, 43 of The Enterprise Bankruptcy Law of the People’s Republic of China
158 Referred to as the “debtor-in-possession” in China.
159 Article 75 of The Enterprise Bankruptcy Law of the People’s Republic of China, See Qi op cit (n157). See also Ren op cit (n153) 160
160 Qi op cit (n157) 22
161 Ren op cit (n153) 161
3.2.6. The United Nations Commission on International Trade Law (UNCITRAL)

The United Nations Commission on International Trade Law (UNCITRAL) has published recommendations regarding post-commencement finance provisions for insolvency proceedings. These include:

3.2.6.1. Purpose of Legislative Provisions

The purpose of provisions on post-commencement finance in corporate rescue proceedings is:

‘(a) To facilitate finance to be obtained for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the estate;

(b) To ensure appropriate protection for the providers of post-commencement finance; and

(c) To ensure appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.’

3.2.6.2. Contents of Legislative Provisions

In addition, the United Nations Commission on International Trade Law recommends the following provisions, in terms of the contents of the legislative provisions, for post-commencement finance:

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163 UNCITRAL op cit (n162) 118
Attracting and authorizing post-commencement finance

The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative. The insolvency law may require the court to authorize - or creditors to consent to - the provision of post-commencement finance.\textsuperscript{164}

Priority for post-commencement finance

The insolvency law should establish the priority that may be accorded to post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of ordinary unsecured creditors.\textsuperscript{165}

Security for post-commencement finance

The insolvency law should enable a security interest to be granted for repayment of post-commencement finance.\textsuperscript{166} The law should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets.\textsuperscript{167} The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied.\textsuperscript{168}

\textsuperscript{164} UNCITRAL op cit (n162) – Recommendation 63 p118.
\textsuperscript{165} UNCITRAL op cit (n162) – Recommendation 64 p118.
\textsuperscript{166} UNCITRAL op cit (n162) – Recommendation 65 p118.
\textsuperscript{167} UNCITRAL op cit (n162) – Recommendation 66 p118.
\textsuperscript{168} UNCITRAL op cit (n162) – Recommendation 67 p118.
Effect of conversion on post-commencement finance

The insolvency law should specify that, where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.\textsuperscript{169}

3.2.7. World Bank Principles

The World Bank Principles, contained in the World Bank’s publication,\textsuperscript{170} suggests solutions, and various policy choices involved in developing those solutions, for effective insolvency and creditor rights systems. It is stated that ‘…the principles have been designed as a broad-spectrum assessment tool to assist countries in their efforts to evaluate and improve core aspects of their commercial law systems that are fundamental to a sound investment climate, and to promote commerce and economic growth.’\textsuperscript{171}

One of the principles for successful post-commencement finance is found in Principle C9.2.\textsuperscript{172} It states that ‘Subject to appropriate safeguards, the business should have access to commercially sound forms of financing, including on terms that afford a repayment priority under exceptional circumstances, to enable the debtor to meet its ongoing business needs.’

3.3. Conclusion

Chapter 11 of the Bankruptcy Reform Act of 1978, and in particular section 364, makes provision for super-priority ranking of debtors who provide post

\textsuperscript{169} UNCITRAL op cit (n162) – Recommendation 68 p118.


\textsuperscript{171} World Bank op cit (n170) p2

\textsuperscript{172} World Bank op cit (n170) p17
commencement financing and funding to companies that are distress in terms of debtor-in-possession financing. Neither the United Kingdom nor the Australian corporate rescue regime has the concept of post-commencement financing with super priority or super priority debtor-in-possession financing,\textsuperscript{173} although it has been suggested by some\textsuperscript{174} that super priority in the United Kingdom Insolvency Act 1986 may be implied.

Reviewing the foregoing, it is noticeable that the South African legislation is in many respects more advanced and clear than even well-developed countries’ legislation. Post-commencement finance would seem to, both locally and internationally, present challenges and opportunities.

In concluding, I found appropriate a comment made by Philip Wood in his article, \textit{The Bankruptcy Ladder of Priorities and the Inequalities of Life}:\textsuperscript{175}

‘Bankruptcy law is the profound motivator of commercial and financial law because, if there is not enough brandy and biscuits on the raft, the law is at its most ruthless in having to choose who to pay.’

\textsuperscript{173} Bradstreet op cit (n74) 360
\textsuperscript{174} McCormack op cit (n92) 198
4. **Private Equity Investments in Distressed Companies**

4.1. **Introduction**

Before discussing the use of private equity investments for distressed companies ensues, it is perhaps appropriate to briefly discuss private equity in general.

‘Private equity is a form of equity investment into private companies that are not quoted on a stock exchange. Private equity is distinguished by its active investment model, in which it seeks to deliver operational improvements in its companies, over several years.’\(^{176}\)

‘Private equity is finance provided in return for an equity stake in potentially high growth companies. However, instead of going to the stock market and selling shares to raise capital, private equity firms raise funds from institutional investors such as pension funds, insurance companies, endowments, and high net worth individuals. Private equity firms use these funds, along with borrowed money and their own commercial acumen, to help build and invest in companies that have the potential for high growth.’\(^{177}\)

The South African Venture Capital and Private Equity Association (SAVCA) and KPMG Venture Capital and Private Equity Industry Performance Survey of South Africa, defines private equity as capital invested into unlisted companies.\(^{178}\)

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\(^{176}\) European Private Equity and Venture Capital Association http://evca.eu/what-is-private-equity/

\(^{177}\) British Private Equity and Venture Capital Association http://www.bvca.co.uk/PrivateEquityExplained/FAQsinPrivateEquity.aspx

\(^{178}\) KPMG and SAVCA - Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2012 calendar year (June 2013)
Private equity investment strategies typically used are:

1. **Growth/Expansion Capital** – these are equity investments, usually a minority stake in relatively mature companies, seeking investment capital in order to expand, restructure or finance current operations or new ventures within the company, without succumbing to a change of control.\(^\text{179}\)

2. **Distressed Debt** – whereby equity and debt investments are used as funding to assist distressed companies.\(^\text{180}\)

3. **Leveraged Buyouts (LBO)** – this involves the acquisition of another company, using a combination of debt and equity funding, to meet the costs of an acquisition. An important aspect of LBO’s is that a significant percentage of the purchase price is funded through debt.\(^\text{181}\)

4. **Mezzanine Financing** – this is a form of hybrid capital that can be either structured as debt or equity, used to finance the expansion for a company. It usually takes the form of senior subordinated debt, convertible subordinated debt, or redeemable preferred securities.\(^\text{182}\)

5. **Secondary Investments** – this refers to the buying up equity of investors in existing private equity funds.\(^\text{183}\)

6. **Venture Capital** – this provides capital funding for start-up or the early stage development of a company or enterprise.\(^\text{184}\)

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\(^\text{179}\) The French Private Equity Association


\(^\text{181}\) Princeton University.
http://www.princeton.edu/~achaney/tmve/wiki100k/docs/Leveraged_buyout.html

\(^\text{182}\) Leonard N. Stern School of Business.
http://pages.stern.nyu.edu/~igiddy/articles/Mezzanine_Finance_Explained.pdf

\(^\text{183}\) The French Private Equity Association

The traditional Private Equity fund structure

In South Africa, private equity funds are generally structured as either an *en commandite* partnership, or Bewind Trusts.185 Both have their own legal implications and tax structures, details of which do not affect the objectives of this dissertation and are therefore not being discussed.

Private Equity is exit driven

An important aspect is that private equity is an ‘exit driven’ investment. This means that when such investments are considered, the private equity deal is structured with an exit strategy already in mind. Some of the exit strategies for private equity investments include: Initial Public Offering (IPO); Trade Sale; Secondary Buyout; Share Buyback; and Leveraged Recapitalisation.186

4.2. Private Equity Involvement in Distressed Debt Investing and Turnaround Management of Companies that are Distressed.

Distressed debt investing can take the form of either purchasing the debt of a company in distress at discounted prices, or the purchase of distressed company securities from investors who wish to dispose of these securities.187

The South African private equity and venture capital industry had R162.2 billion in funds under management as at 31 December 2013.188 Private equity

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186 Hungarian Private Equity and Venture Capital Association, http://www.hvca.hu/
187 Anson op cit (n180)
188 KPMG and SAVCA: Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2013 calendar year (2014)
in South Africa displays significant positive return, displays significant return premium relative to South African listed equities and small-cap equities, displays significant risk adjusted return in comparison to other asset classes, and has low correlation in respect of the performance of other asset classes.\textsuperscript{189} In South Africa, there have been comparatively few distressed debt investments in comparison to other markets.\textsuperscript{190} It has been suggested that the reason for this is as a result of the lower levels of gearing in the local South African deals.\textsuperscript{191}

In the United States of America, hedge funds and private equity funds are committing billions of dollars to investing in companies that are in distress or already in formal bankruptcy proceedings.\textsuperscript{192} Acquiring a company through bankruptcy proceedings is viewed by private equity funds as a low cost way to take over a company, compared to what the private equity company would have to pay for it at an auction.\textsuperscript{193}

In Germany, the risk appetite appears to be less and the behaviour of investors seems to be risk averse. Private equity funds in Germany tend to take management experience, asset sizes, market shares, mature products, and low capital expenditure, into account, to name a few. As a result, low-valued, distressed companies in mature phases of their business cycle are the target of specialised turnaround investors. These investors also tend to purchase equity from distressed companies in order to obtain a majority stake and perform a strategic and operational turnaround.\textsuperscript{194}

\textsuperscript{189} I Missankov; R Van Dyk; A Van Biljon; M Hayes; W Van der Veen (2008) “Private Equity Returns in Emerging Markets: The South African Case”. The Journal of Private Equity (Fall 2008)
\textsuperscript{191} Ibid
\textsuperscript{192} SM Brecher; S Breslow; AC Harris; J Hogan; DA Martini (2007) “Alternative” Investment Managers and Bankruptcy: The Brave New World of Chapter 11”. The Journal of Private Equity (Spring 2007)
\textsuperscript{193} Ibid
In the United Kingdom, 10 per cent of all private equity capital raised in 2011 was accounted for by distressed private equity funds (that is a figure of approximately $1.75 billion). In the period from 2004 to August 2011, 43 turnaround vehicles had collectively raised $16.6 billion in commitments from investors. As of October 2011, the majority of firms in distressed private equity (56 per cent) selected turnaround strategies as their main target for their investments.

It has been observed, by Cuny and Talmor, that the success rate of corporate turnarounds are higher with the involvement of a private equity firm as opposed to corporate turnarounds that do not involve private equity firms.

4.3. A Causal Link Between Business Rescue, Private Equity, and a Section 12J Venture Capital Company

One of the purposes of the Companies Act is to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders. Business rescue is a process through which a financially distressed company is rehabilitated by providing for the temporary supervision of the company.

In order to assist a distressed company in business rescue, the Companies Act makes provision for post-commencement finance to be provided for the company. As discussed above, private equity has a record of providing financing, either in the form of debt or equity finance, or a combination of

195 Preqin Special Report: Distressed Private Equity (October 2011)
196 Ibid
197 Ibid
199 Section 7(k)
200 Section 128(1)(b)
201 Section 135
both, to companies that are distressed or in formal bankruptcy proceedings.\textsuperscript{202}

In terms of the definition of private equity, put forward by The South African Venture Capital and Private Equity Association (SAVCA),\textsuperscript{203} the section 12J Venture Capital Company, discussed below, would be deemed a private equity structure. This is largely because the sole object of the 12J venture capital company is the management of equity investments in unlisted qualifying companies.\textsuperscript{204}

\textsuperscript{202} Brecher op cit (n192)
\textsuperscript{203} KPMG and SAVCA - Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2012 calendar year (June 2013)
\textsuperscript{204} Section 12J(5)(b)
5. **The Venture Capital Company in terms of Section 12J of the Income Tax Act 58 of 1962**

5.1. **Introduction**

The purpose of this chapter is to put forward a private equity structure to facilitate the effective post-commencement financing of business rescue.

In the 2008 Budget Review, National Treasury announced that:

‘Access to equity finance by small and medium-sized businesses has been cited as one of the main challenges to the growth of this important sector of the economy. The private-equity industry in South Africa is well developed but the industry’s appetite for start-up, early stage and seed-capital type transactions is low.

To meet the challenge of access to venture capital for small and medium-sized enterprises, government proposes tax incentives for investors in qualifying small enterprises and start-ups.’

As a result, in 2008 section 12J was inserted into the ITA by the Revenue Laws Amendment Act 60 of 2008.

For the purpose of providing equity finance to small and medium-sized businesses, a tax incentive was provided for investors who invest in such enterprises through a venture capital company. The venture capital company referred to in section 12J of the ITA is intended to be a ring-fenced company that will attract investors for the purpose of investing in such

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206 Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011
207 While researching the subject, officials at National Treasury in fact passed comments to this effect.
small and medium-sized businesses and junior mining companies.\textsuperscript{208} The tax incentive provided for in terms of section 12J(2) of the ITA is a deduction, from the income of a taxpayer, of the expenditure actually incurred by that taxpayer in acquiring any venture capital company share issued to that taxpayer by a venture capital company. This deduction is subject to a recoupment of the amount invested upon disposal of any venture capital shares, in terms of section 9C(2A) of the ITA, if such a disposal is made by the investor of venture capital shares within a period of five years of such acquisition.\textsuperscript{209}

Generally, an investment made, in the form of an acquisition of shares in a company is not a tax-deductible expenditure for the investor.\textsuperscript{210} A company receiving capital from the issue of shares is not taxed on the receipt of such monies as it forms part of the contribution to its share capital.

In order to qualify as a venture capital company, the company must meet certain regulatory requirements in respect of its form, structure, the percentage allocation of its investments into qualifying companies, and types qualifying investments allowed, amongst others. Certain requirements in terms of section 12J(5) of the ITA require upfront approval from the South African Revenue Service (hereafter SARS) in order to commence with the business of a venture capital company, while other requirements, in respect of sections 12J(6) and (6A) of the ITA, need only be complied with after the registration of the venture capital company and during its operation.

Apart from the tax benefits received by investors that invest in approved 12J venture capital companies, equity financing offers some key advantages for

\textsuperscript{208} Section 12J(1)
\textsuperscript{209} Section 12J(9)
\textsuperscript{210} Unless the investor is a ‘share-dealer’ (that is a person using shares as its trading stock - buying and selling shares with the purpose of earning profits), in which event, he would be able to deduct the cost of acquiring the shares in terms of section 11(a) of the Income Tax Act
small businesses. Equity financing allows for small businesses to better weather economic downturns. Equity financing also allows small businesses to use cash surpluses for reinvestment rather than being forced to use that cash for debt servicing.

To better understand this new introduction to our law, it may be beneficial to have a look at similar provisions in other jurisdictions which also have more experience with these types of incentives.

5.2. Comparative Law

Whilst this dissertation will take a closer look at Canada and the United Kingdom with specific reference to Venture Capital Trusts (VCTs), on which the section 12J venture capital regime is broadly based, it is worth mentioning that both France and Germany have also adopted tax incentive schemes to encourage investment in venture capital companies.

There are a few tax incentive schemes adopted across the globe that encourage investment in venture capital companies. A few of them will be briefly mentioned, followed by a discussion of the venture capital regime in South Africa.

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211 Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008
212 While researching the subject, officials at National Treasury in fact passed comments to this effect.
5.2.1. Canada

5.2.1.1. General

In Canada, various Canadian Labour Sponsored Venture Capital Corporations (LSVCC) were introduced to some Canadian provinces in the 1980’s and early 1990’s through the Canadian Income Tax Act. LSVCC’s are corporations listed on a stock exchange and are managed by investment professionals that invest in small medium enterprises. Restrictions on their investment activities in these small medium enterprises are set out in statute. The tax breaks for the Canadian investor in the LSVCC depend on the income of the investor and range from $Can 2610 to $Can 3820, on a $Can 5000 investment. The maximum investment into a LSVCC is an annual amount of $Can 5000 per year.

5.2.1.2. Manitoba

In addition to the LSVCC provisions, various Canadian provinces have also introduced their own small business venture capital tax credit (SBVC) provisions. A tax credit program, in terms of the Income Tax Act (Manitoba) and Regulation #181/2007, governs the tax credit in the Canadian province of Manitoba. The SBVC tax credit program assists eligible (there are statutory requirements that need to be met in order to qualify) small business corporations to issue shares to investors. The issue of shares by a company to all investors may be up to $Can 5 000 000. An eligible investor must invest a minimum of $Can 20 000 during the approval period, and the maximum investment allowed is $Can 450 000. The maximum tax

214 Income Tax Act, RSC 1985, c 1 (5th Supp)
215 Section 211.7 of the Income Tax Act, RSC 1985, c 1 (5th Supp)
217 The Income Tax Act, CCSM c I10
credit that may be earned in a life time is $Can 135 000, and a maximum of $Can 45 000 can be claimed in a year.

### 5.2.1.3. British Columbia

In British Columbia, like Manitoba, the Small Business Venture Capital Act (SBVCA) governs the investment of funds into eligible (there are statutory requirements that need to be met in order to qualify) small business corporations through the issue shares to investors. Like South Africa’s section 12J venture capital company legislation, the investors referred to in the SBVCA are only companies incorporated under the Company Act or the Business Corporations Act. In British Columbia’s legislation, instead of restricting an investment into a particular type of company (as is the case with South Africa’s section 12J venture capital company legislation), it compels the investor to invest in certain types of business activities. The activities that must be complied with by the small business corporation, are found in Regulation 11(1) of the Small Business Venture Capital Act (SBVCA). In addition, at least 75 per cent of the small business corporation’s wages must be paid to British Columbia employees, and the small business corporation may not have more than 100 employees when an initial investment is made by an investor.

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218 A tax credit is the amount of money that a taxpayer is able to subtract from the amount of tax owed. **Example**: Assume the tax rate in Canada is a flat rate of 25 per cent, and investor’s income is $1 000 000. Based on this, the investor would have to pay $250 000 in taxes to the government. If the investor invests $200 000 into a business referred to in the small business venture capital tax credit program of Manitoba, he/she would be able to claim a tax credit of $50 000 ($200 000 x 25%) against the amount of $250 000 that is owed in taxes.

219 A GUIDE TO THE SMALL BUSINESS VENTURE CAPITAL TAX CREDIT PROGRAM (Manitoba) - [http://www.gov.mb.ca/jec/pdfs/sbvctc_guiding.pdf](http://www.gov.mb.ca/jec/pdfs/sbvctc_guiding.pdf)

220 Small Business Venture Capital Act, RSBC 1996, c 429

221 Company Act, RSBC 1996, c 62

222 Business Corporations Act, SBC 2002, c 57

223 Small Business Venture Capital Regulation, BC Reg 390/98

224 British Columbia Eligible Small Businesses and Business Corporations Policy Statement, Small Business Venture Capital Act (SBVCA), s. 10 of the Act, s. 11 of the Regulations (2013)
5.2.2. United Kingdom

5.2.2.1. Venture Capital Trusts (VCT)

Venture Capital Trusts (VCT) scheme was introduced on 6 April 1995 by the Finance Act of 1995 to encourage individuals to invest into smaller United Kingdom companies which are not listed on the London Stock Exchange.\(^{225}\) Part 6 of the Income Tax Act 2007 now specifically provides for Venture Capital Trusts, and its provisions are set out in 6 chapters and 74 sections of the Act.\(^{226}\)

The VCT’s themselves have to be listed on the stock exchange,\(^{227}\) and provide capital finance in the form of debt and/or equity - in terms of specific provisions contained in Part 6 of the Income Tax Act 2007 - to the small companies with the aim of making investment returns for the investors.

The money raised by the investors is pooled by the VCT to acquire a number of different investments into ‘qualifying holdings’.\(^{228}\) Between April 1995, and September 2014, funds raised by Venture Capital Trusts (VCT) have amounted to £5.5 billion.\(^{229}\) The tax relief is received upfront, by way of deduction from income, if the investor subscribes for new VCT shares.\(^{230}\) These shares will need to be held for a period of at least five years to retain the initial tax relief.\(^{231}\)

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\(^{225}\) Section 295 of the Income Tax Act 2007
\(^{226}\) Further legislation also includes the Taxation of Chargeable Gains Act 1992 sections 100; 151A-B; and Schedule 5C. This legislation is supported by The VCT Regulations 1995, The VCT (Amendment) Regulations 1999, The VCT (Exchange of Shares and Securities) Regulations 2002 and The VCT (Winding up and Mergers)(Tax) Regulations 2004.
\(^{227}\) Section 274 of the Income Tax Act 2007
\(^{228}\) Chapter 4 Income Tax Act 2007
\(^{230}\) Part 6 (Chapter 2) Income Tax Act 2007
\(^{231}\) Section 266 Income Tax Act 2007
70 per cent of the VCT’s investments has to be held in ‘qualifying holdings’, the remaining 30 per cent may be invested into non-qualifying holders. No more than 15 per cent of a VCT by value may be invested in any single company. There is also a maximum annual amount of £200 000 that may be invested into VCT’s for the year, and an income tax relief rate of 30% on the amount subscribed for the shares available on investments up to £200 000 a year. Dividends that flow form the VCT to the investor are exempt from income tax and the disposals of VCT shares do not attract capital gains taxes.

There is a gross asset requirement that has to be complied with in an investment into a qualifying company. The threshold of gross assets is no more than £15 million before the investment, and no more than £16 million after the investment.

There are excluded activities that the VCT is not permitted to engage in. Briefly, they are:

1. dealing in land, in commodities or futures or in shares, securities or other financial instruments,
2. dealing in goods otherwise than in the course of an ordinary trade of wholesale or retail distribution,
3. banking, insurance, money-lending, debt-factoring, hire-purchase financing or other financial activities,
4. leasing (including letting ships on charter or other assets on hire),
5. receiving royalties or license fees,
6. providing legal or accountancy services,
7. property development,
8. farming or market gardening,
9. holding, managing or occupying woodlands, any other forestry activities or timber production,
10. operating or managing hotels or comparable establishments or managing property used as an hotel or comparable establishment,
11. operating or managing nursing homes or residential care homes or managing property used as a nursing home or residential care home, and;
12. any activities which are excluded activities under section 310 (provision of services or facilities for another business).

It is evident that many provisions of the VCT tax incentive regime have found their way into the section 12J Venture Capital Company of the ITA tax regime in South Africa. What follows is a summary of the various section 12J components.

5.3. **Summary of Section 12J of the Income Tax Act 58 of 1962.**

From the research I have conducted, it is apparent that one of the central pillars to the efficient and effective financial structuring of a company is the use of income tax incentives and the income tax deductibility of monies that could be invested in the provision of finance for companies in business rescue. The inclusion of Section 12J of the ITA in 2008\textsuperscript{238} facilitates such investments. An examination of the provisions of section 12J of the ITA indicates an opportunity for the structuring of a tax efficient post-commencement financing financial solution, by way of a venture capital

\textsuperscript{238} Revenue Law Amendment Act, 2008.
A venture capital company is a company that has been approved by the Commissioner in terms of section 12J(5) and in respect of which such approval has not been withdrawn in terms of section 12J(6) or (6A). The venture capital company acts as an equity financier to various unlisted small businesses referred to as 'qualifying companies'. Venture capital companies are only allowed to invest in companies that meet the requirements of a ‘qualifying company’. These qualifying companies may not be engaged in any impermissible trade, and may not be set up as passive companies. A venture capital company that invests in a qualifying company may not, whether directly or indirectly, own 70 per cent or more of the equity shares in the qualifying company.

The diagram below depicts the flow of funds/investments from the investor, via the venture capital company, through to the qualifying company.

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239 Section 12J(1)
240 Section 12J(1)
241 Section 12J(6A)
242 Section 12J(1)
243 This is to ensure that the purpose of the venture capital company is achieved, namely to provided equity financing to small and medium-sized businesses and junior mining companies for the purpose of economic activity and job creation. See Budget Review 2008
244 Paragraph (b) of the definition of ‘qualifying company’ contained in section 12J(1) of the Income Tax Act 58 of 1962, requires that a company not be a controlled group company. The definition of ‘group of companies’ in terms of section 1(1) of the Income Tax Act 58 of 1962 indicates that the threshold to qualify as a controlled group company is 70 per cent.
The way in which an investor invests in a venture capital company is by way of capitalisation of the venture capital company through the issue of equity shares from the venture capital company to the investor. These are known as 'venture capital shares'.

If a taxpayer has actually incurred an expenditure to acquire any venture capital share issued to that taxpayer by the venture capital company (on or before 30 June 2021), a deduction of the full amount will be allowed from the taxpayer’s income. However, any amount allowed as a deduction under section 12J(2) is recouped under section 8(4)(a) of the ITA upon the disposal of shares held in an approved venture capital company. Any

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247 Section 12J(1)
248 Section 12J(11)
249 Section 12J(2)
250 Provided that the venture capital shares have not been held for a period of five years or longer.
amount recouped under section 8(4)(a) of the ITA is included in the gross income of the person disposing of the shares, irrespective of the capital or revenue nature thereof.\textsuperscript{251}

The Taxation Laws Amendment Act 43 of 2014 provides that the following be inserted into subsection (9) of section 12J of the ITA, and provides:

\begin{quote}
\textit{\textquoteleft (9) Notwithstanding section 8(4), no amount shall be recovered or recouped in respect of the disposal of a venture capital share if that share has been held by the taxpayer for a period longer than five years.\textquoteright}
\end{quote}

The way in which a venture capital company invests in a qualifying company is by means of capitalisation of the qualifying company through the issue of equity shares from the qualifying company to the venture capital company. These are known as \textit{\textquoteleft qualifying shares\textquoteright}.\textsuperscript{252}

A claim for a deduction in terms of section 12J(2) must be supported by a certificate issued by the venture capital company stating the amounts invested in that company and that the Commissioner approved that company as contemplated in section 12J(5).\textsuperscript{253}

In order for a company to be approved as a 12J venture capital company, the requirements of section 12J(5) of the ITA must be met and are as follows: The venture capital company must be a resident company; the sole object of the company is the management of investments in qualifying companies; the company must be a taxpayer in good standing; the company must be licensed in terms of section 7 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002).

\textsuperscript{251} Interpretation note: No. 43(Issue 5) – South African Revenue Service [2014]
\textsuperscript{252} Section 12J(1)
\textsuperscript{253} Section 12J(4)
For the purpose of paragraph (b) of section 12J(5), the sole object of the company must be the management of investments in qualifying companies. As such, the Memorandum of Incorporation of the company would need to state that the sole object of the company is the management of investments in qualifying companies. Any amendment to this object contained in the company’s Memorandum of Incorporation would result in the withdrawal of approval of that company as a venture capital company.254

Accordingly, the company envisaged in terms of section 12J of the ITA should be a ring-fenced company, as prescribed by section 11(3)(b) read with sections 15(2) (b) and (c) of the Companies Act.

Briefly, section 11(3)(b) of the Companies Act states that if the company’s Memorandum of Incorporation includes any provision contemplated in sections 15(2) (b) or (c), of the Companies Act, restricting or prohibiting the amendment of any particular provision of the Memorandum of Incorporation, the name of the company must be immediately followed by the expression ‘(RF)’ indicating a ring-fenced company.

While section 12J(5) does not require any restriction of prohibition on the amendment the provision of paragraph (b), such amendment to the object of the company will be prohibited by virtue of the fact that, should the object of the company, as required in terms of paragraph (b) of section 12J(5), be amended in such a way that it no longer reflects that the sole object of the company to be the management of investments in qualifying companies, the Commissioner will withdrawal the approval of that company as a venture capital company.255

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254 Section 12J(6)
255 Section 12J(6)
The Practice Note from the Companies and Intellectual Property Commission, regarding the interpretation of section 11(3)(b), read with sections 15(2) (b) and (c) of the Companies Act, in relation to the use of “(RF)” in the name of a company, states:

‘...it is submitted that the expression “(RF)” be used only in cases where it is evident that –

the purpose or objectives of the company are restricted or limited in the MOI of the company;…’

The Commissioner may withdraw a company’s section 12J venture capital status in the following two circumstances:

1. If a venture capital company, during a year of assessment, failed to meet the requirements of section 12J(5) of the ITA, the Commissioner must, after due notice to the company, withdraw approval from the commencement of that year of assessment if corrective steps acceptable to the Commissioner are not taken by the company within a period stated in the notice.  

2. If, at the end of any year of assessment, after the expiry of a period of 36 months commencing on the first date of the issue of venture capital shares, at least 80 per cent of the expenditure incurred by the company to acquire assets held by the company, was incurred to acquire qualifying shares issued to the company by qualifying companies, each of which, immediately after the issue, held assets with a book value not exceeding R50 million (R500 million if the qualifying company was a junior mining company); or no more than 20 per cent of any amounts received in respect of the issue of shares in the company was utilised to acquire qualifying shares issued to the company by any one qualifying company, the Commissioner must

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256 No. 4 of 2012
257 Section 12J(6)

Book Value (or carrying amount) - The amount at which an asset is recognised after deducting any accumulated depreciation (or amortisation) and accumulated impairment
after due notice to the company withdraw that approval from the commencement of that year if corrective steps acceptable to the Commissioner are not taken by the company within a period stated in the notice.\(^{259}\)

If the Commissioner withdraws the section 12J venture capital status, an amount equal to 125 per cent of the expenditure incurred by the investors in acquiring venture capital company shares must be included in the income of the venture capital company in the year that the approval is withdrawn by the Commissioner. This effectively neutralises the deduction the individual taxpayers (with an approximate tax rate of 40 per cent) would have claimed by investing in the venture capital company.

A company may reapply for approval in respect of the year of assessment following the year of assessment during which the 12J venture capital status was withdrawn, if the non-compliance has been rectified to the Commissioner's satisfaction.\(^{260}\)

The capitalisation of both the venture capital company and qualifying company are important, as this is fundamentally how investments into these companies are to be made. Part D of Chapter 2 of the Companies Act provides for the capitalisation of profit companies. Sections 36, 37, and 38 of the Companies Act, in particular, are of importance when either the venture capital company or the qualifying company, are seeking to authorise shares to be issued with various rights, preferences and limitations. Part D of Chapter 2 of the Companies Act in general, and sections 36, 37, and 38 in particular, must be consulted in order to establish the required venture capital shares and qualifying shares. In order to fully comply with all the provisions put forward by section 12J of the ITA in terms of the issue of venture capital

\(^{259}\) Section 12J(6A)  
\(^{260}\) Section 12J(7)
shares and qualifying shares, a closer look at the definitions and aspects thereof, is required.

The requirements to comply with the definitions of a ‘qualifying share’ and a ‘venture capital share’ are similar; as such, they will be discussed together below.

‘Qualifying share’ –

means an equity share\textsuperscript{261} \textbf{[my emphasis]} held by a venture capital company which is issued \textbf{[my emphasis]} to that company by a qualifying company, and does not include any share which-

a) ...........\textsuperscript{262}

b) would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) of the definition of ‘hybrid equity instrument’ in that section; or

c) constitutes a third-party backed share as defined in section 8EA(1).

‘Venture capital share’ –

means an equity share \textbf{[my emphasis]} held by a taxpayer in a venture capital company which is issued \textbf{[my emphasis]} to that taxpayer by a venture capital company, and does not include any share which-

\textsuperscript{261} An “equity share” is defined in terms section 1(1) of the Income Tax Act 58 of 1962 and means – any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution. Also - a distribution, in respect of the definition of an ‘equity share’ in terms of the ITA, may take the form of a distribution of profits (i.e. dividends) or capital (i.e. return of contributed tax capital). As long as the right to participate in either of these types of distribution is unrestricted, the share will be an equity share. If both these rights are restricted, the share will not be classified as an equity share as defined in the ITA. \textbf{[Interpretation Note No. 67 (Issue 2) of the Income Tax Act 58 of 1962]}

\textsuperscript{262} Paragraph (a) of both definitions of a ‘qualifying share’ and a ‘venture capital share’ were deleted by the Taxation Law Amendment Act 24 of 2011.
a) ...........

b) would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) of the definition of 'hybrid equity instrument' in that section; or

c) constitutes a third-party backed share as defined in section 8EA(1).

The use of the word 'issued' in the definition of a 'qualifying share' and 'venture capital share', indicates that the equity shares received from either the qualifying company by the venture capital company, or the equity shares received from the venture capital company by the investor, must be in the form of an issue of shares from the respective company. The purpose of this is to ensure that the respective companies receive actual capital in consideration for their shares. A transfer of shares, as opposed to an issue of shares, has the effect of ceding the rights attached to the shares from one shareholder to the other,\textsuperscript{264} without capitalising the company that originally issued the shares. The tax incentive is only afforded to those taxpayers that acquire newly issued shares from the venture capital company.\textsuperscript{265} Likewise, venture capital companies may only acquire shares in a qualifying company through a share issued by the qualifying company to the venture capital company.

Previously, paragraph (a) of the definition of a 'qualifying share' stated that a 'qualifying share' does not include any share which –

\begin{quote}
the venture capital company has an option to dispose of, or the qualifying company has an obligation to redeem, for an amount other than the market value of the share at the time of that disposal or redemption;
\end{quote}

\textsuperscript{263} Ibid
\textsuperscript{264} Botha v Fick 1995(2) SA 750 (A).
\textsuperscript{265} Section 12J(1)
Previously, paragraph (a) of the definition of a ‘venture capital share’ stated that a ‘venture capital share’ does not include any share which –

\[\text{the taxpayer has an option to dispose of, or the venture capital company has an obligation to redeem, for an amount other than the market value of the share at the time of that disposal or redemption;}\]

From the deletion of paragraph (a) in both of both the definitions of a ‘venture capital share’ and a ‘qualifying share’, it appears as though the taxpayer (or venture capital company), may now acquire issued shares from the venture capital company (or qualifying company), granting a taxpayer (or venture capital company) an option to dispose of, or the venture capital company (or qualifying company) an obligation to redeem, the issued shares.

Upon closer inspection of both the definitions of a ‘qualifying share’ and a ‘venture capital share’, it is evident from the wording in paragraph (b) of both definitions, that shareholders in both the venture capital company and the qualifying company may not be issued with shares which would constitute a hybrid equity instrument, as defined in section 8E(1) of the ITA, but for the three-year period requirement contemplated in paragraph (a) of the definition of ‘hybrid equity instrument’ in that section. As such, a closer inspection of

266 “hybrid equity instrument” means—

\[(a) \text{any share other than an equity share [my emphasis], if—}\]
\[(i) \text{the issuer of that share is obliged to redeem that share in whole or in part; or}\]
\[(ii) \text{that share may at the option of the holder be redeemed in whole or in part, within a period of three years from the date of issue of that share;}\]
\n\[(b) \text{any share other than a share contemplated in paragraph (a), if—}\]
\[(i) \text{(aa) the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share;}\]
\[(bb) \text{that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share; or}\]
\[(cc) \text{at any time on the date of issue of that share, the existence of the company issuing that share—}\]
\[(A) \text{is to be terminated within a period of three years; or}\]
the definition of ‘hybrid equity instrument’, as defined by section 8E(1) of the ITA, is required.

A point of contention is the wording in the definition of paragraph (b) of both a ‘qualifying share’ and a ‘venture capital share’. It is clear that such shares must be equity shares that are issued to the taxpayer (or venture capital company) by a venture capital company (or qualifying company), provided that the share does not constitute a constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) of the definition of ‘hybrid equity instrument’ in that section [my emphasis].

Paragraph (b) of the definition of both a ‘qualifying share’ and a ‘venture capital share’ makes specific reference to the three-year period requirement in paragraph (a) of the definition of ‘hybrid equity instrument’. Although paragraph (b) of the definition of ‘hybrid equity instrument’ also makes reference to a three-year period requirement, this paragraph, for the purpose of the definition of both a ‘qualifying share’ and a ‘venture capital share’, has not been included.

Paragraph (a) of the definition of ‘hybrid equity instrument’, however, makes reference to any share other than an equity share. Paragraph (b) of the

(B) is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time;

and [my emphasis]

(ii)

(aa) that share does not rank pari passu as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes; or

(bb) any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or the time value of money; or

(c) any preference share if that share is—

(i) secured by a financial instrument; or

(ii) subject to an arrangement in terms of which a financial instrument may not be disposed of, unless that share was issued for a qualifying purpose;
definition of ‘hybrid equity instrument’ makes reference to any share other than a share contemplated in paragraph (a) of the definition of ‘hybrid equity instrument’. Paragraph (b) of the definition of a ‘hybrid equity instrument’ thus refers to an equity share in this regard.

The definition of both a ‘qualifying share’ and a ‘venture capital share’ requires that the shares be equity shares. It is peculiar that the legislator would be referring to paragraph (a) of the definition of a ‘hybrid equity instrument’ in the definition of both a ‘qualifying share’ and a ‘venture capital share’, when paragraph (a) of the definition does not encompass an equity share as required in the definition of both a ‘qualifying share’ and a ‘venture capital share’. An argument can thus be made that, by virtue of the omission of the three-year period requirement of paragraph (b) of the definition of a ‘hybrid equity instrument’, in the definition of both a ‘qualifying share’ and a ‘venture capital share’, if the share does not comply with the definition of paragraph (b) of the definition of a ‘hybrid equity instrument’, it may be considered a ‘qualifying share’ and a ‘venture capital share’, even though this section also contains a three-year period requirement.

This could, however, not have been the intention of the legislator. As mentioned in the Explanatory Memorandum of the Revenue Law Amendment Bill 2008, with regards to the definition of a qualifying share in terms of section 12J(1) of the ITA, ‘...an equity share does not meet the requirements of a qualifying share if the venture capital company has an option to dispose of the share or the investee company has an obligation to redeem the share for an amount other than its market value at the time of disposal redemption. The purpose of this test is to ensure that the venture capital company is closing the equity gap and not making explicit or disguised loans [my emphasis].’
Despite the need to interpret a statute using plain language, it is submitted that, by only inserting the three-year period qualifying requirement of paragraph (a) of the definition of a ‘hybrid equity instrument’ as a requirement of the definition of both a ‘qualifying share’ and a ‘venture capital share’, and not including paragraph (b) of the definition of a ‘hybrid equity instrument’ as well, a clear error of drafting has been made. In this regard, it was held in *Hatch v Koopoomal* that:

‘If, examining results, you find absurdity or repugnance of a kind, which, from a study of the enactment as a whole, you conclude the Legislature never could have intended, then you are entitled so to interpret the enactment as to remove the absurdity or repugnance and give effect to the intention of the Legislature.’\(^{267}\)

This approach also accords with the *dictum* of Wallis JA in the recently decided matter of *Natal Joint Municipal Pension Fund v Endumeni Municipality* to the following effect:

‘A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document.’\(^{268}\)

The only sensible meaning, which avoids the absurdity which would otherwise result, is to construe that the “*but for the three-year period requirement contemplated in paragraph (a) of the definition of 'hybrid equity instrument' in that section*” part of the definition of both a ‘qualifying share’ and a ‘venture capital share’, also includes the three-year period requirement of paragraph (b) of the definition of ‘hybrid equity instrument’ in that section. It is thus submitted that paragraph (b) of the definition of both a ‘qualifying share’ and a ‘venture capital share’ be interpreted as follows:

\(^{267}\) 1936 AD 190 at 209.
\(^{268}\) 2012 (4) SA 593 (SCA) para 18.
would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) and (b) [my emphasis] of the definition of ‘hybrid equity instrument’ in that section

With regards to paragraph (b) of the definition of ‘hybrid equity instrument’, the following is relevant. Between paragraph (b)(i) and paragraph (b)(ii), the word “and” appears. This suggests that the test referred to in paragraph (b) of the definition of ‘hybrid equity instrument’ has two parts that have to be met in order for the share to be defined as a ‘hybrid equity instrument’. Paragraph (b) makes reference to “any share other than a share contemplated in paragraph (a)” (this means an equity share). As such, paragraph (b) of the definition of ‘hybrid equity instrument’ means that an equity share [my emphasis] will be a hybrid equity instrument if: “the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share;” or “that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share;” or “at any time on the date of issue of that share, the existence of the company issuing that share is to be terminated within a period of three years or is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time;” and [my emphasis] “that share does not rank pari passu as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes;” or “any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or the time value of money.”

It is submitted that for an equity share to be classified as a hybrid equity instrument, it would need to meet the requirements of at least one of the three requirements contained in paragraph (b)(i) and at least one of the two
requirements contained in paragraph (b)(ii). If an equity share meets the requirements of one of these parts, but does not meet the requirements of the other part, for the purposes of the definition in paragraph (b) of definition of ‘hybrid equity instrument’, it will not be a ‘hybrid equity instrument’.

Paragraph (c) of the definition of both ‘qualifying share’ and ‘venture capital share’ requires that the share not constitute a third-party backed share\(^\text{269}\) as defined in section 8EA(1).

\(^{269}\) ‘Third-party backed share’, as defined in section 8EA(1) of the Income Tax Act, means – any preference share in respect of which an enforcement right is exercisable by the holder of that preference share or an enforcement obligation is enforceable as a result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital attributable to that share not being received by or accruing to any person entitled thereto.
6. The Proposed Structure of a Section 12J Venture Capital Company

6.1. Introduction

Section 12J of the ITA provides that the venture capital company be incorporated in the form of a company in terms of the Companies Act. In terms of section 8 of the Companies Act, there are four types of profit companies, namely a state-owned company; a private company; a limited liability company; and a public company. For the purpose of the 12J venture capital company regime, it is evident that a private company and a public company are the most appropriate company structures envisaged.

The venture capital company is intended to attract equity investors who acquire shares in it. The venture capital company then to uses the capital received from the issue of those shares to invest in qualifying companies through equity investments in those qualifying companies. By virtue of the requirement that the venture capital company is to raise capital through an issue of shares, Chapter 4 of the Companies Act is of relevance and shall briefly be discussed.

6.2. Chapter 4 of the Companies Act 71 of 2008

In terms of section 95(2) of the Companies Act, for the purpose of Chapter 4, a person is to be regarded, by or in respect of a company, as being a member of the public, despite that person being a shareholder of the company or a purchaser of goods from the company. As such, offers270 made by the venture capital company will be regarded as offers to the public.271

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270 Section 95(1)(g)
271 Section 95(1)(h)
unless the offer is one made under the any of the circumstances contemplated in section 96 of the Companies Act.

It is important to note that section 8(2)(b)(ii) of the Companies Act states that a profit company is a private company if its Memorandum of Incorporation prohibits it from offering any of its securities to the public; and restricts the transferability of its securities. Therefore, a private company may not offer any of its securities to the public, unless the offer is one that has been made under any of the circumstances contemplated in section 96 of the Companies Act. From the foregoing, it follows that the most appropriate company structure for a venture capital company is that of a public company.

6.3. Public Company

A public company is a profit company that is neither a state-owned company, a private company, nor a personal liability company. As such, by the very nature of its definition, a public company may offer its securities to the public and the shareholders may transfer their securities freely. However, as a result of its public nature, public companies have a greater responsibility to the public. Accordingly, public companies have more requirements, in respect of transparent and disclosure, to comply with in comparison to other types of companies. Section 34(1) of the Companies Act requires that a public company must also comply with the extended accountability requirements set out in Chapter 3 (sections 84-94) of the Companies Act.

In terms of section 84(4) of the Companies Act, a public company must appoint a person to serve as a company secretary, a person to serve as an auditor, and an audit committee. As the requirements for the appointment of

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272 Section 96 of the Companies Act provides for instances where an offer will not be deemed to be an offer to the public.
273 Cassim op cit (n66) 78.
an auditor, company secretary, and the composition of the audit committee, as well as the rights and duties of such appointments, are beyond the focus of this dissertation, they will not be discussed.

As discussed earlier, the venture capital company requires a ring fenced structure. In terms of section 11(3)(b) of the Companies Act, where the companies Memorandum of Incorporation includes any provision contemplated in sections 15(2) (b) or (c) restricting or prohibiting the amendment of any particular provision of the Memorandum of Incorporation, the name of the company must be immediately followed by the expression “(RF)”. In addition to this, section 11(3)(c)(iii) provides that a company name, irrespective of its form or language, must end with the word ‘Limited’ or its abbreviation ‘Ltd’, in the case of a public company. Therefore, assuming a proposed public company name of “VCC”, the full company name will then have to be stated, in terms of the Companies Act, as: ‘VCC (RF) Ltd’ or ‘VCC (RF) Limited’.

In terms of the incorporation of a public company, section 13(a) of the Companies Act provides that -

‘One or more persons, or an organ of state, may incorporate a profit company, and an organ of state, a juristic person, or three or more persons acting in concert, may incorporate a non-profit company, by—

a) completing, and each signing in person or by proxy, a Memorandum of Incorporation—

i) in the prescribed form; or

ii) in a form unique to the company; and

b) filing a Notice of Incorporation, in accordance with subsection (2).’
Accordingly, a public company, by virtue of being a profit company, is incorporated by one or more incorporators. However, in terms of section 13(4)(b)(i) of the Companies Act, the Commission must reject a Notice of Incorporation if the initial directors of the company, as set out in the Notice, are fewer than required by or in terms of section 66(2) of the Act. Section 66(2)(b) states that a board of a company must comprise, in the case of a public company, at least three directors.

Section 30(2)(a) of the Companies Act makes it compulsory for a public company to be audited. The audited annual financial statements of public companies must contain information and particulars showing the remuneration and benefits received by the directors and prescribed persons of the public company.\(^{275}\) In addition to this, section 33 of the Companies Act provides that every company must file an annual return with the Companies and Intellectual Property Commission within the prescribed period after the end of the anniversary of the date of its incorporation, and that if a company is required to have annual financial statements drawn up in terms of section 30(2) of the Companies Act, a copy of such annual financial statements need to be filed as well.

In terms of section 72(4) of the Companies Act and Regulations 43 and 26(2) thereto, a public company, in certain instances, must appoint a social and ethics committee.

In terms of section 99(2) and (3) of the Companies Act, a person must not make an initial public offering\(^{276}\) unless that offer is accomplished by a \textit{registered} prospectus.\(^{277}\) In respect of offers of securities that are not subject of a company’s initial public offering, a person must not make a primary

\(^{275}\) Sections 30(4) to (6)
\(^{276}\) Section 95(1)(e)
\(^{277}\) Section 95(1)(k)
offer\textsuperscript{278} to the public of any listed securities of a company, other than in accordance with the requirements of the relevant exchange; or unlisted securities of a company, unless the offer is accompanied by a registered prospectus that satisfies the requirements of such a prospectus found in section 100 of the Companies Act. In terms of a secondary offer\textsuperscript{279} to the public of any securities of a company, no offer may be made unless the offer satisfies the requirements of a secondary offer to the public as contained in section 101 of the Companies Act.

6.4. The Issue of Shares

In terms of section 12J(2) of the ITA, a deduction from the income of a taxpayer will only be allowed for the expenditure actually incurred by the taxpayer in the acquisition of venture capital shares issued to that taxpayer by the venture capital company. Accordingly, in order for any company to issue shares, such shares would need to be authorised in terms of the company's Memorandum of Incorporation. Only once shares have been authorised may they be issued to investors. The company issuing the shares needs to comply with various provisions in the Companies Act as well as the Regulations thereto. As such, a brief mention of these provisions may be beneficial.

Before a company may issues any shares, its Memorandum of Incorporation must set out the classes of shares, and the number of shares of each class that the company is authorised to issue.\textsuperscript{280} In respect of each class of shares, the Memorandum of Incorporation must set out a distinguishing designation for that class; the rights, preferences and limitations and other terms associated with that class.\textsuperscript{281}

\begin{itemize}
\item \textsuperscript{278} Section 95(1)(i)
\item \textsuperscript{279} Section 95(1)(m)
\item \textsuperscript{280} Section 36(1)(a)
\item \textsuperscript{281} Section 36(1)(b)
\end{itemize}
Any change to these provisions may only be changed by an amendment of the Memorandum of Incorporation by a special resolution of the shareholders.\textsuperscript{282}

Once shares of a company have been authorised by the company’s Memorandum of Incorporation, the board of the company may resolve to issue shares of the company at any time, but only within the classes of shares authorised.\textsuperscript{283}

Every company must establish a register of its issued securities in the prescribed form and maintain its securities register in accordance with the prescribed standards.\textsuperscript{284} Regulation 32 of the Companies Regulations 2011, prescribes the form and standards of companies’ securities registers.

A certificate evidencing any certificated securities of a company must be signed by two persons authorised by the company’s board, and such certificate is proof that the named security holder owns the securities in absence of any evidence to the contrary.\textsuperscript{285}

The company’s issued securities may be held by, and registered in the name of, a person for the beneficial interest of another, unless the company’s Memorandum of Incorporation provides otherwise.\textsuperscript{286}

If a security of a public company is registered in the name of a person who is not the holder of the beneficial interest in all of the securities in the same

\textsuperscript{282} Section 36(2)(a)  
\textsuperscript{283} Section 38(1)  
\textsuperscript{284} Section 50(1)  
\textsuperscript{285} Section 51(1)(b) and (c)  
\textsuperscript{286} Section 56(1)
company held by that person, that registered holder of security must disclose the identity of the person on whose behalf that security is held.\textsuperscript{287}
7. Section 12J Venture Capital Company and the Provision of Post-Commencement Finance for Business Rescue

7.1. Introduction

Business rescue seeks to facilitate the rehabilitation of a financially distressed company. One of the means of doing this is for the business rescue practitioner to develop and implement a business rescue plan to restructure and rescue the distressed company and maximise the prospect of the company continuing on a solvent basis. If it is not possible for the company to continue in existence, the business rescue should provide for a better return to the creditors and/or shareholders than what would result from an immediate liquidation of the company.

One of the strategies of the business rescue practitioner, other than the general moratorium, is the provision for post-commencement financing. As noted earlier, one of the main reasons why business rescues in South Africa have failed is due to the lack of post-commencement finance. In order for a business to continue on a solvent basis and ensure that the rescue is successful, post-commencement finance is usually required.

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288 In Gormley v West City Precinct Properties (Pty) Ltd [2012] ZAWCHC 33, the court was of the view that business rescue is only available for companies that may in the ensuing six months become financially distressed. However if they are already insolvent, then business rescue will be too late for them. See also Merchant West Working Capital Solutions (Pty) LTD v Advanced Technologies and Engineering Company (Pty) Ltd and Another supra (n78), where the court’s obiter view also expressed that, if a company is already insolvent, it would be too late for business rescue.

289 In Oakdene Square Properties (Pty) Ltd v Farn Bothasfontein (Kyalami)(Pty) Ltd supra (n4) the court clarified that business rescue means the achievement of either two goals contained in section 128(1)(b), namely to return the company to solvency; or provide for a better return to the creditors and/or shareholders than what would result from an immediate liquidation of the company. See also R Bradstreet ‘Business Rescue Proves to be Creditor-friendly: CJ Claassen, J’s analysis of the new business rescue procedure in Oakdene Square Properties’ (2013) 130 South African Law Journal 44-52; R Bradstreet, ‘Lending a helping hand: The role of creditors in business rescues?’ (December 2013) De Rebus 22-23.

290 Pretorius op cit (n6)
Section 135 of the Companies Act provides for the provision of post-commencement financing and with it, also a ranking of claims. While there has been some confusion over the ranking of claims under business rescue, these rankings of claims seem to have been clarified.

Accordingly, post-commencement financiers will rank ahead of all pre-business rescue creditors, regardless of whether they were secured or unsecured pre-business rescue creditors.

While the word ‘finance’ is not defined in the Companies Act, it invariably involves two sources (or a combination thereof), namely debt financing and equity financing. Equity financing has been put forward as one of the mechanisms to fund post-commencement financing. The section 12J venture capital company may only make investments into companies by way of equity financing through the acquisition of issued shares from that company.

### 7.2. Section 12J Appropriate for Business Rescue

The section 12J venture capital company is a ring-fenced funding vehicle that provides equity funding to qualifying companies. These venture capital companies may invest in any qualifying company provided that the qualifying company doesn’t carry on an impermissible trade.

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291 Du Preez op cit (n7)
292 See Merchant West Working Capital Solutions (Pty) LTD v Advanced Technologies and Engineering Company (Pty) Ltd and Another supra (n78); see also Redpath Mining South Africa (Pty) Ltd v Marsden No and Others supra (n80) at para [60]
293 Ward op cit (n83); see also Damodaran op cit (n83)
294 Du Preez op cit (n7)
295 Section 12J(1) of the Income Tax Act
A recent South African survey\textsuperscript{296} indicated that the sectors most likely to be at risk of financial distress are:

1. Manufacturing
2. Retail
3. Construction
4. Resources
5. Agriculture
6. Hotels and leisure

It is interesting to note that none of these sectors mentioned in the survey would fall into the definition of an impermissible trade in terms of section 12J(1) of the ITA. Therefore a 12J venture capital company would be able to provide equity finance to companies in the sectors most likely to be at risk of financial distress. Provided a company in business rescue complies with the requirements of a ‘Qualifying Company’, the venture capital company would be able to invest in it.

7.3. Business Rescue Plan

One of the duties of a business rescue practitioner, after consulting the creditors, affected persons and management of the company, is to prepare a business rescue plan for consideration and possible adoption.\textsuperscript{297}

As part of the business rescue plan, the business rescue practitioner will put forward a proposal suggesting an appropriate course of action that maximises the probability of the company’s continued existence, or in the

\begin{flushleft}
\textsuperscript{296} Deloitte op cit (9)
\textsuperscript{297} Section 150(1)
\end{flushleft}
alternative, would provide for a better return to the creditor and/or shareholders.\textsuperscript{298}

After the development of a business rescue plan, the plan is considered and will be approved on a preliminary basis if it was supported by the holders of more than 75 per cent of the creditors’ voting interests that were voted. The votes in support of the proposed plan must include at least 50 per cent of the ‘independent creditors’\textsuperscript{299} voting interests, if any, that were voted.\textsuperscript{300}

If the proposed business rescue plan, which has been approved on a preliminary basis, does not alter the rights of the holders of any of the company’s securities, the approval of the plan on a preliminary basis will constitute the final adoption of that plan.\textsuperscript{301} A business rescue plan that has been adopted is binding on the company, and on each of the creditors of the company and every holder of the company’s securities.\textsuperscript{302}

If a proposed business rescue plan does alter the rights of any class of holders of the company’s securities the practitioner must hold a meeting of holders of the class or classes of securities whose rights would be altered by the plan, and call for a vote by them to approve the adoption of the propose business rescue plan.\textsuperscript{303} If in such a vote, a majority of the voting rights that were exercised support the adoption of the plan, the plan will have been finally adopted. If the majority of the voting rights that were exercised oppose the adoption of the business rescue plan, the plan is then rejected and may only be considered further in terms of section 153 of the Companies Act.\textsuperscript{304}

\textsuperscript{298} Section 128(1)(b)
\textsuperscript{299} As defined in section 128(1)(g)
\textsuperscript{300} Section 152(2)
\textsuperscript{301} Section 152(3)(b)
\textsuperscript{302} Section 152(4)
\textsuperscript{303} Section 152(3)(c)(i)
\textsuperscript{304} Section 152(3)(c)(ii)
The type of post-commencement finance that could be provided by the section 12J venture capital company is in the form of equity financing. The company in business rescue would have to issue shares to the venture capital company in exchange for such funding. If it is proposed in the business rescue plan to obtain financing by way of an issue of shares in the company, the business rescue practitioner may in accordance with the business rescue plan determine the consideration for, and issue any authorised securities of the company.305 If however, the proposed business rescue plan, that makes provision for post-commencement financing by way of share issue, alters the rights of any class of holders of the company’s securities, the holders of such company securities would need to vote on the business rescue plan for approval.306 If the business rescue plan is approved by the holders of company securities, as contemplated in section 152(3)(c) of the Companies Act, then the business rescue practitioner may amend the company’s Memorandum of Incorporation to authorise, and determine the preferences, rights, limitations and other terms of, any securities that are contemplated to be issued in terms of the business rescue plan.307

If a business rescue plan is rejected, by either the creditors and/or securities holders of company securities, the business rescue practitioner may either seek a vote of approval from the holders of voting interests to prepare and publish a revised plan, or the practitioner may advise the meeting that the company will apply to court to set aside the result of the vote by the holders of voting interests or the shareholders, as the case may be, on the grounds that it was inappropriate.308 In terms of this application, a court may order that the vote on a business rescue plan be set aside if the court is satisfied that it is reasonable and just to do so, having regard to -

1. the interests represented by the person or persons who voted against the proposed business rescue plan;

305 Section 152(6)(a)
306 Section 152(3)(c)(i)
307 Section 153(6)
308 Section 153(1). See also Copper Sunset Trading 220 (Pty) Ltd, t/a Build It Lephalale (under business rescue) v Spar Group Ltd and Another (case number 365/2014)
2. the provision, if any, made in the proposed business rescue plan with respect to the interests of that person or those persons; and
3. a fair and reasonable estimate of the return to that person or persons, if the company were to be liquidated.\(^\text{309}\)

7.4. De-risking the Post-Commencement Finance

Post-commencement funding provided in terms of section 135 of the Companies Act can generally be either in the form of a loan (debt funding), an issue of share (equity funding), or a combination of both.\(^\text{310}\) A share, in terms of the Companies Act, means one of the units into which the proprietary interest in a profit company is divided.\(^\text{311}\) As such, an equity share is not secured by any particular asset of the company. A loan on the other hand, may indeed be secured by an unencumbered asset. Section 135(2)(a) of the Companies Act makes specific reference to the fact that financing may be secured to the lender by utilising any asset of the company to the extent that it is not encumbered. This indicates that debt funding may be secured, as the financier of debt funding is a “lender” of funds, whereas the financier of equity funding on the other hand is a shareholder of the company, and as such has no security over any particular asset in the company, but only a proprietary interest.

7.4.1. Non-hybrid Equity Instrument Redemption

At the outset, and to avoid possible confusion, it is important to clarify the distinction between a redemption of company shares and a repurchase of company shares. While both involve the return of shares to the company that

\(^\text{309}\) Section 153(7)
\(^\text{310}\) Ward op cit (n83); see also Damodaran op cit (n83)
\(^\text{311}\) In *Bradbury v English Sewing Cotton Co Ltd* [1923] AC 744 (HL) 746, Lord Wrenbury said: “A share…is a fractional part of the share capital. It confers upon the holder [certain rights] to a proportionate part of the assets of the corporation, whether by way of dividend or distribution of assets in winding up.”
were issued to shareholders, a redemption of shares is a repurchase of shares in accordance with a contract, contained in either the Memorandum of Incorporation or in terms of the issue of shares, made in terms of a right to purchase or to sell conferred on the company or shareholder of the shares as a term of issue.\textsuperscript{312} On the other hand, a repurchase is a contract entered into between the company and one or more of its shareholders in terms of which it is agreed that the company will acquire their shares.\textsuperscript{313} The distinction “thus turns on whether the company takes back its shares in accordance with rights attaching to the shares themselves (redemption), or in accordance with a separate contract entered into between it and the shareholders concerned (repurchase/buy-backs)”\textsuperscript{314}

As an aside, the provisions relating to a repurchase, namely sections 46 and 48 of the Companies Act, do not apply to redemptions.\textsuperscript{315}

Section 12J venture capital companies may only acquire issued equity shares that have been issued by that company to the venture capital company. In addition, the equity share may not be a hybrid equity instrument; or a third-party back share.\textsuperscript{316} Paragraph (b) of the definition of hybrid equity instrument makes reference to equity shares. There are two parts to paragraph (b), namely paragraph (b)(i) and (b)(ii), and both parts need to be complied with. The equity share needs to comply with at least one of the requirements in paragraph (b)(i), \textit{and} at least one of the requirements in paragraph (b)(ii), in order for the equity share to be classified as a hybrid equity instrument.

\begin{footnotesize}
\begin{enumerate}
\item Cassim op cit (n66) 298.
\item Ibid
\item MS Blackman et al \textit{Commentary on the Companies Act}, Vol 1 (Original Service 2002) 5-43.
\item Section 48(1)(a)
\item Section 12J(1)
\end{enumerate}
\end{footnotesize}
Accordingly, an equity share will be classified as a hybrid equity instrument if:

1. the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share; or

2. that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share; or

3. at any time on the date of issue of that share, the existence of the company issuing that share - (A) is to be terminated within a period of three years, or (B) is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time; and that share does not rank pari passu as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes; or any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or the time value of money.

It needs to be pointed out that the definition of a hybrid equity instrument refers to a redemption of shares, and not a repurchase of shares.

When the venture capital company is engaging with the business rescue practitioner about possible funding by way of equity share issue in the company in business rescue, the new shares to be issued by the company in business rescue should be in the form of a different class of shares issue. Those shares in the different class could make provision, by virtue of section 37(5) of the Companies Act, for a redemption of the shares where the issuer is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share. Alternatively, a provision in the second class of shares could stipulate that, at the option of the holder, the
shares are to be redeemed in whole or in part within a period of three years from the date of issue of that share; as long as all the shares in the different class do rank pari passu as regards its participation in dividends or foreign dividends (it should rank pari passu as the venture capital company is going to be the only holder of the different class of shares of the company in business rescue). Providing that the dividends payable on such a share are not calculated directly or indirectly with reference to any specified rate of interest or the time value of money, the share in question will not be classified as a hybrid equity instrument as it would have failed to comply with paragraph (b)(ii) of the definition of a hybrid equity instrument.

The above will all form part of the business rescue plan contemplated in section 150 of the Companies Act, which will be put to a vote by holders of voting interests, and if the rights of any other class of securities are altered by the proposed business rescue plan, the holders of such securities will also be entitled to vote.

If the business rescue plan is approved, the different class of shares will be authorised by the company, after the business rescue practitioner has amended the Memorandum of Incorporation to make provision for the implementation of the plan. Then issue to the venture capital company shares with the rights and preferences approved by the holders of voting rights and/or the holders of securities, as the case may be, can take place. A business rescue plan that has been adopted is binding on the company, and on each of the creditors of the company and every holder of the company's securities.317

317 Section 152(4)
7.4.2. Business rescue plan - Repurchase Provisions

Any prospective post-commencement financing to be funded to the company in business rescue will be form part of the business rescue plan under section 150(2)(b) of the Companies Act. In order to acquire equity shares in the company in business rescue, in terms of the business rescue plan, provision will need to be made for the authorisation and/or issue of new equity shares of the company in business rescue. These shares will either have additional preferences, rights, limitations and other terms, or will be part of the issue of existing authorised shares.

When the venture capital company is engaging with the business rescue practitioner about possible funding, as part of the business rescue plan, it is advisable that the business rescue practitioner insert a provision in the business rescue plan that stipulates that the company will repurchase the shares at a specified time in the future. In this way, the repurchase of the shares is not contained in either the Memorandum of Incorporation or in terms of the issue of shares. This repurchase will need to comply with sections 46 and 48 of the Companies Act. Consequently the equity share will not be deemed a hybrid equity instrument.

While nothing prevents a company in business rescue from repurchasing its shares in terms of section 48 and 46 of the Companies Act, complications could arise should the company consider acquiring more than 5 per cent of the issued shares of any particular class of the company’s shares. Should the company wish to repurchase more than 5 per cent of any of its issued shares of any class of the company’s shares, then section 114 and 115 of the Companies Act must be complied with. In terms of section 114(1) of the Companies Act, the board is prohibited from proposing a scheme of arrangement between the company and the holders of any class of its

318 Section 48(8)(b)
securities if the company is in the course of business rescue proceedings in terms of Chapter 6 of the Companies Act. The reason for the prohibition of the scheme of arrangement under business rescue proceedings is presumably to preserve the integrity of the business rescue process, which is subject to specific rules and procedures.319

7.4.3. Tracking Stock / Target Stock Shares

A further finance technique that could be considered to reduce post-commencement finance risk is the provision of tracking stock or target stock shares in the utilisation of the post-commencement finance structure.

While there is no generally recognised definition for tracking stock or target stock shares, the following two explanations by Msolli320, and Mason et al321 provide clarity.

According to Msolli:

‘Generally, “tracking stocks” means an equity security of the issuer, but the return of which reflects the performance of a specific activity practised within said issuer company or through one or more of its subsidiaries. Therefore, it is not based on the group in its entirety, but on a division or sector of activity.’

According to Mason et al:

‘Like conventional common stocks, the tracking stock legally represents an equity stake in the diversified parent. Unlike their conventional counterparts, however, they are designed to trade on the

319 Cassim op cit (n66) 725.
fundamentals of a particular business unit, rather than on the whole corporation and are created with features that often limit the rights of the shareholders. Thus, tracking stocks preserve the internal capital market while other forms of restructuring destroy it. A tracking stock structure effectively creates a quasi-pure play without a legal separation of corporate assets and liabilities.

While section 12J venture capital companies are limited to the acquisition of equity shares (that are neither hybrid equity instruments nor third-party backed shares) issued by the qualifying company to the venture capital company, the Memorandum of Incorporation for such authorisation and issue of shares, in terms of section 37(5) of the Companies Act, may establish for any particular class of shares, any preference, rights, or other terms that entitle the shareholders to distributions calculated in any manner. It also provides for shares of that class to have preference over any other class of shares with respect to distribution, or rights upon the final liquidation.

When the venture capital company is engaging with the business rescue practitioner about possible funding by way of equity share issue in the company in business rescue, the new shares to be authorised and issued by the company in business rescue should be in the form of a different class of shares issue. Those shares in the different class could make provision in its Memorandum of Incorporation that holder of the different class of shares will receive its distributions derived from the performance of a particular business unit within the company, and that on liquidation, this different class of shares will be paid before any other class of shares in the company.

This approach will all form part of the business rescue plan contemplated in section 150 of the Companies Act, which will be put to a vote by holders of

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322 Section 37(5)(c)
323 Section 37(5)(d)
voting interests, and if the rights of any other class of securities are altered by the proposed business rescue plan, the holders of such securities will also be entitled to vote.

If the business rescue plan is approved, the different class of shares will be authorised by the company, after the business rescue practitioner has amended the Memorandum of Incorporation to make provision for the implementation of the plan. It will then be issued to the venture capital company with the rights and preferences approved by the holders of voting rights and/or the holders of securities, as the case may be. A business rescue plan that has been adopted is binding on the company, and on each of the creditors of the company and every holder of the company’s securities.\textsuperscript{324}

\textsuperscript{324} Section 152(4)
8. Conclusion

Section 135 of the Companies Act became effective on 1 May 2011, and with it, the provision for business rescue post-commencement finance. In terms of this section, any post-commencement finance provided to the company in business rescue for the ranking of claims, will rank ahead of pre-business rescue secured or unsecured debt. Researched studies showed that, unfortunately, the extent to which post-commencement financing is used for business rescue in South Africa is little to non-existent. Many reasons have been put forward for this by what could be described as disinterested financiers. Unfortunately, both the country’s economy and workforce suffer as a result.

Section 12J was inserted into the ITA in 2008 to address the shortage of funding to small and medium-sized businesses. As part of my research, I held discussions with senior staff at National Treasury as well as various business rescue practitioners. The Taxation Laws Amendment Act 43 of 2014 has been enacted. The result of this that the quantum of investment encouraged for small and medium sized businesses increased to an amount not exceeding R50 million and R500 million if the qualifying company was a junior mining company. Section 12J provides that a deduction for the cost of the acquisition of venture capital shares, made by the investor, may be fully deducted from the taxable income of the investor for the year in which the acquisition is made. The further result of the amendment is that once such an investment has been held for 5 years, a subsequent disposal of such investment would provide tax free proceeds. This makes the investment risks and rewards very attractive.

Many of the complexities of applying these opportunities presented by combining these two pieces of legislation together were examined. As the

325 Gazette No. 38405, Notice No. 21, dated 20 January 2015.
venture capital company is issuing shares to the public, it was suggested that the structure of the company be in the form of a public company. Public companies may issue shares to the public, however by virtue of their public nature, these companies have a greater responsibility to the public. Accordingly, public companies have more requirements, in respect of transparency and disclosure, to comply with in comparison to other types of companies.

It has been shown that it is possible to incorporate the section 12J venture capital company for the purpose of providing equity finance to companies in business rescue. In addition, it would be beneficial for financiers of post-commencement business rescue finance to channel funds through a section 12J venture capital company as they will immediately receive a tax deduction for such investments.

This dissertation has sought to remedy the current situation by describing and putting forward a suggested post-commencement finance structure in terms of which the investors investing in this structured solution would receive an immediate benefit, and the company in business rescue receiving the investment funds from this finance structure would also benefit from fewer cost burdens associated with traditional debt financing (i.e. servicing of the debt). In conclusion then, it is worth reiterating that I hope that this research will be grasped and serve as a stepping stone to more successful business rescue post-commencement finance provision, concomitantly resulting in an improvement in economic activity and importantly, the retention of jobs in South Africa that it so desperately needs.