

**BUSINESS RESCUE IN SOUTH AFRICA AND ITS PRACTICAL  
APPLICATION TO SMEs**

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Mphmik003

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**I hereby declare that I have read and understood the regulations governing the submission of Master of Laws in Commercial Law, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation paper conforms to those regulations.**

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**Abstract**

South African small to medium sized entities are the bread and butter of our economy. Providing much-needed employment and developing skills both formally and informally to historically disadvantaged persons are some of the most significant benefits of small to medium sized entities in a developing country such as South Africa. Unfortunately, despite these highly celebrated significant contributions to the socio-economic development of the country, South African small to medium sized entities have the lowest survival rates in the world, resulting in high rates of business failure and job losses created by these entities.

The Companies Act 71 of 2008 provides for a corporate rescue system in the form of business rescue and a compromise between a company and its creditors which replaces judicial management as a corporate rescue procedure for South African companies. Business rescue provides companies in financial distress with opportunities to reorganise, strategize and come up with useful corporate reorganisation measures which are useful and efficient in saving the financially distressed company and possibly yielding a better return for the creditors than would have been the case if the company was liquidated.

This study analyses whether the overall South African corporate rescue systems, past and present, have developed in line with the needs and interests of South African Small to medium-sized entities, in a manner that is efficient and sensitive to the inherent weakness of our economy as well as the distinctive needs of small to medium sized entities.

A comparative study with similar procedures in the United Kingdom and the United States of America is undertaken to determine whether the evolution of South African corporate rescue laws meets the needs and interests of small- to medium-sized entities in the modern South African economy. Several inherent weakness are identified in the new business rescue regime as well as in compromises between a company and its creditors and a number of recommendations are made to improve the current provisions in the Act, for the purpose of making access and use of these corporate rescue procedures less burdensome and accessible for small- to medium-sized entities.

This is done with the purpose of assisting the South African legislature in developing a corporate rescue procedure tailor-made for South African companies and

not a mere cut and paste corporate rescue system unfitting to the needs and interests of South African small- to medium- sized entities.

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**DECLARATION**

1. I know that plagiarism is wrong. Plagiarism is to use another's work and pretend that it is one's own.

2. I have used the *SALJ* convention for citation and referencing. Each contribution to, and quotation in, this thesis from the work(s) of other people has been attributed, and has been cited and referenced.

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**Signed**

Signature

14 / 09 / 2015

Date

## **DEDICATION**

To my parents Tshifhiwa Doreen and Moad Mashudu Maphiri

## ACKNOWLEDGEMENTS

*Jeremiah 29:11*

*“ For I know the plans I have for you,” declares the Lord, “plans to prosper you and not to harm you, plans to give you hope and a future. ”*

*Thank you my Jesus*

I dedicate this dissertation to my mother Tshifhiwa Doreen Maphiri for there are many women of valour's but none can come close to you. To my Father Moad Maphiri may this dissertation serve as a constant reminder of the true calling of God in your life, the greatest gift I ever had come from God, I called him Dad.

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To my pastors , pastor T Baloyi and pastor EC Baloyi this is a product of Disciples I am the woman I am today because of the church. Thank you for listening to the lord's call I am forever grateful. My brother's junior and Muano Maphiri this is the standard follow through my beloved siblings.

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**LIST OF ABBREVIATIONS**

SME	Small to Medium Enterprises
SMME	Small Micro-Medium Enterprises
BBEEE	Broad-Based Black Economic Empowerment programme
GDP	Gross Domestic Product
DTI	Department of Trade and Industry
CIPC	Companies and Intellectual Property Commission
CVA	Company Voluntary Arrangements
USA	United States of America
UK	United Kingdom

## CHAPTER 1: INTRODUCTION

### *1.1 Background: An SME success story*

‘Business rescue works! Business rescue saved my life...If it was not for business rescue, I would not be having a place called home.’ These are the words of Jonathan De Villiers O’Hagan, a South African businessman with a wealth of knowledge and experience in the information technology business.<sup>1</sup> O’Hagan was the founding member and majority shareholder of Business Accessories Supplies and Equipment CC (BASE), a Close Corporation registered in terms of the Close Corporations Act.<sup>2</sup>

BASE filed for business rescue in terms of section 128 of the Companies Act 71 of 2008 hereafter referred to as the (Companies Act 2008), on 26 March 2012. Prior to filing for business rescue, BASE was a lucrative information technology and office automation business with 20 years’ experience in the field. The corporation flourished, and between 2000 and 2005 had an annual turnover of 12 million rand. However, in 2006, BASE began to experience significant financial distress which was essentially caused by the retirement of a majority of its founding members.

As an attempt to salvage the business, BASE went further to appoint a business rescue practitioner as required for business rescue proceedings in terms of section 143 of the Companies Act 2008.<sup>3</sup> The practitioner appointed by BASE was remunerated in accordance with the tariffs prescribed in section 143<sup>4</sup> for his reorganisation services offered to the corporation throughout the entire business rescue process which lasted for a period of three months. At the commencement of business rescue proceedings the corporation had exhausted its entire bank overdraft facility to the amount of R 490 000, 00 and owed the South African Revenue Services (SARS) R 40 968, 66. Furthermore, the total market value of its assets was R 676 831, 13 and the value of the liquidated assets stood at R 180 984, 81. Overall, BASE owed its creditors a total of R 1 547 411, 49.

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<sup>1</sup> J De Villiers O’Hagan 2015 interview on how business rescue saved my life [interview]. University of Cape Town Kramer Law Building, Middle Campus 23 March 2015 ethics reference number L15-2015.

<sup>2</sup> Close Corporation Act 69 of 1984.

<sup>3</sup> Companies Act 2008. Section 128(1) (d) gives a statutory definition of what is meant by a business rescue practitioner. ‘A business rescue practitioner is a person appointed, or two or more persons jointly appointed, to oversee a company during business rescue’.

<sup>4</sup> Companies Act 2008 section 143.

Upon completion of the business rescue process, BASE was sold as a going concern to MASON Complete Office Solutions (Pty) Ltd, one of BASE's concurrent creditors. Through business rescue, the members of BASE had their assets protected, creditors were paid in full and BASE's employees retained the positions they held in BASE at MASON Complete Office Solutions (Pty) Ltd.

The above account is a success story that proves that South African corporate reorganisation can be achieved successfully through business rescue. The question is whether BASE's experience is representative of other small to medium enterprises (SMEs) that have undergone business rescue in South Africa.

At the preliminary stage of this dissertation it is important to record the statistics in relation to company liquidations in South Africa. At the end of January 2015 statistics South Africa recorded an overall increase of 3, 0 per cent in total liquidation of South African Companies.<sup>5</sup> The periods November 2013 to January 2014 and November 2014 to January 2015 reveal that the overall numbers of company liquidations have increased by 6,5 per cent in the past two years.<sup>6</sup> Thus showing a considerable increase in liquidations of companies of all sizes and confirms growing occurrences of financial distress among South African companies.<sup>7</sup> This increase in liquidations cautions accordingly, the need to implement and improve the current corporate reorganization systems currently provided in South Africa, for the purpose of protecting our economy and improving the greater needs of the communities to which these liquidated companies operate.

## *1.2 Corporate rescue in South Africa*

### *1.2.1 The need for reform*

The need for a change in our corporate insolvency law has been the subject of debate since the late 1980s.<sup>8</sup> This need arose from the fact that South Africa had a traditional liquidation system with a liquidation culture.<sup>9</sup> The traditional liquidation system promotes the notion that when a person, both natural and juristic, is unable to pay their

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<sup>5</sup> Statistics South Africa P0043 available at <http://beta2.statssa.gov.za/publications/P0043/August2014.pdf>, accessed on 23 March 2015

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> *Oakdene Square Properties (Pty) Ltd and others v Farm Bothasfontein (Kyalami) (Pty) Ltd and 5 others*, 2012 (3) SA 273 (GSJ) at 5.

<sup>9</sup> Ibid.

debts when they fall due and payable, their creditors can attach their property for the purpose of securing payment of their debt.<sup>10</sup>

This traditional liquidation system has been the position in many countries in relation to companies; hence, bankruptcy laws are devised to maximise creditor recovery through the liquidation of an insolvent estate.<sup>11</sup> A creditor of a company that is failing to pay its debts due to him has a right by law (*ex debito justitiae*) to liquidate the company.<sup>12</sup> An expected consequence of this right means that the liquidation of would result in the winding up of the company and the auctioning of the company assets for the purpose of securing the payment of the debts owed to the creditors.<sup>13</sup>

Until this day the liquidation system is traditionally justified and highly preferred by creditors because it provides the most orderly and efficient means of securing the return of debts owed to creditors by the debtor.<sup>14</sup> Although the liquidation system remains a favourable and highly preferred method of securing returns to creditors, it has its own inherent socio-economic disadvantage in that it does not consider the impact it has on other stakeholders.<sup>15</sup> The liquidation of companies is detrimental to the South African economy because it leaves the liquidated company in a broken state and does not focus on the rehabilitation of the creditor's debt.<sup>16</sup> Moreover, a socio-economic consequence of the traditional liquidation system is that it leads to unemployment, poverty and a degradation of the overall standard of living of the more vulnerable stakeholders once the company has been successfully liquidated.<sup>17</sup> This has the effect of leading to an increase in crime which is used last resort for survival by the stakeholders.<sup>18</sup>

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<sup>10</sup> R Sharrock, K van der Linde, & A Smith *Hockley's Insolvency Law* 9th Ed (2012) at 253.

<sup>11</sup> AJ Smith 'Corporate administration a proposed model' (1999) 32 *De Jure* at 82.

<sup>12</sup> *Oakdene Square Properties* supra at 8.

<sup>13</sup> Sharrock op cit note 10 at 253.

<sup>14</sup> Smith op cit note 11 at 82

<sup>15</sup> JJ Du Plessis, A Hargovan & M Bagaric *Principles of Contemporary Corporate Governance* 2<sup>nd</sup> ed. (2010). See pages 16-17. It must however be noted that there is no single confined definition of the term stakeholders. Du Plessis attempts to provide a definition of what is meant by a stakeholder in his book corporate governance an over view the concept corporate governance and the essential corporate governance principles. The term stakeholder encompasses a wide range of interests it encompasses 'any individual or group in which the activities of the company have an impact on, stakeholders include employees, customers, the environment, the society within which the company operates, banks as well as the government'. Stakeholder includes any person or thing which is affected by the activities of the company.

<sup>16</sup> Smith op cit note 14 at 83.

<sup>17</sup> G Museta *The Development of Business Rescue in South Africa* (Unpublished LLM theses, University of Pretoria 2011) at 1.

<sup>18</sup> *Ibid.*

A developing economy such as South Africa cannot grow if companies facing financial difficulty are constantly liquidated.<sup>19</sup> This is because the liquidation system does not offer companies an opportunity to restructure, and possibly function as going concerns. The liquidation system should be used as last resort for SME companies and or close corporations (which tend to be smaller entities) for the purpose of protecting and promoting the greater needs and interests of the economy and the society at large.

If BASE<sup>20</sup> had been placed under liquidation, the consequence of such a business decision would have left BASE as a corporate shell. BASE's employees would have had no place to work and continue to provide for their families, the clientele that BASE had developed over the years would have gone elsewhere. Business rescue as a corporate rescue procedure was able to save BASE from capsizing through the traditional liquidation process and provided the financially distressed close corporation with an opportunity to continue business under MASON Complete Office Solutions (Pty) Ltd, thereby providing a win-win situation for all relevant stakeholders including its creditors.<sup>21</sup>

### *1.2.2 Corporate rescue defined*

Corporate rescue is defined as 'the revival of companies in the brink of economic collapse and the salvage of economically viable units to restore, production employment and the continued rewarding capital investment'.<sup>22</sup> Moreover, corporate rescue is perceived as a procedure that acknowledges the fact that most enterprises have more substantial value as a going concern than when liquidated.<sup>23</sup> Today, the modern trend towards corporate rescue, has been led and influenced by a number of countries namely Canada, Australia and some in Europe, to name a few.<sup>24</sup> These countries have broadened their bankruptcy laws to provide various alternatives to liquidation through 'reorganization' and 'rehabilitation' of companies in financial distress.<sup>25</sup> It is through this corporate rescue umbrella that procedures such as judicial management and business rescue were birthed. In today's competitive business world

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<sup>19</sup> Statistics SA, available at <http://beta2.statssa.gov.za/publications/P0043/P0043August2014.pdf>, accessed on 19 February 2015.

<sup>20</sup> De Villiers O'Hagan op cit note 1.

<sup>21</sup> Ibid.

<sup>22</sup> P Kloppers 'Judicial management reform: Steps to initiate a business rescue mechanism in need of reform?' (1999) 3 *Stell LR* at 418.

<sup>23</sup> Ibid.

<sup>24</sup> H Rajak & J Henning 'Business rescue for South Africa' (1999) 116 *SALJ* at 263.

<sup>25</sup> Smith op cit note 11 at 83.

corporate rescue systems become necessary to rescue companies that are suffering temporarily or experiencing financial distress.<sup>26</sup> For this reason, the above mentioned countries have become sensitised to the need for preserving their companies and prefer corporate rescue systems to the traditional liquidation system by revolutionising their company reorganisation procedures.<sup>27</sup>

### *1.3 SMEs and development*

There is an agreement among policy makers, economists and business experts that SMEs are the drivers of economic growth and development.<sup>28</sup> A developing country such as South Africa requires a healthy SME sector to contribute significantly to the economy by generating employment opportunities, increasing productivity, inspiring entrepreneurial skills and breeding more import and export opportunities for South Africans.<sup>29</sup> SMEs are used as catalysts through which the socio-economic goals of South Africa are achieved.<sup>30</sup>

In today's business world there is an emphasis on rescuing business under the new dispensation. This is because of the general tendency of modern governance to focus on a wider range of stakeholders, most importantly the employees who would benefit from the business continuing operations as opposed to the liquidation of the company. This is done for the purpose of promoting sustainability and development of businesses of all sizes and improving the overall standard of living for stakeholders. BASE<sup>31</sup> under business rescue has managed to achieve this successfully and maintain the overall contribution it made to the society by preserving much needed employment

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<sup>26</sup> Companies Act 2008. See definition of financial distress section 128.

<sup>27</sup> G McCormack *Corporate Rescue Law – An Anglo American Perspective* (2008) 1.

<sup>28</sup> E Mahembe 'Literature Review on Small and Medium Enterprises Access to Credit and Support in South Africa Prepared for National Credit Regulator (NCR)' (December, 2011) 1, available at [http://www.ncr.org.za/pdfs/Research\\_Reports/Literature%20Review%20on%20SME%20Access%20to%20Credit%20in%20South%20Africa\\_Final%20Report\\_NCR\\_Dec%202011.pdf](http://www.ncr.org.za/pdfs/Research_Reports/Literature%20Review%20on%20SME%20Access%20to%20Credit%20in%20South%20Africa_Final%20Report_NCR_Dec%202011.pdf), accessed on 12 March 2015.

<sup>29</sup> Ibid.

<sup>30</sup> Ibid. Democratic South Africa introduced a progressive constitution which identified the socio-economic goals of South Africa. The socio-economic goals identified are outlined in South Africa's Millennium Development Goals strategy (MDGs) report also known as the MGD report. This report identifies the eight socio economic goals for South Africa as follows 1.To eradicate extreme poverty and hunger 2.To reduce universal primary education 3.To promote gender equality and empower women 4.To reduce child mortality 5.To improve maternal health 6.To combat HIV/AIDS, malaria and other diseases 7.To ensure environmental sustainability 8.To develop a global partnership for the development. See the country report 2013, available at [http://www.za.undp.org/content/dam/south\\_africa/docs/Reports/The\\_Report/MDG\\_October-2013.pdf](http://www.za.undp.org/content/dam/south_africa/docs/Reports/The_Report/MDG_October-2013.pdf), accessed on 12 June 2015.

<sup>31</sup>De Villiers O'Hagan op cit note 1.

to the community through business rescue. The corporation was purchased by MASON Complete Office Solutions (Pty) Ltd in effect saving the jobs of its employees and promoting a healthy SME sector. The fact that BASE was sold as a going concern to MASON Complete Office Solutions (Pty) Ltd did not rescue the corporation as a shell. However, BASE CC under business rescue was enabled to rescue the business and its stakeholders.<sup>32</sup> This has the effect of promoting SME development in South Africa.

### *1.3.1 SMEs defined*

Apart from the fact that the SME sector is acknowledged internationally by policy makers and business experts, there is no uniform definition of what is meant by an SME.<sup>33</sup> The standard form of defining an SME can be seen by how most countries use economics and statistics to establish a definition unique to their legal system.<sup>34</sup>

An economic definition of an SME will consider the annual turnover profitability and net worth of the business, while a statistical definition of SMEs will look at the size of the workforce within that business.<sup>35</sup> Moreover, in developing countries SMEs are mostly characterised as one-person businesses, in which the working staff can be family members who are often unpaid but are active in the enterprise.<sup>36</sup> Furthermore, African developing countries have identified SMEs as more labour-intensive institutions than larger firms with low capital costs.<sup>37</sup>

Ghana as a developing country has adopted its own unique definition by using statistical factors to define the SMEs sector within its own system. In Ghana, the underlying criterion used in defining SMEs has been the employee component of the enterprise.<sup>38</sup> SMEs have been distinctly defined as companies with less than 10 employees, medium-sized companies as companies with more than 10 employees.<sup>39</sup>

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<sup>32</sup>De Villiers O'Hagan op cit note 1.

<sup>33</sup> Mahembe op cit note 28 at 22 para 1.

<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

<sup>36</sup> Ibid.

<sup>37</sup> J Abor, & P Quartey 'Issues in SME development in Ghana and South Africa' (2010) 39 *International Research Journal of Finance and Economics* 222, available at <http://www.eurojournals.com/finance.htm>, accessed on 23 July 2015.

<sup>38</sup> Mahembe op cit note 28 at 90.

<sup>39</sup> Ibid

On the other hand, Malawi as a developing country defines an SME sector on levels of capital investments, employees and total turnover.<sup>40</sup>

In South African the issue of what constitutes an SME is correspondingly a matter of concern,<sup>41</sup> as there has been no fixed definition of what constitutes an SME. Schedule 2 of the National Small Business Act 102 of 1996<sup>42</sup> provides a statutory definition of 'small business', which has for academic purposes been used as an inclusive definition for SMEs. Chapter 1(xv) of The National Small Business Act<sup>43</sup> defines a 'small business' as:

A separate and distinct business entity, including cooperative enterprises and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or subsector of the economy mentioned in column I of the Schedule and which can be classified as a micro-, a very small, a small or a medium enterprise by satisfying the criteria mentioned in columns 3, 4 and 5 of the Schedule.

In practice this definition has been interpreted wide enough by State Small Enterprise Development Agencies (SEDA)<sup>44</sup> to include both SMEs and Small Micro Medium Enterprises (SMMEs) as 'small business' for the purpose of the Act. The reference to SMEs in The National Small Business Act<sup>45</sup> is important in this dissertation for determining whether these businesses can achieve the benefits realised by BASE<sup>46</sup> when placed under business rescue in terms of the Companies Act 2008.

In relation to the above, the definition of an SME in this dissertation will be restricted to mean either a company or close corporation which continues to exist after the cut off date for registering Close corporations.<sup>47</sup> Furthermore these SMEs must have one or more members and directors as set out in column I of the schedule referred to above. Additionally, such SME will have to be registered in terms of the South African Companies Act 2008<sup>48</sup> and the Close Corporations Act<sup>49</sup> as the case may be.

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<sup>40</sup> Ibid.

<sup>41</sup> Mahembe op cit note 28 at 24.

<sup>42</sup> National Small Business Act 102 of 1996.

<sup>43</sup> National Small Business Act 102 of 1996.

<sup>44</sup> <http://www.seda.org.za/>

<sup>45</sup> National Small Business Act 102 of 1996.

<sup>46</sup> De Villiers O'Hagan op cit note 1.

<sup>47</sup> [http://www.cipro.gov.za/news\\_events/CIPRO\\_received\\_record\\_number\\_of\\_annual\\_returns\\_lodgements.doc](http://www.cipro.gov.za/news_events/CIPRO_received_record_number_of_annual_returns_lodgements.doc). The Companies and Intellectual Property Registration office set the cut-off date for all Close corporations as 21 February 2011.

<sup>48</sup> Companies Act 2008.

<sup>49</sup> Close Corporations Act 69 of 1984.

### 1.3.2 *The reformative role of SMEs in South Africa.*

It is imperative to note at the earliest stage of this dissertation the significant contributions made by SMEs to the economy and society, and their corresponding influence in South Africa. It is a well-known fact that various aspects of South African society have undergone diverse transformation since the first non-racial democratic elections on 27 April 1994.<sup>50</sup>

The changes brought by the transformation of South Africa's political structure include the reformation of old apartheid laws that discriminated against people of colour in both the social and economic sectors.<sup>51</sup> This transformation was facilitated by the introduction of the new Constitution of the Republic of South Africa.<sup>52</sup> This Constitution aims to protect democracy by promoting human dignity, equality and freedom in all sectors including the corporate world.<sup>53</sup> For that reason the purpose of the Companies Act 2008 includes the promotion of and compliance with the Constitution's Bill of Rights in relation to companies.<sup>54</sup>

The reformation process of South Africa went further to include the introduction of the Broad-Based Black Economic Empowerment (BBBEE) strategies and programmes.<sup>55</sup> BBBEE strategies aim to provide corporate opportunities to historically disadvantaged persons and redress the effects of the past political injustices by broadening the economic participation of the black majority.<sup>56</sup> For this reason, SMEs are until this day used as engines to drive and facilitate economic reform in South Africa, and to empower historically disadvantaged persons. Furthermore, these SMEs are used as implementation tools for BBBEE strategies which aim at facilitating corporate reform in South Africa by addressing the challenges of unemployment and poverty alleviation which until this day is a matter of much heated debate.<sup>57</sup>

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<sup>50</sup> LP Kruger 'the impact of black economic empowerment (BEE) on South African businesses: Focusing on ten dimensions of business performance' (2011) 15 *Southern African Business Review* at 207.

<sup>51</sup> Ibid.

<sup>52</sup> Constitution of the Republic of South Africa, Act 108 of 1996.

<sup>53</sup> Ibid.

<sup>54</sup> Companies Act 2008 See section 7(a).

<sup>55</sup> Kruger op cit note 50 at 3.

<sup>56</sup> Ibid.

<sup>57</sup> D Van der Nest *The Impact of Black Economic Empowerment on the Management of Small Companies in South Africa* (unpublished MBA thesis, University of Johannesburg 2004) available at <https://152.106.6.200/bitstream/handle/10210/319/ImpactofBEEontheMngofSMEinSouthAfrica.pdf?sequence=1&isAllowed=y>, accessed on 10 April 2015.

Furthermore SMEs in South Africa are expected to function within the social and economic transition of the country, by improving the overall standard and quality of life, and also providing much-needed value and growth to the economy.<sup>58</sup> This is of absolute importance because the South African economy is currently characterised by high levels of unemployment and low levels of productivity as well as low levels of international competitiveness.<sup>59</sup>

Notwithstanding the above, the formal sector in South Africa continues to consistently shed jobs and decrease its employment absorption rate in the mist of economic calamity.<sup>60</sup> There is, therefore, a need to create an optimal environment for entrepreneurship by developing and cultivating individual business skills.<sup>61</sup> In other words, the development, promotion and protection of SMEs must continue to be cultivated as a useful method for eradicating poverty and promoting growth,<sup>62</sup> which is vital in achieving long-term economic sustainability and development in South Africa.<sup>63</sup>

In June 2004, the Department of Trade and Industry (DTI) provided a clear justification for the repeal of the Companies Act 61 of 1973 (Companies Act 1973).<sup>64</sup> One of the reasons for repealing the Act was the need to ensure that the regulatory frameworks for enterprises of all types of businesses including micro, very small and medium enterprises are accommodated. This was done for the purpose of promoting growth, employment, innovation, stability, good governance, confidence and international competitiveness in South Africa.<sup>65</sup> Hence, recognising the need to facilitate corporate law reform and promote SME development.

Additionally, the new legislation was adopted to promote the empowerment and growth of companies of all sizes, inclusive of SMEs. In consequence of the

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<sup>58</sup> A Keeper 'Failing or not aiming to grow? Manufacturing SMMEs and their contribution to employment growth in South Africa (2001) 12 *Urban Forum*, 171, available at [http://scholar.google.co.za/scholar\\_url?url=http%3A%2F%2Flink.springer.com%2Fcontent%2Fpdf%2F10.1007%2Fs12132-001-0015-5.pdf&hl=en&sa=T&oi=gga&ct=gga&cd=2&ei=7zAmVbmlO-fq0AGwuoC4DA&scisig=AAGBfm0MP5kA0UnVOdmzzGVleaXGxVO-aQ&nossl=1&ws=1920x934](http://scholar.google.co.za/scholar_url?url=http%3A%2F%2Flink.springer.com%2Fcontent%2Fpdf%2F10.1007%2Fs12132-001-0015-5.pdf&hl=en&sa=T&oi=gga&ct=gga&cd=2&ei=7zAmVbmlO-fq0AGwuoC4DA&scisig=AAGBfm0MP5kA0UnVOdmzzGVleaXGxVO-aQ&nossl=1&ws=1920x934), accessed on 9 April 2015.

<sup>59</sup> Ibid.

<sup>60</sup> Ibid.

<sup>61</sup> Ibid.

<sup>62</sup> Ibid.

<sup>63</sup> Ibid.

<sup>64</sup> Department of Trade and Industry *the Companies Act 71 of 2008: Explanatory Guide Replacing the Companies Act 61 of 1973* (2010) 6, available at [https://c.yimcdn.com/sites/www.iodsa.co.za/resource/collection/CB7E5DC1-E790-4BED-9693-9F8AA33E0032/Companies\\_Act\\_Guide.pdf](https://c.yimcdn.com/sites/www.iodsa.co.za/resource/collection/CB7E5DC1-E790-4BED-9693-9F8AA33E0032/Companies_Act_Guide.pdf), accessed on 31 March 2015.

<sup>65</sup> Ibid.

introduction of the Companies Act 2008,<sup>66</sup> SMEs incorporated in terms of this Act<sup>67</sup> are entitled to the same benefits and protection as any other corporate giant that has been incorporated in terms of the Act.<sup>68</sup> This means that corporate rescue strategies provided for in the form of business rescue will apply to South African SMEs incorporated in terms of the Act, provided that they have complied with the requirements set out in the Act<sup>69</sup> and its regulations.<sup>70</sup>

#### *1.4 Objectives, rationale and scope of dissertation.*

##### *1.4.1 Problem statement*

As stated above, SMEs will continue to play a crucial role in the South African economy, providing much-needed employment, experience and income to stakeholders and thus making an immense contribution to the country's Gross Domestic Product (GDP).<sup>71</sup> It is in response to this reality that Trevor Manuel, in his capacity as then Minister of Trade and Industry, pointed out that:

Throughout the world one finds that SMEs are playing a critical role in absorbing labour, penetrating new markets and generally expanding economies in creative and innovative ways. We are of the view that, with the appropriate enabling environment SMEs in this country can follow these examples and make an indelible mark on this economy.<sup>72</sup>

This is why twenty years on SMEs are still of crucial importance to the economy, this is seen by the fact that they contribute up to 30 per cent of the GDP of South Africa and are also responsible for absorbing up to 80 per cent of the national labour force.<sup>73</sup>

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<sup>66</sup> Ibid.

<sup>67</sup> Ibid.

<sup>68</sup> Companies Act 2008.

<sup>69</sup> Ibid.

<sup>70</sup> Companies Regulations, 2011.

<sup>71</sup> Mahembe op cit note 28 at 7.

<sup>72</sup> Department of Trade and Industry *the White Paper on National Strategy and Promotion of Small Businesses in South Africa* (1995), available: [http://www.thedti.gov.za/sme\\_development/docs/whitepaper.pdf#foreward](http://www.thedti.gov.za/sme_development/docs/whitepaper.pdf#foreward), accessed 21 February 2015.

<sup>73</sup> C Ngary, Y Smit & Y Bruwer 'Financial performance measures and business objectives attainment in fast food (SMMES) in the Cape metropolis: A preliminary liability and suitability analysis' accessed on 21 March 2015 *Mediterranean Journal of Social Sciences* 911, available at [https://ujdigispace.uj.ac.za/bitstream/handle/10210/13431/Ukpere.pdf?sequence=1\\_](https://ujdigispace.uj.ac.za/bitstream/handle/10210/13431/Ukpere.pdf?sequence=1_), accessed on 27 February 2015.

Despite the significant importance and contribution of SMEs to the economy, SMEs around the world, particularly in South Africa, are faced with numerous challenges that impede their growth.<sup>74</sup> In the early 2000s it was found that between 70 and 80 per cent of all South African SMEs fail within their first five years of existence; in fact, the failure rate of South African SMEs has been described by researchers as one of the worst in the world.<sup>75</sup>

The low survival rates of SMEs in South Africa is influenced by the following inherent attributes of these entities: First, SMEs are typically financed through private family wealth or through bank loans; they do not have the capacity to fundraise their financing by issuing share capital to the general public like larger entities.<sup>76</sup> Secondly, SMEs are often undercapitalised entities;<sup>77</sup> they do not have adequate immovable and valuable movable property to offer as security to financial institutions when in need of financing.

Thirdly, many SMEs are family-owned enterprises,<sup>78</sup> they are formed by family members with the intention to improve their financial situations and possibly break long chains of poverty. The bond inherent in such family relations can contribute towards the failure of such SMEs in that important financial decisions involving the SME are made without adherence to corporate governance principles.<sup>79</sup> This is due to the fact that family relationships are culturally and religiously based with strong emotional ties<sup>80</sup> and thus business decisions which are meant to be made independently and with sound mind and reasoning are made emotionally based on long-term trust between family members.

Finally, there is no major separation between ownership and control in SMEs:<sup>81</sup> the managers of the company are in many cases the majority and controlling share shareholders of the company, and they have all the voting rights and often make company decisions out of their own discretion with no special resolutions. This leads to an abuse of power by the manager to SMEs. The above mentioned characteristics of SMEs ultimately lead to the high failure rates of SMEs in South Africa.

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<sup>74</sup> Mahembe op cit note 28 at 7.

<sup>75</sup> Ibid at 20.

<sup>76</sup> D Milman *Governance of Distressed Firms: Corporations, Globalisation and the Law* (2013) 35.

<sup>77</sup> Ibid.

<sup>78</sup> Ibid at 36.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid

<sup>81</sup> Ibid at 35

Be that as it may, a ray of hope is offered for SMEs with the ushering in of the Companies Act 2008.<sup>82</sup> Companies that have a reasonable prospect of recovery from financial distress are thrown a lifeline in the form of business rescue proceedings encapsulated in Chapter 6 of the Act.<sup>83</sup> Business rescue, as will be discussed later in this dissertation, is a corporate reorganisation procedure that allows for the rehabilitation of companies in financial distress.<sup>84</sup> It does so by providing for temporary supervision of a company by outsourcing the services of a qualified business rescue practitioner to assist it in coming up with useful and efficient turnaround strategies for the purpose of giving it an opportunity to attempt a recovery process and save the company from closing down.<sup>85</sup>

The business rescue practitioner will manage the property of the company and all its affairs, such as the temporary stay on a claimant's rights against the property of the company, as well as developing and implementing a business rescue strategy.<sup>86</sup> Additionally, it is important to stress that only businesses that have been incorporated in terms of section 13 of the Companies Act 2008<sup>87</sup> and close corporations that fall under the jurisdiction of the same Act<sup>88</sup> will be considered for the purposes of business rescue proceedings. Moreover, existing close corporations can still make use of business rescue as section 66(1) of the Close Corporations Act makes provision for the use of business rescue by close corporation.<sup>89</sup> Despite the much needed reformation of the Companies Act and the introduction of a new reorganisation strategy in the form of business rescue, the process remains burdensome for SMEs.

The requirements of business rescue, as set out in the Companies Act 2008 and the Companies Regulations<sup>90</sup> make the whole process cumbersome for SMEs. Furthermore, regulation 127 of the Companies Regulations<sup>91</sup> categorises the

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<sup>82</sup> Companies Act 2008.

<sup>83</sup> Ibid.

<sup>84</sup> Companies Act 2008 section 128(b).

<sup>85</sup> Ibid.

<sup>86</sup> Ibid.

<sup>87</sup> Companies Act 2008.

<sup>88</sup> See Chapter 2 of Companies Act 2008 and regulation 18 of the Companies Regulations 2011.

<sup>89</sup> Close Corporations Act 69 of 1984.

<sup>90</sup> Companies Regulations 2011.

<sup>91</sup> See regulation 127(2) (a) of the Companies Regulations of 2011.

application of business rescue by limiting its application to three classes of companies.<sup>92</sup> The Regulations<sup>93</sup> classify them as follows:

- (i) “large companies”, being any company, other than a state owned company, whose most recent public interest score, as calculated in terms of Regulation 26(2), is 500 or more;
- (ii) “Medium companies” being—
  - (aa) any public company whose most recent public interest score, as calculated in terms of Regulation 26 (2), is less than 500; or
  - (bb) any other company, other than a state owned company, whose most recent public interest score, as calculated in terms of Regulation 26 (2), is at least 100 but less than 500; and
- (iii) “small companies” being any company, other than a state owned or public company, whose most recent public interest score, as calculated in terms of Regulation 26 (2), is less than 100.

Furthermore, the regulation categorises the classes of companies that can undergo business rescue by emphasising a public interest score requirement.<sup>94</sup> A public interest score is defined as a sum that must be calculated by a company at the end of its financial year.<sup>95</sup>

Although Chapter 6 of the Act makes provision for SMEs, it also presents a number of stumbling blocks, including the fact that the services of business rescue practitioners are out of reach for most SMEs in South Africa. The tariff fees for a business rescue practitioners are pegged at R1 250 per hour, to a maximum of R15 625 per day (inclusive of VAT) in the case of a small company, and R1 500 per hour, to a maximum of R18 750 per day (inclusive of VAT) in the case of a medium-sized company.<sup>96</sup> These and other factors will be discussed extensively in this dissertation.

It is important to note that although BASE,<sup>97</sup> at the time of application had enough assets to cover the costs of business rescue and at one point had an annual turnover of 12 million rand, not all SMEs are as capitalised as BASE, nor can all SMEs afford the tariffs of a business rescue practitioner, and therefore not all SMEs can find

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<sup>92</sup> See regulation 127(2) (b) (i)-(ii) of the Companies Regulations of 2011.

<sup>93</sup> Companies Regulations 2011. See regulation 127(2) (b) (i)-(ii).

<sup>94</sup> Companies Regulations 2011 regulation 26(2).

<sup>95</sup> Ibid. A public interest score is calculated as 1 point for each employee or the average number of employees throughout the year. 1 point per million rand of third party liability. This is the money owed in terms of loans, debentures, and other financing. 1 point for each million rand of turnover during the financial year. If the turnover is half a million rand, score ½ point. 1 point for every individual who, at the end of the year, is known to have a direct or indirect beneficial interest in the company. This will include shareholders, beneficiaries of a trust where a trust is a shareholder and other stakeholders.

<sup>96</sup> Companies Regulations of 2011 regulation 128.

<sup>97</sup> De Villiers O’Hagan op cit note 1

business rescue as an effective corporate rescue procedure. In light of the above, the question that forms the basis of this dissertation is whether the engineers of the new Companies Act 2008 took into account the immense contribution that SMEs make to the economy and considered them when crafting the corporate rescue procedure found in Chapter 6 of the Companies Act 2008.<sup>98</sup>

#### *1.4.2. The significance of the study*

Since ‘75 per cent of South African SMEs fail within their first two years of operation’,<sup>99</sup> there is a need for reformative legislation that offers effective corporate reorganisation strategies for SMEs at the same standard and quality as that of the business rescue provisions contained in Chapter 6 of the Companies Act 2008 in line with international best practice principles.

One would have thought that the drafters of the Companies Act 2008<sup>100</sup> would have effectively considered it prudent to take into account the recommendations made by Rajak and Henning in respect of a radically reformed business rescue regime for South Africa.<sup>101</sup> They recommended that the South African business rescue should suit the needs and culture of the society within which it is implanted.<sup>102</sup>

Rajak and Henning highlighted the fact that South Africa is a society that encourages the further growth and development of small businesses.<sup>103</sup> They proposed a dual system form of business rescue, envisioning a division of business rescue proceedings into two categories: a business rescue regime for large corporate entities and one for small entities. They also suggested that business rescue for small-sized entities must have a much lighter approach in order to help facilitate their successful and effective recovery.<sup>104</sup> Rajak and Henning were conscious of the challenges that SMEs could face in business rescue when invoking the expensive services of a professionally dominated business rescue regime.<sup>105</sup> They were of the opinion that a formal and professionally dominated business rescue approach should be reserved for

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<sup>98</sup> Companies Act 61 of 2008.

<sup>99</sup> Ngary op cit note 73 at 911.

<sup>100</sup> Companies Act 2008.

<sup>101</sup> Rajak & Henning op cit note 24 at 268.

<sup>102</sup> Ibid at 269.

<sup>103</sup> Ibid.

<sup>104</sup> Ibid at 263.

<sup>105</sup> Ibid.

much larger corporate entities and a lighter less professionally dominated approach should be reserved for small-sized entities.<sup>106</sup>

It is argued that the current business rescue regime provided for in Chapter 6 of the Companies Act 2008<sup>107</sup> is not reflective of the dual system proposed by Rajak and Henning.<sup>108</sup> At present, the business rescue procedure of South Africa is a single system designed to cater for all types of businesses, namely, large, medium and small; this system applies uniformly amongst these types of business and only differs in terms of the remuneration requirements for the business rescue practitioner.<sup>109</sup>

The dual system recommended by Rajak and Henning<sup>110</sup> would have provided SMEs with an accommodative business rescue environment sensitive to the needs and significance of their contribution to the economy. Today, most South African SMEs that are failing find the process out of reach for businesses of their size and thus they close down. A revised business rescue regime reflective of the recommendations provided by Rajak and Henning<sup>111</sup> in line with international best practice principles would give South African SMEs a lifeline to recuperate and become more successful.

The significance of this study lies in its examination of whether South Africa's corporate rescue mechanisms have evolved in line with the needs and interests of SMEs by providing an appropriate corporate restructuring mechanism for South African SMEs. This is vital because South Africa is a developing country that aims to promote economic growth by providing corporate opportunities to its citizens for the purpose of promoting development, employment and an improvement in the overall standard of living, as well as by attempting to redress past political injustices.

Business rescue can thus be used to ensure that the investments made by the government as well foreign investors to South African SMEs are put to good use by giving an enabling lifeline to SMEs, to reorganise themselves and, possibly, overcome the possibility of them being liquidated on account of their financial distress, thereby saving jobs and allowing them to continue to contribute to the country's GDP.

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<sup>106</sup> Ibid.

<sup>107</sup> Companies Act 2008.

<sup>108</sup> Rajak & Henning op cit note 24.

<sup>109</sup> Companies Regulations 2011 See regulation 143.

<sup>110</sup> Rajak & Henning op cit note 24 at 269.

<sup>111</sup> Ibid.

As a result of the low survival rate of South African SMEs, it is evident that there is a need for a business rescue regime tailor-made for South African SMEs, one that is reflective of the size of our economy, and sensitive to the needs of SMEs in a manner that promotes development, equality, sustainability and freedom within the South African corporate sector.

#### *1.4.3. Research question*

Does the Companies Act 71 of 2008 provide for useful, sufficient, appropriate and practical corporate rescue mechanisms for SMEs?

#### *1.4.4 Methodology and structure*

The research is analytical, practical and contextual. Primary focus is on SMEs. The dissertation provides a synopsis on judicial management as a corporate rescue procedure and explores how SMEs were accommodated under judicial management. Furthermore, the dissertation explores corporate rescue regimes universally by making use of both primary and secondary sources of law. Chapter 6 of the Companies Act 2008 is the primary source that will be analysed in detail to establish whether the provisions of business rescue in terms of chapter 6 provide workable solutions for financially distressed SMEs. Reference is made to relevant case law, journals and textbooks, both locally and internationally. Data obtained from these sources have formed the blueprint of my study.

This dissertation is structured as follows. Chapter 1 introduces the research topic and lays a foundation for the study by giving a background to the research topic, the problem statement and the significance of and motivation behind the research.

Chapter 2 sets the tone for a theoretical framework and literature review by assessing the methods of corporate rescue under the Companies Act 1973 as they pertain to SMEs. Chapter 3 forms the crux of the dissertation, as it analyses the main topic, that is, business rescue as provided for in Chapter 6 of the Companies Act 2008, and its practical application to South African SMEs.

Chapter 4 provides a comparative perspective of Anglo-American corporate rescue laws by evaluating how business rescue processes for SMEs are provided for in the United Kingdom and the United States of America. Finally, Chapter 5 contains general conclusions and offers recommendations to South Africa's Parliament.

## CHAPTER 2: METHODS OF CORPORATE RESCUE UNDER THE COMPANIES ACT 1973

This chapter will look at judicial management, which was the formal mechanism for corporate restructuring under the Companies Act 1973 and also compromises between a company and its creditors which was the informal way in which companies could reorganise themselves.

### *2.1. Judicial Management*

South Africa was one of the first countries to introduce a corporate rescue regime in the form of judicial management.<sup>112</sup> Judicial management was formally introduced by way of legislation into South Africa's Companies Act 46 of 1926.<sup>113</sup> At that particular time the concept of judicial management was unfamiliar to any other comparable legal system.<sup>114</sup>

Judicial management was re-enacted into South Africa's Companies Act 61 of 1973, this re-enactment being an attempt by South Africa to align itself with international trends and to track corporate rescue developments in Great Britain.<sup>115</sup> Judicial management as a corporate rescue procedure offered companies that were unable to pay their debts, but wished to operate as a going concern, two alternatives in terms of which they could possibly restructure and attempt a process of corporate restructuring.<sup>116</sup> The two options were in the form of judicial management and a compromise between a company and its creditors each of these options will be discussed in turn.<sup>117</sup>

### *2.2. The purpose of judicial management*

The purpose of judicial management, as set out in terms of section 427 of the Companies Act 1973<sup>118</sup> was primarily to restructure the company. This was coupled with the intention to determine whether there was a reasonable probability that if the

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<sup>112</sup> Ibid.

<sup>113</sup> Ibid.

<sup>114</sup> A Loubser 'Judicial management as a business rescue procedure in South African corporate law' (2004) 16 SA *Merc LJ* 137.

<sup>115</sup> Ibid.

<sup>116</sup> Smith *op cit* note 11 at 85.

<sup>117</sup> The Companies Act 61 of 1973 provided for judicial management in terms of chapter 15, see subsection 427 to 440. A compromise between a company and its creditors was provided for in terms of section 331 of the Companies Act.

<sup>118</sup> The Companies Act 61 of 1973 subsection 427 to 440.

company were placed under judicial management it will be able to pay its debts or to meet its obligations and become a successful concern.<sup>119</sup> Moreover, under those circumstances this was seen as a bona fide attempt by the legislature to remain relevant and progressive. Despite its best intentions, judicial management was labelled as a ‘spectacular and abject failure’.<sup>120</sup> This was due to the fact that it was rarely used and it required a high threshold of proof reasonable probability and not a mere possibility that creditor claims were to be paid in full,<sup>121</sup> this had the effect of making the process burdensome for SME companies. Judicial management was not designed to facilitate SME corporate rescue because it was a procedure that relied heavily on court processes which made it very expensive for SMEs to make use of.<sup>122</sup> Furthermore, in *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd*<sup>123</sup> Josman J stated that judicial management is a system that has barely worked since its inception in 1926.

Furthermore, section 427 of the Companies Act<sup>124</sup> did not set out in clear terms the categories of companies to which judicial management applied.<sup>125</sup> Moreover, the use of the word ‘company’ in the Act was vague and narrow; it is not clear whether the Act had all types of companies in mind,<sup>126</sup> for example public corporations and close corporation. Therefore, this raised the question of whether SMEs were accommodated for in judicial management in its inception.

Although the word ‘company’ has been defined in the definition section of the Companies Act 61 of 1973,<sup>127</sup> a much clearer definition or categorisation is required when dealing with corporate rescue processes, perhaps judicial management was not intended to apply to anything other than companies registered in terms of the Companies Act 61 of 1973 thus the procedure was made very expensive to use for SMEs. This disregard of the variety of available entities through which business can

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<sup>119</sup> Loubser op cit note 114 at 141.

<sup>120</sup> *Oakdene Square Properties* supra note 8 at 5.

<sup>121</sup> B Tselane *The Requirements for Business Rescue Proceedings under the Companies Act 71 of 2008 as Discussed in Swart v Beagles Run Investments 25(Pty) Ltd ( Four Creditors Intervening)2011(5)SA 422 GNP* (LLB thesis, University of South Africa 2012).

<sup>122</sup> Rajak and Henning op cit note 24 at 268

<sup>123</sup> In *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* 2001(2) SA 727(CPD).

<sup>124</sup> Companies Act 61 of 1973.

<sup>125</sup> A Loubser *Some Comparative Aspects of Corporate Rescue in South African Company Law* (unpublished LLB thesis, University of South Africa 2010) 17.

<sup>126</sup> Ibid.

<sup>127</sup> Companies Act 61 of 1973 section 1.

be conducted made this process unmindful to the diversity of, and the nature in which, a company can be conducted in South Africa.<sup>128</sup>

### *2.3 Grounds of application for a judicial management order*

The Companies Act 1973 sets out the grounds through which a company could have been placed under judicial management in terms of section 427. For a judicial management order to be granted all four of the specified requirements must have been met.<sup>129</sup> Each of these will be discussed in turn below.

#### *2.3.1 The inability of a company to pay its debts or meet its obligations*

Judicial management as it applied in terms of the Companies Act 1973 limited its application to any form of company that had been incorporated in terms of the Companies Act 1973 and met the requirements of section 427. These requirements specifically excluded close corporations and partnerships from making use of the reorganisation mechanism in the Companies Act 1973.<sup>130</sup> This therefore had the effect of excluding other forms such as SMEs from making use of judicial management if they did not fall within the meaning of a company in terms of section 427.

The first requirement for a provisional judicial management order was that the company must be unable to pay its debts or must be unable to meet its obligations and such commercial insolvency must be proven.<sup>131</sup> The actual or balance sheet test for insolvency which was that the liabilities of the company must exceed the value of the assets was not an actual requirement for the application of a judicial management order.<sup>132</sup>

The irony in this requirement is, however, that most SMEs are unable to pay their debts from the time of their inception because they are undercapitalised;<sup>133</sup> a point often overlooked is that most SMEs are largely incorporated by way of bank loans with high interest rates as well as government funding.<sup>134</sup> It is important to note that before SMEs can run successfully and grow to become a successful concern, they operate from hand-to-mouth and appear financially distressed ab initio.

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<sup>128</sup> Rajak & Henning op cit note 24 at 268.

<sup>129</sup> Loubser op cit note 114 at 115.

<sup>130</sup> Loubser op cit note 125 at 17.

<sup>131</sup> Ibid at 22.

<sup>132</sup> Ibid.

<sup>133</sup> Milman op cit note 76 at 36.

<sup>134</sup> Mahembe op cit note 28 at 50.

### *2.3.2 The company has not been prevented from becoming a successful concern*

This requirement has been interpreted as vague or superfluous.<sup>135</sup> A company that is failing to pay its debts or meet its obligations is evidently not a successful concern.<sup>136</sup> Moreover, a further interpretation of this section would only aid in emphasising the marginalisation of SMEs in the judicial management process as provided for in the Companies Act 1973. The size of SMEs made judicial management an inappropriate corporate rescue procedure. Moreover, SMEs often do not have enough assets to cover the cost of the judicial management procedure. It is for this reason that Rajak and Henning argue that judicial management as it applied then should have been restricted to large and economically important companies because of its tendency to rely on professional personal and highly expensive court procedures.<sup>137</sup>

### *2.3.3 The reasonable probability that the company will be enabled to pay its debts or to meet its obligations and become a successful concern*

The threshold that to be eligible for protection under judicial management the company must be seen to be one capable of recovery to the point where it was able to pay all of its debt in full<sup>138</sup> was a stringent if not almost impossible demand for SMEs. Most SMEs can be viewed as companies that are not capable of recovery due to their small-scale nature and the lack of financial resources necessary to withstand phases of economic and financial distress.<sup>139</sup> Furthermore, it is important to note that an SME could only be seen to function as a successful concern once it had been given enough breathing space to operate as a going concern. This requirement placed a heavy burden on SMEs whose success rate from inception was always considered to be only probable. However, Loubser submits that the requirement should have been a reasonable possibility and not a reasonable probability.<sup>140</sup>

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<sup>135</sup> Ibid.

<sup>136</sup> Ibid.

<sup>137</sup> Rajak and Henning op cit note 24 at 269.

<sup>138</sup> Ibid.

<sup>139</sup> McCormack op cit note 27 at 87. It is of paramount importance to distinguish between economic and financial distress when dealing with corporate rescue laws, economic distress occurs when the business plan of the company is not working and there are some shortcomings on the economic model on which the company is founded for example the projections depicted in the business plan when applied practically do not yield the desired result. On the other hand financial distress implies a liquidity problem where a company cannot meet its financial obligations for example pay a supplier or remunerate its employees.

<sup>140</sup> Loubser op cit note 114 at 142.

### 2.3.4 *The application must be just and equitable*

The fact that it must appear just and equitable for the court to grant a judicial management order was the most problematic and unaccommodating of all the requirements contained in section 427(1).<sup>141</sup> Moreover, this requirement made judicial management an extraordinary procedure and cumbersome for SMEs.<sup>142</sup>

In the case of *Rustomjee v Rustomjee (Pty) Ltd* the obiter dictum of Jansen J suggested that judicial management processes are not appropriate for SMEs. He is quoted as saying ‘[i]t seems doubtful whether in law judicial management proceedings are really appropriate to a small company’.<sup>143</sup> In the same way, the case of *Tobacco Auctions Ltd v AW Hamilton (Pvt) Ltd*<sup>144</sup> expressed a view with regard to the non-inclusion of SMEs in South Africa’s corporate rescue process. Goldin J held that the extent and scope of the business activities of a company, its assets and liabilities and the nature and extent of those business activities should also be taken into consideration when establishing whether judicial management will be a successful and appropriate for restructuring a company.<sup>145</sup> Taking into account the main activities of the business and considering how the business functions could be useful in deciding whether judicial management could be the best option for restructuring a company.

### 2.4 *Persons with power to apply for a judicial management order*

The Companies Act 1973 describes in section 346 the category of persons who may apply for a judicial management order. In terms of section 346, the ailing company itself, one or more of its creditors and either one or more of its members could make an application for the winding up as well as the judicial management order.<sup>146</sup> The employee trade unions and the employees did not have the power to initiate such proceedings in favor of the company. This in effect limited the rights of employees to make reorganisation decisions in favor of the ailing company.

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<sup>141</sup> Ibid.

<sup>142</sup> Loubser op cit note 125 at 25.

<sup>143</sup> Ibid. See Loubser at 25; *Rustomjee v Rustomjee (Pty) Ltd* 1960 (2) SA 753 (D) at 758; *Ronaasen and others v Ronaasen & Morgan (Pty) Ltd* 1935 CPD 562 at 563. In a judgement delivered in this division on the 12 August 1959 the Judge President in the case of *Swarajia Naidoo v Sarkhot (Pty) Ltd* expressed the same doubts as voiced in the *Ronaasen* case.

<sup>144</sup> *Tobacco Auctions Ltd v AW Hamilton (Pvt) Ltd* 1966 (2) SA 51 (R) at 45.

<sup>145</sup> Loubser op cit note 114 at 149.

<sup>146</sup> Museta op cit note 17 at 11.

## 2.5 Shortcomings of judicial management

In practice judicial management was not realistically accessible it was a procedure that was rarely used,<sup>147</sup> and was regarded by some as a spectacular and abject failure.<sup>148</sup> Loubser<sup>149</sup> expresses the view that judicial management as a corporate rescue procedure was endorsed with the intention to accommodate colossal economically esteemed companies and not small corporate entities on the scale of SMEs. Scholars, such as Olver,<sup>150</sup> have argued vigorously for judicial management to be restricted to large and economically important companies.<sup>151</sup> The following aspects have been identified as the critical shortcomings of judicial management.

### 2.5.1 The traditional practice of appointing liquidators as judicial managers of a company

The practice of appointing liquidators as judicial managers contributed to the limited success of judicial management.<sup>152</sup> The judicial manager was appointed by the Master of the Supreme Court after the provisional judicial management order was granted.<sup>153</sup> There were no other qualifications required for the appointment as a provisional or final judicial manager apart from furnishing security for the proper performance of his or her duties.<sup>154</sup>

Moreover, the criteria that were used in appointing a judicial manager contributed to the collapse of judicial management as a corporate rescue procedure. Consequently, the criteria opened a window for abuse by judicial managers and a variety of conflict of interests, as companies on the scale of SMEs required judicial managers with an inherent knowledge, skill and experience of how they operate and how they can be rescued successfully. Consequently, offering of security was not a sufficient requirement, and in order to successfully rescue a company, it was necessary to appoint a judicial manager of merit with experience in the field; mere security was not enough, and hence it was a failure.

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<sup>147</sup> Smith op cit note 11 at 85.

<sup>148</sup> *Oakdene Square Properties* supra note 8 at 5.

<sup>149</sup> Loubser op cit note 125 at 25.

<sup>150</sup> AH Olver 'Judicial management – A case for law reform' (1986) *THRHR* (1986) at 49.

<sup>151</sup> Loubser op cit note 125 at 149.

<sup>152</sup> Ibid.

<sup>153</sup> Loubser op cit note 125 at 155.

<sup>154</sup> Ibid

### *2.5.2 The reliance on court proceedings*

The heavy reliance of judicial management on court proceedings made this processes an expensive one for SMEs.<sup>155</sup> Moreover, court proceedings are usually characterised by inevitable delays and the backlog of administrative costs. Of the SMEs that could access judicial management, most of these were placed at a disadvantage because most they could not afford the costs of court proceedings.

Additionally, court proceedings require the appointment of highly trained personnel who are also generously remunerated. This defeats the purpose of any procedure, because it is invoked with the intention of restructuring an ailing company unable to pay its debts.<sup>156</sup> However, the problem may not have been that judicial management was not a suitable remedy for SMEs, but rather that the heavy reliance of judicial management on court procedure made it an expensive corporate rescue process for SMEs, thus imposing a heavy burden on them . Olver<sup>157</sup> is one scholar who has identified the application for judicial management by SMEs as trivial and frivolous because SME usually do not have the enough assets to cover the costs of judicial management.<sup>158</sup>

### *2.5.3 The negative effect on the credit worthiness of the company*

When a company was placed under judicial management its creditworthiness and confidence in it was critically destroyed.<sup>159</sup> Moreover, financial institutions that gave out loans and overdraft facilities to companies would withdraw from providing much-needed commercial services to companies placed under judicial management. SMEs often struggle to receive any form of financial assistance from financial institutions such as banks and macro lenders to expand their production capacity.<sup>160</sup> This is because SMEs do not have enough movable or immovable assets to offer as security. When a company was placed under judicial management its ability to receive any financing was significantly diminished, thus providing a lethal consequence for those SMEs that relied on financial assistance from lending institutions in order to survive. This therefore implies that placing SMEs under judicial management would diminish

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<sup>155</sup> Ibid.

<sup>156</sup> Rajak and Henning op cit note 24 at 268.

<sup>157</sup> Olver op cit note 154 at 49

<sup>158</sup> Kloppers op cit note 22 at 425.

<sup>159</sup> Museta op cit note 17 at 16.

<sup>160</sup> Mahembe op cit note 28 at 50.

the possibility of their receiving financial assistance from financial institutions for the purposes of recapitalisation.<sup>161</sup>

#### *2.5.4 Judicial management was seen as an extra-ordinary procedure and not as a primary method*

The problem with judicial management was that most courts saw it as an extra-ordinary procedure and not as a viable alternative to liquidation.<sup>162</sup> Judicial management should have been made a primary option which cannot be circumvented when debt relief is sought. However, when creditors of a company could not receive payment due to them timeously they had a right to liquidate the company immediately and circumvent judicial management all together.<sup>163</sup> Due to their size, SMEs require a much simpler procedure in order for them to be rescued successfully. One which does not rely heavily on court process and the appointment of highly remunerated administrating professionals.

#### *2.5.5 The insolvency requirement in terms of section 427(1) (a) the Companies Act 1973*

This requirement states that a company must be unable to pay its debts before a judicial management order can be granted by the court.<sup>164</sup> This requirement weakened the success rate of SME corporate rescue. This is due to the fact that the nature and scale of operation for SMEs needs corporate restructuring before they reach the end of the rope, early symptoms of financial distress are enough to warrant the immediate application of judicial management rescue SMEs. Any sign of distress, both economic and financial, warrants the need for immediate corporate restructuring. Kloppers submits that the earlier a company is granted a judicial management order, the better its chances of success.<sup>165</sup>

#### *2.5.6 Termination of judicial management contract by way of court order*

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<sup>161</sup> Ibid.

<sup>162</sup> Ibid.

<sup>163</sup> Museta note 17 at 16.

<sup>164</sup> DA Burdette 'Some initial thoughts on the development of a modern and effective business rescue model for South Africa (part 1)' (2004) 16 *SA Merc LJ* 349.

<sup>165</sup> Ibid.

According to Loubser,<sup>166</sup> the fact that only an order of the court can terminate judicial management processes meant that a judicial manager was not under any pressure to complete his task within a specified period and could continue to be remunerated for an indeterminate period without making any real progress.<sup>167</sup> Moreover, this lack of accountability contributed to the dismal failure of judicial management as a corporate rescue process.<sup>168</sup> SMEs require strict monitoring and evaluation by corporate rescue administrators; this is pivotal for the successful reorganisation of these entities which are particularly sensitive to dubious and frivolous maladministration.

## *2.6 Informal alternatives*

### *2.6.1 Compromises or an arrangement between a company and its creditors*

The Companies Act 1973 provided for two legislative instruments that a company could use to reorganise its capital structure with the participation of its creditors in order to create agreements between parties. This was done through a series of renegotiation meetings between a company and its creditors, renegotiating the obligations to the contracts entered into by the company and its creditors.<sup>169</sup> These two measures were contained in sub-section 311 and 389 of the Companies Act 1973 as compromises between a company and its creditors or an arrangement between a company and its creditors.<sup>170</sup>

A section 311 compromise established a toned-down, relatively simple three-phase procedure,<sup>171</sup> which allowed for a company to negotiate with its members or creditors with a view to modify existing rights in the common interest.<sup>172</sup> The Company would do so by initially placing a company under provisional liquidation which had the effect of creating a moratorium against the creditors of the ailing company<sup>173</sup> – all writs of executions, demand letters and court orders issued against the ailing company were paused until the compromise or arrangement has been reached by the company and its creditors. However, this moratorium did not occur automatically. The moratorium could only have effect once the ailing company was

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<sup>166</sup> Loubser op cit note 125 at 41.

<sup>167</sup> Ibid.

<sup>168</sup> Ibid.

<sup>169</sup> H Klopper & R Bradstreet 'averting liquidations with business rescue: Does a section 155 compromise place the bar too high?' (2014) 3 *Stell LR* 553.

<sup>170</sup> Companies Act 61 of 1973.

<sup>171</sup> Ibid.

<sup>172</sup> Kloppers op cit note 22 at 428.

<sup>173</sup> Klopper and Bradstreet op cit note 169 at 554.

assigned for liquidation. This is a practical technique can be used to secure a moratorium in the context of a section 155 compromise in the Companies Act 2008.

Many scholars have expressed different views with regard to the application of compromises or schemes of arrangement between a company and its creditors. Rajak submits that many practitioners seek this method of restructuring a company because they believe that compromises are a simple and effective form of rescue.<sup>174</sup> Similarly, Smith views offers of compromise with creditors as a relatively flexible process that allows the company to reorganise its capital, debts and restructure itself.<sup>175</sup>

On the other hand, Burdette submits that a compromise with the company's creditors is an expensive procedure to implement and that a plethora of case law proves that it is not as lucid as it appears to be.<sup>176</sup> Furthermore, Kloppers exposes the fact that section 311 shows no concern for the interests of the employees and the creditors of the company.<sup>177</sup> The conflicting views of these various scholars make it unclear to determine whether section 311 of the Companies Act 1973 could have been used as a method to provide efficient corporate rescue opportunities for SMEs. The use of section 311 was aimed at the rescue of a corporate shell rather than the rescue of a feasible commercial entity proficient at making a useful contribution to the overall economic life and development of the country within which it functions.<sup>178</sup> In light of the above, a section 311 compromise and section 389 arrangements did not provide useful renegotiation opportunities for the purpose of restructuring the company, as will be seen below.

First, the assertion that a section 311 compromise provided an easier way to achieve the effect of renegotiating contractual obligations between the parties<sup>179</sup> can be challenged in the context of SMEs. It was far too complex and expensive to use for SMEs in that it required two applications for leave to convene meetings with creditors, and an additional application to report on the results of the meeting to the court.<sup>180</sup> These costs were accompanied by additional charges that involved the preparation of the applications mentioned above, these being the posting of newspaper publications

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<sup>174</sup> Ibid. See H Rajak *Insolvency Law Theory and Practice: The Economic Implications of Attempting to Rescue Companies* (1993) 309-311.

<sup>175</sup> Smith op cit note 11 at 86

<sup>176</sup> Burdette op cit note 164 at 251.

<sup>177</sup> Kloppers op cit note 22 at 429.

<sup>178</sup> Kloppers op cit note 22 at 429.

<sup>179</sup> Klopper & Bradstreet op cit note 169 at 555.

<sup>180</sup> Ibid.

and the payments of fees of distributions. Furthermore, other payments included those to the chairman who would ordinarily be either an attorney or counsel,<sup>181</sup> both of whom charge their own unique and expensive consultation fees. To put it differently, once a sensitive corporate entity such as an SME is in financial distress, imposing more financial burdens on it can only lead to much more unwanted financial difficulties for the entity.

Secondly, the schemes of arrangements provided for in s 389 were not bona fide methods for restructuring SMEs, rather they were used as a ‘short cut’<sup>182</sup> for entering into subordinate agreements between a company and its creditors.<sup>183</sup> Thirdly the compromises provided in section 311 contained some ‘procedural limitations’.<sup>184</sup>

Moreover, before the Companies Act<sup>185</sup> came into force, the reorganisation instruments available to administrators were limited to ensuring an orderly reorganisation<sup>186</sup> of the SME with a moratorium against the creditors and involved the use of three high court applications,<sup>187</sup> namely the provisional liquidation order, the application for leave to convene meetings of creditors, and the report-back application.<sup>188</sup> This process, which involved the use of the high court together with its associated legal costs, made its use burdensome for SMEs. An SME on the brink of liquidation does not need more costs. Moreover, these procedural limitations made it exorbitantly expensive for an SME to restructure its financial affairs.<sup>189</sup>

### *2.7 The assessment of the available means under the 1973 Act*

The Companies Act 1973 failed to acknowledge the significant contribution of SMEs as corporate entities to the country and the entire economic global community. This resulted in the lack of a seasoned corporate rescue regime sensitive to the needs and culture of the society in which it was seeded.<sup>190</sup> Furthermore, there was ignorance of the need for a radical corporate rescue mechanism that acknowledges the need for corporate rescue development in line with the development of the area in which it is

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<sup>181</sup> Ibid.

<sup>182</sup> Ibid

<sup>183</sup> Ibid.

<sup>184</sup> Ibid.

<sup>185</sup> The Companies Act 2008 came into force on 1 May 2011.

<sup>186</sup> Klopper & Bradstreet op cit note 169 at 557.

<sup>187</sup> Ibid.

<sup>188</sup> Ibid.

<sup>189</sup> Ibid.

<sup>190</sup> Rajak & Henning op cit note 24 at 269.

designated.<sup>191</sup> Rajak and Henning recommended that South Africa's corporate rescue regime should aspire to cater for large, complex financial and industrial mainstream activity, wherein South African corporate rescue will require a much more robust and premium international standard.<sup>192</sup> Therefore, it is important to acknowledge that South Africa recognises the need to encourage the proliferation of SMEs.<sup>193</sup> On the whole, the expense and delays of a professionally dominated, extraordinary judicial management order, ultimately placed heavy burdens on SMEs.<sup>194</sup> In view of its extensive shortcomings judicial management as a corporate rescue procedure was abolished in its entirety in South Africa's company law. I submit that Rajak and Henning<sup>195</sup> were correct in proposing a dual system as an appropriate corporate rescue procedure for South African companies.<sup>196</sup> They advocated for the provision of a more domesticated approach, one which is sensitive to the needs of the economy, less formal and more inclusive.<sup>197</sup> The succeeding chapter will look at whether the current corporate rescue procedure in the form of business rescue adequately provides for a useful reorganisation procedure for ailing SMEs – something that judicial management evidently failed to do.

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<sup>191</sup> Ibid.

<sup>192</sup> Ibid.

<sup>193</sup> Mahembe op cit note 28 at 7.

<sup>194</sup> Rajak & Henning op cit note 24 at 269.

<sup>195</sup> Ibid.

<sup>196</sup> Ibid.

<sup>197</sup> Ibid.

## CHAPTER 3: BUSINESS RESCUE AND COMPROMISES BETWEEN A COMPANY AND ITS CREDITORS AS CORPORATE RESCUE PROCEDURES FOR SOUTH AFRICAN SMEs UNDER THE COMPANIES ACT 2008

This chapter aims to answer the research question by critically analysing whether business rescue as provided in terms of Chapter 6 of the Companies 2008, is an appropriate corporate rescue procedure for South African SMEs.

### *3.1 Definition and purpose of business rescue*

The term ‘business rescue’ is defined in section 128(1) (b) of the Companies Act 2008.<sup>198</sup> Business rescue refers to proceedings aimed at assisting in the rehabilitation of a company that is financially distressed, by providing for the temporary supervision of it by a freestanding business rescue practitioner<sup>199</sup> who will help develop and implement a business rescue plan for the purpose of restructuring the company and achieving the objectives set out in the business rescue plan.<sup>200</sup>

In view of the fact that South African SMEs have the lowest survival rate in the world,<sup>201</sup> business rescue provides SMEs in financial distress with the opportunity to reorganise themselves by appointing an independent business rescue practitioner who will assist them to come up with useful and efficient turnaround strategies that will improve their survival rates and enable them to function efficiently as a going concern.

Furthermore, the appointment of a business rescue practitioner achieves one of the following business rescue objectives: the main objective will be to assist an SME in financial distress with the opportunity to continue to exist on a solvent basis by providing reorganisation services.<sup>202</sup> However, where this objective proves impossible to achieve the business rescue practitioner will forthwith assist the SME to obtain a better return for the company’s creditors and shareholders<sup>203</sup> than would have been the

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<sup>198</sup> Ibid.

<sup>199</sup> Companies Act 2008 at s section 128(1) (d). A business rescue practitioner is a person appointed, or two or more persons including juristic persons who are jointly appointed for the purpose of monitoring and overseeing a company during business rescue proceedings.

<sup>200</sup> Ibid.

<sup>201</sup> Mahembe Op cit note 28 at 7.

<sup>202</sup> ‘Solvent basis’ refers to a position in which the company will have sufficient capacity to pay its debts.

<sup>203</sup> On the liquidation and winding up of the company the shareholders are entitled to the residue of the net assets that will be sold for the purpose of securing payment of creditor’s debt. Although, SMEs are viewed as small corporate entities with low survival rates it is advisable for such SMEs to secure beneficiary shareholder(s) who will receive the residue of the net assets of such an SME upon liquidation. A beneficial shareholder(s) is entitled to the rights attached to the share whilst a registered

case if the SME were to be liquidated immediately.<sup>204</sup> It is important to note that the successful achievement of the objectives of business rescue is of paramount importance to SMEs.<sup>205</sup> Also of utmost importance is the successful achievement of the main objective of business rescue, which will assist in promoting SMEs as vehicles for the achievement of socio-economic benefits for the country.

### *3.2 Grounds of application for a business rescue proceedings*

#### *3.2.1 Financially distressed company*

The basic test for determining whether or not a company should be placed under business rescue is whether or not it is in financial distress.<sup>206</sup> The Companies Act 2008 provides a definition of what is meant by a financially distressed company for the purpose of business rescue.<sup>207</sup> A company will be financially distressed if at any specific time ‘it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months’, or ‘it appears to be reasonably likely that the company will become insolvent within the next six months’.

When initiating business rescue proceedings for SMEs speed becomes a matter of life and death for such corporate entities, these entities include companies registered in terms of the Companies Act 2008 and close corporations as section 66(1) of the Close corporation Act makes provision for access to business rescue.<sup>208</sup> Partnerships and cooperative which fall within the commercial scales of SMEs are not included for the purpose of business rescue as the Companies Act 2008 excludes such business entities.<sup>209</sup> As previously stated the death toll of SMEs in South Africa is between 70 to 80 per cent five years post incorporation.<sup>210</sup> Therefore, any signs of distress should warrant the speedy application of business rescue proceedings. The six-month requirement places a practical difficulty for SMEs in financial distress. If an

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shareholder is a person in whose name the share is registered in. See Farouk HI Cassimet al *Contemporary Company Law* 2ed (2012) 537.

<sup>204</sup> Klopper & Bradstreet op cit note 169 at 554.

<sup>205</sup> Ibid.

<sup>206</sup> E Levenstein & L Barnett *the Basics of Business Rescue Werkmans Attorneys*, available at <http://www.werksmans.com/wp-content/uploads/2013/04/Werksmans-Basics-of-Business-Rescue1.pdf>, accessed on 16 February 2015.

<sup>207</sup> Companies Act 2008 section 128 (1) (f).

<sup>208</sup> Close Corporations Act 69 of 1984.

<sup>209</sup> Companies Act 2008

<sup>210</sup> Mahembe op cit note 28 at 7.

SME is at present unable to pay its debts it becomes highly unlikely that the SME will be able to do so within the reasonably ensuing six- months. SMEs should be allowed to make an application for business rescue at any signs of financial. This is because the time at which the entire application is made affects the basis of the application of business rescue proceedings.<sup>211</sup>

Loubser<sup>212</sup> supports the notion that broadening the definition of financial distress to include circumstances in which a company will be deemed to be financially distressed will, in turn, clarify the situation allowing for the affected people to receive the appropriate information in order to commence the procedure within a reasonable period of time.<sup>213</sup> This is a good recommendation for SMEs, as it would provide them with a wider opportunity to invoke business rescue proceedings at an early stage.

Furthermore, since South African SMEs have the lowest survival rate in the world,<sup>214</sup> it is of supreme importance to initiate business rescue proceedings at the earliest signs of financial distress.<sup>215</sup> A point often overlooked in the current business rescue regime is that SMEs are survivalist in nature and thus any form of distress should forthwith warrant the application of business rescue proceedings.

The submission here is that the time period set out in the Companies Act 2008 of within 'the immediately ensuing six months'<sup>216</sup> should be reserved for large companies with higher survival rates. This would be in line with the recommendations made by Rajak and Henning, in which they envisioned a much lighter approach to business rescue for small companies.<sup>217</sup> Inherently feasible and healthy SMEs may experience unforeseen and provisional cash-flow problems, possibly caused by peripheral factors such as an earthquake, a factory fire, and failure of an important supplier, political unrest, or employee strikes.<sup>218</sup> This form of distress can ultimately place survivalist SMEs in distress and could possibly call for the immediate application of business rescue proceedings.

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<sup>211</sup> Museta op cit note 17 at 37.

<sup>212</sup> Loubser op cit note 125 at 57.

<sup>213</sup> Ibid at 44.

<sup>214</sup> Mahembe op cit note 28 at 7.

<sup>215</sup> Loubser op cit note 125 at 57.

<sup>216</sup> Companies Act 71 of 2008 section 128 1(f) i

<sup>217</sup> Rajak & Henning op cit note 24 at 268.

<sup>218</sup> Ibid.

Loubser<sup>219</sup> submits that a company should be allowed to enter into business rescue proceedings at the first signs of financial trouble.<sup>220</sup> She is of the opinion that if a company waits until it proves that it is actually insolvent and unable to pay its debts; the chances of rescuing it successfully will be significantly weakened.<sup>221</sup>

Moreover, for SMEs to be successful in business rescue any form of distress whether ‘financial distress’ or ‘economic distress’<sup>222</sup> that has the possibility of affecting the company’s operations as a going concern should warrant the immediate application of business rescue. Moreover, an SME in ‘distress’ would be unable to make use of business rescue proceedings unless such an SME is in ‘financial distress’, as required the Companies Act 2008.<sup>223</sup>

This means, therefore, that such an SME would not be able to make use of business rescue proceedings to obtain protection against claims by creditors while its problems were being solved.<sup>224</sup> For example, when an SME is solving employee disputes or dealing with insurance companies after a natural disaster takes place that partially or completely destroys the companies’ premises, it would be unable to make use of business rescue proceedings unless such SME is in financial distress. In light of the above, it would be in the best interest of SMEs if they could apply forthwith for business rescue proceedings at the earliest stage when it shows signs of distress, both economic and financial.

Loubser<sup>225</sup> recommends that the company’s present insolvency or inability to pay its debts should constitute financial distress for the purpose of business rescue.<sup>226</sup> It is further submitted in agreement with Loubser’s recommendation, that the adoption of such a recommendation would increase the likelihood of a successful business rescue procedure for SMEs in South Africa, for the sooner a rescue procedure is initiated, the greater the chances of its success.<sup>227</sup>

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<sup>219</sup> Loubser op cit note 125 at 57.

<sup>220</sup> Ibid.

<sup>221</sup> Ibid.

<sup>222</sup> McCormack op cit note 27 at 9.

<sup>223</sup> Companies Act 2008 section 128(1) (f).

<sup>224</sup> Ibid.

<sup>225</sup> Loubser op cit note 125 at 57.

<sup>226</sup> Ibid.

<sup>227</sup> Ibid.

### 3.2.2 *There must be a reasonable prospect for rescuing the company*

The Companies Act 2008 provides a less stringent requirement than that of judicial management, where it required proving that the company would *probably* become a successful concern.<sup>228</sup> Section 129(1) (b) of the Companies Act 2008 now only requires that the board should have reasonable grounds to believe there is a reasonable *prospect* of rescuing the company.<sup>229</sup> Loubser,<sup>230</sup> however, emphasises that the use of the word ‘prospect’ is lamentable as it creates unnecessary confusion. She suggests that the drafters should have used either a ‘possibility’ or a ‘probability’ in place of the word ‘prospect’. In the light of the above, a clear distinction would have been useful in providing clarity to the board of SMEs as to when they can make use of business rescue proceedings. In the name of creating a much lighter approach for SMEs, the use of the word ‘possibility’ instead of ‘prospect’ should be used for the purpose of creating a much more appropriate corporate rescue procedure.

### 3.3 *Persons with power to initiate business rescue proceedings*

There are two main ways by which business rescue proceedings can be initiated by companies in financial distress, either the company itself initiates by board resolution or an affected person does so by court application in respect of companies in financial distress.<sup>231</sup> A court may make an order placing the company under supervision commencing business rescue proceedings if it is satisfied that the company is financially distressed and there is a reasonable prospect for its rescue.<sup>232</sup> This gives an SME the power to reorganise itself voluntarily and choose its own business rescue practitioner<sup>233</sup>. This is a good addition to our current corporate rescue system as it allows the company to choose a business rescue practitioner best suited for its size and familiar with its industry.

On the basis of the foregoing, it is suggested that it would be in the best interests of SMEs if the requirement for business rescue is made an unalterable provision which would apply by default in the company’s Memorandum of Incorporation. For example, this could be a provision that states that once the company

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<sup>228</sup> Ibid.

<sup>229</sup> Ibid. The board refers to the board of the directors of the company comprising directors and other relevant members.

<sup>230</sup> Ibid at 58.

<sup>231</sup> Companies Act 2008 section 131(4) (a).

<sup>232</sup> Ibid.

<sup>233</sup> Companies Act 71 of 2008 section 129 (1)(b)

shows any signs of financial distress it must be placed under business rescue. This would be useful in improving the survival rates of South African SMEs that are characterised with levels of failure.<sup>234</sup>

### *3.3.1 Power of initiation*

Business rescue in terms of Chapter 6 of the Companies Act 2008 gives wide access to the commencement of business rescue proceedings. A company can initiate business rescue proceedings just by filing a business rescue resolution with the commission and not go to the courts when in need of a business rescue services under chapter 6 of the Companies Act 2008.<sup>235</sup> Section 128(1) (a) of the Companies Act 2008 regards an affected person in relation to a company for the purpose of business rescue to include a shareholder or creditor of the company in financial distress, a registered trade union representing the employees of the company, as well as the employees in general who do not belong to a registered trade union.<sup>236</sup>

Although this approach has been viewed by scholars as a system that could lead to possible abuses,<sup>237</sup> it provides SMEs in financial distress with a wide opportunity to make use of business rescue proceedings by allowing the employees, directors and other affected persons the opportunity to make use of business rescue. In this respect, the commencement of business rescue proceedings by affected persons who do not have access to the company's internal documents could appear burdensome for SMEs when making an application for business rescue. However, a special provision in the form of section 31(3) of the Companies Act 2008 makes the access given by the Act more useful to shareholders who are not directors of the company and trade union representatives to have access to the company's financial records for the purpose of business rescue, this is done through the Commission and subject to the conditions that the Commission may determine.<sup>238</sup>

### *3.3.2 Application made to court by affected persons*

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<sup>234</sup> Mahembe op cit note 28 at 7

<sup>235</sup> Companies Act section 129 (1)(3)

<sup>236</sup> Companies Act 2008 section 128(1) (a).

<sup>237</sup> Museta op cit note 17 at 66.

<sup>238</sup> Companies Act 2008 See section 31(3). The commission refers to the Companies and Intellectual Property Commission commonly referred to as the CIPC.

An affected person can make an application to the court to place the company under the supervision of an independent business rescue practitioner and thereby commence business rescue proceedings.<sup>239</sup> A court may make an order if it is content that the company is financially distressed and there is a reasonable prospect of its rescue.<sup>240</sup> The requirement for satisfying the court is strict for SMEs, and places a burden for SMEs in distress, for the court must not simply be satisfied that the SME is financially distressed the court must be satisfied of the reasonable prospect of rescuing the SME. The general vulnerability of SMEs makes court access on its own a burdensome process this is because business rescue proceedings by court application are accompanied by their own inherent high court costs which places a burden on SMEs.

### *3. 4 Shortcomings of business rescue*

#### *3.4.1 Restriction on entities to which business rescue applies*

Business rescue proceedings are exclusively contained in the new Companies Act 2008 and not in any other legislation. Consequently this means that the proceedings are primarily intended to apply to companies and not to other forms of business entities. However, the Act allows existing close corporations to retain their current status and conceivably continue to exist forever.<sup>241</sup>

It must be noted, that business rescue places a restriction on practice in terms of the Companies Regulations of 2011.<sup>242</sup> The Regulations restrict the application of business rescue proceedings to large, medium or small companies and places a public interest score requirement on those companies.<sup>243</sup>

The companies' regulations goes further to set out the categories of business rescue practitioners which can be appointed in relation to the size of company under business rescue.<sup>244</sup> These practitioners are remunerated in relation to the size of companies to which they are appointed to restructure.<sup>245</sup> This inevitably places a burden on SMEs, which can either be classified as survivalist enterprises,<sup>246</sup> micro-

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<sup>239</sup> Companies Act 2008 section 131.

<sup>240</sup> Companies Act 2008 section 131(4) (a).

<sup>241</sup> FHI Cassim, et al *Contemporary Company Law* (2012) at 68.

<sup>242</sup> Companies Regulation 2011 regulation 127(2) (b).

<sup>243</sup> Ibid.

<sup>244</sup> Companies Regulation 2011 regulation 127 (2) (c).

<sup>245</sup> Companies Regulation 2011 regulation 127 (2) (c).

<sup>246</sup> Mahembe note 28 at 25. This form of SME generates income which is less than the minimum income standard of the poverty line, this category includes hawkers, vendors and subsistence farmers and is categorised as part of the micro-enterprise sector in practice.

enterprises,<sup>247</sup> very small enterprises,<sup>248</sup> small or medium enterprises.<sup>249</sup> The ability of micro-sized, small to medium sized entities to afford the services of a junior or experienced practitioner as set out in the regulations is almost impossible for SMEs which are often naturally undercapitalised<sup>250</sup>

### *3.4.2 The problem of post-commencement finance for SMEs*

Post-commencement finance is one of the most important aspects of business rescue as it is central to the business rescue process.<sup>251</sup> Nevertheless, Post-commencement finance has been largely unsuccessful to date.<sup>252</sup> This is due to the fact that the availability of post-commencement finance determines the success of business rescue.<sup>253</sup> Section 135(2) of the Companies Act 2008 provides that ‘the company may obtain financing that is not unrelated to the employment, which may be secured to the lender by utilising any unencumbered assets of the company and will be paid in the order of preference set out in in section 135(3)(b)’.

Post-commencement finance requires creditors, banks and financiers to provide credit support for companies in financial distress.<sup>254</sup> However, most creditors, banks and financiers are reluctant to finance a company that is in financial distress and undergoing business rescue proceedings.<sup>255</sup> Companies that are placed under the supervision of an independent business rescue practitioner typically do not have many assets or cash that can be used to fund the business activities during the rescue process.<sup>256</sup>

The biggest obstacle to SMEs in South Africa affecting their growth and the possibility of a successful reorganisation process is the challenge of accessing capital

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<sup>247</sup> Ibid. This is a form of enterprise it makes a turnover less than R150 000 per year. Examples are ‘spaza shops’, minibus taxis and household industries .These enterprises employ no more than five people.

<sup>248</sup> Ibid. Very small enterprises are companies with fewer than 20 employees (or ten) depending on industry, they have an annual turnover of less than R200,000 to R500,000 (depending on the industry), gross assets are less R150 000 TO R500 000 (depending on industry).

<sup>249</sup> Ibid. Small enterprises have a maximum of 50 employees they are generally more well established then very small enterprises ,these enterprises usually have gross assets of less than R2 000 000 to R4 5 00 0000.

<sup>250</sup> Milman op cit note 76 at 36

<sup>251</sup> Cassim et al op cit note 241 at 882.

<sup>252</sup> M Pretorius & W Du Preez ‘Constraints on decision making regarding post-commencement finance in Business rescue’ (2013) 6 *SAJESBM* 169.

<sup>253</sup> Ibid at 169.

<sup>254</sup> Cassim et al op cit note 241 at 822.

<sup>255</sup> Ibid.

<sup>256</sup> Ibid.

for their business through financial institutions.<sup>257</sup> Most SMEs have difficulty with securing funding during their start-up phase.<sup>258</sup> As a result, they rely on personal savings; friends and families;<sup>259</sup> during their growth phase they then venture into asset-backed finance and bank debts.<sup>260</sup> Financial lending institutions are often reluctant to finance SMEs because most of these SMEs at the time of incorporation do not have enough funds or property to offer as security.<sup>261</sup>

Furthermore, typical financiers of post-commencement finance would want to conduct investigations to establish whether they believe in the future viability of the company under reorganisation;<sup>262</sup> in economic terms, whether the marginal cost will exceed the marginal benefit. This raises the question as to whether an SME in financial distress would be able to secure post-commencement finance for the purpose of business rescue.

Most importantly, in any corporate reorganisation regime, a degree of financial support is required from the commercial environment through the provision of additional funding.<sup>263</sup> This therefore reduces the chances of a successful reorganisation procedure for SMEs because sometimes the magnitude and nature of the funding required for rescuing the SME exceeds the total value and assets of the SME. Ultimately the successful reorganisation of such SMEs through business rescue will depend on the possibility of securing a financier with a large risk appetite.

Pretorius and Du Preez<sup>264</sup> suggest that the extent of post-commencement finance in South Africa is too small to the extent that it does not exist. Consequently this poses major concerns to SMEs in financial distress because the ability to successfully raise post-commencement finance has a major influence on the successful outcome of business rescue.<sup>265</sup>

In the light of the need to create a more accommodative corporate reorganisation strategy for SMEs, it would be in the best interests of SMEs if the Act could prescribe that small and medium companies can appoint both an experienced

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<sup>257</sup> Mahembe op cit note 28 at 32.

<sup>258</sup> Ibid.

<sup>259</sup> Ibid.

<sup>260</sup> Ibid.

<sup>261</sup> Milman op cit note 76 at 36.

<sup>262</sup> Pretorius & Du Preez op cit note 252 at 174. Typical financiers includes banks, creditors and shareholders.

<sup>263</sup> Ibid.

<sup>264</sup> Ibid.

<sup>265</sup> Ibid.

and junior business rescue practitioner for the purpose of improving the chances of securing post-commencement finance, Pretorius and Du Preez<sup>266</sup> recommend that an experienced and competent business rescue practitioner with their collaborative networks and a thorough knowledge and understanding of the business rescue process and industry are much more effective in securing post-commencement finance.<sup>267</sup> Although this may be true, appointing two business rescue practitioners could pose a problem for survivalist SMEs that cannot afford the tariffs of a business rescue practitioner.

### *3.5 Benefits of business rescue for SMEs*

#### *3.5.1 Automatic Moratorium on creditors*

Business rescue proceedings provide an advantage to SMEs in the form of a moratorium on any legal proceedings against the SME in financial distress.<sup>268</sup> This moratorium provides that ‘no legal proceedings, including the enforcement of action’<sup>269</sup> will take place against the SMEs ‘or in relation to any property belonging to the SME ‘or lawfully in its possession may be commenced or proceeded with in any forum’.<sup>270</sup>

This moratorium is beneficial for SMEs because it provides a breathing space for SMEs in financial distress. The effect of a section 133(1) moratorium is that it automatically stays legal proceedings against the SME, and execution and enforcement actions issued by the SMEs creditors may not be initiated except with both the written consent of the practitioner and with leave of the court.<sup>271</sup>

A business rescue plan must be developed after the initial investigation by the business rescue practitioner have been initiated. This has the effect of providing for a moratorium in respect of actions against the company and in respect of the property in respect of the company's possession until payment can eventually be made from future earnings of the company, or until the SME secures the post-commencement financing which will be used to settle some of the creditors' debts.

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<sup>266</sup> Ibid.

<sup>267</sup> Ibid.

<sup>268</sup> Companies Act 2008 section 133(1).

<sup>269</sup> Ibid.

<sup>270</sup> Ibid.

<sup>271</sup> Companies Act 2008 section 133 (1) (a) (b).

This is advantageous for SMEs, because in both these occurrences the SME will not immediately become liquidated, the plant machinery belonging to the SME that is attached by the sheriff for the purpose of sale by way of public auction will be spared. This is useful in aiding the SME to raise funds and avoid liquidation whilst in the rescue process; putting a stay on these proceeding is advantageous to SMEs because they will be given the opportunity to attempt a corporate rescue strategy that could possibly help the SME to continue trading regardless of whether or not there is legal action pending against the SME, or has some or all of their property attached by the sheriff.

### *3.5.2 Special rights granted to employees.*

Business rescue provides a good advantage to employees of SMEs because it allows for the fair and equitable treatment of employees of financially distressed SMEs.<sup>272</sup> Business rescue offers the employees protection and considerable benefits during the business rescue process: the employment contracts of employees of a financially distressed SME are specifically excluded from a business rescue practitioner's power to scratch off or suspend their contracts during the business rescue process.<sup>273</sup>

The remuneration of employees of financially distressed SMEs is given special preference rights.<sup>274</sup> The Act section 135(1) classifies any 'remuneration, reimbursements'<sup>275</sup> or other payments due and payable by the company to its employees during business rescue proceedings, as post-commencement finance.<sup>276</sup> These claims are afforded special preference rights and they are ranked after the costs of the business rescue proceedings and the business rescue practitioner's fee and costs, but before any claims for other forms of post-commencement finance.<sup>277</sup>

Since it is estimated that 91 per cent of formal business entities in South Africa are SMEs and these SMEs contribute between 52 to 57 per cent to GDP and provide 61 per cent to employment in South Africa.<sup>278</sup> The use of business rescue as a corporate rescue procedure for South African SMEs is advantageous in ensuring that the employment provided by such SMEs is protected and maintained, and at the same

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<sup>272</sup> Cassim, et al op cit note 241 at 844.

<sup>273</sup> Companies Act 2008 section 136 (1).

<sup>274</sup> Ibid at section 135(1).

<sup>275</sup> Ibid.

<sup>276</sup> Loubser op cit note 125 at 47.

<sup>277</sup> Ibid.

<sup>278</sup> Mahembe op cit note 28 at 7.

time, promoting the development and maintenance of the standard of living for the community within which the SME operates.

If one compares the rights of employees of an SME that is immediately liquidated to one which is placed under business rescue, the benefits to be gained by employees from SMEs using business rescue proceedings as a restructuring procedure whilst in financial distress become abundantly clear. When an SME is liquidated in terms of section 38(1) of the Insolvency Act,<sup>279</sup> the liquidation of an employer company suspends all employee contracts of service with its employees from the date on which an order of winding up is issued.<sup>280</sup> During this period of suspension of their contracts, employees are not required to render services nor are they entitled to remuneration in terms of the contracts suspended. Contracts will, however, automatically terminate 45 days after the date of appointment of a final liquidator, except in respect of those employees who have reached agreements with the liquidator as to their continued employment.<sup>281</sup> The special rights granted to employees in the Companies Act 2008, therefore, present them with an opportunity to earn remuneration for a few extra months if the business closes down.

### *3.5.3 Uncompleted contracts*

In addition to the above, the Companies Act of 2008 also protects the company against actions based on breach of any contract, by conferring rights to the business rescue practitioner which include the rights to suspend, whether entirely, partially or conditionally, any obligation that the SME is a party to at the commencement of business rescue proceedings.<sup>282</sup> This is good for preventing any more actions against the SME for breach of contract because of non-performance of the obligations to the contract to which the SME was a party to at the commencement of business rescue proceedings.<sup>283</sup> The suspension of such a contract or obligations arising from the contract will endure for the period of business rescue proceedings<sup>284</sup> for such an SME.

Furthermore, the business rescue practitioner is given the right to make an urgent application to the court <sup>285</sup> for the purpose of ‘suspending or cancelling’,

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<sup>279</sup> Insolvency Act 24 of 1936.

<sup>280</sup> Insolvency Act 24 of 1936 see section 38(1).

<sup>281</sup> Ibid.

<sup>282</sup> Companies Act 2008 section 136(2) and section 136 (2A).

<sup>283</sup> Loubser op cit note 125 at 87.

<sup>284</sup> Cassim, et al op cit note 241 at 886.

<sup>285</sup> Companies Act 2008 section 136(2) (b).

‘entirely, partially or conditionally’<sup>286</sup>any clause of such a contract other than a contract of employment,<sup>287</sup> for such an SME. This right creates a form of contract moratorium which is useful as it gives an SME a breathing space to reorganise itself and develop new strategies that will help it overcome the threat of liquidation.

Moreover, giving the practitioner the right to suspend the contractual obligation is useful in assisting the SME to reflect on the reasons why it is in financial distress. This power given to the practitioner can help the SME to temporarily release itself from a bad investment that had bound it to a state of financial distress. Nevertheless, the rights given to a business rescue practitioner should be exercised with caution, as these could ruin already established useful contractual relations that have the power to possibly assist the SME to transition into a much larger corporate entity. For example, if the practitioner suspends the contract entered into by the SME and a key supplier of the SMEs resources, this could create a situation where the SME will be unable to operate fruitfully as a going concern if the supplier is not lenient and understanding of the business rescue process. The possibility for the SME to contract under the same terms with the key supplier can be significantly reduced.

In conclusion, the main advantage for SMEs of a business rescue is the provision of moratoriums in both legal proceedings and in contract; these moratoriums are useful in that they allow the business rescue practitioner to focus on rescuing the company by developing a proposal and implementing turnaround strategies, without having to be disturbed about impending legal actions, and possible liquidation proceedings.<sup>288</sup>

### *3.6 The business rescue practitioner*

A business rescue practitioner, as previously stated, is an independent third party appointed by a company in financial distress or affected person if the commencement is by court order for the purpose of facilitating it during its reorganisation and restructuring process.<sup>289</sup> Business rescue proceedings cannot take place without the appointment of a business rescue practitioner who will oversee the rescue process of companies in financial distress.<sup>290</sup> For this reason, SMEs in financial distress that wish

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<sup>286</sup> Ibid.

<sup>287</sup> Companies Act 2008 section 136(2A) (a).

<sup>288</sup> Klopper & Bradstreet op cit note 169 at 562.

<sup>289</sup> Companies Act 2008 section 128(1) (d).

<sup>290</sup> Ibid.

to make use of business rescue proceedings must appoint a business rescue practitioner.

### *3.6.1 Appointment of a business rescue practitioner*

Section 138(1) of the Companies Act 2008 sets out the requirements for the appointment of a business rescue practitioner.<sup>291</sup> The Act requires that the business rescue practitioner should be taken from the ranks of good standing members of the legal, accounting or business management profession.<sup>292</sup> Given the fact that South Africa has between 24 to 6 million SMEs where 20 per cent of such SMEs are registered with the Companies Intellectual Property Commission,<sup>293</sup> it would be in the best interest of such SMEs if the appointment of a business rescue practitioner were not solely based on academic merit and experience but rather on special skills and experience with that particular form of SME. A business rescue practitioner should be accompanied by an SME expert with practical knowledge and experience in the SME sector. Since a business rescue practitioner has the power to delegate his powers and functions to any other person who was part of the board or management of the Company in financial distress as well as to appoint any other person as part of the management of the company.<sup>294</sup>

It would be in the best interest of the SME if the business rescue practitioners for SMEs are SME experts. The discretion that can be used by a business rescue practitioner to delegate or appoint other experts can only lead to an increase in the overall costs of the business rescue process.

### *3.6.2 The broad powers of a business rescue practitioner*

Additionally, another challenge faced by SMEs in the current South African corporate rescue procedure is that most business rescue practitioners are inadequately regulated in terms of the Companies Act 2008. The fact that a business rescue practitioner is vested with ‘full management control of the company in substitution for its board and

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<sup>291</sup> Companies Act 2008 section 138(1).

<sup>292</sup> Companies Act 2008 See section 138(1) (a).

<sup>293</sup> Mahembe op cit note 28 at 9.

<sup>294</sup> Companies Act 2008 section 140(1) (b) (c) (ii).

pre-existing management<sup>295</sup> could lead to possible abuse of the SME in financial distress.

Furthermore, the Companies Act 2008 also provides that the practitioner may ‘delegate any power or function of the practitioner to a person who was part of the board or pre-existing management of the company’, the practitioner ‘may also remove such persons from office’, and in the same fashion the practitioner ‘may appoint a person as part of the management of the company’.<sup>296</sup> This would indicate that, even though management of the pre-existing company in financial distress may remain in place to assist the business rescue practitioner, it is the practitioner who has ultimate control over the running of the company,<sup>297</sup> and he or she can control the company in any manner they deem appropriate. Furthermore, when control of a company is diverted from the people involved in the day-to-day management of the company, they become less motivated to work and their contribution towards the possibility of making the company function effectively as a going concern is significantly diminished.<sup>298</sup>

This wide range of power given to business rescue practitioners could lead to fatal consequences for SMEs; the free reign power of a business rescue practitioner to remove key members of management with inherent knowledge of the workings of such a financially distressed SME from office could reduce the chances of a successful reorganisation.

### *3.6.3 The remuneration of business rescue practitioners*

The Companies Regulations set out the remuneration tariffs of fees for business rescue practitioners.<sup>299</sup> As previously stated, the remuneration tariffs set out in the Act are out of reach for most SMEs. Most SMEs cannot afford the services of a business rescue practitioner because of the tariff standards set out in the Companies Regulations 2011.

In terms of the regulations a business rescue practitioner should be remunerated at a maximum of ‘R 1250 per hour, to a maximum of R 15 625 per day, (inclusive of VAT) in the case of a small company’, R 1500 per hour, to a maximum of R 18 750 per day in the case of a medium company’, ‘R 2000 per hour, to a

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<sup>295</sup> R Bradstreet ‘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 *SA Merc LJ* 199.

<sup>296</sup> The Companies Act 2008 section 140 (1)(a)(b)

<sup>297</sup> *Ibid.*

<sup>298</sup> *Ibid.*

<sup>299</sup> Companies Act 2008 section 143.

maximum of R 25 000 per day, (inclusive of VAT) in the case of a large company, or a state owned company case of a large company'.<sup>300</sup>

The tariffs set out in the regulation are problematic for survivalist SMEs which at times of financial distress can have a turnover of less than R15 625 per month. The tariffs in particular make business rescue out of reach for SMEs. Consequently, these useful corporate entities fail and close down because they cannot afford business rescue. In addition, the Act does not limit or restrict any 'further remuneration' for a business rescue practitioner.<sup>301</sup> This means that the business rescue practitioner can prescribe a higher fee than that stipulated in the Act, ultimately making the process even more out of reach for SMEs; even the cheapest practitioner will cost the same amount because the tariffs prescribed are based on on experience and merit but on the size of the corporate entity.

### *3.7 Informal alternatives*

The Companies Act 2008 also provides for a compromise between a company and its creditors.<sup>302</sup> This compromise is entered into as an alternative to business rescue proceedings.<sup>303</sup> This means that an SME can use the compromise between a company and its creditor's provision as a substitute to business rescue for the purpose of restructuring its company.

However, it is important to note that a compromise cannot be used by an SME that is already engaged in business rescue proceedings.<sup>304</sup> When an SME enters into a compromise, its board of directors or the liquidator of such an SME will bind itself in an agreement to arrange for a settlement arrangement or any other form of arrangement made between the SME and its creditors or class of creditors that terminates the disputes over the rights of parties which are to be compromised.<sup>305</sup> A compromise will be appropriate for SMEs when the typical routes for reaching an agreement between the SME and its creditors are unattainable. Moreover, compromises are useful for SMEs as mechanism that allows for this without having to enter into individual contracts with all the creditors but there still needs to a vote on this by the creditors.<sup>306</sup>

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<sup>300</sup> Companies regulations 2011 regulation 128

<sup>301</sup> Companies Act 2008 section 143(2) (4).

<sup>302</sup> Companies Act 2008 See Chapter 6 and section 155.

<sup>303</sup> Cassim, et al op cit note 241 at 909.

<sup>304</sup> Companies Act 2008 section 155.

<sup>305</sup> Cassim, et al op cit note 241 at 910.

<sup>306</sup> Ibid.

### *3.7.1 The advantages of s 155 compromises for SMEs*

#### *3.7.1.1 No financially distressed requirement*

For an SME to make use of compromise with creditors as a reorganisation strategy it need not necessarily be in financial distress. Section 155(1) of the Companies Act 2008 states that a company may enter into a compromise between its creditors ‘irrespective of whether or not the company is financially distressed’.<sup>307</sup> This means that an SME will have the benefits of making use of the process before its inability to pay its debts when they become due and payable is exposed to its creditors. Furthermore, allowing the SME to make use of the process without necessarily being in a state of financial distress will help maintain the financial reputation of the company as well as improve its chances of securing finance from commercial banking institutions.<sup>308</sup>

#### *3.7.1.2 No business rescue practitioner, no tariff fees for practitioner*

A compromise between a company and its creditors does not involve the use of a business rescue practitioner, who must investigate the debtor’s affairs and come up with turnaround strategies to save the company in distress by developing a business rescue plan as well as consulting with affected persons.<sup>309</sup> This therefore means that the SMEs that make use of this reorganisation method must develop its own business rescue plan. Moreover, an SME which makes use of this benefit will profit from developing its administrative skills and improving the skills of other board members who will assist in drafting a business rescue plan in consultaion with turnaround experts. This business rescue plan, once completed, will be used at the creditors’ meetings once the creditors have approved of such a plan.<sup>310</sup>

Furthermore, because the compromise with creditors does not require the services of a business rescue practitioner, the SME will not have to carry the costs of

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<sup>307</sup> Companies Act 2008 section 155(1).

<sup>308</sup> Mahembe op cit note 28 at 44 and 45. Although the commercial banking sector remains the main source of financing SMEs in most countries. SMEs need the commercial banking sector to invest in credit scoring models and other SMEs investments, banks are reluctant to provide financial support to SMEs, as they are often classified as high-risk borrowers. This is because in most cases such SMEs often lack valuable immovable property to offer as security. However, in recent years banks have significantly increased their credit support to SMEs, particularly to those owned by historically disadvantaged individuals.

<sup>309</sup> Klopper & Bradstreet op cit note 169 at 558.

<sup>310</sup> Ibid.

the considerably high fees charged by the practitioner.<sup>311</sup> Very often the monthly turnover of an SME in financial distress that requires business rescue can be within the range of the prescribed fees of the practitioner, thereby making it impossible for the SME to meet the practitioner's service fee. It can thus be argued that a section 155 compromise is likely to benefit the SMEs in terms of reducing costs, as they will not need the practitioner's services to assist in drawing a business rescue plan and/or restructuring the company.

### *3.7.1.3 No administrative costs for the application for a leave to convene meetings with creditors*

Since the board of the company or the liquidator of the company has the power to put forward an arrangement or compromise in respect of 'its financial obligations' with its creditors, to all of the members of any class of its creditors by delivering a copy of the proposal, and notice of a meeting to consider the proposal',<sup>312</sup> to every creditor of the members of any class of its creditors who is known to the company.<sup>313</sup> Significantly, this procedure will enable an SME, whether financially distressed or not and in liquidation or not, to draft a proposal to its creditors without incurring any administrative costs of the leave to convene meetings with its creditors.

Although a compromise between a company and its creditors needs to be made an order of the court to be binding, the costs of making such an application is considerably lower as compared to the costs of business rescue . With this in mind, saving of costs whilst attempting to restructure a company of any size is crucial in ensuring that the company saves funds which can be used contingently in future growth or recapitalisation of the company.

## *3.7.2 Disadvantages of s155 compromise for SMEs*

### *3.7.2.1 No Automatic moratorium*

A section 155 compromise does not provide an automatic moratorium against the creditors of the company.<sup>314</sup> In other words, an affected creditor of the company can

<sup>311</sup> Companies Regulations 2011 see regulation 128.

<sup>312</sup> Companies Act 2008 section 155(2).

<sup>313</sup> Companies Act 2008 section 155(2).

<sup>314</sup> Cassim, et al op cit note 241 at 910.

apply to the court to put the company under business rescue proceedings or put it into liquidation,<sup>315</sup> this has the effect of bringing all negotiations for a compromise between the company and its creditors to a halt. This lack of a moratorium deprives the SME of the security and benefits of a breathing space that business rescue provides for companies when a moratorium is placed on any uncompleted contracts<sup>316</sup> and pending legal actions by creditors,<sup>317</sup> that were set in motion before the commencement of business rescue proceedings. At the same time the probability of coming up with useful, efficiently modified contractual obligations are significantly diminished. This is because unhappy creditors can easily interfere by issuing writs of excutions and attaching the property that the the company is attempting to salvage during the section 155 compromise. Consequently, in order for a section 155 compromise to be more useful and efficient for SMEs, an automatic moratorium on the uncooperative creditors of the SME or on any other size of company would be advantageous.

Although practitioners could apply to court for the provisional liquidation of a company during a section 155 compromise,<sup>318</sup> which has the ‘effect’ of creating a moratorium against creditors’ claims, the disadvantage is that provisional liquidation are accompanied by a number of costs which can add more burdens for an SME in financial distress.

It is often debated that even though the compromise shows potential as a reorganisation procedure for all types of companies, there is a need for some re-adjustment by the legislature in order to make the process a feasible option for reorganising the affairs of a company.<sup>319</sup> In the light of the need to create a much more appropriate corporate reorganisation procedure for SMEs, it is suggested that amending the current section 155 compromise by allowing for an automatic moratorium against uncooperative creditors of the company will help create more useful negotiation outcomes during the compromise or arrangement between the SME and its creditors.

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<sup>315</sup> Ibid.

<sup>316</sup> Companies Act 2008 section 136(A).

<sup>317</sup> Companies Act 2008 section 131.

<sup>318</sup> Klopper & Bradstreet op cit note 169 at 557.

<sup>319</sup> Ibid at 565.

### *3.8 Assessing the change from Judicial Management to Business Rescue and the impact on SMEs*

Given the fact that business rescue is a newly introduced corporate reorganisation strategy for South African companies, it is expected to experience some teething problems when applied in practice. Moreover, when comparing business rescue, proceedings in terms of the Companies Act 2008 to the restructuring of the financial affairs of a financially distressed company under the Companies Act 1973, it can be seen that the 2008 Act provides substantial advantages for companies in financial distress. It does so by promoting the notion that the current financial position of the company does not necessarily reflect the demise of the company. This is useful in improving investors' confidence and the confidence of incorporators of such financially distressed companies. Furthermore, promoting the idea that when an ailing company works together with all affected persons, much more useful turnaround strategies can be achieved. This less burdensome process is a good step towards achieving South Africa's goal of keeping up with international best practice principles in company law.

Despite the teething problems mentioned above, business rescue has the potential to serve as a useful corporate reorganisation procedure for SMEs in financial distress. This can be achieved through some much needed fine-tuning of the legislation – a time-consuming, but necessary exercise for the legislature to implement. Particularly advantageous to SMEs would be the tweaking of the compromise provisions of section 155 to provide for automatic moratoriums. Such modifications would be useful in providing SMEs with an appropriate reorganisation strategy that would be more useful to them than the formalised business rescue proceedings outlined in Chapter 6 of the Companies Act 2008. The conclusion that I have drawn with regard to business rescue is that it needs some refining; this refining can be facilitated by looking at how other countries accommodate SMEs in their corporate reorganisation systems. The next chapter looks abroad to see how other countries are implementing corporate rescue procedures for their SMEs. This will be useful in properly assessing how South Africa is doing in providing for the rescue of SMEs and consider whether there these comparative systems offer any solutions for financially distressed SMEs in South Africa.

## CHAPTER 4: A COMPARATIVE PERSPECTIVE OF BUSINESS RESCUE MECHANISMS IN THE UNITED KINGDOM (UK) AND THE UNITED STATES OF AMERICA (USA)

This chapter aims to evaluate the different business rescue mechanisms employed in USA and the UK in relation to their accommodation of SMEs within their corporate rescue model. An examination of these mechanisms will help establish whether South African corporate rescue procedures adequately accommodate SMEs in line with international standards. The main reason for using the UK and the USA as comparative focal points is because these countries share an Anglo-American heritage with South Africa, and South Africa may benefit in comparing the two countries with an Anglo American history.<sup>320</sup> Additionally, the DTI has used the company laws of both these countries as bench marks in introducing the companies Act 2008.<sup>321</sup> Moreover countries such as Canada and Australia have used the reorganization laws in these countries as benchmarks for their own corporate rescue models successfully.<sup>322</sup>

### *4.1 The United Kingdom*

A steadfast corporate rescue procedure has been cultivated in the UK since the late 1980s in the form of administrations, coupled with a company voluntary arrangement, commonly known as CVAs, and hereafter referred to as such.<sup>323</sup> Furthermore, over the last decade corporate reorganisation law in UK has been radically reformed primarily through the use of the Enterprise Act.<sup>324</sup> This Act was used as a catalyst for a prototype to make the UK the best place in the world to do business.

The Enterprise Act was designed to strengthen the foundations of an enterprise economy by establishing an insolvency regime that promotes honest, but unsuccessful, businesspersons to persevere in spite of initial business failure.<sup>325</sup> Notably, prior to the introduction of the Enterprise Act,<sup>326</sup> the UK had very few adequate methods of rescuing companies in financial trouble.<sup>327</sup> The Cork Committee was the key instrument in facilitating radical reforms in corporate rescue laws in the

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<sup>320</sup> McCormack op cit note 27 at 1.

<sup>321</sup> Department of trade and industry op cit note 43.

<sup>322</sup> Ibid.

<sup>323</sup> McCormack op cit note 27 at 1.

<sup>324</sup> Ibid. See United Kingdom's Enterprise Act 2002 Chapter 40.

<sup>325</sup> Ibid at 45.

<sup>326</sup> Enterprise Act 2002.

<sup>327</sup> Museta op cit note 17 at 55.

UK. They recommended new methods of corporate rescue that would contribute to the formation of alternatives to liquidations.<sup>328</sup> Correspondingly, these alternatives came in the form of a procedure called ‘administration’ regulated by part II of the insolvency Act 1986. In 2001, an amendment was made which replaced the administration procedure by introducing the Enterprise Act 2002, which came into effect from 15 September 2003. This Act substantially replaced all those provisions of the Insolvency Act of 1986 that regulated the administration procedure which was introduced through the Insolvency Act of 1986.<sup>329</sup> It is important to note that these subsequent replacements were based on the fact that the administration procedures were criticised as being burdensome and expensive for small firms,<sup>330</sup> thus making the process unsuitable for SMEs in the UK.

CVAs in the UK are codified under Part 1 of the Insolvency Act 1986.<sup>331</sup> These CVAs are founded upon a proposal to the company and its creditors for a negotiated compromise that will satisfy its creditors, or a scheme that will arrange its affairs.<sup>332</sup> A study has proved that an overwhelming majority of small firms<sup>333</sup> in the UK prefer to use CVAs<sup>334</sup> as corporate rescue procedure rather than administrations. This is because CVAs have been shown to be more successful as a means of recovery for small firms and are less burdensome and expensive to use for the preservation of financially troubled small commercial firms.<sup>335</sup> Furthermore, the study went on to state that since one of the major causes of financial difficulty of small firms is because of poor management and overall poor economic conditions, which can be remedied with time, the breathing space structured within CVAs can be beneficial to small firms in financial difficulty.<sup>336</sup>

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<sup>328</sup> Ibid.

<sup>329</sup> Loubser op cit note 125 at 66.

<sup>330</sup> Ibid at 268.

<sup>331</sup> McCormack op cit note 27 at 67.

<sup>332</sup> Ibid.

<sup>333</sup> Section 27 of the United Kingdom’s Companies Act 1985 defines a small firm as a firm with a turnover below £2.8 million.

<sup>334</sup> R Naresh Pandit, G Cook, D Milman et al’ ‘Corporate rescue: Empirical evidence on company voluntary arrangements and small firms’ (2000) 7(3) *Journal of Small Business and Enterprise Development* 241–254, available at <http://dx.doi.org/10.1108/EUM000000006846> accessed on 30 June 2015.

<sup>335</sup> Ibid at 243.

<sup>336</sup> Ibid at 241.

#### *4.1.1 Entities to which a CVA applies*

The CVA procedure available to all types of companies stipulated in the Insolvency Act 1986.<sup>337</sup> Furthermore, the defining characteristics of CVAs are that they apply predominantly to the affairs of a small firm.<sup>338</sup> However, this does not mean that all other types of companies are unable to make use of CVAs as a corporate rescue procedure in the UK.

#### *4.1.2 Power to initiate a CVA arrangement*

The CVA procedure is initiated by the directors of a financially troubled firm.<sup>339</sup> The directors will make a proposal for a negotiated arrangement in satisfaction of the company's debts or for a scheme of arrangement of its affairs. This proposal must identify a nominee, usually selected from the ranks of insolvency practitioners who are usually members of an accounting firm.<sup>340</sup> The nominee is accountable for the CVA until the creditors have voted for the proposal.<sup>341</sup> The employees and creditors of the company do not have the power to propose a CVA arrangement.<sup>342</sup>

A South African compromise between a company and its creditors on the other hand, does not include the appointment of a nominee; in South African company law such a nominee's functions would be analogous to that of a business rescue practitioner. The non-inclusion of a 'nominee' in our compromise between a company and its creditors is beneficial in reducing the administrative costs associated with the appointment of such persons. Additionally, South Africa could take the plunge in introducing a stakeholder inclusive compromise between a company and its creditors by introducing the option by employees and employee representatives to have the power to propose a negotiated compromise between the companies in financial distress to make a compromise with its creditors on behalf of the ailing company. Moreover, since the compromise between a company and its creditors applies whether the company is in financial distress or not,<sup>343</sup> it would be constructive if all companies, most importantly SMEs, are given the statutory authority to grant their employees the

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<sup>337</sup> See section 1(4) of the United Kingdom's Insolvency Act 1986.

<sup>338</sup> Loubser op cit note 125 at 244.

<sup>339</sup> Ibid at 243.

<sup>340</sup> Kevin MJ Kaiser 'European bankruptcy laws: Implications for corporations facing financial distress' (1996) 25 (3) *Financial Management* 67, available at <http://www.jstor.org/stable/3665809>, accessed on 2 July 2015.

<sup>341</sup> Ibid at 243.

<sup>342</sup> Ibid.

<sup>343</sup> Companies Act 2008 see section 155.

power to propose a compromise with the company and its creditors when a company to which they owe a service to is in financial difficulty. However, such authority to make a proposal to the creditors on behalf of the company in financial distress should be regulated as this could lead to substantial abuses by the third parties.

#### *4.1.3 Requirements for a CVA arrangement*

In the UK there are no specific requirements for a company to qualify for a CVA.<sup>344</sup> However, a company that needs to make use of the CVA procedure need not be insolvent, incapable of paying its debts or likely to become insolvent or unable to pay its debts.<sup>345</sup> Similarly the South African compromise between a company and its creditors apply to companies irrespective of whether or not they are in financial distress.<sup>346</sup> The absence of formal requirements in the application of both a CVA and a compromise between a company and its creditors is useful in reducing the administrative cost of the application; this therefore makes the application process less cumbersome for SMEs.

#### *4.1.4 The CVA and moratoriums*

The CVA procedure previously did not provide for moratoriums.<sup>347</sup> This means that the CVA procedure did not provide for any automatic stay against the claims of creditors. Consequently, it did not provide a breathing space for the nominee and the cooperative creditors to renegotiate new schemes of arrangement. However, the position has now developed to include moratoriums through the introduction of section 1A of and Schedule A1 to the Insolvency Act 1986.<sup>348</sup>

In South Africa, the compromise between a company and its creditors does not provide for any automatic moratoriums during the renegotiation process. However, as previously mentioned a moratorium can be achieved by placing a company under provisional liquidation.<sup>349</sup> This therefore has the effect of tampering with the possible positive outcome of the renegotiation process. Moreover, creditors with competing claims can interfere in a negative way with the negotiation processes which could have

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<sup>344</sup> Loubser op cit note 125 at 244.

<sup>345</sup> Ibid.

<sup>346</sup> Companies Act 2008 section 155.

<sup>347</sup> Ibid at 232.

<sup>348</sup> Ibid.

<sup>349</sup> Klopper & Bradstreet op cit note 169 at 557.

possibly had the effect of improving the existing obligations between the company and its creditors.

#### *4.1.5 Eligibility for moratoriums in CVAs*

In the UK, for a company to make use of the moratorium in CVA proceedings it has to be eligible.<sup>350</sup> Section 1A of the Insolvency Act sets out the requirements for moratorium eligibility.<sup>351</sup> A company is eligible for a moratorium if it meets the requirements of paragraph 3.<sup>352</sup> Thus, in terms of this section the company must satisfy the requirements of being a small company, as set out in the Companies Act 2006,<sup>353</sup> this therefore means that only small firms in the UK can make use of moratoriums during the CVA proceedings.

Since South Africa does not provide for any automatic moratoriums during the compromise between a company and its creditors, it would be in the best interest of SMEs if the legislature can follow through the footsteps of the UK by providing for an automatic stay during the renegotiation process between SMEs and their creditors without initially applying for a provisional liquidation order. This has the effect of delaying the outcomes of the process and adding more costs in the compromise between a company and its creditor's process.

#### *4.1.6 The procedure for securing a moratorium*

The UK Insolvency Act 1986 provided that 'where the directors of an eligible company intend to make a proposal for a voluntary arrangement, they may take steps to obtain a moratorium for the company'.<sup>354</sup> This means that the directors of the eligible firm will furnish the nominee with the relevant documents required to secure a moratorium for the company against creditors during the CVA process.<sup>355</sup>

Unlike the CVA procedure, the South African compromise between a company and its creditors does not involve the use of a nominee, who performs functions analogous to that of a business rescue practitioner. The effect of the exclusion of such a person means that the company itself must initiate the compromise between a

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<sup>350</sup> Loubser op cit note 125 at 233.

<sup>351</sup> The Insolvency Act 1986.

<sup>352</sup> Paragraph 2(1) of the Insolvency Act 1986

<sup>353</sup> Loubser op cit note 125 at 233 .See paragraph 3 (1) (a) (b) of the Insolvency Act 1986.

<sup>354</sup> Ibid.

<sup>355</sup> Loubser op cit note 125 at 234.

company and its creditors.<sup>356</sup> Should the South African legislature follow the position in UK that allows small firms to make use of automatic moratoriums, the effect will be that SMEs will have to make such an application without the use of a business rescue practitioner, thus ultimately cutting down costs.

#### *4.1.7 Effect and benefits of moratorium for UK SMEs*

The effect of this moratorium is that it bars any unhappy creditors from affecting any form of security against the property of the company or performing any execution against the property of the company without permission from the court.<sup>357</sup> This has the effect of providing a breathing space for SMEs in the UK, which thus allows an SME undergoing a CVA time to remedy the business without the fear of being interrupted by summonses from unhappy creditors threatening or attaching the property that the SME seeks to salvage. This moratorium provides creditors with sufficient time to vote on the implementation of a CVA,<sup>358</sup> as well as to facilitate useful renegotiation obligations between the parties.

#### *4.1.8 Duration of the moratorium*

It is important to note that the UK provides for moratoriums on a short-term basis and not for the entire duration of the CVA between the company and its creditors.<sup>359</sup> Moreover, in the UK a moratorium comes into force when all the required documents have been completed, the initial period granted for a moratorium being 28 days.<sup>360</sup> However, if the creditors' meeting is held during the 28-day period the parties can agree to extend the period granted for the moratorium by making an application to the court.<sup>361</sup> This is advantageous for SMEs in the UK in that they are given a fixed period of non-interruption by unhappy creditors during the duration of their CVA. Furthermore, once the 28-day moratorium has kicked in, the creditors and the company can agree on the duration of the moratorium amicably.

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<sup>356</sup> Klopper & Bradstreet op cit note 169 at 588.

<sup>357</sup> Loubser op cit note 125 at 236. See also paragraph 14 of Schedule A1 of the Insolvency Act 1986.

<sup>358</sup> Loubser op cit note 128 at 241.

<sup>359</sup> *Dear Insolvency Practitioner* (November 2002 available <https://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/dearip/dearipmill/fullissue9.doc>, accessed on 30 June 2015).

<sup>360</sup> Ibid.

<sup>361</sup> See paragraph 35 (a) of schedule A1.

#### *4.1.9 Security granted during moratorium*

A further advantage provided in CVA moratoriums in the UK are that security granted over the company's assets during the moratorium will be unenforceable by unhappy creditors of the company undergoing CVA proceedings.<sup>362</sup> This is granted with the exception that unless at the time it was granted there was a reasonable ground for believing that it would benefit the company.<sup>363</sup>

#### *4.1.10 Evaluation of UK CVA procedure*

In light of the fact that the UK did not initially embrace moratoriums in their CVA procedure but recently introduced it for the purpose of making CVAs more accommodating to small firms, South Africa can learn from this amendment by including automatic moratoriums within our very own compromise between a company and its creditors system. As stated above, the moratoriums contain enough valuable advantages that can assist companies in financial distress to persist during tough times and come up with a suitable renegotiation process.

In the UK, CVAs are specifically reserved for small a firm, which allows SMEs to take advantage of the preserved breathing space inherent in automatic moratoriums during the negotiations between a company and its creditors. Additionally, the fact that the CVA procedure provides for the appointment of a nominee is not a concept that should be copied for a compromise between a company and its creditors in South Africa. This is because the appointment of a nominee can lead to further administrative costs which need to be reduced when a company is restructuring.

South Africa can learn from the UK CVA procedure by introducing automatic moratorium in its compromise between a company and its creditors because it has sufficient essential advantages for the reorganization of SMEs and thus cuts the costs for a provisional liquidation order, which is used to create a moratorium during company compromise with its creditors.

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<sup>362</sup> Ibid.

<sup>363</sup> Ibid.

#### *4.2 Chapter 11 of the United States (US) of America corporate rescue system and its practical application to SMEs*

In the US, the law on corporate reorganization is confined to Chapter 11 of the United States Bankruptcy Code hereafter referred to as chapter 11.<sup>364</sup> The US bankruptcy law has adopted a ‘pro-debtor’ rather than a ‘pro-creditor’ approach in relation to the corporate reorganization of companies.<sup>365</sup> Making reference to the Chapter 11 and how corporate reorganization strategies are administered formally for SMEs, is useful in that the 2004 policy document of the DTI stipulates that ‘in creating an appropriate corporate rescue system for South Africa’ the provisions of the of the US Bankruptcy Code are considered.<sup>366</sup> Chapter 11 is seen by many countries<sup>367</sup> as the standard for corporate reorganization, with a potential to facilitate corporate insolvency reforms successfully; this is due to the fact that this model has proved to work successfully in the United States.<sup>368</sup>

Chapter 11 is commonly used when major corporations like Ford General Motors, K–Mart, United Airlines, are in financial distress.<sup>369</sup> These large corporations are most likely to turn to Chapter 11 and the bankruptcy courts for corporate reorganization solutions. However, the most common cases filed by businesses and companies in the bankruptcy courts are far from being globally listed or Wall Street titleholders and household names.<sup>370</sup>

##### *4.2.1 Reorganization plan traditionally reserved for larger companies*

Under Chapter 11 a company can restructure its finances through the use of a reorganization plan, which has to be approved by the bankruptcy court. A Chapter 11 bankruptcy plan can help reduce obligations and modify payment terms between the debtor company and the creditors. A reorganisation plan is traditionally used for larger companies, smaller companies usually do not reach the stage of making a

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<sup>364</sup> McCormack op cit note 27 at 78. See also Chapter 11 of the US Bankruptcy code 1978.

<sup>365</sup> Ibid.

<sup>366</sup> A Loubser ‘Tilting at windmills? The quest for an effective corporate rescue procedure in South African law’ (2013) 25 *SA Merc LJ* 438.

<sup>367</sup> Ibid. Countries such as Germany, France, Spain, Singapore, Japan and the Republic of China used Chapter 11 as a blue print for designing their corporate rescue procedures.

<sup>368</sup> Ibid. at 439.

<sup>369</sup> Bret A Maidman ‘Chapter 11 bankruptcy for small business owners: With Chapter 11 bankruptcy, a small business can restructure and eliminate debts and continue in operation’ *Nolo Law for All*, available at <http://www.nolo.com/legal-encyclopedia/chapter-11-bankruptcy-small-business-owners.html>, accessed on 30 June 2015,

<sup>370</sup> Ibid.

reorganisation plan for their cases are either dismissed or converted into Chapter 7 liquidations.<sup>371</sup> In the case of *Bank of America v 203 North LaSalle Streets Partnership*,<sup>372</sup> Stevens J remarked that authorisation of a reorganization plan is a statutory goal of every Chapter 11 case.<sup>373</sup> This means that the approval of the reorganization plan triggers and confirms the initiation of Chapter 11 proceedings with a larger company in mind. The confirmation of a reorganization plan by the court discharges a corporate debtor from fulfilling all legal obligations not included in the reorganisation plan.<sup>374</sup>

For the most part SMEs in the US have to follow the same rules and meet the same requirements as bigger corporations when they make use of reorganisation strategies under Chapter 11.<sup>375</sup> There are, however, some special provisions for SME debtors that can help to accelerate the process of Chapter 11 by reducing legal and other reorganisation expenditures. These will be discussed below.

#### 4.2.2 *Special provisions for SME debtors in Chapter 11 of the bankruptcy code*

#### 4.2.3 *'Small business debtor equals 'Small business case'*

In terms of the Bankruptcy Code, a Chapter 11 proceeding filed by a 'small business debtor' is categorized as a 'small business case'.<sup>376</sup> In terms of the code a 'small business debtor' is a person or entity who:

- (1) is engaged in business or other commercial activities; and
- (2) Owes no more than \$2 490 925 in total claims.

However, the code excludes the claims and obligations owed to insiders such as family members of the business owners. In the light of creating an SME friendly corporate reorganisation strategy for South Africa, categorising the size of the business in terms of the total amount of creditor claims can be useful in reducing the related legal expenses and other costs associated with business rescue, for example if in South African terms a company in financial distress owes not more than two million rand. An appropriate turnaround strategy for such a company would be regarded as one appropriate for a 'small business debtor' and will be administered on a 'small business'

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<sup>371</sup> McCormack op cit note 27 at 86.

<sup>372</sup> *Bank of America v 203 North LaSalle Street Partnership* (199) 526 US 434.

<sup>373</sup> McCormack op cit note 27 at 86.

<sup>374</sup> Ibid.

<sup>375</sup> *Dear Insolvency Practitioner* op cit note 359 at 439.

<sup>376</sup> Ibid.

scale<sup>377</sup> within the context and meaning of Chapter 11. In terms of the situation in South Africa, it is recommended that the size of the debt should also have an influence when determining the costs and remuneration package of a business rescue practitioner, as well as the choice of appointing either a junior, senior, or experienced practitioner within the definition of the Act.<sup>378</sup> This addition, if properly inserted, would help create a more accommodative environment for SMEs in South Africa.

#### *4.2.4 No creditor's committee for 'small business debtors'*

In Chapter 11 cases, a committee is appointed to represent the interests of unsecured creditors of the ailing company.<sup>379</sup> This committee can retain the services of an attorney, an investment banker, an auditor, as well as other related professionals at the company debtor's expense.<sup>380</sup> However, these services can significantly increase the costs of reorganisation, consequently having the effect of making the process inaccessible for 'small business debtors'.<sup>381</sup> To cure this cumbersome effect, Chapter 11 has placed a special provision for 'small business debtors' by giving the Bankruptcy Court the power to make an order that no creditors' committee be appointed in relation to such company.<sup>382</sup>

In South Africa, business rescue proceedings cannot take place without the appointment of an independent professionally accredited person from the ranks of incumbents of 'good standing legal, accounting or business management' positions.<sup>383</sup> Often, such a requirement makes the process more burdensome for South African SMEs because most experienced 'good standing professionally accredited professionals' come with their own designated consultation fees and other related administration charges. As an attempt to reduce this effect, the Companies Regulations 2011<sup>384</sup> set out the prescribed tariff fees for such professionally accredited persons, according to the size of the corporate entity they attempt to rescue. Despite this bona fide attempt by the legislature, the tariffs pegged within the Act make the process more

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<sup>377</sup> Ibid.

<sup>378</sup> Companies Regulation 127(c).

<sup>379</sup> Ibid.

<sup>380</sup> Ibid.

<sup>381</sup> Ibid.

<sup>382</sup> Ibid.

<sup>383</sup> Companies Act 2008 section 138.

<sup>384</sup> Companies regulation 2011 see regulation128.

burdensome for SMEs, more especially survivalist SMEs.<sup>385</sup> Henceforth, to cure this defect it will be in the best interest of SMEs if the legislature can follow the benchmark set by Chapter 11 which makes the appointment of a professionally accredited body of person(s) subject to this discretion of the Bankruptcy Court. In other words, such appointment of a business rescue practitioner should be made optional, reserved for the discretion of the court or the SME itself for SMEs for the purpose of reducing the costs and making the procedure more accessible for SMEs. SMEs in South Africa can also achieve the same effect if the board of such an SME in financial distress makes an application to the commission without court oversight this has the effect of reducing the costs of business rescue.

#### *4.2.5 Additional filing and reporting duties for 'small business debtors'*

Chapter 11 subjects 'small business debtors' to additional reporting and filing requirements that are not imposed on other Chapter 11 debtors.<sup>386</sup> a 'small business debtor' must attach its most recently organised balance sheet, statement of operations, cash flow statement and federal tax return of its petition when it files for Chapter 11 relief.<sup>387</sup>

In the South African context, if the SME passes the resolution, business rescue commences, the SME will only have to file a copy of the resolution with the CIPC for the purpose of publicity there is nothing else to be filed with the court because in South Africa the Act allows access entirely extra judicially this is a good thing for South African SMEs as it provides a simpler procedure for restructuring by reducing the administration process of filing for business rescue.

#### *4.2.6 Additional US Trustee oversight for 'small business debtors'*

The United States Trustee's Office is the agency that has been put in place to oversee bankruptcy cases on behalf of the Department of Justice. Notably, Chapter 11 confers additional trustee oversight by the US Trustee's Office to 'small business debtors' more than any other Chapter 11 proceedings.<sup>388</sup> In South Africa, imposing a duty on the Companies and Intellectual Property Commission as well as the Companies'

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<sup>385</sup> Mahembe op cit note 28 at 25.

<sup>386</sup> Ibid.

<sup>387</sup> Ibid.

<sup>388</sup> Ibid.

Tribunal<sup>389</sup> will aid in overseeing the reorganization processes for SMEs. Consequently, having the effect of preventing possible abuses by the business rescue practitioner, or by any other person involved during the reorganisation process.

Furthermore, the fact that SMEs are sensitive entities that are usually formed by the individual savings of the incorporators, government funding and in more charitable circumstances by the commercial banking sector.<sup>390</sup> This should warrant the need to have an independent statutory body to oversee and audit the entire reorganization process for SMEs. This can be useful in setting the tone for transparency and accountability of business rescue practitioners during the reorganization process for all sizes of companies including SMEs. Moreover, the additional oversight will help in protecting the needs and interest of the stakeholders of an SME in financial distress, since the powers and duties of the directors of the ailing SME are confined in the business rescue practitioner who has full management and control of the SME.<sup>391</sup>

#### *4.2.7 Plan deadline extended for small business debtors in Chapter 11 of the US Bankruptcy Code*

The general rules applicable in filing for a Chapter 11 plan set by the Bankruptcy Court are that there is no prescribed deadline for filing a Chapter 11 plan.<sup>392</sup> However, ‘small business debtors’ are given only 300 days to put forward a Chapter 11 plan. Furthermore, the Bankruptcy Court is given the discretion to extend the 300-day deadline for the Chapter 11 plan.<sup>393</sup>

In South Africa, the business rescue practitioner, once appointed, is burdened with a duty to draft and prepare a business rescue plan which he has to propose to the creditors for approval, the management of the company and other affected persons as the case may be.<sup>394</sup> Any proposal that the business rescue plan for South African SME companies should be given 300 days to file a business rescue plan could be tantamount to placing the SME in liquidation and performing commercial homicide. Nevertheless, extending the plan deadline from 10 days to a reasonable period of time to be

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<sup>389</sup> Ibid.

<sup>390</sup> Mahembe op cit note 28 at 33.

<sup>391</sup> Companies Act 2008. Section 137 of the Companies Act which addresses the position of the directors and the board of the company during business rescue.

<sup>392</sup> Ibid.

<sup>393</sup> Bret op cit note 369.

<sup>394</sup> Companies Act 2008. See section 150 to 154.

determined by the court would be useful in giving the business rescue practitioner enough time to convene a meeting with the creditors of the SME and any other affected persons to carefully consider the business rescue plan prior to filing.<sup>395</sup> Furthermore, the fact that there is no court oversight were the business rescue procedure has been entered into by way of a company resolution provides substantial difficulty for SMEs in financial distress.

Furthermore, Chapter 11 goes further to create a more fertile environment for ‘small business debtors’ by providing for longer exclusive periods to propose a reorganization plan.<sup>396</sup> Chapter 11 gives the debtor an exclusive right of 120 days after it files for bankruptcy to propose a reorganization plan. However, ‘small business debtors’ are given an exclusive extension period of 180 days to propose a rescue plan. The rationale behind this exclusive special provision is to reduce the risk to a ‘small business debtor’ of having to litigate competing plans and potentially losing its business.<sup>397</sup>

#### *4.2.8 No disclosure statements*

Chapter 11 of the US Bankruptcy Code generally provides that the debtor must prepare a disclosure statement,<sup>398</sup> and submit it to the Bankruptcy Court for approval. Once this is approved, the debtor must circulate copies to creditors and other parties or interested persons.<sup>399</sup> These disclosure statements, as mentioned in Chapter 11, must provide extensive information about the debtor and proposed plan and are often expensive to prepare.<sup>400</sup> Chapter 11 reduces the cost of securing disclosure statement to ‘small business debtors’ by giving the Bankruptcy Court discretion to waive the provision of such disclosure statements.<sup>401</sup> If the Bankruptcy Court grants such a waiver to ‘small business debtors’, the legal and other costs associated with reorganizing the company are significantly reduced.<sup>402</sup>

SMEs in South Africa can benefit significantly if the courts are given discretion to waive the requirement that certain documents related to the reorganization process

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<sup>395</sup> Bret op cit note 369.

<sup>396</sup> Ibid.

<sup>397</sup> Ibid.

<sup>398</sup> Ibid.

<sup>399</sup> Ibid.

<sup>400</sup> Ibid.

<sup>401</sup> Ibid.

<sup>402</sup> Ibid.

provided. This will in turn have the effect of reducing the costs of reorganizing such a financially distressed SME. Alternatively, the costs saved from such a waiver can be invested towards the repayment of preferred and other related creditors or possibly assist in the overall administration costs associated with the reorganization of the company.

#### *4.3 An evaluation of the UK CVA procedure and US 'small business case'*

It is apparent from the above discussion that these Anglo-American countries have adopted sufficient strategies to facilitate an accommodative reorganization environment for SMEs within their corporate rescue model. These countries have identified the sensitivity of SMEs and have established suitable mechanisms to promote the successful reorganization of SME companies within their respective jurisdictions.

With this in mind, South Africa could tweak the current business rescue model and make it more accommodative to SMEs by either designating compromises between a company and its creditors to SMEs and introduce an automatic moratorium for such companies during the corporate rescue process, alternatively reduce the administrative costs and formal nature inherent in Chapter 6 business rescue which makes is cumbersome for SMEs. South Africa could also give special treatment for SMEs as apparent in 'small business case' standard set for SMEs in US chapter 11. But it must be noted that a significant problem with following the US approach is that there is no mechanism provided for court oversight in chapter 11 the process has limited court oversight which could has the possibility of creating an environment for substantial abuses during the corporate rescue process.

## CHAPTER 5: CONCLUSION AND RECOMMENDATIONS

### *5.1 Conclusion*

SMEs form the lifeblood of socio-economic development in South Africa, providing much-needed employment opportunities, training support and developing skills both formally and informally, thereby forming the heart of economic growth in both developing and developed countries. Fortunately, the government of the Republic of South Africa recognises the essential qualities of SMEs by using them as key tools for reforming South Africa's corporate sector in the provision of much-needed equal opportunities for historically disadvantaged persons. Moreover, using SMEs as key tools to implement BEE strategies remains useful in promoting the radical approach of including historically disadvantaged persons both socially and economically in the commercial sector.

However, despite such recognition by government and other key players in the commercial sector, SME failure and survival rates in South Africa remain the worst in the world. Furthermore, the failure rate of SMEs stresses the need for a corporate rescue system that accommodates the requirements, structure, and sensitivity of SMEs which are primarily characterised as survivalist in nature. Moreover, a reformative corporate rescue system is essential for the survival of SMEs in financial and economic distress.

There is a need for a corporate rescue system that acknowledges the needs and interests of SMEs as key players for socio-economic development. This would be useful in reducing the failure rates and improving the survival rates of South African SMEs. It is well-known that judicial management was a dismal and abject failure for South African businesses in need of corporate restructuring. This was because the procedure was highly regulated, inaccessible and hardly used by companies which were in financial difficulty. Moreover, the expense of the procedure as well as the lack of adequate regulation of the administrator, now known as a business rescue practitioner, contributed to the inherent difficulty of making use of this procedure as a corporate rescue process for businesses in financial difficulty. Thus the best alternative for such companies was not to attempt a process of salvaging the business, but rather to opt for the liquidation of the company by the company's creditors and the division of the residue amongst the shareholders. Unapologetically, judicial management did not provide for realistic and practical rescue solutions for SMEs. Additionally, its

structure and application made it cumbersome and unfeasible for SMEs to attempt a corporate rescue process.

The DTI saw a need to promote the international competitiveness of South African businesses by reintroducing a reformed corporate rescue process in the form of business rescue. Business rescue, as introduced in Chapter 6 the Companies 2008, seeks to provide a reformed approach to reorganising South African companies in financial distress by providing them a breathing space in the form of moratoriums, which will enable a company in financial distress to adequately restructure itself, save jobs and attempt a turnaround strategy that will allow the business to recover from financial distress and yield a better return for the creditors than would have been the case if the company in distress were liquidated. It is apparent that business rescue in the Companies Act 2008 provided more advantages to companies in need of corporate reorganisation strategies than judicial management as legislated in the Companies Act 1973. Despite this apparent far-reaching change, it is the contention here that business rescue remains a cumbersome process for SMEs in financial distress that still need the benefit and protection of a business rescue.

The formally regulated procedure inherent in business rescue that requires the services of highly remunerated personnel — known as business rescue practitioners who are often selected from the ranks of legal practitioners and business experts — renders the process burdensome for SMEs. The process is too formal and imposes a number of administrative burdens that are not practicable for SME companies. The one-size-fits-all approach inherent in business rescue is thus not favourable for saving SMEs with a monthly turnover equivalent to the daily prescribed fees of a business rescue practitioner. Moreover, the financial distress requirement is limiting, in that businesses do not fail only due to financial distress but also through economic distress that involves the failure of the business plan. Additionally, because SMEs are sensitive and survivalist in nature, they require seasoned SME experts to assist in the turnaround strategy for them when in financial distress. Furthermore, had the legislature made use of the recommendations made by Rajak and Henning in their article on business rescue for South Africa, in which they envisioned a dual system form of business rescue, one that takes cognisance of the contribution of small companies in our economy, the current difficulties inherent in business rescue would not have been the case for SME companies. Moreover, a dual system that would comprise a formal and informal

procedure form of business rescue, would have resolved some of the problems inherent in business rescue for SMEs.

The Companies Act 2008 provides for an alternative to business rescue by way of a compromise between a company and its creditors, which is an alternative reorganisation strategy. The compromise allows for the directors or members of the companies to make arrangements for a negotiated approach to reorganising a company through compromise between the creditors and the directors of the company at creditors' meetings. The compromise provides the members or directors of the company with an opportunity to restructure the company, regardless of whether the company is in financial distress or not. A further advantage is that this compromise does not require the services of a handsomely remunerated business rescue practitioner. Consequently this has the effect of reducing administrative costs for SMEs and all other companies that make use of this alternative to business rescue.

Although a compromise between a company and its creditors provides for a less formal and more cost-effective form of corporate reorganisation, it has its own inherent weaknesses which makes it unfeasible for an SME in that it does not provide for an automatic moratorium against the company's creditors during the process of renegotiation of the obligations between a company and its creditors. However, the effect of such a moratorium is manipulated by placing the company under provisional liquidation which has a number of inherent costs. This means that an uncooperative creditor, unhappy with the compromise arrangements or meetings, can attach the property or issue summons during the renegotiation process between a company and its creditors if the company is not placed under provisional liquidation during the section 155 compromises. An unhappy creditor could thus attach the property of the company for the purpose of selling the assets by way of public auction and secure his immediate payment of the debt owed to him by the company. Consequently, this has the effect of disrupting the entire outcome of the renegotiation process between a company and its creditors, and defeats the purpose of the entire renegotiation process.

Even though the legislature has tried to be reformative by keeping abreast with international trends in providing a modernised form of corporate rescue analogous to that of the Anglo-American countries, it has, however, failed dismally in providing South Africa with a corporate rescue system suitable to the needs and development of South African companies. The current business rescue process has a

number of inherent teething problem that make it unfeasible and cumbersome for SMEs to use when restructuring themselves whilst in financial distress.

The legislature should have acknowledged the fact that companies in the United Kingdom — a developed country — could not be rescued in an identical manner to companies in the Republic of South Africa — a developing country. A shift by the legislature from a more formal procedure to an informal form of business rescue tailor-made for South African companies, most importantly SMEs, could contribute towards a much more feasible and successful form of business rescue in terms of outcomes. In the light of the above, our current business rescue system is in need of a serious facelift that will make it more practical and efficient for SMEs.

## *5.2 Recommendations*

In light of the need for promoting a pragmatic business rescue procedure that is appropriate for South African SME companies, the following recommendations are proposed.

### *5.2.1 The dual system form of business rescue*

The dual system proposed by Rajak and Henning would be useful in promoting an accommodative corporate rescue mechanism for SMEs. Moreover, a categorising approach where business rescue can either be informal or formal depending on the size of the distressed company, its annual turnover as well as the number employees that it employs would be useful. Separating these two processes will be useful in reducing the costs of business rescue.

#### *5.2.1.1 An informal procedure*

An informal procedure would be one which is less procedural and embodies a negotiated approach inherent in the section 155 compromises between a company and its creditors. This informal approach should be in Alternative Dispute Resolution format in which a negotiated environment will be cultivated between the company and its creditors for the purpose of reaching a compromise and the saving of relationships between the company and its creditors. Often, the creditors are crucial key suppliers and investors, of paramount importance for the overall expansion of the company.

The informal procedure is one that would also include employees and/or employee representatives during the renegotiation process as well as the strategic

planning process. Moreover, including long-term employed employees during the strategic planning process of drafting the business rescue plan and developing rescue strategies would be advantageous because the employees are the ones who have first-hand experience with the inherent challenges of the business — either with issues relating to clients of the company or customers of the business. Their contribution would be more useful in diagnosing the challenges of the business and developing useful strategies for reorganising it than would appointing a business rescue practitioner unfamiliar with the day-to-day running of the company. Furthermore, a proper diagnosis of the problem by a business rescue practitioner and the development of a turnaround strategy by an outsider without inherent knowledge of the company is often time-consuming and contribute to the amplified costs inherent in a Chapter 6 business rescue.

#### *5.2.1.2 A formal procedure*

The formal procedure inherent in business rescue should be reserved for much larger corporate entities. The current business rescue procedure is formal in nature and is workable for large companies that can afford the tariffs of business rescue procedure as well as the duration and administration cost of business rescue.

#### *5.2.2 The inclusion of automatic moratoriums in company compromise with creditors (the United Kingdom approach)*

The current compromise between a company and its creditors provides a number of advantages for SMEs in that it excludes the services of a business rescue practitioner. This has the effect of reducing a number of administrative costs associated with the appointment of a business rescue practitioner. Nevertheless, the procedure remains cumbersome in that it shares many of the weaknesses inherent in business rescue because it remains a formal procedure and is over-regulated. Furthermore, it is submitted that the legislature includes an automatic moratorium against a company's creditors when a company enters into a compromise with its creditors. These may be either short-term or long-term moratoriums, depending on the size of the company and the effectiveness of the renegotiation processes between a company and its creditors. Furthermore, the inclusion of automatic moratoriums on compromises between a company and its creditors will reduce interferences from unhappy creditors.

### *5.2.3 Government must subsidise business rescue proceedings for SMEs*

Since the government of the Republic of South Africa is the key supplier of SME corporate finance, it will be in the best interests of SMEs as well as the government helps to finance the restructuring process of ailing SMEs in financial distress. State funding of SMEs is, however, not enough to promote socio-economic development. The South African Government should subsidise the costs of business rescue for SMEs financed by the government.

This would improve the accessibility of business rescue proceedings by such SMEs. Moreover, establishing in-house business rescue services by state institutions providing for SME initiation and financing would aid in reducing the failure rate of such companies that play a useful role in creating employment and reducing poverty. The subsidising of SMEs business rescue by government will not only help save state resources invested in initiating these corporate entities, but will help bridge the gap of providing employment and developing skills simultaneously. Importantly, it is not enough to finance SMEs and watch them die due to some form of financial distress that could have been resolved through business rescue.

Unless the current business rescue provision embodied in Chapter 6 of the Companies Act 2008 is reviewed, the process will remain more cumbersome for SME companies, and they will be unable to make use of the benefits inherent in business rescue. This recommended review of business rescue will aid in making the process more tailor-made for South African companies, especially SME companies, which are at the heart of employment and over-all socio-economic development in South Africa.

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