



  
**WERKSMANS**  
ATTORNEYS

**A Guide to Business Rescue**  
Prepared by Werksmans Attorneys



## A Guide to Business Rescue

### 1. An introduction to Werksmans' approach to business rescue

Restructuring of companies in financial distress is on the increase globally. In line with this trend, Chapter 6 of the new Companies Act, No. 71 of 2008 introduces business rescue to the South African business landscape. South African companies which are financially distressed or which trade in insolvent circumstances in South Africa now have an opportunity to reorganise and restructure. This has far reaching effects on creditors, financial institutions, shareholders, employees and restructuring specialists.

The members of the Werksmans Business Rescue and Insolvency team have carefully considered the new legislation and the manner in which business rescue proceedings are to be implemented. This includes advising on the manner in which companies should file for business rescue proceedings; the appointment of business rescue practitioners to supervise business rescue proceedings; as well as the duties and liabilities of all parties involved in the business rescue process.

The purpose of business rescue is to maximise the likelihood of the company continuing in existence on a solvent basis. The

key to business rescue will be the successful development and implementation, if approved by creditors, of a business rescue plan to rescue the company by restructuring its affairs, business, property, debt, other liabilities and equity. In the event that this is not possible, the implementation of a business rescue plan should result in a better return for the company's creditors or shareholders than would result from an immediate liquidation of the company.

This guide attempts to assist directors and creditors and sets out a broad overview of business rescue proceedings and the sections of the Act which will affect companies in financial distress. We further provide a flow chart of business rescue proceedings with the time periods required by the legislation in the implementation of the process. We provide a business rescue and insolvency checklist which highlights the importance of when to apply for either business rescue or alternatively liquidation. The impact this decision will have on director's personal liability is also addressed and in particular, the consequences of directors trading a company recklessly, in a position of financial distress or in insolvent circumstances.

## 2. Overview of Chapter 6 of the Companies Act no.71 of 2008

*Chapter 6 of the new Companies Act introduces proceedings to rehabilitate companies that are financially distressed. The aim is to maximise the chances of these companies' continued existence.*

The long anticipated new Companies Act No. 71 of 2008 ("the Act") was promulgated in April 2009 and became effective on 1 May 2011. The Act fundamentally re-writes South African company law and accordingly will have far reaching effects.

Chapter 6 of the Act, which deals with business rescue and compromises with creditors, effectively replaces the existing judicial management provisions of the old Companies Act No. 61 of 1973 ("the old Act"), with a modern business rescue regime.

"Business rescue" means proceedings to facilitate the rehabilitation of a company that is financially distressed<sup>1</sup> by providing for the temporary supervision of the company and of the management of its affairs, business and property, as well as a temporary moratorium on the rights of claimants against the company or in respect of property in its possession.

The business rescue process culminates in the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity. The business rescue plan's objective is to maximise the likelihood of the company continuing in existence on a solvent basis. In the event that this is not possible, the implementation of a business rescue plan should result in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.

In terms of Chapter 6 of the Act, business rescue proceedings ("BRP") are largely self administered by the company under the independent supervision of an appointed business rescue practitioner ("practitioner"). The entire process is also subject to

court intervention by way of application by any affected person (i.e. creditor, shareholder, employee or trade union).

The interests of these affected persons are recognised and their participation in the development and approval of a business rescue plan is extensively provided for. This brief identifies and elucidates upon specific sections of Chapter 6 which are applicable to creditors as "affected persons"<sup>2</sup> during BRP<sup>3</sup>.

### Summary of relevant sections

#### ss 129 and 130 Company resolution to begin BRP:

- ▶ If a company is financially distressed and there appears to be a reasonable prospect of rescuing the company, the board may pass a resolution to voluntarily begin BRP and appoint a practitioner. Notice of such a resolution and appointment must be sent to all affected persons.
- ▶ It is important to note that a company which has adopted a resolution to begin BRP is prohibited from thereafter adopting a resolution to begin liquidation proceedings.
- ▶ After the adoption of such a resolution, but before the adoption of a business rescue plan, an affected person may apply to a court with the requisite jurisdiction for an order setting aside the resolution; setting aside the appointment of the practitioner; or requiring the practitioner to provide security to secure the interests of the company and any affected persons.
- ▶ The resolution may be set aside in the event that there is no reasonable basis for believing that the company is financially distressed; there is no reasonable prospect for rescuing the company; or the company failed to satisfy the procedural requirements in relation to the adoption of such resolution.

- ▶ The appointment of a practitioner may be set aside on the following grounds:
  - ▶ the practitioner is not suitably qualified to hold such a position;
  - ▶ the practitioner is not independent of the company / management; or
  - ▶ the practitioner lacks the necessary skills.
- ▶ In terms of an application brought by an affected person - a copy of such application must be served on the company and the Companies and Intellectual Property Commission ("Commission"), and each affected person must be duly notified. It is important to note that each and every affected person has the right to participate in the hearing of such application.

#### s 131 Court order to begin BRP:

- ▶ In the absence of a resolution to voluntarily begin BRP, an affected person may apply to the court at any time for an order placing a company under supervision and thereby commencing BRP.
- ▶ A copy of such an application must be served on the company and the Commission and each affected person must be duly notified.
- ▶ At the hearing of the application, the court may make an order placing the company under supervision and commencing BRP. This order may only be granted if the court is satisfied that the company is financially distressed; or has failed to pay any amount in terms of an obligation in relation to employment matters; or it is otherwise just and equitable to do so for financial reasons; and there is a reasonable prospect of rescuing the company.

<sup>1</sup> "Financially distressed" means that it appears reasonably unlikely that a 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 reasonably likely that a company will become insolvent in the immediately ensuing six months.

<sup>2</sup> In terms of s 128(1)(a), an "affected person" in relation to a company includes creditors of the company.

<sup>3</sup> Where a number of days is prescribed, it shall consist only of business days (i.e. days other than Saturday, Sundays and public holidays).

## 2. Overview of Chapter 6 of the Companies Act no.71 of 2008 continued

- ▶ In terms of such court order, an affected person would appoint a practitioner to supervise the BRP.
- ▶ The court may dismiss the application and place the company under liquidation.
- ▶ If the court grants an order placing the company under supervision and commencing BRP, the court may appoint an interim practitioner nominated by the affected person who brought the application. However, such nomination is subject to the approval of the holders of a majority of the independent creditors' voting interests at the first meeting of creditors.
- ▶ If liquidation proceedings have already commenced at the time an application for BRP is brought, such application will suspend those liquidation proceedings until the court has adjudicated upon the application or until the BRP ends. In addition, the court may make any of the above-mentioned orders at any time during the course of any liquidation proceedings or proceedings to enforce any security against the company.

### s 133 General moratorium on legal proceedings against a company:

- ▶ Subject to certain exceptions (listed below), during BRP, no legal proceeding, including enforcement action, against a company, or in relation to any property belonging to the company, or lawfully in its possession, may be commenced or proceeded with in any forum.

*Note: Creditors such as Banks which hold general notarial bonds would have to apply to a court to perfect such bonds - to a lawful pledge - prior to the commencement of BRP.*

- ▶ Exceptions:
  - ▶ with the written consent of the practitioner;
  - ▶ with the leave of the court;
  - ▶ as a set-off against any claim made by the company in any legal proceedings;
  - ▶ criminal proceedings against the company / its directors;

- ▶ proceedings concerning any property / right over which the company exercises the powers of a trustee; or
- ▶ proceedings by a regulatory authority in the execution of its duties.
- ▶ In addition, no person may enforce a guarantee or surety by a company in favour of that person during BRP unless the court grants such person leave to do so.
- ▶ In terms of any right to commence proceedings / assert a claim against a company, the running of prescription is suspended during the BRP.

### s 134 Protection of property interests:

- ▶ During BRP, notwithstanding any agreement stating otherwise, no person may exercise any right in relation to property lawfully possessed by the company unless the practitioner consents thereto in writing. Ownership of the property is irrelevant.
- ▶ The practitioner may not unreasonably withhold his consent and must consider the purposes of the business rescue provisions, the circumstances of the company and the nature of the property and the rights claimed in respect of it.
- ▶ During BRP, before a company may dispose of property over which a third party has any security or title interest, such company must obtain such third party's prior consent (unless the proceeds of the disposal will be sufficient to cover the third party's claim). The company must pay as much of the proceeds to that third party as are owing or provide security to the reasonable satisfaction of the third party.

### s 135 Post-commencement finance:

- ▶ During BRP, a company may obtain financing which may be secured to the lender by utilising any asset of the company to the extent that it is not otherwise encumbered. Such lender's claim will have preference in the order in which it has been incurred over all unsecured claims against the company.

### s 136 Effect of business rescue on contracts:

- ▶ During BRP and despite any provision of an agreement to the contrary, during BRP, the practitioner may:
  - ▶ entirely, partially or conditionally suspend, for the duration of the BRP, any obligation of the company that:
    - i. arises under an agreement to which the company was a party at the commencement of the BRP; and
    - ii. would otherwise become due during those proceedings; or
  - ▶ apply urgently to a court to entirely, partially or conditionally cancel, on any terms that are just and reasonable in the circumstances, any obligation of the company which arises from an agreement to which the company is a party.
- ▶ Any party to an agreement that has been suspended or cancelled by the practitioner may only assert a claim against the company for damages.

*Note: Loan and overdraft facility agreements will be at risk if the practitioner is of the view that such agreement is prejudicial to the success of the business rescue plan. However, this problem could be curtailed due to the fact that any suggested suspension of such an agreement would first have to be included in the business rescue plan and then put to the vote by creditors. If creditors believe that they are being unfairly dealt with in respect of such suspension of their agreements, they could simply vote against the adoption of the business rescue plan.*

### s 143 Remuneration of practitioner:

- ▶ A practitioner is entitled to remuneration payable by the company (in accordance with a tariff).
- ▶ In addition to such remuneration, a practitioner may propose an agreement in terms of which the company pays further remuneration. This is calculated based upon various contingencies relating to such practitioner's performance of his duties.

## 2. Overview of Chapter 6 of the Companies Act no.71 of 2008 continued

- ▶ An agreement between the company and the practitioner (in terms of which further remuneration is payable to the practitioner) is final and binding on the company following the approval of: the holders of a majority of the creditors' voting interests; and the holders of a majority of the voting rights attached to any shares that entitle the shareholder to a portion of the residual value of the company on winding-up; present and voting at a meeting called to consider the proposed agreement.
- ▶ Any creditor / shareholder voting against the approval of such an agreement may apply to the court within 10 days after the date of voting, for an order setting aside the agreement. The agreement may be set aside if it is not just and equitable or if the remuneration in terms of such agreement is unreasonable (having regard to the financial circumstances of the company).
- ▶ Any claims that a practitioner may have (for remuneration and expenses not paid by the company) will rank in priority before the claims of all other secured / unsecured creditors.

### s 145 Participation by creditors:

- ▶ During BRP, each creditor is entitled to notice of, and participation in, each court proceeding, decision or meeting. Participation may be formal or informal.
- ▶ Each creditor also has the right to vote to amend, approve or reject a proposed business rescue plan and if such business rescue plan is rejected, a further right to either propose an alternative business rescue plan or present an offer to acquire the interests of any / all of the other creditors (who voted against the approval of the business rescue plan).
- ▶ Creditors may form a creditor's committee and are entitled to consult with the practitioner during the preparation of the business rescue plan.
- ▶ Voting by creditors in terms of BRP occurs as follows:
  - ▶ a secured / unsecured creditor has a voting interest equal to the value of the amount owed; and

- ▶ a concurrent creditor who would be subordinated in a liquidation has a voting interest equal to the amount that the creditor could reasonably expect to receive in the liquidation of the company (the practitioner will request such amount to be independently and expertly appraised and valued).

### s 146 Participation by holders of company's securities (holders of shares, debentures or other instruments):

- ▶ During BRP, each holder of any issued security of the company is entitled to receive notice of, and to participate in, each court proceeding, decision or meeting.
- ▶ If a proposed business rescue plan alters the rights of any class of holders of securities in the company, at a meeting of such holders each person is entitled to vote to approve / reject such business rescue plan. If the business rescue plan is rejected, such holders may either propose the preparation of an alternative business rescue plan or present an offer to acquire the interests of any / all of the creditors or other holders of the company's securities (who voted against the approval of the business rescue plan).

### s 147 First meeting of creditors:

- ▶ Should be convened and presided over by the practitioner within 10 days after such practitioner's appointment.
- ▶ At the meeting, the practitioner must inform the creditors whether he or she believes that there is a reasonable prospect of rescuing the company. The creditors may present proof of claims to the practitioner as well as determine whether or not to form a committee of creditors.
- ▶ A decision at the meeting is approved if it is supported by the holders of a simple majority of the independent creditors' voting interests. However, it is important to note that this does not apply to a meeting convened for the purpose of considering a proposed business rescue plan.

### s 149 Functions, duties and membership of committees of affected persons:

- ▶ A committee of creditors may consult with the practitioner in relation to any matter relating to the BRP, but may not instruct / direct the practitioner.

*Note: this appears to mean that creditors can discuss matters with the practitioner but cannot impose their instructions on such practitioner in the conduct of the BRP.*

- ▶ Such committee may also receive and consider reports relating to the BRP, on behalf of the general body of creditors.
- ▶ It is important that such committees act independently of the practitioner to ensure proper representation of creditors' interests.

### s 150 Proposal of business rescue plan:

- ▶ After consultation with all creditors, other affected persons and the management, a practitioner must prepare a business rescue plan. Such business rescue plan must contain all the information which affected persons may need in order to reach a decision regarding its adoption. A summary of the information to be included in a business rescue plan is included hereunder.
- ▶ The business rescue plan must be published within 25 business days after the date on which the practitioner was appointed or such longer time as may be allowed by the court on application by the company or the holders of a majority of the creditors' voting interests.

### s151 Meeting to consider business rescue plan:

- ▶ Within 10 days after the publication of a business rescue plan, a practitioner must convene and preside over a meeting of creditors and any other holders of a voting interest. Such a meeting is convened in order to consider the proposed business rescue plan.

## 2. Overview of Chapter 6 of the Companies Act no.71 of 2008 continued

### s 152 Consideration of business rescue plan:

- ▶ A vote supported by the holders of more than 75% of the creditors' voting interests as well as at least 50% of the independent creditors' voting interests will indicate a preliminary approval of the proposed business rescue plan.
- ▶ In the event that a proposed business rescue plan is not approved on a preliminary basis, the plan is rejected and may only be considered further after the practitioner has sought a vote of approval to prepare and publish a revised plan, or has advised the meeting that the company will apply to court to set aside the result of the vote (on the grounds that it was inappropriate).
- ▶ If a proposed business rescue plan does not alter the rights of the holders of any class of securities in the company, preliminary approval of such business rescue plan also constitutes the final adoption of that plan (subject to any conditions on which the business rescue plan is contingent).
- ▶ If a proposed business rescue plan does alter the rights of any class of holders of securities in the company, the practitioner is obliged to immediately hold a meeting of such holders. At the meeting a vote must be called to approve the adoption of the proposed business rescue plan. If a majority of the voting rights are exercised in favour of the business rescue plan, it will be duly adopted.
- ▶ If a majority of the voting rights are exercised in opposition to the adoption of the plan, the plan is rejected and may only be considered further after the practitioner has sought a vote of approval to prepare and publish a revised plan, or has advised the meeting that the company will apply to court to set aside the result of the vote (on the grounds that it was inappropriate).
- ▶ An adopted business rescue plan is binding on the company, all of its creditors and every holder of securities (even if a person did not actively participate in the adoption of the business rescue plan).

- ▶ Except to the extent that an approved business rescue plan provides otherwise, a pre-emptive right of any shareholder (in terms of s 39) does not apply with respect to an issue of shares by the company in terms of the business rescue plan.

### s 153 Failure to adopt a business rescue plan:

- ▶ In the event that a business rescue plan is rejected and the practitioner does not seek a vote in respect of a revised plan nor does he / she notify the meeting of his / her intention to apply to the court to set aside the result of the vote, any affected person present at such meeting may:
  - ▶ initiate a vote requiring the practitioner to prepare and publish a revised plan; or
  - ▶ apply to court to set aside the result of the vote (on the grounds that it was inappropriate); or
  - ▶ make a binding offer to purchase the voting interests of the persons who opposed the adoption of such business rescue plan (at a fair and reasonable value determinable by an independent expert).
- ▶ A holder of a voting interest, or a person acquiring such interest in terms of a binding offer, may apply to the court to review, re-appraise and re-value the determination made by an independent expert.
- ▶ Upon application by a practitioner/affected person, a court may order that the vote on a business rescue plan be set aside if the court is satisfied that it is reasonable and just to do so. The factors a court will consider in this regard include:
  - ▶ the interests represented by the person/s who voted against the proposed business rescue plan;
  - ▶ the provision made, if any, in the proposed business rescue plan with respect to the interests of that/those person/s; and
  - ▶ a fair and reasonable estimate of the return to that/those person/s, if the company were to be liquidated.

### s 154 Discharge of debts and claims:

- ▶ A business rescue plan may provide that a creditor who has agreed to the discharge / reduction of the debt owing to such creditor, will lose the right to enforce the relevant debt or part of it.
- ▶ If a business rescue plan is approved and implemented in accordance with the provisions of the Act, a creditor is not entitled to enforce any debt owed by the company immediately before the beginning of BRP, except as provided for in the business rescue plan.

*Note: this might result in the discharge of all suretyship obligations if the principal obligation is extinguished.*

### s 155 Compromise between the company and its creditors:

- ▶ This section applies to a company, irrespective of whether or not it is financially distressed, unless it is engaged in BRP.
- Note: this means that during the period of a s 155 compromise being negotiated with all stakeholders, any creditor could apply either for BRP or the liquidation of the company. A compromise in terms of this section could not occur if BRP are in force.*
- ▶ The board of a company may deliver a proposal regarding an arrangement or compromise of its financial obligations to all of the company's creditors.
  - ▶ A proposal is adopted by the creditors of a company if it is supported by a majority in number, representing at least 75% in value of the creditors present and voting at a meeting called to consider the proposal.
  - ▶ If a proposal regarding an arrangement or compromise of a company's financial obligations to all of the company's creditors is duly adopted, the company may apply to the court for an order approving the proposal.
  - ▶ In terms of such an application, the court may also sanction the compromise as provided in the proposal (if it is just and equitable to do so) after having considered the number of

## 2. Overview of Chapter 6 of the Companies Act no.71 of 2008 continued

creditors who voted in favour of the proposal, and in the case of a compromise in respect of a company being wound-up, the report of the Master required in terms of Chapter 14 of the old Act.

- ▶ As of the date on which it is filed, a copy of a court order sanctioning an arrangement or compromise of a company's financial obligations to all of its creditors / members of any class of its creditors, is final and binding on all of the creditors / members of the relevant class of creditors.
- ▶ Any arrangement / compromise does not affect the liability of any person who is a surety of the company.

### Conclusion

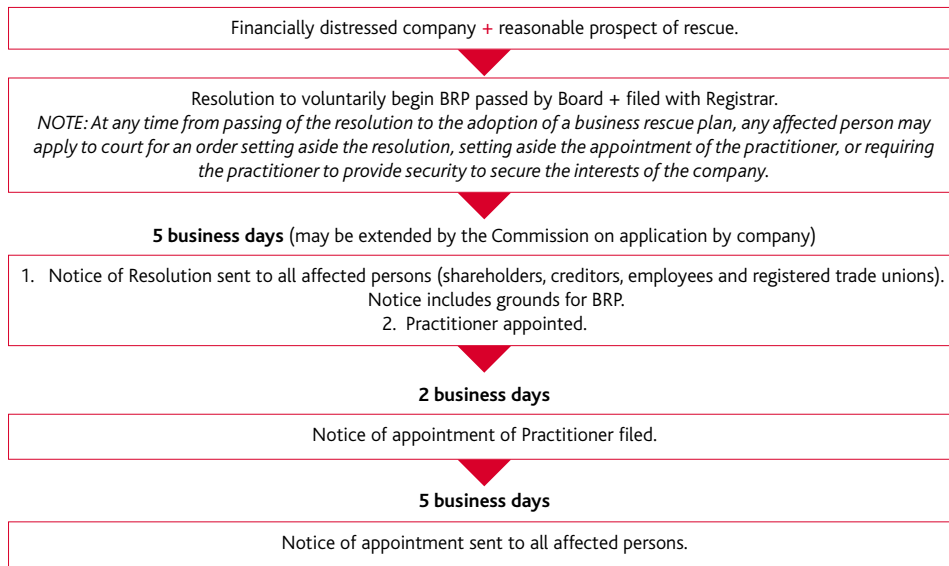
In terms of the provisions of Chapter 6 of the Act, the general areas of concern for creditors include:

- ▶ post-commencement financing i.e. will there be a willingness on the part of banks and financial institutions to provide post-commencement finance during BRP? If so, will a company under supervision have the requisite assets to provide security for continued funding bearing in mind that many of the company's assets might already be encumbered at the time proceedings commence?;
- ▶ the practitioner's discretion to suspend or apply to the court for the cancellation of obligations arising from current contracts of the company (i.e. any banking institution which is a party to a loan / overdraft agreement might find that the obligations of the company arising from such agreement or any part thereof are suspended by the practitioner (e.g. suspension of interest). The result for the creditor is a concurrent claim against the company for damages);
- ▶ without being granted the leave of the court, any enforcement of a guarantee or surety by a company in favour of a creditor during BRP is prohibited;
- ▶ the development, preparation and proposal of the business rescue plan is driven by the practitioner and not by the creditors of the company. Thus, the practitioner will consult with the creditors, shareholders, employees and trade unions, but, such practitioner is not obliged to follow the instructions of any such group;
- ▶ the entire BRP process is very court driven and therefore may become cumbersome due to the backlog of matters in our courts (no specialised business recovery courts have been proposed at this stage); and
- ▶ during the period of a s 155 compromise being negotiated with all stakeholders, any creditor could apply either for BRP or the liquidation of the company, in which event proceeding under s 155 would not be competent.

### 3. Flowcharts illustrating the Business Rescue process

- A – Company resolution to commence BRP
- B – Court order to commence BRP
- C – General overview of BRP (from commencement via resolution/court order to termination of BRP)

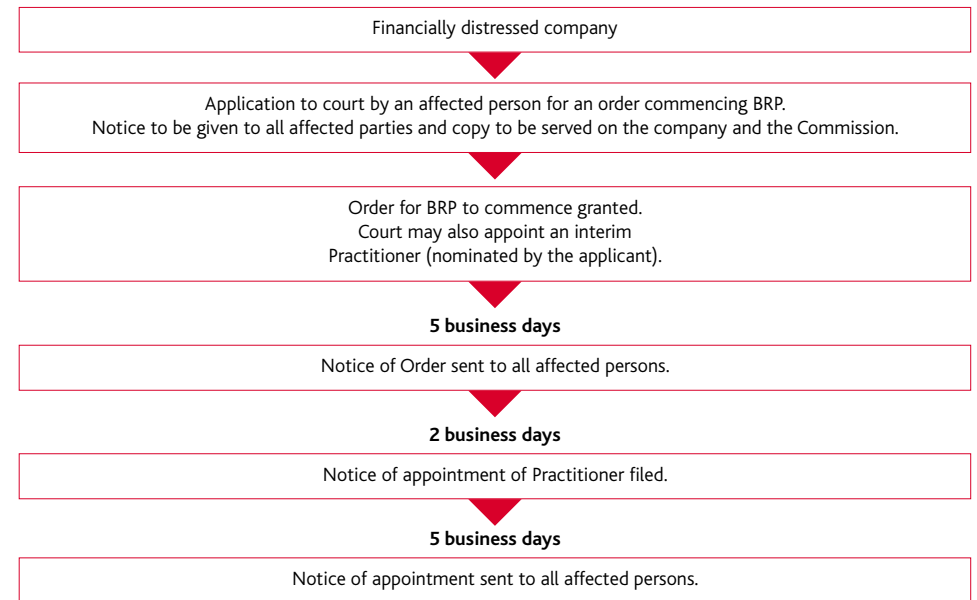
#### A – Company resolution to commence BRP



**If the company fails to file the resolution and notify affected persons – the resolution lapses and is void! No further resolution may then be filed for a period of 3 months thereafter (unless a court orders otherwise).**

From this point: see General Overview of the timing relating to BRP in C.

#### B – Court order to commence BRP



From this point: see General Overview of the timing relating to BRP in C.



### 3. Flowcharts illustrating the Business Rescue process continued

#### C - General overview of the timing relating to BRP

Note: In terms of section 132(3) BRP should generally end within 3 months! (Unless an extension is granted by the court on application by the practitioner)



## 4. Information to be included in a BR Plan (Section 150)

Generally, a business rescue plan must contain all information necessary to ensure that affected persons are able to make an informed decision when voting on whether or not to approve such business rescue plan.

The business rescue plan must be divided into the following three parts:

Part A – Background;

Part B – Proposals; and

Part C – Assumptions and Conditions.

### Part A – Background –

This section of the business rescue plan should include at least the following:

- ▶ a complete list of all the material assets of the company, as well as an indication as to which assets were held as security by creditors when the BRP began;
- ▶ a complete list of the creditors of the company when the BRP began, as well as an indication as to which creditors would qualify as secured, statutory preferent and concurrent in terms of the laws of insolvency, and an indication of which of the creditors have proved their claims;
- ▶ the probable dividend that would be received by creditors, in their specific classes, if the company were to be placed in liquidation;
- ▶ a complete list of the holders of the company's issued securities;
- ▶ a copy of the written agreement concerning the practitioner's remuneration; and
- ▶ a statement whether the business rescue plan includes a proposal made informally by a creditor of the company.

### Part B – Proposals –

This section of the business rescue plan should include at least the following:

- ▶ the nature and duration of any moratorium for which the business rescue plan makes provision;
- ▶ the extent to which the company is to be released from the payment of its debts, and the extent to which any debt is proposed to be converted to equity in the company, or another company;
- ▶ the ongoing role of the company, and the treatment of any existing agreements;
- ▶ the property of the company that is to be available to pay creditors' claims in terms of the business rescue plan;
- ▶ the order of preference in which the proceeds of property will be applied to pay creditors if the business rescue plan is adopted;
- ▶ the benefits of adopting the business rescue plan as opposed to the benefits that would be received by creditors if the company were to be placed in liquidation; and
- ▶ the effect that the business rescue plan will have on the holders of each class of the company's issued securities.

### Part C – Assumptions and conditions –

This section of the business rescue plan should include at least the following:

- ▶ a statement of the conditions that must be satisfied, if any, for the business rescue plan to-
  - ▶ come into operation; and
  - ▶ be fully implemented;
- ▶ the effect, if any, that the business rescue plan contemplates on the number of employees, and their terms and conditions of employment;

- ▶ the circumstances in which the business rescue plan will end; and
    - ▶ a projected-
    - ▶ balance sheet for the company; and
    - ▶ statement of income and expenses for the ensuing three years, (both of which must include notice of any material assumptions on which the projections are based and may include alternative projections based on varying assumptions and contingencies)
- prepared on the assumption that the proposed business plan is adopted.

Finally, the business rescue plan must be concluded with the inclusion of a certificate by the practitioner stating that any actual information provided appears to be accurate, complete, and up to date; and projections provided are estimates made in good faith on the basis of factual information and assumptions as set out in the statement.

## 5. The Directors' Business Rescue and Insolvency check list

### 1 Introduction

Once it is established that a company is trading in circumstances of "financial distress", the directors of such company will be obligated to notify all affected persons that the company is financially distressed or alternatively pass a resolution commencing BRP. In such resolution, a practitioner will be appointed to supervise the company.

What is set out below deals with what directors need to consider from a legal point of view when it becomes evident that a company is trading in a position of financial distress.

Directors need to be aware of the circumstances in which they can be held personally liable for the debts of the company should they fail to adhere to the obligations imposed upon such directors in Chapter 6 of the new Act. It is incumbent upon directors to ensure that when the warning signs become self evident i.e. the company is financially distressed, that they immediately take legal and financial advice and, if necessary, place their companies into business rescue or alternatively into liquidation.

The question to be considered is whether or not financial distress is in fact a real possibility and whether the telltale signs of financial difficulty is self evident to the directors. It is at this stage that a director would be obligated to consider BRP or alternatively liquidation proceedings.

What follows below is an attempt to set out the legal standards that will apply according to South African law in respect of when a director should consider placing his company into business rescue or liquidation.

In addition thereto, also included below is a director's "Business Rescue and Insolvency Checklist" for consideration by directors.

The list is not exhaustive but certainly provides a guideline for directors as to what they should consider when potential insolvency issues are being debated at board level.

### 2 Trading a Company Recklessly, in a Position of Financial Distress or in Insolvent Circumstances and Director's Personal Liability

In South African Law, a director would have a duty to consider a resolution for BRP as soon as he/she is knowingly aware that the company is trading in a position of financial distress or in reckless circumstances.

"Financially distressed" means that it appears reasonably unlikely that a 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 reasonably likely that a company will become insolvent in the immediately ensuing six months. Consequently, if a company is trading in financial distress or in insolvent circumstances, the directors of the company would be obligated to consider a resolution for either business rescue or alternatively for the company's liquidation. The timing of such a resolution depends on the factual circumstances of each case, but if the events set out above are present, such resolution should occur as soon as possible.

In terms of section 129(7) of the new Act, if the board of a company has reasonable grounds to believe that it is financially distressed but the board has not adopted a business rescue resolution, the board must deliver a written notice to each affected person setting out why the board believes that the company is financially distressed and its reasons for not adopting a business rescue resolution. Should a director not proceed in this manner he/she might be held personally liable in terms of section 77 as read with section 76 of the new Act (such section replaces section 424 of the old Act).

### Section 76(3) states that –

*"a director of a company, when acting in that capacity, must exercise the powers and perform the functions of a director –*

- ▶ *in good faith and for a proper purpose;*
- ▶ *in the best interests of the company; and*
- ▶ *with the degree of care, skill and diligence that may reasonably be expected of a person –*
  - ▶ *carrying out the same functions in relation to the company as those carried out by that director; and*
  - ▶ *having the general knowledge, skill and experience of that director."*

Section 76(4) states that in respect of any particular matter arising in the exercise of the powers or the performance of the functions of a director, a particular director of a company will have satisfied the obligations set out in section 76(3), if the director has taken reasonably diligent steps to become informed about the matter.

Furthermore, in terms of section 76(4) of the Act, a director would have satisfied the obligations of section 76(3), if the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company.

In terms of section 77(2)(a), a director of a company may be held liable in accordance with the principles of the common law relating to the breach of a fiduciary duty, for any loss, damages or costs sustained by the company as a consequence of any breach of the director of duties contemplated, inter alia, in section 76.

In terms of section 22(1) of the new Act a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.

## 5. The Directors' Business Rescue and Insolvency check list

Reckless trading would include trading a company in insolvent circumstances. Insofar as tests applicable for a company trading in insolvent circumstances are concerned, our case law has indicated that if any conduct of the company's business occurs at a time that it incurs debts where, in the opinion of reasonable businessmen, standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business of the company is being carried on recklessly or negligently. This latter statement applies in a situation where a company is trading in what is termed "commercial insolvency" i.e. where a company cannot pay its debts to creditors as and when they fall due. Obviously, if a director is aware that a company is "factually insolvent", in that on its balance sheet the company's liabilities exceed its assets, this would be a factor to be taken into account when the reckless test is considered by a court of law. In other words a director might be faced with a situation where a company might be factually insolvent but is in a position to pay its debts. In this instance it might not be necessary to consider BRP or to place the company into liquidation as there might be an opportunity for the company to "trade its way out" of its financial predicament. It is also possible that a company is not factually insolvent but is commercially insolvent. In these circumstances a company in all probability would have to be placed into business rescue or into liquidation. However, if a company is both commercially and factually insolvent, the directors are obligated to either pass a resolution to commence BRP or to apply for the company's liquidation.

Section 214 renders a director (or any person) guilty of a criminal offence if such director/person was a party to conduct calculated to defraud a creditor, employee, security holder (shareholder) of the company or with another fraudulent purpose.

As in all cases involving negligence, the test in our law is essentially an objective one in that it postulates the standard of conduct of the notionally reasonable director. It is subjective

insofar as the said notional director is envisaged as conducting himself with the same knowledge and access to financial information as the relevant director would have had in the circumstances. In this regard the court will have regard, *inter-alia*, to the scope of operations of the company, the role, functions and powers of the directors, the amount of the corporate debt, the extent of the company's financial difficulties and the prospects, if any, of recovery.

These facts would be examined by a Judge at a hearing to consider whether directors should be held personally liable in terms of section 77 of the new Act and in particular to establish whether such director acted in contravention of section 22. He/she would use his/her discretion in deciding if the directors should have, at that time, either obligated to place the company into business rescue or liquidation.

The test will always be that there will come a point in time when reasonable businessmen would either apply for business rescue or apply for the liquidation of the company.

The incurring of credit at a time where directors know that the company would not be able to meet its liabilities when they fall due will be tested by the court in order to substantiate the personal liability of a director. What will be considered is whether the director should have placed the company into business rescue or into liquidation at that time and not continued to do business knowing full well that such company would never be able to satisfy its creditors.

The detail of financial information available to a director, together with the veracity of such information, will be taken into account when the personal liability of such director is examined in terms of section 77 of the new Act. Obviously if a director is in charge of marketing, he will not be expected to be privy to the same level of financial information as the financial director.

Directors should conduct regular and if necessary, daily examination of financial documentation and information to support the contention that they were not knowingly a party to the trading of a company in financial distress or in insolvent circumstances. Obviously this would depend on how dire the financial position of the company is and circumstances will change from case to case.

Once a director has taken advice either from the company's auditors or from legal counsel, and such advice supports the position that the company is financially distressed or insolvent, such director should place the company into business rescue or into liquidation by the passing of a resolution in support of BRP or the company's liquidation.

Once directors have taken advice, it is up to them to ensure that a board meeting is convened as a matter of urgency to consider the passing of a resolution in support of business rescue or liquidation. This process should commence as soon as possible and if necessary on an urgent basis in order to ensure that creditors are not prejudiced by any delays caused by the failure of directors to proceed in this manner. Directors could never be criticised by the court or creditors for proceeding to consider the relevant resolution as soon as such directors have become aware of the fact that the company is trading in a position of financial distress or in insolvent circumstances.

It is important to understand that directors have to behave in a certain manner prior to BRP and to liquidation when it comes to dealing with creditors of the company and at a time when the company is insolvent. The Insolvency Act No 24 of 1936 ("Insolvency Act") (which remains in force), imposes certain obligations on the directors to ensure that dispositions of property not made for value are avoided, that no undue preference is provided to any creditor of the company, that no collusive dealings with any one creditor of the company occurs to the prejudice of other creditors and that generally no

## 5. The Directors' Business Rescue and Insolvency check list

creditor is dealt with in a specific way which causes detriment or financial prejudice to any other creditor.

The Insolvency Act punishes those directors that participate in the aforementioned behaviour but only if the court can be persuaded that the business of the company had been carried on by such director with the intent to defraud creditors or for a fraudulent purpose.

### 3 The Director's Business Rescue and Insolvency Checklist

Directors need to, at an early stage, identify through an examination of the financial accounts of the company whether the company is in fact financially distressed or is trading in insolvent circumstances. Directors need to establish the viability of the company's balance sheet, income statement and other financial information (including management accounts which would be available to such directors from time to time) so as to establish these factors.

Early signals in respect of "looming financial distress" would be issues such as cash flow problems, a balance sheet which reflects liabilities in excess of the company's assets and an inability on the part of the company to pay its debts as and when they fall due. A proper evaluation of the veracity and reliability of financial information provided to the board should occur on an ongoing basis.

A change in market circumstances such as for example a company which exports into a foreign market and whose financial position may be severely curtailed as a result of a significant fluctuation in the exchange rate.

Other market conditions which vary from company to company, from industry to industry, must be understood by directors and evaluated on a meaningful and realistic basis when one considers the possibility of a company trading out of its financial predicament.

Warning signs of looming insolvency and financial distress would be: ongoing trading losses, a net asset deficiency, a continual failure to meet company commitments to SARS, delayed payment to essential and non-essential creditors, part payment to and instalment plans with creditors, dishonoured cheques, artificial valuation of assets, factoring of debts, an increase in the incidence of internal fraud, COD terms with suppliers, receipt of letters of demand, summons/actions and liquidation notices and continued injection by shareholders of capital into the company due to insufficient capital requirements.

A loss of key personnel would be of material significance, particularly in those sectors where a company finds it very difficult or impossible to replace such skilled persons. Workforce management is critical. It may become necessary for certain companies to lay off certain employees in order to rationalise and reduce costs. This must be done by the company in a very careful manner particularly if one starts laying off or retrenching employees with the right skill sets to manage the business through a financial crisis. At some point in the future hopefully there will be an upturn, the question is when? When that upturn occurs, experience and skilled people will be the order of the day. Therefore the retention of such people is extremely important. Loss of management control would always be a significant issue to be considered by directors in considering the viability and prospects of a company trading profitably.

The levels of good corporate governance will always have to be assessed by directors together with the obligations set out in the Act and guidelines such as the King III Report.

The proper control of costs, remuneration packages and bonuses for both staff and directors should be carefully considered and critically analysed at all times.

A proper evaluation of customers and suppliers should occur in order to understand the peculiar financial position that the

company might find itself in when either its customers or suppliers cease trading in the relevant period under assessment.

Directors, particularly financial directors, need to have constant contact and interaction with the company's banks and financial institutions in respect of the levels of financing, loan facilities, overdraft and credit facilities available to the company on an ongoing basis.

Directors should always be ready and open to take both legal and financial advice particularly if they are concerned about the ongoing financial ability of the company to continue to trade at profitable levels.

### 4 Conclusion

All of the above pose challenges for South African directors post the implementation of the new Act.

Directors who allow companies to continue to trade in a position of insolvency or financial distress and who do not take the necessary steps must recognize that such trading may be the subject matter of scrutiny. BRP provides the company with "a second chance" and an opportunity for the company to trade its way out of its financial predicament with the assistance of the practitioner. If the company can be saved, then the earlier one places the company into BRP, the better the chance of the company's survival and of the successful implementation of the business rescue plan. After all, liquidation should be averted at all costs, thus saving the company, employees' jobs and generally boosting the South African economy as a whole.

In current world financial markets, a frank and realistic review by directors of the manner in which companies trade will be essential to survival and for the avoidance of personal liability.

## 6. The Werksmans Business Rescue and Insolvency Team

The Werksmans Business Rescue and Insolvency Team is able to advise business rescue practitioners, directors, stakeholders, employees and creditors during all stages of the business rescue process. This includes guidance to creditors in respect of strategic decisions such as, whether or not to vote in favour of a business rescue plan or whether or not to embark on the winding up process as an alternative to business rescue and advice on protecting their security, particularly when it comes to financing and lending transactions in the business rescue scenario.

Speed is of the essence in the business rescue process. Very short time periods are set out in the Act and it is important that all stakeholders have proper legal support to call upon at short notice.

Werksmans' approach to business rescue is proactive and focuses on advising creditors in a way that ensures that they achieve maximum returns in the business rescue process.

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## About Werksmans Attorneys

Established in the early 1900s, Werksmans Attorneys is a leading South African corporate and commercial law firm serving multinationals, listed companies, financial institutions, entrepreneurs and government.

Werksmans operates in Gauteng and the Western Cape, and is connected to an extensive African network through Lex Africa\*.

With a formidable track record in mergers and acquisitions, banking and finance, and commercial litigation and dispute resolution, the firm is distinguished by the people, clients and work that it attracts and retains.

Werksmans' more than 170 lawyers are a powerful team of independent-minded individuals who share a common service ethos. The firm's success is built on a solid foundation of insightful and innovative deal structuring and legal advice; a keen ability to understand business and economic imperatives; and a strong focus on achieving the best legal outcome for clients.

*\*In 1993, Werksmans co-founded the Lex Africa legal network, which now has member firms in 30 African countries.*

*Nothing in this publication should be construed as legal advice from any lawyer or this firm. This guide should be seen as a general summary of developments introduced by or principles of interest relating to the new Companies Act No. 71 of 2008 and may not apply directly to specific circumstances. Professional advice should therefore be sought before any action is taken.*





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