

# Some Initial Thoughts on the Development of a Modern and Effective Business Rescue Model for South Africa (Part 1)\*

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## 1 Introduction

Much has been written on the failure of judicial management<sup>1</sup> as a business rescue model in South Africa. While it is generally accepted that judicial management is a dismal failure in practice,<sup>2</sup> the question remains as to what will be done in order to rectify the position in South Africa, especially considering the premium that government has now placed on saving both jobs and businesses.

Never before has South Africa been this well positioned to make work of rectifying an aspect of our insolvency laws that need a drastic overhaul. Although one finds it difficult to believe that the failure of large businesses in South Africa may in fact have a positive spin-off, it is submitted that the recent failures of large corporations such as Central News Agency (CNA), Retail Apparel Group (RAG) and LeisureNet, has at last prompted government to take the necessary steps to bring about reform in the area of business rescue. It, of course, helps that South Africa is also currently nearing the end of a long process in reviewing its antiquated insolvency laws, with the unified version of a new Insolvency Act recently having been accepted by the South African Cabinet.<sup>3</sup>

Business rescue and insolvency go hand-in-hand, and it makes sense to address these very important issues simultaneously. The Ministers of Justice and Trade and Industry have indicated that reform in the area of business rescue is imminent, although there appears to be some doubt as to which department will in fact take responsibility for the reform process

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<sup>1</sup> Although compromises in terms of the Companies Act 61 of 1973 are also regarded as being a form of business rescue, these have not been discussed in any detail in this article. The reason for this is that s 311 compromises have been retained in the new proposed Draft Insolvency and Business Recovery Bill that was approved by the South African Cabinet on 5 March 2003. This article therefore concentrates on judicial management as the current form of business rescue in South Africa. However, in order to provide as much background as possible, a brief summary has been given on the various options available to debtors in order to reach some or other form of agreement with their creditors, as well as other more recent options that have been included.

<sup>2</sup> For a judicial summary of the problems associated with judicial management in South Africa, see *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* 2001 (2) SA 727 (C); [2001] 1 All SA 233 (C).

<sup>3</sup> The South African Cabinet approved the unified version of a new insolvency statute on 5 Mar 2003. The proposed legislation has been submitted to the State Law Advisers under the title 'Draft Insolvency and Business Recovery Bill'.

itself. In the interim, and to be of possible assistance with the development of a new business rescue model for South Africa, the Centre for Advanced Corporate and Insolvency Law ('CACIL') at the University of Pretoria thought it prudent to undertake a research project that can make recommendations to government regarding a modern and effective business rescue model. As a first step in this project the CACIL hosted a workshop at the University of Pretoria at which the most important elements of a modern and effective business rescue model could be debated by all the stakeholders in the insolvency industry.

This article has been adapted from the working document prepared for the workshop, and must not be seen to be the first or the last word on a modern and effective business rescue model for South Africa. Quite simply, the main purpose of this article is to explore some of the main elements of a modern and effective business rescue regime for South Africa.

Consequently, in this article the following issues will be addressed, namely:

- The background leading up to the current research into a modern and effective business rescue regime for South Africa.
- The reasons for the failure of judicial management as a viable business rescue mechanism, and the lessons to be learnt from its failure.
- Options, both old and new, that have been included in the Draft Insolvency and Business Recovery Bill.
- The underlying philosophy and meaning of 'business rescue'.
- The main elements of a successful business rescue regime in the South African context.

## 2 Background to Reform Initiatives

During the late 1980s the South African Law Reform Commission ('SALRC') undertook an initiative to totally review the Insolvency Act 24 of 1936 ('the Insolvency Act'). At the initial stages of the review process the Standing Advisory Committee on Company Law, resorting under the auspices of the Department of Trade and Industry, was requested to simultaneously look at the reform of the winding-up provisions of the Companies Act 61 of 1973 ('the Companies Act') and the Close Corporations Act 69 of 1984 ('the Close Corporations Act'). However, nothing was done in this regard until 1998. The SALRC published numerous research papers before being requested, during the mid 1990s, to hasten the project and to publish a Draft Insolvency Bill. The SALRC's Draft Insolvency Bill was eventually published in 1996.

In the meantime the Centre for Advanced Corporate and Insolvency Law at the University of Pretoria had offered to assist the Standing Advisory Committee on Company Law in bringing about the desired amendments also to the Companies Act and the Close Corporations Act. The suggestion was that the CACIL would attempt to unify the winding-

up provisions of the Companies Act and the Close Corporations Act, with those of the Draft Insolvency Bill published by the SALRC in 1996. In doing so the CACIL used the SALRC's Draft Insolvency Act as a point of departure, and a working document appeared in October 1998. This working document was subsequently discussed at a national symposium, attended by over 200 delegates from all disciplines of the insolvency profession. The overwhelming majority of the delegates were in favour of a unified Insolvency Act, but felt that some major amendments had to be made to the initial draft included in the working document. In order to achieve the necessary changes a series of workshops were held at the University of Pretoria during December 1998.

In October 1999 a new version of the Unified Insolvency Act was discussed at length at a technical conference. The delegates at this conference approved the new version of the Draft Unified Insolvency Bill with a few minor amendments. The final version of the Draft Unified Insolvency Bill, reflecting the sum total of the research conducted by the SALRC and the CACIL, was eventually presented to the SALRC in January 2000.

On 5 March 2003 the Cabinet of the South African government approved the introduction of the Draft Insolvency and Business Recovery Bill, the name given to the unified version of the new Insolvency Act. This Bill is currently in the hands of the state law advisers, and the official Bill will hopefully be published sometime during 2004.

### 3 The Underlying Philosophy and Meaning of 'Business Rescue'<sup>4</sup>

Before discussing the various aspects that will impact on the implementation of a workable business rescue regime in South Africa, it is perhaps appropriate to consider the meaning of the concept 'business rescue', and to explode some of the myths surrounding the general understanding of this concept in South Africa.<sup>5</sup>

Despite its name, the purpose of business rescue is not necessarily to prevent a company or corporation from being wound up or liquidated.<sup>6</sup>

<sup>4</sup> See, generally, Muir Hunter 'The Nature and Functions of a Rescue Culture' 1999 *J of Business Law* 491; Michael R Rochelle 'Lowering the Penalties for Failure: Using the Insolvency Law as a Tool for Spurring Economic Growth; the American Experience, and Possible Uses for South Africa' (1996) 2 *Tydskrif vir die Suid-Afrikaanse Reg* 315; Ron W Harmer 'Comparison of Trends in National Law: The Pacific Rim' 1997 (13) *Brooklyn J of International Law* 139-65; Royston Miles Goode *Principles of Corporate Insolvency Law* 2 ed (1997) 267-70; Michael J Herbert *Understanding Bankruptcy* (1995) ch 17 at 303-52. For an instructive comment on the underlying philosophy of reorganisations under United States law, see Thomas H Jackson *The Logic and Limits of Bankruptcy Law* (1986) 209-24. For a useful and more recent discussion of the philosophy underlying rescues under English law, see Vanessa Finch *Corporate Insolvency Law: Perspectives and Principles* (2002) ch 6. For a useful summary of the concepts and theories that apply to business rescue generally, see Alice Belcher *Corporate Rescue* (1997) ch 1-6 at 3-87.

<sup>5</sup> Possibly due to the fact that judicial management in South Africa has as its aim the complete resuscitation of a company, many believe that all business rescue models have the same purpose.

<sup>6</sup> The terms 'winding-up' and 'liquidation' are used interchangeably in this article, although in South Africa the draft (Unified) Insolvency and Business Recovery Bill intends using the term 'liquidation' to denote the winding-up of the estates of all entities.

Even if the business cannot be restored to a solvent and profitable status, the return to creditors in the long-run will be much higher.<sup>7</sup> It is stated thus by Smits:<sup>8</sup>

'Modern "corporate rescue" and reorganisation seeks to take advantage of the reality that in many cases an enterprise not only has substantial value as a going concern, but its going concern value exceeds its liquidation value. Through judicial bankruptcy procedures, reorganisation seeks to maximise, preserve and possibly even enhance the value of a debtor's business enterprise, in order to maximise payment to the creditors of the distressed debtor.'

An important point made by Harmer,<sup>9</sup> is that a business rescue regime has a far better chance of succeeding if the insolvency system in which it is applied is debtor-friendly, as opposed to a creditor-friendly system of insolvency where business rescue regimes are not applied as successfully.<sup>10</sup> This is certainly true of South Africa. South Africa has a creditor-friendly insolvency system, and it is submitted that the fact that the courts take a very conservative approach to insolvency and judicial management is a contributing factor in the failure of judicial management as a business rescue regime in South Africa. This aspect will be discussed in more detail below.

While judicial management, as an example of a business rescue mechanism in South Africa, is seen to be an extraordinary measure, in other jurisdictions business rescue procedures are seen as a necessary and natural precursor to insolvency itself.<sup>11</sup> In this regard it is important to note the legal nature and philosophy behind a business rescue culture. In the so-called Cork Report,<sup>12</sup> the following two aims 'of a good modern insolvency law' were identified with regard to English law:<sup>13</sup>

<sup>7</sup> Section 427(1) of the Companies Act requires that there must be a reasonable probability that the company will be able to pay its debts and meet its obligations if the judicial management order is granted. In *Noordkaap Lewendehawe Ko-op Bpk v Schreuder* 1974 (3) SA 102 (A), the Court confirmed the requirement that there must be a reasonable probability and not merely a reasonable possibility. The Court also stated that the intention of the legislature in using the term 'probability' was to restrict as little as possible the rights of creditors. This requirement is stated as being unrealistic, and sometimes even against the wishes of creditors, by Harry Rajak & Johan J Henning in 'Business Rescue for South Africa' (1999) 116 *SALJ* 268. Anthony J Smits 'Corporate Administration: A Proposed Model' (1999) 32 *De Jure* 86 is of the opinion that the success of judicial management should not be measured by this requirement, as this is not the only goal of a business rescue regime. See also Harmer op cit note 4 at 144 where he attempts to provide an internationally acceptable definition of the term 'rescue'.

<sup>8</sup> Smits op cit note 7 at 83. See also Michael Trebilcock & Jodi Katz 'The Law and Economics of Corporate Insolvency: A North American Perspective' in: Rickett (ed) *Essays on Corporate Restructuring and Insolvency* (1996), where the following is stated at 7:

'The collective interest of all creditors requires the maximisation of the aggregate value of the assets of the debtor. In many cases, an insolvent firm is worth more as a going concern than the sum value of its discrete assets sold on a piecemeal basis. In these situations, it is in the collective interests of all creditors that the business be preserved as a going concern.'

<sup>9</sup> Op cit note 4 at 147.

<sup>10</sup> *Ibid* where Harmer refers to the United States as an example of a debtor-friendly insolvency system where business rescue has a very high success rate, as opposed to Australia with a low rate of success due to its creditor-friendly insolvency system. But this has changed since the introduction of a new business rescue model – corporate voluntary administration – in Australia: see also Finch op cit note 4 at 189.

<sup>11</sup> See, eg, Herbert op cit note 4 at 303-14 where the author discusses the role of business rescue in the United States.

<sup>12</sup> *Insolvency Law and Practice, Report of the Review Committee* (Cmd 8558) 1982 ('the Cork Report').

<sup>13</sup> *Idem* in par 198.

'(i) to recognise that the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome, and to ensure that these public interests are recognised and safeguarded;

(j) to provide means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country;'

In addition to these statements on the general aims of English insolvency law, the Cork Report stated the following in regard to the appointment of administrators as a form of business rescue:<sup>14</sup>

'498. Under our proposals, an Administrator may be appointed for all or any of the following reasons:

(a) to consider the reorganisation of the company and its management with a view to restoring profitability or maintaining employment;

(b) to ascertain whether a company of doubtful solvency can be restored to profitability;

(c) to make proposals for the most profitable realisation of assets for the benefit of creditors and shareholders;

(d) to carry on the business where this is in the public interest but is unlikely that the business can be continued under the existing management.'

In determining what the actual meaning of a 'rescue culture' is,<sup>15</sup> Hunter provides the following explanation:<sup>16</sup>

'What then [is meant] by the term "rescue culture"? It is a multi-aspect concept, having both a positive and protective role, and a corrective and a punitive role. On one level, it manifests itself by legislative and judicial policies, directed to the more benevolent treatment of insolvent persons, whether they be individuals or corporations, and at the same time to a more draconian treatment of true economic delinquents. On another level, it entails the adoption of a general rule for the construction of statutes, which is deliberately inclined towards the giving of a positive and socially profitable meaning (rather than a negative or socially destructive meaning), to statutes of socio-economic import. Of such statutes, insolvency legislation may justly be regarded as the paramount example.'

### 3 Judicial Management as a Business Rescue Model in South Africa<sup>17</sup> and Other Alternatives to Liquidation

#### 3.1 Introduction

Although currently lagging behind most other modern insolvency systems when it comes to business rescue regimes, it is ironic that South Africa was one of the first countries to actually introduce a business

<sup>14</sup> Idem in par 498. See also Goode op cit note 4 at 267-323 for a discussion of administration orders under English law. The so-called Harmer Report (Australian Law Reform Commission, Report No 45, *General Insolvency Inquiry* (1988)) followed similar principles when recommending the introduction of voluntary administration as a form of business rescue in Australia: see the Harmer Report ch 3.

<sup>15</sup> See also Harmer op cit note 4 at 143-8 where he gives an exposition of the general principles that a business rescue culture should ascribe to.

<sup>16</sup> Hunter op cit note 4 at 498.

<sup>17</sup> See, generally, Smits op cit note 7 at 80; HS Cilliers, ML Benade, JJ Henning, JJ du Plessis & PA Delpont *Corporate Law* 3 ed (2000) ch 26 at 477; Jennifer A Kunst (gen ed), Julian C King & Karl E Schmidt *Henochsberg on the Companies Act* (1994 loose-leaf edition) Vol 1 923-59; Pieter Kloppers 'Judicial Management Reform Steps to Initiate a Business Rescue' (2001) 13 *SA Merc LJ* 359; Pieter Kloppers 'Judicial Management A Corporate Rescue Mechanism in Need of Reform?' 1999 *Stellenbosch LR* 417; Rajak & Henning op cit note 7 at 262; David A Burdette 'Unified Insolvency Legislation in South Africa: Obstacles in the Path of the Unification Process' (1999) 32 *De Jure* 44; Albert Henthorne Olver 'Judicial Management: A Case for Law Reform' (1986) 49 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 84; David A Burdette *A Framework for Corporate Insolvency Law Reform in South Africa* (unpublished LLD thesis, University of

rescue model in the form of judicial management.<sup>18</sup> Unfortunately, since the introduction of judicial management in 1926, South Africa has not really developed its business rescue provisions any further, and consequently finds itself out of step with modern insolvency systems regarding this important aspect of insolvency law. While it is not the aim of this article to discuss judicial management in depth, a brief exposition of its mechanics will be given with specific reference to the problems encountered in a country that to a large extent has a liquidation culture.<sup>19</sup>

Judicial management is provided for in ss 427 to 440 of the Companies Act. It is a process that can be used by a company that is experiencing a temporary financial setback as a result of mismanagement or other special circumstances, and that will lead to it once again becoming a successful business concern.<sup>20</sup> This is achieved by replacing the existing management of the company with a judicial manager who takes over the company's business with the purpose of restoring it to profitability.<sup>21</sup>

Judicial management was introduced into South African law by the Companies Act 46 of 1926, South Africa at the time being one of the first countries to introduce a business rescue regime.<sup>22</sup> Judicial management has not changed very much over the years, although a few amendments have been made as a result of a number of commissions of inquiry. The most important of these amendments was introduced in 1932,<sup>23</sup> and made provision for a moratorium on claims by creditors and introduced the principles of impeachable transactions to apply also to judicial management.<sup>24</sup> Further minor amendments were made in 1939, as a result of the report by the Lansdown Commission,<sup>25</sup> and 1952, following the report of the Millin Commission.<sup>26</sup> When the Van Wyk de Vries Commission<sup>27</sup> was deliberating the consolidation of the Companies Act

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Pretoria (2002)) ch 10. For a discussion of the history of judicial management and its application by the courts, see Albert Henthorne Oliver *Judicial Management in South Africa* (unpublished PhD thesis, University of Cape Town (1980)); and *Le Roux Hotel Management v E Rand Ltd* supra note 2. For a summary of the *Le Roux Hotel Management* case, see Patrick O'Brien & André Boraine 'Review of Case Law and Publications' 2001 *South African Insolvency LR* 25.

<sup>18</sup> See Rajak & Henning op cit note 7 at 262.

<sup>19</sup> It is interesting that David Milman & Chris Durrant *Corporate Insolvency Law and Practice* 3 ed (1999) at 1 state that one of the aims of corporate insolvency is in fact to promote business rescue. See also Goode op cit note 4 at 267-70.

<sup>20</sup> Section 427(1) of the Companies Act; Cilliers et al op cit note 17 at 478; *Silverman v Doornhoek Mines Ltd* 1935 TPD 349.

<sup>21</sup> Cilliers et al op cit note 17 at 478.

<sup>22</sup> Rajak & Henning op cit note 7 at 262. In the 1960s Australia imported judicial management into their legal system as a business rescue procedure, but used the term 'official management' instead of 'judicial management'. However, as is the case currently in South Africa with judicial management, official management in Australia was a 'remarkable failure': see Harmer op cit note 4 at 149. Harmer is of the opinion that the reason for official management's dismal failure as a business rescue regime, is that it requires all the debts of the ailing company to be repaid in full.

<sup>23</sup> Companies Act Amendment Act 11 of 1932.

<sup>24</sup> Rajak & Henning op cit note 7 at 265.

<sup>25</sup> *Report of the Companies Act Commission 1935-1936* (UG 45 of 1936).

<sup>26</sup> *Verslag van die Kommissie van Ondersoek insake die Wysiging van die Maatskappywet* (UG 69 of 1948).

<sup>27</sup> *Kommissie van Ondersoek na die Maatskappywet* (there were two reports, the main report (*Hoofverslag* RP 45/1970) and a supplementary report with a draft Bill (*Aanvullende Verslag en Konseptsontwerp* RP 31/1972)).

in the early 1970s, the Masters of the Supreme Court<sup>28</sup> called for the abolition of judicial management due to its low success rate.<sup>29</sup> However, the Commission did not recommend the abolition of judicial management and retained it under the new Companies Act of 1973.

The popularity of modern business rescue regimes worldwide,<sup>30</sup> and the fact that judicial management has not been very successful in South Africa, has of late resulted in a number of commentators calling for a review of South African business rescue procedures.<sup>31</sup> However, at a conference held on 6 October 1999 where three different models for a new business rescue regime were submitted for consideration, delegates could not reach unanimity on the principles of such a new regime. The result was a rejection of all three models, with a call for proper research on the subject and proposals to be made sometime in the future.<sup>32</sup>

Besides the existence of judicial management as a business rescue model in South Africa, there are, or soon will be, a number of possible alternatives to liquidation. Some of these alternatives have been in existence for some time, while others are relatively new or have been recently suggested. In order to make this article as complete as possible, these alternatives are mentioned (and briefly discussed) in par 3.3 below.

### 3.2 The Main Problems Experienced with Judicial Management as a Business Rescue Model

It is difficult to provide a brief exposition of a subject-area as wide as judicial management. Consequently only the most problematic aspects of judicial management will be discussed here. The main problem, it is submitted, lies in the fact that the courts in South Africa see judicial management as an extraordinary procedure, and not as a viable alternative to liquidation.<sup>33</sup> Kloppers submits that this should not be

<sup>28</sup> As this office was known at the time – the name has subsequently been changed to the Master of the High Court.

<sup>29</sup> Van Wyk de Vries Commission op cit note 27, par 51.02 at 147 of the main report; Rajak & Henning op cit note 7 at 266.

<sup>30</sup> It is indisputable that business rescues have become the international buzzword. See Axel Flessner 'Philosophies of Business Bankruptcy Law: An International Overview' in: Ziegel Jacobs (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (1994) 20 where he states:

'Over time, and in all developed economies, the view came to prevail that bankruptcy law should offer not only straight liquidation but also reorganization, including a restructuring of debt and equity, as a solution to insolvency. The American Bankruptcy Act of 1938, with its chapters X and XI, was the first piece of legislation in a capitalist and free-market economy fully to incorporate this idea. Since then it has become commonplace in modern business bankruptcy legislation to provide for alternatives to piecemeal liquidation of insolvent enterprises.'

<sup>31</sup> See Rajak & Henning op cit note 7 at 264-5, 287; Rochelle op cit note 4 at 328-9; Smits op cit note 7 at 107; Kloppers op cit note 17 at 371-9. While most authors call for a whole new system of business rescue to be developed, Kloppers in both his articles points out that there is nothing wrong with judicial management; he is of the opinion that the current shortcomings in the system can be rectified by means of a few legislative amendments.

<sup>32</sup> In terms of a recent communication by the Department of Trade and Industry, it would appear that this task will once again fall on the Centre for Advanced Corporate and Insolvency Law (CACIL) at the University of Pretoria.

<sup>33</sup> Kloppers op cit note 17 at 378; *Le Roux Hotel Management v E Rand Ltd* supra note 2.

the case and states that there is nothing in the provisions themselves that indicate that this should be so.<sup>34</sup>

In terms of s 427(1) of the Companies Act the granting of a judicial management order by a court rests on various requirements. These requirements are:<sup>35</sup>

- (a) If, by reason of mismanagement or any other cause
  - (i) the company is unable to pay its debts or is probably unable to meet its commitments; and
  - (ii) has not become, or is prevented from becoming, a successful business concern; and
- (b) there is a reasonable probability that, if the company is placed under judicial management, it will be in a position to
  - (i) pay its debts or meet its obligations; and
  - (ii) become a successful business concern,

then a court may, if it appears just and equitable, grant a judicial management order.

Part (a) of the requirements relates to the state that a company finds itself in, and must be proved before an applicant will have locus standi to obtain a judicial management order. Part (b) of the requirements relates to what can be achieved by obtaining a judicial management order, and what needs to be proved before the court will grant the order. Even if the above requirements have been met, the court will not grant an order for judicial management if it does not appear to the court that it is just and equitable<sup>36</sup> to do so.

From our case law and the numerous articles that have been written on the subject of judicial management, it is submitted that the following main problems with judicial management as a viable business rescue regime can be identified:

(a) Judicial management is seen as an extraordinary measure. The courts<sup>37</sup> regard judicial management as an extraordinary measure due to

<sup>34</sup> Kloppers op cit note 17 at 378.

<sup>35</sup> With acknowledgement to Cilliers et al op cit note 17 at 480.

<sup>36</sup> According to *De Jager v Karoo Koeldranke & Roomys (Edms) Bpk* 1956 (3) SA 594 (C), the court will consider the interests of both the creditors and the shareholders before deciding whether or not it is just and equitable to grant the judicial management order. See further Michael S Blackman sv 'Companies' in: WA Joubert (ed) *The Law of South Africa* Vol 4 Part 3 (1996) at 460-1. It has been held by our courts on more than one occasion that it is not just and equitable to grant a judicial management order where the parties seek to use the remedy in order to settle internal disputes: see *Makhuvu v Lukoto Bus Service (Pty) Ltd* 1987 (3) SA 376 (V) and *Ben-Tovim v Ben-Tovim* 2000 (3) SA 325 (C).

<sup>37</sup> See, eg, *Silverman v Doornhoek Mines Ltd* 1935 TPD 349 at 353; *Sammel v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (A) at 663; and *Tenowitz v Tenny Investments (Pty) Ltd* 1979 (2) SA 680 (E) at 683. This conservative approach of the courts was recently criticised in *Le Roux Hotel Management v E Rand Ltd* supra note 2. Before the introduction of voluntary administration, Australia too experienced a conservatism by the courts regarding business rescue. The Harmer Report op cit note 14 vol 1 stated it thus in par 52:

'The Commission is also concerned that ... the legislative approach to corporate insolvency in Australia is most conservative. There is very little emphasis upon or encouragement of a constructive approach to corporate insolvency by ... focussing on the possibility of saving a business (as distinct from the company itself) and preserving employment prospects.'

the fact that a creditor of a company that is unable to pay its debts is entitled to make use of liquidation in order to recover payment of its claim.<sup>38</sup>

(b) The requirement that there must be a 'reasonable probability' that the company will become a successful concern.<sup>39</sup> There has been some debate as to whether this test is the same at the time the provisional and final orders are considered, or whether the test should be more stringent upon the return date of the order. Stated differently, the question is whether the test should be more stringent once the provisional judicial manager has had time to investigate the affairs of the company and report back to the court.<sup>40</sup> In *Tenowitz v Tenny Investments (Pty) Ltd*,<sup>41</sup> the Court found that something more than a 'reasonable probability' is required before it can grant a final judicial management order. However, from cases such as *Ex parte Onus (Edms) Bpk: Du Plooy v Onus (Edms) Bpk*,<sup>42</sup> *Kotzé v Tulryk Bpk*<sup>43</sup> and *Ladybrand Hotel (Pty) Ltd v Segal*<sup>44</sup> it is evident that the courts reasoned that the test upon the granting of a final order should be the same as in the case of a provisional order. This latter view is supported by Kloppers<sup>45</sup> and Kunst,<sup>46</sup> although Olver<sup>47</sup> believes that a stricter test should be employed.<sup>48</sup>

(c) Reliance on court proceedings.<sup>49</sup> Kloppers argues that this is one of the most important drawbacks of the current judicial management system, stating that the cost of running a judicial management is hardly a financially sound one. The costs incurred in running the process are so high that it does not make the process attractive for the creditors, as all the available funds are spent on the process itself.<sup>50</sup>

<sup>38</sup> This right of creditors was described in *Tenowitz v Tenny Investments Ltd* supra note 37 at 683 as a right '*ex debito justitiae*' to liquidate the company.

<sup>39</sup> See Kloppers op cit note 17 at 362-3. This requirement is in my opinion also one of the reasons why judicial management cannot be successfully implemented in South Africa, and has been criticised as being outdated and unrealistic: see Rajak & Henning op cit note 7 at 267; and Smits op cit note 7 at 82-4. It is submitted that the burden of proof is too onerous, and that the test should rather be one of a 'reasonable possibility'.

<sup>40</sup> See *Tenowitz v Tenny Investments Ltd* supra note 37 at 683; Kunst et al op cit note 17 at 926; Blackman op cit note 36 at 459; Cilliers et al op cit note 17 at 481 where it is stated that upon the return day the court will be in a better position to assess whether or not the company has a chance of becoming a successful concern.

<sup>41</sup> Supra note 37.

<sup>42</sup> 1980 (4) SA 63 (O).

<sup>43</sup> 1977 (3) SA 118 (T).

<sup>44</sup> 1975 (2) SA 357 (O).

<sup>45</sup> Kloppers op cit note 17 at 363.

<sup>46</sup> Kunst et al op cit note 17 at 926.

<sup>47</sup> Olver op cit note 17, with reference to an unreported decision in annexure IV, sc *In re Olver: Intafine Leasing & Finance (Pty) Ltd* (unreported, CPD, 16 Feb 1977, case no M1830/76).

<sup>48</sup> Kloppers op cit note 17 at 363 argues that since Cilliers et al op cit note 17 do not refer to the *Ex parte Onus* decision, their view will not carry much weight in future. This statement by Kloppers is incorrect as Cilliers et al do in fact refer to *Ex parte Onus* at 481 n12. Kloppers also points out that Olver wrote his thesis before *Ex parte Onus* was decided, and might have come to a different conclusion had he had the benefit of the decision. Although the Court in *Le Roux Hotel Management v E Rand Ltd* supra note 2 referred to this difference in opinion, it did not express its views thereon.

<sup>49</sup> See Kloppers op cit note 17 at 371.

<sup>50</sup> Rajak & Henning op cit note 7 at 268 believe that this factor makes judicial management unsuitable for small to medium business enterprises, as the process is too expensive. See further Kloppers op cit note 17 at 425.

(d) The insolvency requirement.<sup>51</sup> Section 427(1)(a) of the Companies Act contains a strict requirement that the company must be unable to pay its debts before a judicial management order may be granted. Kloppers argues that insolvency or pending insolvency should not be a requirement as it not only acts as a bar for its more general use, but it also defeats the object of the exercise, namely staving off insolvency and making the company profitable again.<sup>52</sup> He submits further that the earlier a company enters judicial management for assistance, the better chance there is that it will become a successful concern.<sup>53</sup>

(e) The use of liquidators as judicial managers.<sup>54</sup> Olver states that it is ludicrous to appoint liquidators as judicial managers, as they have been trained to liquidate companies and not save them.<sup>55</sup> Besides the conflict of interests that liquidators might often have in such a case, the structure of the fees is also seen by Olver as a problem.<sup>56</sup> Rajak and Henning<sup>57</sup> share the view that the wrong people are being used as judicial managers and suggest that a panel of retired or semi-retired businesspeople should be employed in order to oversee the rescue procedure, whatever form it takes.

(f) The fact that judicial management procedures only apply to companies. Currently the provisions relating to judicial management only apply to companies, and not to close corporations, partnerships or business trusts. Some doubt has been expressed by our courts as to whether or not the provisions relating to judicial management should be applied to small companies, for example, private companies with only a few members.<sup>58</sup> However, in *Tobacco Auctions Ltd v AW Hamilton (Pvt) Ltd*<sup>59</sup> the Court stated that there is no reason why the provisions cannot be held to apply also to small companies. The Court further stated that one should not look at the size of the company, but rather at the extent and scope of its business activities, its assets and liabilities and the nature of its difficulties.<sup>60</sup>

While the above exposition does not cover all the aspects relating to judicial management, it does shed some light on the problems that make judicial management an unattractive option as an effective business rescue regime within the South African context.

<sup>51</sup> See generally Kloppers op cit note 17 at 375-7.

<sup>52</sup> Ibid.

<sup>53</sup> Ibid.

<sup>54</sup> See, generally, Olver op cit note 17 at 84.

<sup>55</sup> Idem at 87.

<sup>56</sup> Idem at 84.

<sup>57</sup> Rajak & Henning op cit note 7 at 282-5.

<sup>58</sup> See, eg, *Rustomjee v Rustomjee (Pty) Ltd* 1960 (2) SA 753 (D) 758 where the Court stated that it is doubtful whether judicial management proceedings are appropriate to small private companies.

<sup>59</sup> 1966 (2) SA 451 (R) at 453.

<sup>60</sup> At 453. It is submitted that what the Court was saying, is that one should look to see whether it would be just and equitable to place the company under judicial management. This is a separate requirement under judicial management and has already been discussed above.

### 3.3 Other Business Rescue Mechanisms

#### 3.3.1 Compromises in Terms of Section 311 of the Companies Act

In terms of s 311 of the Companies Act a company may enter into a compromise with its creditors.<sup>61</sup> This is a court-driven process where the eventual compromise must be sanctioned by both the creditors and the court. Consequently it is an expensive procedure to implement, and the plethora of case law regarding these compromises indicates that it is not always a simple undertaking.

The introduction of a capital gains tax in October 2001 has apparently also had a negative impact on s 311 compromises, although the reasons for this will not be explored in this article.

Section 311 compromises have been included under the Unified Insolvency and Business Recovery Bill in a revised form. The revised form entails the separation of the provisions dealing with a compromise between the company and its creditors from those dealing with schemes of arrangement between the company and its members (the latter provisions will remain in the Companies Act). In addition, the provisions have also been made applicable to business trusts and close corporations.

#### 3.3.2 Pre-Liquidation Compositions

As part of its review of South African insolvency law in the 1990s, the South African Law Reform Commission suggested that an alternative to sequestration should be provided to debtors in the form of a composition that could be entered into outside the confines of formal insolvency. The submission was made in the form of an insertion to the Magistrates' Courts Act 32 of 1944, namely s 74X. Upon drafting the Unified Insolvency and Business Recovery Bill it was decided that such a composition, termed a 'pre-liquidation composition', should be included in the unified Bill instead of in the Magistrates' Courts Act 32 of 1944.

This proposal was accepted and the Unified Insolvency and Business Recovery Bill now contains a chapter dealing with pre-liquidation compositions. The provisions were subsequently amended to apply to any type of debtor, and not only to natural persons and partnerships. The advantage of this type of composition is the fact that it can be dealt with in the lower courts, which has positive financial implications for struggling debtors.

#### 3.3.3 Informal Creditor Workouts

Although not formally regulated in terms of legislation, informal creditor workouts seem to have taken root in South African commerce. These informal creditor workouts entail large financial institutions

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<sup>61</sup> In terms of this section it is also possible for the company to enter into a scheme of arrangement with its members, but this aspect of s 311 will not be dealt with here.

joining forces to provide ailing companies with the necessary financial assistance to trade themselves out of their difficulties. By joining forces the risk is spread, and no single institution has to carry the full burden should the informal reorganisation ultimately fail. The lack of legislative provisions supporting such informal creditor workouts does, however, limit their use in practice. One of the greatest drawbacks of this system is that it does not bind other creditors, and they are consequently free to apply for the liquidation of the debtor in appropriate circumstances. This type of business rescue mechanism and its continued use in the South African context is mentioned again in par 4 below.

### 3.3.4 The Application of Winding-up Provisions to Bring about a Business Rescue

The most recent proposal for a possible business rescue mechanism was made in the latter part of 2003 by a firm of attorneys based in Johannesburg. Without going into too much detail,<sup>62</sup> the proposal entails the appointment of a 'turnaround expert' as the provisional liquidator, who can then use the provisions of various pieces of legislation, including the winding-up provisions of the Companies Act and the provisions of the Insolvency Act, in order to attempt to save the ailing company. This proposal is dependent on the court granting a return date of sufficient length on the provisional order to allow the turnaround expert enough time to investigate the affairs of the company, and to report back to the court as to whether the company can be saved or whether the provisional liquidation order should be made final. This proposed method of business rescue was suggested as an interim measure only, to operate until such time as a new business rescue model can be developed and implemented.

This method of business rescue is applied in similar form to ailing companies in Hong Kong, but its use there is due to the total lack of formal business rescue provisions (they do not even have a defective business rescue model such as judicial management). It also needs to be stated that the courts in Hong Kong have much wider powers than their South African counterparts when granting a winding-up order, and it is therefore within their powers to grant the provisional liquidator with the requisite powers to attempt a turnaround of the business concerned.

An article of this nature cannot do justice to the many facets of this new proposal, and consequently no attempt will be made to do so. Suffice it to state that it is encouraging to know that there are practitioners in South Africa who are prepared to take an innovative approach to business rescue. It is this type of commitment that will ensure the ultimate

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<sup>62</sup> It is difficult, at this stage, to provide sufficient detail as the proposals are in a state of flux. The proposals were due to be implemented on 1 April 2004, but this did not take place as further refinement of the provisions was apparently required.

success of business rescue mechanisms in South Africa as a viable alternative to liquidation.

### 3.3.5 Conclusion

Despite the existence of the alternatives to liquidation that have been enumerated above, there appears to be general consensus that South Africa needs, and wants, a modern and effective business rescue model. It is for this reason that the remainder of this article addresses the main elements of a modern and workable business rescue regime that can be tailor-made to cater for the South African economy and its legislative framework.

## 4 The UNCITRAL Draft Legislative *Guide on Insolvency Law*<sup>63</sup>

### 4.1 Introduction

UNCITRAL recently released their latest draft legislative guidelines on insolvency law, and while the document is not yet in its final form it does set out very clearly the generic provisions that UNCITRAL regard as being important when drafting insolvency laws (including business rescue provisions) under any jurisdiction.

In an effort to comply with these guidelines as closely as possible when designing a new business rescue model for South Africa, many of the guidelines (as they apply to business rescue) have been summarised under this heading. Much of the technical content of the guidelines have also been discussed in par 6 below, where the main characteristics of a successful and workable business rescue model for South Africa are set out.

In par 1 of the *UNCITRAL Guide*, the following statement is made:

'1. The purpose of the *Guide* is to assist in the establishment of an efficient and effective framework to address the financial difficulty of debtors. It is intended to be used as a reference by national authorities and legislative bodies when preparing new laws or reviewing the adequacy of existing laws and regulations. The advice provided in the *Guide* aims at achieving a balance between the need to address the debtor's financial difficulty as quickly and efficiently as possible with the interests of the various parties directly concerned with that financial difficulty, principally creditors and other parties with a stake in the debtor's business, as well as with public policy concerns.'

In Part One of the *UNCITRAL Guide* the key objectives and structure of an effective and efficient insolvency law are discussed. Although there are nine key objectives<sup>64</sup> identified by the *UNCITRAL Guide*, the authors realise that balancing these key objectives will be the main objective for many jurisdictions, as all the objectives cannot necessarily be realised simultaneously:<sup>65</sup>

<sup>63</sup> A/CN.9/WG.V/WP.70 (Parts I and II). Both documents may be accessed at <http://www.globalinsolvency.com/insol/intinsolvencies/uncitral.html>.

<sup>64</sup> *UNCITRAL Guide* op cit note 63 in par A.

<sup>65</sup> Idem in par 23.

'23. Since an insolvency regime cannot fully protect the interests of all parties, some of the key policy choices to be made when designing an insolvency law relate to defining the broad goals of the insolvency law (rescuing businesses in financial difficulty, protecting employment, protecting the interests of creditors, encouraging the development of an entrepreneurial class) and achieving the desired balance between the specific objectives identified above. Insolvency laws achieve that balance by reapportioning the risks of insolvency in a way that suits a country's economic, social and political goals. As such an insolvency law can have widespread effects in the broader economy.'

It is the balancing of these key objectives that will form the main challenge when designing a new business rescue model for South Africa. In South Africa there are a number of important issues that need balancing, one example being the protection of employees as opposed to, say, the downsizing of a business in order to keep it operating as a company, or at least as a going concern. The balancing of these issues will be discussed in more depth when dealing with the main elements of a business rescue model in the South African context.

Part 1 of the *UNCITRAL Guide* is divided into three separate sections. Section I is an introductory section dealing with the key objectives of an effective and efficient insolvency law, the balancing of the key objectives and the general features of an insolvency law.

Section II of the *UNCITRAL Guide* briefly deals with the mechanisms for resolving a debtor's financial difficulties, namely voluntary restructuring negotiations,<sup>66</sup> insolvency proceedings<sup>67</sup> and administrative processes.<sup>68</sup>

Section III of the *UNCITRAL Guide* deals with institutional frameworks within which the insolvency laws are applied. This aspect is of critical importance in South Africa, especially in light of the Unified Insolvency and Business Recovery Bill that has already been approved by the South African Cabinet. This aspect will be discussed separately below.

Part 2 of the *UNCITRAL Guide* forms the bulk of it and deals with the core provisions for an effective and efficient insolvency law. These core provisions will be dealt with under par 6 below, and will not be dealt with in any detail here.

## 4.2 Mechanisms for Resolving a Debtor's Financial Difficulties

As stated above, Section II of the *UNCITRAL Guide* deals with three main themes under this heading, namely voluntary restructuring negotiations,<sup>69</sup> insolvency proceedings<sup>70</sup> and administrative processes.<sup>71</sup> In this article the focus will be on insolvency proceedings

<sup>66</sup> This aspect will be briefly referred to in this article.

<sup>67</sup> In this article the emphasis will be on 'insolvency proceedings' which encapsulates the formal proceedings for both business rescue and formal liquidation.

<sup>68</sup> Administrative processes refer mainly to procedures that are in place to address systemic risk, and will not be dealt with in this article. The recent collapse of Saambou Bank is an example of the implementation of 'administrative processes', as the bank was placed under curatorship in terms of banking legislation. These types of procedures are highly specialised and are dealt with in separate legislation.

<sup>69</sup> *UNCITRAL Guide* op cit note 63 at II A pars 31-46.

<sup>70</sup> *Idem* at II B pars 47-69.

<sup>71</sup> *Idem* at II C pars 70-1.

which encompass both the formal liquidation provisions as well as the formal business rescue ('reorganization') proceedings. However, due to the increasing popularity of informal creditor workouts in South Africa, a brief reference has been made to this aspect here.

#### 4.2.1 Voluntary Restructuring Negotiations

This is probably better known as 'informal creditor workouts' in South Africa and by all accounts seems to be taking place with more and more frequency in South Africa.<sup>72</sup> This aspect is discussed in the *UNCITRAL Guide* in some detail<sup>73</sup> as one of the mechanisms for resolving a debtor's financial difficulties.

Although South Africa should be aiming towards making proposals for a *formal* business rescue model, it is worth mentioning that the insolvency laws and legal framework of a country will to a large extent determine the success rate of informal creditor workouts.<sup>74</sup> While there are a number of advantages to be gained from the use of informal creditor workouts,<sup>75</sup> there are also a number of disadvantages when used under the South African insolvency regime. Examples of these disadvantages are:

- any efforts to enter into a compromise with creditors outside the current legislative provisions may lead to the formal processes of insolvency being implemented;
- no moratorium is created;
- other (normally smaller) creditors cannot be bound by the informal procedures and/or agreements which in turn can lead to the implementation of the formal insolvency laws by such creditors (in other words there is no 'cram-down' provision that can be enforced);
- downsizing of the debtor's workforce is often required in order to make the restructuring a success, something that may be difficult taking into consideration South Africa's stringent labour laws.

While informal creditor workouts are likely to remain just that – informal – it is submitted that the available guidelines should be disseminated amongst financial institutions in order to encourage them to take a more supportive role when debtors find themselves in financial distress.<sup>76</sup> It is submitted that this will go a long way to instilling a culture of business rescue in South Africa.

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<sup>72</sup> The fact that use is made of such informal procedures is taken as being indicative of the fact that a country has a 'rescue culture': idem in par 31.

<sup>73</sup> Idem in par II A.

<sup>74</sup> Idem in par 32.

<sup>75</sup> For example, flexibility (by reducing the burden on the judicial infrastructure), obtaining an earlier pro-active response from creditors than would be the case under formal insolvency proceedings, and the avoidance of the stigma that normally attaches to insolvency: idem in par 32.

<sup>76</sup> For more information on this aspect, see *UNCITRAL Guide* op cit note 63 in (Part 1) par II A.

## 4.2.2 Insolvency Proceedings

### 4.2.2.1 Introduction

According to the UNCITRAL *Guide* two main types of proceedings are common to the insolvency laws of most jurisdictions, namely business rescue ('reorganizations') and liquidation.<sup>77</sup> It is further stated that the traditional distinction or division between these two types of proceedings can be artificial, creating 'unnecessary polarization and inflexibility'.<sup>78</sup> Consequently the UNCITRAL *Guide* suggests that

'it is desirable that an insolvency law provides more than a choice between a single, narrowly defined type of reorganization and strictly traditional liquidation. Since the concept of reorganization can accommodate a variety of arrangements, it is desirable that an insolvency law adopt an approach that is not prescriptive and supports arrangements that will achieve a result that provides more value to creditors than if the debtor was liquidated.'<sup>79</sup>

This paragraph appears to imply that not only should the liquidation and business rescue provisions be encompassed within the same legislation, but it should also be flexible enough not to prescribe any specific mode in given circumstances. For example, even though a company may have been liquidated, the procedures should be designed in such a way that the liquidator can use the business rescue provisions insofar as it will allow him or her to bring about a more beneficial return to the creditors.

On a different level, especially with a view to designing a business rescue model in the South African context, it is important to note that the business rescue provisions should in fact form part of South Africa's insolvency legislation. There is a certain school of thought, especially within the Department of Trade and Industry that business rescue legislation should be separated from the insolvency laws and rather be encompassed within the company laws of the country. Clearly this is not an international trend, and therefore one of the first policy decisions that will need to be taken will be where the business rescue provisions will be included. In view of the stance taken in the UNCITRAL *Guide*, it seems clear that these should in fact be included in the Unified Insolvency and Business Recovery Bill. This aspect will be addressed in more detail in par 6 below.

Under the next subheadings the main thrust of business rescue proceedings, expedited business rescue proceedings, liquidation and the organisation of the insolvency laws, are discussed. The main issues that are addressed are the underlying core objectives of each of these facets of insolvency, and will form the basis upon which the business rescue provisions should be inserted and regulated within the insolvency regime in South Africa. In a nutshell, this part of the article provides the framework, or 'bigger picture', in terms of which the introduction of a modern and effective business rescue model should be seen.

<sup>77</sup> *Idem* in par 47.

<sup>78</sup> *Idem* in par 48.

<sup>79</sup> *Idem* in par 49.

#### 4.2.2.2 Business Rescue ('Reorganization') Proceedings

The main points made by the UNCITRAL *Guide* regarding a business rescue model or proceeding, are the following:<sup>80</sup>

- one of the means of resolving a debtor's financial difficulties is a reorganisation that is designed to save a company or, failing that, the business of such company;<sup>81</sup>
- the process of reorganisation may take one of several forms;<sup>82</sup>
- the form a process of reorganisation takes may be more varied as to its concept, acceptance and application than the process of liquidation in which it is applied;<sup>83</sup>
- the term 'reorganisation' is used in its wide sense to refer to the type of proceedings in terms of which its ultimate purpose is to allow the debtor to overcome its financial woes and resume or continue normal commercial operations;<sup>84</sup>
- not all debtors that falter or experience financial difficulties in a competitive marketplace should necessarily be liquidated;<sup>85</sup>
- a debtor with a reasonable prospect of survival should be given an opportunity to recover where it can be shown that there is greater value in keeping the essential business and other component parts of the debtor together;<sup>86</sup>
- business rescue proceedings are designed to provide a debtor with some breathing space to recover from its temporary liquidity difficulties or more permanent over-indebtedness and, if and where necessary, provide such debtor with an opportunity to restructure its operations and its relations with creditors;<sup>87</sup>
- generally speaking, where business rescue is possible it will be preferred by creditors if the value obtained from the continued operation of the debtor's business will enhance the value of their claims;<sup>88</sup>
- business rescue does not imply that all of the stakeholders must be wholly protected, or that they should be restored to the financial or commercial position that would have obtained had the event of insolvency not occurred;<sup>89</sup>
- business rescue does not imply that the debtor will be completely restored, or that its creditors will be paid in full, or that the ownership and management of an insolvent debtor will be retained and preserve their respective positions;<sup>90</sup>

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<sup>80</sup> Idem in pars 51-4

<sup>81</sup> Idem in par 51.

<sup>82</sup> Ibid.

<sup>83</sup> Ibid.

<sup>84</sup> Ibid.

<sup>85</sup> Idem in par 52.

<sup>86</sup> Ibid.

<sup>87</sup> Ibid.

<sup>88</sup> Ibid.

<sup>89</sup> Ibid.

<sup>90</sup> Ibid.

- management may be terminated and changed;<sup>91</sup>
- the equity of shareholders may be reduced to nothing;<sup>92</sup>
- employees may be retrenched;<sup>93</sup>
- the source of a market for suppliers may disappear;<sup>94</sup>
- a business rescue model does, however, imply that whatever forms the rescue proceeding may take, the creditors will eventually receive more than if the debtor was liquidated.<sup>95</sup>

The UNCITRAL *Guide* then lists the following as additional factors that support the use of a business rescue proceeding:<sup>96</sup>

- the modern economy has significantly reduced the degree to which the value of a debtor's assets can be maximised by means of liquidation;<sup>97</sup>
- in circumstances where technical expertise and goodwill are more important than physical assets, the preservation of human resources and business relations are essential elements of value that cannot be realised through liquidation;<sup>98</sup>
- long-term economic benefit is more likely to be achieved through business rescue proceedings, as they encourage debtors to seek assistance before their financial difficulties become too severe;<sup>99</sup>
- there may be social and political considerations that are served by the availability or business rescue proceedings. An example of this is the protection that can be provided, say, to the employees of a debtor.<sup>100</sup>

The UNCITRAL *Guide* is also at pains to point out that 'business rescue' may take different forms.<sup>101</sup> These are referred to as being the following:

- a simple agreement concerning debts (a composition or compromise) in terms of which the creditors agree to receive a predetermined percentage of the debt owed to them as full and final settlement of the claim (the remainder of the debt is written off, the debtor becomes solvent and can continue to trade);<sup>102</sup> and
- a complex reorganisation in terms of which debts are restructured, the conversion of debt to equity together with a reduction of existing equity, the sale of non-core assets and the closure of unprofitable business activities.<sup>103</sup>

<sup>91</sup> Ibid.

<sup>92</sup> Ibid.

<sup>93</sup> Ibid.

<sup>94</sup> Ibid.

<sup>95</sup> Ibid.

<sup>96</sup> Idem in par 53.

<sup>97</sup> Ibid.

<sup>98</sup> Ibid.

<sup>99</sup> Ibid.

<sup>100</sup> Ibid. This is especially true in the South African context, and is one of the crucial issues that needs to be addressed in the model that is ultimately designed for the South African situation.

<sup>101</sup> Idem in par 54. Some of these 'forms' being referred of course already exist under current South African legislation, eg. compositions relating to individuals and compromises relating to companies.

<sup>102</sup> Ibid.

<sup>103</sup> Ibid.

Hereafter the *UNCITRAL Guide* sets out a number of key elements that are common to most business rescue models. Due to the importance of these key elements (they form the basis of the discussion under par 6 below), they are reflected in full below:<sup>104</sup>

- submission of the debtor to the business rescue proceedings (whether it is by the debtor's own accord or by an application brought by the creditors), and which may or may not involve judicial involvement or supervision;<sup>105</sup>
- automatic and mandatory moratorium ('stay'), or a suspension of actions and proceedings against the assets of the debtor, that applies to all the creditors of the debtor for a limited period of time;<sup>106</sup>
- continuation of the business of the debtor, which can either be by the existing management of the debtor, an independent manager or a combination of the two;<sup>107</sup>
- the formulation of a plan that proposes the manner in which creditors, equity holders and the debtor itself will be treated;<sup>108</sup>
- consideration of the plan by creditors, voting on the plan and the acceptance thereof (or not) by creditors;<sup>109</sup>
- the possible judicial approval or confirmation of an accepted plan;<sup>110</sup>
- implementation of the plan.<sup>111</sup>

The point is also made that the mere existence of liquidation provisions within the insolvency laws will serve as an incentive to all the relevant parties to ensure the best possible chance of the business rescue proceeding being a success.<sup>112</sup>

#### 4.2.2.3 Expedited Business Rescue ('Reorganization') Proceedings

The *UNCITRAL Guide* makes a brief reference to what is termed 'expedited reorganization proceedings'.<sup>113</sup> This is a reference to what the *Guide* terms 'pre-insolvency' or 'pre-packaged' procedures. One example used is where the jurisdiction concerned permits proceedings to be commenced to obtain formal court approval of a reorganisation plan that was negotiated voluntarily and approved by creditors through a vote that occurred before the commencement of the proceedings. These proceedings are designed to minimise the cost and delay associated with formal reorganisation proceedings while at the same time providing a means by which a reorganisation plan negotiated voluntarily can nevertheless be approved in the absence of unanimous support of the creditors.

<sup>104</sup> *Idem* in par 55.

<sup>105</sup> *Ibid.*

<sup>106</sup> *Ibid.*

<sup>107</sup> *Ibid.*

<sup>108</sup> *Ibid.*

<sup>109</sup> *Ibid.*

<sup>110</sup> *Ibid.*

<sup>111</sup> *Ibid.*

<sup>112</sup> *Ibid.*

<sup>113</sup> *Idem* in pars 58-60.

The procedure mentioned would appear to be very similar to the current compromises and arrangements that may be entered into in terms of s 311 of the Companies Act, and is therefore not a new concept in the South African context. The proposed 'pre-liquidation composition', currently inserted as a separate chapter in the Unified Insolvency and Business Recovery Bill, will also fall under this category.

#### 4.2.2.4 Liquidation

The distinction drawn between business rescue proceedings and liquidation proceedings by the *UNCITRAL Guide* is best stated with reference to the following paragraph:

'61. The type of proceedings referred to as "liquidation" are regulated by the insolvency law and generally provide for a public authority ... to take charge of the debtor's assets, with a view to terminating the commercial activity of the debtor, transforming non-monetary assets into monetary form and subsequently distributing the proceeds of sale or realization of the assets proportionately to creditors. Although generally requiring the sale or realization of assets to occur in a piecemeal manner as quickly as possible, some insolvency laws permit liquidation to involve sale of the business in productive units or as a going concern; under other laws that is only permissible in reorganization. Liquidation usually results in the dissolution or disappearance of the debtor as a commercial legal entity.'<sup>114</sup>

The *UNCITRAL Guide* then addresses the most common features of a liquidation proceeding.<sup>115</sup> Due to the fact that South African legislation, both current and proposed, complies with all these common features, they will not be repeated here. However, the *UNCITRAL Guide* goes further, and sets out a number of legal and economic justifications for the existence of a liquidation proceeding.<sup>116</sup> These are important within the context of proposed new South African legislation, and bear repeating here:

- A commercial business that is unable to compete in a market economy should be removed from the marketplace.<sup>117</sup>
- A principal identifying mark of an uncompetitive business is one that satisfies one of the tests of insolvency, namely that it is unable to meet its mature debts as they become due, or its debts exceed its assets.<sup>118</sup>
- Liquidation proceedings can be seen as addressing inter-creditor problems, and as a disciplinary force that is an essential element of a sustainable debtor-creditor relationship (in other words liquidation, as a collective debt collecting procedure, avoids creditors acting in their own self-interest while at the same time jeopardising the rights of the creditors as a whole. The equitable treatment of the whole group of creditors is placed above those of the individual creditors).<sup>119</sup>

<sup>114</sup> *Idem* in par 61.

<sup>115</sup> *Idem* in par 62.

<sup>116</sup> *Idem* in pars 63-4.

<sup>117</sup> *Idem* in par 63.

<sup>118</sup> *Ibid.*

<sup>119</sup> *Ibid.*

- An orderly and (relatively) predictable mechanism for the enforcement of the collective rights of creditors can also provide creditors with an element of predictability at the time they make their lending decisions. In addition, such a mechanism can more generally promote the interest of all participants in the economy by facilitating the provision of credit and the development of financial markets.<sup>120</sup>
- Effective insolvency proceedings (liquidation) will ensure that where (individual) debt enforcement mechanisms fail, creditors will have an avenue of final recourse that can operate as an effective incentive to a recalcitrant debtor to encourage payment to the particular creditor.<sup>121</sup>

#### 4.2.2.5 Organisation of the Insolvency Law

Under this heading is meant the structure of the proceedings that leads to the choice between a business rescue procedure and a liquidation procedure. According to the *UNCITRAL Guide* there are basically two alternatives.<sup>122</sup> The first alternative is where the insolvency laws provide for 'unitary, flexible insolvency proceedings with a single commencement requirement alternatively resulting in liquidation or reorganization, depending on the circumstances of the case'.<sup>123</sup> The second alternative is where the insolvency laws make provision for two distinct proceedings, with each proceeding setting out its own access and commencement requirements.<sup>124</sup> The latter alternative usually also has various possibilities for conversion between the two proceedings.<sup>125</sup>

It is important to point out that those jurisdictions that treat liquidation and business rescue as distinct procedures, do so 'on the basis of different social and commercial policy considerations'.<sup>126</sup> However, just as importantly a considerable number of issues are common to both business rescue and liquidation, which may cause considerable overlapping both procedurally and as regards the substantive law.<sup>127</sup> Due to the considerable expense involved in bringing proceedings, be it for business rescue or liquidation, it is suggested that where this distinction is made there should be linkages between the two systems with a view to conversion between them.<sup>128</sup>

Although this question will be addressed in more detail below, one does need to ask whether South Africa should adopt a unitary approach or whether the two procedures should be separated. In this regard it is submitted that South Africa should adopt the approach where business rescue and liquidation are kept separate, with a conversion provision

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<sup>120</sup> *Idem* in par 64.

<sup>121</sup> *Ibid.*

<sup>122</sup> *Idem* in par 65.

<sup>123</sup> *Ibid.*

<sup>124</sup> *Ibid.*

<sup>125</sup> *Ibid.*

<sup>126</sup> *Ibid.*

<sup>127</sup> *Ibid.*

<sup>128</sup> *Idem* in par 66.

allowing for conversion from business rescue to liquidation, and vice versa. This statement can be motivated as follows:

- South Africa has a creditor-friendly insolvency system with an established liquidation procedure that provides relief to creditors. Many elements of business rescue can already be applied within the liquidation regime, such as a s 311 compromise in terms of the Companies Act, and it would not make sense to tamper with the established rules that have been built up over decades.
- Considering that very few insolvent entities that have already reached the stage where they are so insolvent that they can be liquidated have been saved in the past, it is clear that South Africa should provide for a system of business rescue where the management of a debtor, for example, should seek help long before the entity itself can or should be liquidated (in other words before the entity is hopelessly insolvent). An insolvent trading provision, such as the provision that has now been included in the Insolvency and Business Recovery Bill, can ensure that the management of an entity will not trade in insolvent circumstances and apply for the requisite assistance in terms of the proposed new business rescue model.
- The fact that there will in all probability be separate panels of liquidators and business rescue managers means that the business rescue and liquidation procedures will probably have to be kept separate from one another. This is resultant from the fact that South Africa currently has an unregulated insolvency industry, although this problem is currently being addressed.

Although this aspect will be addressed again in par 6 below, it is appropriate at this stage to state that this is another policy decision that will need to be taken by government when implementing a new business rescue model.

#### 4.3 Institutional Framework<sup>129</sup>

This heading is important when deciding who will supervise the introduction of a new business rescue model in South Africa. The only existing forms of business rescue in South Africa, namely s 311 compromises and judicial management, are currently both supervised by the courts. The most important point to be made here is that this has caused the processes to be extremely expensive to implement, and as a result many entities are unable to make use of the processes due to a lack of funds. It seems fair to state that South Africa needs a system which is inexpensive, cost-efficient and swift in its application. It is doubted whether a court supervised process will achieve this, especially considering that most businesses in South Africa consist of small to medium sized enterprises.

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<sup>129</sup> Idem in pars 72-9.

The UNCITRAL *Guide* makes the following instructive statements regarding the importance of the forum in which business rescue will be dealt with:

'73. In most jurisdictions, the insolvency process is administered by a judicial authority, often through commercial courts or courts of general jurisdiction or, in a few cases, through specialized bankruptcy courts. Sometimes judges have specialized knowledge and responsibility only for insolvency matters, while in other cases insolvency matters are just one of a number of wider judicial responsibilities. In a few jurisdictions non-judicial or quasi-judicial institutions fulfil the role that, in other jurisdictions, is played by the courts.'<sup>130</sup>

and

'74. In designing the insolvency law it may be appropriate to consider the extent to which courts will be required to supervise the process and whether or not their role can be limited with respect to different parts of the process or balanced by the role of other participants in the process, such as the creditors and the insolvency representative. This is of particular importance where the insolvency law requires judges to deal quickly with difficult insolvency issues (which often involve commercial and business questions) and the capacity of the judiciary is limited, whether because of its size, a general lack of resources in the court system or a lack of specific knowledge and experience of the types of issues likely to be encountered in insolvency.'<sup>131</sup>

There are various issues that need to be weighed when deciding upon the involvement of the court in a future business rescue model, but these are perhaps better dealt with under par 6 below where the elements of a business rescue model are discussed. Suffice it to state that this will be another policy consideration that will need to be addressed by government.

## 5 The World Bank's *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*<sup>132</sup>

Due to the fact that the World Bank collaborated with UNCITRAL in order to produce the UNCITRAL *Guide* discussed at length in par 4 above and par 6 below,<sup>133</sup> only a brief reference to this document will be made here. The only point that needs to be made is that South Africa needs to take cognisance of the principles and guidelines laid down by the World Bank in order to ensure that a new business rescue model does in fact comply with international criteria. The World Bank document lists 35 principles that need to be taken cognisance of when looking at an effective insolvency and creditors' rights system. All these principles are included in some way or another under the UNCITRAL *Guide*, and will not be repeated here.

*(To be continued.)*

<sup>130</sup> Idem in par 73.

<sup>131</sup> Idem in par 74.

<sup>132</sup> The author of this document is Gordon Johnson of the World Bank and is dated 27 Mar 2001. The document was used in a set of experimental country assessments in connection with the program to develop Reports on the Observance of Standards and Codes (ROSC), using a common template based on the principles. It is to be noted that the World Bank collaborated with UNCITRAL in developing the guidelines discussed in par 4 above and par 6 below.

<sup>133</sup> See World Bank *Principles* op cit note 132 at 2 n2.