

Tilting at windmills? The quest for an effective corporate rescue procedure in South African law

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1 Introduction

When Don Quixote set off on his quest to slay the “monstrous giants”, he did so with the best possible intentions. However, it was clear – even to his faithful squire, Sancho Panza - that this quest was not going to end well, mainly because the monstrous giants were not giants at all, but merely windmills: big, sturdy windmills performing a useful and necessary function in the community. It was only in Don Quixote’s imagination that the fairly harmless windmills appeared to be enemies which had to be fought and defeated.¹

This brings me to the question I ask in this lecture: Is South Africa’s quest for an effective and successful corporate rescue procedure perhaps destined to remain largely unsuccessful because we are using it to fight company liquidations without realising that liquidation is not the enemy we imagine it to be?

South Africa’s quest for a successful formal corporate rescue procedure started with the introduction of judicial management into our law by the Companies Act of 1926.² The idea of attempting to rescue an insolvent company instead of liquidating it was so new and revolutionary that the Minister of Justice who steered the draft legislation through Parliament had to explain where it came from.³ His explanation that it was derived from the procedure for appointing receivers in equity in English

¹ Miguel de Cervantes Saavedra *The Adventures of Don Quixote* (translation by JM Cohen, 1950) at 68.

² Act 46 of 1926.

³:*Union of South Africa House of Assembly Debates*, 25 February 1926, vol 6, col 1138-1139.

and American law probably still left most members of the House of Assembly in the dark since receivership and equity receivership had never been and never became part of South African law. No wonder then that judicial management was not embraced with much enthusiasm in South Africa.

In spite of several submissions that judicial management should be abolished because of a low success rate and instances of abuse, the Van Wyk de Vries Commission⁴ recommended that judicial management should be retained in the new Companies Act of 1973.⁵ Several amendments were made to the original version of judicial management by this Act, but in spite of that, the general view remained that judicial management was 'a dismal failure'.⁶ In a 2001 judgment it was described by the court as 'a system which has barely worked since its initiation in 1926'.⁷

But, like Don Quixote, we persevered in our quest.....

In 2004, the policy document published by the Department of Trade and Industry on its intended corporate law reform, specifically mentioned the creation of a new corporate rescue procedure as one of the areas of company law on which the review process would focus because judicial management was 'rarely used and even more rarely [led] ...to a successful conclusion.'⁸ As a result, the new

⁴ The Commission of Enquiry into the Companies Act appointed in 1963 under the chairmanship of Mr Justice J Van Wyk de Vries: see Cilliers, Benade et al *Corporate Law* par 2.15.

⁵ *Main Report of the Commission of Enquiry into the Companies Act* (RP 45 of 1970) at 524-525.

⁶ Burdette 'Unified Legislation' at 57. See further Anneli Loubser 'Judicial management as a Business Rescue Procedure in South African Corporate Law' (2004) 16 *SA Merc LJ* 137 at 138 for an overview of the criticism against judicial management.

⁷ *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* [2001] 1 All SA 223 (C) at 238.

⁸ *South African Company Law for the 21st Century: Guidelines for Corporate Reform* at 45. The document is available at <http://www.thedti.gov.za/ccrd/companies/Guidelines04.pdf>.

Companies Act of 2008 that came into force on 1 May this year, contains a new business rescue procedure in Part A of Chapter 6 of the Act. The procedure was originally to be called “supervision” but is now called ‘business rescue proceedings’.

2 Chapter 11 reorganizations

2.1 The pervasive influence of Chapter 11 on other jurisdictions

The logical question is why, in spite of our less than happy experience with judicial management, South Africa did not abandon its efforts to find a successful formal statutory corporate rescue procedure since we had been coping quite well without one by using other options.

A clue to the answer can be found in the 2004 policy document of the DTI that I have already referred to, where it states that in creating an appropriate corporate rescue system for South Africa, ‘the provisions of the US Chapter 11 would be considered’.⁹ This, of course, is a reference to the business reorganization procedure in the United States of America in terms of Chapter 11 of their Bankruptcy Code.¹⁰

This was not the first time it had been suggested that we should replace our rather dysfunctional judicial management procedure with something closer to Chapter 11 – several critics of judicial management had already done that over the years.¹¹ We are also not the only country naming Chapter 11 reorganization as a potential model for our corporate insolvency reforms. A large part of the world has

⁹ Ibid.

¹⁰ United States Code Title 11.

¹¹ See generally Rajak & Henning “Business Rescue”; Rochelle “Lowering the Penalties”; Smits “Corporate Administration”.

come to believe that since Chapter 11 reorganization seems to be working so well in America, it should also work for the rest of us. Paul Omar pointed out that one of the things most countries in Europe had in common when reforming their insolvency laws was ‘...a fascination with the American “Chapter 11” procedure...’¹²

This fascination is not confined to Europe. Just about every country has felt compelled to take a long hard look at its insolvency procedures to establish whether it also has a procedure that resembles, or at least measures up to Chapter 11 reorganization. (And here I have to mention that, in contrast to South Africa where our corporate rescue procedure has always been regulated by a Companies Act, most other jurisdictions regard business rescue as part of insolvency law and it is therefore regulated by their insolvency laws.) Countries as diverse as Germany, France, Spain, the Czech Republic, Singapore, Japan and the People’s Republic of China used Chapter 11 reorganizations as a model in designing their corporate rescue procedures.¹³ And they are by far not the only ones.

It would be fair to say that in the area of corporate rescue, Chapter 11 reorganization has reached cult status.

¹² Paul Omar ‘Four Models for Rescue: Convergence or Divergence in European Insolvency Law? (Part 2)’ [2007] 5 ICCLR 171 at 179.

¹³ Rebecca Parry ‘Introduction’ in *Corporate Rescue An Overview of Recent Developments* 2 ed (2006) by Katarzyna Gromek Broc & Rebecca Parry (eds) at 9. See also Oscar Couwenberg ‘Survival Rates in Bankruptcy Systems: Overlooking the Evidence’ (2001) 12 *European Journal of Law and Economics* 253; Paul Omar ‘Four Models for Rescue: Convergence or Divergence in European Insolvency Law? (Part 1)’ [2007] 4 ICCLR 127; Paul Omar ‘Four Models for Rescue: Convergence or Divergence in European Insolvency Law? (Part 2)’ [2007] 5 ICCLR 171.

At a symposium with the theme 'Bankruptcy in the Global Village' held in the United States in 1997, Manfred Balz, who was involved in the German insolvency law reform as advisor to the Ministry of Justice, put it as follows: "The topic of this conference suggests that a developed rescue culture is more civilized than a liquidation culture, and that we should all pray to be blessed with a Chapter 11. According to the City of London folklore ...Germany simply does not have acceptable rescue manners. In short, Germans have been depicted as rescue Neanderthals."¹⁴

2.2 The origins and history of Chapter 11 reorganisations

To understand the true nature and appeal of Chapter 11 reorganizations, it is necessary to look at its origins.

Since American bankruptcy legislation in the 19th century only provided for the liquidation of a debtor's estate to pay creditors, the courts in America developed a special type of reorganisation outside of the bankruptcy legislation and based on the procedure of receivership found in English law.¹⁵ The procedure was known as 'equity receivership' and allowed the appointment of receivers specifically for insolvent railroads. This special treatment was reserved for railroads because they performed an important public service and were also important for the economy of the country. The task of the receiver was to conserve the railroad and then sell it as a whole concern in order to pay the creditors. Most creditors of the railroads held

¹⁴ Manfred Balz "Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law" (1997) 23 *Brooklyn Journal Of International Law* 167 at 167.

¹⁵ For a detailed history see Bradley Hansen 'Bankruptcy Law in the United States' EH.net Encyclopedia at <http://eh.net/encyclopedia/article/hansen.bankruptcy.law.us> accessed on 19 August 2011.

security for their claims, mostly in the form of a mortgage over a specific line of track. If the railroad company failed to pay its debts, different bondholders could thus claim different parts of a railway line over which they held mortgages. Obviously, a piece of railway line is almost worthless without the rest of the railway attached to it, and that is another reason why the business had to be sold as a whole.

Although the courts consistently refused to allow corporations other than railroads to make use of this procedure, a number of amendments to the Bankruptcy Act of 1898¹⁶ during the 1930's opened up the possibility of reorganisation for corporations in general. Eventually, the Bankruptcy Code of 1978 was enacted, and introduced Chapter 11 reorganization.¹⁷

Two things become clear when considering the history and development of Chapter 11 reorganization:

1. Its roots are firmly planted in receivership, which was an enforcement action available to secured creditors to obtain payment of debts due to them. It was not a rescue procedure. That is still evident today because Chapter 11 reorganization is the chosen procedure for nearly all business bankruptcies in the US. Obviously the vast majority of these companies are not capable of being rescued (statistics released by a

¹⁶ Act of 1 July 1898, ch 541, 30 Stat. 544. The most important amendments were made by the Chandler Act of 1938, ch 575, 52 stat 840.

¹⁷ A Commission on the Bankruptcy Laws of the United States was appointed by Congress in 1970 to "study, analyze, evaluate and recommend changes" to the existing bankruptcy legislation. Although the statute proposed by the Commission was not enacted, the Bankruptcy Code of 1978 (Pub. L. No. 95-598, 92 Stat.2549) was "the recognizable descendant" of the proposed statute: Treister et al *Fundamentals of Bankruptcy Law* at 1-2.

Congressional Committee in 1997 suggest that only about 5% of debtors using Chapter 11 survive as operating entities)¹⁸ but the potential to survive is not a requirement for the Chapter 11 procedure. The procedure is flexible and in practice is used to achieve a real reorganisation, a sale as a going concern or even a piecemeal liquidation.¹⁹ Indeed, one of the grounds on which Chapter 11 has been criticised is that it is used by large corporations to effect a sale of their assets and then divide the proceeds among their creditors instead of reorganising the business.²⁰ High success rates of Chapter 11 must therefore be approached with caution because it includes many outcomes that we would regard as failures of a rescue procedure.

2. Chapter 11 reorganization was not a new procedure but was the end result of a known procedure that developed over a long period of time to address the specific needs of the country.²¹ Therefore, it was able to adapt to the unique circumstances and culture of the country and thus kept up with, and probably also influenced the attitude of American society towards bankruptcy and business failure.²²

¹⁸ This was one of the findings in the final report of the National Bankruptcy Review Commission published in 1997: see Thomas E Carlson & Jennifer Frasier Hayes 'The Small Business Provisions of the 2005 Bankruptcy Amendments' (2005) 79 *American Bankruptcy Law Journal* 645 at 649.

¹⁹ Jonathan Friedland 'Why Out-of-Court Restructuring Alternatives are on the Rise' *Daily Bankruptcy Review* 24 October 2007.

²⁰ Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy" (2002) 55 *Stanford Law Review* 751 at 784-785

²¹ John D Ayer "Debt Abides: A Prologema for any Future Chapter 11" (2004) 78 *American Bankruptcy LJ* 427 at 431.

²² The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation" (2005) 28 *Boston College International and Comparative Law Review* 1 at 22.

3 The role of a society's culture in the development of insolvency law

The fact that Chapter 11 was the culmination of a natural development in the United States is an important factor in understanding its general acceptance and success in that country despite the procedure also being sharply criticised by many American jurists. Other jurisdictions that decide to copy Chapter 11, mostly do not appreciate the fact that insolvency law cannot simply be transplanted from one country to another. In a well-argued article on the import or imitation of Chapter 11 by other countries, Prof Nathalie Martin explains that insolvency systems reflect the legal, historical, political and cultural context of the countries that have developed them.²³ In other words, an insolvency system should arise out of existing cultural conditions and attitudes, and how debt is viewed in a specific country. Transplanted insolvency laws do not reflect these views and are then expected to change the cultural attitude towards debt and debt forgiveness, which they cannot do. These imported systems are therefore often ineffective.

Cultural attitudes towards bankruptcy in the United States differ widely from those in most other countries. The US bankruptcy system is generally far more forgiving about bankruptcy, in an effort to encourage risk taking and economic growth.²⁴ As a result, bankruptcy in America does not carry the stigma and shame that insolvency in many other systems do.²⁵

²³ Martin op cit note 24 at 4.

²⁴ Martin op cit note 24 at 3.

Donald Trump, for example, described his second Chapter 11 reorganisation as a sign of success, not failure, and more recently, the chief executive of Chrysler stated that a Chapter 11 reorganization of the company did not signify that he or Chrysler had failed. The cup was half full, not half empty, he said.²⁶

In South Africa, on the other hand, insolvency is generally regarded as a sign of failure, and a shame. There is a significant stigma attached to it and insolvent debtors are suspected of being either reckless or dishonest, or both. I believe that this view was a major contributing factor to the failure of judicial management in South Africa: the decisions of the courts in judicial management applications displayed a mistrust of this procedure which was regarded as an infringement on the rights of creditors because it prevented them from exercising their right to liquidate a company to obtain payment of their claims. Therefore judicial management was treated by the courts as a 'special and extraordinary procedure' that could be ordered only under 'very special circumstances'²⁷ although nothing in the wording of the Act reflected such an intention.²⁸

²⁵ Alexandra Szekely, Fiona Richardson & Adam Gallagher "Chapter 11: one size fits all?" 23 (2008) *Butterworths Journal of International Banking and Financial Law* 457 at 457; Rochelle op cit note 24 at 316.

²⁶ 3 May 2009 *Sunday Times Business Times* at 3.

²⁷ *Silverman v Doornhoek Mines Ltd* 1935 TPD 349 at 352 et seq; *Kotzé v Tulryk Bpk en 'n Ander* 1977 (3) SA 118 (T) at 120-122. See also *Ladybrand Hotel (Pty) Ltd v Segal and Another* 1975 (2) SA 357 (O) at 359; *Ben-Tovim v Ben-Tovim and Others* 2000 (3) SA 325 (C) at 331; *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* [2001] 1 All SA 223 (C) at 233; *Gushman v TT Gushman & Son (Pty) Ltd and Others* [2009] JOL 23589 (ECM) at 24. See further Loubser op cit note 5 at 147-150.

²⁸ Kloppers *AJudicial Management@* at 426.

This creditor-friendly culture still appears to influence our courts and proves that you cannot change society's culture and perceptions overnight by new legislation. In the case of *Swart v Beagles Run Investments 25 (Pty) Ltd and Others* – the first judgment on an application for commencement of the new business rescue proceedings in the North Gauteng High Court – the court (with respect, quite correctly) refused to grant the application because the company was hopelessly insolvent. However, the interesting point about the judgment is the remark by Makgoba, J that '[w]here an application for business rescue...entails the weighing-up of the interests of the creditors and the company the interests of the creditors should carry the day.'²⁹

Many other countries, particularly in Europe, share our views on insolvency and business failures. The Cork Report³⁰ of 1982 recommended several reforms to improve and modernise insolvency law in England, including the introduction of two

²⁹ Unreported case No 26597/2011 of 30 May 2011 at 8 [par 41].

³⁰ *Report of the Review Committee on Insolvency Law and Practice* Cmnd 8558 (1982), under the chairmanship of Sir Kenneth Cork (and therefore usually referred to as the *Cork Report*).

corporate rescue procedures, namely company administration³¹ and company voluntary arrangements. Yet the Report warned that “[i]nsolvency must not be an easy solution for those who can bear with equanimity the stigma of their own failure or their responsibility for the failure of a company under their management.”³² In spite of the increasing number of companies making use of the statutory corporate rescue procedure of company administration in England,³³ it has been found that “...there remains a significant stigma for companies accessing any UK bankruptcy regime.”³⁴

From the above, it is clear that for many countries a business rescue procedure based on or inspired by Chapter 11 reorganisation is simply not a viable option, because they do not reflect that society’s perceptions and attitudes towards debt and financial failure.

I believe that such countries, and that includes South Africa, should accept that they have a liquidation culture and a creditor-friendly insolvency system and develop their law in harmony with their own views rather than trying to adapt to the American approach to financial failure

One example of an unsuccessful attempt to transplant Chapter 11 can be found in the insolvency reform of Germany where in 1978, the year in which the

³¹ The new business rescue proceedings introduced by the Companies Act of 2008 resemble company administration in many respects: see Anneli Loubser *Some Comparative Aspects of Corporate Rescue in South African Company Law* (unpublished LLD thesis, Unisa 2010), Chapter 3.

³² Cork Report par 191.

³³ Regulated by Schedule B1 to the Insolvency Act 1986 (c 45).

³⁴ Szekely, Richardson & Gallagher at 457.

American Bankruptcy Code was passed,³⁵ a commission of insolvency experts was appointed to make recommendations on a fundamental reform of the insolvency law.³⁶ When the Commission delivered its reports³⁷ the new insolvency legislation it proposed was greeted with widespread disapproval, primarily because the recommendations had been heavily influenced by the Chapter 11 reorganization procedure.³⁸ Despite drastic amendments the new Insolvency Code³⁹ enacted in 1994⁴⁰ has been criticised for adopting the American model without taking into account the differences between European and American culture and practices, particularly the German belief that the American system is too debtor friendly.⁴¹

³⁵ According to Ehlers *Statutory Corporate Rescue* at 155, it was no mere coincidence because as a result of the United States Bankruptcy Code (Title 11, United States Code) being passed, 1978 marked a new era of insolvency law globally.

³⁶ The Kommission für Insolvenzrecht (Commission for Insolvency Law), which consisted of academics, practitioners, insolvency judges, trustees and representatives from trade unions and business: Schiessl *Comparative Analysis* at 234.

³⁷ Bundesministerium der Justiz *Erster Bericht der Kommission für Insolvenzrecht*, Köln, 1985; *Zweiter Bericht der Kommission für Insolvenzrecht*, Köln, 1986.

³⁸ Balz and Landfermann *Insolvenzgesetze* at XXXIV-XXXV; Flessner *Germany* at 314; Schiessl *Comparative Analysis* at 259.

³⁹ Insolvenzordnung of 5 October 1994 BGBl. I S 2866. In keeping with the German legislative tradition of referring to statutes and codes by their abbreviations, the abbreviated form of the name (InsO) is normally used when referring to the Insolvenzordnung: Flessner *Germany* at 313.

⁴⁰ Flessner *Germany* at 313.

⁴¹ Kamlah *German Insolvency Act* at 422-423.

4 The advantages of business rescue and liquidation compared

I have already referred to the low rate of company survival after reorganization in the US. In England, the picture looks even worse. A research project undertaken by Dr Sandra Frisby on company administrations (a procedure that is very similar to our new business rescue proceedings) revealed that only 3% of companies survive after administration.⁴² In 46% of administration cases the companies go straight into dissolution because there is no money for distribution to unsecured creditors.

Some may argue that, although only a small number of companies actually survive business rescue, the outcomes of death by business rescue are still better than those of an immediate liquidation. To test this argument I looked at the three advantages of business rescue that are cited most often, to determine to what extent these advantages will be achieved by our new business rescue proceedings.

4.1 Creditors get a better return on their claims than in immediate liquidation.

This is widely accepted as a potential advantage of business rescue, to the extent that it is listed as the second acceptable objective of company administrations in England. The principle has been copied by our legislature in the definition of 'business rescue' where a better return for the company's creditors is stated as an alternative purpose of the business rescue plan if it cannot achieve the continued existence of the company on a solvent basis.⁴³

⁴² Sandra Frisby 'Pre-Packaged Administrations' (March 2008) at 2.

⁴³ Section 128(1)(b)(iii) of the Companies Act of 2008.

The assumption is that even if the company cannot be rescued, its business or part thereof can be sold as a running concern at a higher price than in a sale after the company has been put into liquidation. The research by Dr Sandra Frisby that I have referred to before shows that almost 50% of company administrations in England involve a sale as going concern. However, in about 77% of these cases, there is nothing left for distribution to unsecured creditors. That does not look very promising.

I would submit that the argument of a better return for creditors is based on 3 perceptions that, if not wrong, are at least open to debate:

- 1. Liquidators do not have the skills to run a distressed business so that it can be sold as a running concern**
- 2. Therefore the assets of a company in liquidation will always be sold off piecemeal.**
- 3. A sale of a business as a running concern will always be better than a sale of assets (a so-called break-up sale)**

The traditional view is that liquidators are 'financial undertakers' not rescuers. That means their expertise lies in breaking up and selling off a business in bits and pieces while business rescue practitioners will continue running the business until a purchaser is found. The fact is that in most jurisdictions, liquidators and business rescue practitioners are the same people, they only get different titles according to the case they are dealing with! Judicial managers were routinely appointed from the ranks of liquidators, and although the new Companies Act provides for the creation of a separate profession for business rescue practitioners by licensing them individually, I think we can safely assume that the majority of applicants for such a licence will also be liquidators since only accepting appointments as a business

rescue practitioner will quite probably not generate sufficient income. Liquidators will also regard business rescue as a normal extension of their profession. This may very well turn out to be a good thing because any training that business rescue practitioners will be required to undergo before being licensed, will also make them better liquidators, particularly since the present system does not require a liquidator to have any specific training. We have already seen some indication of what to expect with the appointment of Mr MJ Lane as the business rescue practitioner of Pinnacle Point Group Ltd, the first company to be placed in business rescue by an order of court under the new Companies Act. Mr Lane is a well-known liquidator and is advertised as such on his firm's website.

In any event, I believe that there is more than enough evidence that if there is a viable business or part of a business, liquidators generally try finding a purchaser for the business as a running concern. A liquidator is given the express statutory power to continue running the business with the permission of the creditors until the business is sold.⁴⁴ The whole tragic saga around Aurora Mines was in fact directly caused by the (in this case perhaps misguided) determination of the liquidators to sell the mine as a running concern and not the assets in a piecemeal way. Many assets were allegedly sold for millions of Rands but not by the liquidators and the proceeds were thus not used to pay workers and other creditors, but landed in the pockets of hitherto unidentified individuals. Asset stripping is, of course, a well-known risk of any sale of a financially distressed business.

However, even if it is assumed that a better price will be paid for a business that is sold as a running concern during business rescue proceedings, how much of that additional amount will be available for payment to creditors in the subsequent

⁴⁴ Section 386(3)-(4) of the Companies Act 61 of 1973.

liquidation after payment of the costs of the business rescue procedure? These costs, that enjoy preference rights in a subsequent liquidation, would include the business rescue practitioner's remuneration which could be as much as R15,000 to R25,000 per day attending to the rescue process, as well as the remuneration of employees for the period after commencement of business rescue proceedings, with no limit on either the amount or period for which they must be paid. These and other costs of the rescue attempt would not exist if the company had gone straight into liquidation.

The perception that a business sale will always be more profitable than a break-up sale of assets has also not remained unchallenged. In an article dealing with the question whether the assets of a company are worth more when they are kept together and sold as part of a running concern, Prof Jasmine Girgis of the University of Calgary refers to several American commentators who argue that this may have been the case in a previous era, but not anymore because of the changing nature of firms. They believe that corporate reorganization is now mostly unnecessary because its purpose was to keep the business assets together to enhance their value (as in the railroads of the 19th century) but in modern times the assets could be worth as much or more on their own. They use the example of a computer manufacturer whose computers nobody wants to buy. In this case, the assets will clearly be worth more when sold individually than when kept together. According to Prof Girgis, modern businesses do not own as many physical assets as before because more businesses are focused on providing services and information, rather than being huge manufacturers as in the previous century. The physical assets that they do own are mostly things such as office equipment or machinery, which can be used by other businesses, both inside and outside the same industry. Intangible

assets, such as expertise and data, often reside in a team of workers and managers (a so-called network) and will lose their value if the team is not kept intact during reorganization. However, reorganization will inevitably result in people being laid off and some experts leaving. In the period before the company becomes insolvent, the network starts losing value anyway because teams are broken up and become dysfunctional, while morale plummets and work slows down.

This phenomenon explains the increasing number of so-called liquidating reorganizations in America and Canada that provide for a sale of the assets rather than the business as a going concern.

4.2 Business rescue saves jobs

The only purpose of our new business rescue proceedings discussed in detail in the Memorandum on the Objects of the Companies Bill was that the interests of workers were protected by the new procedure.⁴⁵ In the current economic crisis and considering our high unemployment rate, this is of course of major importance, but as we have seen in recent times, companies start shedding jobs at the first signs of trouble, and long before they actually enter any formal rescue or liquidation procedure. A good example is the proposed retrenchment of more than 3000 workers by Pick n Pay because of declining profits.

Furthermore, in any rescue attempt, some retrenchments are inevitable as the business has to cut costs to survive. One could argue that a business rescue will at least save some jobs and this appears to be the case when looking at the difference in the provisions of the law.

⁴⁵ The Memorandum was attached to the Companies Bill B61 – 2008.

If a company enters liquidation, all contracts of service with its employees are automatically and immediately suspended, and then terminated 45 days after the date of appointment of a final liquidator.⁴⁶

However, when a company is placed in business rescue proceedings, the Companies Act of 2008 provides in no uncertain terms that employees of the company will continue to be employed on the same terms and conditions as before.⁴⁷ Employment contracts are also specifically excluded from a business rescue practitioner=s power to suspend, or apply to court for the cancellation of any agreement or part thereof to which the company is a party.⁴⁸ The Act goes even further, by providing that any remuneration, reimbursements or other payments that become due and payable by the company to its employees during business rescue proceedings, will enjoy preference rights, ranking them just after the remuneration and expenses of the business rescue practitioner and the costs of the procedure, and before other forms of secured and unsecured post-commencement finance, and all unsecured claims against the company.⁴⁹

Experience in other jurisdictions indicate that in most instances we must expect a sale of the business as a going concern, rather than an actual rescue of the company in business rescue proceedings. The fact is that, irrespective of whether a business is sold and transferred as a result of liquidation or of business rescue, employees in South Africa are protected in that in terms of the Labour Relations Act their employment contracts are automatically transferred to the new owner of the

⁴⁶ Except in respect of those employees who have reached agreement with the liquidator on their continued employment: s 38(9) of the Insolvency Act of 1936.

⁴⁷ Section 136(1)(a).

⁴⁸ Section 136(2).

⁴⁹ Section 135(3)(a).

business,⁵⁰ even those contracts that have already been automatically terminated as a result of the company's liquidation.⁵¹ However, there is one big difference: in the case of liquidation, the new owner does not take over any liability for claims the employees may have had against the previous owner of the business for unlawful acts.⁵²

In the case of business rescue however, the new employer is automatically substituted in the place of the old employer in respect of all existing contracts of employment.⁵³ This means that the new employer takes over all the rights and obligations which existed between the old employer and each employee.⁵⁴ Anything done before the transfer by the old employer (including the dismissal of an employee or the commission of an unfair labour practice or act of unfair discrimination), is after transfer of the business considered to have been done by the new employer.⁵⁵ It may therefore be easier to find a purchaser for the business if the company is in liquidation and such a purchaser may even be prepared to pay slightly more, rather than risk the very wide and largely unknown potential liability to employees he would otherwise be exposed to.

4.3. Business rescue does not carry the same stigma as straightforward liquidation

⁵⁰ In terms of sections 197 and 197A respectively of the Labour Relations Act 66 of 1995.

⁵¹ See Boraine and Van Eck 'The New Insolvency and Labour Legislative Package: How Successful was the Integration?' (2003) 24 *ILJ* 1840 and Van Eck, Boraine and Steyn 'Fair Labour Practices in South African Insolvency Law' (2004) 121 *SALJ* 902.

⁵² Section 197A(2) of the Labour Relations Act 66 of 1995..

⁵³ Section 197(2)(a) of the Labour Relations Act of 1995.

⁵⁴ Section 197(2)(b) of the Labour Relations Act of 1995.

⁵⁵ Section 197(2)(c) of the Labour Relations Act of 1995.

Conventional wisdom states that because business rescue is viewed as more positive than liquidation, directors will be encouraged to make use of the procedure while there is still a good chance that the company may be rescued. It may also give the company's business partners and customers enough confidence in the continued existence of the company to do business with the company during business rescue, and perhaps have a positive influence on the value of the business if it has to be sold.

This view is not borne out by evidence from practice. One of the major disadvantages of judicial management was reported to be the fact that it negatively affected the creditworthiness of the company.⁵⁶ Finch also discusses the damage to a company's reputation that company administration in England can cause, or that directors fear it will cause.⁵⁷

In 2008, the CEO of General Motors, explained that one of the reasons why he was asking for a government bailout and not using a Chapter 11 reorganisation for General Motors was that the stigma of bankruptcy would deter consumers from buying GM cars.⁵⁸

When asked why they preferred to sell a company's business by way of a pre-packaged agreement entered into before the formal commencement of administration, most insolvency practitioners in England explained that the commencement of any formal insolvency procedure, even administration, immediately had a negative effect on the goodwill of the business and this caused a

⁵⁶ Cilliers & Benade *Corporate Law* par 26.03.

⁵⁷ Vanessa Finch *Corporate Rescue* at 372 and 457. See also fn 40 above.

⁵⁸ 1 December 2008 *TIME Magazine* at 24.

drop in the price that a purchaser was willing to pay for it.⁵⁹ However, our business rescue practitioners will not be able to use a pre-packaged agreement in this way because, following the example of Chapter 11, our procedure only allows a sale of the business in terms of a formal rescue plan approved after commencement of business rescue proceedings by at least 75% in value of creditors and 50% in value of independent creditors who voted.

We must therefore accept that any business rescue procedure will affect the reputation and creditworthiness of a company because it is so often followed by the liquidation of the company. An indiscriminate and large-scale use of our business rescue proceedings for purposes other than actual rescue will increase the number of companies being wound up after a rescue attempt and strengthen the view that this rescue procedure, just like judicial management, is really just another, albeit longer and more expensive route to liquidation.

There are other compelling reasons why a corporate rescue procedure should not be used for purposes other than a genuine rescue attempt of a company that really has the potential to survive. There is a strong view that successful companies are prejudiced when their failed competitors are propped up, because the insolvent business does not pay interest, operates without depreciation, has no ongoing legal processes, can market more cheaply, and can drive financially sound competitors into financial distress and even insolvency.⁶⁰

We have another very good example of the damage that the business rescue proceedings of one company may have on other companies and businesses. This is the power given to a business rescue practitioner to suspend any contractual obligation of the company for the duration of the proceedings while the other party to

⁵⁹ Frisby 'The Pre-pack Promise: Signs of Fulfilment?' (Spring 2010) *Recovery Supplement* 30.

⁶⁰ E Braun & W Uhlenbruck *Unternehmensinsolvenz* (1997) at 423.

the contract remains bound to perform. This means that a company in business rescue can, for example, continue occupying rented premises without paying rent, while the owner has to continue paying rates and taxes and other costs for the upkeep of the property. Or, the practitioner may decide to suspend payment in terms of a lease agreement while the company continues using the leased equipment. Has anyone considered the damage that will inevitably be caused, particularly to small companies and businesses, as a result of not being paid for an extended period but still being bound to their obligations in terms of the agreement? These companies and businesses could themselves now face serious financial difficulties and even failure.

5 Conclusion

I am not arguing that no attempt should ever be made to rescue a financially distressed company, but I believe that a change in mind-set is required. Firstly, we must accept the fact that only a very small number of distressed companies are capable of being rescued in the true sense, in other words, “returned to a solvent state”. The vast majority of companies that meet the requirements for business rescue proceedings by being financially distressed should go straight into liquidation without wasting costs and time by first being put into business rescue. Most importantly, we must not regard liquidation as the enemy that must be avoided and fought at any price. Instead, we need to realise that in appropriate cases, and if used correctly and properly, liquidation can achieve the same or even better results, than a formal business rescue procedure. In short: liquidation is really our very own home-grown Chapter 11!