DISPUTE RESOLUTION

BUSINESS RESCUE, RESTRUCTURING & INSOLVENCY

NEWSLETTER

Volume 24 | 13 October 2021

CLIFFE DEKKER HOFMEYR

INCORPORATING
KIETI LAW LLP, KENYA

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Business Rescue, Restructuring & Insolvency

October has brought much to look forward to. As the sun starts to rise earlier, we are starting to feel the beginnings of summer. Scientists in South Africa have confirmed that the country has officially exited the third wave of COVID-19 infections, and that some level of herd immunity may have been achieved. The much-anticipated latest instalment of the James Bond films, "*No Time to Die*", has also been released in cinemas. Most exciting of all, the end of the year is finally in sight, with colleagues already starting to book their respective December breaks. However, in the world of business rescue, restructuring and insolvency, it has become clear to us that our work has just begun.

Statistics SA reported at the end of September that the estimated number of insolvencies increased by 129,7% between May and July 2021, compared with the same three-month period of July 2020. In addition, there were a total of 1,327 liquidations during the first eight months of this year. Having borne witness to the exponential increase in the demise of their fellow commercial entities, many existing companies have realised that the crows will soon be circling if they do not take the necessary proactive steps to overcome the continuing, ostensibly insurmountable, obstacles being posed to enterprises. This realisation is evident in the dramatic increase in the number of news reports regarding companies' pursuit and implementation of restructuring and business rescue processes.

For example, the embattled wellness group Ascendis Health has reported that it managed to avoid going under business rescue after its shareholders voted in favour of a recapitalisation deal with its lenders. The Ascendis example shows how corporate restructuring can be successfully used to avoid business rescue. Last month Comair announced that it had achieved a milestone in its business rescue process, after having successfully sold its SLOW Lounge business to FirstRand Bank for R250 million. Our national flag carrier airline, SAA, has finally taken to the skies again; while its chosen strategic equity partner, the Takatso Consortium, is busy finalising the due diligence process leading up to its acquisition in a majority stake in the airline. Ster-Kinekor has similarly had good news to report in relation to its business rescue process, with its business rescue practitioner having received permission to extend the deadline for the publication of its business rescue plan to end November. This is as a result of a potential investor having expressed an interest in the cinematic enterprise, but requiring time to complete a due diligence. Should the potential investor agree to investing, the terms of such investment will necessarily have to be incorporated into the business rescue plan.

Ster-Kinekor's case is set to be a potential further example of a savvy investor timeously identifying a good value distressed asset investment opportunity which, considering the current market conditions for cinematic enterprises, has the very real potential to yield strong returns in the long-term. As a result of the continued vaccination roll out in the country, and our associated exit from the third wave of infections, cinemas have reported a steady increase in their attendance numbers. Ster-Kinekor's CEO has also reported that their confidence in the future commercial success of the company is supported by the strong slate of upcoming film content to be released in cinemas instead of streaming services, demonstrating the film industry's commitment to cinema. The latest instalment of the James Bond series, the prior release of which has been limited to cinemas, has in itself improved the company's balance sheet by stimulating an immediately noticeable increase in attendance numbers. Having proactively pursued the business rescue process, it appears that Ster-Kinekor has taken this new Bond film's title very seriously by deciding that there is "*No Time to Die*".

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In this month's newsletter we will be discussing the proposed amendments to our business rescue legislative scheme, as tabled by the recently published Draft Companies Bill, 2021. We also discuss the court's recent findings in the case of *Educated Risk Investment v The Master* (18358/2020) [2021] ZAJHC (29 September 2021), in relation to the payment of creditors during a liquidation process.

While many of us may wish we lived in a world where circumstances did not dictate that we take immediate and drastic steps to rescue our companies, the reality is that we do. The good news, however, is that our law has provided us with the necessary mechanisms to do so.

In spite of the historical stigma attached to business rescue and restructuring, the noticeable increase in the number of success stories resulting from companies having successfully implemented the restructuring and business rescue mechanisms has proven their utility. The novel investment opportunities that are being presented by these processes have further shown that there is always opportunity in adversity. As always, the CDH Business Rescue, Restructuring & Insolvency Sector remains on standby to assist distressed companies in achieving their own success stories.

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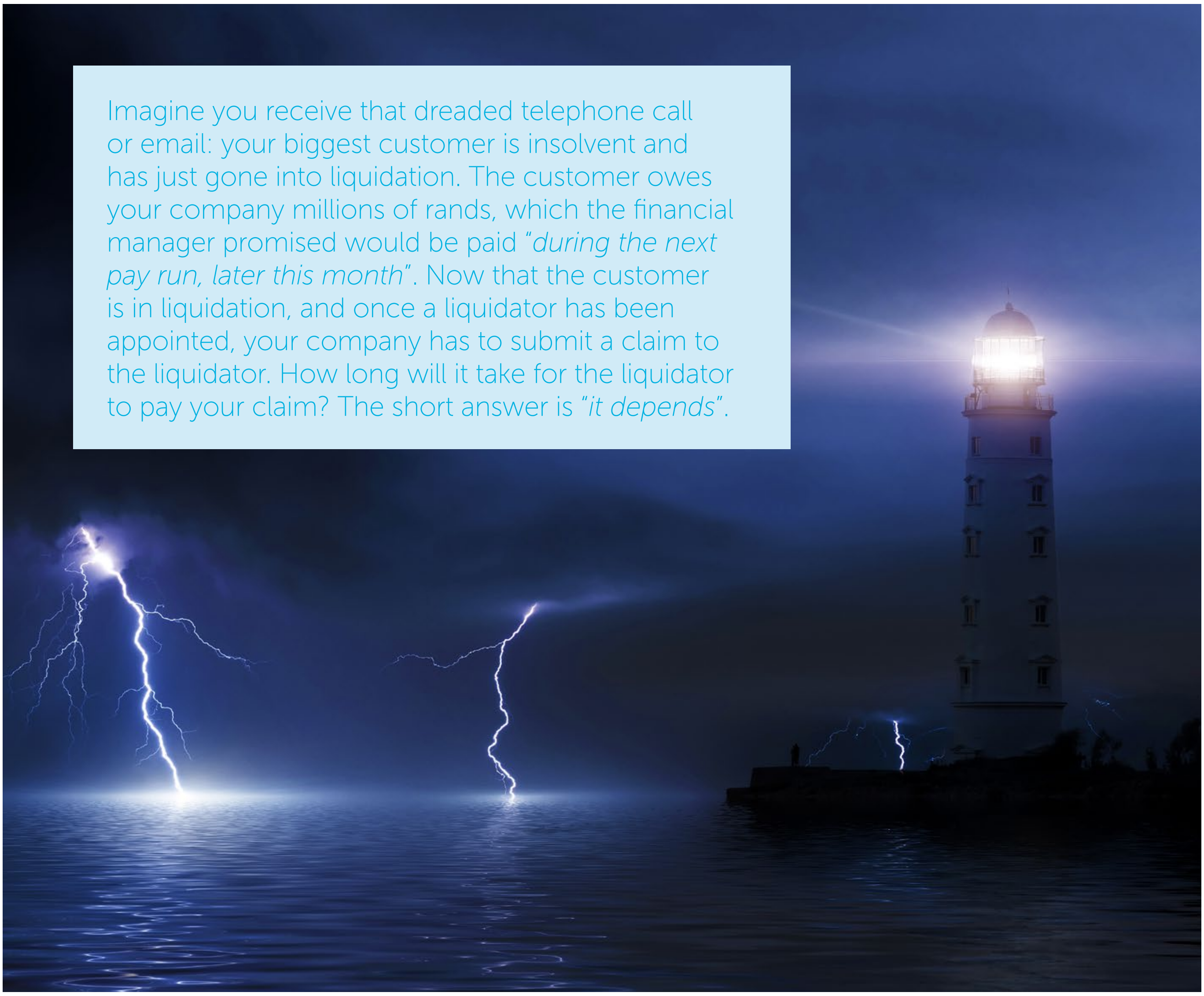
It could take a long time for a liquidator to pay your claim



Imagine you receive that dreaded telephone call or email: your biggest customer is insolvent and has just gone into liquidation. The customer owes your company millions of rands, which the financial manager promised would be paid *"during the next pay run, later this month"*. Now that the customer is in liquidation, and once a liquidator has been appointed, your company has to submit a claim to the liquidator. How long will it take for the liquidator to pay your claim? The short answer is *"it depends"*.

The liquidation process can take years before payments are made to creditors. The amount eventually paid to a creditor will depend on a number of factors, such as: whether or not the creditor's claim is secured; the value of assets of the insolvent company in relation to its total liabilities; and the number of creditors the insolvent company owes money to.

In most instances, banks' claims are secured by mortgage bonds or other forms of security – hence the banks are likely to be paid the full value, or close to the full value, of their claims. The remaining creditors are likely to be paid a portion of their claims, usually referred to as a *"dividend"* expressed as *"cents in the rand"*. The higher the liabilities of the insolvent company, the lower the cents in the rand. The liquidator has the task of determining these cents in the rand.

The liquidator's primary function is to take possession of the insolvent company's assets, sell them and pay creditors in accordance with their ranking. However, before the liquidator pays creditors, the liquidator must prepare a liquidation and distribution account (often referred to as the "L&D"). Three key milestones must be reached after the liquidator has prepared the L&D, before the liquidator can pay creditors.

Firstly, the liquidator must submit the L&D to the Master of the High Court. Theoretically, the liquidator must submit the L&D within six months of the liquidator's appointment. In reality, it may be longer than six months before the liquidator even starts preparing

It could take a long time for a liquidator to pay your claim...*continued*

the L&D. The liquidator may submit the first, second, third (or more) L&Ds to the Master before submitting the final L&D. There may be more assets which the liquidator is collecting or there may be more creditors submitting claims to the liquidator – hence the submission of more than one L&D.

Secondly, the Master must examine and approve the final L&D. When doing so, the Master must check if the L&D is legally compliant and if its entries correspond with, among other things, the creditors' claims. Once the Master has approved it, the L&D must lie for inspection at the Master's office and a local Magistrate's Court, for 14 days. This is to allow creditors to check the L&D and its entries in relation to their claims. There may be, as there often are, objections against the L&D. The Master must deal with all these objections and in some instances, these objections may lead to litigation before the L&D is finalised.

Thirdly, and once all objections have been dealt with, the Master may confirm the L&D. It is only on confirmation of the L&D that the liquidator may start paying creditors. The long-standing principle, as emphasised in *Educated Risk Investment v The Master* (18358/2020) [2021] ZAJHC (29 September 2021), is that once the liquidator starts paying creditors in terms of a confirmed L&D, that L&D is final and may not be reopened.

Before pursuing liquidation as an option, creditors would be best advised to consider how long it will take to recover the amount owing by the debtor and the actual amount which they may receive when the liquidator starts paying. It could be a long time before the liquidator pays.

Lerothodi Mohale
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Draft Companies Amendment Bill, 2021: what you need to know regarding the proposed amendments to Chapter 6

The recently published Draft Companies Amendment Bill, 2021 proposes the following changes to the business rescue legislative framework:

1. utility costs which are due and payable by the company in business rescue to its landlord, during business rescue proceedings, should be regarded as post-commencement financing (commonly referred to as a "PCF claim");
2. a landlord's PCF claim for unpaid utility costs should enjoy preferential ranking before PCF lenders but should rank after employee costs incurred during business rescue; and
3. the landlord's PCF claim should have a voting interest equal to the amount of such claim.

The stated rationale for the proposed amendments is to address the unfairness on landlords who, due to the moratorium on enforcement action, are prevented from recouping the unpaid utility costs which they have already paid on behalf of the company in business rescue. However, although the legislature's intention remains admirable, these amendments have the potential to be problematic in practice.

A general overview on the proposed amendments

The amendment which grants landlords with PCF claims for unpaid utility costs a voting interest, in relation to matters which require creditor approval during business rescue proceedings, is far more problematic, as the Companies Act does not afford PCF lenders the same voting interest. This amendment may disincentivize potential lenders from advancing PCF, and thereby, counterintuitively, jeopardize the success of a business rescue by cutting off the proverbial lifeline to its success.

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Draft Companies Amendment Bill, 2021: what you need to know regarding the proposed amendments to Chapter 6...*continued*

The granting of a voting interest to an identified category of PCF creditor, being landlords with PCF claims for unpaid utility costs, to the exclusion of all other PCF creditors, may arguably lead to the inference that the legislature's intention is that no other PCF creditors may vote on matters requiring creditor approval during business rescue. Based on this inference, potential lenders may be deterred from advancing PCF as they would have no influence on the restructuring of the company and the repayment of their PCF loan.

On the flip side, the proposed amendments may be welcomed by property owners as a "*better than nothing*" gift to the already struggling rental industry. The amendments may also, to a certain extent, assist a business rescue practitioner during negotiations with the landlord regarding the company's continuing occupation of the rental premises during business rescue proceedings. This is so because, at the very least, a landlord's claim for utility costs will rank ahead of PCF lenders and unsecured creditors – thereby increasing the likelihood of recovery of the utility costs. Arguably, this will still fall short of property owners' expectation that the full rental (inclusive of utility costs) would be deemed as a PCF claim.

Having briefly summarized the proposed amendments, and the potential issues which may arise, we now turn to a discussion of the practical consequences of the proposed amendments.

CURRENT VS. PROPOSED

The current position under section 135 of the Companies Act

Currently, landlords' clams for unpaid utility costs are regarded as unsecured claims, and they are not afforded a preferential treatment in the ranking of creditors' claims.

In *South African Property Owners Association v Minister of Trade & Industry and others* [2018] JOL 39915 (GP) the court held that PCF under section 135 of the Companies Act relates to financing obtained in order to assist the company in business rescue out of its financial distress; it does not include contractual obligations which existed prior to the commencement of the company's business rescue, and which are used to assist in managing the company during the business rescue process. As utility costs are incidental to and consequent on an existing lease agreement, they are considered to be pre-existing obligations which are used to manage the distressed company during business rescue and not PCF obtained in order to assist it in getting out of its financial distress.

Any claims for unpaid utility costs are therefore currently treated as unsecured claims, unless an adopted business rescue plan specifically provides otherwise.

Position under the proposed amended section 135 of the Companies Act

Practically, the proposed amendments provide that landlords' PCF claims for unpaid utility costs should be paid:

1. after the business rescue practitioners' claims for remuneration and expenses, the costs arising out of the costs of business rescue proceedings, and employees' PCF claims;
2. but before PCF Lenders and any secured, unsecured (or concurrent) creditors' claims.

The current position under section 145(4) of the Companies Act

Currently, section 145(4)(a) to (b) essentially provides that where decisions in relation to a business rescue requires approval by a vote of the creditors of the company in business rescue:

1. secured and unsecured creditors are afforded a voting interest equal to the value of their claims against the company in business rescue; and
2. concurrent creditors, who would otherwise be subordinated in a liquidation, have a voting interest equal to the amount, if any, that they could reasonably expect to receive in a liquidation scenario.

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Draft Companies Amendment Bill, 2021: what you need to know regarding the proposed amendments to Chapter 6*...continued*

Section 145(5) accordingly does not currently make any express reference to PCF creditors in the context of voting interests. However, the general view from a lender's perspective is that this does not mean that PCF creditors are currently divested of voting interests, as section 145(4) simply refers to "*creditor*" or "*creditors*" without defining who does or does not qualify as a creditor. In other words, the current wording arguably supports an interpretation that the legislature's intention is that all creditors, including PCF creditors, should be vested with a voting interest.

There is however a counterargument that the legislature did not intend for PCF lenders to have a voting interest in relation to matters that require creditor approval during business rescue, and especially not in relation to the approval of a business rescue plan. The basis for this counterargument, amongst others, is that providing PCF lenders with a voting interest could result in an abuse of the business rescue process. This would be in circumstances where a lender provides sufficient PCF to entitle it to a voting interest that could be determinative in any creditor decision-making process, and therefore of matters relating to the outcome of the business rescue.

Notwithstanding the various arguments regarding whether or not PCF creditors are afforded a voting interest under the current section 145(4) of the Companies Act, in practice it has been a matter which has been dealt with on a case-by-case basis in each particular business rescue.

Position under the proposed amended section 145(4) of the Companies Act

Should the proposed amendments to section 145(4) be passed into law, it would mean that the erstwhile generic wording of the section, which did not provide for any outright discrimination against PCF creditors by preventing them from having a voting interest, would be done away with.

The consequences of this, from a statutory interpretative perspective, would be that the only PCF creditors afforded with an express voting interest are landlords with PCF claims for unpaid utility costs, to the exclusion of all other PCF creditors.

The provision of PCF is more often than not essential for a distressed company to be rescued, especially in the current economic climate. In the absence of PCF, a distressed company is often certainly fated for liquidation. The business rescue statutory framework should accordingly be designed in a way that most incentivizes lenders to provide PCF, and avoid any amendments that may suppress lenders appetite to extend PCF to a distressed company. The proposed amendment to section 145(4) may result in the latter outcome as lenders may perceive the risks associated with investing in an already financially distressed company to be more than they are willing to accept, considering that they will be precluded from having any say in the process and outcome of the restructuring of the distressed company.

Conclusion

The deadline for public comment on the Bill is 31 October 2021. Considering the potential undesirable consequences which the proposed amendments may have for lenders' appetite to provide PCF, business rescue stakeholders are encouraged to provide comments on the proposed amendments.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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