DISPUTE RESOLUTION

BUSINESS RESCUE, RESTRUCTURING & INSOLVENCY

NEWSLETTER

Volume 23 | 8 September 2021

CDH
CLIFFE DEKKER HOFMEYR

INCORPORATING
KIETI LAW LLP, KENYA

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Business Rescue,
Restructuring &
Insolvency

When South Africa was plunged into level 5 lockdown some 17 months ago, many, if not most, in the commercial sector anticipated an immediate and exponential increase in the number of companies going under business rescue. However, the economic landscape remained eerily quiet in this regard for a few months to come, and we soon realized that the stigma attached to business rescue was stronger than we had initially misunderstood it to be. It appeared that many boards of directors were paralyzed with fear when their companies were unexpectedly thrusted into financial distress, and they were consequently faced with having to merely consider placing their companies under business rescue. Now, somewhat counterintuitively, with the rise in vaccination rates we have seen a parallel rise in the number of companies being placed under, and successfully undergoing, business rescue proceedings. We can only attribute the recent uptake in business rescue to the visibly successful use of the process by prominent South African companies, in the last few months – which we hope has finally removed the stigma surrounding the process.

Our airline industry certainly led the way in demystifying this formerly misunderstood legal process. For example, after having completed its business rescue process at the end of April 2021, South African Airways (SAA) has announced that it will be taking to the skies again at the end of this month. In addition, SAA's new strategic equity partner, the Takatso Consortium, has reportedly confirmed that the transaction whereby it will be purchasing a majority stake in SAA is in the final stages of its implementation. Following suit from its parent company SAA, Mango Airlines (Mango) has become another state-owned entity to voluntarily place itself under business rescue. Despite the dispute between Mango and certain of its trade unions, as to who placed the airline under business rescue, it is clear that what they could all agree that business rescue was the necessary course of action. Comair similarly placed itself under business rescue during May 2020, and has announced that it would again take to the skies at the start of this month. Turning to our cinema industry, Ster-Kinekor has reportedly been achieving success in the implementation of its business rescue process, as its practitioner recently confirmed that discussions with key strategic partners are at an advanced stage.

In liquidation news, on Monday the Western Cape High Court (the Court) ruled that it has the necessary jurisdiction to hear a liquidation application against Steinhoff, causing the retailer's share price to drop dramatically. Steinhoff sought to rely on the argument that it is classed as an "*external company*" under our Companies Act 71 of 2008. However, it's opposition, the former owners of shoe retailer Tekkie Town, seems to have convinced the Court that Steinhoff was not beyond its jurisdiction on account of being an external company, as the liquidation of companies is still governed by the old Companies Act 61 of 1973, which makes provision for the liquidation of external companies. As a result, the hearing of the retailer's liquidation application is likely to proceed later this week. Following on from the ever-continuing controversy surrounding Steinhoff, we are interested to see whether the constant efforts which have gone into resuscitating this erstwhile giant may come to nil as a result of this liquidation application.

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In some other positive news, RCL Foods has recently confirmed the power of the garage pie, as they recently reported that their food divisions delivered strong financial result. This was due to, amongst other things, their product 'Pieman's Big Deal Pie' experiencing a growth in purchases as people are increasingly again needing a grab-and-go pie from fuel stations. So if the increased vaccination rates were not a good enough metric for how our economic recovery from COVID-19 is progressing, the fact that statistics are showing that more people are again needing that quick grab-and-go pie on their way to their next meeting may serve as some extra needed solace.

What has proven true is that there are certain lessons which can only be learnt during a struggle, and the value offered by business rescue was a lesson so learnt by the South African commercial sector in the last 17 months.

Although we wish these valuable lessons could have been imputed in better circumstances, we hope that companies will be more inclined to resort to business rescue when they find themselves in financial distress in the future. What the business rescue process has also taught us is the value in finding strategic partnerships to overcome adversity, as most of the companies under rescue have been able to return to solvency primarily due to finding the right partnerships.

We at CDH have understood, identified and championed the value of partnership even well before the advent of the pandemic. So should you find yourself in need of a legal partner to help you navigate business rescue during these trying economic times, please look no further than the CDH Business Rescue, Restructuring and Insolvency Sector.

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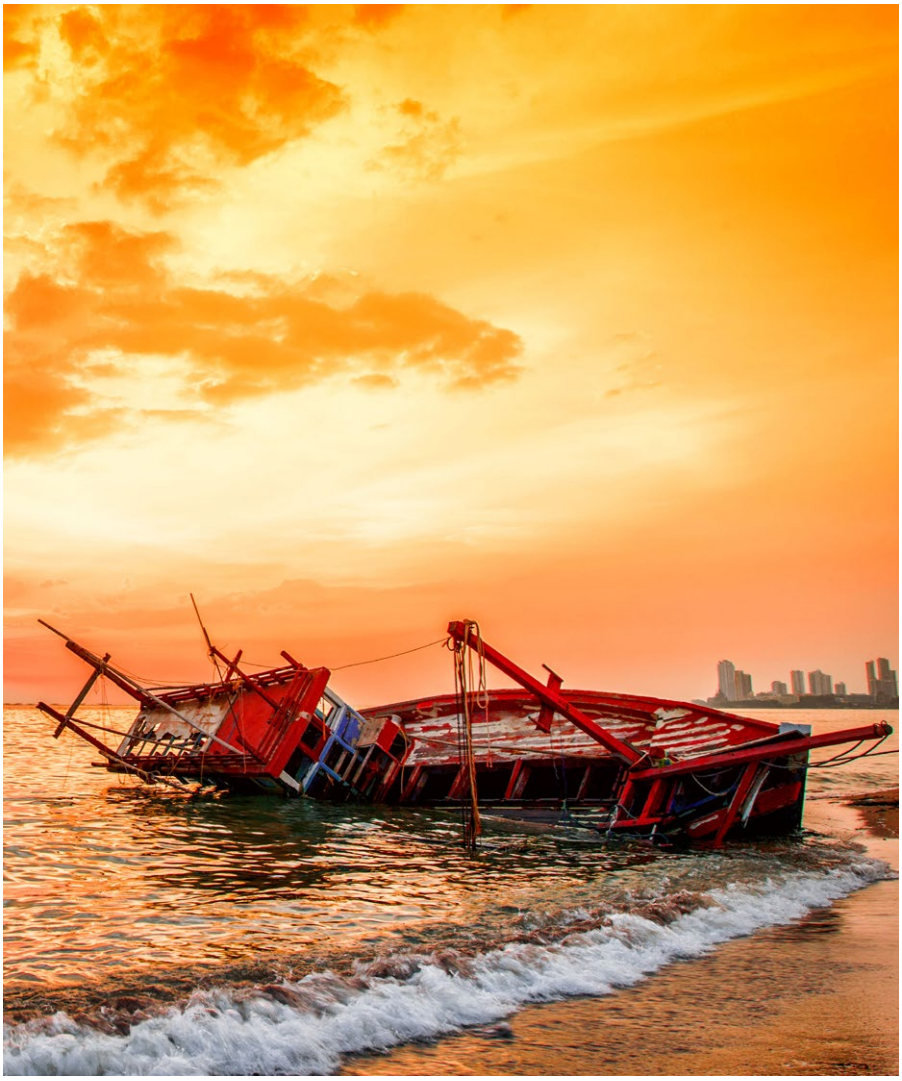
Collateral damage – the landlord's rights during business rescue and liquidation proceedings

It seems strange to think that we have been living with an imposed curfew for more than a year now. The economic consequences of this, and other lockdown related restrictions, have seen most companies suffer a hard financial blow. As a result, many companies have been faced with the harsh reality of liquidation or business rescue proceedings. Whilst this is a difficult situation to navigate for these companies, the creditors of such companies have in most cases become collateral damage. Landlords, as creditors of commercial tenants being liquidated or commencing business rescue, are no exception.



In this article, we examine the differences between liquidation and business rescue proceedings, with a focus on the rights of landlords in each of the scenarios.

Distinguishing between liquidation and business rescue

Liquidation is a process whereby both solvent and insolvent companies are wound-up, either voluntarily or as a result of a court order or creditor's resolution. Although the winding-up of solvent and insolvent companies are regulated by different pieces of legislation, the legal consequences are mostly the same. The company ceases to operate, and its creditors are paid in accordance with their ranking. The company's legal existence is terminated, along with any and all of its obligations or liabilities.

On the other hand, business rescue is a process that seeks to prevent the liquidation of a company, or at least ensure a better return for the creditors in the event that the company cannot be rescued.

Business rescue is defined in section 128(1)(b) of the 2008 Companies Act, as a procedure to facilitate the rehabilitation of a company that is financially distressed, by providing for:

- the temporary supervision of the company, and of the management of its affairs, business and property;
- a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and

Collateral damage – the landlord's rights during business rescue and liquidation proceedings...*continued*

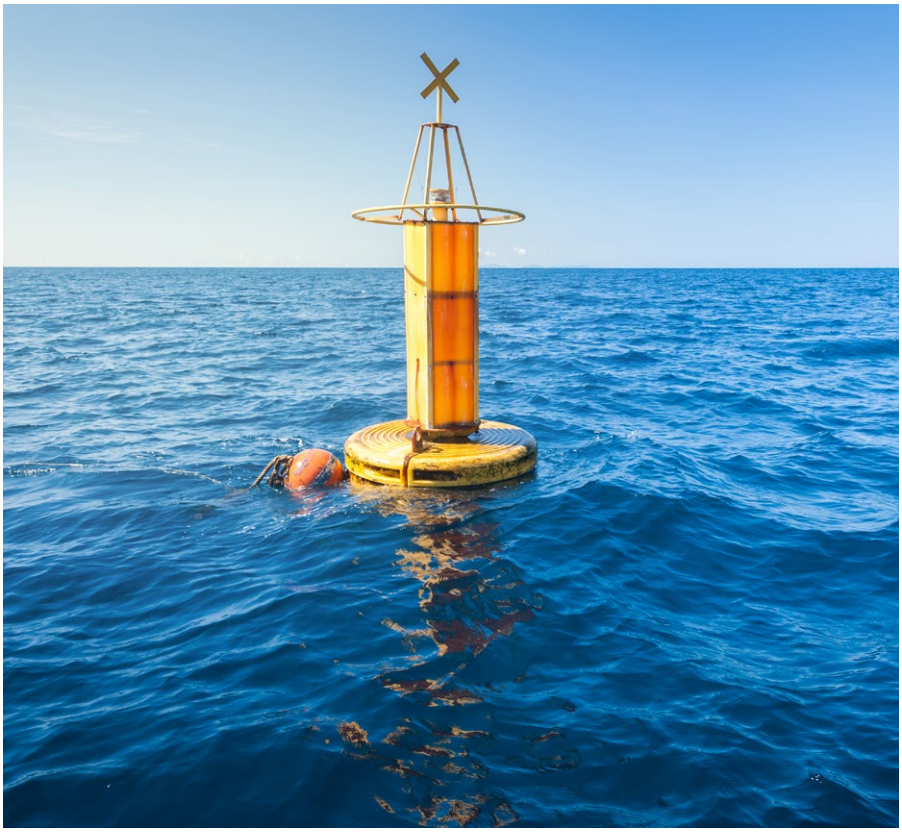
- the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis, or if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.

Landlord's rights during liquidation

The winding up of a company does not automatically terminate an agreement of lease, notwithstanding the provisions of the agreement of lease. Section 386(4)(g) of the 1973 Companies Act, read with section 37 of the Insolvency Act 24 of 1936 affords the liquidator the election to keep a lease agreement in force, or to cancel a lease agreement by notifying the landlord in writing. If the liquidator fails to exercise such an election, the lease agreement automatically comes to an end after 3 months.

In the event of the liquidator electing to keep the lease agreement in force, the liquidator would remain liable for the payment of rental, which will form part as the costs of liquidation. In the event that the liquidator elects to cancel the lease agreement, the landlord retains a common law damages claim against the insolvent estate for loss of profit for the remainder of the lease period, subject to the landlord's obligation to mitigate its damages. For the period up to the liquidator exercising its election, the rental payable in terms of the lease agreement will also form part of the costs of the liquidation

It is common to include a clause in an agreement of lease which provides that "*the insolvency or liquidation of the tenant constitutes an event of default*" and is thus a breach of the lease agreement. Despite this,



the provisions of South Africa's insolvency legislation override any contractual rights that a landlord has in terms of the lease agreement.

The court dealt with the landlord's right to cancel an agreement of lease, in the event of the tenant being wound up, in *Ellerine Brothers (Pty) Ltd v McCarthy Limited* and held that only if the breach notice by the landlord was sent to the tenant prior to the institution of liquidation proceedings, due to a breach event or failure to pay rental (i.e the right to cancel the agreement of lease having accrued prior to the liquidation proceedings being commenced), will such a cancellation be valid.

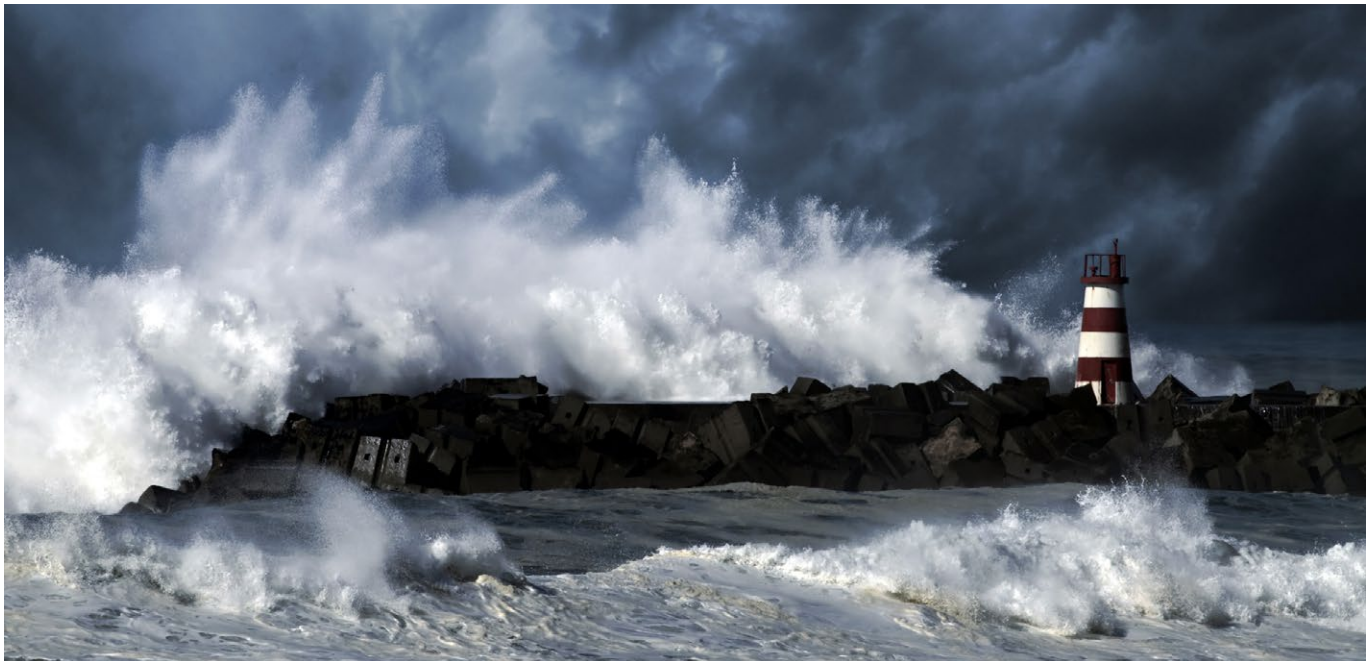
In many respects the landlord's hands are tied, and it will be up to the liquidator to decide whether to maintain or cancel the agreement of lease, and whether to keep paying the rental amounts due.

Landlord's rights during business rescue

Similar to liquidation proceedings, the effect of section 136(2) of the 2008 Companies is that a contract concluded prior to the commencement of business rescue proceedings, is not suspended or cancelled by virtue of the business rescue, but the business rescue practitioner may suspend, or apply to court to cancel, any obligation of the company under the contract.

Section 133(1) of the Companies Act provides that during business rescue proceedings, no legal proceeding, including enforcement action, against a company, or in relation to any property belonging to the company, or lawfully in its possession, may be commenced or proceeded within any forum, except (a) with the written consent of the BRP; or (b) with the leave of the court and in accordance with any terms the court considers suitable.

Collateral damage – the landlord's rights during business rescue and liquidation proceedings...*continued*



The Supreme Court of Appeal in *Cloete Murray and Another NNO v FirstRand Bank Ltd t/a Wesbank* held that that the cancellation of a contract does not constitute "*enforcement action*" prohibited by section 133(1) of the Act, and that a creditor can therefore lawfully and unilaterally cancel a contract that it had concluded with a company under business rescue, prior to the latter being placed under business rescue. One of the reasons provided by the SCA for the aforementioned conclusion, is that the terms "*enforcement*" and "*cancellation*" are mutually exclusive, and not interpreting them as such would be contrary to the language, context, provision and purpose of section 133(1) of the Companies Act.

However, if a landlord cancels an agreement of lease during business rescue proceedings, they might not be able to enforce the cancellation in so as far as it pertains to regaining possession of the leased premises, if this can be regarded as enforcement action. This is especially true if such lease is material to the operation of the company under business rescue and an ejectment order could potentially result in the failure of any attempt at rescuing the business. In that instance, a court is unlikely to enforce the cancellation, as it is likely to defeat the purpose of the business rescue proceedings.

Conclusion

The landlord's position in both instances discussed above is far from ideal and may result in the landlord losing out on several months of rent, either because of the lease premises standing empty, or because of the tenant occupying the property without paying the full rental amount. In both instances, the landlord's claims for outstanding rental ranks relatively low compared to other creditors. Under liquidation, the landlord will only have a preferred claim for three months outstanding rental if rent is payable on monthly basis, whilst the rest of the claim will be a concurrent (unsecured) claim. Under business rescue, the landlord may be able to recover some of the rental that became due after the business rescue proceedings commenced, but prior outstanding rental will be ranked along with other unsecured claims.

The economic consequences of the series of lockdowns experienced in South Africa has not only toppled previously solvent companies, but it has also placed many landlords in a precarious and uncertain financial position. In many instances, a landlord's hands are tied and they have no option but to wait and see what the liquidator or business rescue practitioner decides to do with respect to its lease agreements.

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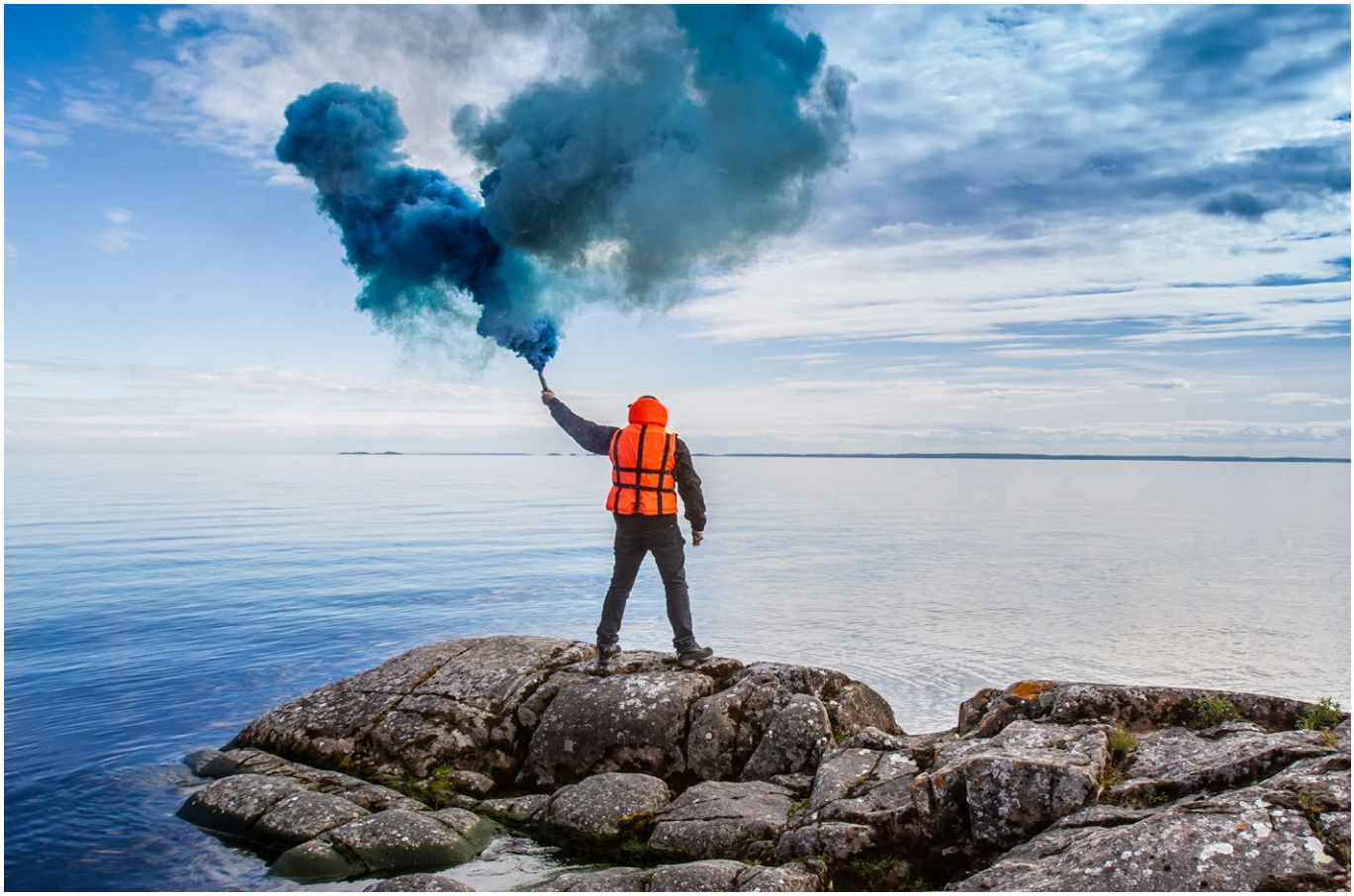
Toxic shareholder relationship may lead to liquidation



The word "*liquidation*" is often associated with a company that is bankrupt, struggles to pay salaries and cannot pay its creditors. However, a perfectly solvent company, where there is a toxic relationship between its shareholders, may be liquidated on the basis that it is "*just and equitable*" to do so.

The grounds on which a court may liquidate a solvent company include (but are not limited to): where the directors are deadlocked in the management of the company and the shareholders are unable to break the impasse, resulting in irreparable harm to the company; where shareholders are deadlocked in voting power, and have failed in at least two consecutive annual general meetings to elect successors to directors who's terms have expired; and where it is just and equitable for the company to be liquidated.

Recently, in *Barbaglia N.O and Others v Noble Land (Pty) Ltd and Others* (A5041/2020) [2021] ZAGPJHC 85 (24 June 2021), the court placed Noble Land (Pty) Ltd in liquidation on the basis that it was just and equitable to do so. This is a reminder of how a family company, with noble begins, can be caught in the middle of a family feud which leads to the company's tragic liquidation demise. That company is Noble Land.

Noble Land is a solvent family business, owned by two brothers through their respective trusts. Their parents are no longer involved in the affairs of Noble Land, however, both brothers are involved in a family feud, which appears to have affected their roles as shareholders of Noble Land. Settlement and mediation attempts to resolve their dispute were not successful, thus the relationship between the two brothers is "*toxic and dysfunctional on a professional and personal level*". Eventually, one of the brothers brought an application to liquidate Noble Land.

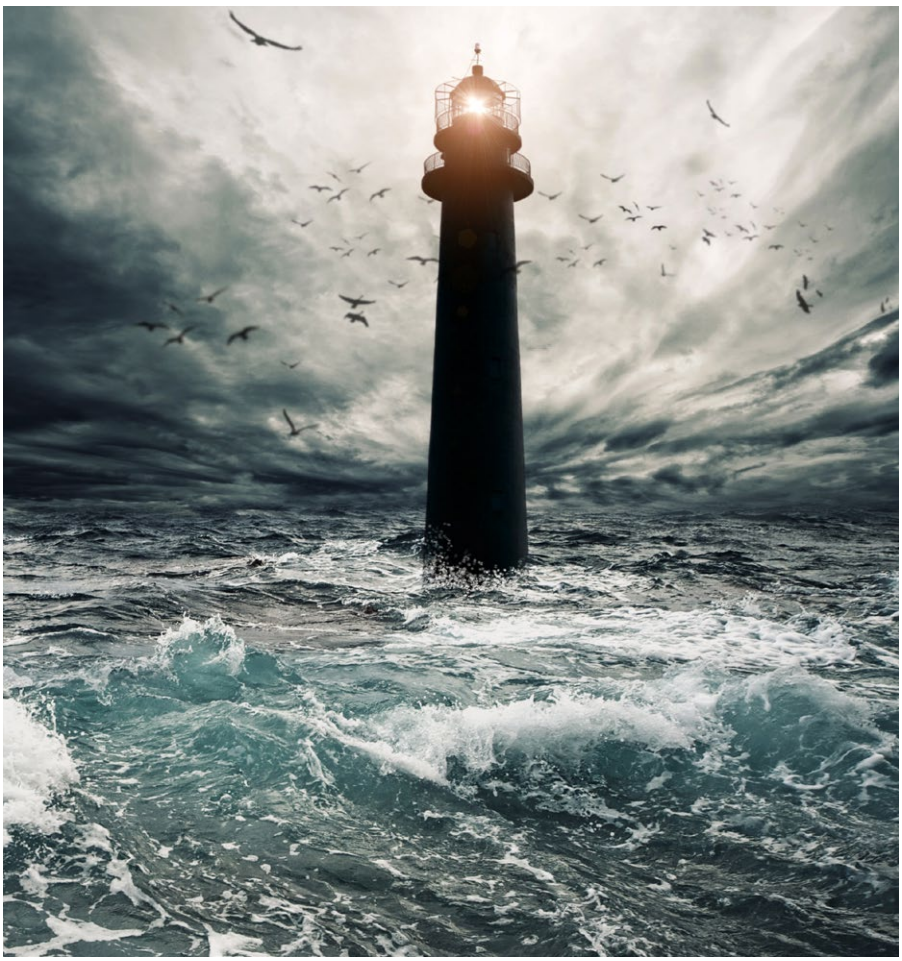
Toxic shareholder relationship may lead to liquidation

...continued

The court laid down the following principles in relation to the liquidation of a company on the basis that it is just and equitable to do so:

- the court has an overall discretion to liquidate a solvent company where there is a general breakdown of the relationship between shareholders;
- the court exercises this discretion after applying the law, justice and equity to the facts of the company in question;
- even in an instance where there is a failure of the relationship between shareholders to a point where shareholders have been unable to elect successors to directors in one AGM, a court may exercise its discretion and liquidate the company;
- there exists between shareholders a particular personal relationship of confidence and trust similar to that which exists between partners in a partnership. If one of the shareholders destroys that relationship, the other shareholder is entitled to claim that it is just and equitable for the company to be liquidated;
- it is not necessary that the shareholder seeking the liquidation should have the proverbial "*clean hands*" in the feud between the shareholders. In many instances, both shareholders would, to some extent, have contributed to the breakdown in their relationship.

The court found there was a complete breakdown in the brothers' relationship, which made Noble Land unable to function. There was no reasonable hope of "*tiding over the period of conflict and of Noble Land emerging as a functioning company*". The brothers were "*hopelessly at loggerheads*" with each other. Noble Land was in a state which could not have been contemplated when it was formed, and the way forward appears to be more and more litigation between the brothers. Hence the disputes between the brothers have reached a level where it would be just and equitable to liquidate Noble Land.



It is reasonably acceptable for shareholders to debate and disagree on commercial aspects of a company. However, if their relationship breaks down to a point where it is toxic, then that may be a basis for a court to liquidate an otherwise solvent company.

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR
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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