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DISPUTE RESOLUTION **ALERT**

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The abuse of business rescue: Exploitation of the Chapter 6 lifeboat

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The abuse of business rescue: Exploitation of the Chapter 6 lifeboat

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The introduction of Chapter 6 of the Companies Act 71 of 2008 (the Act) brought with it a shift from a creditor-protectionist society towards a business rescue model that is debtor-protectionist. In consequence, there has been a multitude of applications over the last 13 years, which showcase the blatant exploitation of the business rescue scheme.

This shift, which affords a debtor company various procedural and substantive protections and advantages, has unfortunately led to considerable misuse of the business rescue procedure, and has courts grappling with the abuse of the system. Whilst many applications for business rescue are properly motivated, there has been a significant number of companies that have simply been in search of a debt holiday.

The abuse of business rescue

A company may commence with business rescue proceedings when its board of directors passes a resolution placing the company in business rescue. This step can be initiated if the board has reasonable grounds to believe that the company is financially distressed and there appears to be a reasonable prospect of rescuing the company. The procedural and financial barriers to entry is very low; shareholders' approval are not required, nor prior notice to unsuspecting creditors, and it is not necessary to apply to court.

Due to the ease of initiating business rescue proceedings, applicants have often commenced the process even when they are well aware that there is no business to rescue and that a better return for creditors will not be obtained. In many instances, resolutions passed for business rescue are nothing more than attempts to delay the ultimate demise of companies that could clearly not pay their debts, and to buy more time from creditors who are threatening liquidation.

One of the drastic consequences of commencing business rescue proceedings is the immediate moratorium of creditors' claims against the company, which lasts for the duration of the business rescue proceedings. Not only may legal proceedings or enforcement action by creditors against the financially distressed company not be initiated, if such actions had been underway, they may not be continued. While the moratorium on a creditor's claims is designed to facilitate a successful rescue, business rescue may be instituted solely to freeze creditors' rights. Debtors have used this moratorium solely to outmaneuver their obligations.

Furthermore, a court application to begin business rescue proceedings may be made even after liquidation proceedings have been commenced against the company, and this will have the effect of suspending the liquidation proceedings until the court has refused the business rescue application, or if it is granted, until the business rescue proceedings have ended. An application for business rescue can be brought by an opportunistic debtor company merely for the purpose of delaying or suspending existing liquidation proceedings.

Another advantage of business rescue for debtors is that the mechanism of an insolvency enquiry is not available, which means reckless or fraudulent conduct by the directors cannot be properly investigated.

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Combating the abuse of business rescue

The Act contains measures that are intended as remedies against the very real potential for abuse by company boards of their power to start business rescue proceedings and appoint a business rescue practitioner.

A significant protection afforded to creditors is to challenge a resolution adopted by the company's board of directors. Any affected person may apply to court to have the resolution set aside on the grounds that there is no reasonable basis to believe that the company is financially distressed, or that there is no reasonable prospect that the company will be rescued, or that the company has failed to comply with the procedural requirements set out in section 129.

The abuse may therefore be intercepted by certain remedies provided in the Act, as court intervention on application is always at the disposal to any stakeholder. But it is debatable whether the costly and time-consuming remedy of obtaining an order of court will prove to be a very effective weapon against abuse. Even so, making it too easy to reverse a board's decisions will undoubtedly undermine the success of the business rescue proceedings. Affected persons therefore have high hurdles to clear to set business rescue proceedings aside.

The whole business rescue application balances on the court's discretion and it is ultimately within the court's discretion to dismiss an application for business rescue when it suspects that it is illegitimate and ill-founded.

Recent case law – the Southern Sky case

The abuse of the business rescue procedure is very evident from the recent case of *Maryne Estelle Syme N.O & Others v Southern Sky Hotel and Leisure (Pty) Ltd & Others*, heard in the Limpopo Division of the High Court, Polokwane (Court).

The essence of the dispute before the Court was whether Southern Sky Hotel and Leisure (Pty) Ltd, being the respondent company in liquidation (the company), ought to be removed from its liquidation proceedings and instead be placed into business rescue.

The business rescue order sought by the applicant and an intervening party (the applicants) was opposed by the liquidators of the company on the basis that there was no prospect of rescuing the company, that the application for business rescue was simply a ruse and was launched solely to suspend the liquidation proceedings, in order to attempt to derail the sale of the immovable property owned by the company (scheduled to take place in the near future).

The Court indicated that an applicant for business rescue must establish grounds for a reasonable prospect of achieving one of the two goals set in section 128(1)(b) of the Act. That is, a business rescue plan must be aimed at either restoring the company to a solvent going concern or at least facilitating a better return for creditors and shareholders than they would secure from a liquidation process.

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The Court held that, after perusing the draft proposed business rescue plan attached to the business rescue application, it is clear that the said plan does not have any sensible and reasonable prospects for the company to be rescued.

Where the majority of creditors are against the proposed business rescue scheme (as it was in this case), that is an important consideration for the Court to have regard to when considering the application before it.

The Court held that, after perusing the draft proposed business rescue plan attached to the business rescue application, it is clear that the said plan does not have any sensible and reasonable prospects for the company to be rescued. It is entirely dependent upon speculative and uncertain eventualities. The Court remarked that the contents of the proposed business rescue plan was *"highly speculative, far-fetched and fanciful because the company was virtually never in a position to make profit"*.

The Court pointed out that since 2013, no less than four different winding up applications had been launched seeking the winding-up of the company. A business rescue failed in 2016 when the creditors voted against the adoption of the business rescue plan. Amongst these creditors was the applicant creditor who ultimately applied successfully for the liquidation of the company. The Court stated that there is no doubt that this applicant creditor will still vote against the business rescue plan in the present case.

The Court concluded that, taking into consideration the conspectus of the evidence before it, nothing had changed since 2012 insofar as the ability of the company to pay its debts and the company was clearly not capable of being rescued. There was a previous attempt to embark upon business rescue in 2016 but with no success. It simply spawned extensive litigation at the instance of Ms. Rinderknecht (the sole director and shareholder of the company) and frustrated creditors.

The Court stated that the application to place the company into business rescue was *"contrived and done solely for the purpose of frustrating the liquidation process and further dragging out the demise of an insolvent company"*. The Court emphasized that business rescue is not meant for the terminally ill company or to frustrate liquidation proceedings.

Conclusion

The Southern Sky case paints an unfortunate picture of how the business rescue scheme can be abused by opportunist debtors seeking to harness the advantages and protections of business rescue for ill-founded reasons. It is clear from the judgment that business rescue should only be commenced if it is a genuine attempt to achieve the goals of business rescue.

The case also illustrates how the court can intervene and safeguard the interests of creditors. Our courts will continue to be on alert for overzealous decisions by the board of directors to plunge a teetering business into the perceived security of the Chapter 6 lifeboat.

Kylene Weyers

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