DISPUTE RESOLUTION

BUSINESS RESCUE, RESTRUCTURING & INSOLVENCY

NEWSLETTER

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Business Rescue, Restructuring & Insolvency

My memory is fading as to life before lockdown. Perhaps it is my brain's way of protecting me against this *"prison"*, or has it been so long that I have forgotten what normal life feels like? Have we become accustomed to our new life or are we all just trying to keep our heads above water?

IS THERE A LIFE AFTER LOCKDOWN? THERE MUST BE!

We've just passed the halfway mark, but has anyone thought about what will happen when the sun rises on 17 April 2020 at 06h25 in Johannesburg (and 30 minutes later in Cape Town)? Will we all head off to work to *"kickstart the economy"*? Is everyone expecting a plug and play outcome? Surely, it can't be as simple as that and *"back to normal"* measures or regulations will have to be implemented to avoid having endured this lockdown for nothing. What will these measures look like and is it even possible to implement in South Africa?

In this edition we will provide insight on directors' liability in financially distressed times. This is an important topic, especially in these troubling times. We also include a summary of a recent judgment handed down in the Supreme Court of Appeal which deals with *"success fees"* in business rescue.

Be sure not to miss next week's edition where we will provide an overview of relief measures, from a legislative perspective, which have been implemented abroad. Hopefully by then, there would have been some movement on home ground. We will also tackle the topic of business rescue and will set out the different modes of commencement and legal consequences.

Everyone has their own way of dealing with self-isolation. Some tend to spring clean and others have grown green fingers. I reacquainted myself with music from my school and university days (having the 2019 rugby world cup final playing as background music also does wonders for the soul). So, it seems that *we've got to hold on to what we've got. We've got each other and that's a lot. Let's give it a shot, woah, we're halfway there*.

Until next week.

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CLIFFE DEKKER HOFMEYR

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Beyond the balance sheet: considering directors' liability in financially distressed times

In the midst of the global concern of COVID-19 and the impact it has had, and continues to have, on the health and wellbeing of the population, a further concern is that of the effect the COVID-19 pandemic has had and shall have on businesses and the greater economy not only in South Africa, but worldwide.

Since President Cyril Ramaphosa's announcement of a national 21 day lockdown and the declaration of a national state of disaster, many businesses have found themselves in very uncertain times. One can only imagine the difficulties faced by directors and business officeholders during this period, as they endeavour to navigate their businesses and companies through these unprecedented times, finding themselves in very unfamiliar territory.

In advising businesses and companies in navigating through these unchartered waters, a starting point would be to try and manage the unavoidable in order to avoid the unmanageable - this was a quote by *New York Times* columnist, Tom Friedman. During this so-called Black Swan event, it is inevitable that many businesses will start to experience the effects in more ways than one, be it employee related issues, financial issues or market related issues.

It is unsurprising to hear that many businesses have already or may begin to experience financial distress during this time. While many of us obsess over our own health and symptoms over the next couple of weeks, as a director of company, it is equally as important to keep a finger on the pulse of the business during this time, so as to allow for swift and cautious action should the business start showing 'symptoms' of financial distress.

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Beyond the balance sheet: considering directors' liability in financially distressed times

In identifying financial distress, the board and its directors would have to determine whether or not the company will be able to pay its debts as they fall due and payable within the immediately ensuing six months; or whether it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months.

These two factors would need to be carefully considered on a rational basis and technically speaking, one would have to consider if the company's liabilities exceeds its assets; or if there are any realisable assets that can be realised in order to satisfy the company's liabilities in the immediately ensuing six months.

Determining financial distress has far greater consequences for a director than a simple balance sheet consideration. In terms of section 129(7) of the Companies Act 71 of 2008 (the Act), there is an onerous obligation placed on a board of directors of a company wherein if the board determines that a business is in fact in financial distress, they are to either adopt a resolution to commence with business rescue proceedings, alternatively, deliver a written notice to each of its creditors, employees, trade unions and shareholders, setting out, inter alia, its reasons for not voluntarily commencing business rescue proceedings.

Failure to adhere to provisions as set out in the Act could result in a director being held personally liable for all the debts of a company. Section 77 of the Act speaks to this personal liability and explains that where a director knowingly carried on the business of the company recklessly or with the intent to defraud creditors or other stakeholders, he/she shall be held personally liable for any loss incurred by the company. Section 214 goes even further to provide for criminal liability for those directors at the steer of a company which is being traded recklessly.

In considering the above, one may surrender to the fact that in order to avoid personal liability in times of financial distress, a director is left with no choice but to either adopt a resolution for the commencement of business rescue or send a notice to all stakeholders, leaving the company in a worse off position and seemingly not acting in its bests interests.

However, in considering a directors' freedom to exercise his/her fiduciary duties, the courts consider these instances on a case by case basis, and the enquiry is predominantly evidentiary based.

One of the main reasons that a director may elect not to send out a notice as provided for in section 129(7) (in the alternative to placing the company in business rescue), is for the sole reason of such notice seeming more like a 'death notice'. This is because more often than not, the creditors may respond to such notice by applying to court for the company to be liquidated, as the notice contains an admission by the company of its commercial insolvency.

Therefore, should a director elect not to adhere to the provisions provided for in section 129(7) insofar as they believe that they would be acting in the best interests of the company, he/she would have to be able to prove that they acted honestly and in a reasonable manner in conducting business while the business was seemingly in financial distress.

The defence provided for in section 77(9) of the Act is not unique to South Africa and is considered internationally as well. Commonly referred to as the Business Judgement Rule, the rule seeks to protect and promote the ability of directors to fully exercise their duties in the best interests of the company, without fear of personal liability arising from such decisions where such director acted honestly and reasonably.

Section 22 of the Act has also provided for the Companies and Intellectual Property Commission's (CIPC) intervention, where the CIPC has the authority to issue notices where it reasonably believes that a company has been trading or carrying on business in a reckless, grossly negligent and fraudulent manner. However, in light of the COVID-19 pandemic and the state of national disaster in which South Africa finds itself, the CIPC has issued a practice note in terms whereof it acceded to not invoke its powers in terms of this section where a company is temporarily insolvent and still carrying on business or trading. This accession shall only be applicable insofar as the CIPC has reason to believe that the insolvency is due to the business conditions which were caused by the COVID-19 pandemic and shall only apply until such time that 60 days has lapsed after the declaration of a national disaster in South Africa has been lifted.

In considering the above, should your company run into financial difficulties during this time, while it is understandable to not readily concede that there may be problems, it would be unwise not to seek guidance in navigating through these uncertain times.

All directors should be asking themselves the following two important questions:

Is it reasonably unlikely that the company will be able to settle all its debts as they become due and payable in the ensuing six months?

Or, is it reasonably likely that the company will become insolvent within the immediately ensuing six months?

If the answer is yes to either of the above questions, we suggest that you make contact with us as soon as possible.

The Insolvency and Business Recue team at CDH is well equipped to guide you through the steps to be taken during early signs of financial distress and to identify various mechanisms available to companies to restructure such potential distressed financial affairs. Directors should take note that if they endeavour to take such pro-active steps to mitigate the distress, such would stand in good stead when considering as to whether or not the directors acted in a manner that was expected of them in the circumstances.

We can and want to help you during these trying times.

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Can a business rescue practitioner be paid a "*success fee*" outside the confines of section 143 of the Companies Act?

This was one of the questions which the Supreme Court of Appeal of South Africa (SCA) had to consider in the recent case of *Caratco (Pty) Ltd v Independent Advisory (Pty) Ltd* (Case No 982/18) [2020] ZASCA 17.

Section 143(1) and (2) of the Companies Act 71 of 2008 (Companies Act) deals with the remuneration of business rescue practitioners and states the following:

"(1) The practitioner is entitled to charge an amount to the company for the remuneration and expenses of the practitioner in accordance with the tariff prescribed in terms of subsection (6).

(2) The practitioner may propose an agreement with the company providing for further remuneration, additional to that contemplated in subsection (1), to be calculated on the basis of a contingency related to:

(a) the adoption of a business rescue plan at all, or within a particular time, or the inclusion of any particular matter within such a plan; or

(b) the attainment of any particular result or combination of results relating to the business rescue proceedings."

Before we answer the question posed in the title of this article, we will look at the background facts in the Caratco case.

Background

Independent Advisory Services (Pty) Ltd (IAS) is a company specialising in business rescue. On 9 October 2015, two of its directors were appointed as joint business rescue practitioners (the Practitioners) of Galaxy Jewelers (Pty) Ltd (Galaxy). Galaxy formed part of a group of companies (Galaxy Group) that were controlled by Mr Tom Watson (Watson).

Following the appointment of the Practitioners, they discussed the payment of a success fee to IAS with the managing director of Galaxy in the event that the Practitioners are successful with the business rescue of Galaxy.

The managing director of Galaxy thereafter approached Watson, who was the controlling mind of the Galaxy Group and also the managing director of Caratco (Pty) Ltd (Caratco), one of the other companies in the Galaxy Group, to discuss the request from the Practitioners. Watson

Can a business rescue practitioner be paid a "*success fee*" outside the confines of section 143 of the Companies Act? *...continued*

agreed that a success fee of R2 million would be paid to IAS if the Practitioners are successful with the business rescue proceedings and informed the Practitioners of his decision.

Shortly thereafter, Caratco's attorney informed the Practitioners that he would advise them in due course which entity in the Galaxy Group would be chosen to pay in terms of the Agreement so as to maximize the income tax advantage to the Galaxy Group.

On 30 March 2016, Caratco's attorney informed IAS that it had to submit its invoice to Caratco. Caratco's attorney further advised the Practitioners that until the Practitioners have filed a notice of substantial implementation with the Companies and Intellectual Property Commission, to bring the business rescue proceedings of Galaxy to an end, Caratco is not obligated to pay any amount to IAS.

IAS subsequently filed a notice of substantial implementation and duly invoiced Caratco for payment. However, Caratco ignored the invoice and the subsequent demand for payment by IAS.

On 4 August 2016, IAS instituted motion proceedings against Caratco for payment of the debt. In Caratco's answering affidavit it admitted the existence of the Agreement but denied liability for payment on several grounds. On 3 March 2017, the Motion Court referred the matter to trial.

Despite Caratco's concession in its answering affidavit that the Agreement existed, it denied the existence of the Agreement in its plea. It further pleaded that:

(i) if there was such an Agreement, its attorneys were not authorised to have concluded it on its behalf;

(ii) alternatively, the Agreement was concluded by a unilateral mistake due to a misrepresentation by the Practitioners that a special fee was due in terms of section 143 of the Companies Act, which was not the case, and as such, the Agreement was void; and

(iii) the Agreement was illegal and contrary to public policy.

One of the Practitioners was the only witness to testify at the trial and he provided a largely unchallenged version of events similar to that outlined above. No version was put to him regarding the factual basis for any of Caratco's pleaded defences other than that no agreement was concluded. Caratco closed its case without calling any witnesses to rebut the Practitioner's version.

The court a quo found that Caratco agreed to pay the success fee in terms of the Agreement and that it had failed to establish any of its defences, including that of illegality and public policy.

Caratco thereafter applied to the SCA for leave to appeal the judgment of the court a quo. In the SCA, the focus was on the defences of (i) statutory illegality and (ii) public policy. The SCA stated that the issue as to whether a business rescue practitioner could earn a success fee beyond the limitations of section 143 of the Companies Act constituted an important question of public policy and was therefore a compelling reason for the appeal to be entertained.

Proceedings before the SCA

Caratco's arguments

Caratco pleaded that a business rescue practitioner is not entitled to earn a special fee from a third party in consequence of acting as the business rescue practitioner, such special fee not being one in terms of section 143 of the Companies Act. It further pleaded that properly construed, section 143 of the Companies Act is the only means by which a practitioner can be remunerated for his/her services in business rescue proceedings, and as such, any fees agreed upon, outside of the provisions stipulated in terms of section 143 of the Companies Act, are implicitly prohibited. In light of the aforementioned, Caratco stated that the court should declare the Agreement void in terms of section 218 of the Act.

Can a business rescue practitioner be paid a "*success fee*" outside the confines of section 143 of the Companies Act? *...continued*

As alluded to above, Caratco further pleaded that if it was found that the Agreement was not illegal, the Agreement was contrary to public policy. Caratco argued that the Agreement was contrary to public policy on the following grounds:

(a) Firstly, it said that the Practitioners 'subverted the democratic vote of the majority of creditors' by claiming the debt was due in terms of section 143 of the Companies Act, when it was not. Caratco submitted that the effect hereof was that the other creditors of Galaxy could have secured a greater dividend for themselves than the amount they received. Considering the aforementioned, Caratco argued that the conclusion of the Agreement between the Practitioners and Caratco (which was also a creditor of Galaxy), without disclosure to the other creditors of Galaxy, was inimical to the legislative purposes of the Companies Act.

(b) Secondly, Caratco argued that because business rescue practitioners have a duty of impartiality and independence towards the company under business rescue, an agreement for payment of a success fee with a single creditor, without seeking the approval of the general body of creditors, offended this duty. In support of its aforementioned argument, Caratco noted that a creditor with whom such an agreement is concluded, would be 'captured' by the business rescue practitioner and secure its own interests outside of the general body of creditors.

SCA's judgment

(i) Section 143 of the Companies Act

In its judgment, the SCA noted that section 143 of the Companies Act regulates the remuneration of business rescue practitioners by the company under business rescue and says nothing about any other fee arrangements between a business rescue practitioner and a third party, such as the success fee agreement relevant to this matter. In light of the aforementioned, the SCA stated that the scope of section 143 of the Companies Act does not apply to the Agreement.

The SCA also stated that section 143 of the Companies Act contains no language entitling a court to the draw the conclusion that any agreement not falling within its ambit, is void.

(ii) Section 218 of the Companies Act

The SCA stated that Caratco did not specifically refer to the subsection of section 218 of the Companies Act on which it wished to rely in order for the Agreement to be declared void.

However, the SCA also stated that it seemed that Caratco envisioned section 218(1) for this purpose. Section 218(1) of the Companies Act provides that a court may declare an agreement void if it is 'prohibited, void, voidable or may be declared unlawful'.

The SCA held that since there was no substance to Caratco's illegality complaints, it was unnecessary to consider the court's power to declare an agreement contrary to the provisions of the Companies Act and therefore void in terms of section 218(1).

(iii) Public Policy

The SCA held that Caratco's submissions regarding the Agreement being against public policy (as set out above) were without any merit. The SCA noted that the evidence revealed that the Practitioners had included the success fee in the draft business rescue plan, which was initially prepared, to be voted on in terms of section 143(4) of the Companies Act. However, Caratco's attorneys requested it to be removed so that it could be dealt with in a separate agreement with another company in the Galaxy Group. The SCA held that there was therefore no factual basis for the suggestion that the Practitioners were subverting the democratic vote of the creditors by agreeing to delete the success fee at Caratco's attorney's request.

The SCA further held that there was no prejudice to any creditor of Galaxy, since one of the Practitioners had testified (which evidence remained unchallenged) that the success fee had no financial impact on creditors, since it was an additional amount that Caratco had undertaken to pay. The success fee that was to be paid by Caratco was not earmarked for the creditors and if they were dissatisfied with their dividend, they would have voted against it, but they did not.

Lastly, the SCA noted that Caratco did not contend that the success fee that it freely negotiated with the Practitioners was unjust, inequitable or egregiously unreasonable as envisaged in section 143(4) of the Companies Act. Hence, the SCA held that Caratco's public policy defence was also without merit.

Conclusion

The SCA has made it clear in this judgment that it is not illegal or in contravention of the Companies Act for a business rescue practitioner to be paid a success fee by a third party outside the confines of section 143 of the Companies Act. However, business rescue practitioners should be aware that the SCA's findings regarding whether the Agreement in this case was against public policy, was case specific. It could very well be that in the future, under different circumstances, the courts find that a success fee agreement between a business rescue practitioner and a third party creditor is against public policy (e.g. where the success fee has a direct impact on the dividends to be paid to other creditors, or where it is clear that the third party creditor is trying to unduly influence the business rescue practitioner's decisions).

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