DISPUTE RESOLUTION

BUSINESS RESCUE, RESTRUCTURING & INSOLVENCY NEWSLETTER

Volume 22 | 12 August 2021

CLIFFE DEKKER HOFMEYR

INCORPORATING
KIETI LAW LLP, KENYA

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Business Rescue, Restructuring & Insolvency

We have officially entered the last third of 2021 – a time where lockdown restrictions have decreased, vaccinations have increased, and our Constitutional Democracy remains intact and supreme. While we have learnt to not hold our breath in the hopes that our now 504-day-long lockdown will come to an abrupt end, and the economy will suddenly take after the Roaring Twenties by ascending into a rapid boom, we do remain grateful for our small victories. For example, we are again allowed to support the hospitality industry by enjoying a glass of wine over dinner at our favourite restaurants.

While our circumstances may not be entirely ideal yet, the process of rebuilding requires us to stay cognizant of the few silver linings and the accompanying opportunities that have presented themselves amidst all the uncertainty and adversity. In the spirit of focusing on the silver linings, in this month's newsletter we have decided to explore the new distressed asset investment opportunities that have been created as a result of the synergistic relationship which has developed between the business rescue process and the world of mergers and acquisitions (M&A). We consider how the legislative benefits provided for in the business rescue process have stimulated the growth of a relatively new distressed asset-based market in South Africa. Having observed a noticeable increase in the number of investors acquiring distressed assets of good value by taking advantage of the commercial opportunities presented by the business rescue process, we believe that distressed M&A opportunities are something which we would all be wise to keep an eye on in the upcoming months.

As we have also noticed a few hasty liquidation applications, we have included an article which sets out the legal consequences to be considered by a company prior to *"pulling the trigger"* by deciding to liquidate.

Turning to current affairs in the world of business rescue and insolvency, news hot off the press is that Mango Airlines has officially been placed under voluntary business rescue. This development seems to have ended the ongoing tussle between the distressed airline's directors and three trade unions (Mango Pilots Association, the South African Cabin Crew Association

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and the National Union of Metalworkers of South Africa) over *"who got there first"* in terms of placing the airline under rescue. Practically, this means that the airline now has a bigger say in determining who will be appointed as its business rescue practitioner, which has left a bitter taste in the trade unions' mouths.

In other news, and in keeping with our focus on distressed asset M&A, the business rescue of the chrome and alloys specialist Afarak Mogale was recently successfully concluded upon the acquiring of Mogale's shares and business by Bright Minerals, at a price tag of approximately R300 million. The conclusion of the transaction has paved the way for Mogale's furnaces to soon be returned to full operation.

Although the silver linings may seem few and far between, August has certainly brought some along with it. So, while it is easy to get lost in our challenges, we urge you to instead focus on keeping an eye out for the multitude of opportunities that are constantly emerging from our *"new normal"*. Had investors failed to do so, we would not have had numerous distressed companies being rescued through the innovative use of the business rescue process in the world of M&A. Should you need help with identifying these opportunities, please know that the CDH Business Rescue, Restructuring & Insolvency Sector is always here to assist.

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BUSINESS RESCUE, RESTRUCTURING & INSOLVENCY
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From growth to survival, and back again: A brief guide to distressed M&A during business rescue proceedings

Historically, when it came to mergers and acquisitions (M&A), the art of the deal was painted with a positive brush. Growth, through the effective identification of opportunity, was always the focus. However, in today's world, beset by economic crises as a result of COVID-19, the true art of the business deal has shifted to focusing less on growth and more on survival. Notwithstanding this shift, the ability to timeously identify and effectively capitalize on novel opportunities, which are presenting themselves as a result of an ever-changing market, has become more important than ever before. Dealmakers armed with this ability are primed to, almost paradoxically, still achieve unprecedented levels of growth (even during unprecedented levels of adversity).

The business rescue and restructuring landscape has provided a fertile playground for dealmakers that are looking to create growth in an economy seeking to survive. It has resulted in the creation of numerous opportunities to acquire good value assets at significantly discounted prices. So, while many investors have focused on companies that proved COVID-resilient by remaining profitable since the advent of the pandemic, others are increasingly starting to take the path less travelled by opting to invest in companies which have gone into distress. These investors are managing to achieve the creation of value in a declining economy by taking advantage of the benefits provided by our business rescue process in the M&A space.

Considering the rarity of opportunities for business growth in the current economic climate, we are unsurprisingly starting to observe a steady increase in M&A activity in what has come to be known as the distressed asset-based market. In light of these developments, we thought it would be prudent to consider some of the frequently asked questions arising in relation to distressed investment opportunities.

How does business rescue create a beneficial environment for M&A?

In order to understand how business rescue has resulted in the growth of M&A transactions dealing with a new distressed asset class, it is important to first have a brief understanding of what the business rescue process entails.

Business rescue is a legal mechanism which is available to a company which is financially distressed. Where there is a reasonable prospect of rescuing the distressed company, meaning that there is either a reasonable prospect of returning the company to a solvent enterprise or placing it under business rescue would result in its creditors receiving more than they otherwise would have, had the company been immediately liquidated, then it can be placed under business rescue either by the resolution of its board of directors or by court order.

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Once under business rescue, the responsibility for the governance of the company is essentially handed over to a business rescue practitioner (BRP). The BRP is responsible for drafting, proposing and implementing the distressed company's business rescue plan (the plan), in terms of which the company's affairs is to be restructured in order to achieve its rescue. The plan will likely provide for, amongst other things:

- the restructuring of the company's debt, as its creditors are generally asked to compromise the value of their claims;
- the provision of post-commencement funding (PCF), which is funding provided after the company has been placed under rescue for the purpose of paying its ongoing expenses during the rescue process; and
- the sale of certain of the company's assets and/or debt.

Essentially, the plan is then adopted and becomes binding when it has been approved by the majority of the distressed company's creditors.

A few additional legal consequences to business rescue, which assist in facilitating deal flows, are that:

- a moratorium on the continuation or instituting of any legal proceedings, including enforcement action, against the distressed company is established;
- unencumbered assets owned by the company can be used as security to obtain refinancing; and
- contracts of the company may be cancelled, or the company's obligations may in certain circumstances be entirely, partially or conditionally suspended by the BRP.

These consequences provide a glimpse into how the business rescue legal framework creates a supportive environment in which a purchaser can obtain a good value asset on favourable terms. For example, the purchaser is given the space to negotiate the terms of the proposed transaction without having to concern itself with pending or potential litigation and onerous contracts may be cancelled or renegotiated.

Having broadly covered what business rescue process and distressed asset-based M&A entails, we now turn to discussing some of the specific factors and benefits to be considered in order to perfect the "*art of the deal*" when it comes to distressed asset-based M&A.

What is the importance of PCF in distressed asset-based M&A?

The provision of PCF comes with various legislated benefits which create commercial opportunities for investors looking at distressed assets. Accordingly, in order to be able to effectively identify and capitalize on distressed investment opportunities, it is important to properly understand how this mechanism works in the business rescue process.

As mentioned, PCF is funding provided to a distressed company by a third party subsequent to the commencement of the business rescue process, and serves the purpose of keeping the distressed company afloat for the duration of its business rescue by enabling it to meet its ongoing expenses.

The provision of PCF is often essential for the distressed company to be successfully rescued. In the absence of PCF, a distressed company would almost certainly be fated for liquidation as it would otherwise not have a reasonable prospect of being rescued. In other words, it will not be possible to justify placing the distressed company under business rescue on the basis that there is a reasonable prospect of rescuing it, because it would not even be able to meet its minimum costs during the life of its business rescue.

PCF accordingly provides a purchaser seeking to acquire a distressed asset on favorable terms with a metaphorical foot in the door, as it enables both the purchaser and the company under rescue with the opportunity to capitalize on the commercial opportunities presented by the benefits of consummating a deal during business rescue. This is because the PCF enables the distressed company to go into business rescue by satisfying the legal requirement that there be a reasonable prospect of its rescue, which then consequently enables the purchaser to later emerge from the rescue as the owner of the distressed asset.

To address any qualms which may arise from the idea of providing money to an ostensibly failing company, investors should also note that there are certain protections afforded to them. Firstly, they can require that the PCF be secured by obtaining security over any of the distressed company's unencumbered assets. Secondly, the Companies Act 71 of 2008 (Companies Act) also confers providers of PCF with a preference in the order of repayment of the company's creditors. In other words, the Companies Act and the business rescue plan will essentially provide that PCF providers' claims for repayment will be paid before that of unsecured pre-business rescue creditors.

In addition to meeting the company under rescue's short- to medium-term funding requirements, PCF can also be cleverly used by an acquiror to achieve their own long-term goals. For example, we have seen that some private equity players have extended PCF as collateralised debt during the lifetime of a company's rescue, which they then convert into equity once the company emerges from business rescue.

What are the other ways in which debt for equity transactions can be used for both the benefit of the company under distress and potential acquirors?

Recognising that the immediate liquidation of a distressed company could result in receiving a lower return than if the company were rescued, creditors have also opted to enter into debt for equity transactions. These transactions entail the distressed company's creditors agreeing to convert their creditor

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claims against the distressed company (i.e. the debt owed to them) for equity in the distressed company.

By essentially causing a seismic shift in the balance of the distressed company's accounting books, these conversions make it possible for both the distressed company to be rescued and for its creditors to receive a good value return in the long term.

These sorts of transactions are ideal where creditors identify that a distressed company holds real long-term value should it be returned to profitability, but all other efforts to rescue it are proving unsuccessful. For example, the BRP may be having difficulty in obtaining PCF or selling off some of the company's non-core assets, making the likelihood of rescuing the company low. In such circumstances, the debt for equity conversion may just be that extra push which the distressed company needs in order to be successfully rescued. The debt for equity swap also creates the possibility of further improving the distressed company's equity standing, as it will become more attractive to potential investors as a result of becoming a viable trading entity.

When implemented correctly, debt for equity conversions during business rescue can result in a win-win situation as the company is given the lifeline it needed in order to survive and return to profitability, and its erstwhile creditors (now shareholders) have generated greater value for themselves as the value of their equity stakes would be greater than the dividend which they would have received in a liquidation scenario.

Creditors of distressed companies should accordingly not be too quick to write these companies off, but should rather be alive to these options and maintain a keen eye for distressed investment opportunities. As the saying goes, "*one man's trash is another man's treasure*".

Are there benefits to buying the business of a company under distress as a going concern during business rescue?

In addition to the legislated benefits to concluding a transaction during business rescue, there is one benefit pertaining to transactions where the company under distress disposes of its business as a going concern which requires mentioning.

Section 112 of the Companies Act provides that the shareholders of a company which is disposing of the whole or a greater part of its assets or undertaking must adopt a special resolution, and goes on to provide a list of onerous and somewhat ambiguous requirements to be met by the resolution in order for it to be valid. The resolution itself is also then required to authorise the specific transaction. However, there remains uncertainty as to what level of specificity is actually required in order for the resolution to stand, notwithstanding the fact that it may have been passed at a duly convened meeting.

Time and other practical constraints pose a risk of invalidating such resolution, with the result that the transaction may also become invalidated. However, section 112(1)(a) of the Companies Act exempts a company under business rescue from these requirements, and thereby stimulates a sale of assets for a company under rescue by providing greater ease for all.

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Conclusion

The legislative provisions of Chapter 6 of the Companies Act have provided benefits to parties conducting M&A transactions with companies under business rescue. These benefits have further created a wealth of distressed investment opportunities, as the business rescue process has created an entirely new asset class for investors to pay attention to.

To successfully capitalize on these opportunities, at a minimum it is required that there be an early identification of a distressed asset, the ability to fund the acquisition, as well as an ability and inclination towards assisting the company through rescue by providing PCF. However, from what has been discussed in this article, it is clear that there are a variety of ways in which one can go about capitalizing on these distressed investment opportunities, as well as a variety of considerations, both legal and commercial, which have to be borne in mind when doing so.

Although exciting, investing in distressed assets does pose a level of risk which demands a specific skillset to successfully address. Having the right advisors, with the necessary experience, is vital to successfully identify and capitalize on distressed investment opportunities.

The CDH Business Rescue, Restructuring and Insolvency Sector looks forward to further engaging in this developing investor landscape, as well as to continuing to assist our clients in being at the forefront of successfully acting on the unique distressed investment opportunities which are starting to present themselves with more frequency.

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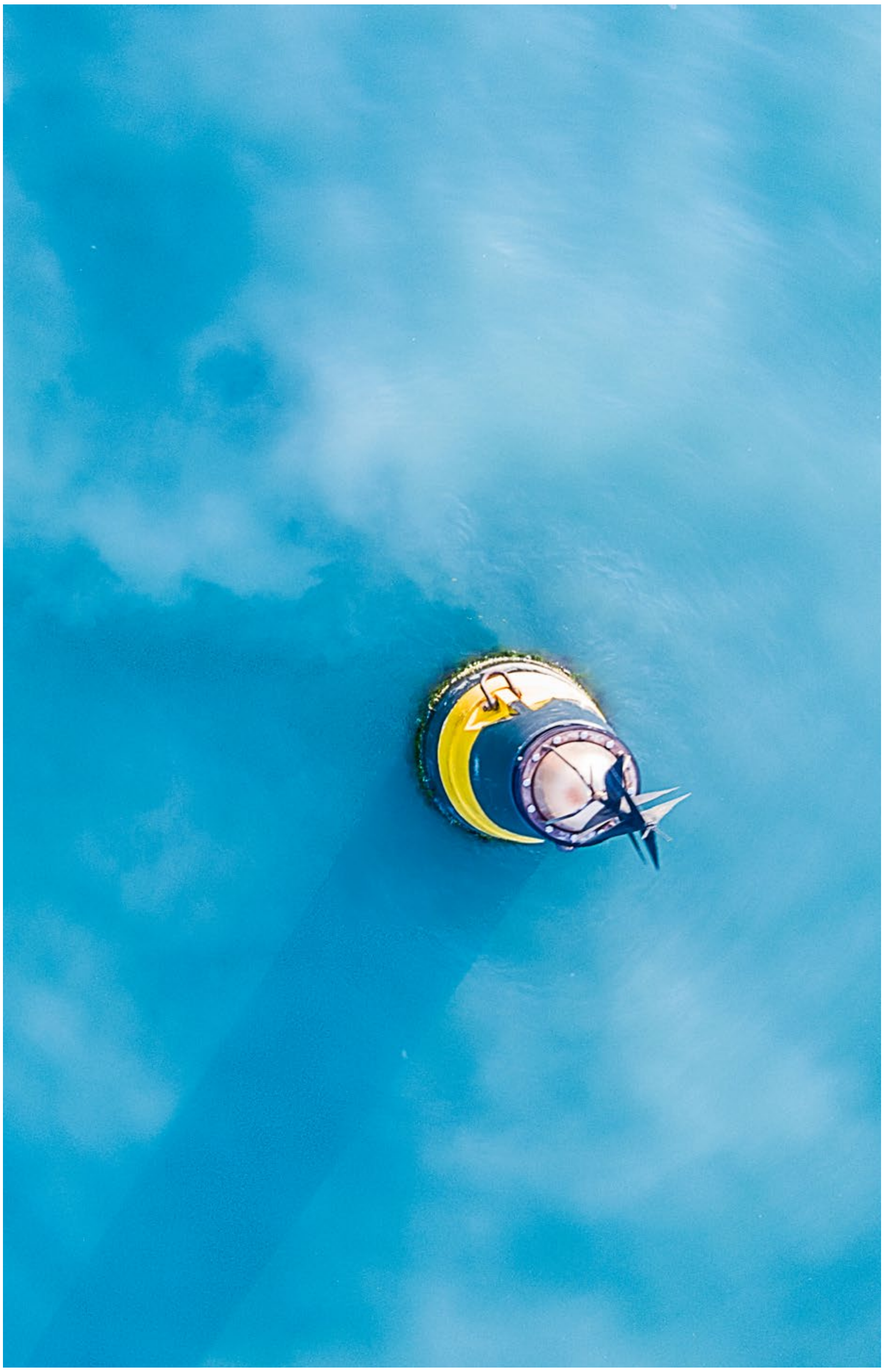

Beware the consequences of liquidation

The current economic climate has no doubt led to many shareholders or directors meetings in which shareholders and directors are at a crossroad: should the company continue as is, downscale, or go into business rescue or liquidation. Similarly, creditors are considering pulling the trigger by launching a liquidation application against that recalcitrant debtor. Before choosing liquidation, one should be aware of the consequences.

Firstly, the powers of directors cease once the company goes into liquidation. The liquidator steps into the directors' shoes, and the directors have no legal power to represent the company. The company's suppliers and service providers must deal with the liquidator – not the directors. Customers and debtors must speak to the liquidator regarding any outstanding payments, contracts and deliveries.

Secondly, assets of the company may not be sold or transferred without the permission of the liquidator. Once the company goes into liquidation, "*the hand of the law is laid upon the estate*" of the company. All the company's cash must be transferred into an estate bank account, which is opened and managed by the liquidator. The financial director may not select suppliers to be quickly paid before a liquidator is appointed. Such payments would be unlawful.

Beware the consequences of liquidation...*continued*

Thirdly, the business operations may not continue except to the extent that it is necessary for the beneficial winding up of the company. This is a decision that is made by the liquidator, having regard to the interests of all creditors of the company (as opposed to the interests of shareholders). This may entail the liquidator conducting a commercial assessment of the company and its business operations, and deciding to shut down some or all of the company's operations.

Importantly, even though the company remains the owner of its assets, the custody and control of those assets vest in the Master of the High Court and then later in the liquidator. This applies regardless of the prestige, or commercial or sentimental value of an asset. In *South African Reserve Bank v Leathern* (854/2020) [2021] ZA (SCA) 102 (20 July 2021), the Supreme Court of Appeal emphasised the principle that it is only those assets which belong to the company which vest in the liquidator. Assets which may be in the possession of the company but belonging to a third party, or assets in respect of which the company has control but which do not belong to the company, do not vest in the liquidator.

Practically, one of the first things that liquidators do upon assuming office is to immediately take control of all assets of the company. If the assets are situated in different parts of the country, a prudent liquidator will authorise an individual or two to travel to where the assets are situated to take control of them. If necessary, the assets may be placed in storage pending a sale on auction or by private treaty.

Regardless of the commercial rationale behind a decision to place a company in liquidation, creditors, shareholders and directors must be aware of the consequences. The liquidator, not the directors, is in control and makes decisions in relation to almost every aspect of the company – having regard to what is in the interests of all creditors – not the liquidating creditor.

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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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