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The Suitability of South Africa's Business Rescue Procedure in the Reorganization of Small-to-Medium-Sized Enterprises: Lessons from Chapter 11 of the United States Bankruptcy Code.

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THE SUITABILITY OF SOUTH AFRICA’S BUSINESS RESCUE PROCEDURE IN THE REORGANIZATION OF SMALL- TO MEDIUM-SIZED ENTERPRISES: LESSONS FROM CHAPTER 11 OF THE UNITED STATES BANKRUPTCY CODE

*Mikovhe Maphiri**

South African small- to medium-sized enterprises (“SMEs”) are the bread and butter of our economy. Providing much-needed employment and developing the skills of historically disadvantaged persons formally and informally are some of the most significant benefits of SMEs in a developing country such as South Africa. However, despite these significant contributions to the socio-economic development of the country, SMEs generally have the lowest survival rates in the world as compared to large enterprises globally, resulting in high rates of business failure and the loss of jobs which these entities create. The Companies Act of 2008 replaces the previous judicial management corporate reorganization procedure for companies in South Africa with the new business rescue model and a compromise between a company and its creditors. Business rescue provides companies in financial distress with the opportunity to reorganize, strategize, and devise reorganization measures that are useful, efficient, and capable of yielding a better return for creditors than liquidation. This Comment comparatively analyzes whether the South African corporate rescue systems, past and present, have developed in line with the needs and interests of South African SMEs in a manner that is efficient and sensitive to the inherent weakness of our economy and the distinctive needs of SMEs in a developing country such as South Africa.

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INTRODUCTION

In developing countries, there is a consensus among policymakers, economists, and business experts that SMEs drive economic growth and development.¹ A developing country such as South Africa requires a healthy SME sector that will contribute to the economy by generating employment opportunities, increasing productivity, promoting entrepreneurial skills, and breeding more import and export opportunities for South Africans.² It is imperative that South Africa promotes an environment that will allow SMEs to grow, and in doing so, alleviates poverty and addresses the dynamics of socio-economic inequality leftover from the apartheid regime.³ SMEs therefore serve as a catalyst through

1. UNDERHILL CORP. SOLUTIONS, LITERATURE REVIEW ON SMALL AND MEDIUM ENTERPRISES' ACCESS TO CREDIT AND SUPPORT IN SOUTH AFRICA 7 (2011) (prepared for South Africa's National Credit Regulator ("NCR")), http://www.ncr.org.za/pdfs/Research_Reports/Literature%20Review%20on%20SME%20Access%20to%20Credit%20in%20South%20Africa_Final%20Report_NCR_Dec%202011.pdf [hereinafter LITERATURE REVIEW].

2. *Id.*

3. South Africa's previous apartheid regime passed laws that segregated groups of people based on race and skin color. After the National Party won the South African parliamentary election of 1948, its President instituted apartheid by way of legislation. For example, the Immigrants Regulation Act No. 22 of 1913 excluded persons not literate in a European language and other so-called "undesirables" from the country. In some cases, apartheid legislation split families; parents could be classified as white while their children were classified as colored. This racial divide severely limited economic opportunities for historically disadvantaged groups, leading to high rates of income inequality and poverty. The harmful effects of apartheid linger in present-day South Africa. *See gener-*

which the socio-economic goals of developing countries are to be achieved.⁴ However, despite the herculean role that SMEs play in developing economies, SMEs in South Africa have the lowest survival rate in the world and often operate in financial distress.⁵

This Comment focuses on business rescue as a corporate reorganization procedure for South African SMEs. Part II discusses the role of SMEs in the South African economy. Parts III and IV address the development of South African bankruptcy law. Part IV offers a comparative analysis of the system codified in Chapter 11 of the United States Bankruptcy Code. Both laws facilitate corporate reorganization procedures for enterprises of all sizes, including SMEs. This Comment will ultimately offer a series of recommendations for policy-makers in South Africa.

I. THE ROLE OF SMEs IN DEVELOPING COUNTRIES: A PLATFORM FOR SOCIO-ECONOMIC DEVELOPMENT

A. The Definition and Role of SMEs in Developing Countries

While the existence, power, and influence of SMEs is internationally acknowledged by policy makers and business experts, there is no uniform definition of an SME.⁶ Most countries adopt either an economic or statistical definition of the SME unique to their own legal and economic structure.⁷ An economic definition of an SME will consider, among other factors, the annual turnover of the company, the company's net worth and the company's profitability.⁸ Alternatively, a statistical definition will measure the SME sector based on the size of the workforce within the company.⁹

In developing countries, SMEs are mostly characterized as single-owner business, in which the working staff can be family members who are often unpaid directors active in the management and overall administration of the enter-

ally Michael R. Carter & Julian May, *One Kind of Freedom: Poverty Dynamics in Post-Apartheid South Africa* 29 WORLD DEV. 1987 (2001).

4. See LITERATURE REVIEW, *supra* note 1. The new democratic regime in South Africa introduced a progressive constitution which identified the socio-economic goals of South Africa. REPUBLIC OF S. AFR., COUNTRY REPORT 2013 11 (2013), http://www.za.undp.org/content/dam/south_africa/docs/Reports/The_Report/MDG_October-2013.pdf (outlining the eight socio-economic goals for South Africa: (1) to eradicate extreme poverty and hunger, (2) to promote universal primary education, (3) to promote gender equality and empower women, (4) to reduce child mortality, (5) to improve maternal health, (6) to combat HIV/AIDS, malaria, and other diseases, (7) to ensure environmental sustainability, and (8) to develop a global partnership for the development).

5. LITERATURE REVIEW, *supra* note 1, at 15.

6. *Id.* at 22.

7. *See id.*

8. *See id.*

9. *See id.*

prise.¹⁰ Developing African countries have identified SMEs as enterprises that are more labor-intensive than larger firms with lower capital costs.¹¹ For example, Ghana, a developing country, has adopted its own unique definition by using statistical factors to define the SME sector within its own economic system.¹² In Ghana, the underlying criterion used in defining the SME sector has been the employee component of the enterprise.¹³ Ghana distinctly defines SMEs as companies with fewer than 10 employees, or medium-sized companies with more than 10 employees.¹⁴ In another example, Malawi, also a developing country, defines its SME sector based on levels of capital investments, employees, and the total annual turnover of the company.¹⁵ In the United States, the definition of an SME varies by industry and the number of workers, and the value and number of assets that the SME enterprise has informs the size of the SME enterprise.¹⁶ For example, in the manufacturing industry, an SME is deemed to have 500 employees or fewer, and in the wholesale trade industry, an SME has fewer than 100 employees.¹⁷

In South Africa, the issue of what constitutes an SME is correspondingly a matter of debate by economists, entrepreneurs, and business law writers.¹⁸ Chapter 1 of the National Small Business Act of 1996 provides a statutory definition of ‘small business,’ which has been used for academic purposes as an inclusive definition for SMEs in South Africa.¹⁹ The National Small Business Act defines ‘small business’ as:

[A] separate and distinct business entity, including cooperative enterprises and non-governmental organi[z]ations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub-sector of the economy mentioned in column 1 of the Schedule and which can be classified as a micro-, a very small, a small or a medium enterprise by satisfying the criteria mentioned in columns 3, 4 and 5 of the Schedule.²⁰

In practice this definition has been interpreted broadly enough by State Small Enterprise Development Agencies (“SEDA”)²¹ to include both SMEs and

10. See Joshua Abor & Peter Quartey, *Issues in SME Development in Ghana and South Africa*, 39 INT’L RES. J. FIN. & ECON. 218, 222 (2010).

11. See *id.*

12. See *id.* at 222–23.

13. LITERATURE REVIEW, *supra* note 1, at 89.

14. *Id.* at 89–90.

15. *Id.* at 90.

16. See generally Susan Ward, *SME Definition (Small to Medium Enterprise)*, BALANCE (Nov. 22, 2018), <https://www.thebalance.com/sme-small-to-medium-enterprise-definition-2947962> (reviewing the definitions of SMEs in various developed and developing economies).

17. See *id.*

18. See LITERATURE REVIEW, *supra* note 1, at 24.

19. National Small Business Act 102 of 1996 (S. Afr.).

20. *Id.* at Ch. I.

21. SEDA is a small enterprise development agency in South Africa established under the National Small Businesses Amendment Act 29 of 2004. SEDA’s mission is to develop, support,

Small Micro Medium Enterprises (“SMMEs”) as “small businesses for the purposes of the Act.”²² The National Small Business Act’s reference to SMEs is important for the purposes of this Comment in determining whether these businesses can achieve the benefits of business rescue under Chapter 6 of the Companies Act of 2008. This Comment restricts the definition of SME to companies registered under the Companies Act of 2008 that qualify as a small business under Chapter 1 of the National Small Business Act.²³

It is imperative to note at the earliest stage of this Comment the significant contributions the SME sector has made in South Africa. It is a well-known fact that various aspects of South African society have undergone transformation since the first non-racial democratic elections were held on April 27, 1994.²⁴ The elections transformed South Africa’s socio-political structure, including the reformation of old apartheid laws which discriminated against people of color in both the social and economic sectors.²⁵ This transformation was facilitated by the introduction of the new Constitution of the Republic of South Africa.²⁶ The Constitution aims to protect and maintain democracy by promoting human dignity, equality, and freedom of all persons in all sectors, including the business world.²⁷ For that reason, one purpose of the Companies Act of 2008 is the promotion of and compliance with the Constitution’s Bill of Rights in relation to companies doing business in South Africa.²⁸

SMEs are required to function within the facets of socio-economic transformation, as they are expected to assist in the social and economic transition of the people of South Africa by improving overall quality of life and providing much-needed value and growth of the economy.²⁹ This is of absolute im-

and promote small businesses throughout South Africa in coordination with various groups, including global partners who assist local entrepreneurs. *See generally* THE SMALL ENTERPRISE DEVELOPMENT AGENCY, <http://www.seda.org.za/> (last visited Nov. 28, 2018).

22. National Small Business Act 102 of 1996 (S. Afr.).

23. *Id.* at Ch. I.

24. L.P. Kruger, *The Impact of Black Economic Empowerment (BEE) on South African Businesses: Focusing on Ten Dimensions of Business Performance*, 15 S. AFR. BUS. REV. 207, 207 (2011). The reformation process in South Africa further included the introduction of the Broad-Based Black Economic Empowerment (“BBBEE”) strategies and programs. *Id.* at 208. BBBEE strategies aim to provide corporate opportunities to historically disadvantaged persons and redress the effects of past political injustices by broadening the economic participation of the black majority. *Id.* at 209. For this reason, SMEs have been and are still used as engines to drive economic reform in South Africa, and to empower historically disadvantaged persons, as advised by the Constitution of the Republic of South Africa. Furthermore, SMEs are used as implementation tools for BBBEE strategies which aim at facilitating corporate reform in South Africa by addressing unemployment and poverty challenges which remain under-addressed in South Africa to this day.

25. *Id.* at 208.

26. S. AFR. CONST., 1996.

27. *See id.*

28. Companies Act 71 of 2008, § 7(a) (S. Afr.).

29. *See* Anna Kesper, *Failing or Not Aiming to Grow? Manufacturing SMMEs and Their Contribution to Employment Growth in South Africa*, 12 URB. F. 171, 175 (2001).

portance because the South African economy is currently characterized by high levels of unemployment along with low levels of both productivity and international competitiveness of SME companies.³⁰

However, notwithstanding these challenges to economic growth in South Africa, research shows that the formal sector continues to shed jobs and decrease its employment absorption rate in the midst of economic and business distress.³¹ There is, therefore, a need to create an optimal environment for entrepreneurship by developing and cultivating the individual business skills of historically disadvantaged persons and unemployed graduates in South Africa.³² In other words, the development, promotion, and protection of SMEs must be cultivated as a useful method for eradicating poverty and promoting growth, which is vital in achieving long-term economic sustainability and development in South Africa.³³ Scholars and economists perceive SMEs as entities that are critical in moving the socio-economic development trajectory in South Africa from poverty to prosperity. As discussed above, SMEs play a crucial role in the South African economy, providing much-needed employment, experience, and income to stakeholders, thereby making an immense contribution to the country's Gross Domestic Product ("GDP").³⁴ It is in response to this reality that Trevor Manuel, in his capacity as then Minister of Trade and Industry, explained:

Throughout the world one finds that SMMEs are playing a critical role in absorbing labo[u]r, penetrating new markets and generally expanding economies in creative and innovative ways. We are of the view that—with the appropriate enabling environment—SMMEs in this country can follow these examples and make an indelible mark on this economy.³⁵

This explains why, 24 years later, SMEs are still of crucial importance to the economy. This is evidenced by the fact that in 2014 alone SMEs contributed up to 52 and 57 percent of South Africa's GDP and absorbed up to 80 percent of the national labor force.³⁶

30. *Id.*

31. *Id.*

32. There has been an increase in the number of unemployed graduates in South Africa. Studies show that this unemployment is primarily embedded in historically disadvantaged communities. See generally Kim Baldry, *Graduate Unemployment in South Africa: Social Inequality Reproduced*, 29 J. EDUC. & WORK 788 (2014). As a result, graduates in South Africa engage in entrepreneurship through SMEs to alleviate poverty and unemployment. *Id.*

33. See Kesper, *supra* note 29, at 175.

34. LITERATURE REVIEW, *supra* note 1, at 7.

35. DEP'T OF TRADE AND INDUS., THE WHITE PAPER ON NATIONAL STRATEGY AND PROMOTION OF SMALL BUSINESSES IN SOUTH AFRICA (1995), https://www.thedti.gov.za/sme_development/docs/White_paper.pdf.

36. LITERATURE REVIEW, *supra* note 1, at 7.

B. *The Failure Rate of SMEs in South Africa*

Despite the significance of SME companies to the economy, SMEs around the world, particularly in South Africa, are faced with numerous challenges that impede their growth.³⁷ In the early 2000s, it was found that between 70 and 80 percent of all South African SMEs fail within their first five years of incorporation; in fact, the failure rate of South African SMEs has been described by researchers as one of the worst in the world.³⁸

Three common attributes account for the low survival rate of SMEs in South Africa. First, financing: SMEs are typically financed through private family wealth or bank loans. They do not have the capacity to fundraise their financing by issuing share capital to the general public like larger entities.³⁹ SMEs are often undercapitalized entities;⁴⁰ they do not have adequate immovable and valuable movable property to offer as security to financial institutions when in need of financing.⁴¹ Second, access to skilled labor, or lack thereof, plays an important role in determining the success of a company and improving the strategy of companies in any industry.⁴² In developing countries, SMEs are usually family-owned enterprises.⁴³ They are formed by family members with the intention of improving their financial circumstances and possibly breaking long chains of generational poverty.⁴⁴ The bonds inherent in such family relations can contribute to the failure of such SMEs because important financial decisions are made without implementing business analytical strategies or enforcing good corporate governance strategies.⁴⁵ This is due to the fact that family relationships are culturally and religiously based on strong emotional ties.⁴⁶ Thus business decisions, which are meant to be made independently and with sound mind and reasoning, are made emotionally based on long-term trust among family members.⁴⁷ Finally, there is no major separation between ownership and control in SMEs: the managers of the company are in many cases the

37. *Id.*

38. *Id.* at 20. Although SME business activity constitutes approximately 40% of South Africa's total GDP, this figure is relatively small compared to other developing countries such as China (60%) and Brazil (59%). See generally Fatoki Olawale & Van Aardt Smit, *Business Environmental Influences on the Availability of Debt to New SMEs in South Africa*, 4 AFR. J. BUS. MGMT. 1778, 1778–1779 (2010).

39. DAVID MILMAN, GOVERNANCE OF DISTRESSED FIRMS: CORPORATIONS, GLOBALISATION AND THE LAW 35 (2013).

40. *Id.*

41. See LITERATURE REVIEW, *supra* note 1, at 35.

42. See generally Abor & Quartey, *supra* note 10, (arguing that the lack of management skills as well as the lack of finance to acquire management skills leads to the failure of SME companies).

43. MILMAN, *supra* note 39, at 36.

44. See *id.* at 35–36.

45. See *id.*

46. See *id.* at 36.

47. See *id.*

majority and controlling share shareholders of the enterprise, and they have all the voting rights and often make company decisions at their own discretion with no special resolutions.⁴⁸ This leads to an abuse of power by SME directors, as the separation of ownership and control within SMEs is not clearly distinguished. These characteristics ultimately lead to the financial distress of SMEs in South Africa. This weakness is unique in the South African case because of the country's socio-political history of apartheid. From an economic perspective, the apartheid regime in South Africa primarily excluded the economic participation of historically disadvantaged persons from mainstream business participation and executive management positions. The economic exclusion of historically disadvantaged persons by the apartheid government influenced the deficiency of astute business skills in most SMEs owned by historically disadvantaged persons as the apartheid laws and education aimed at excluding the black majority from engaging in mainstream business activities and education which are crucial in installing the business skills that most SMEs need to be profitable in the long run. This process therefore cuts short the ability of SMEs to contribute positively to the economy and limits the achievement of socio-economic objectives and poverty reduction. However, recourse for SMEs in financial distress can be pursued through the business rescue model. The question now becomes whether SMEs in financial distress can devise successful reorganization strategies through a Chapter 6 business rescue procedure under the Companies Act of 2008.

II. HISTORY OF CORPORATE REORGANIZATION IN SOUTH AFRICA

Over the last four decades, South Africa has made use of corporate reorganization strategies in the form of judicial management and business rescue. The Companies Act of 2008 entirely replaced judicial management as a corporate reorganization procedure in South Africa. The success and failure of these procedures in relation to SMEs is discussed below.

A. *Judicial Management Under the Companies Act of 1973*

South Africa was one of the first countries to introduce a judicial management corporate reorganization regime.⁴⁹ Judicial management was formally introduced by way of legislation in the South Africa's Companies Act of 1926.⁵⁰ At that particular time, the concept of judicial management was unfamiliar to any other comparable legal system.⁵¹ Judicial management was re-enacted in

48. *Id.*

49. Anneli Loubser, *Judicial Management as a Business Rescue Procedure in South African Corporate Law*, 16 S. AFR. MERCANTILE L.J. 137, 139 (2004).

50. *See id.* at 138. The academic debate on judicial management as a corporate rescue procedure in South Africa was not a highly pursued topic until the early 2000s. This was primarily influenced by the liquidation culture in most corporate entities.

51. *Id.*

the South Africa's Companies Act of 1973 in an attempt by South Africa to align itself with international trends and to follow developments of corporate reorganization in Great Britain.⁵² Judicial management as a corporate rescue procedure offered companies that were unable to pay their debts but wished to operate as a going concern two alternatives through which they could possibly restructure.⁵³ The purpose of judicial management, as set out in terms of Section 427 of the Companies Act 1973,⁵⁴ was primarily to restructure the distressed company. Coupled with this was the aim of determining whether there was a "reasonable probability"⁵⁵ that the company would be able to pay its debts or to meet its obligations and become a successful concern if it were placed under judicial management.⁵⁶ Moreover, given the circumstances, the re-enactment under the Companies Act 1973 was seen as a bona fide attempt by the legislature to remain relevant and progressive by borrowing from developments in Great Britain.

However promising in theory, judicial management has been labelled a 'spectacular and abject failure.'⁵⁷ This was due to the fact that it was rarely used and required a high threshold of proof: a 'reasonable probability' rather than a mere possibility that creditor claims would eventually be paid in full when an enterprise is placed under judicial management in the Companies Act 1973.⁵⁸ Scholars who have studied in this area argue that the judicial management made the process of restructuring more burdensome for enterprises trying to restructure under the provisions of Sections 427–440 of the Companies Act 1973. This was because judicial management relied heavily on court procedures which made the restructuring process more expensive, especially for small to medium enterprises.

Furthermore, Section 427 of the Companies Act 1973⁵⁹ did not set out in clear terms the categories of companies to which judicial management applied.⁶⁰ The use of the word "company" was vague and narrow, and it was not

52. See generally Tshepo H. Mongalo, *An Overview of Company Law Reform in South Africa: From the Guidelines to the Companies Act 2008*, 2010 ACTA JURIDICA xiii (2010); Loubser, *supra* note 49, at 138.

53. See Companies Act 61 of 1973 §§ 427–440 (S. Afr.); see also Anthony J. Smits, "Corporate Administration"—*A Proposed Model*, 32 DE JURE 80, 83 (1999).

54. Smits, *supra* note 53, at 85.

55. Companies Act 61 of 1973 §§ 427–40 (S. Afr.).

56. Loubser, *supra* note 49, at 141–42.

57. *Oakdene Square Properties Ltd. v. Farm Bothasfontein (Kyalami) Ltd.*, 2012 (3) SA 273 (GSJ), at 5.

58. Blessing Tselane, *The Requirements for Business Rescue Proceedings Under the Companies Act 71 of 2008 as Discussed in SWART v. Beagles Run Investments 25 (PTY) LTD (FOUR CREDITORS INTERVENING)* 2011 (5) SA 422 GNP (Oct. 2012) (unpublished L.L.B. dissertation, University of South Africa) (on file with author).

59. Companies Act 61 of 1973 (S. Afr.).

60. Anneli Loubser, *Some Comparative Aspects of Corporate Rescue in South African Company Law* (Feb. 2002) (unpublished L.D. dissertation) (on file with author) [hereinafter "Loubser Thesis"].

clear whether this would include all types of companies like public corporations and close corporation, for example.⁶¹ The question therefore arose whether the highly litigious and professionally dominated judicial management procedure under the Companies Act 1973 accommodated SMEs in financial distress in South Africa.

The Companies Act 1973 failed to acknowledge the significant contributions that SMEs in financial distress can provide to not only the socio-economic development of the country, but to the entire global economic community. This resulted in the lack of a seasoned corporate rescue regime sensitive to the needs and culture of the society in which it was seeded.⁶² Significantly, Rajak & Henning, in their analysis of business rescue for South Africa, recommend that South Africa have a dual corporate rescue regime.⁶³ Such a regime would cater to large, complex financial and industrial mainstream activity with a more robust and premium international standard. Conversely, it would also cater to smaller companies with a less sophisticated standard.⁶⁴ It is therefore important to acknowledge, as Rajak & Henning do, that South Africa recognizes the need to encourage the sustainable growth of SMEs and the successful restructuring of companies of all sizes.⁶⁵ In view of its extensive shortcomings, judicial management as a corporate rescue procedure was abolished in its entirety in South Africa's Companies Act of 2008.

In light of this argument, Rajak & Henning were correct in proposing a dual corporate rescue system for South African companies.⁶⁶ They advocated for the provision of a domestic approach, one which is more sensitive to the needs of the South African economy and therefore less formal and more inclusive.⁶⁷ The past judicial management restructuring procedure was too litigious in nature and created a corporate rescue environment that was inaccessible for SMEs in financial distress. This critical flaw inspired a call for corporate law reform in South Africa.

61. *Id.* at 17.

62. Harry Rajak & Johan Henning, *Business Rescue for South Africa*, 116 S. AFR. L.J. 262, 269 (1999).

63. *Id.*

64. *See id.*

65. *See* LITERATURE REVIEW, *supra* note 1, at 7.

66. *See* Rajak & Henning, *supra* note 62. A dual corporate rescue system distinguishes between formal and informal business rescue proceedings. The use of either formal or informal business rescue proceedings would be dependent on the size of the distressed company—in terms of both revenue and number of employees. A formal business rescue procedure would follow the formal court process and require the appointment of a business rescue practitioner. An informal business rescue procedure would be less judicial and would require the financially distressed company to facilitate business rescue proceedings without outsourcing the services of a business rescue practitioner. Separating these two processes will be useful in reducing the costs of business rescue. *Id.*

67. *Id.*

B. *The Call for Reform*

The need for a change in South Africa's corporate insolvency law has been the subject of debate since the late 1980s.⁶⁸ This need arose from South Africa's traditional liquidation system and culture.⁶⁹ Hence, bankruptcy laws are devised to maximize creditor recovery through the liquidation of an insolvent estate.⁷⁰ A creditor of a company that is failing to pay its debts due to him has a right by law (*ex debito justitiae*) to liquidate the company.⁷¹ An expected consequence of this right is that entering liquidation will result in the winding up of the company and the auctioning of the company's assets for the purpose of securing the payment of the debts owed to the creditors.⁷²

This liquidation system is popular across the world because it provides creditors with immediate results. Liquidation does not give companies in financial distress opportunities to secure the help of a business rescue practitioner and enjoy moratorium against the company's creditors. To this day, the liquidation system is traditionally justified and highly preferred by creditors because it provides the most orderly and efficient means of securing the return of debts.⁷³

In June 2004, the Department of Trade and Industry provided a solid justification for the repeal of the Companies Act 1973.⁷⁴ The 1973 Act remained in force until April 31, 2011 and was replaced by the 2008 Act the following day. The Companies Act of 1973 had provided the regulatory framework for company law for 35 years. The Department of Trade and Industry's rationale behind corporate law reform was that the 1973 Act was now outdated, far too formal, consisted of laws which were unnecessary, and limited the effective participation of historically disadvantaged persons in the economy.⁷⁵ One of the reasons given for the repeal was the need to ensure that the regulatory frameworks for enterprises of all types of businesses, including micro, very small, and medium enterprises, are accommodated.⁷⁶ Doing so would promote growth, employment, innovation, stability, good governance, investor confidence, and international competitiveness in South Africa.⁷⁷ Hence, the repeal of Companies Act 1973 demonstrated a recognition of the need to facilitate corporate law reform

68. *Oakdene Square Props. v. Farm Bothasfontein (Kyalami)*, 2012 (3) SA 273 (GSJ), at 5 para. 6 (S. Afr.).

69. *Id.*

70. Smits, *supra* note 53, at 82.

71. *Oakdene Square Props.*, 2012 (3) SA 273 (GSJ), at 5 para. 6.

72. See ROBERT SHARROCK ET AL., *HOCKLY'S INSOLVENCY LAW* 253 (9th ed. 2012).

73. Smits, *supra* note 53, at 82.

74. DEP'T OF TRADE AND INDUS., *THE COMPANIES ACT NO. 71 OF 2008: EXPLANATORY GUIDE REPLACING THE COMPANIES ACT, NO. 61 OF 1973* 6 (2010), https://cdn.ymaws.com/www.iodesa.co.za/resource/collection/CB7E5DC1-E790-4BED-9693-9F8AA33E0032/Companies_Act_Guide.pdf [hereinafter EXPLANATORY GUIDE].

75. *Id.*

76. *Id.*

77. *Id.*

and promote SME development. The replacement legislation was adopted to promote the empowerment and growth of companies of all sizes, including SME companies. As explained below, this means that corporate rescue strategies provided for in the form of business rescue will apply to South African SMEs incorporated under the Act, provided that they have complied with the requirements set out in the new legislation and its regulations.⁷⁸

III. BUSINESS RESCUE UNDER THE COMPANIES ACT OF 2008

In line with the objective of the Department of Trade and Industry,⁷⁹ business rescue entirely replaces judicial management as South Africa's corporate reorganization procedure. In the "new" Companies Act of 2008, the introduction of business rescue was in line with the objective of the Companies Act of 2008 by aiming to ensure the effective relief and recovery of financially distressed companies in a manner that balances the rights and interests of all relevant stakeholders.⁸⁰ The following section of this Comment outlines the workings of business rescue as a corporate reorganization procedure for financially distressed enterprises under the Companies Act of 2008.

A. *The Definition and Purpose of Business Rescue*

The term "business rescue" is defined in Section 128(1)(b) of the Companies Act of 2008.⁸¹ Business rescue refers to proceedings aimed at assisting in the rehabilitation of a company that is financially distressed by providing for the temporary supervision of the company by a freestanding business rescue practitioner.⁸² The business rescue practitioner will help develop and implement a business rescue plan to restructure the company and achieve the plan's objectives.⁸³ In view of the fact that South African SMEs have the lowest survival rate in the world,⁸⁴ business rescue provides SMEs in financial distress with the opportunity to reorganize themselves by appointing an independent business rescue practitioner who will assist them in developing useful and efficient turnaround strategies to improve their chance of survival and enable them to function efficiently as a going concern.

Additionally, the appointment of a business rescue practitioner achieves one of the following business rescue objectives: to give an SME in financial distress

78. See Companies Regulations of 2011 (S. Afr.).

79. EXPLANATORY GUIDE, *supra* note 74.

80. *Id.*

81. Companies Act 71 of 2008 § 128(1)(b) (S. Afr.).

82. Companies Act 71 of 2008 § 128(1)(d) (S. Afr.) (defining a business rescue practitioner as a person, or two or more persons, appointed to oversee a firm during business rescue proceedings).

83. Companies Act 71 of 2008 § 150 (S. Afr.).

84. LITERATURE REVIEW, *supra* note 1, at 7.

the opportunity to continue to exist on a solvent basis by providing reorganization services.⁸⁵ However, where this objective proves impossible to achieve, the business rescue practitioner assists the SME in obtaining a better return for the company's creditors and shareholders than if SME was liquidated.⁸⁶ The achievement of the first objective by the business rescue practitioner is thus of paramount importance to the survival and overall sustainability of enterprises of all sizes, including SMEs.⁸⁷

B. *Elements of Application for Business Rescue Proceedings*

The Companies Act of 2008 provides for some requirements that must be fulfilled before a company is placed under business rescue under Chapter 6. The company must satisfy two elements: (1) the company must be in financial distress, and (2) there must be a reasonable prospect of rescuing the company.

The first element for determining whether a company should be placed under business rescue is whether the company is in "financial distress."⁸⁸ The Companies Act of 2008 defines what constitutes a financially distressed company for the purposes of business rescue. A company will be financially distressed if at any specific time "it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months," or "it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months."⁸⁹ Again, the failure rate of SMEs in South Africa is one of the highest in the world.⁹⁰ Most SMEs appear to be in financial distress within their first year of incorporation. Loubser argues that broadening the definition of "financial distress" to include circumstances in which a company anticipates financial distress will, in turn, clarify the situation and allow for the affected people to receive the appropriate information to commence the procedure within a reasonable period.⁹¹ This is a good recommendation for SMEs, as it would provide them with greater opportunity to invoke business rescue proceedings at an earlier stage.

Furthermore, since South African SMEs have the lowest survival rate in the world,⁹² it is of supreme importance to initiate business rescue proceedings at

85. "Solvent basis" refers to a position in which the firm will have sufficient capacity to pay its debts.

86. Richard S. Bradstreet, *Averting Liquidations with Business Rescue: Does a Section 155 Compromise Place the Bar Too High?*, 25 STELLENBOSCH L. REV. 549, 550 (2014).

87. *Id.*

88. Companies Act 71 of 2008 § 128 (1)(f) (S. Afr.); ERIC LEVENSTEIN & LAUREN BARNETT, *BASICS OF BUSINESS RESCUE* (2013), <http://www.werksmans.com/wp-content/uploads/2013/04/Werksmans-Basics-of-Business-Rescue1.pdf>.

89. Companies Act 71 of 2008 § 128(1)(f) (S. Afr.).

90. LITERATURE REVIEW, *supra* note 1, at 7.

91. Loubser Thesis, *supra* note 60, at 34.

92. LITERATURE REVIEW, *supra* note 1, at 7; Loubser Thesis, *supra* note 60, at 29.

the earliest sign of financial distress.⁹³ A point often overlooked in the current business rescue regime is that SMEs are survivalist in nature, and thus any form of distress should warrant the application of business rescue proceedings.⁹⁴ This would be in line with the recommendations made by Rajak & Henning, who envisioned a much more lenient approach to business rescue for small enterprises.⁹⁵ Inherently viable and healthy SMEs may experience unforeseen and provisional cash-flow problems, possibly caused by external factors such as an earthquake, a factory fire, a failure of an important supplier, political unrest, or employee strikes.⁹⁶ These factors can ultimately place survivalist SMEs in distress and justify the immediate application of business rescue proceedings. Loubser argues that an enterprise should be allowed to enter business rescue proceedings at the first sign of financial distress.⁹⁷ If an enterprise waits until it can prove its insolvency and inability to pay its debts, the chances of a successful SME rescue are significantly weakened.⁹⁸

Moreover, for SMEs to be successful in business rescue, any form of distress, whether “financial distress” or “economic distress,” should qualify a company for business rescue.⁹⁹ For example, when an SME is solving employee disputes or dealing with insurance companies after a natural disaster takes place that wholly or partially destroys its premises, it would be unable to make use of business rescue proceedings unless it is in financial distress. In light of the above, it would be best if SMEs could apply for business rescue proceedings at the earliest stage when it shows signs of distress, both economic and financial. Loubser recommends that a company’s present insolvency or inability to pay its debts should constitute financial distress for business rescue.¹⁰⁰ It is further submitted in agreement with Loubser’s recommendation that the adoption of such a proposal would increase the likelihood of a successful business rescue for SMEs in South Africa. The sooner a rescue procedure is initiated, the higher the chances of its success.¹⁰¹

The second element under the Companies Act of 2008 provides a less stringent requirement than that of judicial management, which requires that the company would *probably* become a successful going concern.¹⁰² Section 129(1)(b) of the Companies Act of 2008 now requires only that the board should have reasonable ground to believe there is a reasonable *prospect* of res-

93. Loubser Thesis, *supra* note 60, at 57.

94. Companies Act 71 of 2008 § 129.

95. Rajak & Henning, *supra* note 62, at 263.

96. *Id.*; see generally Loubser, *supra* note 49.

97. Loubser, *supra* note 49, at 57.

98. *Id.* at 57.

99. See GERARD MCCORMACK, CORPORATE RESCUE LAW—AN ANGLO-AMERICAN PERSPECTIVE 9 (2008).

100. Loubser, *supra* note 49, at 57.

101. *Id.*

102. *Id.*

cuing the company.¹⁰³ Loubser,¹⁰⁴ however, emphasizes that the use of the word “prospect” creates unnecessary confusion. Loubser suggests that the drafters should have used either a “possibility” or a “probability” in place of the word “prospect.” A clear distinction would have made it clear when SMEs can make use of business rescue proceedings. In the name of creating a more lenient approach for SMEs, the use of the word “possibility” instead of “prospect” should be used to create a more appropriate corporate rescue procedure for distressed SMEs.

C. *Persons with Power to Initiate Business Rescue Proceedings*

There are two main ways by which companies in financial distress can initiate business rescue proceedings: either the company itself initiates via board resolution or an affected person does so by court application.¹⁰⁵ A court may place the enterprise under supervision and commence business rescue proceedings if it is satisfied that the company is financially distressed and that there is a reasonable prospect of its rescue.¹⁰⁶ This gives SMEs the power to reorganize voluntarily and choose a business rescue practitioner.¹⁰⁷ This is an excellent addition to our corporate rescue system, as it allows the company to choose the business rescue practitioner best suited for its size industry. This suggests that it would be in the best interests of SMEs if unalterable business rescue provisions were regularly included in their Memoranda of Incorporation. Such a provision could state that once a company shows any sign of financial distress, it must be placed under business rescue. This would be useful in improving the survival rates of South African SMEs, which are characterized by high levels of failure.¹⁰⁸

1. Affected Persons

An affected person can initiate business rescue proceedings by filing a business rescue resolution with the Companies and Intellectual Property Commission and avoid going to the courts. Section 128(1)(a) of the Companies Act of 2008 considers an affected person to include “a shareholder or creditor of the company in financial distress, a registered trade union representing the employees of the company, as well as the employees in general who do not belong to a registered trade union.”¹⁰⁹ Although scholars have viewed this approach as cre-

103. *Id.* The board refers to the board of the directors of the firm comprising directors and other relevant members.

104. *Id.* at 78.

105. Companies Act 71 of 2008 § 131(4)(a) (S. Afr.).

106. *Id.*

107. Companies Act 71 of 2008 § 129(1)(b) (S. Afr.).

108. LITERATURE REVIEW, *supra* note 1, at 7.

109. Companies Act 71 of 2008 § 128(1)(a) (S. Afr.).

ating a system that could lead to abuse, it provides SMEs in financial distress with a full opportunity to make use of business rescue proceedings by including employees, directors, and other affected persons in the process.¹¹⁰ In this respect, the commencement of business rescue proceedings by affected persons who do not have access to the company's internal documents could appear burdensome for SMEs applying for business rescue. However, Section 31(3) of the Companies Act of 2008 makes this additional access more useful to shareholders who are not directors of the company by allowing trade union representatives to access to the company's financial records for the purpose of business rescue. This is done through the Companies Intellectual Property Commission ("CIPC") and subject to the conditions that the Commission may determine.¹¹¹

2. The Business Rescue Practitioner

Section 138(1) of the Companies Act of 2008 sets out the requirements for the appointment of a business rescue practitioner.¹¹² It requires that the business rescue practitioner be selected from the ranks of good standing members of the legal, accounting, or business management profession.¹¹³ Given the fact that South Africa has between 2 to 6 million SMEs, and 20 percent of these SMEs are registered with the CIPC,¹¹⁴ it would be in the best interest of SMEs if the appointment of a business rescue practitioner were not solely based on academic merit and experience but rather on special skills and experience with that particular form of SME. A business rescue practitioner should be accompanied by an SME expert with practical knowledge and experience in the SME sector. A business rescue practitioner has the power to delegate his or her powers and functions to any other person who was part of the board or management of the Company in financial distress as well as to appoint any other person as

110. George M. Museta, *The Development of Business Rescue in South African Law* 66 (Nov. 2011) (unpublished L.L.M. dissertation, University of Pretoria).

111. Companies Act 71 of 2008 § 31(3) (S. Afr.). When the Companies Act of 2008 came into effect on May 1, 2011, the Companies Intellectual Property Commission ("CIPC") was created from the merger of Companies and Intellectual Property Registration Office ("CIPRO") and the Office of Firm and Intellectual Property Enforcement ("OCIPE"). Its function is to cater to the registration of companies, co-operatives, and intellectual property rights (trademarks, patents, designs and copyright) and maintenance thereof; to disclose information on its business registers; to promote education and awareness of firm and intellectual property law; to promote compliance with relevant legislation; efficiently and effectively enforce relevant legislation; to monitor compliance with and violations of financial reporting standards and make recommendations thereto to the Financial Reporting Standards Council ("FRSC"); to facilitate the licensing of business rescue practitioners; and to report, research, and advise the Minister on matters of national policy relating to firm and intellectual property law. *See generally* COS. & INTELL. PROP. COMM'N, <http://www.cipc.co.za/> (last visited Nov. 28, 2018).

112. Companies Act 71 of 2008 § 138(1) (S. Afr.).

113. *Id.*

114. LITERATURE REVIEW, *supra* note 1, at 9.

part of the management of the company.¹¹⁵ It is in the best interest of SMEs for business rescue practitioners to be SME experts. The discretion of the business rescue practitioner to delegate or appoint other experts can only lead to an increase in the overall costs of the business rescue process.

Another challenge faced by SMEs in the current South African corporate rescue procedure is that most business rescue practitioners are inadequately regulated under the Companies Act of 2008. The Companies Act of 2008 provides that the practitioner “may delegate any power or function of the practitioner to a person who was part of the board or pre-existing management of the company.” The practitioner may also remove such persons from office, and in the same fashion, the practitioner may appoint a person as part of the management of the company.¹¹⁶ Even though the pre-existing management of a distressed company remains in place, it is the practitioner who has ultimate control once a company is placed under business rescue.¹¹⁷ And he or she can control the company in any manner they deem fit.¹¹⁸ Such a broad grant of power to the practitioner may be counterproductive. When control is diverted from the people involved in the day-to-day management of the company,¹¹⁹ they may lose motivation to help it become profitable again. On the other hand, the broad power of business rescue practitioners could lead to successful SME reorganizations. For example, the business rescue practitioner can remove uncooperative or inefficient managers without the pressure of family ties within the SME.

The Companies Regulations of 2011 outline the remuneration tariffs and fees for business rescue practitioners.¹²⁰ Most SMEs cannot afford the services of a business rescue practitioner because of the tariff standards set out in the regulations. A business rescue practitioner can be rewarded with the following schemes: at a maximum rate of \$88 per hour to a maximum amount of \$1,110.97 per day (inclusive of Value Added Tax (“VAT”)) in the case of a small company; at a maximum rate of \$106.65 per hour, to a maximum amount of \$1,333.16 per day (inclusive of VAT) in the case of a medium-sized company; and at a maximum rate of \$142.20 per hour, to a maximum amount of \$1,777.55 per day (inclusive of VAT) in the case of a large or a state-owned company.¹²¹ The tariffs set out in the Companies Regulations are problematic for survivalist SMEs, which in times of financial distress can have a turnover of less than \$ 1,130 *per month*. These remuneration tariffs alone make business rescue out of reach for most SMEs. Consequently, otherwise salvageable and useful corporate entities fail because they cannot afford business rescue. Also,

115. Companies Act 71 of 2008 §§ 140(1)(b), (c)(ii) (S. Afr.).

116. *Id.* §§ 140 (1)(c)(i)–(ii).

117. *Id.* § 140 (1)(a).

118. *Id.* §§ 140 (1)(a)–(c).

119. *Id.*

120. Companies Regulations of 2011 (S. Afr.).

121. *Id.* §§ 128(1)(a)–(c). Monetary amounts were converted from South African Rand to United States Dollar amounts on November 20, 2018.

the Companies Regulations do not restrict any “further remuneration” for a business rescue practitioner.¹²² This means that the business rescue practitioner can charge a higher fee than that stipulated in the Companies Regulations—ultimately making the process even less accessible to SMEs. Even the least experienced practitioner will cost the same amount because the tariffs are based on the size of the corporate entity rather than merit.

D. Evaluating Business Rescue

1. Exclusive Rights Granted to Employees and an Automatic Moratorium on SME Creditors

Business rescue provides an excellent advantage to employees of SMEs because it allows for fair and equitable treatment of employees when the SME is financially distressed.¹²³ Business rescue offers the employees protection and considerable benefits during the business rescue process: employment contracts are specifically excluded from a business rescue practitioner’s power to render void or suspend contracts during the business rescue process.¹²⁴ Employees of financially distressed SMEs are given individual preference rights with respect to remuneration.¹²⁵ Section 135(1) of the Companies Regulations classifies any “remuneration, reimbursements”¹²⁶ or other payments due and payable by the company to its employees during business rescue proceedings as post-commencement finance.¹²⁷ These claims are afforded special preference rights, and they are ranked after the costs of the business rescue proceedings and the business rescue practitioner’s fee and costs, but before any claims for other forms of post-commencement finance.¹²⁸

It is estimated that 91 percent of formal business entities in South Africa are SMEs, and these SMEs contribute between 52 and 57 percent of South Africa’s GDP and 61 percent of employment.¹²⁹ Business rescue ensures that the employment provided by SMEs is protected while also promoting the development and maintenance of the standard of living of the community within which the SMEs operate. If one compares the rights of employees of an SME that is immediately liquidated to one which is placed under business rescue, the benefits to employees from SMEs using business rescue proceedings as a restructuring procedure become abundantly clear. When an SME is placed under liquidation

122. Companies Act 71 of 2008 §§ 143(2)–(4) (S. Afr.).

123. FAROUK H.I. CASSIM ET AL., CONTEMPORARY COMPANY LAW 537 (2d ed. 2012).

124. Companies Act 71 of 2008 § 136 (S. Afr.).

125. *Id.* §§ 133, 135.

126. *Id.* § 133(1).

127. *Id.* §§ 133, 135.

128. *Id.*

129. LITERATURE REVIEW, *supra* note 1, at 7.

via Section 38(1) of the 1936 Insolvency Act,¹³⁰ the liquidation suspends all employee contracts of service from the date on which an order of winding up is issued.¹³¹

The special rights granted to employees under the Companies Act of 2008, therefore, present an opportunity to earn remuneration for a few extra months if the business shuts down. Additionally, the Companies Act of 2008 protects the company against breach of contract actions, by conferring rights to the business rescue practitioner. These include the right to suspend—whether entirely, partially, or conditionally—any obligation that the SME is party to at the commencement of business rescue proceedings.¹³² This helps prevent additional actions against the SME for breach of contract based on non-performance of the SME's contractual obligations.¹³³ The suspension of obligations endures until business rescue proceedings are concluded.¹³⁴

Furthermore, the business rescue practitioner is given the right to make an urgent application to the court to “cancel or suspend entirely, partially or conditionally”¹³⁵ a clause of any non-employment contract on behalf of an SME.¹³⁶ This right creates a contract moratorium that gives an SME breathing space to reorganize itself and develop new strategies to overcome the threat of liquidation. Moreover, providing the practitioner with the right to suspend contractual obligations helps the SME reflect on the cause its financial distress. It can also help temporarily release the SME from bad investments that led to financial distress.

Nevertheless, the rights given to a business rescue practitioner should be exercised with caution, as they may void established contracts that could contribute to the SME's growth. For example, if the practitioner suspends the contract with a vital supplier, the SME may be unable to operate fruitfully as a going concern if the supplier is not lenient and understanding of the business rescue process. The possibility for the SME to contract under the same terms with the critical supplier would be significantly reduced. In conclusion, the main advantage to SMEs of business rescue is the provision of moratoriums in both legal proceedings and contract; these moratoriums allow the business rescue practitioner to focus on rescuing the company by developing a proposal and implementing turnaround strategies without the burden of impending legal actions and possible liquidation proceedings.¹³⁷

130. Insolvency Act 24 of 1936 § 38 (S. Afr.).

131. *Id.* § 38(1).

132. Companies Act 71 of 2008 §§ 136(2)–(2A) (S. Afr.).

133. Loubser, *supra* note 49, at 87.

134. CASSIM ET AL., *supra* note 123, at 886.

135. Companies Act 71 of 2008 §§ 136(2)–(2A) (S. Afr.).

136. *Id.*

137. Bradstreet, *supra* note 86, at 562.

2. The Problem of Post-Commencement Finance for SMEs

Most SMEs have difficulty with securing initial funding.¹³⁸ As a result, they rely on personal savings, friends, and family members;¹³⁹ during their growth phase, they then venture into the realm of asset-backed finance and bank debts.¹⁴⁰ Financial lending institutions are often reluctant to finance SMEs because most do not have enough assets to offer as security at the time of incorporation.¹⁴¹

Financing is no easier after incorporation, even as post-commencement finance is one of the most important aspects of business rescue.¹⁴² Companies that are placed under the supervision of an independent business rescue practitioner do not have the assets or cash to fund regular business activities during the rescue process.¹⁴³ The biggest obstacle to successful reorganization is the challenge of accessing capital for business through financial institutions.¹⁴⁴

Section 135(2) of the Companies Act of 2008 provides that “the company may obtain financing [that is not unrelated to the employment,” which “may be secured to the lender by utilising any [unencumbered] assets of the company,” and “will be paid in the order of preference set out in subsection 135(3)(b).”¹⁴⁵ Yet Pretorius & Du Preez¹⁴⁶ suggest that the availability of post-commencement finance in South Africa is practically non-existent. Post-commencement finance requires creditors, banks, and financiers to provide credit support for companies in financial distress.¹⁴⁷ Most creditors, banks, and financiers, however, are reluctant to finance a company that is in financial distress and undergoing business rescue proceedings.¹⁴⁸ The chances of a successful reorganization procedure for SMEs are reduced where the magnitude and nature of the funding required for rescuing the SME exceeds the total value and assets of the SME. Ultimately, the successful reorganization of such SMEs through business rescue will depend on the possibility of securing a financier with an appetite for significant risk. Furthermore, typical financiers of post-commencement finance would want to conduct investigations to establish their confidence in the future

138. See LITERATURE REVIEW, *supra* note 1, at 8.

139. *Id.* at 62.

140. *Id.* at 33.

141. *Id.* at 62.

142. CASSIM ET AL., *supra* note 123, at 882.

143. *Id.*

144. LITERATURE REVIEW, *supra* note 1, at 32.

145. Companies Act 71 of 2008 § 135 (S. Afr.).

146. Marius Pretorius & Wanya Du Preez, *Constraints on Decision Making Regarding Post-Commencement Finance in Business Rescue*, 6 S. AFR. J. ENTREPRENEURSHIP AND SMALL BUS. MGMT. 168, 169 (2013).

147. CASSIM ET AL., *supra* note 123, at 882.

148. *Id.*

viability of the company under reorganization.¹⁴⁹ This poses major concerns to SMEs in financial distress because the ability to successfully raise post-commencement finance can determine whether the business rescue is successful.¹⁵⁰

It would be in the best interests of SMEs if the Companies Act of 2008 prescribed that small and medium companies can appoint both an experienced and junior business rescue practitioner to improve the chances of securing post-commencement finance. Pretorius & Du Preez recommend that two experienced and competent business rescue practitioners, with their collaborative networks and thorough knowledge and understanding of the business rescue process and industry, are much more effective in securing post-commencement finance.¹⁵¹ Although this may be true, appointing two business rescue practitioners could pose a problem for survivalist SMEs, which already cannot afford the tariffs of one business rescue practitioner.

E. Informal Alternatives

Section 155 of Companies Act of 2008 provides for a settlement agreement between a company and its creditors. This compromise is entered as an alternative to business rescue proceedings. This means that an SME can use the compromise between a company and its creditor's provision as a substitute to business rescue to restructure a company in financial distress.¹⁵² However, it is important to note that a compromise cannot be used by an SME that is already engaged in business rescue proceedings. When an SME enters into a compromise, its board of directors or the liquidator will bind itself in some form of agreement to arrange for a settlement or any other form of arrangement made between the SME and its creditors that terminates the dispute. A compromise will be appropriate for SMEs when the process of placing a company under business rescue is unattainable.

For an SME to make use of a compromise with creditors as a reorganization strategy, it need not necessarily be in financial distress. Section 155(1) of the Companies Act of 2008 states that a company may enter into a compromise between its creditors "irrespective of whether or not [the company] is financially distressed."¹⁵³ This means that an SME will have the benefit of making use of the process before the creditors learn of the SME's inability to pay its debts when they become due and payable. Allowing SMEs to make use of the process without necessarily being in a state of financial distress helps maintain

149. Pretorius & Du Preez, *supra* note 146, at 174. Typical financiers include banks, creditors, and shareholders.

150. *Id.*

151. *Id.* at 186.

152. Companies Act 71 of 2008 § 155(1) (S. Afr.).

153. *Id.*

their financial reputation and improves their chances of securing finance from commercial banking institutions.¹⁵⁴

A compromise between a company and its creditors does not involve the use of a business rescue practitioner, who would normally investigate the debtor's affairs and offer turnaround strategies to save the company in distress by developing a business rescue plan and consulting with affected persons.¹⁵⁵ This means that the SMEs that make use of this reorganization method must develop a business rescue plan. Moreover, an SME that makes use of this benefit will profit from developing experience in administration and improving the skills of board members who will assist in drafting a business rescue plan with turnaround experts. The business rescue plan, once completed, will be used at the creditors' meetings once the creditors have approved the plan.¹⁵⁶

Furthermore, because the compromise with creditors does not require the services of a business rescue practitioner, the SME will not bear the practitioner's high fees.¹⁵⁷ It can thus be argued that the compromise is likely to benefit SMEs by reducing costs, as they will not need the practitioner's services to assist in drawing a business rescue plan and restructuring the company.

The board of the company or the liquidator of the company has the power to put forward an arrangement with respect to "its financial obligations to all of its creditors, or to all of the members of any class of its creditors, by delivering a copy of the proposal, and notice of a meeting to consider the proposal,"¹⁵⁸ to the creditors known to the company.¹⁵⁹ Significantly, this procedure enables an SME to draft a proposal to its creditors without incurring any administrative costs of the application to convene meetings with its creditors.¹⁶⁰ A company that makes use of a Section 155 compromise will incur only the costs of turning the compromise into a court ruling for it to be binding.¹⁶¹ Saving costs while attempting to restructure a company of any size is crucial in ensuring that the company saves funds to be used contingently in its future growth or recapitalisation.

Business rescue proceedings provide an advantage to SMEs in the form of a moratorium on any legal proceedings against the SME in financial distress.¹⁶² This moratorium provides that "no legal proceeding, including [an] enforcement action"¹⁶³ will take place against the SME "or in relation to any property be-

154. *Id.*

155. Bradstreet, *supra* note 86, at 558.

156. *Id.*

157. Companies Regulations 2011 § 128 (S. Afr.).

158. Companies Act 71 of 2008 § 155(2) (S. Afr.).

159. *Id.*

160. *Id.*

161. This procedure is less administrative, as there are fewer costs associated with making a court application and pursuing a highly procedural reorganization process.

162. Companies Act 71 of 2008 § 133(1).

163. *Id.*

longing to the [SME], or lawfully in its possession, may be commenced or proceeded with in any forum.”¹⁶⁴ This moratorium benefits SMEs in financial distress by providing breathing space. The effect of the Section 133(1) moratorium is that it automatically stays legal proceedings against the SME, and execution and enforcement actions issued by the SMEs’ creditors may not be initiated except with both the written consent of the practitioner and with leave of the court.¹⁶⁵ A business rescue plan must be developed after the business rescue practitioner has initiated his or her preliminary investigation. This has the effect of providing for a moratorium with respect to actions against the company and actions concerning the company’s ownership until payment can eventually be made from the future earnings of the company, or until the SME secures the post-commencement financing which will be used to settle some of its debts. In both these events, the SME will not immediately enter liquidation, and this will spare the plant machinery belonging to the SME that is attached by the sheriff for sale by way of a public auction. This helps the SME to raise funds and avoid liquidation during in the rescue process. Staying these proceedings creates an opportunity to attempt a corporate rescue strategy that could allow the SME to continue trading regardless of whether there is legal action pending against it and regardless of whether some or all the SME’s property has been attached by the sheriff. This moratorium is not provided for when a company enters a compromise with its creditors. Although business rescue has provided useful turnaround strategies for companies in financial distress, it does not necessarily provide for reorganization strategies that can be effectively used by SMEs. It is therefore important that South Africa comparatively looks at innovative ways to which SMEs can be effectively reorganized under Chapter 11 of the United States Bankruptcy Code.

III. CHAPTER 11 OF THE UNITED STATES BANKRUPTCY CODE

In the United States, the law on corporate reorganization is confined to Chapter 11 of the United States Bankruptcy Code.¹⁶⁶ The Bankruptcy Code has adopted a “pro-debtor” rather than a “pro-creditor” approach to the corporate reorganization of companies.¹⁶⁷ Due to Chapter 11’s success in the United States, many countries view it as the standard for corporate reorganization, with the potential to facilitate corporate insolvency reforms successfully.¹⁶⁸ The 2004 policy document of the Department of Trade and Industry, for example, stipulates that “in order to create a system of corporate rescue appropriate to the needs of a modern South African economy,” the provisions of the of the United

164. *Id.*

165. *Id.* §§ 133(1)(a)–(b).

166. MCCORMACK, *supra* note 99, at 78.

167. *Id.*

168. Anneli Loubser, *Tilting at Windmills? The Quest for an Effective Corporate Rescue Procedure in South African Law*, 25 S. AFR. MERCANTILE L.J. 437, 439 (2013).

States Bankruptcy Code are considered as part of South Africa's recognition of international law.¹⁶⁹ Chapter 11 is commonly used when major corporations, like Ford, General Motors, K-Mart, or United Airlines are in financial distress.¹⁷⁰ These large corporations are the most likely to turn to Chapter 11 and the bankruptcy courts for corporate reorganization solutions as opposed to other methods of reorganization (such as private agreements with creditors). However, the most common cases filed by businesses and companies in the bankruptcy court courts are far from being globally listed or Wall Street titleholders and household names.¹⁷¹

Under Chapter 11, a company can restructure its finances using a reorganization plan, which must be approved by the bankruptcy court. A Chapter 11 bankruptcy plan can help reduce obligations and modify payment terms between the debtor company and its creditors. A reorganization plan is traditionally used for larger companies; smaller companies do not usually reach the stage of making a reorganization plan, as their cases are either dismissed or converted into Chapter 7 liquidations.¹⁷² The confirmation of a reorganization plan by the court discharges a corporate debtor from fulfilling all legal obligations not included in the reorganization plan.¹⁷³ For the most part, SMEs in the United States must follow the same rules and requirements as bigger corporations when they make use of reorganization strategies under Chapter 11.¹⁷⁴ There are, however, some special provisions for SME debtors that can help to accelerate the process of Chapter 11 by reducing legal and other reorganization expenditures. These are discussed below.

First, under the Bankruptcy Code, a Chapter 11 proceeding filed by a "small business debtor" is categorized as a "small business case."¹⁷⁵ A "small business debtor" is a person or entity who: (1) is engaged in business or other commercial activities and (2) owes no more than \$2,490,925 in total claims.¹⁷⁶ In creating an SME-friendly corporate reorganization strategy for South Africa, categorizing the size of the business in terms of the total amount of creditor claims can reduce legal expenses and other costs incidental to business rescue. An appropriate turnaround strategy for such a company would be one appropriate for a "small business debtor" and would be administered on a "small business" scale

169. DEP'T OF TRADE & INDUS. OF S. AFR., SOUTH AFRICAN COMPANY LAW FOR THE 21ST CENTURY 45 (2004).

170. CARA O'NEILL, CHAPTER 11 BANKRUPTCY FOR SMALL BUSINESS OWNERS, <https://www.nolo.com/legal-encyclopedia/chapter-11-bankruptcy-small-business-owners.html> (last visited Nov. 28, 2018).

171. *Id.*

172. MCCORMACK, *supra* note 99, at 86.

173. *Id.*

174. O'NEILL, *supra* note 170.

175. *Id.*

176. *Id.*

within the context and meaning of Chapter 11.¹⁷⁷ In the context of South Africa, it is recommended that the size of the debt should also have an influence in determining the costs and remuneration package of a business rescue practitioner, as well as the choice of appointing either a junior, senior, or experienced practitioner as defined by the Companies Regulations.¹⁷⁸ This addition, if correctly implemented, would help create a more accommodating environment for SMEs in South Africa.

Second, in Chapter 11 cases, a committee is appointed to represent the interests of unsecured creditors of the ailing company.¹⁷⁹ This committee can retain the services of an attorney, an investment banker, an auditor, and other related professionals at debtor's expense.¹⁸⁰ However, these services can significantly increase the costs of reorganization, making the process inaccessible for "small business debtors."¹⁸¹ To cure this, Chapter 11 has provided a special provision for "small business debtors" by giving the bankruptcy court the power to order that no creditors' committee is appointed.¹⁸²

In South Africa, business rescue proceedings cannot take place without the appointment of an independent professionally accredited person from good standing legal, accounting, or business management positions.¹⁸³ Often, such a requirement makes the process more burdensome for South African SMEs because most experienced "good standing professionally accredited professionals" come with their own designated consultation fees and other related administration charges. To reduce this effect, the Companies Regulations¹⁸⁴ set out the prescribed tariff fees for such professionally accredited persons according to the size of the corporate entity in distress. To remedy this, the legislature should follow the benchmark set by Chapter 11 which makes the appointment of a professionally accredited body of person(s) subject to the discretion of the bankruptcy court. In other words, such appointment of a business rescue practitioner should be optional and reserved for the discretion of the court or the SME itself in order to reduce costs and make the procedure more accessible. SMEs in South Africa can also achieve the same effect if the board makes an application to the Commission without court oversight. This has the effect of reducing the costs of the business rescue.

Third, Chapter 11 subjects "small business debtors" to additional reporting and filing requirements that are not imposed on other Chapter 11 debtors: a "small business debtor" must attach its most recently organized balance sheet, statement of operations, cash flow statement and federal tax return of its petition

177. *Id.*

178. Companies Regulations of 2011 §§ 127(2)(c), 128(1) (S. Afr.).

179. O'NEILL, *supra* note 170.

180. *Id.*

181. *Id.*

182. *Id.*

183. Companies Act 71 of 2008 § 138 (S. Afr.).

184. *See* Companies Regulations of 2011 § 128 (S. Afr.).

when it files for Chapter 11 relief.¹⁸⁵ In the South African context, if the SME in financial distress passes a resolution, business rescue commences. The SME will only have to file a copy of the decision with the CIPC for publicity purposes. There is nothing else to be filed with the court because in South Africa the Companies Regulations allows access entirely extra-judicially. This benefits South African SMEs, as it provides a more straightforward procedure for restructuring by reducing the administration process of filing for business rescue.

Fourth, the United States Trustee's Office is the agency responsible for overseeing bankruptcy cases on behalf of the Department of Justice. Notably, Chapter 11 confers additional trustee oversight to the United States Trustee's Office for "small business debtors" more than any other Chapter 11 proceedings.¹⁸⁶ In South Africa, imposing a duty on the Companies and Intellectual Property Commission as well as the Companies' Tribunal¹⁸⁷ would aid in overseeing the reorganization process for SMEs and prevent possible abuses by the business rescue practitioner or any other person involved in the reorganization process. Furthermore, SMEs are sensitive entities that are usually formed by the individual savings of the incorporators, government funding, and, in more charitable circumstances, the commercial banking sector.¹⁸⁸ This warrant having an independent statutory body to oversee and audit the entire reorganization process for SMEs. This would set the tone for transparency and accountability of business rescue practitioners during the reorganization process for enterprises of all sizes. Moreover, the additional oversight will protect the needs and interests of the stakeholders, since the powers and duties of the directors of the ailing SME are confined in the business rescue practitioner.¹⁸⁹

Fifth, the general rules applicable in filing for a Chapter 11 plan set by the bankruptcy court prescribe no deadline for filing a Chapter 11 plan, unless such a plan deadline is set by the court.¹⁹⁰ However, "small business debtors" are given only 300 days to put forward a Chapter 11 plan subject to extension at the bankruptcy court's discretion.¹⁹¹ In South Africa, the business rescue practitioner, once appointed, has the duty of drafting and preparing a business rescue plan, which he or she must propose to the creditors for approval; he or she may also present the plan to management and other affected persons as well.¹⁹² Any proposal that the business rescue plan for South African SME companies should be given 300 days to file a business rescue plan could be tantamount to placing the SME in liquidation and performing commercial homicide. The current business rescue regime in South Africa requires business rescue practitioners to

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. O'NEILL, *supra* note 170.

191. *Id.*

192. Companies Act 71 of 2008 §§ 150–153 (S. Afr.).

draft, prepare, and publish a business rescue plan within 25 days of their appointment.¹⁹³ Extending the plan deadline from 25 days to 300 days granted at the court's discretion would be useful in giving the business rescue practitioner enough time to convene a meeting with the creditors of the SME and any other affected persons to carefully consider the business rescue plan before filing.¹⁹⁴

Chapter 11 goes further to create a more fertile environment for "small business debtors" by providing for longer exclusive periods to propose a reorganization plan.¹⁹⁵ Chapter 11 gives the debtor an exclusive right of 120 days after it files for bankruptcy to propose a reorganization plan. However, "small business debtors" are given an exclusive extension period of 180 days to propose a rescue plan. The justification underlying this exclusive special provision is to reduce the risk to a "small business debtor" of having to litigate competing plans and potentially losing its business. South Africa does not provide for this extension period, which can be valuable for SMEs, as it can provide SMEs with an extended amount of time to draft the business rescue plan.

Finally, Chapter 11 generally requires the debtor to prepare a disclosure statement and submit it to the bankruptcy court for approval. Once the statement is approved, the debtor must then circulate copies to creditors and other parties or interested persons.¹⁹⁶ These disclosure statements, in accordance with Chapter 11, must provide extensive information about the debtor and proposed plan.¹⁹⁷ Chapter 11 reduces the cost to "small business debtors" of securing a disclosure statement by giving the bankruptcy court discretion to waive the requirement.¹⁹⁸ If the bankruptcy court grants such a waiver to "small business debtors," the legal and other costs associated with reorganizing the company are significantly reduced.¹⁹⁹ Distressed SMEs in South Africa would benefit significantly if the courts were given the discretion to waive the requirement of documents related to the reorganization process. Alternatively, the costs saved from such a waiver can be invested towards the repayment of preferred and other related creditors or possibly assist in the overall administration costs associated with the reorganization of the company.

CONCLUSION

Chapter 11 has adopted useful strategies to facilitate an accommodative reorganization environment for SMEs within their corporate reorganization model. The United States has identified the sensitivity of SMEs and established suitable mechanisms to promote the successful reorganization of SME compa-

193. *Id.* § 150(5).

194. O'NEILL, *supra* note 170.

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.*

nies within their respective jurisdictions. South Africa could refine the current business rescue model to make it more accommodative to SMEs by either designating compromises between a company and its creditors to SMEs, or by introducing an automatic moratorium for such companies during the corporate rescue process. Alternatively, South Africa could adopt the approach of Chapter 11, which reduces the administrative costs of Chapter 6. South Africa could also give the same special treatment to SMEs as Chapter 11 provides for “small business” SME cases. But a significant problem with following the United States approach is that there is no mechanism provided for court oversight in Chapter 11. This lack of oversight creates an environment for substantial abuse throughout the process by all affected persons including the business rescue practitioner, the creditors, and the debtors of the financially distressed company.

SMEs form the lifeblood of socio-economic development in South Africa, providing much-needed employment opportunities and training support and developing worker skills both formally and informally. Fortunately, the government of South Africa recognizes how essential SMEs are in reforming South Africa’s corporate sector to provide equal opportunities for historically disadvantaged persons. Moreover, using SMEs to implement Broad Based Black Economic Empowerment strategies helps to promote the radical approach of including historically disadvantaged persons both socially and economically in the commercial sector. However, despite such recognition by government and other key players in the commercial sector, SME failure and survival rates in South Africa remain the worst in the world. The failure rate of SMEs stresses the need for a corporate rescue system that accommodates the requirements, structure, and sensitivity of SMEs which are primarily characterized as survivalist in nature. A reformatory corporate rescue system is therefore essential for the survival of SMEs in financial and economic distress.

It is well known that judicial management was a failure for South African businesses in need of corporate restructuring. Judicial management did not provide realistic and practical rescue solutions for SMEs. The procedure was highly regulated, inaccessible, and hardly used by companies in financial difficulty. Its structure and application made it cumbersome and unfeasible for SMEs to attempt a corporate rescue process. The expense of the procedure as well as the lack of adequate regulation of the administrator—now known as a business rescue practitioner—contributed to the inherent difficulty of the procedure. Thus, the best alternative for distressed SMEs was not to attempt to salvage the business but rather to opt for liquidation and divide the residual amongst the shareholders.

The South African Department of Trade and Industry saw a need to promote the international competitiveness of South African businesses by introducing a reformed corporate rescue process in the form of business rescue. Business rescue, as introduced in Chapter 6 of the Companies Act of 2008, seeks to provide a reformed approach to reorganizing South African companies in financial distress by offering them breathing space in the form of moratoriums. These enable a company in financial distress to adequately restructure itself, save jobs,

and attempt a turnaround strategy that will allow the business to recover and yield a better return for the creditors than liquidation. Business rescue succeeded in providing more advantages to companies in need of corporate reorganization strategies than judicial management as legislated in the Companies Act 1973. Despite this apparent far-reaching change, business rescue remains a cumbersome process for SMEs in financial distress, which still need the benefit and protection of business rescue.

Although the legislature has tried to keep abreast with international trends in providing a modernized form of corporate rescue analogous to that of the Anglo-American countries, it has failed dismally in providing South Africa with a corporate rescue system suitable to the needs and development of South African companies. The current business rescue process has an inherent teething problem that makes it cumbersome for SMEs to use. The legislature should have acknowledged the fact that companies in the United States—a developed country—could not be rescued identically to companies in South Africa—a developing country. A shift by the legislature from a more formal to an informal procedure tailor-made for South African companies, most importantly SMEs, could be much more successful. Our current business rescue system needs a serious facelift that will make it more practical and efficient for SMEs.

The formally regulated procedure inherent in business rescue that requires the services of high-paid personnel—business rescue practitioners who are often selected from the ranks of legal practitioners and business experts—renders the process burdensome for SMEs. Because SMEs are sensitive and survivalist in nature, they require seasoned SME experts to develop their turnaround strategy. The one-size-fits-all approach of business rescue is thus not favorable for saving SMEs with a monthly turnover equivalent to the daily prescribed fees of a business rescue practitioner. Moreover, the financial distress requirement is limiting, in that businesses do not fail only due to financial distress but also through economic distress that involves the failure of the business plan. Had the legislature made use of the recommendations made by Rajak & Henning, who envisioned a dual system form of business rescue—one that takes cognizance of the contribution of small companies in our economy—the current difficulties could have been avoided.

Alternatively, the Companies Act of 2008 also provides for business rescue by way of a compromise between the company and its creditors. Directors or members of the companies may negotiate an approach to reorganizing the company through compromise between the creditors and the directors of the company at creditors' meetings. The compromise provides the members or directors of the company with an opportunity to restructure the company, regardless of whether the company is in financial distress. A further advantage is that this compromise does not require the services of a handsomely remunerated business rescue practitioner. This reduces administrative costs for SMEs and all other companies that make use of this alternative.

Although a compromise between a company and its creditors provides for a less formal and more cost-effective form of corporate reorganization, it has its

inherent weaknesses which make it unfeasible for an SME. Importantly, it does not provide for an automatic moratorium against the company's creditors during the process of renegotiation of the obligations between a company and its creditors.

To promote a pragmatic business rescue procedure that is appropriate for South African SMEs, the following recommendations are proposed:

First, a dual system form of business rescue, like the dual system proposed by Rajak & Henning, would create an accommodative corporate rescue mechanism for SMEs. A categorizing approach where business rescue can either be informal or formal depending on the size of the distressed company, its annual turnover as well as the number employees that it employs would be useful. Separating these two processes will be useful in reducing the costs of the business rescue.

Second, an informal procedure that would be less procedural and embody a negotiated approach inherent in the Section 155 compromises between a company and its creditors must be implemented. This informal approach should be in an alternative dispute resolution format in which a negotiation environment will be cultivated between the company and its creditors that aims to reach a compromise and the save relationships. Often, creditors are crucial key suppliers and investors, of paramount importance for the overall expansion of the company.

The informal procedure would also include employees and/or employee representatives during the renegotiation process and a strategic planning process. Employees have first-hand experience with the inherent challenges of the business—especially with issues relating to clients and customers. Their contribution would help diagnose problems and develop valuable strategies for reorganization more than appointing a business rescue practitioner who is unfamiliar with the day-to-day running of the company. A proper diagnosis of the problem by a business rescue practitioner and the development of a turnaround strategy by an outsider without knowledge of the company is often time-consuming and contributes to the amplified costs inherent in a Chapter 6 business rescue.

Third, the formal procedure inherent in business rescue should be reserved for much larger corporate entities. The current business rescue procedure is formal in nature and is workable only for large companies that can afford the tariffs of business rescue procedure as well as the duration and administration cost of business rescue.

Fourth, the scheme should include automatic moratoriums in company compromises with creditors. The current compromise between a company and its creditors provides several advantages to SMEs, one being the exclusion of business rescue practitioners. This greatly reduces administrative costs. Nevertheless, the procedure remains cumbersome, over-regulated, and formal. The legislature must include an automatic moratorium when a company enters a compromise with its creditors. These may be either short-term or long-term moratoriums, depending on the size of the company and the effectiveness of the renegotiation processes. The inclusion of automatic moratoriums on compro-

mises between a company and its creditors will reduce interferences from unhappy creditors.

Finally, government must subsidize business rescue proceedings for SMEs. Since the government of South Africa is the principal supplier of SME corporate finance, it will be in the best interests of SMEs as well as the government to help finance the restructuring process of ailing SMEs. State funding of SMEs is, however, not enough to promote socio-economic development. The South African Government should subsidize the costs of business rescue for government-financed SMEs. This would improve the accessibility of business rescue proceedings to many SMEs. Moreover, establishing in-house business rescue services by state institutions providing for SME incorporation and financing would reduce the failure rate of the companies that play a useful role in creating employment and reducing poverty. By subsidizing the business rescue of SMEs, the government will not only help save state resources already invested in these entities but will help bridge the gap between providing employment and developing skills simultaneously. Importantly, it is not enough to finance SMEs and watch them die from some form of financial distress that could have been resolved through business rescue. Unless the current business rescue provision embodied in Chapter 6 of the Companies Act of 2008 is reviewed, the process will remain burdensome for SME companies, and they will be unable to make use of the benefits of business rescue. This recommended review of business rescue will help tailor the process for South African companies, especially SME companies, which are at the heart of employment and overall socio-economic development in South Africa.