

INSOL International: Restructuring Options for MSMEs and Proposals for Reform – South Africa

6 June 2018 16 min read

Directors, Nastascha Harduth and Dr. Eric Levenstein contribute on the Special Report on MSME insolvency, giving a holistic South African view.

1. Is there a legal definition of MSMEs?

1.1 Does any legislation define what is a micro, small or medium enterprise?

Regulation 127(2)(b) to the South African Companies Act 71 of 2008 (Companies Act) defines large, medium and small companies. The aforesaid regulation defines a large company as one with a public interest score (PI score) of 500 or more points, a medium company has a PI score of at least 100 points but not less than 500 points, and a company with a PI score of less than 100 points is considered a small company.

In order to calculate a PI score, the company must give due consideration to:

- the number of employees of the company;
- the liabilities of the company;
- the turnover of the company; and
- the shareholders of the company.

Regulation 127 is, however, only relevant to the requisite level of experience a [business rescue](#) practitioner (BRP) to be appointed must have, and the fees which such a practitioner may charge in the course of a company's business rescue proceedings.

There is, in addition, also several other legal entities that can be classified as MSMEs. This will often include, inter alia, close corporations, partnerships, and sole proprietors.

1.2 Is there any conflict between any of those definitions?

There is no conflict between any of the definitions.

2. Is there currently a formal restructuring process? If so, what are the main characteristics?

2.1 Is there a legislated restructuring framework?

Section 155 of the Companies Act sets out the procedure and requirements for a compromise to be proposed to creditors of a company (whether not the company is in financial distress). Furthermore, chapter 6 of the Companies Act applies to all South African companies and allows for a formal rescue and restructuring process through the appointment of a supervisor, namely the Business Rescue Practitioner (BRP). Section 66(1A) of the Close Corporations Act 69 of 1984, read with item 6 of Schedule 3 of the Companies Act, provides that Chapter 6 of the Companies Act also apply to close corporations. A reference to a company herein therefore includes close corporations. If a company is financially distressed as defined in section 128(1)(f) of the Companies Act (i.e. the company will either be unable to pay its debts as and when they fall due for payment or become insolvent on its balance sheet within the immediately ensuing 6 months) and there appears to be a reasonable prospect of rescuing the company as contemplated in section 128(1)(h) read with section 128(1)(b) (i.e. it continues as a going concern, or creditors receive a higher dividend than they would have in liquidation proceedings), then –

- the company's board of directors may adopt a resolution in terms of section 129(1) of the Companies Act to enter into business rescue proceedings voluntarily; or
- an affected person (employee, its representatives or trade union, shareholder or creditor) can, in terms of section 131 of the Companies Act, bring an application to Court to place the Company under business rescue by court order.

The Companies Act does not apply to partnerships or sole proprietors. However, such debtors may apply for debt relief under the National Credit Act 34 of 2005, or for an administration order under the Magistrates' Court Act 32 of 1944, in order to pay off the debts in instalments or otherwise. Some drawbacks would be that administration applications can only be made if the debtor's debts do not exceed ZAR50,000, whereas debt review has no monetary cap but applies only to credit agreement debt. Neither the administration nor the debt review process prohibits other debt relief measures such as a voluntary distribution based on a composition between a debtor and his / her creditors, or sequestration of the estate of a debtor in terms of the Insolvency Act 24 of 1936.

2.2 Is the restructuring legislation specifically developed to apply to MSME insolvency or is the existing legislation modified to apply to MSMEs?

The legislation and timelines of the business rescue process remain the same, regardless of the size of the company.

However, the remuneration which BRPs may expect during the course of business rescue proceedings are subject to the tariff set out in Regulation 128 to the Companies Act and is based on the size of a company placed under supervision.

2.3 Who controls the company during the period of restructuring?

A BRP is responsible for supervising and managing the company whilst it is under business rescue and, as such, the board of directors and individual members of the board are obligated to continue to perform their duties and functions, subject to the authority, in each instance, of the BRP.

2.4 How are the different classes of creditors treated?

Section 135 of the Companies Act sets out the order in which the claims of creditors rank during business rescue. In terms of this section, post-commencement financiers are preferred. Section 135(3)(a)(ii) of the Companies Act states that the claims of post-commencement financiers (whether secured or unsecured) will rank ahead of the claims of all "unsecured" creditors, but after the business rescue practitioner's claim for remuneration and expenses and employees' remuneration during the business rescue process.

Save for post commencement financiers, there are no other statutory preferred creditors (such as the South African Revenue Service) which must be paid before other concurrent (unsecured) creditors in terms of a business rescue plan. That is, all pre-

commencement unsecured creditors rank equally in business rescue proceedings. This usually results in unsecured creditors receiving a dividend in business rescue proceedings, whereas they would a negligible dividend, or none at all, in liquidation proceedings.

In addition, section 134(3) of the Companies Act sets out how secured creditors must be treated in a business rescue:

- Unless the proceeds of the assets that form the subject matter of the secured creditors' security are sufficient to discharge the company's indebtedness to that creditor in full, the company must obtain the consent of that secured creditor before disposing of the asset in question; and
- The company must promptly pay the proceeds from the disposal of the assets in question to the creditor up to the amount of the company's indebtedness to the creditor or provide security for the amount of those proceeds to the reasonable satisfaction of that creditor.

2.5 Are there government incentives for restructuring?

Through Chapter 6 of the Companies Act 2008, government has clearly indicated a preference for restructuring over liquidation and this is stated quite clearly in a number of provisions in the Act.

The business rescue provisions in Chapter 6 of the Companies Act 2008 provide for the provision of post-commencement financing and also provides for a super priority in favour of those who provide fresh funds for a restructuring.

There are no other government incentives that encourage use of the corporate rescue provisions.

3. Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?

3.1 Are there any preconditions required before entering into restructuring?

As mentioned above, in terms of section 129 of the Companies Act, the precondition for a company entering into the business rescue process is that it is "financially distressed" and that "there appears to be a reasonable prospect of rescuing the Company".

3.2 Does a complex restructuring process discourage timely use by MSMEs and is the cost of formal restructuring prohibitive to MSMEs?

The remuneration of the BRP and ancillary costs (e.g. legal and accounting fees) can be a financial burden for smaller companies in financial distress and may prove to be prohibitive in some cases.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

4.1 Are businesses transferred to related parties prior to liquidation as an alternative to a formal restructuring?

Section 112 of the Companies Act, read with section 115, provides that a Company may dispose of the whole or greater part of its business, only if such a disposition has been approved by a special resolution (75% majority) of the Company's shareholders, or if such a disposition is pursuant to an approved business rescue plan as contemplated in Chapter 6 of the Companies Act.

A viable business can therefore be transferred to related parties prior to liquidation as an alternative to a formal. However, there must be a proper valuation of the business before it is transferred in order to ensure that the company receives value

for the transfer. Should a company's business be transferred for no / inadequate value, then a liquidator may apply to Court to have that transfer declared void (more fully dealt with below).

As an alternative, section 155 of the Companies Act sets out the procedure and requirements for a compromise to be proposed to creditors of a company (whether not the company is in financial distress). The board of a company may deliver a proposal regarding an arrangement or compromise of its financial obligations to all of the company's creditors. A proposal is adopted by the creditors of a company if it is supported by a majority in number, representing at least 75% in value of the creditors present and voting at a meeting called to consider the proposal. If a proposal regarding an arrangement or compromise of a company's financial obligations to all of the company's creditors is duly adopted, the company may apply to the court for an order approving the proposal. Once sanctioned by court order, the compromise or restructuring will be final and binding on all of the creditors or members of the relevant class of creditors. Section 155 does not, however, apply to companies in business rescue and while a compromise in terms of this section is being negotiated, any creditor could apply either for the business rescue or the liquidation of the company.

Also, a business may also be transferred to related parties as a "pre-pack" in business rescue proceedings. In this regard, prior to entering into business rescue, the Company will have to conduct a proper valuation of the business and commence negotiations with major creditors in order to secure a pre-agreed 75% statutory vote (50% of which must be unrelated to the Company).

4.2 If so, is this regulated in any way?

The business of an insolvent company, together with the company's employees (in terms of section 197 of the Labour Relations Act 66 of 1995 (LRA)), may only be transferred to another entity (whether related or unrelated) if value is received. That is, where a company's business is transferred without it having received value, such a transfer would constitute an impeachable disposition in terms of the Insolvency Act 24 of 1936 (Insolvency Act), read with section 340 of the Companies Act 61 of 1973 (the 1973 Companies Act) and item 9 of Schedule 5 of the Companies Act and which can then be set aside by court order.

4.3 Is it the preferred method of restructure?

Informal restructurings (whether by transferring the business of the company, or reaching a compromise in terms of section 155 of the Companies Act) in South Africa hold several advantages, which may result in it being the preferred restructuring tool. That is, informal restructurings are usually conducted in a confidential manner and as such distressed companies are not affected by adverse publicity, their reputations remain intact, market value is preserved and missed opportunity costs are reduced. Informal restructurings are consequently also less disruptive to relationships with employees, customers and suppliers, whether current or prospective. Informal restructuring also holds other significant advantages such as the flexibility to agree on "tailor-made" solutions, and continued control by management. Because these advantages can make informal restructurings more attractive than business rescue, it attracts companies that are more inclined to commence informal restructurings earlier on, which then in turn increases the prospects of a successful rescue.

5. Are there any barriers or restrictions on the use of the procedures identified in question 4? Are they open to abuse?

5.1 Are there laws that prevent the "phoenixing" of businesses in the jurisdiction?

As mentioned above, section 340(1) of the 1973 Companies Act, read with item 9 of the Schedule 5 of the Companies Act, states that '[e]very disposition by a company of its property which, if made by an individual, could, for any reason, be set aside in the event of his insolvency, may, if made by a company, be set aside in the event of the company being wound up and unable to pay all its debts, and the provisions of the law relating to insolvency shall mutatis mutandis be applied to any such disposition'. Also, in terms of the LRA, a company's business (assets) may not be transferred without its employees being transferred with it.

It is also worth mentioning that, in terms of section 162(7)(b) of the Companies Act, a court may make an order placing a director under probation if, within any period of 10 years, the director was a director or managing member of two or more companies that were unable to fully pay all of their debts to creditors, except in terms of a business rescue plan in terms of Chapter 6 of the Companies Act or a statutory compromise in terms of section 155 of the Companies Act. A court order for a director's probation may also include an order for the director to pay compensation to any person adversely affected by that director's conduct.

6. Are there any implications for restructuring through an informal process?

6.1 Can a director be held liable for the debt of a company during the period of restructure?

Section 22(1) of the Companies Act states that a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person, or for any fraudulent purpose. In this regard, section 77(3)(b) continues to state that any director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director:

- having acquiesced to the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22(1) of the Companies Act; or
- being party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a company creditor, employee or shareholder, or had another fraudulent purpose.

On what constitutes recklessness, the Supreme Court of Appeal in the case of *Heneways Freight Services (Pty) Ltd v Grogor* 2007 (2) SA 561 (SCA) referred with approval to *Ex parte De Villiers NO: In re Carbon Developments (Pty) Ltd* 1993 (1) SA 493 (A) which in turn quoted with approval from the case of *Ex parte Strydom NO: In re Central Plumbing Works (Natal) (Pty) Ltd* 1988 (1) SA 616 (D): "...the true test of a company's solvency is not whether the company's liabilities exceed its assets but whether it is able to pay its debts." Therefore, directors can be held liable for the for any loss, damages or costs sustained by the company as a direct or indirect consequence of the directors allowing the company to incur credit under circumstances where the company is unable to pay its debts as and when they fall due.

However, this conclusion was qualified by the South African Supreme Court of Appeal in the case of *Fourie NO v Newton* [2010] JOL 26517 (SCA) which stated that "The essential question is whether the board would be acting recklessly in seeking to exploit the other sources of funding. The answer to that question would in the first place depend on the amount of funding required, for how long it would be required, and the likelihood of it being obtained whether timeously or at all; and in the second place, on how realistic the possibility is that the company's fortunes will be turned around. The second consideration will materially depend on whether there is a credible business plan or strategy that is being or could be implemented to rescue the company. A business that may appear on analysis of past performance to be a hopeless case, may legitimately be perceived as a golden opportunity for a turnaround strategy."

6.2 Can the advisor be held liable for the debts of a company during the period of restructure?

Section 140(3) of the Companies act provides that during a company's business rescue proceedings, the practitioner has the same responsibilities, duties and liabilities of a director of the company as set out in sections 75 and 77. Therefore, the advisor can also be held liable for any loss, damages or costs sustained by the company in terms of section 77(3).

In addition, in terms of section 424 of the 1973 Companies Act, read with section 218 and item 9 of Schedule 5 of the 2008 Companies Act, a court can declare any person who knowingly allowed company to conduct its business recklessly or with intent defraud that company's creditors, personally liable for all or any of the debts or other liabilities of the company as the Court may direct once that company is placed in liquidation.

7. Are there any current proposals for reform of the restructuring processes with respect to MSMEs?

7.1 Is there any current proposed legislation to deal with restructuring of MSMEs?

There are no current proposals dealing with the restructuring of MSMEs.

7.2 Are any interest groups proposing any changes to the legislation in respect of MSMEs?

There are no interest groups currently proposing any changes to MSME legislation.

8. What reforms would be useful if they were to be implemented?

8.1 Should existing legislation be modified to apply to MSMEs or new legislation specifically be designed for MSMEs?

The costs of business rescue can be prohibitive for companies and close corporations that are MSMEs and both administration and debt review proceedings are geared towards individuals as opposed to businesses. In sum, existing legislation does not currently cater for MSMEs and there is certainly room for improvement in this regard.

8.2 Should further non-judicial assistance such as mediation be provided to MSMEs?

Within the current business rescue framework, it is often the case that formal dispute resolution mechanisms need to be introduced where ongoing and protracted disputes, which might hamper the success of the business rescue process, be resolved in a speedy fashion. Protracted litigation delaying the ultimate discharge of the company from its business rescue process is a frustrating prospect, therefore non-judicial assistance such as mediation should be provided to MSMEs.

Originally published in the INSOL International: Restructuring Options For MSMEs and Proposals For Reform, South Africa



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