

# Keep Calm – We are Coming to the Rescue !!

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Business rescue was introduced into our law with the enactment of Chapter 6 of the Companies Act 71 of 2008 (“**Companies Act**”). In essence, business rescue proceedings are aimed at facilitating the rehabilitation of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders. This objective is achieved by, *inter alia*, reorganising or restructuring the financially distressed company's affairs and business, in a manner that either maximises the likelihood of the company continuing to exist on a solvent basis as a commercially viable entity, or if this is not possible, provides a better return for the creditors and shareholders of the company than that which would ordinarily result from the immediate liquidation of the company.

A central feature of the business rescue process is the appointment of a business rescue practitioner. In this regard, the Companies Act provides that once a company has been placed into business rescue, a business rescue practitioner immediately steps into a supervisory role and is tasked with managing and overseeing the financially distressed company (in substitution for the company's incumbent board of directors), with the objective of turning the company around, through the implementation of an approved business rescue plan.

Given the pivotal and far-reaching role of business rescue practitioners within the business rescue process, and where the board of directors of the company become answerable, to a large degree, to such practitioners in respect of the ongoing conduct of the company's operations and affairs, it is unsurprising that the relationship between business rescue practitioners and the board of directors may, in certain instances, be a contentious one. From our experience, directors (who themselves have never been through a business rescue process) are often confused and somewhat bewildered by their change of status and are often unsure as to their continued role in the company.

With the above background in mind, we explore, in this article, directors' rights, duties and obligations, both before and during the business rescue process. Moreover, we consider the practical approaches that ought to be taken by directors when the company, on whose board they sit, is facing financial difficulties. As a pretext to this discussion, we briefly set out certain aspects of the law that are relevant for directors, such as the standards for director conduct and the potential claims that may be brought against directors if they fail to comply with their duties and obligations.

## Required Standard of Directors' Conduct

Section 76 of the Companies Act addresses the standard of conduct expected from directors and prescribed officers (collectively hereinafter referred to as "directors" for purposes of this section). Section 76(3) states that a director of a company, when acting in that capacity, must exercise the powers and perform the functions of a director:

- in good faith and for a proper purpose;
- in the best interests of the company; and
- with the degree of care, skill and diligence that may reasonably be expected of a person:
  - carrying out the same functions in relation to the company as those carried out by that director; and
  - having the general knowledge, skill and experience of that director.

Section 76(4) states that in respect of any particular matter arising in the exercise of the powers or the performance of the functions of a director, a particular company director will have satisfied the obligations set out in section 76(3), if the director has taken reasonably diligent steps to become informed about the matter. This goes to the degree of knowledge that a particular director would have as to the financial status and affairs of the company.

In terms of section 76(4) of the Companies Act, a director would have satisfied the obligations of section 76(3), if the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company.

## Claims Against Directors

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There are certain instances, where a company's board of directors can be held personally liable for the company's debts. In terms of section 77(2)(a) of the Companies Act, a director of a company may be held liable in accordance with the principles of the common law relating to the breach of a fiduciary duty, for any loss, damages or costs sustained by the company as a consequence of any breach by the director of duties contemplated, inter alia, in section 76 of the Companies.

Also, section 77(3)(b) of the Companies Act, as read with section 22 of the Companies Act, penalises and holds directors personally liable to the company for any loss incurred through knowingly carrying on the business of the company recklessly, with gross negligence, with the intent to defraud any person or for any fraudulent purpose.

It is important to note, however, that the Companies Act does not limit the application of section 77 only to directors as such. It applies to prescribed officers as well, which includes any person who exercises general executive control over and management of the whole or a part of the business and activities of the company, or who regularly participates to a material degree in the exercise of general executive control over and management of the whole or a portion of the company.

Section 77(6) allows the company to claim against more than one director and against any person who contravened the provisions of the Companies Act. In this regard, section 77(6) of the Companies Act states that the liability of a person in terms of section 77 is joint and several with any other person who is or may be held liable for the same act.

Finally, as a general catch-all provision, section 218(2) of the Companies Act provides that any person who contravenes any provision of the Companies Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention. Therefore, the liability contemplated in section 77(3)(b) of the Companies Act goes beyond the company and extends to any person who may be adversely affected by the unlawful conduct of a director.

## Duties when the Company experiences Financial Distress

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When a company experiences financial difficulties (or more specifically, financial distress as such term is defined in the Companies Act), it is incumbent upon a company's board of directors to ensure that correct decisions are taken in the specific circumstances. In particular, boards of directors must consider whether business rescue proceedings are appropriate for the company.

In this regard, section 129(1) of the Companies Act provides that –

*"the board of a company may resolve that the company voluntarily begin business rescue proceedings and place the company under supervision, if the board has reasonable grounds to believe that (a) the company is financially distressed; and (b) there appears to be a reasonable prospect of rescuing the company."*

In terms of section 128(1)(f) of the Companies Act, the words "*financially distressed*" mean that –

*"(i) it appears to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months; or*

*(ii) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months".*

Consequently, there are two instances in which a company may be held to be "financially distressed", and in order to determine whether or not either instance has occurred, the following tests must be performed:

- a cash flow test, which pertains to the so called "commercial insolvency" where a company cannot pay its debts as and when they fall due for payment; or
- a balance sheet test, which relates to the so called "factual or technical insolvency" where a company's liabilities exceeds its assets.

In both instances, the word "reasonably" is used. Accordingly, the test for financial distress is objective, it being whether or not a reasonable director, in the same position as the directors of the company, would have come to the same conclusions regarding the company's financial position had they been required to make the same decision.

The Companies Act is silent on when it should be concluded that the company will be unable to pay all its debts as they fall due in the immediately ensuing six months, or how it is to be decided that that company is likely to become insolvent during the same period. It is recommended that the board of directors should, *inter alia*, continuously monitor whether the company is able to pay its debts as they fall due and payable in the ensuing six months or if the company is likely to become insolvent.

To the extent that a company's decides not to adopt a resolution commencing business rescue proceedings, section 129(7) of the Companies Act provides that –

*"[i]f the board of a company has reasonable grounds to believe that the company is financially distressed, but the board has not adopted a resolution contemplated in this section, the board must deliver a written notice to each affected person, setting out the criteria referred to in section 128(1)(f) that are applicable to the company, and its reasons for not adopting a resolution contemplated in this section".*

Therefore, if the board of directors of a company concludes that the company is financially distressed at any particular point in time, it will be obliged to either (i) adopt a resolution in accordance with the provisions of section 129(1) of Companies Act to place the company under business rescue; or (ii) deliver a written notice to each affected person (in accordance with the provisions of section 129(7) of the Companies Act) advising why such resolution was not adopted.

The aforementioned decisions, i.e. to either place a company in business rescue, or to send out a "section 129(7) notice" should be carefully considered, particularly the latter, which may give rise to unintended consequences. It goes without saying, however, that directors ought to take appropriate advice, especially when assessing whether a company is financially distressed and whether business rescue proceedings are appropriate in the circumstances.

## Directors' Duties during Business Rescue

Once a company is placed into business rescue, Chapter 6 of the Companies Act sets out certain roles and obligations (in this changed environment) for directors. In particular, section 140(1)(a) and (b) of the Companies Act, states that –

*"[d]uring a company's business rescue proceedings, the practitioner, in addition to any other powers and duties set out in this Chapter- (a) has full management control of the company in substitution for its board and pre-existing management; (b) 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".*

Additionally, section 137(2)(b) of the Companies Act provides that during a company's business rescue proceedings "each director of the company has a duty to the company to exercise any management function within the company in accordance with the express instructions or direction of the practitioner, to the extent that it is reasonable to do so". In fact, section 137(3)

goes further and states that "[d]uring a company's business rescue proceedings, each director of the company must attend to the requests of the practitioner at all times, and provide the practitioner with any information about the company's affairs as may reasonably be required". Section 137(4), on the other hand, provides that if, during a company's business rescue proceedings, the board, or one or more directors of the company, purports to take any action on behalf of the company that requires the approval of the practitioner, that action is void unless approved by the practitioner.

As a final word, it is important to note that if at any time during the business rescue proceedings, a director has –

- failed to comply with a requirement of Chapter 6; or
- by act or omission, has impeded, or is impeding –
  - the practitioner in the performance of the powers and functions of practitioner;
  - the management of the company by the practitioner; or
  - the development or implementation of a business rescue plan in accordance with this Chapter 6 of the Act,

then the practitioner may, in terms of section 137(5) of the Companies Act, apply to a court for an order removing a director from office and may apply to have a director declared delinquent in terms of section 137(6) read with section 162 of the Companies Act.

Moreover, if a director has acted in a manner that contravenes any provision of the Companies Act, section 218(2) of the Companies Act provides that such director would be liable to any person who has suffered any loss or damage as a result thereof.

## **Practical Aspects for Directors to Consider**

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Given the nature of the business rescue process, business rescue practitioners inevitably come into the company cold. In such circumstances, it is axiomatic that business rescue practitioners will be heavily reliant on existing members of the board, as well as the company's management. Consequently, a constructive and cooperative relationship between a company's board and the appointed business rescue practitioner is imperative for the success of the business rescue process.

In terms of the provisions of the Companies Act, business rescue practitioners are obligated, within a short space of time, to consult with creditors, suppliers and contracting parties, in order to ascertain whether or not there is a realistic prospect of the company being rescued. If there is no reasonable prospect of rescuing the company, the practitioner is obligated by the Companies Act to place such company into liquidation. This supports the proposition that there is a need for practitioners to engage and cooperate with board members from the outset.

Certain provisions of the Companies Act seek to ensure that such cooperation ensues between the company's board and the appointed practitioner and in this regard, sections 142(1) and (2) of the Companies Act places an obligation on the board to deliver to the practitioner (as soon as practicable after business rescue proceedings have commenced), all of the books and records of the company that relate to the affairs of the company and which are in the board's possession.

In addition, a director must, in terms of section 142(3) also provide the practitioner with a statement of affairs containing particulars relating to, –

- any material transactions involving the company or the assets of the company, and occurring within 12 months immediately before the business rescue proceedings began;
- any court, arbitration or administrative proceedings, including pending enforcement proceedings, involving the company
- the assets and liabilities of the company, and its income and disbursements within the immediately preceding 12 months;
- the number of employees, and any collective agreements or other agreements relating to the rights of employees;
- any debtors and their obligations to the company; and
- any creditors and their rights or claims against the company.

Thus, there is an expectation on the part of the business rescue practitioner to be given full access to all the relevant and pertinent information relating to the financial and operational affairs of the company. This will enable the practitioner to

properly investigate the affairs of the company and to develop a business rescue plan that can be published and placed before all affected persons at a section 151 meeting for approval.

Notwithstanding the wide range of powers conferred upon business rescue practitioners during business rescue proceedings, it is important to note that practitioners cannot do it all alone. In practice, practitioners will be required to engage with the board and report to the board on the business rescue process, the continued operation of the company, the suspension/termination of contracts, the provision of post-commencement finance, and on the development of the business rescue plan. If practitioners require the board to assist them in the business rescue process, then the practitioner has the right to request that the board do so in terms of section 137 of Companies Act. Of course, if the practitioners' request is reasonable, the board will be obliged to act in accordance with the practitioners' express instructions or directions.

Having regard to section 137(3) and 137(5) of the Companies Act, if any directors on the board do not wish to act in accordance with the practitioners' express instructions or directions, then those directors should opt to resign, as failure to do so could result in such directors being removed from the board and declared delinquent, in terms of section 162 read with section 137(5) of the Companies Act. In addition, directors may also be held liable under the section 218 catch-all liability provision, for any losses incurred as a result of such directors' contraventions of the Companies Act.

It is important to note, however, that during business rescue proceedings, the directors of the company will be relieved from their duties as directors, as set out in section 76 of the Companies Act, as well as their liabilities as set out in section 77 of the Companies Act, to the extent that such directors have acted in accordance with the express instructions or directions of the practitioner, and to the extent that it was reasonable for them to do so.

## **The distinction between external and internal functions of directors and business rescue practitioners**

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As mentioned above, a primary objective of the business rescue process is to facilitate the rehabilitation of financially distressed companies. This is achieved, in large part, by affording business rescue practitioners wide-ranging management powers. As a consequence, questions that often arise, in such circumstances, are the following: (i) to what extent are directors' powers are limited by virtue of the appointment of a business rescue practitioner and by extension (ii) to what extent do directors become redundant? Based on our courts' interpretation of the relevant provisions of the Companies Act, the legal position is that (i) directors of companies in business rescue continue to exercise the functions of a director, albeit subject to the authority of the business rescue practitioner, and (ii) to the extent that any power, function or duty falls outside the ambit of the authority of the business rescue practitioner, the board of directors is able to exercise such powers, functions and duties without requiring the approval of the business rescue practitioner.

In the judgment of *Tayob and another v Shiva Uranium (Pty) Ltd and others* [2020] ZASCA 162 (8 December 2020) and confirmed by the Constitutional Court in *Shiva Uranium (Pty) Limited (In Business Rescue) and Another v Tayob and Others* [2021] ZACC 40 (9 November 2021), the courts deal with the question of the role of a company's board of directors during the business rescue process. In this regard, the Supreme Court of Appeal and the Constitutional Court confirmed that there is a distinction made between "management functions" and "functions of governance". The former being within the scope of the business rescue practitioner's powers, whilst the latter remained in the domain of the company's board of directors. The courts further confirmed that any function of a director that falls outside the ambit of the authority of the practitioner cannot be subject to the practitioner's approval.

In the judgment of *Ragavan and Others v Optimum Coal Terminal (Pty) Ltd N.N.O and Others* [2022] ZAGPJHC 14 (18 January 2022), the High Court dealt with the interplay or "rules of engagement" between business rescue practitioners and the company's board. The judgment hinged on the concept of "internal vs external" functions, whereby governance functions (or functions that are internal in nature), for instance presenting annual financial statements, issuing shares, scheduling shareholders' meetings, proposing resolutions and holding board meetings, are retained by directors during the course of business rescue proceedings. On the other hand, external functions, which involve interactions with the outside world and that concern management powers (including voting at section 151 meetings) are conferred upon practitioners, pursuant to the provisions of Chapter 6 of the Companies Act.

Whilst there is no express provision in the Companies Act delineating the distinction between “internal” and “external” functions, section 66 of the Companies Act confers on directors the power to manage and control the business of the company and its affairs. *Henochsberg* comments on the distinction between “business” (which refers to dealings between the company and outsiders) and “affairs” (which encompasses a wider definition and refers to both the internal relations of a company and its existence).

In the *Ragavan* decision referred to above, Victor J agreed with distinction made by *Henochsberg* and remarked that by examining whether conduct amounts to controlling the “business” of the company or managing its “affairs”, one may determine whether conduct is internal or external in nature, and by implication whether such conduct falls within the domain of the business rescue practitioner or remains with the directors of the company.

The abovementioned judgments go some way in providing clarity on the legal position which is that the directors of a company in business rescue remain the decision makers in respect of all issues which fall outside the day-to-day management of the company (which are the preserve of the business rescue practitioner). This means that whilst business rescue practitioners are responsible for all external functions of the company, which involve interactions with the outside world and those functions that concern management powers, directors still have a role to play in the business rescue context. Accordingly, an important lesson to be learnt is that directors are not completely absolved from actively fulfilling their fiduciary duties once a company is placed in business rescue, in view of the fact that their powers are not totally relinquished to business rescue practitioners during the business rescue process.

## Conclusion

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Business rescue proceedings can be complex and daunting for directors, especially if the business rescue proceedings become protracted and drawn out over a lengthy period of time. It is suggested that if a director is faced with his/her company going into business rescue, close attention is given to the provisions of the Companies Act discussed above and, if required, legal advice should be sought from the outset. If directors do not comply with their duties and obligations, they may find themselves facing personal claims against them, possible removal and where their already damaged reputation can be placed at further risk.



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