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INSOLVENCY & BUSINESS RESCUE

Section 22 – A Springboard into Business Rescue

25 October 2024 *9 min read*

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In August 2024, Statistics South Africa revealed that 1020 entities filed for liquidation in the first 8 months of 2024. In contrast, the Companies and Intellectual Property Commission (CIPC) recorded that only 230 companies entered into business rescue during the same period. This stark contrast highlights the underutilisation of the business rescue mechanism and suggests that many companies may have defaulted into liquidation because their directors and shareholders were not aware of the potential benefits of business rescue. Engaging with a restructuring professional may have provided these companies with the opportunity to turn their businesses around, thereby avoiding liquidation.

Reckless trading and conducting a company's business with the intention of defrauding creditors is addressed in section 22 of the Companies Act 71 of 2008, as amended (the Act). This section delineates the powers and responsibilities of the CIPC in dealing with companies that engage in reckless trading. In the case of *Ozinsky NO v Lloyd & Others 1992*, the court held that if a company continues to carry on business and to incur debts when, in the opinion of reasonable businessmen, standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business is being carried on recklessly.

Section 22(1) of the Act provides 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 the recent Supreme Court of Appeal (SCA) judgment of *Venator Africa (Pty) Ltd v Watts and Another* (Venator Africa SCA judgment), the SCA highlighted that the duty outlined in this provision is incumbent upon the company, and not directly on the directors of the company.

Section 22(2) of the Act indicates that the CIPC may issue a notice to a company to show cause why the company should be permitted to continue carrying on its business, or to trade, if it has reasonable grounds to believe that a company is engaging in conduct prohibited by subsection (1), or is unable to pay its debts as they become due and payable in the normal course of business. This affords a company the opportunity to respond to the CIPC notice.

One should bear in mind that in 2015, the CIPC issued a guidance note on the application of Section 22 on Close Corporations, where the CIPC emphasised that a consequence of this provision is that they "may" call on a company to show cause why it should be allowed to continue trading. Emphasis on the word "may" introduces uncertainty as it does not ensure that the CIPC will take decisive action, even when a company is clearly in financial distress. This lack of decisiveness is concerning as it weakens the enforcement mechanism intended by the Act and raises concerns about the CIPC's role in proactively enforcing compliance.

To protect creditors that are trading with companies that are trading recklessly or not paying their debts, the CIPC should adopt a firmer and more proactive stance, ensuring that it utilizes the full extent of its powers to bring companies into compliance with the section.

Once the CoR. 19.1 form has been issued by the CIPC (this is the notice that the CIPC is empowered to issue in terms of section 22(2) of the Act), a company is required to show cause as to why it should be permitted to carry on business or to trade. Any decision by the company to disregard the CIPC notice, might very well have dire consequences for such company.

In terms of section 22(3) should a company fail within 20 (twenty) business days to satisfy CIPC that it is not engaging in conduct prohibited by subsection (1), or that it is unable to pay its debts as they become due and payable, subsection (3) empowers the CIPC to issue a compliance notice to a company requiring it to cease carrying on its business or trading. In some circumstances, the CIPC may impose conditions on such companies who receive this compliance notice, whereby the company may not dispose of any immovable property.

Nova Propgrow Group Holdings Ltd (Nova) is an example of a company which received a compliance notice from the CIPC. Initially, Nova was issued with a notice to show cause regarding reckless trading or trading under insolvent circumstances through a CoR. 19.1 form, requiring it to show cause as to why it should be permitted to carry on business or to trade due to possible contraventions of section 22 of the Act.

Nova's board of directors was required to provide evidence that the company was not in financial distress and was operating in compliance with the provisions of the Act, however, Nova's board of directors provided unsatisfactory responses to the CIPC.

A compliance notice was issued to Nova in terms of section 22(3) of the Act to afford it a final opportunity to prove beyond a reasonable doubt that it would not be in a financially distressed position by the end of its financial year. Furthermore, the CIPC instructed Nova to temporarily cease carrying on its business, with the condition that it may continue meeting its contractual operational obligations but may not dispose of any immovable property.

Nova's inability to comply with the CIPC's notice to show cause resulted in Nova receiving a compliance notice, restricting the company's ability to dispose of immovable property and placing limits on its trading operations. The actions of the CIPC in relation to Nova highlights the importance of regulatory oversight in protecting creditors and ensuring that companies do not trade recklessly or under insolvent circumstances, to the detriment of stakeholders.

Notwithstanding the Venator Africa SCA judgement regarding director liability, section 129(1) of the Act places a duty on directors to adopt a resolution placing the company in voluntarily business rescue if they believe that there is a reasonable prospect of rescuing a financially distressed company. Therefore, on receipt of the relevant CIPC notice, directors have no choice but to consider whether the company should commence with business rescue proceedings on the basis that its trading in conflict with the provisions of section 22(1) – reckless trading, or where it is unable to pay its debts as they become due and payable in the normal course of the company's business. If the latter is applicable then the company would be financially distressed, and the directors are obligated to pass a resolution in terms of section 129(1) and place the company into business rescue.

In terms of section 128(1)(f) of the Act, a company will satisfy the financial distress test if –

- 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 6 (six) months (commercial insolvency); or
- It appears to be reasonably likely that the company will become insolvent within the immediately ensuing 6 (six) months (factual insolvency).

In these circumstances, and in the event that directors do not adopt a resolution contemplated in section 129(1) of the Act, directors of the company must deliver a written notice to each affected person, setting out the criteria referred to in section 128(1)(f) of the Act, that are applicable to the company, and its reasons for not adopting such as outlined in section 129(7) of the Act. Delivering this notice to affected person is the only alternative available to directors other than filing for the formal business rescue process, however it comes with a grave risk that creditors will bring applications to have the company liquidated.

Much has been said by stakeholders (in particular the banking fraternity) that financially distressed companies do not place themselves into the business rescue process early enough in its downward spiral into financial distress. Generally, boards of directors wake up too late and where the company is placed into business rescue where there is very little left to rescue. If the board of directors consider filing far earlier and where they appoint a business rescue practitioner at an early stage, the prospects of a successful rescue are increased.

Should CIPC play a more active role in sending out compliance notices as contemplated by section 22(3), there is no doubt that we will see boards of directors of financially distressed companies placing themselves into a rescue process at a far earlier stage. A business rescue practitioner of a company in business rescue is able to effectively use the restructuring mechanism in ensuring the survival of viable companies, preserving jobs, and preventing companies from prematurely defaulting into liquidation. Compared to its alternatives, business rescue presents a far more favourable option.

The proper activation of a section 22 process, on the basis mentioned above, affords the CIPC an important opportunity to play a pivotal role in the corporate restructuring landscape in South Africa. If this was so, creditors would be encouraged to engage with CIPC when there are reasonable grounds to believe that a company is unable to meet its financial obligations. Upon receiving such notification from an unpaid creditor, CIPC would be prompted to assume a proactive regulatory role by enforcing the section 22 mechanism.

Conversely, directors on the receiving end of section 22 notices would be motivated to use such notice as a springboard to filing for business rescue. Boards of directors would need to act swiftly to prevent worsening financial conditions, making it impossible for a successful turnaround.

When a company initiates business rescue too late in its distress curve, the chances of a successful recovery diminish significantly. Proactive intervention by the CIPC and directors will lead to early filings for business rescue, thereby preserving value for creditors and ensuring a viable turnaround in favour of all stakeholders.



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