

**CRITICAL ANALYSIS OF SECTION 153 (1) (A) (II): IN WHOSE INTERESTS DO  
CREDITORS ACT DURING BUSINESS RESCUE PROCEEDINGS?**

**by**

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## Declaration

I declare that this research project is my own, unaided work. It is submitted in partial fulfilment of the requirements of the LMM (Corporate Law), University of Pretoria. It has not been submitted before for any degree or examination at any other university.

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## CHAPTER 1

### General introduction

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#### I BACKGROUND INFORMATION

The South African legal system stems from Roman-Dutch law, which generally forms part of the South African common law. In Ancient Rome, “the penalty for declaring bankruptcy was slavery or being cut into pieces and the choice was left to the creditors”.<sup>1</sup> One writer described Bankruptcy as a gloomy and depressing subject that no society was immune to<sup>2</sup>. It is from this that we find different bankruptcy systems within the various jurisdictions which have developed over centuries.

The early English law had origins that were creditor friendly and accompanied by an extremely harsh treatment of bankrupt debtors. Under this system not only could one be imprisoned for being unable to pay their debt but this went as far as also allowing for seizure of a debtor dead body, which would only be released once the debt had been paid in full<sup>3</sup>. English law today has developed significantly from this ancient practice.

In contrast to most other jurisdictions Bankruptcy in the United States of America was reformed in the mid 1900’s and the current system does not signify a bankrupt debtor taking its last gasp for air once it files for bankruptcy but instead provides a possibility for the debtor to not only gasp their last breath but to catch its breath and recover, empowering it to have a new fresh start and another chance within the corporate realm. This not only benefits the corporate and its shareholders but stimulates economic growth by ensuring companies continue to contribute to the economy and provide employment within various industries.

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<sup>1</sup> Le Roux and Duncan. 2016. The naked truth: creditors’ understanding of business rescue: a small business perspective. *SAJESBM*, 6: 58

<sup>2</sup> Warren, 1935. *Bankruptcy in the United States history 1*

<sup>3</sup> Tabb. 1996. *History of bankruptcy law*, ABI Law review 3:7

The Insolvency Act<sup>4</sup> in South Africa governed the sequestration of estates of individuals, trusts and partnerships that become insolvent. The winding up and reorganisation of companies fell under the ambit of the Companies Act 61 of 1973 (“the 1973 Act”) which incorporates a number of sections of the Insolvency Act that deal with companies that can no longer pay their debts<sup>5</sup>. Under the 1973 Act the options available to financially distressed companies in South Africa were liquidation or judicial management. The effects of liquidation were and remain drastic and have often been described as the guillotining of a company,<sup>6</sup> since it results in the demise of the corporate entity. In the case of *R v Meer*,<sup>7</sup> the court remarked that “the Insolvency Act was passed for the benefit of the creditor and not for the relief of harassed debtors”. The *R v Meer* judgment confirmed the position that the South African law system was, at that stage, a creditor-oriented system and, in principle, similar to that of Ancient Rome as the scales weighed on the benefit of creditors.

In contrast to the South African insolvency law system, which was essentially creditor-oriented, many other systems had changed to an approach focused on assisting debtors in need of relief, with a view to saving the corporate entity. In the United States of America, the Bankruptcy Reform Act was promulgated in 1978, making it widely accepted that debt relief by means of procedural discharge enables a debtor to make a fresh start.<sup>8</sup> As a result of the procedural discharge approach, the United States of America’s insolvency law system is today not only regarded as a collective debt-collecting instrument, but it is also accepted that it has an important social and corporate role to fulfil.<sup>9</sup>

Notably the most significant development under South African insolvency and company laws was the introduction of the new business rescue model which replaced the system of judicial management. The new model encompassed a departure from South Africa’s creditor friendly regime to a more debtor friendly regime.<sup>10</sup> The introduction of the Companies Act, No. 71 of 2008 (“the Act”), represents an overhaul of South Africa’s former regime of corporate rescue

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<sup>4</sup> Insolvency Act 27 of 1936

<sup>5</sup> Zuylen. 2009. *Restructuring and insolvency in 57 jurisdictions worldwide*, getting the deal through: 414

<sup>6</sup> Wood. 2001. *Principles of International Insolvency*, 7: 31

<sup>7</sup> 1957(3) SA 614 (N): 619

<sup>8</sup> Bertelsmann et al, *Mars: the Law of Insolvency in South Africa*, 9: 4

<sup>9</sup> Ibid.

<sup>10</sup> Zuylen. 2009. *Restructuring and insolvency in 57 jurisdictions worldwide*, getting the deal through: 423

and offers ailing companies a possible alternative to liquidation, in the form of business rescue. Chapter 6 of the Companies Act encompasses the objectives and procedures to be followed before, during and after a company has filed for business rescue. The primary purpose of business rescue is to enable the restructuring of the affairs of a company, in order to either ensure that the company continues in existence on a solvent basis, or provides a better return for the creditors and shareholders than would ordinarily result from liquidation.<sup>11</sup> Business rescue has two possible independent results. The primary purpose and aim of business rescue is to save the ailing company as a going concern and enable it to continue on a solvent basis and in the event that this is not possible, then the secondary aim and objective of the Act is to restructure the company in such a manner that the stakeholders involved including the creditors will get a return which is better than what they would have received in liquidation.<sup>12</sup>

Business rescue is defined as the proceedings to facilitate the rehabilitation of a company that is in financial distress by appointing an independent business rescue practitioner to temporarily supervise the management of a company's affairs, business and property and to place a moratorium on the rights of creditors against the company, so as to enable the development and implementation of a business rescue plan to restructure the company's affairs.<sup>13</sup>

## II THE DISSERTATION QUESTION AND RELEVANCE

Business rescue is aimed at offering practical guidance and solutions to ailing companies that need rescue, which will in turn benefit the company, its creditors, employees and various other stakeholders. The purpose of this dissertation is to scrutinise the developments that have taken place with regards to the position and, more particularly, the voting powers of creditors during business rescue and consider if such powers enable the business rescue procedure to be a viable option within the corporate law realm that companies can utilise.

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<sup>11</sup> Pretorius and Rosslyn-Smith. 2014. Expectations of a business rescue plan: international directives for Chapter 6 implementation. *Southern African Business Review*, 18: 109

<sup>12</sup> Delport. 2014. *New Entrepreneurial Law*. Lexis Nexis

<sup>13</sup> Ibid

This paper will analyse and interrogate the powers given to creditors and to whose benefit such powers are exercised. In terms of section 7(k), the purpose of the Act is “to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders”.<sup>14</sup> Further, the primary objective of business rescue is to rehabilitate the company and enable it to continue on a solvent basis. However, in practice, the interests of larger creditors such as banks and security holders often seem to take precedence and this has the potential to override the primary objective of business rescue. The question of who benefits from the legal powers given to creditors will be critically analysed, in line with the purpose and objectives of the Act.

In terms of the business rescue procedures, the business rescue plan must be considered and approved on a vote by the creditors. In the event that the creditors reject the proposed business rescue plan, the Act provides that the business rescue practitioner may solicit a vote of approval of the business rescue plan from the relevant creditors, or holders of voting rights. Alternatively, the business rescue practitioner may inform the meeting that the company will apply to set aside the vote, on the grounds that it is inappropriate, in terms of section 153(1)(a)(ii) of the Act.<sup>15</sup> The question then arises as to what is an inappropriate vote by creditors and in whose interests such a vote is made. This paper seeks to critically analyse this question and clarify the position, for future reference for creditors who find themselves entangled in the business rescue process, for the company in business rescue and the business rescue practitioners.

### **III THE DISSERTATION OBJECTIVE**

Business rescue enables companies to restructure and reorganise their business and represents a fresh addition to South African corporate law, which recognises the importance of corporate entities to social and economic welfare. The business rescue regime is still in its infancy and remains relatively undocumented. The objective of this study is to critically analyse the provisions of section 153 (1) (a) (ii) of the Act and to consider the inappropriate vote in relation to the interests of the voting creditors.

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<sup>14</sup> Section 7(k) of the Act

<sup>15</sup> Faroul HI Casim (eds). 2012

#### **IV RESEARCH METHODOLOGY**

The research methodology adopted includes a comprehensive literature review of primary legal sources in the form of the available court cases (which are very limited) and relevant legislation. The statutes analysed will include the Act and the US Bankruptcy Code. Secondary sources, in the form of textbooks and articles from academic journals, will be used. The Internet has also been utilised in certain instances, since it provides new and updated information. In terms of the choice of legal system, the scope of the discussion applies to South African law. However, the United States has been considered, given that South Africa's business rescue regime is largely influenced by foreign law.



## Chapter 2:

### Business Rescue in South Africa

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#### I THE DEVELOPMENT OF BUSINESS RESCUE IN SOUTH AFRICA

In recent years, insolvency systems around the world have begun to adopt mechanisms to aid financially distressed companies. Such systems acknowledge the general rule that a business offers greater value as a going concern than when in liquidation.<sup>16</sup> These systems have aided economic growth and sustainability of a company as a corporate entity within various jurisdictions.

South Africa, under the 1973 Act, had a judicial management procedure that had been part of its legal system since 1926. Judicial Management was a vehicle created in terms of section 427 to 440 of the 1973 Act. Through this system a company was given a chance to overcome its financial difficulties and thus providing an alternative to liquidation. Judicial management provided companies with an opportunity to restructure their affairs by providing a moratorium against creditors and placing the company under the control of a judicial manager.<sup>17</sup> The judicial management system was highly under utilised and largely unsuccessful as evidenced by the limited number of cases that come before the courts. The reasons for the failure of this system have been attributed to the inadequate legislation, the attitude of the courts and the lack of legal precedents to name a few<sup>18</sup>. The success of the judicial management system was clearly summed up in *Le Roux Hotel Management (Pty) Ltd v E Rand*, where the court described it as “a system which has barely worked since its initiation in 1926”.<sup>19</sup> The judicial management regime was a creditor-friendly system that required that creditors’ claims be paid in full. As a result, it was

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<sup>16</sup> M Pretorius and W Rosslyn-Smith. 2014. *Southern Africa Business Review*, 18: 109

<sup>17</sup> Burdett. 2004. *Some Initial thoughts on the development of a modern and effective business rescue model for South Africa*. SA Merc LJ:241

<sup>18</sup> Ibid.

<sup>19</sup> *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd*. 2001. All SA 223(C) 238

difficult for companies under judicial management to secure funding. From this summary of the legal system, it is clear that there was a need for judicial reform and development in this area of the law.

In 2004, the Department of Trade and Industry published a policy document that highlighted the need for a new corporate rescue procedure, since there had remained a vacuum within this area of law, due to the failure of judicial management.<sup>20</sup>

The failure of the judicial management system was largely the reason for a new business rescue system, which would attempt to save a company, as opposed to liquidating it without any tangible interventions. The Act came into effect on 1 May 2011 and, as part of its corporate law changes and developments, it introduced a business rescue system in South African law that shows strong similarities to the bankruptcy protection systems found in the United States and the United Kingdom.

Business rescue entails the proceedings intended to facilitate the rehabilitation of a company that is financially distressed, by providing for temporary supervision of the distressed company and the management of its affairs, as well as a stay on the rights of claimants against the company, or in respect of property in the company's possession.<sup>21</sup>

Although Business rescue may not always offer a full payment to the creditors an effort is made through this process to ensure that payment is made to the creditors which is accompanied by a business rescue plan that offers a plan on how the business can be restructured and enabled to continue on a solvent basis.

Despite the system being new, the Companies and Intellectual Property Commission (CIPC) has reported that 12% (129) of the 1,338 businesses that have entered into business rescue over the past three years have successfully concluded their business rescue proceedings.<sup>22</sup> It should also be noted that there are a number of cases where companies have failed to attempt business

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<sup>20</sup> Department of Trade and Industry, South African company law for the 21<sup>st</sup> century: guidelines for corporate reform. Notice 1183 of 2004 GG 26493 of 23 June 2004: 45

<sup>21</sup> Companies Act

<sup>22</sup> CIPC, Annual Report 2013/2014. Available: [www.cipc.co.za](http://www.cipc.co.za) (Accessed 28 November 2015)

rescue, due to creditors opposing such proceedings or the courts determining that liquidation was the better option. Creditors' opposition to business rescue will be carefully considered by weighing the interests of the various stakeholders involved in the process.

The Success of a business rescue process is defined in terms of section 128 (1) (b) (ii) and section 128 (1) (b) (iii) of the Act. The first sign of a successful business rescue is the company emerging from the process as a going concern or alternatively the business rescue should result in the yielding a better return for the creditors. It has been argued that the statistics kept by the CIPC does not distinguish between the different options that are regarded as success in business rescue as it does not provide for the statistics of a reorganisation v better return in liquidation. As a result thereof it is difficult to get a clear indication of how successful the business rescue process has been during this infancy years.

## II COMMENCEMENT OF BUSINESS RESCUE

### Board Resolution

Business rescue proceedings may be initiated by an affected person who applies to court for an order to place a company under supervision and commence business rescue.<sup>23</sup> Alternatively, proceedings may be initiated by a resolution of the board of directors of a company to voluntarily commence with business rescue. The timing and commencement of business rescue proceedings is essential to the success or failure of such an attempt. It has often been found that, in instances where companies delayed the commencement of business rescue, the turnaround of such companies was less likely to be successful. In the case of *Anthonie Welman v Marcelle Props 193 CC*,<sup>24</sup> Judge Tsoka highlighted that “business rescue proceedings are not for the terminally ill ... Nor are they for the chronically ill. They are for ailing corporations, which, given time, will be rescued and become solvent.”<sup>25</sup>

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<sup>23</sup> Companies Act, section 131(1)

<sup>24</sup> *Welman v Marcelle Props 193 CC and Another*, 2012, ZAGPJHC 32

<sup>25</sup> *Ibid.*

The test to determine whether business rescue should be implemented is whether or not a company is financially distressed. The Act defines the term “financially distressed” under section 128(1)(f) to mean and refer to instances where 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 it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months”.<sup>26</sup> Judicial management has been largely criticised in that it may only be commenced by an order of Court and as a result therefore this made the process rather costly and complex more so because the companies required to be under judicial management had to apply for a court order and where already in financial distress and as a result did not have the financial muscle nor could they afford to waste any time whilst waiting for a court date. Critics have therefore applauded and welcomed the new business rescue provision through which a business rescue process can be commenced by a resolution of the board of directors without any approval from the shareholders at a general meeting.

The board of directors may pass a resolution commencing business rescue proceedings if the board has reasonable grounds to believe that:

- a) The company is financially distressed<sup>27</sup>
- b) There appears to be a reasonable prospect of rescuing the company.<sup>28</sup>

Within five days of filing for business rescue, a business rescue practitioner must be appointed. The business rescue practitioner has three primary rights and protections provided for by law and this can be described as: First, the company under business rescue has the benefit of a moratorium on claims against it by creditors;<sup>29</sup> second, the business rescue practitioner has the right, in terms of the Act, to suspend any contractual obligations that the company was a party to at the beginning of the business rescue proceedings and become due during its supervision; third, third, the business rescue process is intended to be concluded in the adoption of a business rescue plan that is voted into operation by the creditors, employees, trade unions, and, in certain

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<sup>26</sup> Section 128(f) of the Act

<sup>27</sup> Ibid.

<sup>28</sup> Section 129(1)

<sup>29</sup> Morgan. 2012. South Africa’s new business rescue law – the courts’ view, *Insol International News Update*

instances, shareholders. The purpose of the business rescue plan is to provide flexible and workable solutions for the company.<sup>30</sup>

Also critical and worth noting is that the time constraints in the business rescue process are stringent and the courts have indicated a zero tolerance to non-compliance. In *Advanced Technologies and Engineering Company (Pty) Ltd (in business rescue) v Aéronautique et Technologies Embarquees SA and Others*<sup>31</sup> the court showed no tolerance to the failure to adhere to the time periods provided for in the Act and held that:

*‘It is clear from the relevant sections contained in chapter 6 that a substantial degree of urgency is envisaged once a company has decided to adopt the relevant resolution beginning business rescue proceedings. The purpose of s 129(5), is very plain and blunt. There can be no argument that substantial compliance can ever be sufficient in the given context. If there is non-compliance with s 129(3) or (4) the relevant resolution lapses and is a nullity. There is no other way out, and no question of any condonation or argument pertaining to “substantial compliance”.*<sup>32</sup>

## **Court Order**

An affected person may approach the court in terms of section 131(1) of the Act for an order, placing the company under supervision and commencing business rescue proceeding. The court after hearing such matter may make an order to place the company in business rescue if it is satisfied that:

- a) *The company is financially distressed; or*
- b) *The company has failed to pay an amount due to a government authority in terms of a statutory obligation in respect of its employees, such as unemployment insurance or money due in terms of a contractual obligation; or*
- c) *It is otherwise just and equitable to do so for financial reasons; and*
- d) *There is a reasonable prospect of rescuing the company.*<sup>33</sup>

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<sup>30</sup> Ibid.

<sup>31</sup> *Advanced Technologies and Engineering Company (Pty) Ltd (in business rescue) v Aéronautique et Technologies Embarquees SA and Others (GNP)* (unreported case no 72522/11, 6-6-2012)

<sup>32</sup> Ibid.

<sup>33</sup> Section 131(1)

Such an applicant must then serve a copy of the application on the company and the commission and notify each affected person of the application in the prescribed manner.

Irrespective of how the process commenced, the business rescue process is intended to be concluded in the adoption of a business rescue plan that is voted into operation by the creditors, employees, trade unions, and, in certain instances, shareholders. The purpose of the business rescue plan is to provide flexible and workable solutions for the company.<sup>34</sup>

In the case of *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd*<sup>35</sup> the Court highlights that there is a higher threshold for succeeding when the business rescue is commenced through involuntary circumstances.

### III DEVELOPMENT OF CASE LAW

Although the business rescue system is fairly new in South Africa, a number of cases have been heard and decided on by our courts which will be discussed hereunder:

On 30 May 2011, Judge Makgoba handed down the first reported business rescue judgment in *RA Swart v Beagles Run Investments 25 (Pty) Ltd*.<sup>36</sup> Judge Makgoba held that, where an application for business rescue entails weighing up the interests of creditors and the company, the interests of creditors should carry the day.<sup>37</sup> Makgoba's judgment was unexpected under the new regime, since business rescue was intended to be the beginning of a balancing era through which the interests of all stakeholders are considered. Makgoba's judgment was a lot more aligned with the principles of the judicial management system, which prioritised the interests of creditors over those of other stakeholders. The judgment was considered to be a correct reading of the facts. However, the legal principles that were applied went against the objectives of the

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<sup>34</sup> Morgan. 2012. South Africa's new business rescue law – the courts' view, *Insol International News Update*

<sup>35</sup> *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012 (2) SA 423 (WCC)

<sup>36</sup> *RA Swart v Beagles Run Investments 25 (Pty) Ltd* 2011(5) SA 422

<sup>37</sup> *Ibid.*

Act and, to say that the interests of creditors should hold, sways from the debtor friendly regime and could be viewed as an attempt to attack the principles of business rescue.

In *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd*,<sup>38</sup> the judge made an order of liquidation, as opposed to business rescue, and provided a number of reasons relating to the particular facts of the case. However, the SCA held that “business rescue” means to facilitate “rehabilitation”,<sup>39</sup> which in turn means the achievement of any one of two goals, namely rehabilitation, or ensuring a better return for creditors. The SCA noted that the distinction between the regime of business rescue and its unsuccessful predecessor must be considered. Whereas an order for judicial management required a reasonable probability of a return to solvency, it “can be accepted with confidence that the legislature did not intend to repeat the mistakes of the past”.<sup>40</sup> The SCA confirmed the view that, even in the event that a company cannot be saved from liquidation and, as a result thereof, the primary objective of the Act may not be achieved, but instead the facilitation of a better return for creditors or shareholders of a company will, on its own, constitute business rescue. Business rescue is therefore not limited to returning a financially distressed company to solvency, but also ensuring a better return for creditors.

The notion and the decision that business rescue may be a viable option, even if the only possible outcome is the facilitation of better returns for creditors, should be an indication that the perception that business rescue is unfair to creditors is misplaced.

#### **IV THE BUSINESS RESCUE PLAN**

The ultimate goal of a business rescue process is to culminate in the approval of a business rescue plan. The business rescue plan is a document prepared by the business rescue practitioner after consulting with the company’s various creditors, management and any other affected persons. The business rescue plan should contain all the information that may be of assistance to any affected persons, as part of the process of adopting such a plan. The plan may outline

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<sup>38</sup> *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* 2012 (3) SA 273

<sup>39</sup> *Ibid.*

<sup>40</sup> *Ibid.*

proposals for the company to restructure its affairs, business, property, debt and any other liabilities, in order to assist the company in ensuring that it continues in business. The business rescue plan must be published within 25 business days of the date on which the practitioner was appointed, or such longer time as may be allowed by the court, on application by the company or the holders of a majority of the creditors' voting interests.

Section 150 of the Act provides a guideline for what the business rescue plan should entail. The guideline states that a business rescue plan must contain sufficient information to assist creditors in deciding whether or not they wish to accept or reject the plan.

### **VOTING ON THE BUSINESS RESCUE PLAN**

The Act requires that, 10 days after the business rescue plan has been published, the business rescue practitioner must convene a meeting of creditors and any other holders of a voting interest to vote on the business rescue plan. The affected persons must be notified of this meeting at least five days before it is due to take place. The sole purpose of the meeting is to consider the proposed business rescue plan and vote on it. The voting creditors and/or parties with voting rights have the right to approve or reject the business rescue plan. A majority vote at the meeting will be binding on the company, creditors and shareholders, irrespective of whether they were present at the meeting.

### **V FAILURE TO ADOPT A BUSINESS RESCUE PLAN**

In the event that a plan has been rejected by shareholders, the Act empowers the business rescue practitioner to either request the consent of the holders of voting interests to prepare a revised plan or to apply to a court to have the results of the vote set aside, on the grounds that the decision was inappropriate.<sup>41</sup> As highlighted above, section 153(1)(a)(ii) enables the business

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<sup>41</sup> Section 153(1)(a)



rescue practitioner to make an application to a court to set aside the outcome of the creditors' or shareholders' vote.

It is critical to note that section 153(7) of the Act states that, in an application of this nature, a court may order that the vote on a business rescue plan be set aside, if the court is satisfied that it is reasonable and just to do so, having regard to the interests represented by the persons who voted against the plan.<sup>42</sup>

In *Henochsberg*<sup>43</sup>, it is argued that it is not clear what the legislature envisaged with the term "inappropriate" in section 153(1)(a)(ii) of the Act. Further the writer of *Henochsberg* argues that the essence of a vote is that it reflects the voter's perception of his or her own interests. However, the legislature appears to have intended that a court, singularly, would be required to substitute its own view for how the members of the class in question ought to have voted, in order to satisfy the requirements of inappropriateness.

Section 153(7) of the Act does not provide any further clarity with regard to the process of declaring a vote inappropriate. Section 153(7) seems to indicate that, while the business rescue practitioner may bring an application before the courts to declare that the creditors' vote was inappropriate, the court is enjoined by ss(7) not to consider whether the result of the vote was inappropriate, but whether it is reasonable and just to set the vote aside, having regard to the factors mentioned in the sub-section. A prima facie conclusion on the meaning of this rather ill-drafted measure is that a court must proceed in an application for an order under section 153 of the new Companies Act as follows: The Court must first determine whether the result of a vote was inappropriate. If the conclusion is that the result of the vote has indeed been shown to have been inappropriate, then the court must then determine whether it is reasonable and just to order that the vote be set aside. This matter will be discussed in further detail below considering the available case law.

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<sup>42</sup> Section 153(7) of the Act

<sup>43</sup> Delpont et al. 2011. *Henochsberg on the Companies Act 71 of 2008*. Durban: LexisNexis

## APPLICATION TO SET ASIDE AN INAPPROPRIATE VOTE

The Act is not clear on the definition or interpretation of “inappropriate”. The author of *Henochsberg* is, with respect, correct when he says it is difficult to think of circumstances where the creditors’ vote for the rejection of the business rescue plan would be inappropriate.<sup>44</sup> The fact of the matter seems to be a simple one in that Creditors are entitled to exercise their votes freely, depending on their exposure and their policies in relation to such exposure. However the development of case law in this regard has clearly indicated that the matter is not as simple and that there are various considerations to be made.

In one of the first cases involving the operation of section 153(1)(a)(ii), the matter of *Copper Sunset*,<sup>45</sup> Judge Makgoba set aside the creditors’ vote, on the grounds that it was inappropriate. The Act allows the court, on application by the business rescue practitioner, to set aside the result of a vote, on the grounds that the vote was inappropriate<sup>46</sup>. Section 153(1)(a)(ii) of the Act must be read with section 153(7), which provides that the court may order that the vote on a business rescue plan be set aside, if the court is satisfied that it is reasonable and just to do so, having regard to:

- the interests represented by the persons who voted against the plan
- the provision, if any, made in the proposed plan with respect to the interests of the persons who voted against the plan
- a fair and reasonable estimate of the return to that person if the company were to be liquidated<sup>47</sup>

In the case of *Copper Sunset*,<sup>48</sup> the court found that the first respondent was self-serving and unreasonable by gunning for liquidation, given that the first respondent would be the only creditor that would receive a higher return in liquidation (a dividend of 45 cents to the rand). The

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<sup>44</sup> Delport. 2011. *Henochsberg on the Companies Act* (1): 529. Lexis Nexis

<sup>45</sup> *Copper Sunset Trading 220 (Pty) Ltd t/a Build It Lephale (in business rescue) and Spar Group Limited and another* 2014 (6) SA 214 (LP)

<sup>46</sup> Section 153(1)(a)(ii)

<sup>47</sup> Section 153(7)

<sup>48</sup> 2014 (6) SA 214 (LP)

clear principle that emerged from this case was that *creditors should participate in good faith and objectively consider the merits and demerits of a proposed business plan.*<sup>49</sup>

Of great interest in this judgment was the view on whose interests the creditor should consider in a vote. From a reading of the Act, it seems that the creditor may vote according to what he or she deems to be his or her own interests. There seems to be no expectation of the creditor to vote in accordance with the purpose of the Act, contained in section 7(k), which calls for the rescue and recovery of financially distressed companies to take place in a manner that balances the rights and interests of all relevant stakeholders.<sup>50</sup> The Act indicates that the opposite is also true, in that creditors are entitled to vote freely and whichever way they wish.

The challenge that has been noted as a point of concern is that the Act provides no guidelines on the circumstances under which a plan may be rejected due to inappropriate grounds. We are therefore at the mercy of the courts for interpretation of the Act.

In her finding, Judge Makgoba considered the factors set out in section 153(7) of the Act, which states that the court may order that the vote on a business rescue plan be set aside, if the court is satisfied that it is reasonable and just to do so, having regard to the interests of the person who voted against the proposed rescue, the provisions of the plan with respect to the interests of those who voted against the plan and a fair and reasonable estimate of the return due to them if the company were to be liquidated.<sup>51</sup> In practice it seems clear that even in the event where a business rescue plan is approved and falls through shortly the after liquidation remains an available option but at least as an option of last resort in this particular instance.

In terms of the Act, the court has the power to set aside the vote if it was mala fides and if the creditor was acting contrary to public interest and the dictates of commercial morality.<sup>52</sup> Judge Makgoba made no finding about the bona fides of the vote, but stated that “it is worth it to

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<sup>49</sup> Ibid

<sup>50</sup> Section 7(k) of the Companies Act

<sup>51</sup> Section 153(7) of the Act

<sup>52</sup> Delpont et al. 2011. *Henocheberg on the Companies Act 71 of 2008*. Durban: LexisNexis (Volume 1 – page 529)

embark upon the business rescue plan than resort to a more devastating process of liquidation of the company”.<sup>53</sup>

It is suggested in the *Sunset Copper* case that a practical and business-like interpretation of section 153(7) is that the interests of persons who voted against the business rescue plan must be protected, taking into account the provisions, if any, made in the business rescue plan for creditors. In addition, a fair and reasonable estimate of the return in liquidation must also be considered.

In assessing whether Judge Makgoba’s decision was a correct application of the law, it is necessary to consider in whose interests the creditors had voted. Although the creditors had voted in their own interests the court deemed such vote inappropriate on grounds that it was self serving and unreasonable. This clearly shows that the test followed in this case not only considered that interests of the creditors but the various stakeholders involved in the process.

Section 153(7) (a) to (c) of the Act continuously makes reference to the interests represented by those who voted against the business rescue plan, the provisions made in the proposed plan with respect to the interests of that person, as well as a fair and reasonable estimate of the return due to that person. The Act, in this section, seems clear in its intention that the interests of the creditors must clearly be considered by the courts when setting aside a vote against a proposed business plan. Section 153(7) considers the interests of creditors from various angles and, as such, it is clear that the interests of the creditors are paramount. Accordingly, it would be difficult to find that the vote of a creditor was inappropriate on the basis that it was self-serving and, to test this on the basis of section 153(7) would not be possible.

Of critical importance is the issue that creditors may vote in accordance with their own interests. In the *Copper Sunset* case, the court did not seem to agree with this position and seems to have felt the need to neutralise the vote of creditors and, more so, majority creditors. The basis for the court’s reasoning could be that the creditors may not solely vote in terms of their interests, but should instead consider the purpose of the Act in terms of the provisions of section 7(k), which is

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<sup>53</sup> 2014 (6) SA 214 (LP)

“to provide for the efficient rescue and recovery of financially distressed companies, in the manner that balances the rights and interests of all relevant stakeholders”.<sup>54</sup> It is clear that the spirit of the Act is to seek the best possible outcome for all stakeholders.

In the Case of *Artio Investments (Pty) limited v Absa Bank Limited and Others*<sup>55</sup> the court was once again faced with the issue of what is inappropriate and also shed light to how the creditor’s interests should be considered. The applicant in this case had been a major role player in the building and development of the Brits Platinum Mall. For purposed of this project the applicant had received a mortgage loan agreement for R107 million from Absa. After defaulting on a few payments Artio Investments commenced and started business rescue proceedings during November of 2012. The applicant made an application to the Court in terms of section 153(1)(a)(ii) of the Act, requesting the court to declare the first respondents vote inappropriate as the first respondent (ABSA) had disapproved the business rescue plan that had been presented to the voting rights holders.

The Court in making its Judgement considered the case of *SAA Distributers (Pty ) Ltd v Sport and Spel (Edms) Bpk 1973 (3) SA 371*<sup>56</sup> where van Zijl J held: “*The wishes of creditors cannot fetter the Court’s discretion, but they must be given great weight and should be followed unless there are special circumstances to which greater weight should be attached.*”<sup>57</sup> In this particular case the court found that there where no special circumstance that required the court to apply its own discretion and as a result thereof the court did not grant the relief sort by the applicant.

Creditors are crucial participants in the business rescue process and they have a responsibility to ensure their rights are not unfairly prejudiced by the outcome of the business rescue plan. It can be presumed that their vote is in line with this responsibility. The decisions of creditors are binding on all other stakeholders. The business rescue legislation raises concerns around a lack of consistency throughout the Act. The competing interests of the different affected parties can have a negative impact on the business rescue process. The voting process, for example,

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<sup>54</sup> The Companies Act 71 of 2008

<sup>55</sup> *Artio Investments (Pty) Limited v Absa Bank Limited and Others (7562/2014) [2014] ZAGPPHC 689 (8 September 2014)*

<sup>56</sup> *SAA Distributers (Pty ) Ltd v Sport and Spel (Edms) Bpk 1973 (3) SA 371 (C)*

<sup>57</sup> *Ibid*, p 375

empowers larger creditors to dictate the future of other stakeholders, like employees. As a result, the process has the ability to put at risk the just and equitable treatment of all stakeholders.

## VI WHAT IS AN INAPPROPRIATE VOTE?

Where a proposed business rescue plan is rejected on the basis of a vote, the Act provides that the business rescue practitioner or any affected person may apply to the High Court to have the result of the vote set aside, on the grounds that it was inappropriate. But it is critical to consider what “inappropriate” means and what the applicant needs to do to show the court that the voting result was inappropriate.

In *KJ Foods CC v First National Bank*,<sup>58</sup> the company in business rescue employed over 200 permanent employees. Due to its financial troubles, the company commenced with business rescue proceedings and a business rescue plan was produced accordingly. First National Bank, one of the larger creditors of the company, voted against the plan.

KJ Foods lodged an application with the High Court to set aside the outcome of the voting process, in terms of section 153(1)(a)(ii) of the Act, on the grounds that the vote by First National Bank was inappropriate. The court, in this particular matter, quoted from earlier judgments that highlighted that the business rescue provisions of the new Companies Act sought to bring about “a shift from creditors’ interests to a broader range of interests”.<sup>59</sup>

In reaching its decision, the court considered the case of *Koen v Wedgewood Village Golf Estate*,<sup>60</sup> where the court held that:

*“Business rescue is intended to serve that public interest by providing a remedy directed at avoiding the deleterious consequences of liquidations in cases in which there is a reasonable prospect of salvaging a financially distressed business, or of securing a better return to creditors than would probably be achieved in an immediate liquidation”.*

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<sup>58</sup> *KJ Foods CC v First National Bank*. 2015. ZAGPPHC 221

<sup>59</sup> *Ibid*

<sup>60</sup> *Koen v Wedgewood Village Golf Estate*. 2012. (2) SA 378 (WCC)

The court, in *KJ Foods cc v First National Bank*, found that the bank was a secured creditor that would receive full payment of its claim, regardless of whether the company went into immediate liquidation or whether the proposed business plan was successful.

The court stated that First National Bank was the one creditor that would benefit the most if the company was liquidated. On the other hand, the business rescue plan had also made provision for First National Bank to receive full payment if the plan was implemented. Nevertheless, First National Bank had voted against the plan. The court found that the bank's failure to vote for the plan was inappropriate and premised on self-interest. The decision by the court considered socioeconomic factors, taking into account the livelihood of the company's employees and junior creditors, who stood to receive a much smaller cut in the event of liquidation. The court's view was that public interest must be considered.

One view would argue that there are no guarantees that a proposed business plan will be feasible and functional. In *KJ Foods cc v First National Bank*, the court addressed this, stating that there was no crystal ball to predict whether the proposed business rescue plan would be successful. However, the court applied a value judgement of the facts and merits of the case, relying on the legal requirement that a business rescue plan must have reasonable prospects for success in order to be approved.

What seems to emerge from the above judgment is that the court deems it inappropriate for a creditor to vote against a business plan when: a) it stands to obtain a greater benefit from liquidation than other stakeholders and b) the creditor would be no worse off if the proposed business plan is successful.<sup>61</sup> The test developed by the court, in this instance, seems to steer away from the intentions of the legislature. In terms of the courts, the creditors do not only vote in their interests, but must consider the interests of other stakeholders. The legal test that should be applied is also not clear from the legislature.

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<sup>61</sup> Strime, Summary Companies Act Amendments dealing with business rescue, available at <http://www.fluxmans.com/summary-companies-act-amendments-dealing-with-business-rescue-by-colin-strime/> accessed on 12 July 2016.

It is evident that there is a need to clarify the purpose of the Act, in relation to the different stakeholders, and to bring about consistency in the application of the law through the various cases that are brought before the courts. Clarifying the purpose of the Act would ensure that the various stakeholders within the business rescue process are clear on the procedures to follow. As a result, the number of cases brought before the courts would be reduced, since the various parties would be certain of their position in law.

In the case of *Shoprite v Berry Plum Retailers*, the parties debated the meaning of the term “inappropriate”. The Berry Plum argued that a creditor had voted against a business rescue plan on the basis that the creditor’s interests were better served by rejecting the plan. However, it was argued that such a vote was inappropriate, given that a number of employees stood to lose their jobs, for the benefit of one creditor. The judge disagreed with the plaintiff’s view and, in judgment, considered the “meaning that can be derived from the word inappropriate in the Shorter Oxford Dictionary” and concluded that “appropriate”, in the context of *Shoprite v Berry Plum*, would mean “suitable or proper”. The judge found that a vote that was cast in good faith by a creditor and would advance that creditor’s interests cannot be inappropriate. It was the judge’s view that there was nothing “unsuitable, unfitting or improper” in a vote that honestly reflects a voter’s opinion as to his or her best interests. The judge held that the purpose of business rescue is to revive faltering companies or achieve greater returns for those companies that cannot be revived. Accordingly, the judge held that the interests of creditors, whose own money is at risk, are predominant.<sup>62</sup> The judge reasoned that the outcome of each particular case depends on a forecast, which itself is based on one or more assumptions, in short, an assessment of risk. The business of companies and their creditors, he found, was the pursuit of monetary profit.<sup>63</sup>

The judge in the above case held the view that the purpose of the Companies Act could not have been to vest in the courts the power to impose uncalculated financial risks on business people that the courts themselves would deem ill-advised.

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<sup>62</sup> *Shoprite v Berry Plum Retailers* cc [2015\] ZAGPPHC 255 \(11 March 2015\)](#)

<sup>63</sup> *Ibid*



## VII APPLICATION OF SECTION 153(7) IN DETERMINING AN INAPPROPRIATE VOTE

The Act is unclear on whether section 153(7) should be used to determine if a vote is inappropriate or whether it should only be applied once the vote has been deemed inappropriate.

In the case of *Shoprite v Berry Plum Retailers cc*, the court considered that it was necessary to determine whether a vote was inappropriate before establishing whether it would be reasonable and just to set the vote aside.<sup>64</sup> It was further noted that, taking into consideration the factors listed in section 153(7), it is clear that such enquiry into inappropriateness should be viewed purely from the perspective of the persons who voted against the business rescue plan.<sup>65</sup>

In the case of *Ex parte: Bhidshi Investments cc*,<sup>66</sup> the court supported the view of *Shoprite Checkers (Pty) Ltd v Berry Plum Retailers* in the two-stage approach that an attack on a vote under section 153(7) must first determine whether a vote was inappropriate, then it could proceed to make a finding on whether it would be reasonable and just to set the vote aside. In the case of *Ex parte: Bhidshi Investments CC*, the court was unable to find that the vote was inappropriate and, as a result, the court did not deem it necessary to determine whether it would be reasonable and just to set aside the vote.

In the *Ex parte case of Target Shelf 284*,<sup>67</sup> the judge noted the alignment of the two-stage approach adopted in the *Shoprite Checkers* judgment above, but held a different view. The judge found that the legal requirement was to consider whether it was reasonable and just to set a vote aside, even where the court made a finding that the vote is appropriate. In essence, the *Ex parte case of Target Shelf 284* supports the view that an enquiry in respect of an inappropriate vote is not done through a two-stage approach, but instead such enquiry should consider section 153(1)(a)(ii) together with section 153(7).

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<sup>64</sup> Ibid

<sup>65</sup> Ibid

<sup>66</sup> *Ex parte: Bhidshi Investments CC* (20189/14) [2015] ZAGPPHC 783 (7 October 2015)

<sup>67</sup> *Ex parte case of Target Shelf 284 CC Commissioner, South African Revenue Service and Another v Cawood NO and Others* [2015] ZAGPPHC 740

The view in the case of *Ex parte Target Shelf* 284<sup>68</sup> was supported in the Copper Sunset judgment, the facts of which are discussed above. The court, in the latter application, was faced with the challenge of determining whether Copper Sunset had made out a proper case that the votes of Spar and Normandien Farms were inappropriate within the meaning of section 153(1)(a)(ii). To determine the merits of Copper Sunset's case, the court had to consider 153(1)(a)(ii), read with section 153(7). Section 153(1)(a)(ii) allows an application to court to set aside the result of a vote by the holders of voting interests or shareholders, on the grounds that the vote was inappropriate. However, it is critical to note, as highlighted by the Copper Sunset judgment, that section 153(7) provides that a court may order that the vote on a business rescue plan be set aside if the court is satisfied that it is reasonable and just to do so.

The courts remain divided on the application of section 153(7). It is worth noting that the application of section 153(1)(a)(ii) of the Act appears to be a subjective enquiry, conducted by the courts. Section 153(7), although well-articulated, is clearly an objective test. As a result, the approach that prefers that the two sections be read together and applied under one enquiry, may be the preferred option. It remains for the courts to provide a clear approach to be followed.

In the event that the court grants the order sought by the business rescue practitioner setting aside the vote due to it being inappropriate, the Act is not clear on what the next process is. By simply eliminating the inappropriate vote which the court nullified one may assume that no further voting or convening of a further meeting would be required. In line with this line of thought the business rescue practitioner would be empowered to commence with the implementation of the plan. A number of scholars are of the view that a notification to affected persons informing them that the plan has been approved and is being implemented should suffice.

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<sup>68</sup> Ibid.

## Chapter 3:

### United States Bankruptcy Codes

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#### I BACKGROUND OF THE UNITED STATES BANKRUPTCY CODE

The United States of America initiated the reform of its bankruptcy and insolvency statutes, from which business rescue emerged. In terms of Chapter 11 of the Bankruptcy Code of 1978, filing for the reorganisation of a company brings about a stay on enforcement proceedings against a debtor in financial distress, or his or her property, while a plan of reorganisation is being put in place. The purpose of Chapter 11 can be summed up as a plan of reorganisation that aims to keep the business alive and pay creditors over time.

Many scholars have argued that America's Bankruptcy Code has been largely successful, due to the cultural attitude towards bankruptcy within the United States. It has been noted that the United States bankruptcy system is generally far more forgiving, in an effort to encourage risk-taking and economic growth. Bankruptcy within the United States has no stigma of failure attached to it, as in other jurisdictions, where insolvencies and business bankruptcies are regarded as a sign of failure and poor management.<sup>69</sup>

#### II THE CHAPTER 11 PROCESS

##### Filing of petition

A Chapter 11 case commences with the filing of a petition with the bankruptcy court. The petition may be filed by a debtor (voluntary petition) or by creditors (involuntary petition). When filing a voluntary petition, the applicant is required to submit a number of documents with the court, which include schedules of assets and liabilities, a schedule of current income and expenditures, a schedule of contracts and unexpired leases and a statement of the company's financial affairs. Upon submission of a petition, the debtor assumes the term

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<sup>69</sup> Mindlin. 2013. Comparative analysis of Chapter 6 of the South African Companies Act

“debtor in possession”. Generally, the debtor in possession continues to manage and operate the business.

### Disclosure statement

Once the plan for reorganisation has been prepared, a written disclosure statement, together with a plan for reorganisation, should be filed with the court. The disclosure statement can be defined as an information document that provides the court and creditor’s insight and information regarding the company’s assets and liabilities and the business affairs of the debtor. The disclosure statement should enable a creditor to make an informed decision on the debtor’s plan of reorganisation. The reorganisation plan provides information on how the claims have been classified and how each class of claims will be dealt with under the plan.<sup>70</sup>

Prior to a Chapter 11 plan being distributed to creditors, the court is required to approve a disclosure statement that describes the plan and its impact on each of the classes of creditors, so as to provide a tangible basis for their vote. A disclosure statement can only be approved in the event that the court finds that it contains sufficient information. After a disclosure statement has been filed, the court must conduct a hearing to determine if the disclosure statement must be approved.<sup>71</sup>

It is illegal to petition for votes for the approval or rejection of a plan at any point before court approval of the disclosure statement.<sup>72</sup>

### Voting by the creditors and the confirmation hearing

Once the disclosure statement has been approved by court and circulated to all creditors, the Bankruptcy Code specifies that the reorganisation plan must be voted on by creditors, before being approved by a bankruptcy court. The approval process is commonly known as the confirmation of the plan. A confirmation hearing is held, where the court determines whether the proposed plan meets the requisite standards for confirmation. Amongst other things, a

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<sup>70</sup> [www.uscourts.gov/service-forms/bankruptcy](http://www.uscourts.gov/service-forms/bankruptcy), accessed on 13 April 2016

<sup>71</sup> Ibid.

<sup>72</sup> Ibid.

plan may not be confirmed by the courts if it offers creditors less than what they would have received in liquidation.

In the event that there are no objections to the confirmation of the plan filed with the court during the confirmation hearing, the Bankruptcy Code allows the court to consider if the reorganisation plan was proposed in good faith and in accordance with the provisions of the law.<sup>73</sup> Furthermore, before the court can confirm the reorganisation plan, it is required that the court considers and finds the plan feasible, that it was proposed in good faith and is in compliance with the provisions of the Bankruptcy Code.

#### Best interests of creditors

The expectations of the Chapter 11 reorganisation plan are set by the parties responsible for its approval, which rests upon the creditors and the court. In terms of the Bankruptcy Code, the ultimate confirmation rests with the court. The court must, in all fairness, approve a plan that is feasible,<sup>74</sup> in the best interests of creditors, fair, equitable and completed in good faith.<sup>75</sup>

If a creditor objects to the plan, it must undergo a “best interests of creditors” test in court. Section 1129(a)(7) of the Bankruptcy Code is known as the “best interests of creditors test”, or “best interests test”. The best interests test is one of 13 requirements that a plan proponent must satisfy in order to obtain confirmation of a plan of reorganisation, guaranteeing that, unless otherwise agreed, each creditor or interest holder will receive at least as much under the plan as he or she would in a liquidation of the debtor in a Chapter 7 case. In other words, the plan of reorganisation establishes a “floor” with respect to the level of recovery to which creditors and interest holders are entitled. The best interests test only applies to creditors in impaired classes of creditors. Over and above the disclosure statement, Chapter 11 requires the plan to pass a best interest of creditors test for an objecting creditor or shareholder, as

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<sup>73</sup> [www.uscourts.gov/service-forms/bankruptcy](http://www.uscourts.gov/service-forms/bankruptcy), accessed on 13 April 2016

<sup>74</sup> Ibid.

<sup>75</sup> M Pretorius and W Rosslyn-Smith. 2014. *Southern Africa Business Review*, 18: 114

previously mentioned. It is clear that these tests are designed to ensure that the plan is objective and realistic.<sup>76</sup>

The point of Chapter 11 is that it is a tool created by Congress to allow a business to continue operating if its creditors believed it could pay more by continuing to operate than if it was liquidated. In other words, the company was “worth more alive than dead”.

### Cramdown

In terms of Section 1129(a) of the Bankruptcy Code, a debtor is required to satisfy all secured claims in full under the reorganisation plan, before making any distributions to junior creditors. It is required that a majority of the creditors must approve the reorganisation plan, which is followed by court confirmation. There are instances where one or more classes of creditors do not accept the reorganisation plan presented for approval. In this case, the bankruptcy law provides an alternative option in the form of the cramdown provisions, which enable the case to proceed if the applicable legal standards are met.<sup>77</sup>

The cramdown statute generally prohibits “unfair discrimination” and treatment that is not “fair and equitable”, with respect to the dissenting class. As a result, a debtor may confirm a Chapter 11 plan over the objection of a class of secured claims, so long as the plan does not unfairly discriminate against, and is “fair and equitable” with respect to, the dissenting secured class.

In assessing a cramdown case, the unfair discrimination test, together with the fair and equitable rule, is applied.<sup>78</sup> The unfair discrimination test looks at the amount to be received by the impaired creditors over the liquidation value they would have received, also called the reorganisation surplus. Although there may be discrimination in the manner in which a plan pays out this excess amount, the discrimination may not be unfair.

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<sup>76</sup> Bracewell and Giuliani, Chapter 11 of the United States Bankruptcy Code: background and summary, available at [https://www.insol.org/\\_files/Fellowship%202015/Session%203/Chapter\\_11\\_Overview.pdf](https://www.insol.org/_files/Fellowship%202015/Session%203/Chapter_11_Overview.pdf), accessed on 12 February 2016

<sup>77</sup> [www.uscourts.gov/service-forms/bankruptcy](http://www.uscourts.gov/service-forms/bankruptcy), accessed on 13 April 2016

<sup>78</sup> Mindlin. 2013. Comparative analysis of Chapter 6 of the South African Companies Act

Courts differ on the factors that make up the unfair discrimination test. A commonly used test states that a plan may be unfairly discriminatory if there are two or more creditors of the same class and one creditor receives a much lower recovery than other creditors in that class.<sup>79</sup> Regardless of the test used, most cases tend to look at whether or not it is justified to treat creditors differently.

The debtor must show the plan is fair and equitable to the impaired class. The fair and equitable rule has two main parts, the absolute priority rule and the rule that no creditor may be paid more than what is owed. The absolute priority rule generally means that senior creditors must be paid full value before junior creditors receive anything. The second part speaks for itself and requires that no creditor be paid a “premium” over the allowed amount of a claim.<sup>80</sup>

In terms of the absolute priority rule, the plan must be fair and equitable, with respect to each impaired, non-accepting class of claims or interests. The absolute priority rule provides that a non-accepting class of creditors or interest holders cannot be compelled to accept less than full compensation, while a more junior creditor or equity holder receives anything or retains interests in the debtor under the plan.<sup>81</sup> The absolute priority rule is intended to ensure that the priority rules set forth in Section 507 are followed.

Section 1129 (b) (2) of Chapter 11 sets forth three standards of treatment necessary in order for a plan to be considered fair and equitable: (1) secured claims (2) unsecured claims and (3) interests.<sup>82</sup> It is critical to note that Chapter 11 also has its own challenges, but the law gives solutions for the various instances. The aim is to put the finances of a business back on track and to provide the fresh financial start bankruptcy provides.

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<sup>79</sup> Ibid

<sup>80</sup> [www.uscourts.gov/service-forms/bankruptcy](http://www.uscourts.gov/service-forms/bankruptcy), accessed on 13 April 2016

<sup>81</sup> [https://www.insol.org/\\_files/Fellowship%202015/Session%203/Chapter\\_11\\_Overview.pdf](https://www.insol.org/_files/Fellowship%202015/Session%203/Chapter_11_Overview.pdf)

<sup>82</sup> Bracewell and Giuliani, ‘Chapter 11 of the United States Bankruptcy cod: background and summary’ available at [https://www.insol.org/\\_files/Fellowship%202015/Session%203/Chapter\\_11\\_Overview.pdf](https://www.insol.org/_files/Fellowship%202015/Session%203/Chapter_11_Overview.pdf), accessed on 12 February 2016

## Chapter 4:

### Comparative Analysis

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#### I INTRODUCTION

Having considered the South African business rescue system and the Chapter 11 Bankruptcy Code of the United States, it is clear that, although South Africa sought to emulate the principles of the Chapter 11 Bankruptcy Code, the two systems remain different. It is therefore necessary that we compare certain elements of these systems in order to identify gaps and offer solutions that may be useful.

#### II COMMENCEMENT OF PROCEEDINGS

**United States:** The Bankruptcy proceedings maybe voluntarily filed by the debtor company in terms of chapter 11 or by the creditors in terms of chapter 7 and 11 (involuntary). For an Involuntary cases to be filed with the courts it is required that such filling be supported by at lease 3 creditors with claims of at least \$14,425 unless there are less than 12 creditors. Creditors can be held liable for damages if their petition was filed in bad faith. Voluntary filings Bankruptcy cases may be dismissed if filed in bad faith.

**South Africa:** the South African Act also allows for the proceedings to be commenced by either the debtor company or the creditors. The Act further seems to widen the scope of those that are empowered to commence proceedings it makes provision for third parties to initiate business rescue proceedings. Further the Act makes no provision for any claims of damages.

#### III INVOLVEMENT OF THE COURTS

**United States:** The United States is known for having specialised courts within its legal system. Bankruptcy matters are adjudicated and overseen by dedicated specialised courts.



The Bankruptcy Code also involves the court as part of its process, which commences with the filing of a petition with a specialised bankruptcy court. Further down the process, a written disclosure statement must be filed, to which the court must grant approval before any voting on the reorganisation plan can be cast.

In terms of the United States Bankruptcy Code, the court plays a vital role in ensuring that the process entails independent adjudication and is fair and equitable. The ultimate confirmation of a Chapter 11 reorganisation plan rests with the bankruptcy court. As a result, the court must act fairly and independently and approve plans that it deems feasible, in the interests of the creditors, fair, equitable and completed in good faith. Once the court has confirmed a reorganisation plan, it becomes binding on all creditors and the debtor and cannot be modified.<sup>83</sup>

**South Africa:** the Act provides, in terms of section 128 (3), that the judge president of a High Court may assign a specialist judge to determine matters relating to business rescue.<sup>84</sup> Although the intention of the Act may have been to assign business rescue cases to specialists within the field, this has not been the case thus far. A case study taken from the United States of America has clearly shown that having experienced judges in bankruptcy and commercial matters has yielded a great benefit. Judges with experience are better equipped to assess the feasibility of proposals and the merits of each case.<sup>85</sup> The South African business rescue process is lacking in this regard, as evidenced by a number of inconsistencies that can be noted from various court cases. Some judges still believe that creditors' opinions remain paramount under the business rescue regime. South Africa's business rescue process is similar to that of Australia, with very limited court involvement throughout the process. The courts in South Africa play an adjudication role in the event that there is a dispute amongst the parties. The South African process can run from start to finish without the need for court intervention.

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<sup>83</sup> Bracewell and Giuliani, 'Chapter 11 of the United States Bankruptcy code: background and summary' available at [https://www.insol.org/files/Fellowship%202015/Session%203/Chapter\\_11\\_Overview.pdf](https://www.insol.org/files/Fellowship%202015/Session%203/Chapter_11_Overview.pdf), accessed on 12 February 2016

<sup>84</sup> Section 128(3) of the Act

<sup>85</sup> Mindlin, 2013. Comparative analysis of Chapter 6 of the South African Companies Act

However, the Act does afford the court powers in cases where it is alleged that the system or process is being abused.

Contrary to the United States, where the courts have the ultimate power to confirm a reorganisation plan, in South Africa this power rests with creditors.

#### IV POSITION AND PARTICIPATION OF CREDITORS

**South Africa:** In terms of section 145 of the Act, creditors may form committees to consult with a business rescue practitioner. However, in practice, the creditors may also consult with the practitioner directly and often this approach is preferred by practitioners and smaller creditors. The role played by creditors in South Africa is critical. In terms of the business rescue provisions in South Africa, creditors have a deciding role.

South African law appears to make no distinction between secured and unsecured creditors for the purposes of voting on the business rescue plan.<sup>86</sup> As a result, secured creditors, who stand to receive the full amount of their claim, also vote alongside unsecured creditors.

**United States:** Creditors in the United States are not allowed to play a direct role in the management and operations of the business of the debtor, in terms of Chapter 11. A Chapter 11 case commences with the appointed trustee assigning a committee of creditors holding unsecured claims.<sup>87</sup> The creditors' committee oversees the management and operations of the debtor and is empowered to consult with the debtor on major business resolutions and decisions that may have an impact on the outcome of the case. A creditors' committee in a Chapter 11 case may, with the necessary court approval, appoint attorneys, accountants and other professional specialists to perform work and advise the committee.

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<sup>86</sup> Ibid. at 9

<sup>87</sup> [www.uscourts.gov/service-forms/bankruptcy](http://www.uscourts.gov/service-forms/bankruptcy) accessed on 13 April 2016

In the United States, there is a clear distinction between creditors and only classes of creditors or shareholders that have “impaired” claims or equity interests are entitled to vote on the plan.<sup>88</sup>

## V THE INAPPROPRIATE VOTE VS CRAMDOWN

**United States:** The court and the creditors set the expectations of a reorganisation plan. In terms of the process under Chapter 11, the creditors’ vote is required for a plan to be confirmed by the courts. However, in the event of a cramdown, the creditors become less of an authority in the process because the ultimate decision is with the bankruptcy courts. The court’s role and responsibility is to ensure that it approves a reorganisation plan that is feasible, non-discriminatory, in the best interests of the creditors, fair, equitable and completed in good faith.

The bankruptcy court’s role is to apply an objective test that focuses on the content of the plan, as opposed to the subjective views of the creditors. The court considers feasibility, which requires it to assess the content of the business rescue plan and consider whether it can be implemented.

Further, the objective test considers whether the plan is non-discriminatory to creditors and in their best interests. The objective test is based on factual support and stems from the content of the business rescue plan.

**South Africa:** On the other hand, the cramdown’s counterpart in South African law would be the inappropriate vote, in terms of section 153(1)(a)(ii), which empowers a business rescue practitioner to approach the courts to declare the vote of dissenting creditors inappropriate. The test on the inappropriate vote is subjective.

Academics have argued that a creditor’s vote cannot be deemed inappropriate if it considers the creditor’s interests. Creditors are entitled to exercise their votes freely. One

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<sup>88</sup> Ibid.

author compared it to a political vote. To suggest that a political vote could in any circumstances be characterised as inappropriate is absurd.

## VI Debtor in possession

**South Africa:** Upon commencement of the business rescue process and in terms of section 142 of the Act, the directors must continue to exercise their powers under the control and overall management of the business rescue practitioner, who has full management control of the company. In practice, the business rescue practitioner delegates his management powers to the directors and management and he plays a more strategic and overseeing role.

**United States:** The Bankruptcy Code empowers the debtor in possession to assume the position of a fiduciary and his rights are similar to those of a trustee under Chapter 11. The position of a debtor in possession is not much different from that under South African law.

## VII Creditor-oriented vs debtor-oriented

Bankruptcies, or business rescue regimes, are divided into “creditor-oriented” and “debtor-oriented”, based on certain characteristics. A creditor-oriented bankruptcy replaces management with a court-appointed trustee and, during this period, it does not provide a moratorium for creditors with regard to the enforcement of their rights, but permits creditors to enforce their claims against the debtor’s assets. As a consequence, business continuation during bankruptcy is unlikely. The applicable distributive rule is the absolute priority rule, meaning that the distribution to creditors and shareholders should follow the priority ranking outside of bankruptcy. The priority of such a regime is ensuring that the interests of the creditors are taken care of. South Africa’s judicial management system, which was replaced by business rescue, was regarded as a creditor-oriented system.

Academics have come to the conclusion that a corporate regime may be considered debtor-oriented if it provides for a restructuring procedure that enables the management of the company to assume the position of a debtor in possession and also offers a complete stay of the creditors' enforcement rights during such a period.<sup>89</sup> Liquidation remains an option under a debtor-oriented regime. A debtor-oriented regime is therefore considered to place less emphasis on the protection of creditors, but still ensures that their interests are taken care of in the process. The main belief in terms of this system is that a company or corporate entity is better alive than dead, hence the aim to resuscitate the ailing company, over the interests of the creditors.

**South Africa and the United States:** The development of South African law has encompassed a shift from a creditor-oriented to a debtor-oriented system, similar to that of the United States. As a result, both systems are debtor-oriented, with the paramount aim being rehabilitating the company in financial distress or, alternatively, ensuring a better return for creditors.

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<sup>89</sup> Sefa, Franken. 2004. Creditor- and debtor-oriented corporate bankruptcy regimes revisited, *European Business Organization Law Review*, 12

## Chapter 5:

### Conclusion and Closing Remarks

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The advent of business rescue within the South African corporate law system has brought a viable option that ailing companies can rely on, in an effort to return to solvency or, alternatively, to ensure a better return for creditors. Having shifted from a creditor-friendly judicial management system to a debtor-friendly business rescue system, it was inevitable that creditors on the receiving end of this debtor-friendly system would on numerous occasions put the system to the test in the courts, in an effort to have their roles, responsibilities and powers clearly defined.

Despite the infancy of the business rescue regime within South African there has been a number of cases that have shed light and provided further clarity to the provisions of the Act. A number of shortcomings have been highlighted, relating to the position of creditors and how their powers and votes are exercised. From the Act, it is clear that the legislature's intentions are not expressly articulated in the wording, therefore clarity is sought from the courts in this regard. The legislature, in its wording, does not provide clarity on the powers of creditors when voting and neither is it clear what the legislature envisaged by the term "inappropriate" in Section 153(1)(a)(ii).

It is clear from the Law and must be noted that any action that advances one's interests as a creditor should be considered as having been done in good faith, even in the case where a vote is contrary to that of other creditors. One can therefore conclude that creditors are not expected to consider other stakeholders, but rather their own interests, which should be bona fides.

The courts, however, seem to hold a different view. A number of judgments, highlighted throughout this paper, found against votes that considered the interests of the creditor alone and often these votes were ruled inappropriate. The inconsistency in the Act and the court creates uncertainties within the system and shortfalls of this nature should be critically analysed and reviewed to ensure that creditors, debtors, business rescue practitioners and other interested parties within a business rescue process are certain of their rights, powers and responsibilities

throughout the process.

When assessing the intentions of a creditor who voted against a business rescue plan not much weight seems to be placed on the purpose of the Act in terms of section 7(k) which aims to “provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders”.<sup>90</sup>

On analysing the shortcomings of the provisions of section 153(1)(a)(ii) and comparing certain aspects of the South African business rescue law to Chapter 11 in the United States, a number of differences stood out.

First, it seems to be a critical flaw that South African law makes no distinction between secured and unsecured creditors. As a result, business rescue practitioners are forced to seek help from the courts to declare creditors’ votes inappropriate, as per 153(1)(a)(ii). It is recommended that the legislature consider a system that distinguishes the votes of secured and non-secured creditors. A secured creditor who is deemed to receive 100% of his claim has no interest in the process and is therefore most likely to vote recklessly. This proposal will enable the voting is limited to creditors with a real interest in the business rescue process and who also stand to lose if the business rescue process has not been successful and the company is liquidated. What is required is a process through which there is a differentiation of creditors.

Second, American law, in terms of Chapter 11, clearly details the course of action to be followed in the event of dissenting creditors and outlines the tests that the courts need to follow in an effort to make a decision on dissenting creditors’ votes. The United States system provides certainty and clarity. Although South Africa’s Companies Act provides guidelines under section 153(7), these, as highlighted above, do not provide much clarity or certainty and, as a result, the decision is often left to the courts. Currently under South African Law the link between section 153(1)(a)(ii) and section 153(7) remains unclear and as a result thereof it remains unclear how the court determines an inappropriate vote as discussed in the paper. A clear and detailed process that addresses what processes is followed to determine a vote by a creditor to have been

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<sup>90</sup> Section 7(k)

inappropriate is required which clearly outlines the tests the courts need to apply. Not only will this allow for consistency in the courts but it would ensure the process is clear and transparent providing certainty.

Lastly, there is a need for the South African legal system to develop functional specialised courts that can play an active role within the business rescue arena. The role of bankruptcy courts in the United States is critical to the process and would be even more appropriate in South Africa, as business rescue and debt forgiveness is not necessarily a part of the culture but is developing. The involvement of the courts brings in an added benefit to the process that allows for an independent party through out the process.

South Arica's business rescue system has made tremendous strides from its judicial management predecessor. It is, however, necessary that we critically analyse the development of business rescue to enable the system to grow from stride to stride and from success to success.



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