South Africa’s new Companies Act, Act no. 71 of 2008, is due to be implemented in the final quarter of 2010, almost two years after the statute was signed into law. In late 2009 the dti implemented an unprecedented ‘rectification process’ to address grammatical and technical problems and other weaknesses in the Act. By the end of June an Amendment Bill had not yet been published. Draft Regulations were released in December 2009, for comment by March 2010. It was understood that comment received on the draft Regulations had resulted in substantial changes, and that revised draft Regulations would be re-released for public consultation. Business representatives have argued strongly that, in the continuing absence of a final Act and Regulations, compliance requirements remain unclear and implementation in 2010 will be extremely problematic.

Against this background, SBP held a high-level roundtable discussion in late June, focusing on issues related to better regulation, using the Companies Act and its business rescue provisions as a case study. The discussion was situated in the context of the potential value of regulatory impact assessment (RIA) in policy development and the legislative process. Some significant problems related to the Companies Act – both perceptual and substantive – could have been mitigated by a public RIA process, but unfortunately none was undertaken, although RIA is currently being introduced in national departments, including the dti.

Roundtable participants included representatives from organised business, government regulators and regulatory specialists, experts from the banking, legal and academic sectors, and business rescue and insolvency practitioners. The roundtable was held under ‘Chatham House’ rules of confidentiality.

This roundtable formed part of SBP’s 2010 series of discussions on Making South Africa a better place to do business. This summary highlights some of the main points that emerged in the discussion.
Regulatory Impact Assessment

RIA is potentially an enormously valuable tool for better regulation that achieves the government’s policy objectives as cost-efficiently as possible, is based on sound evidence and effective consultation, and minimises risks and unintended consequences.

From a business perspective, regulatory good practice must be directed towards making policy, legislation, regulation and administration as favourable to trade and investment as possible.

RIA is now used in many countries to test regulatory options and assess their likely social and economic impacts, costs and benefits, and to identify and mitigate possible perverse consequences. A key feature of an effective RIA system is that it involves comprehensive consultation in the course of policy development. RIA can also be applied retrospectively, to assess impacts in practice.

In South Africa, RIA can play a major role right across the legislative process - from the initial stages of policy development to the drafting of Bills; in Nedlac negotiations; and in the passage of legislation through Parliament, to support Parliament’s oversight function and MPs’ ability to scrutinise Bills on the basis of fuller information.

Key to its success is that stakeholders must understand what is needed to make the RIA system effective: policy makers and drafters must be faithful to its principles of critical analysis, constructive stakeholder consultation, transparency and accountability. In countries where this approach is well-established, RIA reports are public documents that accompany Bills to Parliament, and are posted on departmental websites.

SBP has been closely associated with the introduction of RIA in this country. In 2005 the Presidency and Treasury commissioned SBP to design an RIA system for South Africa. Its introduction was endorsed by Cabinet in 2007, and a central RIA Unit has now been set up in the Cabinet Office to support national departments in implementing the system. Departments will be expected to apply RIA to all major new pieces of legislation, and we can expect this to gather momentum over the next few years. However, although some RIAs have been carried out, no South African departments have as yet published any RIA reports, and the quality and transparency of the actual processes leave much to be desired. Consultation remains very uneven, and deeply controversial legislation continues to be passed.

The Companies Act 2008

The new Companies Act was a long time in gestation. There appears to have been no internal departmental RIA associated with the Act, but the dti describes the consultation process as “robust and extensive”, involving Parliament and Nedlac, as well as direct consultations with business. Industry stakeholders nevertheless report considerable dissatisfaction with the quality of that process, and the extent to which government was actually willing to listen to stakeholders on key issues. While it is inevitable that not all interests can be accommodated, and policy choices have to be made, businesses say that valid concerns appear to have been largely unacknowledged.
The Act re-writes South African company law completely and will have far-reaching effects. Laudable objectives include cutting red tape, promoting higher standards of corporate governance, strengthening shareholder rights, and encouraging entrepreneurship. Wide-ranging legislation of this kind is bound to be controversial in various respects, and some aspects of the Act have attracted strong criticism. The business rescue provisions are a specific area of concern.

The Companies Act is drafted in plain language, is not as detailed and prescriptive as current legislation, and offers companies greater flexibility to accommodate their particular needs. It substantially reforms the way in which business law is administered, introduces a number of new regulatory bodies, simplifies mechanisms for the incorporation and administration of companies and streamlines regulatory processes. Key objectives include making company registration easier, reducing the number of steps required to start a new business, establishing a flexible regime for the capitalisation of companies, and introducing a business rescue process for financially distressed companies.

The Act provides for the classification of companies into either profit or non-profit companies. Profit companies are divided into four categories – private companies, personal liability companies, state owned companies and public companies. It does away with the close corporation as a category for new registrations.

Positive features identified by roundtable participants include simplified requirements regarding public offering of securities and uncertificated securities; and the introduction of standards of conduct for directors and the partial qualification of directors’ duties, which codifies common law in this area (though it was noted that the qualification of directors’ duties could discourage entrepreneurship and innovation).

Under financial reporting provisions, the removal of audit requirements for private companies and small businesses should reduce their costs of doing business over time. But there could be some unintended negative consequences that will need to be monitored. For example, banks may become more risk averse in providing credit to small businesses without audited books; and there could also be a greater likelihood of fraud, theft and tax evasion.

While roundtable participants agreed that the new Act is likely to support new company start-ups, they noted that increased flexibility poses considerable challenges for some sectors - specifically credit providers - to put appropriate arrangements in place. This could mean that banks and other credit providers will pass their cost increases on to business, and small businesses in particular.

The more contentious sections of the Act include Section 4 – solvency and liquidity tests; Section 22 – reckless trading; Section 23 – registration of external companies; and Section 136 – the business rescue process for financially distressed companies.
Business Rescue

The Minister of Trade and Industry said in late June in a meeting with representatives of organised business that it was imperative to introduce the new Act as soon as possible, emphasising the importance of the provisions for business rescue.

Business rescue is a formal process which may be initiated by a company’s board of directors, or by court order brought by shareholders, trade unions, or employees. It is also possible for a court to make an order, during liquidation proceedings or proceedings to enforce any security against the company, placing the company under supervision to commence business rescue proceedings.

Unlike the judicial management process provided for in the Companies Act 1973, business rescue may be conducted without recourse to the courts.

Roundtable participants agreed that, in principle, business rescue is a commendable concept. When a company is financially distressed, it is generally preferable for its directors to consider rescue solutions before resorting to liquidation. Many small businesses are illiquid, rather than insolvent. Business rescue options can be particularly important in a growing economy as a means to avoid job losses and losses to the fiscus associated with liquidation. It is to be hoped that the introduction of business rescue will help to stem the tide of new business failures in their first two years of operation.

However, it is extremely important for a business rescue model to balance the rights of debtors against those of creditors. If this is not achieved effectively, there could be severe negative consequences, discouraging financiers from lending both start-up and working capital, and frightening off foreign investment.

Business rescue proceedings entail the appointment of an independent business rescue practitioner to supervise the company and its management on a temporary basis. The process begins when a resolution is filed with the Companies and Intellectual Property Commission to place the company under supervision. A business rescue practitioner, who must be appointed by the company’s board within five business days after the resolution is filed, takes over full management control of the company, although the board may be retained.

Business rescue is intended to be consultative and inclusive process, involving all stakeholders. The practitioner engages with affected parties (shareholders, creditors and employees) to develop a business rescue plan, which can entail restructuring the company’s affairs, business, property, equity, and debt and other liabilities, to maximise the likelihood of its continuing on a solvent basis. Affected parties may intervene at various stages by application to court. The business rescue plan is either adopted or rejected by all parties with voting interests (depending on circumstances, these include shareholders, creditors and employees). If the plan is rejected, the company is liquidated.

Once in business rescue, a company is protected by a moratorium on the rights of claimants against the company or in respect of its property, to allow the company to trade back to solvency. The nature and duration of the moratorium is proposed by the practitioner, and its terms can be changed only with the practitioner’s consent or by leave of the court.
Unlike judicial management, if the company undergoing business rescue can’t achieve solvency, the company’s entire business and assets may be sold, provided that this generates a better return for creditors than liquidation. However, commentators point out that the business rescue model omits the checks and safeguards present in a liquidation.

The new business rescue process is in some ways similar to the informal business rescue proceedings that have been conducted in South Africa hitherto, whereby a company’s major creditors (mainly the banks) work together to develop a way to rescue the company rather than allowing it to become insolvent.

For business rescue to work smoothly, it will be important to facilitate constructive relationships among the different role players. Roundtable participants suggested that a voluntary agreement will need to be developed for business rescue, similar to the voluntary code on debt counselling that banks and debt counsellors are currently signing off. The latter code – which is an extremely comprehensive and lengthy document – aims to improve the implementation of debt counselling as provided for by the National Credit Act. But developing such a code takes time.

**Business rescue: Some key issues**

- **Will some companies resist the business rescue option – and could some abuse it?**

Companies may be reluctant to follow the business rescue route, given that the practitioner has the power to take over the responsibilities of the board of directors.

Conversely, business rescue can be commenced by a simple directors’ resolution to the effect that the company is ‘financially distressed’, which is then registered at the Commission. No prescribed supporting documentation is required, and there is no external scrutiny (for example, by a court, or the Master). The board can pass this resolution without notifying shareholders, creditors, financiers or employees before business rescue is in place. This undoubtedly makes the system quick, cheap and accessible – but commentators warn that there is potential for abuse.

- **Business rescue practitioners: A shortage of skills and experience**

The Act provides for the creation of a regulatory entity, the Business Rescue Practice Regulatory Board, which is still to be established. The Regulatory Board will be responsible for the registration and oversight of business rescue practitioners. But does South Africa have enough appropriately skilled and experienced people who can function as business rescue practitioners?

Business rescue draws on a broad range of skills, covering financial, legal, management and business expertise – and good judgement. There is certainly an existing pool of skills in the turnaround-management sector, and in banks already engaged in informal business rescue processes. Practitioners will also be able to use their discretion in retaining members of a company’s Board, to draw on their knowledge and experience. In many cases business rescue will require multi-skilled teams of practitioners rather than a single individual.
However, available expertise is limited. A considerable investment in a skills development programme may be needed for business rescue to be feasible at scale.

Roundtable participants were also concerned that the cost of the practitioner role has been underestimated. It is not clear where the necessary funding will come from.

- **Limitations on creditors’ rights**

There is considerable concern about the restrictions on creditors’ rights under business rescue provisions. Much will depend on interpretation and precedent following implementation of the Act. Until it is tested in practice, credit providers perceive themselves as facing significant risk.

As noted earlier, Section 132(1) of the Act places a moratorium on legal proceedings, including any enforcement action against the company or its property, except under certain circumstances (for example where when the business rescue practitioner consents in writing, or by leave of the court). Furthermore, Section 133(2) provides that during business rescue proceedings, a guarantee or surety by a company in favour of any other person may not be enforced by any person against the company except with leave of the court and in accordance with any terms the court considers just and equitable in the circumstances.

Credit providers are in effect being asked to take a big leap of faith, trusting that a business rescue practitioner will act reasonably and security won't be cancelled. However, there appears to be a real risk that credit providers may re-price credit provision to cover the increased possibility of non-payment brought about by uncertainties introduced under business rescue. Uncertainty may also lead to foreign lenders withdrawing from the country.

- **Cancellation and suspension of contracts**

Business rescue undermines the predictability of the rights and obligations of contracting parties, and can be used to ‘cherry pick’ provisions in contracts. Section 136(2) – the most controversial aspect of the business rescue model - provides that the practitioner may “cancel or suspend entirely, partially or conditionally, any provision of an agreement to which the company is a party at the commencement of the business rescue period", except for employment agreements. Non-variation clauses will become meaningless.

While the legislation requires the practitioner to exercise this power in a reasonable manner, it is not clear how ‘reasonableness’ will be determined. Credit providers are deeply concerned at the practitioner’s ability to intervene in established commercial arrangements and agreements, in ways that may materially affect creditors’ rights. The section effectively allows for a secured creditor to become unsecured – and for judges to interpret the provisions as they see fit.

There are serious concerns that a company could choose to go into business rescue knowing that liquidation is inevitable – while deliberately using the business rescue period to destroy creditors’ security before going into liquidation.

Will creditors have a say? It is not clear at what stage in the process such decisions may be made by the business rescue practitioner, and thus whether such decisions will be subject to
vote by the creditors. If these decisions are to be taken in accordance with an adopted business rescue plan, creditors will have had an opportunity to influence this plan and approve or reject particular actions. But if the practitioner is able to exercise the power to suspend or cancel agreements before the approval of the rescue plan (which may take place up to 30 business days after the commencement of business rescue proceedings), creditors would not have had the opportunity to vote on this. In discussion, it was pointed out that if it is decided that a company cannot survive and the business rescue plan is rejected, the liquidation process may be compromised if decisions taken by the business practitioner during the interim period are not automatically voided.

Some commentators argue that there are also serious implications for South Africa’s participation in the ISDA Agreement\(^1\), which provides that contracts originating outside South Africa include a clause that the contract will be enforceable inside South Africa. The Act throws this clause into question, with negative impacts on, for example, banks’ risk management status (which translates into a requirement to have a higher capital holding).

While Section 136 is subject to sections 35A and 35B of the Insolvency Act, 1936, which provide for rights in favour of counterparties to derivative transactions, it is not clear how this will be interpreted given that the latter provisions apply to companies in the insolvency process – and are thus not applicable to companies under business rescue.

A creditor who is adversely affected by any action to cancel or suspend agreements has a right to claim damages under section 136(3). However, it is not clear what course of action would establish a claim for damages, given that the business rescue practitioner is acting within the authority provided by legislation. The ability to claim for damages is in any event unlikely to allay the concerns of off-shore lending institutions, which require absolute certainty in the security of debt.

- **Incentives for financing after business rescue commences?**

For business rescue to succeed, shouldn’t there be provision for post-commencement financing? Has government given this sufficient thought? In the USA, the well-established business rescue regime works because there is a level of financiers who specialise in post-commencement financing. This doesn’t exist in South Africa. What incentives will financiers have to provide post-commencement finance, particularly since business rescue costs and employee claims take preference?

Section 135 of the Act could have the unintended consequence of making credit providers more averse to extending credit to higher risk businesses. This provision ranks claims related to post-commencement financing in the following order: 1) payment of the business rescue practitioner’s remuneration and costs; 2) all other claims arising out of the costs of business rescue proceedings; 3) all claims for post-commencement financing obligations related to employment; 4) all claims in respect of post-commencement financing raised from third-party lenders, where this lending has been secured; 5) all unsecured claims against the company.

\(^1\) The International Swap and Derivatives Association (ISDA) regulates derivative contracts.
Roundtable Business Rescue

• Can our courts handle business rescue quickly and efficiently?

Roundtable participants argued that the business rescue provisions simply don’t recognise how slowly South Africa’s court system operates. Business rescue proceedings are supposed to be concluded within three months. Is that realistic, given how long it can take to get onto a court roll? What happens if creditors seek to set aside the business rescue practitioner? Will we need specialised courts for business rescue to work effectively?

Towards better regulation

Was the consultation process around the Companies Act wide enough, and were stakeholders’ views taken seriously?

Various industry bodies and individual companies submitted their concerns to the dti during the consultation process, but roundtable participants reported that by and large their submissions appeared to have been ignored. No acknowledgement or response to the submissions was received, and there was no visible impact on the process – undermining their confidence in government’s willingness to engage with them.

To generalise, this certainly suggests that interactions between government and stakeholders need to be improved. A well-managed RIA process, resulting in the publication of a report that highlights key concerns and issues raised in public submissions, would go a long way to build confidence, even where not all concerns can be addressed.

An open RIA process would also encourage stakeholders – in this case, business, - to be much more proactive in working with draft legislation and developing coherent responses and solutions to the key problems, which can be presented to government for consideration. (In the roundtable, participants noted that sector bodies had lacked consensus on how they should respond to the Bill, with different perspectives on key issues undermining their ability to lobby effectively.) Furthermore, by ensuring that the list of stakeholders who have made submissions is publicised, RIA could also help to uncover any significant gaps in the consultation process.

RIA could improve the quality of the consultation process by ensuring that ‘public submissions’ submitted by external stakeholders do in fact become public documents – easily accessible to inform debate and discussion. At present, government generally does not make such submissions accessible, and for various reasons businesses are often reluctant to do so themselves.

Where legislative and regulatory changes are likely to involve significant compliance costs or have other negative impacts, this must be clearly demonstrated by business. Government in turn needs to give more attention to what those costs will be, their cumulative impacts, and who will pay them - for example, banks’ concerns about increased risks created by the Companies Act are likely to translate into increased costs of credit for small businesses. For Parliament, RIA reports can be an important source of information for committees considering Bills with significant impacts – and the quality of these reports would also provide telling reference points for its scrutiny and oversight functions. Where major changes in legislation are introduced during the parliamentary phase, these too should be subject to RIA as part of the better regulation agenda.
Once legislation is implemented, stakeholders - and, perhaps business in particular - can also play a critical role in finding ways to measure the impacts of legislation over time. Government tends to be poor at monitoring impacts, or undertaking critical regulatory reviews.

From a business perspective, the quality of the regulatory framework will be greatly enhanced if business can track impacts over time and engage with government on the basis of this evidence. Business needs to translate the challenges and risks created by legislation such as the business rescue provisions into measurable indicators, and to track these over the short and medium term. Such a process needs to be driven from a central point able to draw together a wide range of business perspectives. Working together to gather and collate objective, consistent and credible evidence, business would be in a strong position to support a process of retrospective impact assessment, against which to hold government to account where necessary – and to advocate for regulatory change where needed.

In practice, will the new Companies Act cut red tape, promote higher standards of corporate governance, strengthen shareholder rights, and encourage entrepreneurship? Can business rescue be implemented effectively in South Africa? Will it find a satisfactory balance between the rights of debtors and creditors? Will it scare off foreign lenders, or can their fears be allayed? In short, will the Act make South Africa a better place for doing business? Much will depend on the extent to which critical concerns noted above are adequately addressed in the Act and Regulations.

*SBP wishes to thank Claire van Zuylen - Director, Bowman Gilfillan Attorneys - for additional comments on the business rescue provisions in the Companies Act.*