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IS POST COMMENCEMENT FINANCE PROVING TO BE THE THORN IN
THE SIDE OF BUSINESS RESCUE PROCEEDINGS UNDER THE
COMPANIES ACT OF 2008?

by

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submitted in partial fulfillment of the requirements for the degree of

LLM (MASTER OF LAWS)

in

COMMERCIAL LAW

in the

FACULTY OF LAW

at the

UNIVERSITY OF JOHANNESBURG

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ABSTRACT

With the onset of the new corporate rescue regime in South Africa, the impact of the current post commencement finance culture in the country could have adverse effects on such proceedings. Due to the growing number of financially distressed entities, this topic, and in particular, turnaround funding in developing countries like South Africa is becoming more and more relevant.

Due to the juvenility of the current legislation regarding business rescue proceedings, there are still issues that need addressing. One of the major stumbling blocks of these proceedings stems from a lack of post commencement finance. In comparison to other, more established jurisdictions, South Africa seems to be behind in the commercial rescue realm. Thus, an evaluation of post commencement financing in South Africa is critical in order to determine whether the relationship is positive or negative in terms of the actual proceedings themselves.

By way of normative methodology this paper will describe the magnitude of post commencement finance in South Africa as well as address the reasons for the situation this country finds itself in. Finally an attempt will be made to show the best way(s) in which to go about creating a culture within the economy that is partial to participation in the rehabilitation of distressed institutions.

To this end, it appears from the literature and studies undertaken that the post commencement finance environment is lacking essential components. Through time, the development and refinement of these applicable provisions and influential factors will enable the corporate landscape to evolve into a competent dwelling for companies facing financial woes.
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1 Introduction

The Companies Act 71 of 2008\(^1\) introduced a new corporate rescue regime into the South African commercial law landscape. This was much needed as it is generally accepted that judicial management was a miserable failure in practice.\(^2\) Although the move away from judicial management is still in its infancy, there have been a fair amount of reported cases dealing with this new regime. The Act, which came into effect in May 2011, contains Chapter 6: “Business rescue and compromises with creditors”. The purpose of this chapter is to provide the opportunity to companies that are financially distressed to reorganise and restructure themselves in order to have the best possible chance at returning to a position of solvency while having regard to the rights and interests of all stakeholders.\(^3\)

In all rescue systems, there is the need for financial support from the commercial environment through the use of additional funding as well as agreements by creditors to postpone their claims or even to go as far as a compromise.\(^4\) It logically follows that one of the most important factors to business rescue proceedings bringing about a successful rehabilitation is that of post commencement finance. Due to such proceedings still being fairly new to South African law, there are still issues that need to be addressed.

This paper will focus on rescue failures that arise due to the lack of post commencement finance in South Africa. Locally, there have been several shortcomings due to this very aspect of these proceedings, some of which will be

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\(^1\) Hereafter referred to as the ‘Act’.

\(^2\) Burdette “Some initial thoughts on the development of a modern and effective business rescue model for South Africa (Part 1)” 2004 SA Merc J 241; Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd 2001 (2) SA 727 (C).

\(^3\) Rushworth “A critical analysis of the business rescue regime in the Companies Act 71 of 2008” 2010 Acta Juridica 375; Section 7(k) of the Act.

discussed at a later stage. A comparison will be drawn against the United States of America’s (US) rescue administration, which is contained in Chapter 11 of the United States Bankruptcy Code, as well as the guidance provisions that have been issued by the United Nations Commission on International Trade Law, and the World Bank in order to determine what prerequisites are required in a system to ensure that successful turnaround financing is secured for distressed companies.

South Africa seems to be behind in the ‘corporate rescue’ realm in terms of having a debtor friendly rescue culture, this may well be because the legislation is new or because of economic factors facing a developing country. It is important to critically assess the position relating to post commencement finance in South Africa in order to determine the problems facing distressed companies as well as to suggest possible solutions in creating a culture within the economy that is partial to participation in the rehabilitation of struggling institutions.

2 Business Rescue In South Africa: A Brief Discussion

With globalisation becoming increasingly relevant in most business activity, the effects of economic slumps are felt amongst companies worldwide. South Africa has felt the effects of such downturns as is visible in the data issued by the Companies and Intellectual Properties Commission (CIPC) in the 2012/2013 Annual Report, which saw an increase in corporate failures and subsequent liquidations. Wood describes liquidation as the ‘guillotining of a company’ and considers it to be a drastic measure. Once a liquidation order is granted there are certain consequences that ensue such as the demise of the corporate entity, loss of employment for many as well

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6 Hereafter referred to as UNCITRAL.
7 In Swart v Beagles Run Investments 25 (Pty) Ltd (Four Creditors Intervening) 2011 (5) SA 422 (GNP) 28, Makgoba J stated that “where an application for business rescue…entails the weighing-up of the interests of the creditors and the company the interests of the creditors should carry the day”.
as “an unsatisfactory pro rata share in the residue for unsecured creditors, and the abandonment of claims when such are not proved”. Due to such results, it is appropriate to have legislation that provides other options in situations of business turmoil.

The business rescue procedure attempts to provide temporary measures that aid in the rehabilitation of a company. During the time of such a rescue, the company’s management will be placed under the supervision of a business rescue practitioner as well as having a moratorium on all claims against the company on behalf of the creditors. It should be noted that there are two ways in which such proceedings can be entered into, namely, by either a voluntary resolution by the board of directors or an application to court by an ‘affected’ person. The actual rescue will come together in the form of a ‘rescue plan’ put together by the business rescue practitioner in terms of the Act. This plan essentially deals with all of the company’s affairs, assets, liabilities and other relevant areas relating to the business and attempts to strategize a way in which these elements can be restructured in order to maximise the chances of the distressed company returning to solvency.

The number of liquidations and insolvencies serves as a good indicator as to a country’s general health and fortunes of its companies; over the past 5 years there has been a significant increase in both of these aspects which essentially means that there is a growing trend of financial instability in South Africa. There have been some high profile cases in which large South African companies have entered into business rescue proceedings, this has brought the proceedings and their results to the attention of the public through the media hype surrounding them.

11 Bradstreet “The new business rescue: will creditors sink or swim?” 2011 SALJ 352.
12 Bradstreet “The leak in the lifeboat: Inadequate regulation of business rescue practitioners may adversely affect lenders willingness and the growth of the economy” 2010 SA Merc J 195; Section 133.
13 Davis, Cassim, Geach, Mongalo, Butler, Loubser, Coetzee and Burdette Companies and other Business Structures in South Africa (2011) 165 – 167; Section 129 and section131.
14 Part D of Chapter 6 deals with the development and approval of a business rescue plan.
15 Section 128(1)(b).
16 Pretorius and Du Preez (n 4) 169.
17 Du Preez (n 8) 5.
The first of these casualties was that of Velvet Sky, a low cost airline operating locally. In 2012 an application was made by British Petroleum (South Africa) to have the airline put into provisional liquidation due to the large amount of debt outstanding. An application to enter into rescue proceedings was not accepted due to various reasons but Velvet Sky’s executive officer was recorded as saying that daily costs could be met if foreign investors provided funds and costs were cut. A construction organisation, Sanyati, followed suit by applying for business rescue due to unpaid debts. The application was rejected by 96% of the voting interests. Finally, and probably the most high profile of these three examples, 1Time Airline filed for business rescue proceedings due to its subsidiaries undergoing some financial distress. These proceedings never materialised as the company filed for liquidation later that year.

It can be seen that, in any corporate rescue regime, financial support is required from the surrounding commercial domain in order to enable the rescue to take place. As noted by Du Preez, during times of recession (such as the 2008 worldwide recession) such financing is even harder to come by as investors are more wary of the risks involved in placing money in an, essentially, failing entity. Ironically, when financing is needed most in order to secure a turnaround for the business in question, it is often unavailable or creditors themselves are financially troubled. An example of this irony is the statement previously mentioned by the executive officer of Velvet Sky. In relation to the three examples discussed above, the main reason cited for the failure of the business rescue proceedings was the inability to secure any post commencement finance. This point is embodied by the media statement given by the Chief Executive Officer of 1Time, in which it was bluntly stated that, “a potential...

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18 SAPA “Provisional liquidation for Velvet Sky” 2012 Fin24 (http://www.fin24.com/Companies/TravelAndLeisure/Velvet-Sky-liquidated-20120621 (06-10-2014)).
19 SAPA “Low-cost airline 1Time filed for liquidation on Friday, leaving passengers stranded countrywide” 2012 Mail & Guardian (http://mg.co.za/article/2012-11-02-1time-airline-files-for-liquidation (07-10-2014)).
20 Du Preez (n 8) 6.
financier notified us this afternoon that they are no longer able to invest in our airline”. 

Thus, one of the most important factors of a corporate rescue attempt involves obtaining additional finance to meet temporary trade obligations, such as working capital requirements, covering the rescue/restructuring costs and restoring the company to a position of solvency. 

3 Post Commencement Finance – A Current South African Perspective

It can be extremely difficult for a company to secure funding when it is the subject of business rescue proceedings; this is due to the fact that creditors have the valid concern that they may in fact not be paid. One of the main ‘stumbling blocks’ of business rescue proceedings in South Africa is the inability to secure the required capital. In order for the distressed company to continue in the day-to-day operations after the initiation of formal rescue proceedings, it is imperative to obtain a source of finance as soon as possible. In order to sustain the business as a going concern, there are certain business activities that will require funding such as “goods and services from suppliers, labour costs, insurance, rent, maintenance of contracts and other operating expenses, along with the cost of maintaining the value of assets”. It is important to stress that post commencement financing extends from short term goals to that of the long term strategy that will be implemented in trying to obtain a successful turnaround.

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21 Hedly “1Time files for liquidation” 2012 Business Day Live (http://www.bdlive.co.za/business/transport/2012/11/02/1time-files-for-liquidation (08-10-2014)).
22 Pretorius and Du Preez (n 4) 170; Meskin, Galgut, Magid, Kunst, Boraine and Burdette Insolvency Law LexisNexis; see 18.8.2.3.
23 Davis (n 13) 170.
24 Pretorius and Du Preez (n 4) 170.
25 Meskin, Galgut, Kunst, Delport and Vorster Henochsberg on the Companies Act 71 of 2008; see s 135.
In order to deal with the difficulty of obtaining such financing, Chapter 6 provides, under section 135, mechanisms in which such financing becomes more attractive to the financier. In short, this is done by allowing the company to use its assets as security for such loans and provides these post commencement creditors the privilege of being paid before any unsecured creditor.\textsuperscript{28}

The nature and extent of post commencement financing is detailed in section 135 as follows:\textsuperscript{29}

\textbf{135.}

(1) To the extent that any remuneration, reimbursement for expenses or other amount of money relating to employment becomes due and payable by a company to an employee during the company’s business rescue proceedings, but is not paid to the employee -

(a) the money is regarded to be post-commencement financing; and

(b) will be paid in the order of preference set out in subsection (3)(a).

(2) During its business rescue proceedings, the company may obtain financing other than as contemplated is subsection (1), and any such financing -

(a) may be secured to the lender by utilizing any asset of the company to the extent that it is not otherwise encumbered; and

(b) will be paid in the order of preference set out in subsection (3)(b).

(3) After payment of the practitioner’s remuneration and expenses referred to in section 143, and other claims arising out of the costs of the business rescue proceedings, all claims contemplated -

(a) in subsection (1) will be treated equally, but will have preference over -

(i) all claims contemplated in subsection (2), irrespective of whether or not they are secured; and

\textsuperscript{28} Davis (n 13) 170.
\textsuperscript{29} Companies Act 71 of 2008.
(ii) all unsecured claims against the company; or

(b) in subsection (2) will have preference in the order in which they were incurred over all unsecured claims against the company.

(4) If business rescue proceedings are superseded by a liquidation order, the preference conferred in terms of this section will remain in force, except to the extent of any claims arising out of the costs of liquidation.

Based on this provision, the ranking of creditors claims are important for purposes of understanding why, possibly, investors are not as interested in sinking money into companies that are subject to rescue proceedings. Initially the ranking was as follows:30

1. The business rescue practitioner’s remuneration and costs (as per section 143) arising from business rescue proceedings (section 135(3)); then
2. All other claims from costs of business rescue proceedings; then
3. All PCF claims related to employment once business rescue has commenced; then
4. Secured lenders/creditors pre-business rescue; then
5. All secured post commencement finance claims related to third-party lenders/creditors (section 135(3)(a)(i)); then
6. Insolvency Act preferences; then
7. Unsecured claims by PCF or lenders/creditors during business rescue in the order in which they were incurred (section 135(3)(b)); then
8. Remuneration of employees which became due and payable before business rescue commenced (section 144(2)); and then
9. All unsecured claims against the company.

There has been considerable debate regarding these rankings, in particular between point four and five and whether or not they should be swapped.31 In the case of Merchant West Working Capital Solutions (Proprietary) Limited v. Advanced Technologies & Engineering Company (Proprietary) Limited & Gainsford,32 the issue

30 Pretorius and Du Preez (n 4) 171.
31 Du Preez (n 8) 14.
of ranking was discussed by Kgomo J. The court stated that the claim belonging to
secured creditors, pre-business rescue, will now rank below those creditors who have
supplied funding to the distressed entity post-business rescue proceedings (i.e. post
commencement financiers).\textsuperscript{33} Subsequently, in the \textit{Redpath Mining South Africa v
Marsden No and Others},\textsuperscript{34} Kgomo J attempted to confirm his previous \textit{dicta} by once
again stating that the ranking is as listed in the judgment handed down in \textit{Merchant
West}. In terms of these judgments, there is a critical point that needs to be addressed
in the sense that despite these judgments dealing with the ranking of creditor claims
the cases’ focal points were not related to the ranking of claims and thus both
comments can be considered \textit{obiter}. The fact that these remarks were \textit{obiter} lends
itself to the position that currently in our law; the issue of creditor ranking in terms of
business rescue proceedings can be considered a grey area due to the case law
accompanied by academic debate. However it must be remembered that having a grey
area in such a significant area of the law can only be detrimental to key components
of the business rescue process such as post commencement finance.

Due to the fact that the corporate rescue regime in South Africa came into effect in
May 2011, there is very little literature on the issue of post commencement financing
in the country. Thus, there is minute assistance on this matter in trying to identify key
factors that would play a role in successfully securing turnaround finance.\textsuperscript{35} It is
therefore necessary to examine the “debtor in possession” system in the United States
of America as well as the guidance principles put forth by the World Bank and
UNCITRAL on matters of insolvency. This will enable a comparison to be drawn
with South Africa and subsequently identify the preconditions of successful post
commencement finance.

\section*{4 Sources Of Post Commencement Finance}

Before delving into the complexities of the foreign jurisdiction and international
legislative directives that will be discussed, it is submitted that it is beneficial to
consider some of the sources of such funding and their mentality towards such high-
risk investments. Entities requiring salvaging usually require a combination of both

\textsuperscript{33} [2013] ZAGPJHC 109 21.
\textsuperscript{34} [2013] ZAGPJHC 148 60.
\textsuperscript{35} Du Preez (n 8) 36.
capital and credit in order to subsidize the business operations of the organization. These resources can usually be accessed through the many financial institutions available. These financial means include traditional sources such as working capital acquired from internal resources, ownership capital which stems from the shareholders’ capital in the business, non-ownership capital which relates to loaning institutions such as banks as well as creditors and finally venture capitalists.\(^\text{36}\)

According to reports, typical financiers are banks, creditors and the shareholders.\(^\text{37}\) It has been stated that external finance is more costly than that of internal funding, however, as noted by Du Preez,\(^\text{38}\) once a company becomes financially troubled it usually would mean that there are no more internal options available to that entity and thus it is forced to look for backing externally. For any financier thinking about investing in a ‘failing’ entity, there are certain factors that would be taken into account before making the decision to invest. An investigation into whether or not the company is a viable option would be the first port of call in deciding if one should throw a lifeline to the concern. For these financiers the post commencement financing deal (the nature and extent of the funding) will very much depend on the current financial situation of the company (as well as the economic state of the country) and how much risk this lending institution is willing to take.\(^\text{39}\)

A traditional bank is among the most commonly known lending institutions. The issue with them is that they are commonly conservative and therefore do not venture into high-risk investments.\(^\text{40}\) With that being said, they will only lend to credit worthy companies and their standards for obtaining loans are extremely stringent and thus it becomes hard for distressed entities to rely on these lenders.\(^\text{41}\) Another option available to entities searching for financing are via their trade creditors (suppliers), they can continue to supply various goods and services on a revised commercial deal if they believe there is a probable long term benefit for both parties. Often this type of financing is only done in order to try and secure as much of the money that is payable

\(^{36}\) Du Preez (n 8) 38.
\(^{37}\) Pretorius and Du Preez (n 4) 174.
\(^{38}\) Du Preez (n 8) 38.
\(^{39}\) Pretorius and Du Preez (n 4) 174.
\(^{40}\) See generally Du Preez (n 8) 39 – 40.
\(^{41}\) See generally: Goldblatt “Alternate financing sources” 2012 Journal of Corporate Renewal 4-9.
to them from the first agreement. These types of ‘investors’ are perfect for short-term needs as the day-to-day running of the business can be maintained. Customers are often not approached for post commencement financing but in the right circumstances some customers may be willing to invest money in the product or service. Shareholders can be a good source of financing but due to the tendency of the board of directors to file for business rescue proceedings too late, the shareholders’ enthusiasm for investment is usually at an all time low.

Institutions such as the Development Bank of South Africa and the Industrial Development Corporation can also be used to secure financing for the right candidate. These development finance organizations have been placed in a position in which helping resurrect a distressed economic entity is well within their mandate. However the only issue facing this source of funding is the amount of time it takes for such applications to be accepted, due to the rigorous authorization process. Finally there is the last group of possible financiers; these include private equity firms, venture capitalists and distressed lenders. These groups of investors specialize in high risk lending and thus are highly suited to the business rescue sphere. They are not constrained by banking regulations as well as the fact that their reputation will not be damaged as significantly as that of a bank’s if the concerned entity subsequently ends up in liquidation.

It may be all well and good that a group of investors such as these are well suited to this market but it is dependent on the country as to whether these investors thrive or not. For example in South Africa the private equity industry is fairly under-developed as opposed to those first world countries; therefore it can be seen that firms in this country lack the luxury of having these investors waiting in the wings.

It is important to note that post commencement finance can be more profitable than

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42 Pretorius and Du Preez (n 4) 175.
43 Pretorius and Du Preez (n 4) 175.
44 The right candidate could be a corporation conducting business in the industrial sector.
46 Du Preez (n 8) 41.
other investments in the situation that the company is successfully turned around and can carry on with business as usual. This is due to the high risk attached to such investments as there is a high premium placed on the borrowing entity. Based on what is stated above it seems as though investment into distressed entities is dependent on the nature of the entity as well as the risk a lender is willing to take.

5 Comparative Overview

5.1 The United States ‘Debtor in Possession’ System

Due to the lack of literature relating to post commencement financing in developing countries such as South Africa, it seems necessary to delve into one of the most recognized corporate rescue systems in the world. A secondary reason for choosing to explore this jurisdiction lies in the fact that when the legislature decided that it was necessary to move away from judicial management and develop a corporate rescue procedure that would be inherently more successful than its predecessor, it was stated that in creating this new and improved reorganization process that “the provisions of the US Chapter 11 would be considered”.

This was not the first time that it had been suggested that we look at the Bankruptcy Code in the United States, commentators often noted that judicial management was dysfunctional and needed to be re-worked by paying close attention to the United States system. It has been pointed out that a common trend in European countries was that during reform of their particular insolvency laws, special time and consideration was placed on Chapter 11 and its procedures. This allure was not only felt by European countries, just about every country has felt the need to examine this system in order to determine whether the local system measures up to the Chapter 11

48 Du Preez (n 8) 36.
49 Du Preez (n 8) 43.
51 Bankruptcy Reform Act of 1978.
52 Rajak and Henning “Business rescue for South Africa” 1999 SALJ 262.
reorganization system.\textsuperscript{54}

To understand the US Chapter 11 provisions properly, it is essential to look at their origins. This procedure’s roots are based in the English system of receivership. This was an enforcement action available to a company’s creditor whose claim was secured (either over assets, good will or cash), this creditor had the power to appoint a receiver if the debt was not paid when due. The receiver’s job was to liquidate the asset at the best possible return in order to satisfy the creditor’s claim. Despite this remedy being specific to a certain creditor, it sometimes had the unintended result of turning the business around and subsequently making it a profitable concern again through the running of the business by the receiver in order to sell it as a going concern.\textsuperscript{55} Thus, due to the 19th century insolvency laws in the United States only providing for the liquidation of a debtor’s estate to satisfy the creditor’s claims, the courts devised a special type of reorganization outside bankruptcy provisions based on this receivership action. This reorganization did not apply to corporations and was often refused, but eventually the 1898 Bankruptcy Act\textsuperscript{56} introduced this procedure to the corporation. Years later the Act of 1978 introduced Chapter 11 reorganization and was the result of years of development in the United States.\textsuperscript{57}

As is known, in the United States the laws are divided into state law (applying only to that specific state) and federal law, which is a nationwide ruling. The ‘Bankruptcy Code’ is a federal act with Chapter 11 applying to corporate and sole proprietorships when those businesses are no longer able to realize theirs debts. The main aim of Chapter 11 is to avoid the complete collapse of an ailing business by providing a financial restructuring that is binding on all parties. During a rescue attempt, a firm enjoys temporary relief from its creditor’s claims (similar to the moratorium created in South Africa), so that while still in business, the existing management, can address its current business model and attempt to reorganize it in a way that will bring about a successful resurrection of said company.\textsuperscript{58}

\textsuperscript{54} Loubser “Tilting windmills? The quest for an effective corporate rescue procedure in South African law” 2013 \textit{SA Merc LJ} 437 439.
\textsuperscript{55} Loubser (n 54) 440.
\textsuperscript{56} Act of 1 July 1898.
\textsuperscript{57} Loubser (n 54) 441.
\textsuperscript{58} Bracewell and Giuliani “International and Comparative Corporate Insolvency Law” 2012
The distinguishing feature of this system is that the distressed organization is referred to as the ‘debtor’, the entity’s ownership and control by management is not disregarded during this attempted reorganization of the company’s affairs. The system is often described as ‘Debtor in Possession’ (DIP) due to the fact that the existing management is not substituted by judicial management or the control of a business rescue practitioner/business administrator.\(^59\) Although there is no new addition to the management of the failing entity these proceedings are subject to judicial oversight, there are exceptional circumstances in which an administrator will replace the management team for instances of fraud or gross mismanagement.\(^60\) It must be noted that the USA has a debtor-friendly system which essentially entails that the legislation provides companies protection from creditors in times of uncertainty, this in turn allows the for the best possible chance at a return to solvency.\(^61\)

In brief, mention must be made to a ‘management displacement’ approach and to that of the ‘debtor in possession’ approach. There are varying degrees of both of these systems and as such it is not a simple either-or consideration. The 2008 provisions in the Act show a definite shift away from the management displacement of judicial management but “a company under the Chapter 6 rescue is still far from being a debtor in possession”.\(^62\)

5.2 DIP Financing

The bankruptcy provisions provide a number of different ways in which to secure finance for a struggling entity, these can be located in section 364. This financing is one of the most important, if not the most important instruments created to enable “the DIP to provide current or new lenders the first priority claim on the finances (i.e. right of repayment priority) through the acquisition of financing and loans on
favorable terms for the company”.

The courts in the US allow a debtor to incur unsecured debt as a first priority administration expense (top ranking claim) or as secured debt over unencumbered assets or a remaining portion there of, this type of financing is usually in the form of cash through secured claims on assets, new investments or even trade credit. Due to the extreme risk involved in DIP financing, potential investors are unenthusiastic about investing in a company that faces bankruptcy and thus the rules relating to the payment of claims has been engineered to be more favorable to lenders who have provided such financing. In section 364(d) it states that a ‘super-priority’ status will be placed on pre-petitioned assets if these lenders can prove that there is no other financing available as well as making sure that the originally secured party is still reasonably protected in the circumstances.

The hierarchy of claims under Chapter 11 are as follows:

1. Secured Claims
2. Super-priority claims (DIP financing)
3. Priority claims (administration expenses such as legal fees / wages and salaries / employee benefits claims / claims against facilities that store grain or fish produce / alimony and child support / tax claims / unsecured claims base on commitment to a federal depository institutions regulatory agency)
4. General unsecured claims
5. Preferred stock
6. Common stock

Another common occurrence in the United States is that of a ‘pre-packaged’ or a ‘pre-pack’ in which a company simultaneously files for bankruptcy but also submits a formal reorganization plan that can be voted upon by claimants. The results of this are anything but negative, it allows for time to be saved and in turn saves money; it also

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63 Du Preez (n 8) 26.
64 Du Preez (n 8) 26.
65 Guar (n 60) 23.
works best for firms with financial problems (as opposed to operational problems). In essence this means that the trade debt is still relatively low at the time of submission, which in turn suggests there is a higher chance of a successful turnaround.67

The United States’ debtor in possession system is a classic example of a debtor-friendly structure that is modeled around the desire to genuinely rescue those distressed businesses. This type of system is clearly not to the detriment of creditors and illustrates well that there needs to be a balance struck between both interests. Essentially the rationale behind this system is that all creditors will be better off if the debtor is successfully rescued from liquidation.68

5.3 A concise comparison of the post commencement financing spheres in the USA and South Africa

This section of the paper will offer a brief insight into the differences between both of these jurisdictions. This will enable us to later address an important section of this topic, which will delve into the problems facing South Africa in relation to post commencement finance as well as possible prerequisites that would ensure the success of turnaround financing in any jurisdiction.

It is fairly obvious that both the ‘debtor in possession’ system found in Chapter 11 as well as the business rescue proceedings of Chapter 6 in South Africa are both debtor friendly, while still catering to the interests of creditors.69 The approach taken in the United States is extremely sophisticated stemming from an evolution of the laws relating to corporate rescue, the process is predictable and directed by courts that have a specialty in the solvency and rescue arena. The approach in South Africa is still fairly uncertain in that the legislation is new and courts are still working out the kinks in the approach.70 In South Africa there is no rescue culture as of yet for the same reason mentioned above but once again due to the well established US system their rescue culture is fairly evident from having a transparent process which is highly supported by the parties involved. There is also little or no damage to one’s reputation in United States when a company files under Chapter 11 because the public

67 Du Preez (n 9) 27.
68 Pretorius and Rosslyn-Smith (n 26) 113 – 116.
69 Pretorius and Du Preez (n 4) 172.
70 Pretorius and Du Preez (n 4) 173.
understands that the system works for salvaging distressed entities.71

Although both jurisdictions make provision for post commencement financing, there are differences that should be noted. The ranking difference could be a factor as to why the US system works so well as opposed to some of the short coming of the South African rescue regime, in that, turnaround finance in the United States is ranked as a super priority after secured claims where as in South African these financiers are ranked below the practitioner’s remuneration and costs of the actual proceedings as well as employee claims. Mention must also be made to the fact that in the US there is the availability of pre-packaged finance agreements along with the fact that there are sources of funding that specialize in debtor in possession financing, these are possible missing links in the South African system that could be what is needed in order for turnaround financing to become a mere formality in such proceedings.72

6 International Guidelines On Insolvency Law

6.1 The World Bank

The World Bank’s international publication titled “Principles for Effective Creditor Rights and Insolvency Systems”73 contains various recommendations regarding the principles for successful post commencement financing. One such principle relates to the issue of stabilizing distressed businesses along with the sustainment of business operations. Contained in this principle it is stated that, subject to certain safeguards, a business should have access to commercially viable forms of funding and that these ‘loans’ should be on terms of agreement that afford repayment priority under exceptional circumstances in order to allow the debtor to meet its day-to-day needs.74

It was further stated that in developing countries (such as South Africa) the form of financing that usually appears is in the form of debt in which security is often required in the form of unencumbered assets that are either immovable or movable in nature. It

71 Pretorius and Du Preez (n 4) 173.
72 Pretorius and Du Preez (n 4) 174.
73 World Bank “Principles for effective creditor rights and insolvency systems” 2005 (http://www.worldbank.org/ifa/IPG%20%20Revised%20Pples%20FINAL%20%5B21%20De
c%202005%5D.pdf (13-10-2014)).
74 Principle C9.2 - World Bank (n 73) 17.
is of importance to note that the World Bank collaborated with UNCITRAL, to develop a set of principles that would afford various jurisdictions guidance in evaluating and developing new laws which would stand up to the international standard of insolvency laws.\textsuperscript{75} It is due to this collaboration, that this paper will focus on the UNCITRAL provisions as they are all encompassing.

6.2 UNCITRAL’s Legislative guide on insolvency law

The “Legislative guide on insolvency law”\textsuperscript{76} sets out very clearly the provisions that are regarded as essential by UNCITRAL when drafting insolvency laws in any jurisdiction.\textsuperscript{77} Much of this guide has placed a considerable amount of focus on that of post commencement finance, for obvious reasons. The guide describes the post commencement financing needs of a debtor and as well as noting the possible sources of such finance in the form of available cash, the sale of liquid assets, funding through the means of trade credit as well as loans.\textsuperscript{78} There is emphasis placed on the need of new funding and thus a tentative distinction is drawn between the financing of transactions outside the normal course of business and those that can be considered necessary for survival.\textsuperscript{79}

The legislative guide has placed forth recommendations regarding post commencement finance provisos that should be included in present day insolvency and creditor systems. Firstly, note is made of the purpose of having post commencement finance provisions in business rescue legislation; these entail that in order for the continued operation and survival of the company a degree of finance is required as well as to provide the correct protection for the entities that supply this type of funding and finally to ensure that protection is granted to those whose rights

\textsuperscript{75} Burdette (n 2) 263.
\textsuperscript{76} UNCITRAL (n 27) 115.
\textsuperscript{77} Burdette (n 2) 253.
\textsuperscript{78} Van der Linde “Priority Issues in post commencement financing: A view from South Africa” 2009 \textit{The Intersection of Insolvency and Company Laws} 41 43.
\textsuperscript{79} UNCITRAL (n 27) 115.
will be affected by the issuing of such financing.\textsuperscript{80}

UNCITRAL recommended particular contents be included into the relevant legislation surrounding post commencement finance. This specifically deals with the attracting and authorizing of turnaround funding. Under recommendation 63 it was stated that:\textsuperscript{81}

“The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the estate. The insolvency law may require the court to authorize or creditors to consent to the provision of post-commencement finance”.

Du Preez gave mention to the fact that UNCITRAL created this recommendation based on three different aspects of post commencement financing which included the need for turnaround funding, the sources of such funding and the authorization of said financing.\textsuperscript{82}

In terms of the need for funding, it is clearly critical for a struggling company to have access to funding that will enable them to pay the day-to-day costs of business.\textsuperscript{83} The funding should come from various sources (as previously mentioned – liquid assets, incoming cash flow from operations or funding from a third party) and this need for funding should be identified early in the process in order to make sure the continuation of the business is realized after that business has filed for such proceedings.\textsuperscript{84} In terms of the sources, there are two types, pre-insolvency lenders who provide trade credit or in some instances provide new funds in order to increase the probability of the company surviving and in turn salvaging their initial claims. The other group is lenders with no previous relationship to the distressed company and are motivated by the chance to receive a higher rate of return on an investment.\textsuperscript{85} The final pillar in the trio regarding recommendation 63 relates to the authorization

\textsuperscript{80} UNCITRAL (n 27) 118 recommendation 63-68.
\textsuperscript{81} UNCITRAL (n 27) 118.
\textsuperscript{82} Du Preez (n 8) 22.
\textsuperscript{83} UNCITRAL (n 27) 113 at 94.
\textsuperscript{84} UNCITRAL (n 27) 114 at 95.
\textsuperscript{85} UNCITRAL (n 27) 115 at 99.
for post commencement finance; UNCITRAL noted that among various jurisdictions the insolvent entity is allowed to decide whether new financing is required and then is subsequently authorized to obtain unsecured credit without court approval, whereas in some dominions court approval is required in such circumstances. Due to this reason UNCITRAL decided that court intervention is only really required where the priority or security derived from the post commencement financing will affect the interests of pre-existing secured creditors who are inherently against the rescue proposal.

The 64th recommendation relating to the priority for post commencement finance states that:

“The insolvency law should establish the priority that may be accorded to post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of ordinary unsecured creditors, including those unsecured creditors with administrative priority”.

This recommendation is based on two points. The first being because of expenses relating to the operation of standard business tasks, these are usually dealt with as administration expenses. These administrative creditors will not rank ahead of secured creditors but will rank ahead of those creditors whose claims are unsecured as well as statutory priorities such as taxes. In terms of a trade creditor advancing funds to the entity, this is seen as lending funds to the insolvent state as opposed to a distressed entity and it is due to this that the funding becomes an expense to the insolvent estate and subsequently attracts a higher ranking. The second reason this recommendation came about was due to the fees of the insolvency representative or professional employed in the matter, in some jurisdictions this contained a ‘super’ priority in which this ranked ahead of administrative creditors.

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86 UNCITRAL (n 27) 117 at 105.
87 UNCITRAL (n 27) 117 at 106.
88 UNCITRAL (n 27) 118.
89 UNCITRAL (n 27) 116 101.
90 UNCITRAL (n 27) 116 102.
The next three recommendations relate directly to the security that will or can be lodged in favor of the turnaround funding that is forwarded by the various sources. These recommendations state.\footnote{UNCITRAL (n 27) 119.}

65. “The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower-priority security interest on an already encumbered asset of the estate”

66. “The law should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67”

67. “The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

(a) The existing secured creditor was given the opportunity to be heard by the court;
(b) The debtor can prove that it cannot obtain the finance in any other way; and
(c) The interests of the existing secured creditor will be protected”

Once again it is important to discuss the reasons why these recommendation were put forth. These suggestions were based on the following three aspects. The first reason relates to what the security will be (i.e. security can be lodged against unencumbered assets, even though in situations of financial distress these types of assets are hard to come by or security can be lodged as ‘junior security’ on encumbered assets in which there is an excess value over the asset relating to an existing obligation).\footnote{UNCITRAL (n 27) 116 at 103.} These recommendations came about because in the case of existing lenders, their pre-commencement priority relating to encumbered assets is retained unless otherwise agreed. In certain jurisdictions, laws exist which entail that when there is new financing, that source can be ranked above existing secured creditors but there is often reluctance from the courts on this issue and is usually only accepted if it is a final
The final recommendation relating to post commencement financing issued by UNCITRAL deals with the effect of conversion on post commencement finance. Under the 68th recommendation it follows that:

“The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation”

This was based on the fact that once a company enters liquidation proceedings; the most desirable approach is to make sure those creditors who have acquired a priority for new financing, that are pre-liquidation, will maintain such a priority in any subsequent liquidation. The reason for this is that if this principle does not apply then there is no incentive for investment by potential financiers.

The guidelines set down by UNCITRAL take into account the acute needs of a corporate rescue system in which there is room for successful post commencement financing of struggling businesses. These guidelines had to be undertaken when developing a new set of corporate rescue laws in South Africa, and as a result our local rules largely comply with what was recommended. It must be noted that in doing this, another formidable barrier against the interest of foreign investment has been lowered as well as the beneficial socio-economic impact these laws will and have had on all affected persons.

7 Factors That Can Influence The Success Of Post Commencement Finance

It must be remembered that there is a scarce amount of literature regarding certain factors that can play a role in influencing whether or not there will be successful post commencement finance.

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93 UNCITRAL (n 27) 116 at 104.
94 UNCITRAL (n 27) 119.
95 UNCITRAL (n 27) 118 at 107.
96 Burdette “Some initial thoughts on the development of a modern and effective business rescue model for South Africa (Part 2)” 2004 SA Merc J 409 446.
97 Burdette (n 96) 447.
While analyzing data in relation to a corporate debt restructuring study, Brunner and Krahnen identified an institutional arrangement (often seen in German cases) that in essence has the purpose of coordinating lender decision making when there is a financially distressed entity borrowing. They refer to this as creditor pooling or a ‘creditor pool’. It was stated that in an instance where there are multiple lenders, then there is a reduced incentive for the firm to default, but the later result is that there is a risk of a lower expected pay off if liquidation ensues. “For the borrower, the debt structure is thus transformed from a multi-lender to a single-lender debt structure with regard to the debt by the pool of banks”. The problem with this type of debt is that it is significantly harder to restructure as lenders have increased bargaining power when there are multiple financiers. In a situation where the group of lenders is smaller, the prospect of a successful turnaround is greater as opposed to if there were a larger number of lenders for the reason that less time is taken to make a decision thus providing more time to focus on other areas of the reorganization. The authors of that study also made mention to the fact that having multiple lenders can be beneficial in terms of the financial flexibility by a group of lenders as opposed to the monopoly bargaining power of an individual lender. Therefore, what can be deduced from this is that, the ideal size of ‘creditor pools’ is dependent on the subjective context of the situation facing the financially troubled entity and that either way could be beneficial.

Du Preez makes mention to the fact that these ‘pooling’ agreements are often used early on in the rescue cycle, when the financial problems begin to occur within the company. It is due to this that there are so few workout activities once rescue proceedings have started because many of the options have already been exhausted. This may also show why, in many situations, possible financiers are tentative to invest at such a late stage in the proceedings as most of the serious workout attempts are likely to have already been made.

99 Brunner and Krahnen (n 98) 13.
100 Brunner and Krahnen (n 98) 14.
101 Brunner and Krahnen (n 98) 14; Or other possible sources of lenders, the use of banks is due to the fact that they are the most common lender in that jurisdiction.
102 Brunner and Krahnen (n 98) 16.
103 Du Preez (n 8) 36.
104 Du Preez (n 8) 37.
In a survey with 10,000 firms from 80 different jurisdictions, various factors were identified in being able to predict whether or not a firm was likely to face financial hurdles.\(^{105}\) Among the various characteristics identified in the study, it revealed that the size, age and ownership of the firm gave the best indication as to the potential woes that could face an entity.\(^{106}\) It became apparent that larger, older firms that were foreign owned seem to struggle less than the opposite smaller, younger, and domestic owned firms. However, despite this finding, attention was also given to the conditions facing such firms due to the corporate landscape in the various jurisdictions. Upon this investigation it became evident that firms would have a significantly lower chance of dealing with financial turmoil in countries where there was a higher GDP (Gross Domestic Product) per capita, the legal systems were effectively better, more efficient stock markets in which the stock market itself was more liquid as well as if the financial intermediaries system was better developed.\(^{107}\) From this it seems clear that in countries that are considered ‘first world’, companies have a higher chance of becoming a successful entity with the lowered risk of enduring financial distress at some point during their existence.\(^{108}\) On the other hand, it follows that companies located in developing economies face a greater challenge of being a viable entity for a prolonged period of time.

Another potential factor that can influence the success of post commencement financing has to do with the cooperation and communication between the debtor and creditors.\(^{109}\) In times of financial distress lenders/creditor often want progress reports regarding the rescue endeavor but due to the seriousness of the situation these reports are frequently last on the mind of the debtor, which can lead to a breakdown in communication.\(^{110}\) The breakdown can amplify problems and tensions between parties, which can result in ineffective partnerships, and agreements. It has been suggested that during these times, a valuable tactic is to keep communication between


\(^{106}\) Beck (n 105) 934.

\(^{107}\) Beck (n 105) 933.

\(^{108}\) This can be attributed to the fact that countries with a higher GDP are usually considered to be first world and as mentioned, firms within economies attaining higher GDP’s tend to have a lesser chance of enduring financial turmoil.

\(^{109}\) Adiecha “Managing lender communications during financial distress” 2012 *Journal of Corporate Renewal* 14.

\(^{110}\) Adiecha (n 109) 15.
parties flowing as well as making sure that they are clear, credible and consistent, this in turn will help create a relationship that is beneficial to the rescue scenario. 111

In trying to identify the chances of success of a financial turn around, potential investors can take note by what has been stated by Tsuruta and Xu in the discussion paper titled “Debt structure and bankruptcy of financially distressed small businesses”.112 It was suggested that companies facing times of difficulty that have more bank debt (this debt is equivalent to debt owed to financial institutions or other sources of post commencement finance) than trade credit (agreements with current trade creditors) have the tendency to survive for a longer period of time as opposed to those companies who have a large deficit of trade credit than bank or loan debt. This identification can aid investors in making the crucial decision of whether or not to invest in a certain distressed entity.113

The notes discussed above make up some of the few (international and local) suggested conditions that can have a positive effect on the outcome of post commencement financing.

8 The Prominence Of Post Commencement Finance In South Africa

There is a shortage of literature on turnaround financing in South Africa but a recent study was undertaken by Pretorius and Du Preez, delving into the nature and extent of post commencement finance in the country. Brief mention must be made to the way in which this study was completed. Because of the majority of post commencement finance literature emerging from a ‘developed world paradigm’ little research has been conducted in the South African context (due to the young age of the legislation) or even a similar developing economy’s perspective.

The aim of this study was to “identify and explain the embedded knowledge and experience of specialist rescue practitioners and specialists who had been involved in many informal turnarounds and rescues as bank officials”.114 This was done by first attempting to review the literature relating to the topic and secondly through face-to-

111 Adiecha (n 109) 17.
113 Tsuruta and Xu (n 112) 6.
114 Pretorius and Du Preez (n 4) 176.
face structured interviews with experts in business rescue.

I will now highlight some of the findings from the study and discuss them in relation to this paper.

8.1 Problems facing turnaround funding in South Africa

In trying to understand the problems facing post commencement financing in a developing country like South Africa, questions were posed to the experts regarding the reason there seems to be such a lack of financial aid. According to the data, the main reason for the scarcity of interest by potential investors is due to the negative impact of entering into business rescue proceedings, and subsequently being at the mercy of the business rescue practitioner, has on a company’s profile.\footnote{Pretorius and Du Preez (n 4) 183.} Another highly ranked reason was that when a company files for business rescue it is either for the wrong purpose (to possibly try and prolong liquidation proceedings)\footnote{Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein [2013] ZASCA 68.} or the application is made too late which leaves a short amount of time to attempt a turnaround.\footnote{Pretorius and Du Preez (n 4) 183.}

The next two problems recognized by the study state that the reasons there is no eagerness by investors to supply turnaround financing is due to the fact that there is no business rescue culture in South Africa along with there being a negative perception about such proceedings. This can only be because the legislation is only just over three years old and has had virtually no time to establish itself (like the US system has done over decades). Relating directly to this explanation is the uncertainty and concern with the priority ranking of post commencement finance in South Africa.\footnote{Pretorius and Du Preez (n 4) 183.}

Another issue identified is the bank’s mentality towards investment and their ‘typically’ conservative approach. It is this ‘risk aversion’ culture that does not aid the situation for companies seeking turnaround finance. This same ‘risk aversion’ is what stops potential investors (that are not banking institutions) from participating in these
high-risk high-return investments.\textsuperscript{119} Businesses need to engage their possible or current financiers before an application to enter into rescue proceedings is submitted,\textsuperscript{120} this will allow time to be saved during the rescue phase in which the rescue plan should be the main focus as opposed to trying to find last minute funding.

Several other reasons were listed, such as the unavailability of such financing, potential investors having no confidence in the rescue plan relating to a viable entity, the lack of cooperation by banks in times of distress as well as the inadequate relationship between the distressed company’s management with the potential financier(s).\textsuperscript{121}

8.2 The suggested reasons for the ‘non-existence’ of post commencement finance in South Africa

As already stated, one of the most apparent reasons for the lack of post commencement finance in the country is due to the immaturity of the legislation, meaning that, there is little understanding of the provisions and thus people associate risk with uncertainty or the ‘unknown’. Alongside this, the processes are not necessarily as clear as they could be and there are evident loopholes and inefficiencies, which can only be righted by the courts, but this process takes time. The lack of case law and legal precedent on the matter contributes to the problem in creating this uncertainty and because litigation can be extremely costly, alternative dispute resolutions are being used more and more and the law itself is not being tested as often as it should.\textsuperscript{122}

The negative role of banks was also highlighted as a reason because of the power that banks have in many instances of investment, they are able to sway proceedings in their favour due to a majority vote. According to the findings, banks seem to use loan agreements incorrectly by sometimes including contractual stipulations that state the

\textsuperscript{119} Pretorius and Du Preez (n 4) 184.
\textsuperscript{120} Pretorius and Du Preez (n 4) 184.
\textsuperscript{121} Pretorius and Du Preez (n 4) 184.
\textsuperscript{122} Pretorius and Du Preez (n 4) 181.
relevant entity must consult with the bank before entering into business rescue proceedings otherwise that entity will be in breach. It has also been noted that in times where turnaround funding is required banks can be unreasonable in negotiations as they usually already have security for their prior investment or loan and do not want to risk taking a loss.123

Potential investors may shy away from turnaround funding in South Africa because of the incorrect or malicious use of the business rescue provisions thus far, essentially firms often file for business rescue proceedings for the wrong reasons, or due to poor timing or even acting on the incorrect advice from a professional. This same reason is linked to the abuse of the turnaround system taking place, for example, companies have been filing for business rescue for the deliberate reason of delaying time, this ulterior motive can do nothing but instill zero confidence in potential investors when they can not be sure if the motives for such an application are for the correct reasons.124

Poorly crafted rescue plans and the lack of available unencumbered assets also lend a hand to the growing list of reasons that post commencement finance is virtually non-existent in this country.

8.3 Advised prerequisites for successful post commencement financing in a developing country such as South Africa

During the study undertaken by Pretorius and Du Preez, both financiers to business rescue proceedings as well as business rescue practitioners gave mention to certain prerequisites for successful post commencement finance.125 The first of these, and probably the most obvious, is that there needs to be availability of security in the form of unencumbered assets or parts there of, left over from the percentage of the asset’s value that has not been subject to a security agreement.126

In my opinion, as well as is evident from the results of their study, a sustainable business plan for a viable business is extremely important, with emphasis placed on

123 Pretorius and Du Preez (n 4) 181.
124 Pretorius and Du Preez (n 4) 181.
125 Pretorius and Du Preez (n 4) 182.
126 Pretorius and Du Preez (n 4) 183.
whether or not the business is viable or not. Not all companies deserve to be put into a position of corporate rescue, in many instances liquidation or the alternative goal to business rescue proceedings is the better option. Thus it is critical to determine whether the distressed entity is a viable candidate for the rescue. A clear formula to determine this has not yet been discovered.

Other possible factors that have been identified that will aid the success of post commencement finance relate to time. The first of these being that the management of the distressed firm should engage with potential investors as early as possible and especially before the actual application for business rescue proceedings is submitted, this will allow the firm time to look elsewhere for funding if the financiers that were originally approached decline to put money forward. Secondly, and quite closely related to this issue, is the timing of the filing of the application for rescue proceedings. It is imperative to file earlier rather than later while the financial problems can still be rectified.

The next few proposed prerequisites relate to the business rescue culture in the country. Essentially, there needs to be a positive outlook on a company entering into these proceedings as opposed to the negative connotation that currently plagues the corporate environment. This should be coupled with a good relationship between the financier(s) and the management of the company/business rescue practitioner; otherwise the potential investment will amount to nothing.

9 Suggestions To Improve The Position In South Africa

It must be noted that the findings from the study mentioned above are extremely similar to what has been debated from the academic writings discussed in this paper. It is now important to explain some of the ways in which improvements can be made to this country’s system in trying to create an environment, which is conducive to turnaround funding.

A point that is evident from the comparison made between the South African system

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127 Pretorius and Du Preez (n 4) 183.
128 2011 (5) SA 422 (GNP); Section 128 (1)(b)(iii).
129 Pretorius and Du Preez (n 4) 183.
130 Pretorius and Du Preez (n 4) 183.
and the United States’ ‘debtor in possession’ system had to do with the ranking of creditors. In our local legislation, post commencement financing does not take the form of a ‘super priority’ status when looking at debt repayment by the borrowing entity, as can be seen from the list of rankings mentioned earlier. In South Africa post commencement financing is ranked after employee benefits. According to Bradstreet, the reason that these employee claims are ranked highly is due to the fact that if these claims were ranked lower, businesses could suffer a fatal blow in the form of multiple resignations by employees who have lost faith in the company. Bradstreet states that by offering this high-priority claim, employees will have the desired motivation to stay and continue their employment as opposed to cutting their losses and looking for alternative employment. Although I understand the point that Bradstreet is attempting to make, it must be remembered that international guides have tended to encourage that post commencement finance should enjoy ‘super priority’, for example above employee claims. This falls under the best practices for a turnaround-funding situation. The courts will need to address this point while trying to balance both sides of the coin in terms of employee rights (which are well protected in South Africa) as well as trying to ensure that business rescue proceedings in this country can begin to function as they do in other jurisdictions. Once this is done, confidence will be instilled in investors and this will make them more willing to sink money into distressed entities.

Along with this point, is the debate about whether or not secured creditors (pre-business rescue) should be ranked higher than all secured post commencement finance claims under s135(3)(a)(i). In order for light to be shed on this grey area which negatively impacts post commencement financing, the courts will have to address the ranking of claims directly (as opposed to making obiter attempts such as Kgomo J) because as seen in other jurisdictions and international guidelines, post commencement claims should enjoy priority over pre-business rescue claims that are secured as this provides more incentive for investors.

A large issue that seems to have emerged is the abusive tendencies shown by

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131 Du Preez (n 8) 155.
132 Page 12.
133 Bradstreet (n 11) 359.
134 Du Preez (n 8) 155.
companies in times of struggle towards the new legislation. “Anecdotal evidence (confirmed by the facts in the many failed applications to court for business rescue orders) strongly suggests that there is widespread abuse of the voluntary business rescue proceedings in terms of section 129 of the Companies Act 2008 by company directors, with the assistance of unethical business rescue practitioners”135. This ‘abuse’ can either be attributed to the legal and financial advisors giving the company the incorrect advice or the devious hunger to use the creditor moratorium that is imposed.136 Either way, this plays a major role in corroding the trust of potential investors.137 What is needed in this situation is a relationship based on trust which can be accomplished through the use of Adiecha’s three C’s, namely, clear, credible and consistent communication between the financiers and the borrower.138

As can be seen from the study discussed above, one of the main reasons that there seems to be a lack of post commencement finance has to do with the fact that the legislation is so young. Judicial management did not match up to current predispositions regarding insolvency law as a large amount of preference was placed in the interests of the creditors.139 This was the main characteristic of the system, which was deemed to be ‘creditor-friendly’. As mentioned beforehand, the importance of protecting creditor’s interests attributed to the failure of that system.140 The corollary of this, essentially means that a ‘debtor friendly’ system is needed, as can be seen by the success in the United States. South Africa’s new chapter 6 provisions are considered to be ‘debtor friendly’ as they balance the rights of both the debtor and the creditors.141 The problem is that due to having a creditor friendly regime in this country for so long, a sudden 180-degree change to a debtor friendly system is not necessarily going to show positive effects immediately. Thus, it needs to be understood that in creating a culture that is pro-business rescue among the corporate landscape in South Africa is going to take time. How much time exactly is impossible to calculate, but with that being said there are certain things that can be

135 Loubser (n 54) 456.
136 Du Preez (n 8) 154.
137 Pretorius and Du Preez (n 4) 185.
138 Page 28.
139 Bradstreet (n 11) 354.
141 Bradstreet (n 11) 357.
done in order to help the process.

In order to raise the probability of encountering successful post commencement financing, a huge amount of importance is placed on the timing of events prior to the filing of a business rescue application. From the evidence adduced by the study performed by Pretorius and Du Preez as well as drawing upon practices in the United States relating to ‘pre-packaged’ agreements, it is critical that some form of action is taken prior to the formal procedure commencing.\(^{142}\) These actions can range from assessments being made regarding the viability of the company as soon as there seems to be an element of financial distress, to early consultations of the board with stakeholders and potential financiers as to the possible options going forward (relating to the nature and extent of the post commencement finance that may be required).\(^{143}\)

The role of banking institutions plays an important part in the sphere of turnaround financing, especially in a developing economy such as South Africa, due to the lack of other potential investors such as ‘distressed investors’ and venture capitalists. In many instances banks are the majority creditor and thus have a heavily weighted voted when it comes to business rescue proceedings.\(^{144}\) This means that these establishments often have a major influence on the outcome of the rescue plan and subsequently the entire rescue proceedings.\(^{145}\) As previously mentioned above, banks are seldom willing to invest in distressed entities due to their risk aversion policies. In a developing economy, these financial institutions can sometimes be the only form of possible finance and thus it makes it difficult to secure post commencement finance when this entity is trying to make sure that they do not lose any more money or are guarding against the dilution of their security.\(^{146}\) This leaves a window of opportunity for venture capitalists and alike in South Africa.

Finally, indication must be made to security. Security, in the form of unencumbered assets,\(^{147}\) is one of the most critical factors in securing post commencement finance.\(^{148}\) If this is provided for it creates a sense of confidence in the investor because they are

\(^{142}\) Pretorius and Du Preez (n 4) 184.

\(^{143}\) Du Preez (n 8) 154.

\(^{144}\) Pretorius and Du Preez (n 4) 186.

\(^{145}\) Du Preez (n 8) 156.

\(^{146}\) Pretorius and Du Preez (n 4) 186.

\(^{147}\) Section 135(2).

\(^{148}\) Du Preez (n 8) 155.
assured that they will either lose no money or the potential loss will be significantly less.

10 Conclusion

In conclusion, the newly introduced corporate rescue regime has yet to provide us with results that leave us with a sense of awe. The shift away from judicial management was much needed as could be seen from the international legislative directives on insolvency law. The contents of chapter 6 have now placed companies that are in financial distress, in a much better position with regard to the options available to them.

In order for the potential turnaround of a struggling entity to become a reality, a degree of financial support is needed in order to satisfy the day-to-day costs of business as well as the long terms costs of the proceedings.149 What is evident is that, local legislation loosely adheres to the international guidelines relating to the corporate rescue realm but due to the newness of chapter 6, success in this area has been staggered.

One of the main reasons for this relates to the aspect of post commencement finance. In relation to turnaround funding in South Africa, the position seems to be that it is fairly non-existent.150 There are various reasons for this which have been discussed in detail above, but what needs to be borne in mind is that despite these loopholes and inefficiencies with the said provisions, time will lead to rigorous testing and refinement of these principles through the judicial system.

A recurring theme throughout my research regarding this topic is the need to develop a test that will give an indication as to the viability of a distressed company, essentially stating whether or not the company is worth saving. Although it seems like a tough task, the benefits that will be gained from a test such as this one will be insurmountable, especially in the confidence that will be instilled in potential investors if they have a decent indication as to the worth of a distressed firm. This is especially true for a developing country such as South Africa in which there are virtually no companies with a modus operandi of investing in high-risk high-reward

149 Van der Linde (n 78) 41.
150 Pretorius and Du Preez (n 4) 181.
The path to a successful business rescue system stems from an effective post commencement-financing sector. Although at this stage, the light at the end of the tunnel seems distant, time and perseverance is what is needed from all affected parties in going about creating a truly ‘debtor friendly’ culture within the confines of the new legislation.

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3.2 United States of America

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