Creditors’ interests still carry the day in business rescue: Swart v Beagles Run Investments 25 (Pty) Ltd 2011(5) SA 422 (GNP)

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Abstract: The Companies Act 71 of 2008 introduced a new business rescue regime into South African corporate law. Business rescue is a procedure that facilitates the rehabilitation of a financially distressed company. The business rescue regime is debtor-friendly and replaced the judicial management which was creditor-friendly and which proved to have been inadequate and ineffective in rescuing companies experiencing financial difficulties. The case of Swart v Beagles Run Investments 25 (Pty) Ltd is significant as it was the first case dealing with the business rescue provisions. The court had to consider the requirements for commencing business rescue and looked to the judicial management provisions for assistance. The study focuses on the decision of the court and its reliance on judicial management despite the two regimes having different emphasis in terms of the interests of the stakeholders and the requirements for commencing the business rescue procedure as set out in the Companies Act.

Keywords: business rescue; judicial management; stakeholders; corporate rescue; financial distress; creditor’s interests; rehabilitation; creditor-friendly; debtor-friendly; solvent.

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1 Introduction

Restructuring of companies in financial distress is on the increase globally. South Africa recently introduced business rescue provisions in the Companies Act 71 of 2008 (hereinafter ‘the Act’). The business rescue procedure is debtor-friendly and replaces judicial management, which was also a form of corporate rescue albeit creditor-friendly.
Although judicial management was introduced in 1926 into South African corporate law, it was outdated and ineffective, often leading to many businesses being liquidated without attempting to rescue them (Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd 2001 (2) SA 727 (C) at 738G); Lamprecht C The case for business rescue Accountancy SA 2010 26 at 26). Business rescue offers an alternative to judicial management and aims to facilitate the rehabilitation of a financially distressed company by providing a temporary supervision of the company and the development and implementation of a rescue plan or if not possible, a plan that would achieve a better return for creditors than they would have received had the company been liquidated immediately (s128 (1) (b) of the Act).

The case of Swart v Beagles Run Investments 25 (Pty) Ltd 25 (Pty) Ltd 2011(5) SA 422 (GNP) (hereinafter ‘Swart’) is significant as it was the first case dealing with the business rescue provisions. The court had to consider the requirements for commencing business rescue and looked to the judicial management provisions for assistance. This note focuses on the decision of the court and its reliance on judicial management and the requirements for commencing the business rescue procedure as set out in the Act. This paper will set out the facts and decision of the court and then evaluate and comment on the decision.

2 The facts

Mr. Swart was the sole director and shareholder of Beagles Run Investments. The company operated a charter business dealing with exotic wildlife species. The company also owned various aircrafts including a Beechcraft King Air 200 aeroplane and a helicopter. The company’s financial affairs had deteriorated to such an extent that it could not meet its immediate financial obligations. Swart applied for a court order (in his capacity as a shareholder) of the company in terms of s131 (4) (a) of the Act to place the company under supervision and commence business rescue. He contended that if the company were to be commenced and implemented all the creditors would be paid in full and the company would be granted an opportunity to proceed with its business.

Four creditors intervened with one creditor supporting the application and three opposing it. The creditors opposed the application on the grounds that the business rescue application was an abuse of process and was another attempt to avoid and postpone paying creditors’ debts. They alleged that the company was had been trading recklessly for at least a year. The company made some questionable dispositions and attempted to frustrate liquidation applications and execution sales.

The creditors also alleged that Mr Swart had used the company as his alter ego and had conducted the affairs of the company without paying due and proper attention expected from a director (Swart case at 423J–426A).

The issues to be decided in this case were whether the company was financially distressed, if so, whether the Applicant had made out a proper case that there were reasonable prospects that the company could trade in solvent circumstances through business rescue.
3 The court’s decision

The court pointed out that business rescue plan is a novelty brought about by the new Companies Act and without precedent in South African law especially with regards to case law (Swart case at 428D). The court then held that section 427 of the Companies Act 61 of 1973 (this Act has been repealed except chapter 14) dealing with judicial management will be of assistance. The court then followed the court in Norman Milman v Swartland Huis Meubileerders which held that it must be reasonably probable that the company is viable and capable of solvency and within a period of time it would become a successful concern (Norman Milman v Swartland Huis Meubileerders (Edms) Bpk 1972 (1) SA 741 (C) at 744H). The court in Swart then held that ‘successful concern’ in the Milman case meant that the company would be able to carry on its operations effectively in order to yield a return to its creditors and shareholders (Swart case at 428H–I).

The court then looked at the requirements for a business rescue application in the Act and found that the purpose of the provisions is to assist a financially distressed company by means of a business rescue plan to maximise the possibility of the company continuing on a solvent basis or to achieve a better return for its creditors. The court then turned to section 131(4) (1) (a) of the Act which provides for the requirements that need to be satisfied before an order can be granted. These requirements are that the company is financially distressed; the company has failed to pay an amount in terms of an obligation under a contract or in terms of a public regulation, with respect to an employment related matter or it is otherwise just and equitable to do so for financial reasons and there is a reasonable prospect for rescuing the company (s131 (4) (1) (a) (i–iii)). The court found that even if the requirements are met, it still has a discretion to grant the order and this is achieved by determining whether a case has been made out that the company will be able to carry on business on a solvent basis and that granting the order will result in creditors achieving a better dividend (Swart case at 431B).

The court accepted that the company was financially distressed as it was clearly unable to pay its debts as they became due and payable. The court then concluded that there was no prospect of the company carrying on business on a solvent basis again and no case was made out that the creditors will be better off in business rescue than in liquidation and therefore, the business rescue will not be feasible (Swart case at 431H). Lastly the court held that where an application for business rescue as was the case with judicial management entails the weighing-up of the interests of creditors and the company (or the applicant), the interests of the creditors should carry the day (Swart case at 431G). The application was dismissed.

4 Comments

The court made it very clear that business rescue applications initiated for ulterior motives will not be allowed and the abuse of the proceedings will not be sanctioned. The court in Swart surprisingly turned to section 427 of the repealed Companies Act 61 of 1973 for guidance in the matter. This is highly questionable. The section provides that a court can grant an order for judicial management for a company in financial distress if there is reasonable probability that the company will be able to pay its debts and become a successful concern if placed under judicial management. The phrase ‘reasonable probability’ in the section is too stringent and requires a high threshold of proof (D
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Burdette ‘Unified Insolvency Legislation in South Africa: Obstacles in the Path of the Unification Process’ 1999 De Jure 44 at 57; A Smit ‘Corporate Administration: A Proposed Model’ 1999 De Jure 80 at 96. This high threshold contributed to the failure of judicial management. Section 131(4)(a) of the Act provides that a court can grant a business rescue order if there is a reasonable prospect for rescuing the company. It is clear from the wording of the section that the Act moved away from the strict test which was required for judicial management. The phrase ‘reasonable prospect’ indicates that something less is required than that the rescue should be a reasonable probability (Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 (Pty) Ltd 2012 (2) SA 423 (WCC) para 21). Loubser argues that applying the same threshold test used in judicial management to business rescue would be disastrous for the new procedure (A Loubser ‘The Business Rescue Proceedings in the Companies Act of 2008: Concerns and Questions (Part 1) (2010) Tydskrif vir die Suid-Afrikaanse Reg 501 at 506). The court in Swart had an opportunity to apply the more lenient approach to grant the business rescue order.

Judicial management had as its main target the reimbursement of creditors and its emphasis stands in contrast to the main aim of rescuing a debtor company. This stems from the fact that South Africa had a liquidation system with a liquidation culture. In liquidation, the interests of creditors are more superior to the other stakeholders in the sense that in order for a court to grant a liquidation order, it has to be in the interests of creditors. Thus making it creditor-friendly, as the main aim will be to repay the creditors. Business rescue operates on the premise that the value of a company is greater if it, or its business is preserved as a going concern as opposed to assets being sold off on a piecemeal basis [R. Parry Introduction In K. Gromec and R. Parry Corporate Rescue: An Overview of Recent Developments, (2006) p.406]. When a company’s value is preserved, it can benefit a range of stakeholders’ interests and not only those of the creditors.

Business rescue attempts to secure and balance the opposing interests of creditors, shareholders and employees. It encapsulates a shift from creditors’ interests to a broader range of interests. Section 7(k) of the Act provides that one of the purposes of the Act is to provide for the efficient rescue of a distressed company in a manner that balances the rights and interests of all the relevant stakeholders. Thus business rescue is not only concerned with repaying the creditors, but also protecting all the affected parties (i.e., shareholders, employees and creditors) by ensuring that their interests are equitably balanced. The section represents a shift in the primary focus from the interests of creditors to a broader range of stakeholders. It is submitted that the court’s conclusion that the creditors’ interests should carry the day in business rescue goes in the face of section 7(k). The court came to that conclusion probably because it relied on judicial management in its decision which prioritises the interests of the creditors. Section 5 of the Act states that the Act must be interpreted in a manner that gives effect to the purposes of the Act contained in section 7. Thus when a court considers an application for business rescue, it must be done in a manner that does not subvert the purposes of the Act or disregard the interests of the other stakeholders of the company.

The court in the Swart case further held that in order for the court to exercise its discretion, it must determine whether any case has been made out that granting the order will result in creditors achieving a better dividend (Swart case at431B–C). The court viewed the objective of ensuring a better return for creditors provided for in the definition of business rescue in section 128 of the Act as an independent alternative to that of
restoring the company to solvency. It is doubtful whether the objective of ensuring a better return for creditors can be used to convince the court that the court can be rescued \((\text{Petzetakis International Holdings Limited v Petzetakis Africa (Pty) Ltd Case No. 35891/2011 6 February 2012 (GSJ) para 12})\). This means that the alternative of a better return for creditors can only be resorted to if complete recovery of the company cannot be achieved. The court in \textit{Southern Point} held that when a court is exercising its discretion, due weight must be given to the legislative preference for rescuing ailing companies and that it is inappropriate for a court to maintain the mind-set from judicial management that a creditor is entitled \textit{ex debito justitiae} to be paid or to have the company liquidated (\textit{Southern Point op cit} para 22). The judicial management mind-set was creditor-friendly as the interests of the company’s creditors were given priority. By basing its discretion on the ‘better return for creditors’ the court in the Swart, did not give due weight to the legislative preference and also maintained the judicial management mind-set, which emphasise the interests of the creditors as compared to the other stakeholders. Had the court looked at the Act and not gone back to judicial management, it could have come to a different conclusion.

5 Conclusions

The decision in \textit{Swart} is welcomed. Business rescue provides companies in distress with an alternative to liquidation and an opportunity to restructure and reorganise their businesses with a view to continue on a solvent basis. However, not every company is suitable for business rescue and the court will not tolerate frivolous applications. Since this was the first judgment dealing with the business rescue procedure, it was expected of the court to develop guidelines that could be followed later. Unfortunately, the court’s reliance on judicial management and its emphasis on creditors’ interests might have been a step backwards to the Act’s initiative towards a debtor-friendly regime that strives for a balancing of the interests of all the stakeholders. This may be attributed to the fact that South Africa followed the creditor-friendly approach and it was the first decision to be made on the business rescue procedure. The business rescue procedure created an opportunity to move towards a debtor-friendly approach as evidenced by the purposes of the Act. The approach taken by the court shows that the court was influenced by the creditor-friendly approach which the Act made efforts to move away from. Only time will tell whether the procedure will be successful in South Africa and also influence the courts to move away from the creditor-friendly approach to a more debtor-friendly approach.