

**THE IMPACT AND ORIGIN OF EMPLOYEE RIGHTS IN
CHAPTER 6 OF THE COMPANIES ACT 71 OF 2008**

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i STATEMENT

I, Pippa Faul, declare that this mini-thesis is my own work. It is presented in partial fulfilment of the requirements for the degree of Master of Laws (LLM) in the Faculty of Law, University of Kwa-Zulu Natal. It has not been submitted for any other degree or examination at any other University. I further declare that I have obtained the necessary authorisation and consent to carry out this research.

Pippa Faul

1. Introduction

1.1 Statement of the problem

Business rescue was introduced in large part to keep the “productive capacity of (the) economy ... intact”¹ at a time when South Africa was in recession and suffering from an ever increasing trend in insolvencies which was socially and economically harmful. An effective rescue mechanism was required to limit this growing problem.

However, in spite of the apparent success of the rescue procedure in reducing the number of insolvencies, questions have recently been raised about the effectiveness of Chapter 6 of the Act (hereinafter referred to as Chapter 6) in preserving the “productive capacity” of deserving businesses in distress and reversing the destructive impact of insolvencies in these cases.

Recent statistics released by the CPIC on business rescue², have revealed that there have been 1398 applications for business rescue since the inception of the procedure to July 2014. During this same period there have been 4029 insolvencies.³ If the number of insolvencies is added to the number of business rescue applications it can be roughly calculated that around 5400 businesses were in distress during this period. Of this number, only 172 are recorded as having had ‘substantial implementation or completion of the rescue plan’⁴, amounting to an impact of a little over 3% on all businesses in distress.

The number of businesses restored to viable ‘productive capacity’ within this total, in terms of the primary objective of Chapter 6, is even lower because a plan, described in the report as substantially completed, may have had to resort to the secondary objective of a better return for creditors, which amounts to little more than a “glorified

¹ I le ROUX, K Duncan ‘The naked truth: creditor understanding of business rescue: A small business perspective’ (2013) 6 *SAJESBM* 58

² L Ensor ‘Business rescue under scrutiny as remedies fail to save stricken firms’, *Business Day Live* 06 August 2014 available at <http://www.bdlive.co.za/business/2014/08/06/business-rescue-under-scrutiny-as-remedies-fail-to-save-stricken-firms> accessed on 30 August 2014

³ Statistics South Africa *Statistics of liquidations and insolvencies (Preliminary)* (2014) 2 Figure 1- number of liquidations

⁴ Ensor (note 2 above)

liquidation”⁵ having no greater impact on the economy than a distortion of the insolvency statistics.

Although the statistics do not reveal details on the businesses that were liquidated, it is safe to assume that there must have been more than 3% of the total number of businesses in distress that would have been eligible to have had “productive capacity” restored through an effective rescue mechanism.

These results have prompted the Government via the Department of Trade and Industry, to appoint a special committee under the chairmanship of Michael Katz to “study the dynamics of the system”⁶

There can be many reasons for this underwhelming performance, some of which include the fact that the legislation is still very new, the corporate culture of South Africa is still very creditor friendly as opposed to the debtor friendly culture in the USA,⁷ and that a rescue culture still has to develop where the concept of debt forgiveness needs to take root.⁸

However, there is also criticism that “excessive”⁹ employee rights contained in Chapter 6 have led to an imbalance in the treatment of stakeholders, creating commercial distortions and uncertainties, which may be undermining the success of the rescue procedure.

1.2 Aim of the study

This study aims to examine the specific impact of these rights on business in general and upon the efficiency of the rescue procedure in achieving its objectives.

It will be important to understand why the interests of employees received this special protection and a study of the background and origin of these rights will be undertaken.

⁵ ‘Usefulness of Business Rescue in Spotlight’ *Legal Brief Today* 06 August 2014 available at <http://www.legalbrief.co.za/article.php?story=2014080609420681> accessed on 30 August 2014

⁶ *ibid*

⁷ W du Preez *The Status of Post Commencement Financing for Business rescue South Africa* (unpublished thesis, Gordon Institute of Business Science, University of Pretoria, 2012) 114

⁸ *ibid*

⁹ A Loubser *Some Comparative Aspects of Corporate Rescue in South African Company Law* (unpublished LLD dissertation. UNISA, 2010) 53.

1.3 Methodology

The research methodology employed has been largely based on secondary research with extensive reliance made on published articles, reports and existing research on the topic of business rescue.

1.3 Overview of the chapters

Chapter 2 provides a background to the rationale of business rescue in modern corporate law and describes the essential features that constitute a successful procedure. This provides context for the examination of the development of the South African procedure and the extent to which it was successful in developing those elements required to produce a successful rescue model.

Chapter 3 examines the origins of employee rights in Chapter 6 with specific focus on the influence of the underlying policy shifts in corporate law in compliance with the new constitutional democracy. The broadened participation of stakeholders in the legislative process as a result thereof, is examined with particular focus on the powerful role of labour. This extraordinary influence, as evidenced by the substantial gains made by employees in Chapter 6, is examined in the context of the vacillating power relations in the post-apartheid socio-political environment.

Chapters 4 and 5 evaluate the impact of these rights on business in general and the objectives of business rescue and a comparison is made with employee rights in other jurisdictions to assess the extent to which South African employees are uniquely empowered and protected.

2. Corporate Rescue

2.1 *The rationale behind corporate rescue*

Social attitudes towards the sanction for insolvency have come a long way since the practice in Ancient Greece of amputating a debtor's limbs or selling him into slavery.¹⁰

The modern trend to cast insolvency as an economic rather than a moral failure¹¹ with debtor protection taking the place of debtor repression¹² can trace its roots to the 18th century collapse of the railway industry in the United States of America where the courts recognised that greater value was realised in the selling of a business in distress as a going concern rather than the piecemeal realisation of its assets.¹³

Apart from an improved value proposition, the new approach supported the concept of a “fresh start” necessary for the development of the entrepreneurial spirit that characterises the US economy.

These early developments in the US law of insolvency culminated in the “debtor-in-possession model” contained in the 1978 Bankruptcy code which is recognised as one of the leading corporate rescue systems upon which many other rescue systems around the world are based.¹⁴

¹⁰ C Bridge ‘Insolvency – A second chance? Why modern insolvency laws seek to promote business rescue’ *Law in transition report for EBRD* (2013) 28-41 available at www.ebrd.com/downloads/research/law/lit13e.pdf 37

¹¹ *ibid* 32 quoting B H Mann ‘Bankruptcy in the Age of American Independence’ 2009 *Harvard University Press*

¹² *ibid* 32 quoting P Wood *Principles of International Insolvency* 2 ed (2007) (Sweet & Maxwell for biblio)

¹³ *ibid* 33

¹⁴ *ibid* 33

2.2 The objects of corporate rescue

The philosophy behind corporate rescue which differs according to the policy context of the different jurisdictions, generally dictates the emphasis and priority of the various objects of corporate rescue.¹⁵

The common denominator across all jurisdictions however, is the recognition of the economic benefits arising from the rescue of deserving businesses upon which national economies are heavily reliant.

In addition, many jurisdictions are motivated by the spirit of entrepreneurialism which rescue procedures foster, allowing risk-takers, the life-blood of vibrant economies, a second chance, which is likely to be more successful because of lessons learnt before.¹⁶

In France however, the objective of entrepreneurialism is subordinated to the social consideration of employment preservation whilst in Ireland, state protectionism trumped entrepreneurialism as a key motivator for the development of corporate rescue, to save an industry which was important to the national interest.¹⁷

In many jurisdictions another important object of corporate rescue is to provide a better return to creditors than would have been the case if an enterprise in distress was immediately liquidated. It is likely that this object features so prominently across the various jurisdictions because it is necessary to incentivise creditors to support rescue and not seek the conventional remedy of liquidation.

The UNICTRAL draft legislative guide on insolvency law¹⁸ specifically recognises that there are many objects of corporate rescue which often represent a reflection the competing interests of various parties.

¹⁵ Bridge (note 10 above;34)

¹⁶ *ibid* 35

¹⁷ *ibid* The Irish “rescue procedure... was introduced in 1990 at a time when the Goodman Group of companies, of strategic importance to the Irish beef industry, seemed to be in a state of imminent collapse..”

¹⁸ UNICTRAL draft legislative guide on insolvency law A/CN.9/WG.V/WP.70 (Parts I and II) available at; www.globalinsolvency.com/insol/intinsolvencies/unictral.html.

It proposes that a balancing of these objects will generally be the primary objective for most jurisdictions.¹⁹

In his paper on corporate rescue in 2004, Burdette discussed the difficulty in balancing these interests and predicted that the South African drafters of business rescue would face a challenge in balancing the interests of employment protection with the economic necessity of downsizing a business in distress.²⁰

The accuracy of this prediction will become evident as this study progresses.

2.3 Key elements for an effective rescue system

There are many important elements that constitute an effective rescue mechanism some of which are listed in UNICTRAL guide as;

- “Submission of the debtor to the rescue proceedings...
- Automatic and mandatory moratorium...
- Continuation of the business of the debtor... and
- The formulation of a plan” and acceptance and implementation thereof²¹

As part of “the formulation of a plan,” one of the most important aspects in this process is the securing of fresh capital. The reason for this is that the main ground upon which business rescue is initiated, particularly in South Africa, is financial distress which generally arises from a lack of liquidity. A fresh capital infusion is thus vital in most instances to reinvigorate the business. Without this, rescue, in most cases, would be an exercise in futility.

Wanya du Preez states in her thesis on post-commencement financing;

Therefore one of the critical components of the business rescue plan involves securing turnaround finance to meet short-term trade obligations (such as working capital requirements), covering

¹⁹ DA Burdette *The development of a modern and effective business rescue model for South Africa* (a pre-consultation working document presented by The Centre for Advanced Corporate Insolvency Law, University of Pretoria, 2004)18

²⁰ *ibid*

²¹ *ibid* 25,26

turnaround/restructuring costs, and restoring the company's balance sheet to solvency²²

In addition to access to fresh funds, speed and efficiency in the process is also very important to limit ongoing losses of a business in distress and set it once more on a healthy trajectory. This requirement is recognised in Section 7(k) of the Act which states that the purpose of the Act is to provide for “the efficient rescue and recovery of financially distressed companies.”

Burdette emphasises this in his proposals for the development of a modern and effective corporate rescue for South Africa, claiming that;

Invariably speed will be one of the most important factors that can save a viable business, and unnecessary delays could defeat the very purpose of the business rescue provisions²³

In further support of the importance of an expedited process, Anneli Loubser in her dissertation on business rescue, quotes from an article by K Schmidt in her proposals for insolvency reforms where she states that; “Best rescues took place silently and quickly.”²⁴

Cassim notes that the sooner a business in distress submits itself to the process of rescue, the better the chances for success and in this regard he quotes from the Cork report on insolvency law reforms in the UK where it states that ;

The earlier a company reorganises itself, the better the chances of success and avoidance of liquidation.²⁵

In essence rescue laws need to create a mechanism whereby, a viable company in distress can submit at an early stage to a rescue system that has an automatic moratorium, where an efficient practitioner can swiftly and decisively implement a

²² du Preez (note 7 above;6 quoting from Corporate Renewal Solutions. (2011a) *Turnaround funding and financial restructuring* available at www.turnaroundsa.com/turnaround%20strategy/turnaround%20funding.php)

²³ Burdette (note 19 above; 33)

²⁴ Loubser(note 9 above; 309 quoting from K Schmidt ‘Insolvenzrechtsreform nach dem 54. Deutschen Juristentag’ (1982)*Zeitschrift fur konkurs-, Treuhand-und schiedsgericht-wesen* 613)

²⁵ FH Cassim...et al Contemporary Company Law 2 ed (2012)862

plan in conjunction with existing management, to secure post-commencement financing and restructure the business to restore profitability.

This ideal will serve as a useful reference in the analysis of the impact of employee rights on the efficiency of the South African procedure.

2.4 Business rescue in South Africa

The new business rescue mechanism in South Africa was motivated in large part by the severe impact of insolvency upon employees and the burgeoning unemployment rate and the fact that the existing rescue mechanism was ineffectual.

2.4.1 Origin and evolution

Although South Africa was a trailblazer in the field of corporate rescue having been one of the first corporate law regimes to have a rescue mechanism, judicial management had proved to be an inefficient vehicle disparagingly referred to in *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* as “a system which has barely worked since its initiation in 1926.”²⁶

There is some debate however as to whether judicial management should have been abandoned. The de Vries Commission²⁷ maintained that the principal problem with the process was that there was no reliable system in place to determine the viability of the business applying for judicial management. An amendment to rectify this shortcoming was in the view of the Commission, all that was required, not the outright repeal of the process.²⁸

Whilst technically this might probably have been correct, judicial management had suffered significant reputational damage over the years and a ‘new brand’ was

²⁶ Loubser (note 9 above;3 quoting from *Le Roux Hotel Management (Pty) Ltd v E Rand (Pty) Ltd* [2001] 1 All SA 223 (C) at 238) describing the inefficiency of judicial management, the previous rescue system in S.A

²⁷ *ibid* quoting from The Commission of Enquiry into the Companies Act appointed in 1963 under the chairmanship of Mr Justice J Van Wyk de Vries: see Cilliers, Benade et al *Corporate Law* par 2.15.)

²⁸ G M Museta *The Development of Business Rescue in South African Law* (Unpublished LLM thesis. University of Pretoria, 2011) 19

needed to transform perception that the rescue of a business in distress was an automatic “kiss of death.”²⁹

There were a number of attempts to address the impotence of judicial management the first of which was during the process of overhauling the insolvency legislation.

There was a key focus placed on the rescue of businesses in the draft Insolvency and Business Recovery Bill³⁰ with numerous recommendations made by all stakeholders. In addition, a two billion rand fund was proposed to be made available to assist businesses in distress.³¹

However these initiatives were abandoned when it was decided that a business rescue mechanism was to form part of a new Companies Act that was being developed in the corporate legislative reform.³²

According to Anneli Loubser, South Africa in particular, in a low growth, high unemployment environment needed an effective mechanism to improve the survival rate of companies and reverse the liquidation culture³³ prevalent in the country. The statistics revealed a grim picture. Over a ten year period from 1993 to 2003, insolvencies had increased by 57% which Anneli Loubser described as “close to a disaster” for a country with unacceptable levels of unemployment.³⁴

²⁹ ‘Business rescue under the new Companies Act is an improvement over judicial management’ <http://www.roodtinc.com/newsletter78.asp>, accessed on 30 May 2014

³⁰ Labour submission to NEDLAC on the insolvency and business recovery Bill ,11 May 2004

³¹ A Loubser ‘The Interaction Between Corporate Rescue and Labour Legislation: Lessons to be Drawn from the South African Experience’ (2004) 14(1) *International Insolvency Review* 58

³² Loubser (note 9 above; 5)

³³ A Loubser *Tilting at Windmills* (unpublished lecture notes ,UNISA,2011) 11 where she quotes from a paper presented at a symposium with the theme ‘Bankruptcy in the Global Village’ “The topic of this conference suggests that a developed rescue culture is more civilized than a liquidation culture, and that we should all pray to be blessed with a Chapter 11.”

An explanation of the term ‘liquidation culture’ is found in the University of Pretoria, Faculty of Law *Final report containing proposals on a unified insolvency Act* (200) quoting Smits in the Corporate administration in *De Jure* (1999)80 “It would appear that it is far easier to liquidate a company and start a new one, than to try and save an existing business.”

³⁴ Loubser (note 31 above; 58)

2.4.2 Preservation not liquidation

Liquidations generally have a devastating impact on employees where they are, according to Alice Belcher ; “in some ways the lost souls in insolvency law.”³⁵

Employees are particularly vulnerable in insolvencies because wages generally constitute the only source of income for employees³⁶ and this is exacerbated in a country with low employment prospects and a relatively poorly developed welfare system.

Peter Carolus states that;

It is not an exaggeration to say that the financial security of employees is sometimes so closely related to the stability of a company that the insolvency of the latter means financial disaster for its labour force.³⁷

It therefore comes as no surprise that the problem of employee vulnerability in insolvencies was high on the labour agenda which was to prove highly influential in the development of the rescue procedure.

Valuable insights into this agenda are revealed in its response to the amendments to the Insolvency Law and the Insolvency and Business recovery Bill.

2.4.2.1 The Insolvency Amendment Act

This was enacted to rectify the low levels of protection afforded to employees in insolvencies.

Employee rights to information, participation and protection were improved.

Under the new amendments, employers experiencing financial distress were required to inform employees and provide opportunities for participation in decisions to downsize the workforce.

Greater protection of employees was provided in the ranking of employee claims where unpaid salaries and benefits, although capped at a certain amount, received

³⁵ Cassim (note 25 above;884 quoting Alice Belcher *Corporate Rescue:A Conceptual Approach to Insolvency Law* (1997)4)

³⁶ P Carolus,T G Tiemeni,K Ziervogel 2007 ‘Effects on the employment relationship of the insolvency of the employer: A worker perspective’*Law, Democracy and Development* 109

³⁷ *ibid* 110

better protection, ranking 5th, behind, *inter alia*, secured creditors and the costs of the insolvency.

Additional protection was provided with respect to employment contracts which were no longer automatically terminated on formal insolvency but suspended for a period of 45 day after the appointment of a liquidator allowing for the transfer of these contracts in the event of a sale of the insolvent business.³⁸

Although this presented a considerable improvement for employees, labour believed these rights did not go far enough and still regarded the insolvency legislation as harsh and unfair on employees.³⁹

In addition, labour was dissatisfied with a perceived bias towards secured creditors in the legislation and by the liquidators⁴⁰ where, in its view, the satisfaction of secured debt very often resulted in an insufficient free residue to settle workers claims.

Although some employee protection had been introduced with regard to employment contracts which were no longer automatically cancelled, the relief provided by the suspension thereof for 45 days was generally more of an illusion than a practical benefit, where it is said that generally employees merely; “witness the countdown of what can be referred to as industrial euthanasia”⁴¹ without remuneration.

Another criticism of the amendments by labour, was that its dissatisfaction with the ease of embarking upon liquidation had not been addressed. For instance, the power of a single creditor to liquidate an otherwise solvent business on the basis of an ‘act of insolvency,’ had been left unaltered.

³⁸ T Joubert, S van Eck & D Burdette ‘Impact of Labour Law on South Africa's New Corporate Rescue Mechanism’ (2011) 27 (1) *International Journal of Comparative Labour Law and Industrial Relations* 7

³⁹ Carolus (note 36 above;110)

⁴⁰ *ibid* 114

⁴¹ *ibid* 116

Similarly, abuse of the insolvency laws was still possible through voluntary liquidations and the movement of assets by reorganization and restructuring of corporations.

Employee impotence in the procedure was therefore a source of deep concern to labour.

Carolus, articulating the voice of organized labour, proposed *inter alia*, the following recommendations, in order to rectify the shortcomings of the amendments;

- A compulsory disclosure of a company's financial affairs to workers
- Criminal and civil liability to attach to directors for fraud and recklessness and
- The prioritization of employee claims.⁴²

These recommendations together with measure to address the impotence of employees in a business in distress, would feature high on labour's agenda in the development of the new business rescue procedure.

2.4.2.2 The Insolvency and Business Recovery Bill

Around the same time the Government produced the Insolvency and Business Recovery Bill which was based on the recommendations in reports by the South African Law Commission and the Standing Advisory Committee on Company Law. This was tabled at NEDLAC in 2003 and the bill was presented by the Department of Justice and Constitutional Development to the Labour Market Chamber on 28 July 2003 and 23 November 2006 where a task team composed of government, business and labour was established to review the Bill.⁴³

Although there were no specifics on the rescue procedure, it is revealing to note the disagreement between labour on the one side and business and government on the other with regard to the prioritisation of employee claims in insolvency proceedings.

Labour supported the concept of super preference for salary claims, stating;

⁴² Carolus (note 36 above;118)

⁴³ Labour submission to NEDLAC (note 30 above;1)

employees lose, not only wages, leave pay and long service bonus, but also their contributions to the workers medical aid and retirement funds which the employer has not yet paid over...(and) proposes that in respect of wages and other benefits workers should be ranked above all secured creditors.⁴⁴

Business was opposed to this prioritisation, claiming;

claims for salary, etc, can be of such a magnitude that it will simply wipe out the securities; this would work against the whole scheme of credit supply and have a devastating effect on the economy.⁴⁵

The Law Commission agreed with business and stated;

A super-preference or secured status by means of devices such as statute created security devices is not advisable. It is predicted with confidence that investments in companies with substantial work forces would be discouraged substantially if wages and other benefits of workers are ranked above secured creditors. On balance this will probably do more harm than good to workers in general.⁴⁶

The comments on this proposal are concluded as follows;

- Government and Business submits that a super preference for salary claims is not advisable.
- Labour supports a preference above secured creditors.⁴⁷

Whilst this commentary on the Bill does not specifically deal with business rescue, it, also provides a valuable insight into the influence of the agenda of labour that was to find expression in Chapter 6.

⁴⁴ Labour submission to NEDLAC (note 30 above; 29)

⁴⁵ *ibid* 29

⁴⁶ *ibid* 30

⁴⁷ *ibid*

2.4.3 Employees – *primus inter pares*

Inasmuch as there was dissatisfaction by some that the Insolvency Act contained too little employee protection, the new rescue provisions were accused by others of containing too much.

It would appear that Chapter 6 had become the site of rectification for all the shortcomings in employee protection in the Insolvency Act.

As previously discussed, an effective corporate rescue system achieves a balance between the competing interests of the various stakeholders and it is in this regard that the South African rescue system has come under fire with many believing that the interests of employees have been prioritised above other stakeholders.

Cassim describes South African corporate rescue as “pro-employee”⁴⁸ with many instances where the interests of employees override “creditor-wealth maximisation.”⁴⁹

This is in stark contrast to labour’s criticism of the Insolvency Act’s bias towards creditors.

Anneli Loubser describes some employee rights as; “excessive ... (with) no equivalent in any other comparable system”⁵⁰, whilst Joubert maintains that;

the provisions are too obviously skewed in favour of the employees, and not enough emphasis is placed on the primary objective of the legislation, namely that of saving the company or its business.⁵¹

concluding that;

In the final analysis the overprotection of employee rights may have the unintended result of being to the detriment of the employees, essentially making a mockery of South Africa’s new corporate rescue mechanism.⁵²

⁴⁸ Cassim (note 25 above; 899)

⁴⁹ *ibid* 885,899

⁵⁰ Loubser (note 9 above; 53)

⁵¹ Joubert (note 38 above; 17)

⁵² *ibid*

It is important to remember when considering the comments on this excessive employee protection, that the policy guidelines for the Act provide that Chapter 6 is to be based on the rescue system in the USA; “In particular, the provisions of the US Chapter 11 will be considered”⁵³

Chapter 11 operates within one of the strongest free market systems in the world, predicated *inter alia* upon highly flexible labour laws.

It will therefore be important to examine the origin of these rights, to understand the reasons why, in adapting this system to the South African environment, the employee rights that were provided resemble those found in socialist, co-ordinated market economies rather than those contained in the US system upon which business rescue is based.

⁵³ GN 468 of GG 26493, 23/06/2004 ;45

3. The origins of South Africa's "pro-employee" business rescue

A fundamental underpin in the transition from apartheid to a new South African society was the concept of broad-based democracy which needed to be extended to all areas of society through legislation.⁵⁴

In this regard it is important to study the process involved in the promulgation of the new Companies Act to gain an understanding of some of the more important influences which shaped the Act in general and the rescue provisions in particular.

An examination of the socio-political context within which this corporate reform took place will also provide valuable insight into the origin of these employee rights.

3.1 A new corporate law

3.1.1 The corporate law reform project

The advent of the new constitutional democracy in South Africa necessitated a comprehensive legislative overhaul of existing legislation. The Companies Act 61 of 1973, which had fallen out of step with developments in the world and more particularly with South Africa in its transition to a modern democratic state, was targeted for reform.

In addition, South Africa needed to develop a robust and rapidly expanding economy to alleviate a large socio-economic backlog that had developed under apartheid. Companies, as the engine room of growth, required a modern and effective regulatory environment within which to flourish.

The old Companies Act⁵⁵ where attempts to keep pace with change had led to patchy and incremental reform⁵⁶ which had created ambiguities and conflict in the 'underlying philosophy and policy'⁵⁷ leading to a complex and opaque corporate law regime, was the very antithesis of what was required for robust economic growth.

⁵⁴ R van der Walt 'Have workplace forums contributed to worker participation? Some management perceptions' (2008)39(2) *South Africa Journal of Business Management* 45

⁵⁵ 61 Of 1973

⁵⁶ Cassim (note 25 above; 3)

⁵⁷ *ibid*

A mere tinkering of the Act would no longer suffice, because in the words of Cassim;

Legislation that has outlived its usefulness and is stifling development of the economy must be replaced.⁵⁸

In 2004, the Department of Trade and Industry was charged with the responsibility of leading the process of corporate law reform, with the objective of developing a “clear, facilitating, predictable and consistently enforced governing law”⁵⁹ the culmination of which would be the new Companies Act of which Chapter 6 would be a key feature.

3.1.2 The guidelines

The first step in the process of Corporate Law reform was to provide, according to Tshepo Mongalo, the project manager of the process, a policy framework which would inform and guide the legislative process.⁶⁰

Local and international reference teams were established to “advise on policy and legislative consistency”⁶¹ and produce guidelines for this corporate reform.

These policies and guidelines would play a significant role in the development and shape of Chapter 6 which would come to reflect the problems of trying to balance irreconcilable objectives.

The intention to contextualise these reforms within the constitutional environment of the new South African Society was an important object of the Guidelines where it is stated that;

No area of South African law can be analysed or evaluated without recourse to the Constitution.⁶²

Whilst the necessity for constitutional harmonisation in corporate reform cannot be doubted, it was never to be an easy task because of the inherent competition which often exists between business objectives and the objectives of social justice.

⁵⁸ Cassim (note 25 above; 3)

⁵⁹ GN 468 (note 53 above;13)

⁶⁰ T H Mongalo ‘Modern Company Law for a Competitive South African Economy’ 2010 Acta Juridica xiv

⁶¹ *ibid* xiii

⁶² GN 468 (note 53 above;16)

On the one hand the Guidelines recognised, that capital is mobile because of global competition,⁶³ and that corporate laws need to create a;

fertile environment for economic activity...(where there should be sensitivity to the fact that) economic citizens...respond to a wide range of incentives and disincentives.⁶⁴

On the other hand, the Guidelines enjoin a “social responsiveness” in line with the “socio-political and economic change in South Africa”⁶⁵ where it is proposed that the new company law should be a vehicle “to create a democratic society based on equity (and) equality”⁶⁶ with specific mention that this new law should enhance “equity in employment...(through)‘decisive government intervention.”⁶⁷

Unfortunately it is often the case that, “mobile capital” is often “dis-incentivised” by “decisive government interventions.”

Understanding the potential contradictions in the various objectives, the Guidelines propose somewhat optimistically, that there should be a balancing of the “competing interests of economic actors”⁶⁸

However it appears that the “unbalanced”⁶⁹ employee protection in Chapter 6, would indicate, according to critics, that the resultant policy was unable to satisfactorily chart a coherent course between the proposed social reforms and the often harsh commercial demands of competing in the global market.⁷⁰

⁶³ GN 468 (note 53 above;13,15)“The overriding issue for any market-based economy is vibrant capital formation and deployment....We now live in a world of greater globalisation...fast changing markets, greater competition for capital’

⁶⁴ ibid 13

⁶⁵ ibid 15

⁶⁶ ibid 16

⁶⁷ ibid 11

⁶⁸ ibid 10

⁶⁹ Joubert (note 38 above; 2)

⁷⁰ ibid 17

3.1.3 *In whose interest*

In the process of reforming corporate policy it was inevitable that the question of in whose interest a company should be run would arise, in determining the new corporate philosophy. The outcome of the debate and subsequent adoption of a uniquely South African approach to this question, is of significant importance in the understanding of the origins of South Africa's pro-labour rescue provisions.

In South Africa, where capital formation and corporate ownership continue to follow racial lines⁷¹, the constitutional principles of equity and equality required that corporate law would need to move away from the traditional *raison d'être* of a company for shareholder value and explore a more inclusive approach for all stakeholders.

The Guidelines consider the three most common approaches to the question. The first of these is the traditional "in the interest of the shareholder" approach⁷² where the primary focus of the company is the on the maximisation of the interests of the shareholder at the exclusion of the interests of other stakeholders. The previous Companies Act was modelled around this approach.

The second, more radical departure from the "shareholder interests" approach can be found in the "pluralist" approach which espouses an egalitarian conceptualisation of power and interests across all stakeholders in a company where is no primacy of the interests of any one group of stakeholders.⁷³

A third, more moderate departure from the shareholder interest approach is found in the "enlightened shareholder value"⁷⁴ approach which seeks to recognise the interests of the other stakeholders because in doing so this will ultimately maximise the value to shareholders.

⁷¹ S J Terblanche, *The Ideological Journey of South Africa: From The RDP to the GEAR Macro-economic Plan* (paper presented at in a workshop on 'Globalisation, Poverty, Women and the Church in South Africa, 1999) available at http://web.uct.ac.za/depts/ricsa/confer/me99/procs/pro_terr.htm

⁷² GN 468 (note 53 above; 24)

⁷³ *ibid* 25

⁷⁴ *ibid*

Whilst accepting that the enlightened shareholder approach would be the most appropriate for the South African corporate legal environment, the Guidelines stressed however, that this approach needed to be further developed to conform to the dictates of South Africa's constitutional democracy.⁷⁵

In this regard it was proposed that although the corporate focus should be on the economic success of the business, this goal could in certain circumstances be subordinated to;

policies and principles that are reflected in the constitution⁷⁶ (where) the company's pursuit of economic objectives should be constrained by social and environmental imperatives⁷⁷

The result of this constitutional harmonisation of corporate law therefore creates circumstances when stakeholders acquire an independent value, in other words a value that is not dependent upon the furthering of shareholder interests, where;

Directors may, in certain situations, have a specific duty to promote the stakeholders' interests (such as employee welfare⁷⁸) as ends in themselves⁷⁹

The South African model has therefore modified the enlightened shareholder approach to include pluralist elements under some circumstances.

It is likely that this hybridisation of the enlightened shareholder approach provided the legislative latitude to attend to the specific needs of employees of a business in distress, allowing the drafters to protect the interest of employees as an end in itself.

3.1.4 Consultation

The policy guidelines were also the product of a democratisation of the legislative procedure as reflected in the intention by the Department of Trade and Industry to

⁷⁵ GN 468 (note 53 above;27)

⁷⁶ *ibid*

⁷⁷ *ibid*

⁷⁸ *ibid* 28

⁷⁹ *ibid*

include a broad range of economic actors in the process of corporate law reform to ensure that in the consultative phase, all voices across the economic spectrum were heard,⁸⁰

At the round table of 11 and 12 July 2003, the DDG made it clear that the process was going to be as broadly inclusive as possible⁸¹

In addition to this widely consultative approach with a broad range of economic and social stakeholders, the reform of corporate law fell within the realm of economic policy and was therefore subject to a statutory consultations process with NEDLAC⁸² in terms of the National Economic Development and Labour Council Act 35 of 1994.

NEDLAC is made up of four groups representing the interests of labour, community and development, business, and government and has been constituted to;

consider all significant changes to social and economic policy before it is implemented or introduced in Parliament.⁸³

In light of the significant gains made by employees in Chapter 6, it is the influence of labour in NEDLAC that will be the most important to examine, particularly as it has been an influential force in legislative processes, even during the apartheid era, through the strategic use of the power of numerical strength.⁸⁴

Prior to the formation of NEDLAC, during the late 1980's and early 1990's the main unions organised into a negotiating entity which primarily served to wield influence in the field of labour law through the thwarting of proposed legislative reform by the illegitimate apartheid state.⁸⁵

⁸⁰ Mongalo (note 60 above; xvi)

⁸¹ *ibid*

⁸² NEDAC is the acronym for the National Economic Development and Labour Council, an advisory body constituted by the National Economic Development and Labour Council Act 35 of 1994

⁸³ K Gostner & A Joffe 'Negotiating the future: Labour's role in NEDLAC' (1998) 2(1) *Law, Democracy & Development* 133

⁸⁴ *ibid* 131

⁸⁵ *ibid* 132

This power obtained through obstruction by organised labour was, however, to change in NEDLAC where the central purpose and objective of this new body was creative, requiring all groups to positively influence policy on economic and social matters before being presented to parliament.⁸⁶

It is in this role that labour would have been enabled to influence policy and make proposals and recommendations relating to the protection of employees in Chapter 6.

It is important to note that organised labour, through its status as a partner to the ruling party in the tripartite alliance, potentially has additional power to advance an agenda that promotes its interests⁸⁷

However the extent to which it is able to exert this influence is according to Gostner and Joffe, dependent; “on the power relations between the social partners”⁸⁸

It is these “power relations” that require further investigation to determine the extent of labour’s influence at the time of the legislative process which produced the employment rights in Chapter 6.

3.2 The influence of labour within the socio-political context prevailing during corporate law reform

The “pro-employee” character of Chapter 6 suggests considerable influence on the process by organised labour operating within an environment that was receptive to the promotion of social justice.

It will therefore be useful to examine the politics and power struggles of the competing ideologies dominating the post-apartheid period in order to trace the development of the influence of labour in promoting its agenda at the time of the enactment of Chapter 6 of the Act.

⁸⁶ Gostner (note 83 above; 132)

⁸⁷ *ibid* 139

⁸⁸ *ibid* 133

3.2.1 *An ideological contest*

The power of labour to promote its agenda has waxed and waned in the fluctuating power relations of post-apartheid South Africa which has been an ideological battleground between 'rival visions of economic development.'⁸⁹

The pre-1994 apartheid state which was capitalist in nature favoured the capital formation of the white minority largely at the expense of black South Africans through, according to Sampie Terblanche, the; "systemic exploitation and structural injustices towards people other than white."⁹⁰

The focus and tendency during this period was on the concentration of institutional economic power amongst the white minority with scant regard for conditions of employment or human development.⁹¹

There were some concessions towards labour during this period, namely the de-racialisation of collective bargaining from 1979 which permitted black labour to "participate in industry-level bargaining"⁹² which was largely achieved through the power of labour's numerical strength.⁹³

It was not surprising that the workplace became a potent representation of the apartheid state and a natural arena to galvanise the anti-apartheid struggle.

The transition in 1994, from a racially polarised society, produced a new struggle based on the pursuit of economic hegemony between those pursuing a market economy ideology and others pursuing a socialist policy agenda.

Although there have been significant structural changes in institutional power relations in the post-apartheid society, there is still marked social inequality in South African society where; "two economies" appear to persist in this country.

⁸⁹ N Nattrass *South Africa: Post-Apartheid Democracy and Growth*, conference paper for Democracy Works Project Seminar, Centre for Development and Enterprise and the Legatum Institute, (April 2013) 4

⁹⁰ Terblanche (note 71 above)

⁹¹ *ibid*

⁹² Nattrass (note 89 above;13)

⁹³ Gostner (note 83 above;131)

The first is an advanced, sophisticated economy, based on skilled labour, which is becoming more globally competitive. The second is a mainly informal, marginalised, unskilled economy, populated by the unemployed and those unemployable in the formal sector.⁹⁴

To a very large extent this “informal, marginalised, unskilled economy” is represented by organised labour which pursues a socialist agenda that envisions an interventionist state with labour-friendly policies.⁹⁵ This was also the policy of the ANC prior to and immediately after its unbanning.

The socialist camp at that stage, which was made up of the ANC, the SACP and COSATU consolidated their ties through the creation of the tripartite alliance where the ANC was from the outset the uncontested leader, until it began to diverge ideologically from the other two partners.⁹⁶

Although it is unclear what precipitated the gradual move by the ANC away from its socialist ideology towards a capitalist, neoliberal policy, it may have had something to do with the collapse of the Soviet Union which had been very influential during the apartheid era with the members that made up the tripartite alliance.⁹⁷

Whatever the reasons might have been, this shift marked the beginning of damaging internal conflict in the alliance that has intensified steadily since then.

Initially the SACP and COSATU were very influential in the alliance and played a major role in the development of the Reconstruction and Development Plan (RDP) which was imbued with socialist strategies with pro-labour policies.⁹⁸

The formation of NEDLAC during this period represented one of the biggest achievements for labour. Set up to ensure that “state policy does not compromise the interests of the working people”⁹⁹

⁹⁴ GN 468 (note 53 above;11)quoting *Towards a Ten Year Review: Complete Report*, Synthesis report on implementation of government programmes:Discussion document, October 2003. Available at: <http://www.gov.za/reprts/2003/10vrbook.udf>

⁹⁵ N Nattrass (note 89 above; 5)

⁹⁶ P Agupusi ‘Trajectories of Power Relations in Post-Apartheid South Africa’ (2011) 4 *The Open Area Studies Journal* 36

⁹⁷ *ibid*

⁹⁸ *ibid*

⁹⁹ Gostner (note 83 above;131)

This influence of labour however weakened during the height of Mbeki's power where, by 1996 the cracks had widened further in the alliance. Mbeki, who at that time was deputy president, was steadily moving economic policy along a more neo-liberal trajectory¹⁰⁰ which envisioned flexible labour policies, very little state interference, and reliance on the market to regulate the economy.

This new approach was to find full expression in GEAR,¹⁰¹ the plan that was to replace the RDP.

Unlike its predecessor which was a symbol of economic policy compromise and inclusive negotiation, GEAR was the product of a team of highly skilled experts. It was presented as a *fait accompli* and predictably the remaining partners of the alliance felt excluded and marginalised.¹⁰²

Whilst it can be argued that the process could have been more inclusive there is almost no doubt that the impracticalities of the RDP had precipitated this new trajectory which saw in GEAR a greater reliance being made on the supposed "automatic and efficient forces of the market."¹⁰³

A central feature of GEAR was the adherence to "sound fiscal, monetary and labour policies."¹⁰⁴ Social spending would therefore be subordinated to the health of the fiscus and the labour market would become more flexible. Both these cornerstones of GEAR were, however, inimical to the alliance's left leaning partners.

The lack of consultation and outright disregard of the serious objections of COSATU and the SACP in the production of this new policy was a clear indication of Mbeki's increasingly "centralised leadership...and the (gradual) decline in influence"¹⁰⁵ of the socialist camp in the alliance.

This inevitably led to increased acrimony where Mbeki came under intense pressure from the left.

From as early as 2005, just after the commencement of the corporate law reform project, the sustained attacks on the neoliberal agenda showed signs of bearing fruit. After the initial benefits afforded by the neoliberal policies, in particular the steadying

¹⁰⁰ Agupusi (note 96 above;37)

¹⁰¹ GEAR is the acronym for the Growth, Employment and Redistribution plan which replaced the RDP

¹⁰² Agupusi (note 96 above;37)

¹⁰³ ibid

¹⁰⁴ Terblanche (note 71 above)

¹⁰⁵ Agupusi (note 96 above;38)

of the macro-economy, there was a steady decline in the “strict adherence to the GEAR model as a consequence of criticisms from various quarters”¹⁰⁶

The socialist coalition within the ANC, long side-lined and silenced by Mbeki, increased the pressure and mounted a concerted campaign to remove Mbeki and install someone who they believed would be more sympathetic to their cause.¹⁰⁷

The Polokwane conference in 2007 marked the peak of the campaign against the neoliberal agenda. Mbeki was unceremoniously removed thereafter and Jacob Zuma, promoted as a champion of the socialist left and a friend of the worker, was swept to power in the ANC, on a strong labour ticket.

As repayment for their help in getting Zuma elected, COSATU and the South African Communist Party expected an equal say in the governing of the country, especially with regard to determining the economic agenda.¹⁰⁸

A significant shift in the power relations between the partners took place after the weakening of the neo-liberal agenda making the voice of organised labour increasingly difficult to ignore.

The resulting influence by labour on the shaping of government policy is considered unprecedented and according to Jayendra Naidoo;

has given labour a far bigger bite (at directing national policy) than any other system in the world.¹⁰⁹

This view is supported by D’arcy du Toit, Professor of Law at the University of the Western Cape where he states;

The trade union movement is a powerful player in the shaping of socio-economic policy at national as well as local level. No serious attempt at reform is likely to succeed in the face of union opposition.¹¹⁰

The infusion of constitutional values and objectives into the new corporate law was bound to create a Companies Act with a broadened focus on the interests of all

¹⁰⁶ Agupusi (note 96 above;38)

¹⁰⁷ ibid

¹⁰⁸ Zuma's economic tightrope (2010) 51 (10)*Africa Confidential*

¹⁰⁹ Gostner (note 83 above;138)

¹¹⁰ D du Toit 'Industrial democracy in South Africa's transition' (1997) *Law, democracy and development law journal*

stakeholders. However, the extent to which employees were prioritised in Chapter 6, contrary to the objective in the Guidelines to achieve a balance between the interests of all the stakeholders, is evidence of the ascendancy of labour at this time and the powerful influence of its agenda, the impact of which will now be assessed on healthy business and business in distress.

4. The impact of employee rights in Chapter 6 on business in general and on the rescue of a business in distress

4.1 The impact of employee rights in Chapter 6 on business in general

Employee rights in Chapter 6 are so extensive that in some instances they impact on the operation of a successful business.

It is a source of some irony that although the core objective of business rescue is the preservation of business, some of the rights afforded to employees in Chapter 6 may have the effect of undermining the health of a profitable and viable business.

The relationship between employers and employees in South Africa can often be described as militantly adversarial¹¹¹ and it is therefore fair to assume that any adjustment to the power relations in this environment may run the risk of producing unintended consequences in this volatile and delicate environment.

Section 31(3) of the Act runs this risk by entitling trade unions to;

be given access to company financial statements for purposes of initiating a business rescue process.

Although this right is not contained in Chapter 6 it was enacted, in pursuance of the objective of transparency, to equip employees to exercise the unique right¹¹² to institute business rescue proceedings in terms of Section 131 of the Act.

There is no limit placed on how often this right may be exercised and no liability attaches to the union for abuse of this right¹¹³ and the use of the word “must” in the section means that even if *mala fides* is suspected neither the court nor the company can refuse such request.¹¹⁴

¹¹¹ du Toit (note 110 above)

¹¹² Loubser (note 9 above; 53)

¹¹³ *ibid* 54

¹¹⁴ *ibid*

It is clear that a very real potential exists thereby, to interfere with the power relations between employers and employees by being abused as a bargaining tool by unions who would be aware that this demand could result in reputational damage to a business and risk to its credit worthiness which management would be keen to avoid¹¹⁵

These delicate power relations may be similarly affected by Section 131 of the Act to which Section 31 (3) relates, which entitles employees to institute business rescue proceedings. This right, according to Anneli Loubser; “has no equivalent in any other comparable system.”¹¹⁶

This right may be abused for leverage in negotiations, where an unsatisfactory wage settlement based on affordability, could be used as a ground for instituting rescue proceedings.¹¹⁷

This potential for abuse can extend to a situation where even a single employee who may be disgruntled, has the right to institute rescue proceedings.

Whilst the likelihood of such an application succeeding is slim where a company is in good health, an action such as this is not without serious consequences.

In terms of Section 132 of the Act, business rescue commences as soon as there is an application in terms of Section 131 of the Act;

Business rescue proceedings begin when an affected person applies to the court for an order placing the company under supervision...

The first consequence of this is that all affected parties must be notified of this application in terms of Section 131 (2)(b) of the Act;

An applicant...must.... notify each affected person of the application in the prescribed manner.

¹¹⁵ Loubser (note 9 above; 54)

¹¹⁶ ibid 53

¹¹⁷ ibid 54

The impact of such an application on the creditors of a company can serve to severely undermine the reputation and creditworthiness¹¹⁸ of a company. In addition there is a very real risk that actual damage can arise due to the fact that the application for rescue in isolation does not invoke the moratorium as contemplated in Section 133 of the Act. This only comes into effect when an order for rescue proceedings has been granted by the court.

In the case of malicious abuse of Section 131 of the Act by a disgruntled employee, a moratorium will never come into effect because the order will not be granted. This could therefore expose a healthy company to a potentially devastating “run on its assets”¹¹⁹

The potential leverage afforded to employees by the threat of this action should not be underestimated.

Another example of the potential of employee privilege afforded in Chapter 6 to disrupt and damage a healthy business is found in Section 131 (4) (a) (ii) of the Act where employees are elevated to super-creditors.

As previously stated the commencement of business rescue proceedings has a significant reputational impact on a business which may impact on its credit worthiness. It should therefore not be undertaken lightly and the grounds required for making an application in terms of Chapter 6 should be substantial.

It is for this reason that the bar is set high in Section 131 read with Section 128 (f) of the Act which provides that an order shall not be granted in an application to place a business into rescue unless the court is satisfied that a business is in distress. This requires that a company is either found to be unable to pay its debts or that it will become insolvent within the ensuing six months.¹²⁰ A careful analysis of proven facts pertaining to the financial health of the business and its prospect for rescue would be required before an order would be granted.

However this judicious approach is undone by Section 131 (3) (a) (ii) of the Act which in line with the general prioritisation of employees, the court is simply required

¹¹⁸ Loubser (note 9 above;54)

¹¹⁹ *ibid* 85

¹²⁰ Sections 131 and 128 of The Companies Act 71 of 2008

to grant an order if it is satisfied that there has been a failure by the business to pay *any* amount owed to an employer arising from a contract or public regulation.

This is a significant advantaging of a singular interest group in a company which may come at the considerable expense of other stakeholders.

Taken to its logical conclusion, an otherwise healthy company, not financially distressed which has failed to make a single payment to a single employee could be put at risk through the injudicious exercise of this provision.¹²¹

4.2 Employees become active participants in business rescue

It has been established above that employee rights in Chapter 6 have the potential to damage healthy business.

It is now important to assess the impact of these rights on the efficiencies and objectives of the rescue procedure itself.

According to Cassim, employees have been “given a vital role in the business rescue proceedings”¹²² in a process that is “consultative and inclusive”¹²³ in nature and have thereby become influential participants of business rescue through the many rights and privileges afforded to them in Chapter 6.

The merits of employee participation in strategic business activities is a controversial subject in general but even more so in the context of the South African industrial relations environment.

It will be important therefore to review some of the opinions of employee participation in general and thereafter evaluate the potential effect of employee participation in business rescue in the current labour relations environment in South Africa.

4.2.1 Employee participation, the subject of ongoing debate

Participation of employees in corporate governance is often referred to as the;

¹²¹ Loubser (note 9 above;60)

¹²² Cassim (note 25 above; 899)

¹²³ *ibid* 868

employees' voice (and) can manifest itself through ownership rights....veto rights....requirements to consult or provide information on strategic decisions.¹²⁴

The extent to which employees participate in the affairs of a business will in large part depend upon the corporate governance structure adopted by a country. This structure is in turn a product of a country's unique socio-political-legal mix within its historical and cultural legacy.¹²⁵

Predictably there are many different models and structures of corporate governance around the world, and therefore a great variety in the degree of worker participation in the corporate affairs of a company.

The subject of employee participation in a company on a strategic level is controversial. Some argue that it is highly beneficial whilst others are concerned that it is counter-productive because of an inherent conflict of interest between employers and employees.

On the one hand those in favour of increased employee participation argue that it has a positive effect in helping regulate "the distribution of wealth between labour and capital"¹²⁶

It can also engender positive attitudes amongst workers through a sense of belonging, which leads to greater identification with the ongoing management and strategic direction of the business which can translate into increased productivity and profitability.¹²⁷

On the other hand, it is argued that high levels of employee participation may impede essential decision-making through employee resistance to remedial actions which are regarded as impacting negatively on employee interests but which may be required for the ongoing viability of the company.¹²⁸

¹²⁴ E Z Geva 'Corporate Insolvency Law- Employee Participation' (2011) 12 (2) *European Business Organization Law Review* 319

¹²⁵ *ibid* 323

¹²⁶ *ibid* 319

¹²⁷ *ibid*

¹²⁸ The World Bank *Principles and guidelines for effective insolvency* (2001) 44

The corporate governance models of countries like the UK and USA are predicated on flexibility in the labour market, unencumbered by time consuming consultation associated with employee participation.¹²⁹

This, it is argued, is regarded as assisting in competitiveness where this high degree of corporate flexibility enables swift industrial reorganisation in times of economic downturns or “technological developments” thereby engendering innovation and sustainability.¹³⁰

After the collapse of the world economy in 2008, this model came under scrutiny¹³¹, with increased calls for greater involvement of employees in these liberal economies, to curb the perceived excesses and recklessness of management.

4.2.1.1 Arguments for increased employee participation

Kenneth G. Dau-Schmidt, a leading voice in support of increased employee participation, argues that high levels of employee participation prevent corporate short-termism created by shareholders, where they are;

too focused on short-run profits and stock prices, at the expense of long-term strategies and investments that would benefit the long-run value of the firm, employees, and the American economy at large¹³²

He maintains that employee insight is valuable in the formulation of long-term strategies with their access to inside information on the running of the business.

He proposes that employees share common goals with both shareholders and management.

On the one hand they share the goal of “monitoring the management” with shareholders because although their investments in the business are rarely capital in nature, they are deeply invested with regard to their ongoing livelihood and pensions.

¹²⁹ Geva (note 124 above; 323)

¹³⁰ *ibid* 324

¹³¹ *ibid* 315

¹³² K G Dau-Schmidt ‘Promoting Employee Voice in the American Economy: A Call for Comprehensive Reform’ (2011) *Faculty Publications*. Paper 551 available at <http://www.repository.law.indiana.edu/facpub/551> accessed on 15 August 2014 766

They offer alliance value to shareholders through their inside operational knowledge thereby assisting them in monitoring and controlling management.

On the other hand employees also offer alliance value to management in the potential to pressurise shareholders to make; “investments and do things that insure long-run profitability”¹³³

He downplays the advantages of greater corporate flexibility arising from subordinated employee participation which he claims;

comes at the expense of employees and long-term investments in human capital and relationships.¹³⁴

Ultimately he maintains that this participation and potential for alliances with the other corporate role players will lead to a decrease in the short-termism of quick profits and improve a company’s long-term prospects.¹³⁵

Many of the virtues of high employee participation extolled by Dau Schmidt are reflected in the German model of corporate governance where there is a rich tradition of employee voice associated with a socialist co-ordinated market economy. It would appear that the Germans are willing to forgo the flexibility of their Anglo-American counterparts in pursuit of quick profits, to allow engagement with their employee stakeholders. This model is predicated on what is known as “patient capital” which supports long term projects and allows the economy to focus on and retain a skilled workforce during economic downturn.¹³⁶

According to Eyal Z Geva, industrial relations there are not adversarial but rather take the form of partnership where, in times of financial distress, employees are embedded in the management and participate in the strategic direction of the restructuring.¹³⁷

¹³³ Dau-Schmidt (note 132 above; 801)

¹³⁴ *ibid*; 801 ,citing M A. O'Connor, ‘The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation’ 78 CORNELL Law Review 899, 902, 915, 925-27 (1993)

¹³⁵ *ibid* 802

¹³⁶ Geva (note 124above;328)

¹³⁷ *ibid*

4.2.1.2 Arguments against increased employee participation

The argument by Professor Dau Schmidt for greater employee participation¹³⁸ is critiqued by Aditi Bagchi on the grounds that corporate performance and the promotion of employee interests may frequently be oppositional objectives at loggerheads with each other, maintaining that;

Employee voice is not a panacea with which one can reconcile genuine conflicts of interest.¹³⁹

In challenging the views of Dau Schmidt, Bagchi analyses the different forms of employee participation. He conceives of three forms of employee voice;

The first is 'Hard voice' which is a voice;

in which the speaker may back up the persuasive force of her views with some measure of power¹⁴⁰

This form of participation provides a direct input into the management and direction of a business and the interests of employees themselves¹⁴¹

The second is "Soft voice" which is a more consultative form of participation, providing employees the;

ability to engage in dialogue with or provide feedback to the relevant decision-makers.¹⁴²

The third form of employee participation, which Bagchi describes as; "only abstractly recognizable as a form of 'voice'"¹⁴³, is the right of access to information and it is this form of participation that he most supports.

¹³⁸ Dau-Schmidt (note 132 above)

¹³⁹ A Bagchi 'Who should talk? What counts as employee voice and who stands to gain' (2011) 94 (3) *Marquette Law Review* 870

¹⁴⁰ *ibid* 869

¹⁴¹ *ibid* 871

¹⁴² *ibid*

¹⁴³ *ibid* 870

“Hard voice”, he argues, where employees participate, usually through their union, is not necessarily in the best interests of the company, but usually in the best interests of the employees who are able to safeguard their rights and privileges often “at the expense of company competitiveness”¹⁴⁴

“Soft voice”, Bagchi suggests, which does not involve the exercise of power by employees, is largely inconsequential as it merely creates an opportunity for expression without the ability to effect any real changes to the direction of the business or the lot of the employees.¹⁴⁵

Suggestions and opinions which constitute this “soft voice” will either be dismissed for having no value or would in any case have been taken up by management if possessing the ability to contribute to the prosperity of the enterprise.

By contrast, he regards the right to information as the most effective form of worker participation. This “voice” presents no conflict of interest but provides employees access to important information of the company which provides the ability to make important life decisions such whether to join a union, resign or work harder etc. This reduces employee vulnerability to the perceived capriciousness of the corporate existence.¹⁴⁶

In support of Bagchi, Scott Moss argues that employee voice is best directed at labour relations and is inappropriate in corporate governance.¹⁴⁷ The reason for this is that he is of the opinion that employee voice is not necessarily directed at the long-term well-being of the business where all too often, especially with the involvement of heavily politicised unions, short-termism and rampant opportunism is present.

According to the World Bank in its study of effective insolvency procedures, the divergent goals between employers and employees become even more problematic when there is substantial employee participation in the in the management process of a business in distress where worker participation may serve to undermine efforts

¹⁴⁴ Bagchi (note 139 above; 873)

¹⁴⁵ *ibid* 881-882

¹⁴⁶ *ibid* 884

¹⁴⁷ S A Moss ‘Yes, labor markets are flawed but so is the economic case for mandating employee voice in corporate governance’ (2011) 94 (3) *Marquand Law Review* 960,975,976

to “keep the business viable and if possible restore it to profitability’ by possibly thwarting “a sharp reduction in the workforce” necessary to achieve this end.¹⁴⁸

Of significance to South African business rescue, this article goes on to warn that the promotion of a worker agenda through unprecedented employee involvement and protection in a business, puts at risk businesses that are labour intensive making them “a higher credit risk than capital intensive businesses, which may penalize job creation.”¹⁴⁹ It mentions at the same time, that globally there has been a reaction to the advantaging of “special interests” of a businesses in distress which may have the unintended consequence of distorting “normal commercial incentives.” It cautions that “insolvency laws should not serve as surrogate social security systems.”¹⁵⁰

4.2.2 Employee participation in the South African context

It is interesting to note that the degree of employee participation reflected in Chapter 6 bears more resemblance to the German co-ordinated market model of employee participation admired by Dau Schmidt, than the Anglo-American, liberal market approach.

Perhaps this is not surprising considering the significant influence of labour on these provisions who have long promoted Western European systems for work place democratisation¹⁵¹ as reflected in the Labour Relations Act, which was shaped by this strong labour agenda.

The problem is that South African industrial relations bear no resemblance to the German labour environment, with a skilled and educated workforce. German labour relations are sophisticated and have developed a co-operative character since 1835 when worker committees were introduced for the purposes of profit sharing in industry. Employee participation reduced significantly under Nazi Germany but again revived at the end of the war with the need to rebuild the economy. At first this only entailed consultation in certain economic areas, but the Works Constitution Act of 1972 elevated this participation to co-determination and joint decision-making.¹⁵²

¹⁴⁸ The World Bank (note 128 above; 44)

¹⁴⁹ *ibid* 45

¹⁵⁰ *ibid*

¹⁵¹ R van der Walt (note 54 above;45)

¹⁵² *ibid* 46

South African labour relations by contrast, are highly politicized and adversarial in nature.¹⁵³

In addition, the inherent conflict of interest between employers and employees as proposed by Bagchi is present in South African industrial relations where du Toit speaks of the;

contradictory interests...(of) employers and workers...(which) compete with one another.¹⁵⁴

This has been exacerbated by the fact that during the apartheid years, labour developed a militant approach which has resulted today in “a highly polarised industrial relations system.”¹⁵⁵

It is therefore unsurprising that attempts by the Labour Relations Act to democratise the workplace through the creation of work forums which are the South African version of the West European work councils, have met with limited success, where, according to du Toit;

management and labour habitually make contradictory proposals, reach deadlock and move into dispute-resolution mode.¹⁵⁶

The fact that workplace democratisation has been relatively unsuccessful under normal work conditions must raise questions about the wisdom of providing high levels of employee participation during the highly stressful event of business rescue.

The specific impact of these rights of participation in business rescue are now analysed in the light of this general critique on employee participation, within the South African industrial relations environment.

¹⁵³ du Toit (note 110 above)

¹⁵⁴ ibid

¹⁵⁵ ibid

¹⁵⁶ ibid

4.2.3 *The impact of employee participation in business rescue*

Employees derive rights of participation under Chapter 6, firstly as a class on their own and secondly through their inclusion in the class “affected persons.”¹⁵⁷

It is this double endowment of rights that places employees at a significant advantage to other stakeholders and affords their participation across all the categories of “voice” described by Bagchi.

It will be useful to examine the extent of these rights of participation with reference to his critique of these various employee “voices”.

4.2.3.1 “Soft Voice” employee participation in business rescue

“Soft voice”, which Bagchi describes as being that form of employee participation that is not underpinned by power but is rather a form of consultative participation which is in his words, unlikely to;

bring about any important changes in methods of corporate governance, or even micro-level changes in how a particular plant or factory operates¹⁵⁸

and is thus relatively ineffectual.

He argues that there should be no need to legislate for this type of participation as management will be likely to implement good ideas from employees in any case.

Examples of “soft voice” participation in chapter 6 are found in Section 144 (3) (d) read with Section 152 (1) (c) of the Act which requires that employees be consulted by the practitioner during the development of the business rescue plan and be afforded time to review the plan and prepare a submission to the meeting constituted to consider the plan.

The positive effect of this provision is that this consultation has the potential to draw upon employee innovation and thereby obtain their buy-in and commitment¹⁵⁹ to plans that may entail the restructuring of the business.

¹⁵⁷ Joubert (note 38 above;10)

¹⁵⁸ Bagchi (note 139 above; 882)

¹⁵⁹ Du Toit (note110 above)

The success of this consultation will depend on the degree of co-operation and trust that exists between employees and management. In South Africa's adversarial industrial relations environment this is usually at a low level, so this provision may therefore have limited value.

It may in addition suffer from the redundancy, described above by Bagchi, which is associated with employee voice that comes without power. These consultations provide no power to employees to effect changes or reject the plan at this stage.

Section 149 (1) of the Act, provides that whilst employees;

may consult with the practitioner about any matter relating to the business rescue proceedings...' they 'may not direct or instruct the practitioner.

Without legal consequences attaching to these sections and in an uncooperative labour environment, these consultations are likely to be formalistic and meaningless. If on the other hand, the practitioner does perceive a benefit, it is likely that he would have consulted with employees in any case, without the need for this to be legislated.

4.2.3.2 The Right to Information

Employees are granted extensive right to information in Chapter 6 which, according to Bagchi is the best form of employee participation because it provides some measure of employee empowerment¹⁶⁰ which largely has little impact on the strategic direction of the company where, he posits, a conflict of interests can exist between employers and employees.

There are many examples of this form of participation in Chapter 6.

Section 144 (3) (a) of the Act ensures employees or their registered union are highly informed and apprised of all aspects of the rescue proceedings by providing that employees are "entitled to... notice of ...each court proceeding, decision, meeting or other relevant event concerning the business rescue proceedings"

¹⁶⁰ Bagchi (note 139 above;884)

This broad right is reinforced through procedural requirements in the Act relating to the provision of information to employees.

Section 129 of the Act specifies that employees are entitled to receive notification within 5 business days of a filed board resolution to commence business rescue proceedings together with “the facts relevant to the grounds (upon which) the resolution was founded.”

In addition employees are entitled to receive notice of the appointment of a business rescue practitioner within 5 business days of the filing of the appointment.

The primary benefit to this form of employee participation according to Bagchi is that employees are provided with the information necessary for them to make decisions about their future.

Although this may indeed hold value in an economy with unlimited employment opportunities for employees to choose between, this is not the position for the majority of employees in South Africa where employment opportunities are limited and job seekers are plentiful. The degree of empowerment through information is therefore debatable in the South African context.

It is therefore unlikely that the drafters of Chapter 6 regarded the provision of information as an end in itself but rather provided it as a means to the exercise of the many “hard voice” rights provided to employees in this Chapter.

4.2.3.3 “Hard Voice” employee participation in business rescue

“Hard voice” holds real power for employees by providing the ability to effect change and influence process.

Bagchi is critical of ‘hard voice’ participation believing that the absence of unity of purpose by parties with conflicting interests will ultimately undermine corporate success.

As has been discussed previously, the policy underpin of the new Companies Act in general and business rescue in particular is the recognition of a broader group of stakeholder interests, with employees in many instances, specifically prioritised. It is

therefore no surprise that Chapter 6 is replete with examples of “hard voice” for employees.

The most influential example of “hard voice” participation is provided by Section 131 of the Act which allows employees through their classification as “affected person”, to make an application to place a company under supervision.

As previously discussed, there is a real potential that this right could be abused for the purpose of interfering with the power relations between employers and employees.

However, in the matter *Solar Spectrum Trading 83 (Pty) Ltd v AFGRI Operations Limited and Solar Spectrum Trading 83 (Pty) Ltd*¹⁶¹, the employees of a company in distress which was in the process of being liquidated, successfully applied for the company to be placed under supervision. The application had the effect of suspending the liquidation proceedings.

The court weighed up the interests of the secured creditor in reducing its risk of further depletion of the company assets through immediate liquidation with the interests of the employees whose livelihood depended on the preservation of the business and ruled for the employees on evidence presented that the business was in the process of recovering.

Whilst this was a legitimate and productive exercise of the an employee right to suspend liquidation proceedings if commenced, in terms of Section 131 (6) of the Act, there is a real potential that this right could be abused due to the fact that employees obtain considerably better rights under business rescue which are later transferred to insolvency proceedings if the rescue attempt fails.

Employees are also afforded the right to object to rescue proceedings in terms of Section 130 (1) (a) of the Act where it is believed that a company is not in financial distress or is unable to be rescued or there are procedural problems with the application. They are also able to apply to set aside the appointment of a practitioner

¹⁶¹ Employees of Solar Spectrum Trading 83 (Pty) Limited v AFGRI Operations Limited and Another, In Re; AFGRI Operations Limited v Solar Spectrum Trading 83 (Pty) Ltd 2012(5) ZAGPPHC 359

in terms of Section 130 (1) (b) of the Act or require that a practitioner provide security.

In many respects these employee rights of participation serve to ameliorate the concerns raised by labour of the cynical abuse of insolvency proceedings by management and shareholders and the appointment of practitioners which are biased in the favour of creditors.

Section 144 (3) (b) of the Act broadly empowers employees to “participate in any court proceedings arising during business rescue proceedings.” This allows employees to remain actively involved and informed on all aspects throughout the process.

Employees are assigned a particularly active role in the preparation and acceptance of a business rescue plan once proceedings have commenced.

As previously discussed, there is “soft voice” consultation with employees prior to the production of the plan, followed by the right to participate in the meeting convened 10 business days after the publication of the plan where a representative has the right to address this meeting prior to the vote of acceptance. This holds no real potential for power and is merely influential in nature.

However if a plan is rejected, a “hard voice” component of participation kicks in, where employees are empowered through Section 153 of the Act to apply to set aside a vote of rejection of a plan, call for the practitioner to prepare and publish a revised plan or offer to purchase the voting interest of “one or more persons who opposed adoption.”

On the face of it this seems to be a reasonable right for employees determined to preserve a business in distress. However, in light of the super-priority ranking of employee costs during rescue proceedings, these rights could be abused to prolong the proceedings and deplete the assets of the business at the expense of creditors to the business.

It is evident from this study of Chapter 6, that employees have been afforded all forms of “voice” in business rescue proceedings, in terms of Bagchi’s analysis of employee participation which, according to Anneli Loubser;

will almost certainly lead to protracted hearings and escalating costs, especially in the case of larger companies, because of the adversarial nature that now characterises the procedure¹⁶²,

She concludes that the level of employee participation in South Africa is unparalleled in comparable legal jurisdictions.¹⁶³

In England the rights of participation in proceedings are limited to the applicant and the company as represented by one or more of the directors. In some circumstances the court may on application, agree to extend the right of participation to interested parties. Specific involvement of employees is not provided for and their voice as a class is mute.¹⁶⁴

The position is similar in Australia where apart from the right to vote at the creditors meeting in their capacity as creditors, employees generally play an insignificant role in the procedure.

There is even less employee participation in Chapter 11 proceedings in the United States where under normal circumstances there is not even a duty on an employer to notify employees of an impending petition for Chapter 11 unless it can be proved that there were mala fides on behalf of the employer.¹⁶⁵

Employees play a relatively minor role in Chapter 11 proceedings. They can neither initiate proceedings nor object to the initiation thereof and they may only participate in proceedings in the capacity of an unsecured creditor for any monies that may be outstanding.

In addition, employees may not participate on an individual basis and may only vote as a class and even this right of participation is not unlimited, where for instance, objections by employees as a class to the acceptance of a rescue plan, can be disregarded and the plan imposed upon them regardless of dissent; “so long as it does not discriminate unfairly and is fair and equitable”¹⁶⁶

¹⁶² Loubser (note 9 above; 78)

¹⁶³ Joubert (note 38 above; 16)

¹⁶⁴ Loubser (note 9 above; 189)

¹⁶⁵ D R LaRocca , D Egan,DLA Piper ‘Labor and employment law: Chapter 11 considerations’(25 March 2013 available at <http://www.dlapiper.com/en/global/insights/publications/2013/03/labor-and-employment-law-chapter-11-considerations/>

¹⁶⁶ P Mindlin *Comparative Analysis of Chapter 6 of the South African Companies Act, no. 71 of 2008 (Business Rescue Proceedings)*(Presentation to the Company Law Symposium organized by The South Africa Department of Trade and Industry & The Specialist Committee on Company Law)15

It is probable that this limitation on employee participation in these jurisdictions is to avoid the dilatory impact arising from “tension and conflict” which, according to Cassim, may occur between stakeholders whose interests are often diametrically opposed to each other, in proceedings that are “consultative and inclusive” in nature.¹⁶⁷

This limitation on employee participation in the United States is considered necessary to streamline the process by removing the potential for disruption and derailment by too many participating parties¹⁶⁸ in order to expedite the process and thereby lower;

both direct and indirect financial distress costs, lessen(ing) the risk that the restructuring will fail altogether¹⁶⁹

and end up as a liquidation.

South Africa on the other hand has provided employees in terms of Sections 130, 131, 135, 136, 144 and 152 of the Act the rights to be notified, to initiate, to object to proceedings, form committees, be consulted on the plan, allowed to propose an alternative plan, object to and remove a practitioner and generally participate, even on an individual basis.

This makes employees central participants in business rescue.

In a co-operative labour climate these rights of participation would, according to Dau Schmidt, enhance a rescue process through the unique operational knowledge of employees and their long term view.

However Bagchi’s view of the inherent conflicting interests of employers and employees, in the context of South Africa’s adversarial labour environment, would make these levels of participation seem extra-ordinarily high.

¹⁶⁷ Cassim (note 25; 868)

¹⁶⁸ S Gilson ‘Coming through in a crisis’ (2012) 24 (4)*Journal of Applied Corporate Finance* 29

¹⁶⁹ *ibid*

4.3 Employee protection and the impact on the flexibility to restructure

If employees are “considered the lost souls in insolvency law”¹⁷⁰ this is certainly not the case in business rescue

Employees derive considerable protection from Section 136 (1)(a) of the Act which provides that employment contracts remain in force and may only be altered subject to the prevailing labour laws.¹⁷¹

The Labour Relations Act is predicated on a high degree of employee consultation and participation and this is evident in the sections dealing with retrenchment and restructuring. This degree of engagement is of course complex and time consuming requiring;

meaningful joint consensus-seeking process and attempt to reach consensus on appropriate measures-

- to avoid the *dismissals*;
- to minimise the number of *dismissals*;
- to change the timing of the *dismissals*; and
- to mitigate the adverse effects of the *dismissals*;
- the method for selecting the *employees* to be dismissed; and
- the severance pay for dismissed *employees*.¹⁷²

The sections require the disclosure information and substantial consultation and negotiation with unions or labour representatives. Consultation is in itself time consuming and the process may be further protracted through the referral of disputes to the CCMA or the labour court.¹⁷³ For large companies with over 50 employees the position is even worse where the intention to downsize can be resisted via strike action.¹⁷⁴ In addition, a failure to adhere to the provisions in Sections 189 and 189A¹⁷⁵ could result in the employees being deemed to have been dismissed unfairly on operational requirements which would expose a company to

¹⁷⁰ Cassim (note 25 above;884)quoting Alice Belcher *Corporate Rescue:A Conceptual Approach to Insolvency Law* (1997)4

¹⁷¹ Joubert (note 38 above; 15)

¹⁷² Section 189 of the Labour Relations Act 66 of 1995

¹⁷³ A Loubser (note 31 above;66)

¹⁷⁴ *ibid* 67

¹⁷⁵ Labour relations act 66 of 1995

the liability “for compensation up to an amount equal to the employees’ remuneration for 12 months”¹⁷⁶

The delays resulting from this ‘meaningful joint consensus seeking’ approach, in addition to the prospect of further delays in the event of a dispute being declared could, according to Anneli Loubser; “have an extremely adverse effect on a company already teetering on the brink of collapse.”¹⁷⁷

This is because labour costs generally constitute the largest expense in a business and restrictions in the ability to swiftly reduce costs in this area can jeopardise an effective strategy to stabilise a business in distress.

The process of downsizing a workforce in England is far less complicated and thus quicker to implement.

An administrator is afforded 14 days to decide on the dismissal of employees. If during this period employees are dismissed, they become “ordinary creditors within the administration so will line up along suppliers and other creditors.”¹⁷⁸ If they are not dismissed during this period, they go on to become a preferential creditor and if the business does not survive the rescue attempt, and proceeds to insolvency, this preferent claim relates to the unpaid salary owed up to 4 months “immediately preceding the insolvency” and is also subject to an upper limit which is determined from time to time.¹⁷⁹

Furthermore employees are subjected to the moratorium on claims against a business under administration and are prohibited from making claims without consent of either the courts or the administrator.¹⁸⁰

In Australia, whilst there is some degree of protection of contracts of employment in their rescue process, there is considerably less than that afforded by the South African system.

¹⁷⁶ Loubser(note 31 above;67)

¹⁷⁷ ibid

¹⁷⁸ P Landau ‘Employee rights, what to expect’ (18 January 2013 available at <http://www.theguardian.com/money/blog/2013/jan/18/employee-rights-administrators> , accessed on 2 August 2014)

¹⁷⁹ ibid

¹⁸⁰ Loubser (note 9 above;195)

The Australian practitioner is afforded the discretion to alter these contracts in the process of restructuring the business. This discretion was clarified in the *Patricks case*¹⁸¹ where; the

High court made it clear that a fundamental aspect of the administrator's task was to operate the company as he or she saw fit and that accordingly even where there were possible breaches of industrial legislation, it was not prepared to order that employees must be retained.¹⁸²

The United States is generally characterised by a relatively unregulated labour market with many employees employed on an "at will" basis¹⁸³ which allows either party to terminate the employment relationship at any time without complicated procedures.

It follows therefore that a business which has filed for Chapter 11, may with very little procedural impediment, embark upon swift and dramatic reorganisation through dismissals. The only requirement in these circumstances is that these dismissals are non-discriminatory and comply with any contractual legal notice that may exist.¹⁸⁴

The position is a little more complicated if the employment relationship is governed by an employment contract. As part of the protection afforded by a Chapter 11 bankruptcy filing, a business is entitled to

assume or reject executory contracts subject to a bankruptcy court's approval and provided certain requirements are satisfied.¹⁸⁵

The test to determine whether a contract is executory or not is whether there are obligations to perform from either party at the time of filing the petition. Employment contracts are generally viewed as executory contracts due to the obligation to perform on both parties. Businesses undergoing Chapter 11 proceedings are thus entitled to assume or reject these contracts. However these rights are not unfettered

¹⁸¹ Patrick Stevedores Operations (No 2) v Maritime Union of Australia 195 CLR 1; 27 ACSR 53; 572 ALJR 873; 79 IR 339; 153 ALR 643; [1998] HCA 30

¹⁸² C Anderson 'Viewing the Proposed South African Business Rescue Provisions from an Australian Perspective' (2008) 4 *P.E.R* 21

¹⁸³ LaRocca (note 165 above)

¹⁸⁴ *ibid*

¹⁸⁵ *ibid*

and decisions to reject or alter employment contract agreement are subject the oversight of a bankruptcy court which will base its approval of a business decision to reject or assume these contracts upon whether it was based on “sound business judgement and whether the interests of other creditors will be prejudiced.”¹⁸⁶

Collective bargaining agreements are also viewed as executory contracts and are also subject to rejection or assumption by the debtor. There are however more onerous conditions attaching to the rejection of collective bargaining agreements where decisions are subject to Section 1113 of the Bankruptcy Code¹⁸⁷

There is also a requirement that the business engages with the relevant Union representative and makes a proposal on a potential restructuring. Should this proposed restructuring or rejection of the bargaining agreement be opposed by the Union without good cause and if, in a Bankruptcy court’s view, the rejection or alteration of such bargaining agreement is favourable on a balance of equities, then the changes or rejection of this agreement will be allowed.

An employee claim arising from a successful rejection of an employment contract or bargaining agreement will rank alongside other unsecured claims in a potential liquidation and this claim will in addition be subject to an upper limit as determined by Section 502 (b)(7) of the Bankruptcy Code.¹⁸⁸

It is clear from an analysis of the flexibility in restructuring in these foreign jurisdictions that the ability to restructure under the South African system is burdened with a high degree of inflexibility.

The US system is more flexible than any of the other jurisdictions but the benefits arising from this flexibility, does not come without controversy.

There is criticism that US employees are particularly vulnerable as a class of creditors where although in theory employees are provided with limited rights of participation potentially through their classification as unsecured creditors;

¹⁸⁶ LaRocca (note 165 above)

¹⁸⁷ *ibid*

¹⁸⁸ *ibid*

in practice the special relationship between employer and employee will silence the employee stakeholder and cause them to be less protective of their rights¹⁸⁹

Even the procedural protection of employee rights under a collective bargaining agreement provided by Section 1113 of the Bankruptcy code sets a very low bar for the adjudication of a decision to reject such an agreement and thereby encourages unions to avoid high-risk, hard-line positions and rather elect to discharge their;

fiduciary duty to its membership...to protect the most jobs for the most Union members¹⁹⁰

Ironically the requirement to consult with employees protected under a collective bargaining agreement “was established with the vision of the Wagner Act and the New Deal reforms at its core”¹⁹¹ which were enacted in 1935 and were “the most pro-worker laws ever enacted by the Federal Government.”¹⁹² However notwithstanding this apparent protection of employee rights through collaboration between organised labour and management on the future and direction of a distressed business , Chapter 11 has become “the managerial avenue of choice for cross-industry restructuring...”¹⁹³ This has served to severely weaken the collective bargaining mechanism through the practice of “strategic bankruptcies”¹⁹⁴ which exploit the system enabling

an employer to avoid substantial legacy and benefit costs, reject collective bargaining agreements, and drastically reduce labor costs.¹⁹⁵

It is apparent that the extra-ordinary protection of employee rights in Chapter 6 would be held in high regard by these critics of Chapter 11, but the fact remains that swift and effective savings that can be made to the labour costs of a distressed business

¹⁸⁹ J J Berry ‘ Different Playing Fields: What Affect Does Chapter 11 Bankruptcy Have on Employees of the Debtor and Why Do These Affects Drive Companies to Bankruptcy?’ 2012 *Social Science Research Network*
¹⁹⁰ *ibid*

¹⁹¹ E Z Geva (note 124 above;318)

¹⁹² M D Yates ‘Should We Return to the Policy of the Wagner Act?’ (2013) 4 *University of Pennsylvania Journal of Business Law* 559

¹⁹³ E Z Geva (note 124 above; 318)

¹⁹⁴ *ibid*

¹⁹⁵ J J Berry (note 189 above)

holds the most potential “to change its fortunes going forward”¹⁹⁶ where, paradoxically, less protection presents a greater prospect for the preservation of employment.

Although slightly off point but demonstrating the relationship between protection and employment, a paper which examined and compared labour market flexibility with job creation across the various states in the US, authors Bauer and Lee concluded that;

Higher rates of flexibility are correlated with higher growth rates for both output and employment¹⁹⁷

Whilst closer to home Tendai and Moyo in their study of the impact of employment protection on job creation, conclude in their investigation and analysis of a large sample of companies from six African countries, that;

restrictive labour market regulations are detrimental to export propensity, export intensity, investment and employment.¹⁹⁸

It seems as if the drafters of Chapter 6 prioritised stronger employee protection in a business in distress, rather than the provision of an enabling environment for a business to take swift steps when necessary, to downsize in order to effect a recovery.

4.4 Employee privilege and the impact on post commencement financing.

It would appear, according to Professor Marius Pretorius who will be undertaking the review of the rescue provisions on behalf of the committee established by DTI, that one of the most important issues affecting the efficacy of the procedure has to do with resistance by the banks; “especially (their) ‘withholding (of) finance once the rescue process had begun.”¹⁹⁹

¹⁹⁶ J J Berry (note 189 above)

¹⁹⁷ PW Bauer, Y Lee ‘Regional Variation in Job Creation and Destruction’ *Economic Commentary* (2007)1-4

¹⁹⁸ G Tendai, M Busani ‘Impact of employment protection legislation on employment and exporting in select African countries’ (20 14) 31 (2) *Development Southern Africa* 11

¹⁹⁹ L Ensor (note 2 above)

It will be important to understand the reasons for this lack of enthusiasm for business rescue by the banks which generally constitute a key stakeholder in most businesses.

Almost invariably, the single most important aspect of rescue is the ability to secure turnaround finance in order to restore the company to health²⁰⁰ It is, in the words of a respondent in a survey conducted by Wanya du Preez in her thesis on post commencement finance;

probably the most fundamental leg to the process, without it, it is stillborn.... it's like the oxygen tank for the patient. Without the oxygen he is going down.²⁰¹

This point is further emphasised by Thekiso Lefifi in an article in Business Day Live where he states that;

without post commencement finance(PCF), business rescue was akin to a boat without a paddle, leaving the few companies that had the option of saving their business without any hope.²⁰²

Although PCF is critical to the success of business rescue, empirical findings conducted by Wanya du Preez in her study on this subject; “confirmed that the current level of PCF in South Africa is non-existent.”²⁰³

Whilst there are a number of reasons for these low levels, amongst them being that the law is still relatively new and “processes are not clear (with) many loopholes and inefficiencies”²⁰⁴ and that banks are too powerful and haven’t bought into the process, one of the top reasons for this state of affairs has to do with “concerns and uncertainty regarding the priority ranking of post commencement financing”²⁰⁵

²⁰⁰ W du Preez (note 7 above;6)

²⁰¹ ibid 80

²⁰² T A Lefifi ‘Why most business rescue processes are failing’ (12 November 2012 available at <http://www.bdlive.co.za/business/2012/11/11/why-most-business-rescue-processes-are-failing> accessed on 12 May 2014)

²⁰³ W du Preez (note 7 above;89)

²⁰⁴ ibid 154

²⁰⁵ ibid 116

In terms of section 135(3)(b) of the Act it appeared as if PCF ranked behind secured creditors, the costs of the process and claims relating to costs of employment during the period.

However a recent interpretation of this section in the *Merchant West*²⁰⁶ decision handed down in the South Gauteng High Court, the position of post commencement finance was improved by ranking it ahead of secured creditors. This improvement in the status of post commencement financiers, could have a positive impact on the encouragement of this industry but Professor Marius Pretorius, claimed that was still uncertainty surrounding the;

definition and interpretation of what constitutes PCF (and that it would be) critical that such uncertainty be clarified in order to provide potential financiers with the confidence that their funding will be recognised as a higher priority debt and the certainty that their debt will be repaid.²⁰⁷

An unintended consequence of this decision to prioritise PCF, may be a disruption to the commercial certainty of secured creditors. This may lead to higher lending costs to offset the heightened risk or subdue the lending industry altogether.

It may also discourage existing secured creditors from supporting an application for rescue as there is substantial risk that the value of the business will be undermined by the introduction of superior new claims against the assets of an already distressed company. These creditors will therefore be incentivised to proceed directly to liquidation to better protect their interests.

In a comparative review of employee claims treatment in insolvency systems in South Africa, US Aid restates the World Bank International Insolvency standards, warning of the risks involved in the disruption of normal commercial relationships and notwithstanding its recognition of the vulnerability of employees promotes a balanced treatment of employee rights and the interests of other creditors, to ensure that;

²⁰⁶ *Merchant West Working Capital Solutions (Pty) Limited v Advanced Technologies and Engineering Company (Pty) Limited* 2013 (5) ZAGPJHC 109

²⁰⁷ M Pretorius, W du Preez 'Constraints on decision making regarding post-commencement finance in business rescue' (2013) 6 *SAJESBM* 181

confidence in the commercial sector through greater enforceability of bargained for contractual and collateral rights (is maintained) so as to support access to finance.²⁰⁸

The study goes on to add that the vast majority of countries typically recognise and give effect to secured rights in an insolvency proceeding and relegate employee claims to a preferential position below secured and administrative claims.²⁰⁹

Similar sentiments are expressed by the United Nations Commission on International Trade Law which warns that these ranking priorities;

should be based on commercial bargains and not reflect social and political concerns that have the potential to distort outcomes of insolvency. According priority to claims that are not based on commercial bargains should be minimised.²¹⁰

It is important to recognise as previously discussed, that any resultant commercial uncertainty arising from an undermining of commercial bargains could deter investment, particularly in commercial undertakings which require a large workforce.

Despite these potential problems, the decision in *Merchant West* has improved the status of post commencement financiers, however the problem exists that these claims still rank behind the costs of the actual process and the uncapped claim of employee costs during the rescue period. In light of the fact that some of the more strenuous criticisms of business rescue is the “incompetence of practitioners” coupled with claims that some are also unscrupulous²¹¹, the rescue period can be significantly protracted resulting in an erosion of new finance by the ongoing employment costs, particularly in the case of distressed companies with a large workforce which are the very entities from a socio-political perspective, most in need of rescue.

²⁰⁸ US Aid Southern Africa *Insolvency Systems in SA employee claims* (2011) 1

²⁰⁹ *ibid*

²¹⁰ United Nations Commission on International Trade Law *Legislative Guide to Insolvency Law* (2005) 13

²¹¹ Ensor (note 2 above)

It is clear that banks, the most likely source of PCF, are unlikely to be attracted to developing a PCF industry under current conditions.²¹²

Once again it would appear that in the legislators' eagerness to protect employee rights, an essential element of rescue has been undermined which has the effect of reducing the effectiveness of the procedure to save the business and protect employment.

With access to the best practices and legislation around the world aimed at the encouragement of post commencement financing, the failure of South African legislators to prioritise PCF ahead of employee claims appears to have been driven by considerations other than the main objective of the rescue of a business.

It is also evidence of the power dynamics that were involved in the legislative process which, according to Anneli Loubser is a clear example of an interest group, in this instance labour, driving an agenda focussed "only on their own interests"²¹³ where in fact there should have been;

one test, and that is whether a particular provision or measure would increase the chances of a successful rescue...because that (would) ultimately be to the advantage of everybody.²¹⁴

It would appear that South Africa is not alone in failing to provide the right legal infrastructure to promote the development of the post commencement finance industry.

The English rescue system does not have a well-developed post commencement financing environment because, like South Africa, there is no concept of super-priority status for post commencement financiers.²¹⁵

²¹² W du Preez (note 7 above)

²¹³ Loubser (note 9 above;381)

²¹⁴ ibid

²¹⁵ W du Preez (note 7 above;67)

In general financing during this period emanates from existing creditors²¹⁶ and due to the reluctance of these creditors to further increase their risk, the development of PCF has tended to be discouraged.²¹⁷

Efforts have been made in the Enterprise Act of 2002 to encourage this type of financing, by providing the administrator with the power of “borrowing money and granting security on the organisation’s behalf.”²¹⁸ While this does not provide greater priority than other secured creditors, secured post commencement financiers enjoy higher priority than the costs of administration and employee claims.

Australia, like England and South Africa, has muted success in promoting “life blood” financing for a business in distress. Australia has also not provided “super-priority ranking for funding advanced to assist in the rehabilitation process.”²¹⁹

This prevents the development of a separate financing industry specialising in post commencement finance as is found in the USA. According to Michael Blazic, the primary lenders to distressed businesses will more than likely be banks already exposed to the failing business who will then be more likely to behave

in a manner highly motivated and focused on negotiating strategies that protect their existing exposure and interests²²⁰

rather than the successful rescue of such an entity.

By contrast, Chapter 11 in the United States has a highly functional system of PCF resulting in the development of a financial industry specifically focussed on this form of financing.

It appears that legislators there have recognised that the most important consideration for the development of a flourishing PCF industry is to provide legal mechanisms to mitigate the inherent risk of extending credit to an entity in distress.

²¹⁶ W du Preez (note 7 above; 29)

²¹⁷ *ibid*

²¹⁸ *ibid*

²¹⁹ M J Blazic *In Search of a Corporate Rescue Culture* (paper presented at SBS HDR Student Conference, University of Wollongong, 2010)

²²⁰ *ibid*

Chapter 11 deals with this dilemma by according post commencement financiers with super-priority status which ensures that these lenders to a company in distress are amongst the first to be repaid. This, together with an attractive interest rate serves to balance the ratio of risk to reward which is essential to promotion of this financial industry.

What is interesting is that although post commencement financiers in the US enjoy an elevated status, they do not rank ahead of secured creditors, in contrast to the recent South African decision in *Merchant West*

It would appear that the US system strikes the right balance. Although secured creditors enjoy the highest protection (thereby creating financial predictability and reliability in the macro financing system) new financiers of a distressed business can secure enhanced status by either categorising the new loans under an administrative expense which rank third after secured creditors and priority creditors or can elect to occupy an even more favourable position provided by Section 364(d) where such claims are ranked second, immediately after secured claims.²²¹

This promotes the development of the post commencement finance industry without destabilising the financial system.

²²¹ du Preez (note 7 above;26)

5. The impact of employee rights on the return to creditors after failed rescue

The purpose of Chapter 6 is twofold. The first is the rescue of a business in distress and the second, if this is not possible, is to obtain

a better return for the company's creditors or shareholders than would result from an immediate liquidation of the company

in terms of Section 128 of the Act.

In light of this objective, it will be necessary to compare the rights of employees under the Insolvency Act with the corresponding rights accruing to employees in business rescue in order to evaluate the extent to which this objective is achieved.

5.1 The impact of employee rights in Chapter 6 on the sale of a business as a going concern

In the event of a failure to restore a distressed business to health, one of the key strategies to realise maximum value for all stakeholders is to sell the business as a going concern rather than liquidate its assets in a piecemeal fashion.²²² It is therefore important to make the sale of a business in distress as attractive as possible.

An impediment to this arises in the form of Section 197 of the Labour Relations Act which provides as follows;

If a transfer of a business takes place, unless otherwise agreed...

- the new employer must take over all of the employees on the same conditions of service
- the rights of the employees who are transferred workers (such as unpaid salary) and duties apply to new employer
- everything done by the old employer (such as unfair dismissal) is transferred to the new employer
- and the transfer does not interrupt the continuity of service.²²³

In the case of the sale of a business in distress considerable liability could therefore attach to a new owner.

²²² Bridge (note 10 above; 33)

²²³ Section 197 of the Labour Relations Act 66 of 1995

It is for this reason that, in terms of Section 197A of the insolvency Act,²²⁴ the sale of a business in liquidation proceedings provides exemption to the new owner from

any liability for claims the employees may have had against the previous owner of the business for unlawful acts.²²⁵

Therefore;

- claims that employees may have had against their old employers in respect of unpaid salary and unpaid leave do not transfer to the new employer; and
- the new employer cannot be held liable for the unfair dismissal of any of the employer's former employees.²²⁶

Business rescue does not provide this indemnity to potential buyers of a distressed business. The preferent position provided to employees after a failed rescue attempt will impact significantly on the value to creditors. The reason for this is that the liabilities arising from employee claims may render a business unattractive, which would require, at best, the value of the business to be substantially discounted to attract a sale. At worst, these liabilities may completely destroy the possibility of selling the business as a going concern requiring a piecemeal liquidation.

In both scenarios, the value destruction arising from the improved employee rights in business rescue would have defeated the objective of the Act to obtain a better value for creditors than an immediate liquidation.

5.2 The impact of employee rights in Chapter 6 on employee claims

Employee claims against the assets of a business in distress, during rescue also serve to undermine the “superior return to creditor” objective of the Act.

The Insolvency Act provides limits on claims by employees against an insolvent estate. In the first instance;

²²⁴ The Insolvency Act 24 of 1936

²²⁵ Loubser (note 33 above; 19)

²²⁶ Joubert (note 38 above;5 quoting *A Borraine and BPS van Eck 'The New Insolvency and Labour Legislative Package: How Successful was the Integration?' Industrial Law Journal 2003 at 1840.*)

all contracts of service with its employees are automatically and immediately suspended and then terminated 45 days after the date of appointment of a final liquidator²²⁷

There is thus an immediate arrest of potential claims arising from the contracts of employment.

In addition to limiting ongoing claims against an insolvent business, Section 98 of the Insolvency Act no 24 of 1936 limits employee claims against the balance of the free residue of the insolvent estate to; “salary and wages (salary 3months), leave pay, and severance pay”²²⁸ which are capped at an upper limit which is determined from time to time by the Minister.

In contrast, Section 144 (2) of the Act provides that any monies owed to employees, in terms of their contract of employment, prior to the commencement of business rescue proceedings, entitles employees to become preferred unsecured creditors. Unlike the position under the Insolvency Act, there is no time limit on how far back the claim may extend, nor is there an upper limit imposed on the total claim. In addition to this, the priority rankings place the business rescue practitioner, the costs of the process and an uncapped claim for all employee costs during the period of rescue ahead of all other creditors with theoretically; “no limit on either the amount or period for which they must be paid.”²²⁹

This would have a considerable impact on other unsecured creditors who would have been in a far better position than if they had proceeded to immediately liquidate the business contrary to the objective contained in Section 128 (b) (3) of the Act

With only a 12% success rate for businesses that embark upon rescue, it means that the balance of about 88% that do not succeed are likely to have placed creditors in a worse position than if they had moved immediately to liquidate.

²²⁷ Loubser (note33 above; 18)

²²⁸ S 98A of the Insolvency Act.

²²⁹ Loubser (note 33 above; 16)

In light of these significant advantages obtained by employees under business rescue, it must be borne in mind that they have been given the power to convert insolvency proceedings to business rescue proceedings through Section 131 (6) of the Act.

Whilst the precondition that there must “be a reasonable prospect for rescuing the company”²³⁰ this may be undermined by the fact that, according to Professor Barnard in a recent article in Business Day Live;

One of the weaknesses of the South African system... was that it had no dedicated courts with specialist judges (which) resulted in contradictory judgments being handed down; ‘Every time a judge is appointed he might never have seen a case of business rescue and has to start from scratch.’²³¹

The real risk exists therefore, that an inexperienced judge may fail to recognise that there is no prospect for the rescue of a distressed business in an application by employees to convert insolvency proceedings into a business rescue.

This potent provision, providing employees with the power to radically alter their circumstances has the potential for exploitation through the ability of employees to convert a legitimate liquidation into a business rescue to place themselves in a better position.

It appears that the impact of the extra-ordinary rights afforded to employees in Chapter 6 not only undermines healthy business and reduces the efficiency of the rescue procedure but also results in reduced value accruing to creditors than if a business had been immediately liquidated.

²³⁰ Section 131 (4) (a) (iii) Companies Act 71 of 2008

²³¹ L Ensor (see note 2 above)

6. Conclusion

It may be said that the privileging of employees in Chapter 6 was a triumph of idealism above pragmatism, paradoxically undermining the very security of employment that these rights set out to achieve.

Liquidations which were on an upward trajectory prior to the corporate law reform project in 2004, made the provision of an effective rescue mechanism a national priority, to retain “productive capacity”²³² and prevent the job destruction that resulted from the liquidation of these distressed businesses. Judicial management was no defence against this rising trend in insolvencies which was taking a toll economically and socially.

However, this privilege and protection provided to employees in the new South African rescue procedure has undermined many of the key elements that are necessary for successful business rescue.

In the first instance the empowerment of employees in this process has introduced a level of participation ill-suited to the current climate of industrial relations in the country. It is unlikely in this environment that these high levels of participation are able to advance synergies between employees and employers and may instead exacerbate the inherent conflict of interests between these two parties.

Abuse of some of the provisions by employees holds the risk of destabilising delicate power relation in the work environment, potentially imperilling even healthy business and almost certainly leading to costly delays in a rescue process that relies on a speedy resolution for success.

Restructuring which is a fundamental part of the process is predicated on speed and flexibility. Unfortunately, the wholesale infusion of labour legislation to regulate this process undermines these requirements and denies the procedure of important strategies for optimal efficiency.

²³² I Le Roux (note 1 above; 58)

The super-prioritisation of employee claims has introduced commercial uncertainty in the lending industry and resulted in a poor uptake by banks to develop a post commencement finance industry, without which rescue proceedings are inevitably doomed to failure.

In addition the impact of employee rights has not only jeopardised the rescue of a business, but has also undermined the secondary objective contained in Section 128, where creditors are generally placed in a worse position after rescue proceedings than if they had resorted to liquidation proceedings immediately.

It seems inexplicable that the efficiency of a procedure, so necessary for economic and social reasons could have been compromised by the prioritisation of the interests of employees.

In this regard however, it is important to realise that law is ultimately the product of the society in which it is made, and therefore, in this instance, subject to the various influences and dictates of modern South Africa.²³³

Subordination of the new corporate law philosophy to the constitutional framework resulted in a re-conceptualisation of the purpose of a company which, without abandoning the shareholder value approach, permitted a wider recognition of the interests of other stakeholders in a company even, at times, as ends in themselves.

In this broader conceptualisation of a company it was necessary, in the development of a rescue mechanism, to obtain a balance between the competing interests and objectives of the stakeholders of a distressed business, which according to UNICTRAL, would “generally be the primary objective for most jurisdictions”²³⁴

However, the prioritisation of employee rights demonstrates that this proved to be a daunting task for South African legislators in the context of the complicated power relations prevailing at the time of the reform process.

²³³ GN 468 (note 53 above;7) ‘to ensure that the new legislation is appropriate to the legal, economic and social context of South Africa as a constitutional democracy and an open economy.’

²³⁴ Burdette (note 19 above; 18)

Labour in particular, which typically bears the brunt of liquidations, was agitating for insolvency law reform which needed to include an effective rescue system to better protect employees.

Employee empowerment, privilege and protection which was high on the labour agenda found expression in pro-labour rescue legislation with the incorporation of employee rights that in some respects, have no equal in other jurisdictions.

This demonstrates the substantial influence of organised labour which was able to graft rights which produced a “greater ‘voice”²³⁵ for employees and more labour protection, typically associated with co-ordinated market economies such as Germany and Scandinavia, onto a rescue system modelled on the US Chapter 11 which is a product of a liberal market economy, predicated on high labour-market flexibility.

The incongruity of infusing this labour protection and privilege, associated with socialist economies, into a system which is based on free-market labour flexibility is a microcosmic reflection of the ideological conflict and constantly vacillating power relations within the government, arising from incompatibilities within the tripartite alliance.

According to Niccoli Nattrass, this ideological conflict has;

entrenched (an) oppositional relationship between macroeconomic and labour-market policy making at the heart of the state²³⁶

This conflict is visible in the Guidelines where it is apparent that policies therein, were influenced by a clash between the socialist alliance, as represented by organised labour on the one hand, which promotes; “a developmental state tasked with disciplining capital and promoting decent work at relatively big wages”²³⁷ with the neoliberal alliance on the other hand, which promotes flexible labour policies and very little state interference.

²³⁵ Nattrass (note 89 above; 6)

²³⁶ *ibid* 16

²³⁷ *ibid* 5

This debilitating contestation of ideas has resulted in policy incoherence which is at the heart of the dysfunction of Chapter 6 where the extra-ordinary protection of employees has removed the working parts of Chapter 11. This is largely why the process has under-performed upon its potential.

It would appear that the importance of creating an effective rescue system to promote a stable corporate environment and ameliorate the seemingly intractable unemployment crisis was sacrificed at the altar of political expediency.

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