

The ranking of creditors' claims during business rescue proceedings as  
envisaged in the Companies Act 71 of 2008

By

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## **Declaration**

I hereby declare that the research in this dissertation, except where otherwise indicated is my original research. It is submitted in partial fulfilment of the requirements of the LLM (Business law), University of KwaZulu-Natal. It has not been submitted before for any degree or examination at any other university.

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## Table of Contents

<b>1. Introduction .....</b>	<b>6</b>
1.1 Background.....	6
1.2 Statement problem.....	12
1.3 Rationale.....	13
<b>2. Business Rescue in South Africa.....</b>	<b>13</b>
2.1 Companies Act 46 of 1926.....	13
2.2 Companies Act 61 of 1973.....	14
2.3 Failure of Judicial Management.....	15
2.4 Reformation of the Rescue Procedure.....	19
2.4.1 The United States of America.....	20
2.4.2 The United Kingdom.....	21
2.4.3 Australia.....	22
2.5 Business Rescue in terms of the Companies Act 71 of 2008.....	22
2.5.1 Background.....	22
2.5.2 Meaning of Business Rescue.....	23
2.5.3 Commencement of Business Rescue.....	25
2.5.4 Legal Consequences of Existence of Business Rescue Proceedings.....	27
2.5.4.1 Moratorium on the Legal Proceedings against the Company.....	27
2.5.4.2 Protection of Property Interest.....	29
2.5.5 Effect of Business Rescue on Security Holders.....	29
2.5.6 The Business Rescue Plan.....	30
2.5.7 Post-Commencement Finance.....	31
<b>3. Creditors Ranking.....</b>	<b>34</b>
3.1 Ranking in terms of Companies Act 2008.....	34
3.2 Merchant West Working Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company Ltd and	

Another and Redpath Mining South Africa (Pty) Ltd v Marsden No and Others.....	36
<b>4. Critical Comments.....</b>	<b>42</b>
<b>5. International Guidelines on Post-Commencement Finance.....</b>	<b>50</b>
5.1 Chapter 11 of US Bankruptcy Code Debtor-in possession.....	50
5.2 World Bank Principles.....	52
5.3 UNCITRAL Legislative Guide on Insolvency Law.....	53
<b>6. Conclusion.....</b>	<b>57</b>
<b>7. Bibliography.....</b>	<b>61</b>

## 1. Introduction

### 1.1 Background

#### 1.1.1 Importance of companies

Companies are one of the highest contributors to economic growth and social renewal.<sup>1</sup> They play a pivotal role in the communities in which they operate and through its employees, suppliers and distributors directly impact the economic and thus social well-being of those communities.<sup>2</sup> In a report by Quantec Research, a South African economic consultancy, businesses were identified to be the “most significant direct contributor to the South African economy.” Amongst their findings is that companies employ 6.9 times the number of public sector employees and through taxation they provide support to some of the important institutions in the country.<sup>3</sup>

The chief executive of Business Leadership South Africa (BLSA), stated that “the report confirms that businesses are a vibrant part of the South African economy and just the employees or the creditors.<sup>4</sup> Therefore, it is imperative that there is a successful corporate rescue mechanism in place to aid those companies that are experiencing financial difficulties and place them back in the economy. This will ensure job preservation, which will in turn ensure economic growth and stability in the country.

Saving jobs in South Africa has been paramount for a long time. Rochelle argued that more citizens and companies would have taken more economic risks had the

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<sup>1</sup> Department of Trade and Industry, South African Company Law for the 21<sup>st</sup> century: Guidelines for Corporate Law Reform GN1183 of GG 26493, 23/06/2004.

<sup>2</sup> A Loubser Some Comparative Aspects of Corporate Rescue in South African Company Law (unpublished LLD thesis, University of South Africa, 2010) at 1.

<sup>3</sup> Ibid.

<sup>4</sup> Loubser (note 2 above; 1).

sanctions for financial failure been less severe than what they were.<sup>5</sup> In his discussion, he further states that:<sup>6</sup>

*“society should not reward the cautious man who buries his talent and takes no chances, it most emphatically should do everything in its power to assist the man who creates jobs- the man who strives to turn his one talent into ten-even if he fails in the attempt.”*

This dissertation will focus on the business rescue proceedings as envisaged and implemented in the Companies Act 71 of 2008, including but not strictly confined to the issue of ranking of creditors’ claims.

### 1.1.2 Importance of business rescue

In the last few years insolvency systems globally have adopted formal mechanisms to assist companies that are financially distressed and are engaged in the process of reorganization.<sup>7</sup> These systems acknowledge that, “as a general rule, a business offers greater value as a going concern than when in liquidation”. Business rescue is universally accepted and supported as a means of savings jobs and ensuring that debts are paid or “at least to a greater extent than if the debtor were permanently removed from commercial life”.<sup>8</sup> By rescue it is meant simply a “reorganization of the company to restore it to a profitable entity and avoid liquidation.”<sup>9</sup> In South Africa, business rescue has two alternative objectives, of which the second alternative does entail liquidation.

Where a liquidation order is granted and the company is removed from commercial life, this will not only affect the members and creditors but also the employees, suppliers and distributors and through them the whole community at large will

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<sup>5</sup> R Rochelle “Lowering the Penalties for Failure: Using the law as a Tool for Spurring Economic Growth, the American Experience and Possible Uses for South Africa” (1996) at 215 available at <https://heinonline.org/HOL/Page?handle=hein.journals/jsouaf1996&collection=journals&id=325&startid=&end=340> accessed on 8 August 2018.

<sup>6</sup> ibid

<sup>7</sup> M Pretorius & W Rosslyn-Smith “Expectations of a Business Rescue Plan: International Directives for Chapter 6 Implementation” (2014) p111 available at [https://repository.up.ac.za/bitstream/handle/2263/.../Pretorius\\_Expectations\\_2014.pdf](https://repository.up.ac.za/bitstream/handle/2263/.../Pretorius_Expectations_2014.pdf) accessed on 10 August 2018

<sup>8</sup> H Rajak & J Henning J “Business Rescue for South Africa” (1999) at 263.

<sup>9</sup> R Cassim... et al Contemporary Company Law 2 ed (2000) at 861.

suffer.<sup>10</sup> It is therefore important to have a formal corporate rescue mechanism that will focus on rescuing ailing companies that are experiencing a temporary setback and are capable of survival if given the assistance they need to overcome their financial difficulties.<sup>11</sup>

This view was also supported by the World Bank in which it was stated that:

*“If an enterprise is viable meaning it can be rehabilitated, its assets are often more valuable if retained in a rehabilitated business than in liquidation.<sup>12</sup>The rescue of a business preserves jobs, provides creditors with a greater return based on higher going concern values of the enterprise, potentially produces a return for owners and obtains for the country fruits of the rehabilitated enterprise.”<sup>13</sup>*

Such corporate rescue mechanisms are even more necessary in developing countries experiencing high unemployment levels and where job preservation is just as important as employment creation.<sup>14</sup> Particularly in South Africa where we have such high unemployment rates. Failure of corporate entities will only aggravate the already existing struggle of unemployment in South Africa. Another important factor that has to be considered is the introduction of Black Economic Empowerment (BEE). Black Economic Empowerment was intended to ensure that black people are given the opportunity to participate on all levels of the economy, this means that there are minimum targets of participation and ownership by historically disadvantaged black people that have to be met.<sup>15</sup>

The introduction of BEE afforded many people who lack the necessary skills, training and experience, the opportunity to enter businesses for the very first time.<sup>16</sup> A large number of these business are owned and controlled by people who do not have the

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<sup>10</sup> A Loubser “Judicial Management as a Business Rescue Procedure in South African Corporate Law” (2004) South African Mercantile Law Journal available at [https://heinonline.org/HOL/Page?handle=hein.journals/safrmerlj16&div=20&start\\_page=137&collection=journals&set\\_as\\_cursor=0&men\\_tab=srchresults](https://heinonline.org/HOL/Page?handle=hein.journals/safrmerlj16&div=20&start_page=137&collection=journals&set_as_cursor=0&men_tab=srchresults) at 137 accessed on 4 September 2018.

<sup>11</sup> Ibid.

<sup>12</sup> “The World bank Principles for Effective Insolvency Creditor/debtor Rights system” available at <http://pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes-2016.pdf> .

<sup>13</sup> Ibid.

<sup>14</sup> A Loubser “Business Rescue in South Africa: A Procedure in Search of a home” (2007) available at <https://www.jstor.org/stable/pdf/23252658.pdf?refreqid=excelsior%3Ac786c132eda5dec6ee5a0705b6fdd1b5> accessed on 3 September 2018.

<sup>15</sup> Ibid.

<sup>16</sup> Ibid.



required skills and experience to sustain the business. A business owned and managed by people who do not have the skills nor experience will most likely experience difficulties. Therefore there is a “real need to assist these businesses or at least the viable ones when they show signs of distress and imminent failure,” in order to ensure job preservation.<sup>17</sup>

From the above mentioned reasons, it is important that the South African economy has legislation that aims to provide effective escape routes for companies that are heading towards liquidation.<sup>18</sup> South Africa has until recently lagged behind the rest of the world in terms of having a formal rehabilitation model.<sup>19</sup> The Companies Act 71 of 2008<sup>20</sup>, (hereinafter “the Act”) introduced a formal corporate rescue model that presented financially distressed companies with two alternative objectives. Chapter 6 of the Act, sets in place the objectives and procedures to be followed before, during and after company has filed for business rescue.<sup>21</sup>

“The primary purpose of business rescue, is the restructuring of the affairs of the company in order to either ensure that the company continues in existence on a solvent basis or provide a better return for the creditors and shareholders than would ordinarily result from liquidation.”<sup>22</sup> Business rescue means simply means proceedings to facilitate the rehabilitation of financially distressed companies, if this is not possible, it aims to ensure that the creditors and shareholders get better returns than would have resulted in an immediate liquidation. Section in terms of 128(1) (b) business rescue is described as follows:<sup>23</sup>

*“Business rescue” means proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for-*

*(i) the temporary supervision of the company, and of the management of its affairs, business and property;*

*(ii) a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and*

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<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> Pretorius (see note 8 above).

<sup>20</sup> Act 71 of 2008.

<sup>21</sup> Act 71 of 2008.

<sup>22</sup> Pretorius (see note 8 above) & S Conradie, & C Lamprecht “Business Rescue: How can its Success be evaluated at Company Level?” (2015) available at

<https://www.ajol.info/index.php/sabr/article/viewFile/127488/117015>, accessed at 24 July 2018.

<sup>23</sup> S128 (1) (b), Act 71 of 2008.

*(iii) the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company"*

In the case of *Southern Palace Investments (pty) Ltd v Midnight Storm Investments*<sup>24</sup>, the court held that that "like its Australian equivalent, one of the aims of the remedy is to render it possible for companies in financial difficulty to avoid winding up and to be restored to commercial viability. It was further noted that, business rescue does not necessarily entail a complete recovery of the company in the sense that after the procedure, the company will have regained its insolvency, its business will have been restored and its creditors paid.<sup>25</sup> There is also the further recognition that even though the company may not continue in existence, better returns for its creditors may be gained by adopting the rescue procedure".<sup>26</sup>

*Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd*<sup>27</sup>, was the first judgment delivered by the Supreme Court of Appeal on business rescue proceedings. The Court interpreted s128 (1) (b) to mean that "business rescue" means to facilitate rehabilitation. This means the achievement of one of two alternative goals:

*"a primary goal, which is to facilitate the continued existence of the company in a state of solvency and a secondary goal, which is to facilitate a better return for the creditors or shareholders of the company than would result from immediate liquidation."*<sup>28</sup>

Intrinsic to the success of a "business rescue" is the ability of the company to raise funds.<sup>29</sup> Regardless of how well thought-out, detailed or impeccable a business

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<sup>24</sup> *Southern Palace Investments (Pty) Ltd v Midnight Storm Investments* 2012 (2) SA 423 pg. 2 at para 2

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

<sup>26</sup> *Ibid.*

<sup>27</sup> *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others* 2013 (4) SA 539.

<sup>28</sup> *Oakdene* at para 23

<sup>29</sup> R Jones & R Wellcome "The elephant in the room –whether pre-business rescue creditor's rights to their security are compromised" available at <https://www.cliffedekkerhofmeyr.com/en/news/publications/2016/dispute/dispute-resolution-alert-20-july-the-elephant-in-the-room-post-commencement-financing-and-whether-pre-business-rescue-creditors-rights-to-their-security-are-compromised.html>.

rescue plan can be, it will not succeed without financial assistance.<sup>30</sup> Jurisdictions around the world have recognized that any attempt to rescue a financially distressed company requires financing so that the business can continue as a going concern until the business rescue plan is successfully established and executed.<sup>31</sup> Therefore it logically follows that the success of a business rescue plan is dependent on the business being able to obtain finance known as post-commencement finance.<sup>32</sup>

Rushworth states that is it significant that the Act permits the company to raise finance during the proceedings, which may be secured on assets of the company which are not otherwise encumbered and which will therefore rank ahead of “unsecured creditors” of the company, subject to certain costs and expenses and liabilities to employees.<sup>33</sup> This is known as post-commencement finance. Section 135 aims to address the difficulties associated with obtaining such financing.<sup>34</sup> It does this by providing mechanisms which make post-commencement finance more attractive to potential lenders.<sup>35</sup> This is achieved by granting priority or permitting the company to use its assets in order to secure such loans.<sup>36</sup> In terms of s135 “post commencement finance will have preference in the order in which it is incurred in priority to all unsecured claims against the company. However it will rank after the remuneration and expenses of the practitioner, other costs of the proceedings and certain remuneration due to employees.”<sup>37</sup>

However post-commencement financing has proven to be rather difficult for companies to obtain. Post-commencement finance is arguably one of the most important yet controversial features of a successful business rescue model.<sup>38</sup>

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<sup>30</sup> Ibid.

<sup>31</sup> J Calitz & G Freebody “Is post commencement Finance Proving to be a Thorn in the side of Business Rescue Proceedings under the 2008 Companies Act (2016) at 266 available at <http://www.saflii.org/za/journals/PER/2016/65.html> accessed on 13 June 2018.

<sup>32</sup> Ibid.

<sup>33</sup> J Rushworth “A critical Analysis of the Business Rescue Regime in the Companies Act 71 of 2008” (2010) at 385.

<sup>34</sup> Calitz (see note 32 above; 270).

<sup>35</sup> Ibid.

<sup>36</sup> Ibid.

<sup>37</sup> Section 135(3) (a), Act 71 of 2008

<sup>38</sup> DA Burdette “Some Initial Thoughts on the Development of a Modern and Effective Business Rescue Model for South Africa” ( Part two) (2004) 16 Merc LJ at 422 Available at [https://journals.co.za/docserver/fulltext/ju\\_samlj/16/3/ju\\_samlj\\_v16\\_n3\\_a5.pdf?expires=1542278440&id=id&accname=57926&checksum=7777535BBD07A4D18F9AF6FD6637C37A](https://journals.co.za/docserver/fulltext/ju_samlj/16/3/ju_samlj_v16_n3_a5.pdf?expires=1542278440&id=id&accname=57926&checksum=7777535BBD07A4D18F9AF6FD6637C37A)

Obtaining funding can be extremely problematic for any company, and being subject to business rescue proceedings can exacerbate the situation.<sup>39</sup> A further contributing factor to the reluctance of providing PCF is the uncertainty in our law regarding how such financing should be dealt with and when granted, how this will affect the ranking of creditors who were secured prior to the commencement of the business rescue proceedings.<sup>40</sup>

The Act is vague on the ranking of creditors post and pre-commencement financing. The way the Act is drafted makes it difficult to understand what was intended by the legislature. For example, the Act deals with the position of unsecured creditors but does not state whether or not post-commencement financing will also rank ahead of secured pre-commencement lenders. This has led to a great deal of contention and confusion amongst legal practitioners and authors, with some believing that post-commencement financiers should rank ahead of creditors who were secured prior to the commencement of the proceedings and others believe that secured pre-commencement creditors should rank ahead of post commencement financiers.

## 1.2 Statement problem

The Act deals with the position of unsecured pre-commencement creditors in relation to post-commencement finance extensively but it failed to deal with the position of secured pre-commencement lenders. This has led to uncertainty with regards to the ranking of creditors. This dissertation, focuses on how post-commencement financing affects the ranking of secured pre-commencement creditor. It evaluates how post-commencement financing has affected the ranking of creditors more specifically secured pre-commencement creditors.

## 1.3 Rationale

The “ranking of claims of creditors” in business rescue has been a contentious and much debated topic.<sup>41</sup> With post commencement financing plausibly being the most fundamental and complicated characteristic of a business rescue model, it is

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<sup>39</sup> Calitz (see note 32 above; 270).

<sup>40</sup> Jones & Wellcome (see note 30 above).

<sup>41</sup> L Becker “In Business Rescue where do you Rank?” (2014) available at <https://www.werksmans.com/legal-briefs-view/in-business-rescue-where-do-you-rank/>, accessed on 4 July 2018

imperative that the uncertainty concerning the priority ranking of creditors and post-commencement financing is addressed.

The successful rehabilitation of a business experiencing financial difficulties is predominately dependent on it being able to secure post-commencement finance.<sup>42</sup> With post-commencement financing being a relatively new concept, very few investors are ready to provide ailing companies with financial assistance. This reluctance is further aggravated by the uncertainty in our regarding the ranking of creditors.<sup>43</sup> Without post commencement financing, this means many businesses who are up for business rescue will be unsuccessful due to the lack of funding. The failure of these business rescue proceedings means that the businesses will subsequently be liquidated.

Liquidation will have harsh ramifications for not only the company but for the economy. Therefore, it is critical that business rescue plans are successful in order to avoid liquidation. With that being said, it is essential that all the gaps and anomalies in the Act concerning business rescue be addressed in order to provide an efficient and well-functioning business rescue procedure.

## 2. Business Rescue in South Africa

### 2.1 The Companies Act 46 of 1926

In 1926, judicial management was introduced into our law as a means of establishing a formal corporate rescue procedure in South Africa.<sup>44</sup> It was actually one of the first countries to establish a corporate rescue regime.<sup>45</sup> Judicial management was introduced at a time when the “concept of business rescue was still unknown in any other comparable legal system.”<sup>46</sup> Even Great Britain which was the usual source of

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<sup>42</sup> “Deloitte Post commencement finance : Silver Bullet for Business Rescue “available at <http://www.deloitteblog.co.za/post-commence-finance-the-silver-bullet-for-business-rescue/>

<sup>43</sup> Jones & Wellcome (see note 30).

<sup>44</sup> A Loubser “A Tilting at Windmills? The Quest for an Effective Corporate Rescue Procedure in South African Law (2011) available at [https://heinonline.org/HOL/Page?handle=hein.journals/safrmerlj25&div=36&g\\_sent=1&casa\\_token=&collection=journals#](https://heinonline.org/HOL/Page?handle=hein.journals/safrmerlj25&div=36&g_sent=1&casa_token=&collection=journals#) accessed on 22 August 2018.

<sup>45</sup> Rajak (see note 9 above) & DA Burdette “Some Initial Thoughts on the Developments of a Modern and Effective Business Rescue Model for South Africa” ( part one ) at 246, available at [https://heinonline.org/HOL/Page?handle=hein.journals/safrmerlj16&div=20&start\\_page=137&collection=journals&set\\_as\\_cursor=0&men\\_tab=srchresults](https://heinonline.org/HOL/Page?handle=hein.journals/safrmerlj16&div=20&start_page=137&collection=journals&set_as_cursor=0&men_tab=srchresults) accessed on 5 September 2018.

<sup>46</sup> Loubser (see note 11 above; 139).

inspiration for matters relating to companies, only enacted its first statutory business rescue provision in 1986.<sup>47</sup>

However this “phenomenon” was not welcomed with much eagerness and several submissions were made that the procedure should be put to an end because of its “low success rate and instances of abuse.”<sup>48</sup> Despite the criticism surrounding judicial management, the *Van Wyk de Vries Commission* recommended retaining the procedure and recommended it to be re-enacted in the Companies Act 61 of 1973.<sup>49</sup>

## 2.2 The Companies Act 61 of 1973

The original version of judicial management was subsequently amended several times and the judicial management provisions were contained in s427-440 of the “Companies Act 61 of 1973.”<sup>50</sup>

The Judicial Management procedure requires the company or its creditors or jointly by any of them, to make an application to the High Court for the granting of an order that permits the company to be placed under judicial management.<sup>51</sup>

The court would only provisionally appoint a judicial manager in circumstances where it can be proven that the “company is unable to pay its debts or would probably be unable to meet its obligations, and when the company has not become or is prevented from becoming a successful going concern; <sup>52</sup> and that there is a reasonable probability that it will be enabled to pay its debt or to meet its obligations and become a successful concern if it is placed under judicial management, in addition the court has to be satisfied that it is just and equitable to grant a judicial management order in respect of that company.”<sup>53</sup>

The court may make any order it deems fit, which includes granting a provisional judicial management order, if it is satisfied that all the requirements have been met

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<sup>47</sup> Rajak (see note 9 above)

<sup>48</sup> Loubser (see note 11; 139)

<sup>49</sup> EP Joubert “Reasonable Possibility versus Reasonable Prospect: Did business rescue succeed in creating a better test than Judicial Management” (2013) at 550 available at [https://repository.up.ac.za/bitstream/handle/2263/40920/Joubert\\_Reasonable\\_2013.pdf?sequence=1](https://repository.up.ac.za/bitstream/handle/2263/40920/Joubert_Reasonable_2013.pdf?sequence=1) accessed on 1 June 2018.

<sup>50</sup> Companies Act 61 of 1973.

<sup>51</sup> Section 427(2) of Act 61 of 1973.

<sup>52</sup> Section 427(1) of Act 61 of 1973.

<sup>53</sup> Ibid.

or dismiss the application.<sup>54</sup> The order may include a stay of all actions, proceedings, execution of all writs, summons and other processes.<sup>55</sup> On the return date, no longer than 60 days following the date of the provisional judicial management order, the court has a discretion to either issue a final judicial management order if it is satisfied that the company will be able to become a “successful going concern” after being placed under judicial management and that it is “just and equitable”, or the court can discharge the provisional order or make any other order it may deem just.<sup>56</sup>

### 2.3 Failure of Judicial Management

For many years in South Africa judicial management was the only formal corporate rescue process that was intended for the purpose of rescuing ailing companies. However despite the best intentions of the legislature, the judicial management provisions “did little to restore financial stability in the South African economic environment or credibility in the business realm.”<sup>57</sup> Judicial management has experienced its fair share of criticism, with commentators unanimously describing it as a cumbersome and ineffective procedure and some going as far as stating that it was a dismal failure in practice, and as a result, a general consensus was reached that judicial management in its current form needed substantial reform, as it was not fulfilling its intended purpose.<sup>58</sup> The court in *Le Roux* described it as a system “that has barely worked since its initiation in 1926”.<sup>59</sup>

The problem began when the legislature failed to express the original intention of judicial management. Loubser argues that because the wording of the Act failed to expressly reflect the intention of judicial management, there was no limitation as to the size or type of company that could qualify to be placed under judicial

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<sup>54</sup> Section 428(1) of the Companies Act 61 of 1973.

<sup>55</sup> Section 428(2) (c) of the Companies Act 61 of 1973.

<sup>56</sup> Section 432 (1) & (2) of the Companies Act 61 of 1973.

<sup>57</sup> PJ Veldhuizen “Regulation and Control of Business Rescue Practitioners, is there a Suitable Legal Framework?” Vol 6 (2015).

<sup>58</sup> Burdette (see note 46 above) at p241 & Joubert (see note 50 above) at 550 & Loubser (see note 11 above; 138) & M Seligson “The Impact of Business Rescue on Tax Claims: Does SARS Enjoy a preference under S135 of the Companies Act Against a Company in Business-Rescue Proceedings” (2014) available at <https://journals.co.za/content/btclq/5/3/EJC173381> & A Smith “The Major Creditors Wishes Usually Prevail” (2001) available at accessed on [https://heinonline.org/HOL/Page?handle=hein.journals/jutbusil9&div=42&g\\_sent=1&casa\\_token=&collection=journals](https://heinonline.org/HOL/Page?handle=hein.journals/jutbusil9&div=42&g_sent=1&casa_token=&collection=journals) 5 August 2018

<sup>59</sup> *Le Roux Hotel Management (Pty) Ltd and Another v E Rand (Pty) Ltd* (2001) All SA 223 (K) para 60.

management.<sup>60</sup> The courts assumed the responsibility of ensuring that the procedure was not misused by interpreting the legislation in a “conservative and restrictive way, that the burden of proof on an applicant became extremely onerous”.<sup>61</sup> As a result, it was difficult for an applicant to satisfy a court that all the requirements as per s427 (1) were met.

There was an obvious display of mistrust by our judiciary in the procedure, this was evident in the decisions they took when deciding the judicial management applications.<sup>62</sup> The courts believed that this procedure could be used to allow an insolvent company to avoid paying its creditors when payment was due.<sup>63</sup> The courts were of the opinion that judicial management was an infringement of creditors’ rights and therefore felt compelled to protect creditors.<sup>64</sup> Loubser argues that because South Africa had a creditor friendly insolvency system, this invariably diminished any chances of a corporate rescue system succeeding.<sup>65</sup> In several cases the creditors opposed judicial management, based on the grounds that they were entitled to be immediately paid out.<sup>66</sup> Courts dealing with judicial management application orders would therefore in most instances refuse to grant the order on the belief that it should only be ordered in special circumstances as it was an infringement of creditors’ rights.<sup>67</sup>

Bradstreet also supports this view as; he argues that judicial management focused on reimbursement of creditors as the main target of the process and that this is a “hallmark of a so-called creditor-friendly bankruptcy process”.<sup>68</sup> He argues that this sort of approach generally results in liquidation than the rescue of a business.<sup>69</sup> He further argues that judicial management’s failure could be attributed to its protective

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<sup>60</sup> Loubser (see note 15 above; 156)

<sup>61</sup> Loubser (see note 15 above ;157)

<sup>62</sup> A Loubser “Defining the Unincorporated Business in Financial Distress: Should it be Treated as a Business or as a Consumer (2007) 19 SA Merc p454 available at [https://www.heinonline.org/HOL/Page?handle=hein.journals/safrmerlj19&div=44&start\\_page=444&collection=journals&set\\_as\\_cursor=0&men\\_tab=srchresults](https://www.heinonline.org/HOL/Page?handle=hein.journals/safrmerlj19&div=44&start_page=444&collection=journals&set_as_cursor=0&men_tab=srchresults) accessed on 5 September 2018

<sup>63</sup> Ibid.

<sup>64</sup> Loubser (see note 63 above; 454)

<sup>65</sup> Loubser (see note 15 above; 157).

<sup>66</sup> Ibid.

<sup>67</sup> Ibid.

<sup>68</sup> Bradstreet “The New Business Rescue: will creditors sink or swim” (2009) at 352 available at [https://heinonline.org/HOL/Page?handle=hein.journals/soaf128&div=26&g\\_sent=1&casa\\_token=&collection=journals](https://heinonline.org/HOL/Page?handle=hein.journals/soaf128&div=26&g_sent=1&casa_token=&collection=journals) accessed on 25 June 2018.

<sup>69</sup> Ibid.



emphasis on creditor's interest.<sup>70</sup> He also identified the tendency of judicial management orders to end in liquidation as a result of liquidators being appointed as judicial managers.<sup>71</sup>

### 2.3.1 Shortcomings of Judicial Management

#### 2.3.1.1 Reliance on Court Proceedings and cost

One of the most significant shortcomings of judicial management was its reliance on court proceedings.<sup>72</sup> Litigation can be very expensive and therefore the reliance on court proceedings, increased the costs of the procedure and made judicial management a rescue mechanism that not only proved to be unsuitable for the needs of small and medium sized businesses but also made the process unattractive to creditors.<sup>73</sup> Judicial management in South Africa required a court order which required applications for both a provisional and a final order.<sup>74</sup> This meant that it required much greater involvement and preparation by legal practitioners, which made it much more expensive to set in motion.<sup>75</sup> Academics have described this method to be cumbersome and self-defeating, and consequently led to the failure of judicial management.<sup>76</sup>

#### 2.3.1.2 Requirement of 'Reasonable Probability'

The requirement that judicial management should only be granted when there is a "reasonable probability" that all debts would be paid and that the "company would become a successful concern" was another factor that contributed to the failure of the procedure.<sup>77</sup> Klopper argues that this was in hindsight the wrong approach.<sup>78</sup> This requirement placed an onerous burden of proof on the applicant who was required to prove a reasonable probability and not merely a possibility.<sup>79</sup> This

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<sup>70</sup> Bradstreet (see note 69; 352).

<sup>71</sup> Ibid.

<sup>72</sup> P Kloppers "Judicial Management Reform- Steps to initiate a Business Rescue" (2001), 13 S. Afr. Mercantile L.J. available at [https://www.heinonline.org/HOL/Page?public=true&handle=hein.journals/safrmerlj13&div=37&start\\_page=358&collection=journals&set\\_as\\_cursor=0&men\\_tab=srchresults](https://www.heinonline.org/HOL/Page?public=true&handle=hein.journals/safrmerlj13&div=37&start_page=358&collection=journals&set_as_cursor=0&men_tab=srchresults) accessed on 2 September 2018.

<sup>73</sup> Kloppers (see note 73 above; 370).

<sup>74</sup> Ibid.

<sup>75</sup> Ibid.

<sup>76</sup> Rajak (see note 9 above; 268).

<sup>77</sup> Klopper (see note 73 above; 372).

<sup>78</sup> Ibid.

<sup>79</sup> Loubser (see note 15 above; 144).

requirement was argued to be “outdated, unrealistic and often contrary to the wishes of the creditor.”<sup>80</sup> This argument was supported by Klopper who stated that:<sup>81</sup>

*“Nowhere in other business rescue schemes is this seen as a qualifying requirement in the prevalent credit economics of today as it is widely accepted that creditors would usually accept a reduction of their claims and rather reap the longer term benefits of having a liable debtor with which to do business.”*

The same view was illustrated in the guidelines for corporate reform, which stated that this requirement ignored the “well-high universal reality of creditors being prepared for their own benefit to forgive part of the debt”.<sup>82</sup> It was also recognised that it would be more beneficial for a creditor to have the company back in the market place than having it liquidated.<sup>83</sup>

#### 2.3.1.3 Insolvency as a requirement

The question that had remained to be answered was whether a company had to be insolvent before it could apply for judicial management.<sup>84</sup> Submissions were made that it should not be a strict requirement that a company is unable to pay.<sup>85</sup> The basis for this argument is that, the earlier a company recognizes that it should reorganize itself because of an emerging financial disaster, the better the chances will be for avoiding eventual liquidation and the greater the possibility of successful reorganization.<sup>86</sup>

#### 2.3.1.4 Exceptional Circumstances

The courts approach towards judicial management was to treat it as a remedy that would only be granted in exceptional circumstances.<sup>87</sup> The courts were of the opinion that it would rarely, if ever be “just and equitable” to go against the wishes of all the creditors and shareholders and grant the judicial management order.<sup>88</sup>

Klopper submits that even though there was nothing in the legislation that indicated

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<sup>80</sup> Rajak (see note 9 above; 268).

<sup>81</sup> Klopper (see note 73; 372).

<sup>82</sup> GN 1183 of GG 26493, 23/06/2004

<sup>83</sup> Ibid.

<sup>84</sup> Klopper (see note 73 above; 375).

<sup>85</sup> Ibid.

<sup>86</sup> Klopper (see note 73 above; 375)

<sup>87</sup> Klopper (see note 73 above; 376) & Burdette (see note 46 above; 248) & Joubert (see note 50 above; 551).

<sup>88</sup> Ibid.

that judicial management should be treated as an extra ordinary measure, the courts treated it as such.<sup>89</sup>

The court in *Le Roux* quoted *Silverman v Doornhoek Mines Ltd*<sup>90</sup> (the case which courts frequently referred to when dealing with judicial management applications) where the judgment stated that “judicial management is a special and extraordinary procedure and a special privilege given in the favour of a company and is to be authorized only in very special circumstances”. This approach was decided in favour of protecting the interest of creditors. Burdette argues that the decision by the courts to treat judicial management as extra ordinary remedy, is one of the problems that gave rise to the demise of judicial management as a corporate rescue mechanism.<sup>91</sup>

#### 2.4 The reformation of the rescue procedure

Despite South Africa being one of the first countries to establish a formal corporate rescue regime, South Africa had fallen behind in taking heed of international trends in corporate reorganisation.<sup>92</sup>

It was clear that there was a need for substantial reform and development in this area. In 2004, a policy paper was published by the Department of Trade and Industry expressing an intention “to create a new corporate rescue procedure that would be appropriate to the needs of the modern South African economy” because of the non-success of judicial management.<sup>93</sup> It further stated that in doing so, the provisions of the US Chapter 11 will be considered.<sup>94</sup>

The need to reform and develop judicial management would bring South Africa in line with international best practices, mainly to implement rescue mechanisms for financially ailing companies rather than simply provide for their demise through liquidation.<sup>95</sup>

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<sup>89</sup> Ibid.

<sup>90</sup> *Silverman v Doornhoek Mines Ltd* 1935 Tpd 349 cited in *Le Roux Hotel Management (Pty) Ltd and Another v E Rand (Pty) Ltd* (2001) All SA 223 (k) 238 at para 41.

<sup>91</sup> Burdette (see note 46 above) at p248 & Joubert (see note 51; 551)

<sup>92</sup> Bradstreet (see note 69 above; 354)

<sup>93</sup> GN 1183 of GG 26493, 23/06/2004

<sup>94</sup> Ibid.

<sup>95</sup> R Bradstreet “The Leak in the Chapter 6 Lifeboat: Inadequate Regulation of Business Rescue Practitioners May Adversely Affect Lenders’ Willingness and the Growth of the Economy” 2010) 22 SA Merc LJ available at [https://heinonline.org/HOL/Page?handle=hein.journals/safrmerlj22&div=20&start\\_page=195&collection=journals&set\\_as\\_cursor=0&men\\_tab=srchresults](https://heinonline.org/HOL/Page?handle=hein.journals/safrmerlj22&div=20&start_page=195&collection=journals&set_as_cursor=0&men_tab=srchresults) accessed on 19 September 2018

Propositions had already been brought forward by several critics of judicial management recommending that the “dysfunctional judicial management procedure” be replaced with a model that closely resembles Chapter 11 of the United States.<sup>96</sup> Chapter 11 of the United States has been a standard or point of reference for just about every country.<sup>97</sup> Countries as diverse as Germany, France, Singapore, China and Japan used chapter 11 reorganisation as a yardstick in developing their own procedures.<sup>98</sup> Loubser describes it as having reached cult status.<sup>99</sup>

There is a lack of literature on post-commencement finance in South Africa and that’s why we look at the most recognised international corporate systems. Modern systems such as the United States, United Kingdom, and Australia are all considered to be true representations of what “latest international developments” should look like.<sup>100</sup> Therefore a brief summary will be provided for each of these systems and how they have influenced the recent introduction of business rescue in South African company law.

#### 2.4.1 United States of America

The modern trend of business rescue regimes can be said to have started with “Chapter 11 of the United States of America’s Bankruptcy Act of 1978” which is a federal law that governs reorganisation in the US.<sup>101</sup> The purpose of Chapter 11 is to save the enterprise from closing down in the hope that, if allowed to continue; it will recover and become once more productive, pay its debts, produce returns to its shareholders and preserve jobs.<sup>102</sup> Business reorganization may be commenced voluntarily by a debtor.<sup>103</sup> Once a debtor files for reorganisation under Chapter 11, the company enjoys an automatic stay (moratorium) from the enforcement of proceedings being sought against it or the company’s property while a reorganisation

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<sup>96</sup> Loubser (see note 11 above; 39).

<sup>97</sup> Ibid.

<sup>98</sup> Ibid.

<sup>99</sup> Ibid.

<sup>100</sup> Pretorius & Rosslyn-Smith (see note 8 above; 111).

<sup>101</sup> Rajak (see note 9 above; 263).

<sup>102</sup> H Dahl “ USA: Bankruptcy under the Chapter 11” (1992) International Business Law Journal, Vol. Issue 5 p556 available at

[https://www.heinonline.org/HOL/LuceneSearch?searchtype=advanced&submit=Go&search\\_within=&prev\\_q=&prev\\_origterms=&cited\\_by=&maxresults=10&terms=Chapter](https://www.heinonline.org/HOL/LuceneSearch?searchtype=advanced&submit=Go&search_within=&prev_q=&prev_origterms=&cited_by=&maxresults=10&terms=Chapter) accessed on 2 October 2018

<sup>103</sup> A Loubser (see note 63 above; 449).

plan is being formulated with the creditors.<sup>104</sup> During the first 120 days, the debtor is allowed to propose a plan for reorganisation.<sup>105</sup> After this period, the creditors can also present their own plans.<sup>106</sup>

The United States may have initiated the essence of business rescue however other jurisdictions that later followed have proved to be better influences for South Africa's reform, the reforms of the UK and Australia are of particular relevance for South Africa.<sup>107</sup>

#### 2.4.2 The United Kingdom

The Insolvency Act of 1986, is the legislative framework in the United Kingdom which provides recourse to financially distressed companies enabling them to undergo rehabilitation, through two rescue procedures an "Administration" or "Company Voluntary Arrangement" (CVA).<sup>108</sup> The primary concern of the Insolvency Act of 1986 is to ensure that viable businesses are rehabilitated and preserved, to provide businesses heading towards liquidation better chances of survival by allowing them to be restructured.<sup>109</sup>

The company itself, its directors or the creditors can initiate the Administration procedure by making an application to court for an order placing the company under administration.<sup>110</sup> The objectives of the administration order are; "firstly for the company to survive as a going concern, secondly for its assets to be realised for the benefit of the creditors as a whole, and finally for the distribution to secured or preferential creditors."<sup>111</sup> In order for Administration to be available there are two qualifying requirements.

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<sup>104</sup> Pretorius (see note 8 above; 113).

<sup>105</sup> Dahl (see note 103 above; 558).

<sup>106</sup> Ibid.

<sup>107</sup> Kloppers (see note 73; 358)

<sup>108</sup> S Conradie & C Lamprecht "Business Rescue: How can its Success be evaluated at Company Level?" (2015) Southern African Business Review Vol.19 available at

<sup>109</sup> Ibid.

[https://journals.co.za/docserver/fulltext/sabr/19/3/sabr\\_v19\\_n3\\_a1.pdf?expires=1561562139&id=id&accname=guest&checksum=C1A127268AB35CA31DCA1E3617D47DD](https://journals.co.za/docserver/fulltext/sabr/19/3/sabr_v19_n3_a1.pdf?expires=1561562139&id=id&accname=guest&checksum=C1A127268AB35CA31DCA1E3617D47DD) accessed on 16 August 2018.

<sup>110</sup> Klopper (see note 73 above; 362).

<sup>111</sup> Conradie (see note 109above; 16).

<sup>112</sup> Firstly the court needs to be satisfied that “the company is, or is likely to become, unable to pay its debts.”<sup>113</sup> Secondly the court has to consider whether the granting of the order would likely achieve one of the intended objectives of administration proceedings.<sup>114</sup>

### 2.4.3 Australia

The primary objective of the Australian corporate rescue regime is to increase the company’s chances of survival as much as possible and if that is not possible the secondary object is to ensure that the creditors and shareholders of the company obtain a better return than they would have received as a result of an immediate liquidation.<sup>115</sup> The board of directors, a secured creditor or a liquidator can initiate the procedure by appointing an administrator in writing, provided that they are of the opinion that “the company is insolvent or is about to become insolvent”.<sup>116</sup>

Once the company effectively enters into voluntary administration, it enjoys a “moratorium” which protects the company from the enforcement of actions or claims sought against it by creditors.<sup>117</sup> The purpose of a moratorium period is to afford the administrator time to acquaint himself with the affairs of the company and set up the required meetings with the company’s creditors, while also determining whether the company can be saved.<sup>118</sup> The administrator may decide that the company may be saved or commence liquidation proceedings.<sup>119</sup>

## 2.5 Business Rescue in terms of the Companies Act 71 of 2008

### 2.5.1 Background

The Companies Act 71 of 2008<sup>120</sup> came into operation on 1 May 2011. An important concept of the Act was the introduction of a new “corporate rescue regime” for

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<sup>112</sup> Kloppers (see note 73 above; 363).

<sup>113</sup> Ibid.

<sup>114</sup> Kloppers (see note 73 above;363)

<sup>115</sup> Anderson “Viewing the proposed South African Business Rescue Provisions from an Australian Perspective” (2008) PER Vol.11 No 2, at 102 available at [https://www.heinonline.org/HOL/Page?handle=hein.journals/per2008&div=3&start\\_page=1&collection=journals&set\\_as\\_cursor=0&men\\_tab=srchresults](https://www.heinonline.org/HOL/Page?handle=hein.journals/per2008&div=3&start_page=1&collection=journals&set_as_cursor=0&men_tab=srchresults) accessed 2 October 2018

<sup>116</sup> Anderson (see note 116; 112 & Kloppers (see note 73; 359 & Rajak (see note 9; 276).

<sup>117</sup> S Fridman “Voluntary Administration: Use and Abuse, Bond Law Review” (2003) volume 15, at 336.

<sup>118</sup> Ibid.

<sup>119</sup> Ibid.

<sup>120</sup> Act 71 of 2008.

financially distressed companies. The Chapter 6 business rescue provisions are intended to bring South African company law “in line with international best trends.”<sup>121</sup>

The provisions of the Companies Act unlike the judicial management “creditor – friendly approach” appears to be debtor friendly and primarily focuses on ensuring that the business is rescued.<sup>122</sup> The change in emphasis from a creditor-friendly approach to a debtor friendly approach is evidenced by section 7(k) of the Act which provides that one of the main objectives of the Act is: <sup>123</sup>

*“To provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.”*

Section 7(k) of the Act, reiterates the objectives set out by the Department of Trade and Industry in the 2004 policy paper, which emphasised an intention “to create a system of corporate rescue appropriate to the needs of the current South African economy.”<sup>124</sup> The new business rescue regime is more accessible and aims to better balance all the interests of the relevant stakeholders than was previously the case under judicial management.<sup>125</sup> The business rescue provisions in Chapter 6 of the Act were inspired and imported from several provisions of the Chapter 11 of the US Bankruptcy Code and from the Kingdom Enterprise Act of 2002.<sup>126</sup>

### 2.5.2 The meaning of Business Rescue

The business rescue process is defined in s128 (1) of the Act:

*(b) “means proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for-*

*(i) the temporary supervision of the company, and of the management of its affairs, business and property;*

*(ii) a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and*

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<sup>121</sup> Seligson (see note 59 above; 3) & Veldhuizen (see note 58; 25) & Bradstreet (see note 96; 196).

<sup>122</sup> Bradstreet (see note 96; 198).

<sup>123</sup> Section 7(k) of the Companies Act 71 of 2008.

<sup>124</sup> GN 1183 of GG 26493, 23/06/2004.

<sup>125</sup> Bradstreet (see note 96 above; 198)

<sup>126</sup> Cassim (see note 10; 864).

*(iii) the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company."*

Business rescue is a corporate rescue regime which is predominately managed and controlled by the company itself under the supervision of an independent business rescue practitioner, which also allows the relevant stakeholders to make an application for the court to intervene.<sup>127</sup> This is a significant feature of business rescue that distinguishes it from judicial management.<sup>128</sup> Business rescue also intended to significantly save costs, which makes it a more feasible and attractive alternative to liquidation.<sup>129</sup>

It is important to take cognisance of the fact that preventing liquidation is not necessarily the main objective of business rescue but the regime seeks in the alternative to provide creditors with better returns than would have resulted if the company was immediately liquidated.<sup>130</sup> Although one of the objectives of business rescue is to restore the company to solvency, this is not the sole objective unlike judicial management.<sup>131</sup> Therefore the general consensus is that the two alternative objectives of business rescue are to firstly "facilitate the rescue and rehabilitation of a company in financial difficulty and alternatively if this cannot be achieved, to facilitate a better return for the creditors than would have resulted from liquidation proceedings." The secondary objective imposes a less onerous duty on the business rescue practitioner than the primary object of saving the company as a going concern.<sup>132</sup>

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<sup>127</sup> Merchant west Capital Solutions (Pty) v Advance Technologies & Engineering Company (Pty) Ltd & Another 2013 ZAGPHC 109 at para 3.

<sup>128</sup> Merchant West at para 3.

<sup>129</sup> Merchant West at para 3.

<sup>130</sup> Burdette (see note 46; 247) & Southern Place Investments v Midnight Storm Investments & Oakdene Square Properties and Others v Farm Bothasfontein & Merchant West.

<sup>131</sup> Merchant West at para 4.

<sup>132</sup> Cassim (see note 10 above; 864).



### 2.5.3 Commencement of Business Rescue

Chapter 6 of the Act provides for two courses of action for the commencement of the business rescue proceedings, namely by a voluntary resolution adopted by the board of directors,<sup>133</sup> alternatively an “affected person” may make an application to court for an order permitting the company to be placed under supervision and commence with business rescue proceedings.<sup>134</sup>

#### 2.5.3.1 Commencement by voluntary board resolution

If the board of directors have “reasonable grounds to believe that the company is financially distressed” and there is a “reasonable prospect of rescuing the company” the board of directors may pass a resolution by majority vote that the company voluntarily begin business rescue proceedings and place the company under supervision, provided that the board has reasonable grounds to believe that the company is financially distressed and there appears to be a reasonable prospect of rescuing the company.<sup>135</sup>

In order to be ‘financially distressed’ at any particular time, it must appear to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months (commercial insolvency), or appear to be reasonably likely that the company will become insolvent within the immediately ensuing six months (factual insolvency).<sup>136</sup> However such resolution may not be adopted if liquidation proceedings have been initiated by or against the company.<sup>137</sup>

The first test involves cash-flow insolvency, on the basis of the company being unable to pay its debts as they fall due.<sup>138</sup> The second test is a balance sheet test, on the basis that the value of the assets of the company is less than the amount of its liabilities at any time.<sup>139</sup>

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<sup>133</sup> Section 129(1), Act 71 of 2008.

<sup>134</sup> Section 131(1), Act 71 of 2008.

<sup>135</sup> S129 (1), Act 71 of 2008.

<sup>136</sup> S128 (1) (f), Act 71 of 2008.

<sup>137</sup> S129 (2), Act 71 of 2008.

<sup>138</sup> Rushworth (see note 34; 377)

<sup>139</sup> Ibid.

According to Cassim,<sup>140</sup> this route was designed in order to encourage the directors of a financially distressed company to seek help at an early stage instead of waiting until it is too late. The sooner a company receives assistance in the form of business rescue proceedings, the better the chances the company will have of being rescued.<sup>141</sup>

### 2.5.3.2 Commencement by Court order

In the absence of a director's resolution in terms of section 129, to commence such proceedings, an affected party may apply to a court with jurisdiction for an order initiating business rescue proceedings and the placement of an entity under supervision.<sup>142</sup> An affected party is defined as either a shareholder or creditor of the entity, registered trade union acting on behalf of the employees and if any of the employees of the company are not represented by a registered trade union, each of those employees or their respective representatives qualify as affected persons.<sup>143</sup>

A copy of the above application must be served upon the entity itself, commission and any other party affected by such proceedings.<sup>144</sup> Every affected party has a right to participate by making submissions at the hearing of such an application.<sup>145</sup> In order for the court to grant an order commencing business rescue proceedings, the court must be satisfied that:<sup>146</sup>

- (i) *"The company is financially distressed;*
- (ii) *the company has failed to pay over any amount in terms of an obligation under or in terms of a public regulation, or contract, with respect to employment-related matters; or*
- (iii) *It is otherwise just and equitable to do so for financial reasons, and there is a reasonable prospect for rescuing the company."*

When an application is made to court, the grounds considered are much more extensive than a mere outlook on the liquidity and asset register against the liabilities

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<sup>140</sup> Cassim (see note 10; 866).

<sup>141</sup> P Delport & Q Vorster Henochsberg on the Companies Act 71 of 2008 Lexis Nexis available at <https://www.mylexisnexis.co.za/Index.aspx> accessed on 7 June 2018

<sup>142</sup> Section 131(1), Act 71 of 2008.

<sup>143</sup> Section 128(1) (a), Act 71 of 2008.

<sup>144</sup> Section 131(2), Act 71 of 2008.

<sup>145</sup> Section (3), Act 71 of 2008.

<sup>146</sup> Section (4) (a), Act 71 of 2008.

of the entity.<sup>147</sup> A much more holistic approach is adopted by the court.<sup>148</sup> If the court makes an order initiating business rescue proceedings, the court itself may appoint an interim business rescue practitioner suggested by the affected person making the application.<sup>149</sup> In the event that liquidation proceedings have already been started by the time the application for business rescue is brought, the business rescue application suspends liquidation proceedings pending the outcome of the application.<sup>150</sup>

#### 2.5.4 Legal Consequences of Business Rescue Proceedings

When business rescue proceedings commence, the affairs of the entity fall under the supervision and control of a business rescue practitioner. The business rescue practitioner essentially assumes all decision-making power.<sup>151</sup> The second major legal consequence which flows from the commencement of business rescue proceedings is the moratorium on legal proceedings envisaged in s133 of the Companies Act.<sup>152</sup> These consequences occur irrespective of how the business rescue procedure may have commenced.

##### 2.5.4.1 Moratorium on legal proceedings against the company

The commencement of business rescue proceedings result in a general *moratorium* on all legal proceedings against the company. Section 133(1) of the Act provides as follows:

- (1) “ *During business rescue proceedings, no legal proceedings including enforcement action, against the company, or in relation to any property belonging to the company, or lawfully in its possession may be commenced or proceeded within any forum except-*
  - (a) *with the written consent of the practitioner;*
  - (b) *with the leave of the court and in accordance with any terms of the court considers suitable*
  - (c) *as a set-off against any claim made by the company in any legal proceedings, irrespective of whether those proceedings commenced before or after the business rescue proceedings began*
  - (d) *criminal proceedings against the company or any of its directors or officers*

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<sup>147</sup> Rushworth (see note 34; 381).

<sup>148</sup> Section 131(4) (b), Act 71 of 2008.

<sup>149</sup> Section 131(5), Act 71 of 2008.

<sup>150</sup> Section 131(6), Act 71 of 2008.

<sup>151</sup> Section 131, Act 71 of 2008.

<sup>152</sup> Section 133, Act 71 of 2008.

- (e) *proceedings concerning any property or right over which the company exercises the powers of a trustee or*
- (f) *proceedings by a regulatory authority in the execution of its duties after written notification to the business rescue practitioner.”*

The moratorium also known as an automatic stay has been described as one of the main characteristics of a business rescue model.<sup>153</sup> Most jurisdictions seem to provide for a moratorium particularly in the United States and Australia as discussed above. Although the scope of the stay and the length of the time for which it operates will be different from jurisdiction to jurisdiction.<sup>154</sup>

The moratorium gives the business practitioner breathing space to formulate and implement the business rescue plan without having to concentrate on litigation and the funding thereof.<sup>155</sup> The moratorium arises by virtue of the commencement of the business rescue proceedings and operates throughout its course.<sup>156</sup> The moratorium freezes the existing rights acquired by the company’s creditors in that the creditors may not enforce their rights without the written consent of the business rescue practitioner in certain circumstances.<sup>157</sup>

This protection is important for the company as it prevents a flood of potential creditors instituting legal action to deplete what little is left of the company’s resources and prevents the distraction of the business management team from the rescue at hand.<sup>158</sup> This suspension of legal proceedings against the company generally applies to all the company’s creditors.<sup>159</sup> The *moratorium* is effective until the business rescue process ends.<sup>160</sup>

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<sup>153</sup> Burdette DA (see note 39 above)

<sup>154</sup> *ibid*

<sup>155</sup> Veldhuizen (see note 58; 28)

<sup>156</sup> P Osode “Judicial Implementation of South Africa’s New Business Rescue Model: A Preliminary Assessment” (2015) Penn State Journal of Law and International Affairs at 462 VOL. 4 No. 1 available at <https://elibrary.law.psu.edu/cgi/viewcontent.cgi?article=1121&context=jliap462> accessed on 7 June 2018

<sup>157</sup> *ibid*

<sup>158</sup> Bradstreet ( see note 96; 372)

<sup>159</sup> Cassim (see note 10; 878).

<sup>160</sup> *Ibid.*

#### 2.5.4.2 Protection of property interests

According to the Act, during business rescue proceedings, subject to certain exceptions, an entity may only dispose or agree to dispose of its movable or immovable property only in the ordinary course and scope of its business. The transaction must further be for fair market value and with the written approval of the business rescue practitioner.<sup>161</sup> This is how the Act ensures that the rights of creditors as well as the interests of shareholders are protected.

Third parties who are in lawful possession of any property owned by the company due to an agreement made in the normal course and scope of the business before commencement of business rescue proceedings can continue to enjoy any rights and responsibilities in respect of that property as outlined in that agreement.<sup>162</sup> In addition the provisions of the Act contain restrictions against actions by third parties, no person may enjoy any right or responsibility in respect property in the lawful possession of the entity during the business rescue proceedings, irrespective of whether the property is owned by the entity in the absence of written consent by the practitioner.<sup>163</sup>

If the business rescue practitioner wishes to dispose of the entity's property in which a third party holds an interest in the form of security or title, the practitioner must obtain that third party's consent unless the disposal of such property would render the entity able to discharge its indebtedness towards the third party fully.<sup>164</sup> Upon disposal of the property, the company must immediately pay the third party the proceeds or provide security in lieu thereof and to the satisfaction of that person.<sup>165</sup>

#### 2.5.5 Effects of Business Rescue on security holders

Section 137 of the Act provides that during business rescue proceedings any "classification or status of any issued securities" will only be altered if the securities

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<sup>161</sup> Section 134(1) (a), Act 71 of 2008.

<sup>162</sup> Section 134(1) (b), Act 71 of 2008.

<sup>163</sup> Section 137(1), Act 71 of 2008.

<sup>164</sup> Section 134(3) (a), Act 71 of 2008.

<sup>165</sup> Section 134(3) (b), Act 71 of 2008.

are transferred in the “ordinary course of business” except if the court directs otherwise or an accepted business rescue plan states otherwise.<sup>166</sup>

### 2.5.6 The Business Rescue Plan

One of the most important components of the business rescue process, is the “development, approval, and implementation of a competent rescue plan.”<sup>167</sup> The rescue plan includes a detailed strategy of how the company will be rehabilitated and helps the practitioner develop and facilitate the reorganisation process.<sup>168</sup> The practitioner is required to consult all the “affected persons” and thereafter formulate a business rescue plan that will be considered for adoption in the next meeting of creditors.<sup>169</sup> The Act requires the plan to include all the information reasonably necessary to enable the “affected persons” to make a decision on whether or not to accept or reject the plan.<sup>170</sup> After the business rescue plan has been published, the practitioner must preside over a meeting between the creditors and other holders of voting interest within 10 days of such publication.<sup>171</sup>

The business rescue plan can only be approved if the plan was endorsed by creditors who hold more than seventy five percent of the creditors voting interest that voted and the votes in favour of the plan must compromise at least fifty percent of the independent creditors, in the event that they voted.<sup>172</sup> Where a plan is not approved in the first instance, it is regarded as “rejected” but may still be considered further only in terms of the Act.<sup>173</sup> If the business rescue plan is adopted, the company, the company’s creditors and security holders are all bound by it.<sup>174</sup> The company will thereafter under the guidance and direction of the business rescue practitioner take the required action to satisfy all the conditions to the plan and implement the plan.<sup>175</sup>

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<sup>166</sup> Section 137(1), Act 71 of 2008.

<sup>167</sup> Osode (see note 157; above; 465).

<sup>168</sup> Pretorius (see note 8 above; 128).

<sup>169</sup> Section 150(1), Act 71 of 2008.

<sup>170</sup> Section 150 (2), Act 71 of 2008.

<sup>171</sup> Section 151(1), Act 71 of 2008.

<sup>172</sup> Section 152(2) (a), Act 71 of 2008.

<sup>173</sup> Section 152(3) (a), Act 71 of 2008.

<sup>174</sup> Section 152(4) (a), Act 71 of 2008.

<sup>175</sup> Section 152(5), Act 71 of 2008.

### 2.5.7 Post-commencement finance

Any attempt to rescue a business in financial distress will in all likelihood require finance to effect the rescue.<sup>176</sup> The business has to carry on as a going concern and therefore funds will be required for certain operating expenses such as rent, labour cost, insurance, goods and services from suppliers and other operating expenses.<sup>177</sup> Securing finance during the business rescue proceedings helps ensure that while the business rescue plan is still being developed, the company continues to operate on a “satisfactory basis”<sup>178</sup> The accessibility of such finance is also important for the approval of a business rescue plan.<sup>179</sup>

However it can be very difficult for a company under business rescue proceedings to obtain this new finance, given the risk of the rescue attempt failing.<sup>180</sup> The mere commencement of business rescue proceedings will affect the creditworthiness of the company.<sup>181</sup> As a result, very few creditors would be keen to lend money to an entity that is already subject to business rescue proceedings, on the basis that they might not get a return on their investments.<sup>182</sup>

The legislature, in drafting the business rescue provisions recognized that companies in business rescue would be burdened with the task of having to obtain financing on account of their financial distress and therefore included section 135.<sup>183</sup> In order to persuade possible lenders to finance the business rescue proceedings, s135 of the Act, provides for “preferential repayment” of money regarded as “post-commencement finance” as its main incentive and allows the company to use its assets as security for such loans to the extent that it is not otherwise encumbered.<sup>184</sup>

Post-commencement finance can be defined as the “funding which is made available to the financially distressed company after the commencement of the business rescue proceedings, in order to enable the company to continue trading.”<sup>185</sup> Without

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<sup>176</sup> Bradstreet (see note 69).

<sup>177</sup> Calitz (see note 32; 270).

<sup>178</sup> Rushworth (see note 35; 385).

<sup>179</sup> Calitz (see note 32; 269).

<sup>180</sup> Bradstreet p359 (see note 96; 359) & Calitz (see note 32; 270).

<sup>181</sup> Burdette (see note 39; 422).

<sup>182</sup> Burdette (see note 39; 423).

<sup>183</sup> “Business Rescue Exchange ‘Post commencement finance’ available at <https://www.brexchange.co.za/post-commencement-finance-2/> accessed 28 September 2018

<sup>184</sup> Bradstreet (see note 96; 359).

<sup>185</sup> Delport & Vorster (see note 142).

PCF, the business maybe unable to continue to operate and accordingly the business cannot be rescued.<sup>186</sup>

Section 364 of the US Bankruptcy Code gives recognition to the importance of post-commencement finance by providing that “any credit extended to the company during the reorganization or rescue process enjoys priority over unsecured claims incurred before the rescue process.”<sup>187</sup> This acts as an incentive intended to induce post-commencement financiers by affording the payment of their claims preference or super-priority.<sup>188</sup>

Cassim argues that the justification for this approach is that:<sup>189</sup>

*“Pre-commencement unsecured creditors must submit to the preferential treatment of post-commencement creditors in order to facilitate the raising of finance for the company in the hope of full repayment of their claims in the event of a successful business rescue.”*

The Act follows the example of Chapter 11 of the US Bankruptcy code by creating a statutory framework for super-priority post commencement financing. However it remains an important objective that the pre-existing rights and priorities of creditors are protected insofar as it is reasonably practicable.<sup>190</sup> A careful balance must be drawn.<sup>191</sup> Existing secured creditors must be protected.<sup>192</sup>

The nature and extent of post-commencement is regulated by s135, which provides as follows:

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

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

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<sup>186</sup> K Da Costa “Post Commencement Finance: Jumping the ranking queue’ A Critical analysis of Merchant Wets Working Capital Solutions v Advanced Technologies and Engineering Company Ltd and the order of preference in Business Rescue” ( unpublished LLM thesis, University of Johannesburg, 2014) 9.

<sup>187</sup> 465 US 513 (1983) 528 cited in Cassim (See note 10; 882).

<sup>188</sup> Cassim (see note 10; 883).

<sup>189</sup> Ibid.

<sup>190</sup> Ibid.

<sup>191</sup> Ibid.

<sup>192</sup> Ibid.



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

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

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

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

The provision specifies two categories of creditors that are regarded as post-commencement finance. Section 135(1) describes remuneration, reimbursement for expenses or any other amount relating to employment which becomes due and enforceable by the company to an employee during the company's business rescue proceedings, as post-commencement finance.<sup>193</sup> Secondly, s135 (2) allows a company to obtain finance which is unrelated to employment and also allows the company to use any of its assets as a means of securing loans following the commencement of business rescue proceedings to the extent that it is not otherwise encumbered.<sup>194</sup> What this essentially means is that although the company is permitted to give security to new lenders for the purpose of obtaining post-commencement finance, this is only permitted with assets that are not already encumbered.<sup>195</sup>

There is a lot of uncertainty and ambiguity in our law regarding how PCF should be applied, and once granted how it affects the ranking of creditors who were secured prior to the commencement of business rescue.<sup>196</sup> It is not clear from the Act whether post-commencement financiers will also rank ahead of secured pre-commencement creditors. The legislature dealt extensively with the position of unsecured creditors but failed to deal with the position of secured pre-commencement creditors. Section 135(3) (a) (ii) merely states that "post-commencement financiers will rank ahead of the claims of all unsecured creditors".

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<sup>193</sup> Section 135(1), Act 71 of 2008.

<sup>194</sup> Section 135(2), Act 71 of 2008.

<sup>195</sup> Delport & Vorster (see note 142).

<sup>196</sup> Jones & Wellcome (see note 30 above).

### 3. Ranking of Creditors' Claims in Business Rescue

#### 3.1 Ranking of Creditors in terms of the Act

The ranking of creditors' claims in terms of business rescue proceedings is regulated by Section 135 (3) of the Companies Act, which provides as follows:<sup>197</sup>

*(3) "After payment of the practitioner's remuneration and expenses referred to in section 134, and other claims arising out of the costs of the business rescue proceedings, all claims contemplated-*

- (a) all claims contemplated in subsection(1) will be treated equally, but will have preference over-*
  - (i) all claims contemplated in subsection (2), irrespective of whether or not they are secured; and*
  - (ii) all unsecured claims against the company; or*
- (b) in subsection (2) will have preference in the order in which they were incurred over all unsecured claims against the company."*

In terms of the Act, the first claim that to be paid out is the remuneration of the business rescue practitioner, expenses and other cost of the business rescue proceedings.<sup>198</sup> This is important because the success of the proceedings is also dependent on the ability to secure a competent and skilled business rescue practitioner, and it would be difficult to secure such a person without a guarantee of payment.<sup>199</sup> Although the phrase and "other claims" is not defined in the Act, it is submitted that these expenses will include all the costs that were incurred in order to facilitate the continuation of the business while undergoing the business rescue process, this includes the costs of bringing an application in terms of s131 of the Act.<sup>200</sup> The claims of "pre-commencement employees" are separately dealt with in terms of section of 136.<sup>201</sup>

Employee's claims are ranked in second place and are paid after the business rescue practitioner's remuneration and expenses have been paid out.<sup>202</sup> This is in line with the Act's general approach to balance the rights of all relevant stakeholders.<sup>203</sup> The provisions of section 135) include wages, reimbursement for

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<sup>197</sup> Section 135(3), Act 71 of 2008.

<sup>198</sup> S131 (3), Act 71 of 2008.

<sup>199</sup> H Stoop & Hutchison "Post-Commencement Finance- Domiciled Resident or Uneasy Foreign Transplant?" PER/PELJ 2017 (20) at 17.

<sup>200</sup> Delpont & Vorster (see note 142).

<sup>201</sup> Section 136, Act 71 of 2008.

<sup>202</sup> Ibid.

<sup>203</sup> Stoop & Hutchison (see note 200 above).

expenses, and contributions by the employer to the employee's pension funds.<sup>204</sup> It is important to note that this priority applies only to employment costs incurred during business rescue proceedings.<sup>205</sup>

Claims by lenders of post-commencement finance obtained by the company are paid after the business rescue practitioner's remuneration and expenses, and the claims by employees. These claims qualify for preferential payment in the order in which they were incurred, however all such claims will have preference over the unsecured claims of the company.<sup>206</sup> If the business rescue proceedings are superseded by liquidation proceedings, the order of preference created in terms of 135(3) will remain in force and will only be subordinate to the cost of liquidation arising out of the liquidation proceedings.<sup>207</sup>

However s135 (3) (b) fails to state whether the claims of secured post-commencement financiers will be given priority over the claims of unsecured post-commencement financiers, it only provides that post-commencement financiers will have preference "in the order in which they were incurred over all unsecured claim".<sup>208</sup> Therefore issues with ranking of creditors, arises from the uncertainty regarding the priority ranking of post-commencement finance and how this affects "secured pre-commencement creditors".

In October 2011, Stein<sup>209</sup> published the first interpretation of the ranking of creditors' claims under business rescue. The author stated that the creditors' claims will rank in the following order of preference:<sup>210</sup>

1. *"the practitioner for remuneration and expenses, and other persons (including legal and other professionals) for costs of the business rescue proceedings;*

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<sup>204</sup> Ibid.

<sup>205</sup> Ibid.

<sup>206</sup> Delport & Vorster (see note 142 above).

<sup>207</sup> Ibid.

<sup>208</sup> L Becker & E Levenstein "In Business Rescue, Where do you Rank?"(2013) available at <https://www.werksmans.com/legal-briefs-view/in-business-rescue-where-do-you-rank/> accessed on 15 August 2018.

<sup>209</sup> Stein & Everingham "The New Companies Act Unlocked: A Practical Guide (Cape Town)" (2011) cited in Prins "Priority issues in business rescue" (unpublished LLM thesis, University of Cape Town, 2015).

<sup>210</sup> Ibid.

2. employees for any remuneration which became due and payable after business rescue proceedings began;
3. secured lenders or other creditors for any loan or supply made after business rescue proceedings began (ie, post-commencement finance)
4. unsecured lenders or other creditors for any loan or supply made after business rescue proceedings began (ie, post-commencement finance);
5. secured lenders or other creditors for any loan or supply made before business rescue proceedings began;
6. employees for any remuneration which became due and payable before business rescue proceedings began; and
7. unsecured lenders or other creditors for any loan or supply made before business rescue proceedings began.”

The ranking as explained by Stein, indicates that both the claims of secured and unsecured post-commencement financiers will rank ahead of the claims of secured pre-commencement creditors.

Recent reported judgment attempt to clarify the ranking of creditors during business rescue; see *Merchant West Working Capital Solutions v Advanced Technologies and Engineering Company Ltd and Another*<sup>211</sup>, and *Redpath Mining South Africa (Pty) Ltd v Marsden No and Others*<sup>212</sup>, handed down by Kgomo J. These judgements will be critically analysed below.

### 3.2 Merchant West Working Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company Ltd and Another and Redpath Mining South Africa (Pty) Ltd v Marsden No and Others

Since the coming into force of the Companies Act 2008, there have been various judgments delivered by the High Court’s dealing with the provisions of business rescue as well as related matters.<sup>213</sup> These judgments have been significant and informative tools in the application of the business rescue provisions.<sup>214</sup>

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<sup>211</sup> Merchant west Capital Solutions (Pty) v Advance Technologies & Engineering Company (Pty) Ltd & Another 2013 ZAGPHC 109

<sup>212</sup> Redpath Mining South Africa (Pty) Ltd v Marsden NO 2013 JDR 1410 (GSJ).

<sup>213</sup> L Barnett & E Levenstein “Where you stand in the business rescue queue, Without Prejudice” (2013) available at [https://journals.co.za/docserver/fulltext/jb\\_prej/13/5/jb\\_prej\\_v13\\_n5\\_a5.pdf?expires=1542790592&id=id&acname=57926&checksum=60D1F19D33E39BBBC27EDB97C95912FF](https://journals.co.za/docserver/fulltext/jb_prej/13/5/jb_prej_v13_n5_a5.pdf?expires=1542790592&id=id&acname=57926&checksum=60D1F19D33E39BBBC27EDB97C95912FF) accessed on 21 November 2018.

<sup>214</sup> Ibid.

One such judgment, is that delivered by Kgomo J in *Merchant West Working Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company (Pty) Ltd*.<sup>215</sup> Whilst the judgment highlights and restates a number of seminal principles related to business rescue,<sup>216</sup> it is also the first judgment to deal with the ranking of creditors' claim in business rescue.

The judgment by Kgomo J, sets out the order of preference in which the claims of creditors will rank during business rescue proceedings.<sup>217</sup> The order was subsequently affirmed by Kgomo J in *Redpath Mining South Africa (Pty) Ltd v Marsden N.O & Others*<sup>218</sup>, when he repeated verbatim the ranking of creditors set out in the Merchant West case. These judgments will be discussed below.

### 3.2.1 Merchant West Capital Solutions (Pty) Ltd v Advance Technologies & Engineering Company (Pty) Ltd & Another

On the 10<sup>th</sup> of April 2013, the applicant (Merchant West Working Capital Solutions (Pty) Ltd) launched an urgent application while the respondent Advanced Technologies and Engineering Company was undergoing business rescue proceedings.<sup>219</sup> The application was for the attachment of a helicopter which formed part of Merchant's West security arising from the agreement of cession and pledge between the parties.<sup>220</sup> When the helicopter was not delivered, Merchant West sought an order removing it from the respondent's premises and having it delivered to its own premises or any other third party.<sup>221</sup> After two attempts by the board of directors to have the company placed under business rescue proceedings in terms of s129 (1) of the Act had failed due to non-compliance, the respondent was finally placed under business rescue when two of the company's creditors brought an

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<sup>215</sup> Merchant west Capital Solutions (Pty) v Advance Technologies & Engineering Company (Pty) Ltd & Another 2013 ZAGPHC 109

<sup>216</sup> Barnett & Levenstein (see note 214 above).

<sup>217</sup> Barnett & Levenstein (See note 214 above).

<sup>218</sup> Redpath Mining South Africa (Pty) Ltd v Marsden NO 2013 JDR 1410 (GSJ).

<sup>219</sup> Merchant West at para 24

<sup>220</sup> Merchant West para 24.

<sup>221</sup> Merchant west Capital Solutions (Pty) v Advance Technologies & Engineering Company (Pty) Ltd & Another 2013 ZAGPHC 109 at para 31.

application for the respondent to be placed under business rescue.<sup>222</sup> This application resulted in the company being placed under business rescue in terms of section 131 of the Act.<sup>223</sup> In the business rescue plan, the business rescue practitioner had acknowledged that the applicant's claim was being regarded as "an excluded claim" and that the applicant had a secured claim against the company.<sup>224</sup> The court defined "secured creditors" as follows:

*"All legal entities, including natural persons, having secured claims against ATE as at the commencement date as envisaged in terms of Insolvency Law."*

It was common cause that Advanced Technologies was indebted to Merchant West. Both Merchant West and Advanced Technologies were financial service providers and in the normal course of business they entered into several agreements with each other.<sup>225</sup> Relevant to the present matter was the "cession and pledge agreement". The cession and pledge agreement was the material issue in dispute.<sup>226</sup> In terms of this agreement the first respondent (Advanced Technologies) had "pledged ceded, assigned, transferred and delivered the rights, title and interest to the applicant (Merchant West) as security for the due and punctual performance of the indebtedness."<sup>227</sup> The security in question was the helicopter.<sup>228</sup>

Although the main issue that the court had to decide was whether or not the applicant was allowed to institute or launch the application when a moratorium in terms of the law and rules relating to business rescue was in place,<sup>229</sup> the court also had the opportunity to consider the ranking of creditors' claims under section 135 of the Act. Kgomo J stated in unequivocal terms that ranking of creditors' during business rescue should be as follows: <sup>230</sup>

1. *"The practitioner, for remuneration and expenses, and other persons (including legal and other professionals) for costs of business rescue proceedings."*

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<sup>222</sup> Merchant West at para 44.

<sup>223</sup> Merchant West at para 44.

<sup>224</sup> Merchant West at para 45.

<sup>225</sup> Merchant West at para 47.

<sup>226</sup> Merchant West at para 47.

<sup>227</sup> Merchant West at para 47.

<sup>228</sup> Merchant West at para 48.

<sup>229</sup> Merchant West at para 52.

<sup>230</sup> Merchant West at para 21.

2. *Employees for any remuneration which became due and payable after business rescue proceedings began.*
3. *Secured lenders or other creditors for any loan or supply made after business rescue proceedings began, i.e. post-commencement finance.*
4. *Unsecured lenders or other creditors for any loan or supply made after business rescue proceedings began, i.e. post-commencement finance.*
5. *Secured lenders or other creditors for any loan or supply made before business rescue proceedings began.*
6. *Employees for any remuneration which became due and payable before business rescue proceedings began*
7. *Unsecured lenders or other creditors for any loan or supply made before business rescue proceedings began.”*

Prins<sup>231</sup> points out that Kgomo J’s ranking specifically refers to Stein’s interpretation of creditors ranking and is a “verbatim copy” of the ranking suggested by Stein.

The ranking of the claims of creditors during business rescue proceedings has been a complex and highly debated issue, despite the matters not being directly relevant to the issue before the court, however the consideration and deliberation by the court are an important addition to the “development of the jurisprudence on the topic of the ranking of claims.”<sup>232</sup>

### 3.2.2 Redpath Mining South Africa (Pty) Ltd v Marsden NO<sup>233</sup>

Kgomo J, had another opportunity to consider the ranking of claims in business rescue and reaffirmed the ranking determined in Merchant West.

The applicant (Redpath Mining) launched an urgent application to set aside a business rescue plan.<sup>234</sup> The applicant alleged that the business rescue plan deprived it of its security and diminished its security by requiring the applicant to forego 15% of its secured claim in favour of other creditors (post-commencement financiers), arguing that such deprivation of security is not sanctioned by Chapter 6

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<sup>231</sup> D Prins “Priority Issues in Business Rescue” (unpublished LLM thesis, University of Cape Town, 2015) at 8

<sup>232</sup> Barnett & Levenstein (see note 214).

<sup>233</sup> Redpath Mining South Africa (Pty) Ltd v Marsden NO 2013 JDR 1410 (GSI).

<sup>234</sup> Redpath at para

of the Companies Act.<sup>235</sup> The applicant further argued that this deprivation of security would be unconstitutional and would amount to arbitrary deprivation of its rights to property.<sup>236</sup>

It was submitted by the applicant that the Companies Act does not authorise the business rescue practitioner, in proposing a plan, to interfere with the applicant's security without the latter's consents.<sup>237</sup> It was further submitted by the applicant that to the contrary, Chapter 6 of the Act specifically recognizes and protects the applicant's right as a secured creditor and that the implementation of the business rescue plan as it was will unlawfully deprive it of its security.<sup>238</sup>

Kgomo J reaffirmed his previous dicta by re-stating verbatim that the claims of creditors during business rescue should rank in the following order of preference:<sup>239</sup>

1. *"The practitioner, for remuneration and expenses, and other persons (including legal and other professionals) for costs of business rescue proceedings.*
2. *Employees for any remuneration which became due and payable after business rescue proceedings began.*
3. *Secured lenders or other creditors for any loan or supply made after business rescue proceedings began, i.e. post-commencement finance.*
4. *Unsecured lenders or other creditors for any loan or supply made after business rescue proceedings began, i.e. post-commencement finance.*
5. *Secured lenders or other creditors for any loan or supply made before business rescue proceedings began.*
6. *Employees for any remuneration which became due and payable before business rescue proceedings began.*
7. *Unsecured lenders or other creditors for any loan or supply made before business rescue proceedings began."*

Kgomo J, referred to the provisions of s134 (3) of the Companies Act, he held that in a business rescue atmosphere secured creditors stand on the same footing during its subsistence as other creditors. The common purpose and desired objective is that

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<sup>235</sup> Redpath at para 24.1.

<sup>236</sup> Redpath at para 24.1.

<sup>237</sup> Redpath at para 25.

<sup>238</sup> Redpath at para 25.

<sup>239</sup> Ibid.



each creditor ultimately gets every cent he/she is owed, unlike in a liquidation or in its predecessor, the judicial management system.<sup>240</sup> Kgomo J, held further that in the event that a rescue plan faces difficulties and it becomes necessary to liquidate the assets, section 134(3) “serves as a safe guard and assurance that the interests of secured creditors especially are protected.”<sup>241</sup>

Kgomo J concluded by stating that that there was nothing unconstitutional about the business rescue plan.<sup>242</sup> He held that the business rescue plan should be implemented immediately so that the financially distressed company can be “healed and rehabilitated for the benefit of all creditors and affected and interested instances.”<sup>243</sup>

There have been debates concerning the ranking of creditors during business rescue proceedings more particularly regarding the position of creditors who were secured prior to the commencement of business rescue.<sup>244</sup> The comments by various academics will be discussed below.

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<sup>240</sup> Redpath supra at para 66.

<sup>241</sup> Redpath supra at para 66.

<sup>242</sup> Redpath supra at para 83.

<sup>243</sup> Redpath supra at para 84.

<sup>244</sup> Calitz (see note 32 above; 271).

#### 4. Critical Comments

Various academics and practitioners have questioned the interpretation of section 135 taken by Kgomo J. The big debate has been centred on the position taken by the judge that pre-commencement secured creditors will rank below post-commencement financiers whether secured or not. It is important to note that in both judgements, the ranking of creditors' claim were not the focal points of the cases. Therefore, it has been correctly pointed out that despite the judgements declaring the ranking of claims of creditors, the focal issues of the cases were not directly linked to the ranking of claims and therefore both these comments should be considered obiter.<sup>245</sup>

The judgements make it clear that pre-commencement secured claims rank after the claims of both secured and unsecured post-commencement financiers. An argument in support of this interpretation is that "if a lender or creditor wants to provide post-commencement finance to a company in business rescue, it would want assurance that it will rank ahead of secured pre-commencement creditors."<sup>246</sup> Therefore, Kgomo J has provided comfort to post-commencement financiers by attempting to settle the much-debated position of the ranking of claims of secured pre-commencement creditors.<sup>247</sup>

However, on the other side of the coin, if effect were given to Kgomo J's ranking, this would mean that if a liquidation were to take place, creditors who were secured prior to the commencement of business rescue would no longer be protected. In that the failure of their claims being satisfied from the security or title interest they hold, would result in them being paid out only after the claims of post-commencement financiers have been settled.<sup>248</sup> Barnett and Levenstein argue that "this would undermine the very reason why lenders take security, to protect them or at the very least to mitigate their exposure from an eventuality such as liquidation."<sup>249</sup> Museta also argues that

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<sup>245</sup> Calitz (see note 32; 271) & Delpont & Vorster (see note 142).

<sup>246</sup> Barnett & Levenstein (see note 214; 11).

<sup>247</sup> Ibid.

<sup>248</sup> Ibid.

<sup>249</sup> Ibid.

this “would dissolve the function that security has in that it confers a right of preference in claims over preferential and concurrent claims.”<sup>250</sup>

The authors of Henochsberg, expressly disagree with Kgomo J’s order of preference by arguing that the ranking determined in both the cases is not in accordance with the provisions of s135 (3) because “the subsection does not refer to ‘secured claims before business rescue began as such creditors are regulated by s134 (3)”.<sup>251</sup> Van der Linde states that:

*“Section 134(3) expressly regulates the rights of secured creditors during business rescue proceedings and makes it clear that if the property is sold, the secured claim must be ‘promptly’ paid from the proceeds or otherwise (alternative) security for its payment must be provided to the satisfaction of the secured creditor. This principle applies for the entire duration of business rescue proceedings. It is obvious that section 135(3), which sets out the ranking of claims, makes no mention of secured pre-commencement claims. In my view this is precisely because these claims are paid separately from the proceeds of the security that no mention is made of them in section 135.”<sup>252</sup>*

Therefore it has been submitted that the order of preference under s135 specifically excludes the position of pre-commencement creditors and that it was not the intention of the legislature to alter the order of preference of the secured lender during business rescue proceedings.<sup>253</sup>

Jones and Wellcome criticise Kgomo J’s ranking, arguing that the justification of this ranking cannot be founded on the wording of s135 and is also not reconcilable with the provisions of s134(3) which provides pre-commencement secured claims with the necessary certainty in respect of their security during business rescue proceedings.<sup>254</sup> Although Kgomo J, made express reference to the provisions of s134 (3) dealing with the protection of secured pre-commencement creditors in the

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<sup>250</sup> GM Museta “The Development of Business Rescue in South African Law” (Thesis SA University of Pretoria, 2011) 41.

<sup>251</sup> Delport & Vorster (see note 142).

<sup>252</sup> Van der Linde “Company and Insolvency Law Update ‘2014 Annual Banking Law Update 15” cited on Calitz (see note 3 above, 272)

<sup>253</sup> Calitz (see note 32; 273).

<sup>254</sup> Jones & Wellcome (see note 30 above).

Redpath case, it has been submitted that the judge failed to notice the prescribed by s134 as to the treatment of secured creditors.<sup>255</sup>

Section 134 (3) specifically gives protection to pre-commencement secured creditors by prescribing requirements for the company undergoing business rescue to abide by, when dealing with such creditors. This would include obtaining the consent of a person with security or title interest over property of the company that is to be sold during business rescue proceedings and then promptly paying the proceeds from that sale to that person.<sup>256</sup> Further protection would also include post-commencement financiers being awarded security over any asset of the company, provided that no other creditor has security over that asset.<sup>257</sup>

Applying this judgement would mean that pre-commencement secured claims rank after the claims of both secured and non-secured post-commencement financiers.<sup>258</sup> It has been argued that an application of Kgomo J's interpretation of s135 would lead to an "absurd result that post-commencement financiers who do not hold security would be paid out first from the proceeds of the security held by pre-business rescue creditors."<sup>259</sup> Prins argues that the order that pre-commencement secured creditors rank after the claims of both secured and unsecured post-commencement financiers causes a conflict with regards to the simultaneous interpretation of sections 134 and 135.<sup>260</sup>

According to s135 (2), during business rescue proceedings, the company may obtain financing and such financing may be secured to the lender by utilizing any asset of the company to the extent that it is not otherwise encumbered.<sup>261</sup> Stoop and Hutchison, submit that "a plausible literal reading of this provision suggest that pre-existing security is not subordinated to new secured lenders."<sup>262</sup> Therefore the new finance may only be secured with existing equity in the company's assets or with

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<sup>255</sup> Ibid.

<sup>256</sup> Section 134(3), Act 71 of 2008.

<sup>257</sup> Section 135(2), Act 71 of 2008.

<sup>258</sup> Jones & Wellcome (see note 30 above) & Prins (see note 241; 9).

<sup>259</sup> Jones & Wellcome (see note 30 above).

<sup>260</sup> Prins (see note 232 above; 9).

<sup>261</sup> Section 135(2), Act 71 of 2008.

<sup>262</sup> Stoop & Hutchison (see note 200; 16).

assets not already subject to a security interest.<sup>263</sup> Stoop and Hutchison suggest that post-commencement secured creditors should rank ahead of unsecured creditors in the order in which such claims are incurred.<sup>264</sup>

Stoop and Hutchison further argue that the judgement does not expressly consider the wording of the provision nor does it consider the impact of the chosen interpretation and does not cite the legislation directly but instead only relies exclusively on a single secondary source.<sup>265</sup> This submission is significant as it illustrates that the ranking of creditors by the judge was obiter dictum. The absence of a discussion of the wording of the relevant provision itself, should indicate that the judge did not apply his mind correctly to the interpretation of s135 neither did the judge take into account the protection afforded (to pre-commencement secured creditors) by s134.

Stoop and Hutchison suggest that although it may be debatable whether secured post-commencement creditors might rank ahead of pre-commencement secured creditors but argue that it is “highly questionable whether the wording of the Act envisages that unsecured post-commencement creditors should do so.”<sup>266</sup> This suggests that, at the very most an argument can be put forward for secured post-commencement financiers to rank ahead of pre-commencement secured creditors, however it seems absurd to argue that the drafters of the Act had intended unsecured post-commencement financiers to outrank pre-commencement secured creditors. At this point, statutory interpretation becomes vital.

In *Natal Joint Municipal Pension Fund v Endumeni Municipality*, Wallis JA held:<sup>267</sup>

*“Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a*

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<sup>263</sup> Stoop & Hutchison (see note 200; 16).

<sup>264</sup> Stoop & Hutchison (see note 200; 16).

<sup>265</sup> Stoop & Hutchison (see note 200; 18).

<sup>266</sup> Ibid.

<sup>267</sup> *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 4 SA 593 (SCA) at para 18 cited in Stoop & Hutchison (see note 200; 19).

*whole and the circumstances attendant upon its coming into existence... The process is objective and not subjective, requiring an investigation into the meaning of the words actually used. A court should also prefer a meaning, which makes business common sense, in line with purposive construction.”*

Subsection 135(3) provides that post-commencement finance will rank above all “unsecured claims against the company”.<sup>268</sup> Stoop and Hutchison argue that by the legislature expressly including “unsecured claims” in the wording of s135 (3), this implies that secured claims are excluded in this instance.<sup>269</sup> They correctly point out that such an interpretation also coincides with section 135(2) which permits the company to dispose of its assets for the purposes of securing post-commencement provided that such assets are “unencumbered”<sup>270</sup> What this provision does is to effectively prevent the company from obtaining post-commencement finance at the expense of “existing secured creditors.” It prevents the company from affording priority to new lenders over existing secured creditors. The interpretation taken by Kgomo J “effectively undermines or renders obsolete the provisions of this subsection 135(2) by negating the rights of the pre-commencement secured almost entirely.”<sup>271</sup> Stoop and Hutchison further argue that such an interpretation will likely not pass constitutional muster as it could be argued that such an interpretation will deprive pre-commencement secured creditors of their property rights in an unconstitutional manner.<sup>272</sup>

Prins, made reference to the constitutional court judgement of *Cool Ideas 1186 CC v Hubbard* and another, where the court confirmed that giving words in a statute their ordinary grammatical meaning is a fundamental tenet of statutory interpretation, unless doing so results in an absurdity.<sup>273</sup> Prins also referred to the case of *Casserly v Stubbs*<sup>274</sup> in which Wessels J stated the following:

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<sup>268</sup> Section 135(3)(b), Act 71 of 2008

<sup>269</sup> Stoop & Hutchison (see note 200; 20).

<sup>270</sup> Stoop & Hutchison (see note 200; 20).

<sup>271</sup> Stoop & Hutchison (see note 200; 20).

<sup>272</sup> Stoop & Hutchison (see note 200; 20).

<sup>273</sup> *Cool Ideas 1186 CC v Hubbard and Another* (2014) ZACC 16 at para 28 cited in Prins (see note 241 above;11)

<sup>274</sup> *Ibid.*

*“It is a well-known canon of construction that we cannot infer that a statute intends to alter the common law. The statute must either explicitly say that it is the intention of the legislature to alter the common law, or the inference from the Ordinance must be such that we can come to no other conclusion than that the legislature did have such an intention.”*

Therefore it can be submitted that if the legislature had intended post-commencement financiers to rank ahead of creditors who were secured prior to commencement, then the legislature would have expressly stated so in s135(3), as it did with unsecured claims. Prins points out that the wording of s135 does not refer to pre-commencement secured creditors and if it was the intention of the legislature to alter the law as far as it relates to the distribution rules in South African insolvency law, then it must explicitly state so. He then referred to Wessels J, who stated that “the inference must be that we can come to no other conclusion that the legislature did have such an intention.”<sup>275</sup>

If we apply the approach taken by Wessel J, then it cannot be reasonably concluded that the legislature intended for pre-commencement secured creditors to rank after post-commencement financiers, because s134(3) already provided for the prescription for the treatment of pre-commencement secured creditors. Prins, also made reference to the 2007 Companies Bill.<sup>276</sup> Chapter 6 business rescue provisions were contained in s130 to 157 of the Bill. Section 138 was the relevant provision dealing with post-commencement finance and read as follows:<sup>277</sup>

(1) *“To the extent that money becomes due and payable by a company to an employee during the company’s business rescue proceedings, but is not paid to the employee –*

*(a) the money is deemed to be post-commencement financing, irrespective whether it has been approved by other creditors; and*

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

(2) *Any amount of financing obtained by the company during its business rescue proceedings, other than as contemplated in subsection (1), will be paid in the order of preference set out in subsection 3(b).*

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<sup>275</sup> Prins (see note 232; 63).

<sup>276</sup> GN 166 in Government Gazette.

<sup>277</sup> Section 138 of the 2007 Companies Bill cited in Prins (see note 232; 27)

(3) *After payment of the supervisor's remuneration and costs referred to in section 146, and other claims arising out of the costs of the business rescue proceedings, all claims contemplated*

*(a) in subsection (1) will have preference in the order in which they were incurred over –*

*(i) all claims contemplated in subsection (2); and*

*(ii) all secured and unsecured claims against the company; or*

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

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

However, by the time the Companies Act had come into effect, the provision had been renumbered to section 135 and significantly amended.<sup>278</sup> Section 135(3)<sup>279</sup> now provided as follows:

*“After payment of the practitioner's remuneration and expenses referred to in section 143, and other claims arising out of the costs of the business rescue proceedings, all claims contemplated –*

*(a) In subsection (1) will be treated equally, but will have preference over –*

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

*(ii) all unsecured claims against the company; or*

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

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

Subsection 3(a) refers to all the employee expenses that are regarded as post commencement finance. The subsection had been substantially amended to include only unsecured claims and reference to ‘secured claims’ in subsection 3(a) (ii) was deleted.<sup>280</sup> Prins argues that this amendment is significant, in that it implies that the

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<sup>278</sup> Prins (see note 232; 28).

<sup>279</sup> Section 135(3) Act 71 of 2008.

<sup>280</sup> Prins( see note 232; 30)



legislature specifically intended to remove secured pre-commencement claims from the operation of the subsection.<sup>281</sup>

Prins argues that s135 should be interpreted to indicate the ranking of priorities in business rescue should be as follows: <sup>282</sup>

1. *“The practitioner’s remuneration and expenses*
2. *Secured pre-commencement claims;*
3. *Deemed employee post-commencement finance, pari passu;*
4. *Secured post-commencement finance;*
5. *Unsecured post-commencement finance in the order in which they were incurred;*
6. *Employee (unsecured) claims for remuneration that arose prior to business rescue proceedings commencing;*
7. *Other unsecured pre-commencement claims.”*

The effect of Prins’ ranking would be that the business rescue practitioner’s rescue would rank in first place. Secured pre-commencement claims would rank below the practitioner’s remuneration but would rank ahead of the employee’s claim (deemed post-commencement finance), “secured post-commencement finance” and “unsecured post-commencement finance” in the order which they were incurred. This would be followed by employee claims for remuneration that arose before business rescue proceedings commenced. Unsecured pre-commencement claims would rank in last place.

Jones and Wellcome also hold that the correct position should be that “post commencement financier’s only rank in priority of unsecured creditors and that pre-commencement creditors’ rights to their security, must be respected in terms of section 134(3) of the Act.” <sup>283</sup>Therefore post-commencement financiers who hold no security cannot be ranked ahead of pre-commencement creditors who hold security.<sup>284</sup> Bradstreet also supports this interpretation and submits that claims of post-commencement financiers claims rank below claims of secured pre-

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<sup>281</sup> Prins (see note 332;30)

<sup>282</sup> Ibid.

<sup>283</sup> Jones & Wellcome (see note 30).

<sup>284</sup> Ibid.

commencement creditors however, as contemplated by the Act, will have priority over all claims of unsecured creditors.

Stoop and Hutchison, argue “the fact that section 135(2) allows for assets to be further encumbered only to the extent possible, and then determines that such creditors have a preference in the order in which they were incurred. Seems to suggest that what was envisaged was a ranking that preferred the secured pre-commencement creditor, followed by post-commencement creditors in the order in which their claims were incurred.”<sup>285</sup>

## 5. International Guidelines on Post-commencement Finance

Much of our business rescue provisions were borrowed from Australia, the United Kingdom and the United States of America.<sup>286</sup> The DTI policy document published in 2004 indicated that as far as business rescue was concerned, the provisions of the United States Chapter 11 would be considered.<sup>287</sup> Recommendations and guidelines by international bodies such as the “United Nations Commission on International Trade Law” (UNCITRAL) and the World Bank have also contributed significantly in the development of business rescue in South Africa.<sup>288</sup>

### 5.1 Chapter 11 of the US Bankruptcy C Debtor- in possession

As mentioned above the Department of Trade and Industry expressed an intention in creating a corporate rescue model suited to the needs of South Africa by considering the provisions of Chapter 11 of the US.<sup>289</sup>

One of the most significant features of the Chapter 11 rescue model, is the need to obtain finance.<sup>290</sup> Instituting Chapter 11 proceedings requires financing, in order to ensure the continuation of the business.<sup>291</sup> Section 363 of the Bankruptcy code

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<sup>285</sup> Stoop & Hutchison (see note 200; 21).

<sup>286</sup> Prins (see note 232; 33).

<sup>287</sup> Prins (see note 232; 33).

<sup>288</sup> Ibid.

<sup>289</sup> GN 1183 OF GG 26493, 23/06/2004

<sup>290</sup> Vedder Price Publication “Debtor in Possession Financing” available at <https://www.vedderprice.com/-/media/files/vedder-thinking/publications/2003/03/debtorinpossession-financing/files/debtorinpossession-financing/fileattachment/debtorinpossession-financing.pdf> accessed on 6 August 2018.

<sup>291</sup> Ibid.

authorises the debtors to dispose its property other than in the “ordinary course of business”, provided that the debtor obtains prior consent of the creditor holding security or permission is granted by the court.<sup>292</sup> This is known as “cash collateral” and is defined by the Bankruptcy Code to mean “cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the estate and an entity other than the estate have an interest.”<sup>293</sup>

Apart from the creditor’s consent, the court prior to permitting the use of “cash collateral” has to be satisfied that the creditor’s secured interest will be adequately protected.<sup>294</sup> Such protection, includes amongst other things cash payments, which must be sufficient enough to cover any decrease in value of the creditor’s security.<sup>295</sup> In instances where the debtor is unable to obtain “cash collateral” section 364 authorizes the debtor to obtain new money from “pre-petition lenders” or from new lenders (after the filing of the bankruptcy).<sup>296</sup>

In terms of s364 (a) of the Code, the debtor is allowed to acquire “unsecured credit” and incur new debts in the “ordinary course of business” without consent from the court.<sup>297</sup> The debtor may approach the court to authorize obtaining unsecured credit or to incur unsecured debt for any purpose other than in the ordinary course of business.<sup>298</sup> Where the debtor fails to obtain such credit, the court has the discretion to permit the debtor to secure finance by conferring “priority” over all “administrative expenses, a security interest in an unencumbered property of the debtor or a junior lien on an already encumbered property.”<sup>299</sup> The court may also consent to the debtor providing a “senior or equal lien” on property that is already encumbered.<sup>300</sup> This is called “priming lien”.<sup>301</sup> However, the court must be satisfied that the debtor

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<sup>292</sup> Section 363(b) (c) of the US Bankruptcy Reform Act 1978.

<sup>293</sup> Section 363(a), US Bankruptcy Reform Act 1978.

<sup>294</sup> Veddar (see note 291 above).

<sup>295</sup> Ibid.

<sup>296</sup> Ibid.

<sup>297</sup> Section 364(a), US Bankruptcy Reform Act 1978.

<sup>298</sup> Section 364(b), US Bankruptcy Reform Act 1978.

<sup>299</sup>Section 364(c), US Bankruptcy Reform Act 1978.

<sup>300</sup> Section 364 (d), US Bankruptcy Reform Act 1978.

<sup>301</sup> Prins (see note 232 above).

could not obtain such finance and that the interest of the existing creditor on which a “senior or equal lien” is being proposed will be adequately protected.<sup>302</sup>

The Bankruptcy Code clearly provides for considerable protection for the rights of secured creditors. Their interests are protected even if a “priming lien is granted” this is done by forcing the business debtor to prove that the interest of the creditors whose lien is primed is adequately protected.<sup>303</sup> Da Costa, argues that in light of this requirement, the ranking determined by Kgomo J, falls short by not imposing the same onerous requirements.<sup>304</sup> In contrast to Kgomo’s J judgement, the US bankruptcy law allows for secured claims to be paid in priority to unsecured even where the court has granted a ‘priming lien’.<sup>305</sup> The interest of that existing secured creditor is still protected.<sup>306</sup>

## 5.2 World Bank Principles

The “Principles for Effective Insolvency and Creditors Rights Systems” state that:<sup>307</sup>  
*“The priority of secured creditors in their collateral should be upheld and, absent the secured creditor’s consent, its interest in the collateral should not be subordinated to other priorities granted in the course of the insolvency proceedings. Distribution to secured creditors should be made as promptly as possible.”*

The “World Bank principles” expressly point out that no priority given during insolvency proceedings will be ranked higher than the priority of existing secured creditors. Claims relating to costs and expenses of administration come after payment of secured creditors, followed by claims of unsecured creditors, except if there are “compelling reasons” justifying the need to grant priority above other claims.<sup>308</sup>

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<sup>302</sup> Section 364(d), US Bankruptcy Act 1978.

<sup>303</sup> Da Costa (see note 187; 30).

<sup>304</sup> Ibid

<sup>305</sup> Prins (see note 232; 39).

<sup>306</sup> Ibid.

<sup>307</sup> “World Bank Principles for Effective Insolvency and Creditor/ Debtor Regimes Revised” (2011) available at [www.worldbank.org/en/topic/financialsector/brief/the-world-bank-principles-for-effective-insolvency-and-creditor-right](http://www.worldbank.org/en/topic/financialsector/brief/the-world-bank-principles-for-effective-insolvency-and-creditor-right) accessed on 19 July 2018.

<sup>308</sup> World Bank Principles at C12.3 p19.

The World Bank principles clearly gives adequate protection to secured creditors. It ensures that the priority of secured creditors is upheld, and their interest in their security is not ranked lower than other claims, which may be granted during the corporate rescue. If the Chapter 6 business rescue provisions were to be interpreted in the light of these principles, this would mean any priority status given to post-commencement financiers will not result in the impoverishment of the priority previously granted to pre-commencement secured creditors.

The principles then further state that the available proceeds “should be distributed to the remaining general unsecured creditors, unless there are compelling reasons to justify giving priority status to a particular class of claims.”<sup>309</sup> Unsecured creditors are ordinarily paid after secured creditors, however the principles do recognize that there are instances during insolvency proceedings that will require priority to be afforded to new lenders, however as stated above, secured creditors “should not be subordinated to such priorities.” Whatever priority is given only extends to unsecured claims of the business and not existing secured creditors. It logically follows that pre-commencement secured creditors will rank ahead of post-commencement financiers, followed by unsecured creditors.

### 5.3 UNCITRAL

The “United Nations Commission on International Trade Law Legislative Guide on Insolvency Law” aims to provide guidance on how to address the difficulties experienced by financially distressed companies by establishing a legal framework that is both effective and efficient.<sup>310</sup> The guidelines are aimed at balancing the needs of the debtor with the interest and rights of all the relevant stakeholders concerned with the debtor.<sup>311</sup>

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<sup>309</sup> World Bank Principles at C12.3 p19.

<sup>310</sup> United Nations Commission on International Trade Law Legislative Guide on Insolvency Law (2005) p1 available at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/2004Guide.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html) accessed on 28 July 2018.

<sup>311</sup> Ibid.

Recognizing and enforcing the different rights that creditors have in insolvency proceedings will guarantee certainty and confidence in the market, which will make it easier to obtain credit. <sup>312</sup>The UNCITRAL Guide states that:<sup>313</sup>

*“Clear rules for the ranking of priorities of both existing and post-commencement creditor claims are important to provide predictability to lenders, and to ensure consistent application of the rules, confidence in the proceedings and that all participants are able to adopt appropriate measures to manage risk.”*

According to the UNCITRAL guidelines, it is important to balance post-commencement finance provisions against a number of factors.<sup>314</sup> These factors include the “general need to uphold commercial bargains, protecting the pre-existing rights and priorities of creditors and minimize any negative impact on the availability of credit, in particular secured finance that may result from interfering with those pre-existing security rights and priorities.”<sup>315</sup> The guidelines affirm that there are various different approaches that can be used to attract post-commencement finance and provide for the repayment of the loans.<sup>316</sup>

### 5.3.1 Establishing a priority

If the business continues to operate after commencement of insolvency proceedings whether incidental to an attempted reorganization or to preserve value by sale as a going concern, those expenses incurred in the operation of the business are to be paid as administrative expenses. <sup>317</sup> Administrative priority creditors do not rank ahead of a secured creditor but are generally afforded a first priority that ranks ahead of ordinary unsecured creditors and any other statutory priorities. <sup>318</sup> Which means that the lender will be paid before unsecured creditors but after secured creditors.

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<sup>312</sup> UNCITRAL (see note 311; 113).

<sup>313</sup> Ibid.

<sup>314</sup> UNCITRAL (see note 311; 115).

<sup>315</sup> Ibid.

<sup>316</sup> Ibid.

<sup>317</sup> UNCITRAL (See note 318; 116).

<sup>318</sup> Ibid.

### 5.3.2 Granting Security

In circumstances where security is required, such security may be given on unencumbered assets or as a lower security interest on already encumbered assets, provided that the value of the encumbered assets is sufficiently more than the debt owed to the creditor who holds security on that assets.<sup>319</sup> In such instances, the rights of the pre-commencement creditor will not be adversely affected and therefore will not require any special protection.<sup>320</sup>

In jurisdictions that afford priority to new financiers over already existing creditors, this can only be done provided that certain conditions are met.<sup>321</sup> These are amongst others, notifying the affected secured creditors and providing them the chance to be heard by the court, submission of proof by the debtor that without the priority, it is unable to acquire the necessary finance it needs.<sup>322</sup> The UNCITRAL Guide recognises that as a rule, “the economic value of the rights of pre-existing secured creditors should be protected so that they will not be harmed.”<sup>323</sup>

According to Recommendation 66<sup>324</sup> of the UNCITRAL Guide, the law should explicitly specify that any secured interest over any asset of the company provided to new financiers in order to secure “post-commencement finance” do not rank ahead of existing secured creditors who hold security over the same assets. Except if prior consent of the existing secured creditors is obtained or the procedure in recommendation 67 is followed.

Recommendation 67<sup>325</sup> provides the debtor with an alternative solution in instances where the existing creditor refuses to give consent, in such circumstances the court has the discretion to authorize priority to be given to post-commencement financiers over pre-commencement secured creditors, subject to the following conditions being satisfied:

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<sup>319</sup> Ibid.

<sup>320</sup> Ibid.

<sup>321</sup> UNCITRAL (see note 318; 117)

<sup>322</sup> Ibid.

<sup>323</sup> Ibid.

<sup>324</sup> Recommendation 66 of the UNCITRAL p119.

<sup>325</sup> Recommendation 67 of the UNCITRAL p119.

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

It is clear from the above international guidelines that corporate rescue regimes favour the protection of pre-commencement secured creditors. The general rule is that pre-commencement secured creditors rank ahead of post-commencement financiers. Only in exceptional circumstances, will post-commencement financiers rank ahead of pre-commencement secured creditors. In such instances, judicial intervention will be required and the debtor will be required to prove to the court that existing secured creditor’s rights will be adequately protected. These exceptional circumstances will be granted as a last resort. This is in line with the international best practice of ensuring that the rights and interest of secured pre-commencement are protected.

The legislature’s intention was to create a business rescue regime that would measure up to international trends followed modern systems such as be Chapter 11 of the United States.<sup>326</sup> This is evident by considering our own laws against the backdrop of principles set out by the World Bank and the UNCITRAL Guidelines, one can immediately see that the legislature had regard to these principles in the drafting process.<sup>327</sup>

The order of preference of the ranking of creditors set out in both the Merchant West and Redpath cases does not seem to be in line with international best practices. The judgements clearly overlook the principles set out by the World Bank and the UNCITRAL or Chapter 11 of the US Bankruptcy Code.

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<sup>326</sup> Stoop & Hutchison ( see note 200; 1)

<sup>327</sup> Da Costa (see note 187; 22)



## 6. Conclusion

Prior to the enactment of the Companies Act 71 of 2008<sup>328</sup>, our corporate rescue mechanism was contained in the Companies Act 61 of 1973.<sup>329</sup> The judicial management procedure did very little to assist ailing companies, and was subsequently described as a cumbersome and ineffective procedure.<sup>330</sup> In 2011, the Companies Act 71 of 2008<sup>331</sup> came into operation. The Act introduced business rescue provisions, which sought to “provide efficient rescue and recovery of financially distressed companies.”<sup>332</sup>

One important component of a successful business rescue procedure is the ability to secure funding.<sup>333</sup> Post-commencement finance is important for the rescue and rehabilitation of the business or if this is not possible to provide creditors and shareholders better returns in the event that a liquidation takes place than they would have received from an immediate liquidation.<sup>334</sup>

In order to secure such funding it might be necessary to grant priority or permit the company to use its asset in order to secure such loans.<sup>335</sup> However policy considerations in favour of granting such priority status to post-commencement financiers have to be balanced against principles such as the “pari passu rule, the vested rights principle, the idea of upholding commercial bargains.”<sup>336</sup> Post-commencement finance should not have an automatic preference over existing secured creditors as was decided by Kgomo J in the Merchant West case.<sup>337</sup>

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<sup>328</sup> Companies Act 71 of 2008

<sup>329</sup> Companies Act 61 of 1973

<sup>330</sup> Burderre (see note 46 above) at p241

<sup>331</sup> Companies Act 71 of 2008

<sup>332</sup> Section 7(k) of the Companies Act 71 of 2008.

<sup>333</sup> “Deloitte Post-Commencement Finance : Silver Bullet for Business Rescue” available at <http://www.deloitteblog.co.za/post-commencement-finance-the-silver-bullet-for-business-rescue/>

<sup>334</sup> Sher “The Appropriateness of business rescue as opposed to liquidation : A critical analysis of the requirements for a successful business rescue as set out in Section 131(4) of the Companies Act 71 of 2008 (2019 Thesis SA) University of Johannesburg 41

<sup>335</sup> J Calitz & G Freebody “Is post Commencement Finance Proving to be a Thorn in the Side of Business Rescue Proceedings under the 2008 Companies Act (2016) at 266 available at <http://www.saflii.org/za/journals/PER/2016/65.html> accessed on 13 June 2018

<sup>336</sup> Da Costa “Post Commencement Finance: Jumping the ranking queue. A critical analysis of Merchant West Working Capital Solutions v Advanced Technologies and Engineering Company Ltd and the Preference in Business rescue (2014 Thesis SA) University of Johannesburg at p30

<sup>337</sup> Ibid

The main problem with the business rescue provisions laid down in Chapter 6 of the Companies Act, is that the provisions failed to take into the order of preference as set out in the Insolvency Act.<sup>338</sup> South African Company law, including insolvency law makes provision for the protection of the rights of creditors, affording them the ability to collect what is owed to them by debtors. “Traditionally secured creditors (creditors who hold some form or real security for their claims) have always ranked higher in priority when it comes to repayments of their claims.”<sup>339</sup> If the legislature had intended to alter the common law as far it relates to distribution rules in South African insolvency law, then the legislature should have expressly stated such.

The wording of s134 (3) (b) provides that the company must “promptly pay to the other person the sale of proceeds attributable to that property up to the amount of the company’s indebtedness to that other person.”<sup>340</sup> The Oxford dictionary defines promptly as ‘with little or no delay; immediately.’<sup>341</sup> By using the word ‘promptly’ it makes more practical sense to assume that the legislature’s intentions was to ensure that creditors with security or title interest, are paid immediately. Therefore it would be illogical to say that the legislature had intended for secured pre-commencement creditors to rank after post-commencement financiers, when it expressly stated that they must be paid immediately after the property has been disposed.

Prins argues that this provision was amended by the legislature to provide for even greater protection of the rights and interest of secured creditors by placing a requirement of obtaining consent from the relevant creditor, should the anticipated proceeds from the disposal of that asset be insufficient to release fully the indebtedness that is protected by that security or title interest.<sup>342</sup>

Secondly, s135 (3) enables the company to obtain financing and provides that “such financing may be secured to the lender by utilizing any asset of the company to the extent that it is not otherwise encumbered.” The subsection expressly states that the

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<sup>338</sup> Ibid

<sup>339</sup> Ibid.

<sup>340</sup> S134 (3) (b) (i), Act 71 of 2008.

<sup>341</sup> English Oxford living Dictionaries available at <https://en.oxforddictionaries.com/definition/promptly> accessed on 22 August 2018.

<sup>342</sup> Prins (see note 232; 25)

asset that the company wishes to use for security must be unencumbered. An unencumbered asset is defined as an “asset or property that is free from debt, any clear of any legal defect in its title.”<sup>343</sup> A reasonable interpretation of this subsection, would mean that new financing can only be secured with assets that are not already secured by existing creditors. Stoop and Hutchison, also argue that “new finance may only be secured by existing equity in the company’s assets or with assets which are not already subject to a security interest.”<sup>344</sup> Therefore the only reasonable inference to make is that secured pre-commencement creditors rank ahead of post-commencement financiers.

Our business rescue provisions have been informed by international guidelines in order to ensure that our corporate rescue system is in line with international best practices. The guidelines and principles set by the World Bank and UNCITRAL show that post-commencement should not automatically rank ahead of existing secured creditors unless certain conditions are met. Therefore the order of preference determined in both Merchant West and Redpath is inconsistent with these recommendations and therefore is incorrect.

Therefore the correct ranking of the priority of creditors’ claims during business rescue proceedings should be as follows:

1. The practitioner, for remuneration and expenses;
2. Employees for any remuneration which became due and payable after business rescue proceedings began;
3. Secured pre-commencement creditors;
4. Secured post-commencement finance;
5. Unsecured post-commencement finance;
6. Employees for any remuneration which became due and payable before business rescue proceedings began;
7. Unsecured pre-commencement creditors.

The above ranking is consistent with the recommendations set by the World Bank and the UNCITRAL. Which protects the interest of secured pre-commencement

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<sup>343</sup> Business dictionary available at <http://www.businessdictionary.com/definition/unencumbered.html> accessed on 22 August 2018.

<sup>344</sup> Stoop & Hutchison (see note 200 above).

creditors. It takes into account the need to provide preferential repayment of post-commencement financiers in order to induce possible lenders to provide finance, whilst also protecting existing secured creditors. Post-commencement financiers will be given priority over all unsecured claims against the company but will rank after pre-commencement secured creditors.

In circumstances where financing cannot be acquired without priority status being afforded to new financiers over secured existing creditors, the affected secured creditor must be notified and should be given an opportunity to be heard by the court.<sup>345</sup> Post-commencement financiers should not be given an automatic preference. An application must be made to court for an order granting such preference, provided that all the requirements in recommendation 67 of the UNCITRAL have been met.<sup>346</sup> The court will need to balance the policy considerations in favour of post-commencement financiers against the need to uphold commercial bargains.<sup>347</sup>

In conclusion, in order to resolve the uncertainty regarding the interpretation of the business rescue provisions, it is important that the legislature amend the wording of the Act in order to expressly state whether or not post-commencement finance should rank ahead of secured pre-commencement creditors. Failure by the legislature to amend the Act, the courts must intervene and interpret the business rescue provisions as far they relate to the ranking of creditors.

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<sup>345</sup> United Nations Commission on International Trade Law Legislative Guide on Insolvency Law (2005) p1 available at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/2004Guide.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html) accessed on 28 July 2018.

<sup>346</sup> Da Costa (see note 337;31)

<sup>347</sup> Da Costa ( see note 337;31)

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18 March 2020

**Ms Lumka Ziwa (214502960)**  
School of Law  
Howard College Campus

Dear Ms Ziwa,

**Protocol reference number: HSS/1425/018M**

**Project title: The ranking of creditors' claims during business rescue proceedings as envisaged in the Companies Act 71 of 2008**

### **Approval Notification – Amendment Application**

This letter serves to notify you that your application and request for an amendment received on 04 March 2020 has now been approved as follows:

- Change in title

Any alterations to the approved research protocol i.e. Questionnaire/Interview Schedule, Informed Consent Form; Title of the Project, Location of the Study must be reviewed and approved through an amendment /modification prior to its implementation. In case you have further queries, please quote the above reference number.

**PLEASE NOTE: Research data should be securely stored in the discipline/department for a period of 5 years.**

Best wishes for the successful completion of your research protocol.

Yours faithfully



.....  
**Professor Urmilla Bob**  
University Dean of Research

/ss

cc Supervisor: Mr S Phungula  
cc. Academic Leader Research: Professor Donrich Thaldar  
cc. School Administrator: Mr Pradeep Ramsewak

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