Ernst & Young Incorporated
Ernst & Young House
35 Lower Long Street
PO Box 656
Cape Town 8000

Tel +27 (0) 21 443 0200
Fax +27 (0) 21 443 1200
Docex 57 Cape Town
ey.com

Co Reg No 2005/002308/21

Building a better working world

5 October 2016

Mr. I. Vanker
The Director - Standards
Independent Regulatory Board for Auditors
Building 2
Greenstone Hill Office park
Emerald Boulevard
Modderfontein

standards@irba.co.za

Dear Imran

Comment letter: Proposed IRBA Guide on Solvency: Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent

We welcome the opportunity to comment on the Proposed Guide for Registered Auditors: Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent ("the proposed guide"). This comment letter deals with responses to the specific questions posed as well as our general comments on the proposed guide. The comments and considerations expressed in this comment letter are based on collated views of Ernst & Young Inc. South Africa and do not represent the collective view of Ernst & Young Global.

We support the IRBA's desire to update the guide which is in the public's interest. Our comments should be read in the context of our support for the achievement of those objectives.

Our comments are set out under the following main headings (attached):

Section 1 - General comments
Section 2 - Responses to specific questions
Section 3 - Other comments (grammar, formatting and other)

We have also attached senior counsel's opinion to which our comment letter refers.

We thank the IRBA for an opportunity to comment on the proposed guide. We would be pleased to discuss these comments further with the IRBA if needed (if so please contact Mike Bourne (021 443 0258), Michael Schafer (011 772 5400) or Lindsay Croeser (011 772 5206).

Yours sincerely

Michael F.J. Bourne
Professional Practice Director

Building a better working world

Section 1 - General Comments

We agree that the proposed auditor's guide is necessary to resolve inconsistencies in dealing with audited or reviewed entities that are trading while factually insolvent.

Our primary concern however is that the proposed guide offers only one strict interpretation of factual insolvency when there are valid alternative interpretations. We will set out our argument in the responses to the specific questions below.

Of further concern is the limited scope of the proposed guide. It is noted that the proposed guide is intended to cover the matters to be considered by an auditor or a reviewer of financial statements of a company which is factually insolvent, having regard to the Auditing Profession Act, 2005 ("the APA"), the Companies Act, 2008 ("the Act"), common law and case law - including in particular:

1. Section 22 of the Act dealing with carrying on business recklessly or fraudulently;
2. Section 129 of the Act dealing with "financially distressed" companies;
3. Companies Regulation 29 dealing with reportable irregularities in the context of a review of financial statements in terms of the Act;
4. Section 45 of the APA dealing with reportable irregularities in the context of an audit of an entity.

Without fully exploring the alternative interpretations of "insolvent", "financial distress" and the responses to insolvency, we believe the guide will create further inconsistency or unintended consequences. The guide deals extensively with technical insolvency but does not deal at all with commercial insolvency which we believe is the most critical element in the assessment of any company's ability to continue to trade.

Furthermore, the guide gives an illustrative example of a subordination agreement but fails to give examples of the other letters which may address an uncertainty, namely, a letter of guarantee, letter of comfort and letter of support.

We fear that the proposed guide, if released without amendment for at least the issues noted above, would cause significant adverse consequences for businesses that are understandably trading in insolvent circumstances, for example start-up companies.

Registered auditors may be put in a position where they will be required to report reportable irregularities of entities that are trading while factually insolvent but not financially distressed and accordingly such auditors will expose themselves to legal action from such companies or other parties.

We support the IRBAs drive to finalise the guide at the earliest possibility, especially given protracted development time, however we believe that the benefits of publishing a complete and comprehensive guide which is based on a sound interpretation of the law far outweigh the benefits of closing the project out in this quarter.

Building a better working world

Section 2 - Responses to specific questions

(i) With respect to paragraphs 48 to 50 of this proposed Guide, respondents are asked to consider the implications of the interpretation of "financially distressed" as defined in Section 128(1) (f) of the Companies Act, 2008. Respondents are asked to share the basis of their views.

We comment here on whether we agree with the interpretation of "financially distressed" as defined in section 128(1) (f) of the Companies Act, 2008. The definition in the Act includes two parts, as follows:

"Financially distressed", in relation to a particular company at any particular time, means that -

(i) It appears 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; or

(ii) It appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months

It is our opinion that the determination of whether an entity is "financially distressed" is dependent on an understanding of what both commercial insolvency and factual insolvency means. Regrettably this guide only covers factual insolvency.

Secondly, the Act does not define "insolvent". In view of the fact that there are more than one views on what this term means in the context of the Companies Act it is necessary in terms of section 5 and 7 of the Act to consider the intention of the legislation.

The word "insolvent" is interpreted by the proposed Guide as being the literal English meaning of the word, and without considering the intention of the provisions of the Act.

Our legal advisers inform us that this interpretation of the word will not be supported by our courts.

In resolving this critical matter we recommend that IRBA CFAS takes counsel's opinion before finalising the guide.

The Guide, in paragraphs 49 & 50 , states that:

"49. Section 129(7) of the Companies Act provides that if a company is financially distressed as defined and the board has not resolved that the company voluntarily begin business rescue proceedings, the board must deliver a written notice to shareholders, creditors and representatives of the employees of the company, explaining that the company is financially distressed as contemplated in section 128(1)(f), and provide the reasons for not adopting the resolution to begin business rescue proceedings.

50. If a company is factually insolvent, then it falls within the definition of "financially distressed" in section 128(1) (f), and the company is required to act in the manner set out in section 129(7)."

Building a better working world

These paragraphs raise two points:

1. What does the RA do if the circumstances are such that a company is not able to pay its debts as they fall due but the Board resolves that it is NOT financially distressed? This happens in practice where the board do not want to deliver the said written notice. The guide must deal with this if it is to be helpful to RAs. Is it a material breach of fiduciary duty where a board knowingly denies it is in distress ?
2. We contend that, in interpreting the above referenced Sections contextually and purposively as set out in Sections 5 and 7 of the Act, factual insolvency, in the strictest sense, on its own, is not sufficient, to constitute "financial distress". The guide notes in a footnote 28 in respect of para 50 that the interpretation of section 128(1) (f) is based on the actual words used and the plain meaning of the words used and does not permit any consideration of the purpose of the section or of the act as a whole when interpreting the meaning of the language of the provision itself.

We have often found that factual interpretation of the Companies Act is overlooked because one must consider section 5 which requires that "This act must be interpreted and applied in the manner that gives effect to the purpose set out in section 7" which includes, among others, to "provide for efficient rescue and recovery of financially distressed companies". Although this is generally phrased, and so open itself to interpretation, it does talk to the purpose, which is to rescue companies that are financially distressed. Together with Deloitte, PWC and KPMG, we have sought legal counsel opinion on the interpretation of financially distressed as far as the meaning of "insolvent" as well as whether a company that is factually insolvent is required to act in the manner set out in section 129(7) of the Act. We recommend that in IRBA's dialogue with DTI and with legal counsel that the IRBA seek to clarify the extent to which the intention of the act set put in section 7 should be used in interpretation of subsequent sections, particularly for consideration here, section 128/129. The plain reading of the definition of financial distress without purpose, results in illogical outcomes.

We believe that the appropriate place to deal with the various interpretations of "insolvency" is in the beginning of the proposed guide in paragraph 22 where the initial strict interpretation is introduced.

The following paragraphs need to be amended to resolve the interpretation issues in respect of "insolvent":

> Para 24 - deals with the fair value of assets, assuming the company is a going concern. However what is missing is how one would determine the fair value of liabilities (and not contingent liabilities) in that situation, and whether the re-classification of liabilities to equity would be more appropriate where an amount has been subordinated. We fully agree that these adjustments would not equate to the IFRS valuation and classification of such liabilities but the footnote to this paragraph indicates that the fair value of the assets taken into consideration for assessing factual insolvency may well be different from the carrying values under IFRS. That interpretation should thus apply equally to the liabilities used in said calculation.

Building a better working world

Para 50 – This paragraph must be corrected. As it currently reads, as soon as a company has liabilities in excess of its assets it must be considered to be financially distressed and must act in terms of section 128(1) (f) and deliver written notice to its stakeholders if business rescue is not pursued. We believe this statement must be revised to say "If a company is factually insolvent, this may be an indication that the company is also financially distressed, though this is not always the case and should be considered in light of the circumstances and the purpose of business rescue. Please refer to the attached senior counsel opinion.

Para 74 illustrates clearly another absurd consequence of the interpretation of insolvent that is applied to section 128 of the companies act and regulation 29. If two companies are in exactly the same net liability position and in the same circumstances, but one is audited and the other reviewed, the independent reviewer will be required to report an irregularity on the company subject to a review, but the same will not be required for the company that is being audited if the insolvent position does not result in material financial loss, is not fraud or theft, and it is not due to a material breach in fiduciary duty.

We question whether it was ever the intention to require different outcomes in terms of reporting of irregularities based on whether a company was subject to a review or subject to an audit. We do not believe this was the intention.

(ii) With respect to paragraph 56 of this proposed Guide, respondents are asked whether they agree with the interpretation of Regulation 29(1) (b). Respondents are asked to share the basis of their view.

The Guide stipulates, in paragraphs 56 & 57 that:

"56. Regulation 29(1) (b) (iii) is considered to deal with factual insolvency.

57. Thus, in terms of Regulation 29(1) (b) (iii), if a company whose annual financial statements are subject to a review (and not an audit), has traded, or is trading whilst factually insolvent, that conduct itself constitutes a reportable irregularity. Consequently, the reporting obligations of the independent reviewer of that company in terms of the Regulations would apply"

We acknowledge that the reportable irregularity definition in the Companies Act ("the Act") for a company subject to a review is different to the definition of a reportable irregularity in the Auditing Professions Act ("APA") and includes special reference to circumstances when an act or omission causes a company "to trade under insolvent circumstances". However, we do not agree that the word "insolvent" used in the Act must be interpreted in the strictest sense of the word giving no consideration to the intention of the regulation or the purpose of the Act, and the proposed guide does not provide for alternative interpretations of "insolvent" as it should be understood in terms of the regulations.

Building a better working world

The interpretation of "insolvent" in relation to the regulations is perhaps even more important than the reportable irregularity definition under the APA. For a company to meet the definition in regulation 29(1)(b)(iii) there must be "any act or omission", regardless of whether this act is unlawful or not, that causes a company to trade under insolvent circumstances. This is because the word "unlawful" is not included in regulation 29(1)(b)(iii) but only in regulation 29(1)(b)(i).

The basis for the conclusion on whether para regulation 29(1)(b)(iii) relates to commercial or factual insolvency appears to be based on a CIPC Guidance Note dated 23 June 2015 (see footnote 31 iro para 56). This guidance notice is not listed on CIPC's website, has possibly been withdrawn or has been misquoted in the bullet. There is also no mention of "insolvent" or "factual insolvency equating to financial distress" on the business rescue section of the CIPC website. We understand that the CIPC is in the process of re-determining their view on the application of section 128 in terms of financial distress.

We do not believe that the proposed guide addresses this possibility adequately by noting later on in the proposed guide (in particular paragraph 71) that reporting of a reportable irregularity in terms of the Auditing Profession Act is not automatically the default action of the registered auditor in all instances. This reference is too far removed from the initial strict interpretation of factually insolvent in paragraph 57 for a practitioner to easily make the link. Further, although para 71 does attempt to address the issue, it does so by concluding that it is possible that the RI definition would not be met because it does not cause financial loss, is not fraud / theft and is not a breach of fiduciary duty. This still implies the strict definition of insolvent is the only available interpretation and as such as one still has to concluded that there is an unlawful act in the first place.

(iii) Do respondents agree with the identifications, descriptions of and distinctions between the various types of common responses to factual insolvency dealt with in this proposed Guide, being the letters of support, letters of comfort, guarantees and subordinations?

We do not believe that all the common types off responses have been identified. We fully acknowledge that there are many possible responses in practice and that it is not possible for an exhaustive list to be drawn up but there are other responses that are common enough to warrant inclusion in this proposed guide.

Additional common response could include, but are not limited to (1) increasing equity through capital injections; (2) recovery to profitability through business restructuring; (3) secured contracts for profitable projects or sales; and (4) proven cost reduction strategies.

We do not believe that there is sufficient description of or distinction between the letters of support, letters of comfort, guarantees and subordinations. In practice, the terms "letter of comfort", "letter of support" and "letter of guarantee" are often used interchangeably and accordingly are often misinterpreted by the providers of the support and by the users of the financial statements where this support is described. It is therefore important that the difference between these types of support is absolutely clear in this guide. The text in the guide currently (para 73 to 106) does give some guidance regarding the differences however we believe further description of and distinction between the various options is required along with the implications of using each is required.

Building a better working world

At the very least we would suggest the inclusion of the following paragraphs to introduce the "responses to factual insolvency" section:

- *There are many measures which can be taken to address factual and commercial insolvency. The most common include letters from a holding company or major creditors in the form of letter of support, letter of financial guarantee, letter of comfort and subordination agreements. Though commonly perceived as being equally effective in addressing insolvency, these letters offer quite different levels of assurance over the financial state of a company. We provide a brief description of each letter and an indication of its comparative effectiveness in addressing factual insolvency.*

- *Subordination Agreement – This letter does not in itself provide additional cash to enable the entity to settle its debts, but it effectively removes the subordinated amount from the total liability amount until the company is again in an asset position. When calculating insolvency by comparing assets to liabilities, the subordinated amount should be removed from the total liability position when considering financial distress. The subordination agreement itself does not resolve commercial insolvency. It has the effect only of re-ordering the order in which creditors will be settled in the event of the entity being liquidated.*

- *Letter of guarantee – An irrevocable letter of guarantee is a promise from the guarantor that it will provide enough capital to cover all cash needs of the company until such time as the company's assets exceed liabilities and contingent liabilities fairly valued. Provided the guarantee does not limit the support, is irrevocable by the guarantor and the guarantor is financially capable of providing the support in question this provides one of the strongest forms of financial support. An example is contained in Appendix ….*

- *Letter of support – Quite opposite to a letter of guarantee, a letter of support does not fully mitigate insolvency concerns as it is not written with any legally binding consequences. It is simply an indication of current intent by the provider of the letter to support the company financially. It does not require notification of any parties if the intent of the grantor changes and is not enforceable by creditors or the company under any laws in South Africa.*

- *Letter of comfort – This letter is similar to a letter of support but covers only certain debts and provides some mitigation, but not alone sufficient mitigation to fully resolve insolvency in all cases.*

Introductory paragraphs of this nature will allow the reader to understand up front the different weightings of the options and understand which indicators of uncertainty each type of letter addresses.

Thereafter, the discussion that is currently in the guide will be easier to digest. The other responses in paragraph 120 should be moved forward to the introductory sections of the "responses to factual insolvency" section to provide the broader context of responding to insolvency before the detail of the various types of letters is discussed. Again, there also needs to be a clearer split between the responsibilities of an auditor in the context of an audit and in the context of an independent review.

Building a better working world

We disagree with the interpretations put forward in paragraphs 86 to 88. These paragraphs indicate that a subordination agreement has no effect on determining whether the entity is "insolvent". We agree that the classification of the subordinated loan remains a liability in law and for IFRS purposes, but we do not believe that the subordinated amount cannot be excluded from the liability balance when calculating whether an entity is insolvent for the purpose of the financial distress definition.

We suggest alternative wording as follows:

> *86. The subordination by a creditor does not change the legal nature of the amount owing to the subordinating creditor - which remains a liability. However, since the repayment of the debt has been delayed until such time that the company is no longer factually insolvent, and thus will not become due for as long as the definition of financial distress is under debate, the debt in this instance is more characteristic of equity and is thus not included in total liabilities in assessing whether an entity is financially distressed.*
>
> *87. The subordination by a creditor does not change the accounting nature of the amount - which remains a liability (and does not become equity) in terms of International Financial Reporting Standards (IFRS), assuming the entity is a going concern.*
>
> *88. Thus, a subordination agreement does can reduce the factual insolvency position, even though the subordinated liabilities remain liabilities in terms of law and IFRS - because the payment of those liabilities have been deferred until the company is solvent.*

Paragraph 91 should also be amended to read as follows:

> 91. However, in a going concern scenario, the implicit assumption is that the subordinated creditor will ultimately be paid, and thus the amounts due to the subordinated creditor are properly classified as liabilities - both in law and for financial reporting purposes, albeit not considered as part of the assessment of insolvency for the purpose of determining whether the definition of financial distress has been met.

These changes result in a more logical conclusion about whether an entity is in fact in need of business rescue, and not just the literal reading of the definition without acknowledging the intention of section 128 which is to prompt business rescue of companies in need thereof.

Paragraph 109 mentions that a letter of comfort "may not" provide a legally enforceable obligation. Instead of "may not" we recommend it state that it "normally does not". Furthermore the consequences of this are not written strongly enough in the guide. It needs to be made clear that the fact that this type of response to insolvency does not result in a legally enforceable arrangement that it does not cure either factual or commercial insolvency and must be taken in combination with other factors when considering insolvency. The addition of the underlined wording here, into paragraph 109, will clarify that matter.

(iv) This proposed Guide contains an illustrative subordination agreement in Appendix 3. Respondents are asked to comment on whether or not an illustrative subordination agreement should be included in this proposed Guide.

Building a better working world

We agree that an illustrative subordination agreement should be included in the guide and that it should be made clear that any deviation from the wording of the illustrative agreement should only be considered in consultation with the RAs legal advisers. We agree with the illustration that has been included except for the following points:

- The illustrative subordination agreement includes the following wording *"As at _____ [date] X was owed approximately R_____ (_____ Rand) by Y for monies lent or advanced / goods supplied / services rendered / interest"*. We do not believe that it is appropriate to include the word "approximately" as this leaves the agreement open to interpretation as to how must of the amount is subordinated should the actual amount of the loan/advance not be exactly equal to the amount stated in the agreement.
- We note that the illustrative subordination agreement does not include the following term, or similar wording, "the claims of such other creditors of Y, both present and future, will rank preferentially to the subordinated claim of X against Y". However, we believe that the wording in paragraph 4 of that agreement has the same effect of ensuring that the claims of creditors of X would rank preferentially against the loan/advance from Y to X. Thus we are not opposed to its omission.

(v) Do respondents believe that this proposed Guide should include an illustrative letter of guarantee or letter of support, particularly taking into account the many variations thereof in practice?

We firmly believe that the guide should also include an illustrative letter of support, letter of comfort and letter of guarantee to address the many incorrectly used forms which are being misused and misinterpreted by RAs in professional practice.

We acknowledge that there are many variations of these letters in practice but we do not believe that these variations prohibits us from including an example in this guide, as long as the appropriate explanations and caveats are included alongside the example.

Please refer to appendix A and appendix B for a letter of guarantee template which we developed in conjunction with legal adviser Ed Southey and a letter of support template that we suggest be included, along with the commentary and caveats that we believe are important to include in the guide.

Building a better working world

Section 3 - Other Comments

Section	Comment
Overall	The guidance applicable to independent reviews and to audits is so intertwined in the guide that it is difficult to see clearly which aspect apply to each type of engagement. We suggest having the discussion of what is meant by insolvent upfront, and then having one section that deals with the requirements applicable to an audit and a separate section that then deals with all the requirements of an independent review. This is not clearly split in the guide.
Page iii	The scope of the guide states that it is not intended to provide legal advice. We believe that this statement is inconsistent with the objective and content of the guide. After all the matters being considered are all of a legal nature. See para 8 of the guide.
Page iv	Effective date : In view of the need to have the guide reviewed by experienced expert legal counsel before it is re-exposed we suggest the effective date be made later than from the date of publication if this is intended to be this year.
Page 2, Contents	Include illustrative letter of guarantee, letter of support and letter of comfort to index references.
Page 3	This page should not be headed "contents".
Page 3	The first paragraph states that this guide helps the auditor implement the requirements in the relevant standards, but in the scope ISA 570 is specifically excluded. Further, the sentence structure is not clear. We suggest this alternative wording, having removed reference to the standards. "This Guide for Registered Auditors: *Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent* (this Guide), provides guidance to registered auditors ("Auditors") who are performing an audit or an independent review to meet the additional regulatory reporting requirements in the Companies Act, 2008, the Company Regulations, 2011 and the Auditing Profession Act, 2005."
Page 3	The third paragraph on this page notes that the guide should not be interpreted as introducing new and mandatory requirements for the auditor. However the fourth paragraph notes that the *"auditor must, in the performance of an audit, comply with [...] guidelines [...] issued or prescribed by the Regulatory Board"*. The fourth paragraph thus implies that the auditor MUST comply with this guide. The third paragraph is thus a direct contradiction with the fourth paragraph. We recommend deleting the third paragraph.
References from this point onwards refer to the paragraph number of the guide, and not the page number.	
Para 3	We should include reference to the Companies Act regulations in this paragraph, since it is included in the stated purpose of the guide on page 3.
Para 5	Consider noting in a paragraph after para 5 that the guide may be relevant to the auditor's responsibilities in an interim review dealt with in ISRE 2410. Since going concern assessments and assessments of possible reportable irregularities are also performed during an interim review, this guidance would be equally relevant in those circumstances.

Building a better working world

Para 8	We believe that this paragraph is important, and is well written to remind users to seek appropriate legal counsel if the situation warrants such consultation. We do ask though that we replace "The guide deals with the law as it stands at the date of publication of the guide" with "The guide deals with the law as it stands at [insert date of publication]". This allows the reader to instantly know the date without having to find that information separately.
Para 9	States that the guide may be useful for the consideration of the solvency and liquidity test. We suggest this be deleted because the guide is prepared for another purpose.
Para 10 & 14	The second sentence here is unnecessary. We have already clarified in para 2 that this guide applies to audits and reviews of companies. There is no need to repeat it here in para 10. Para 14 also duplicates the inclusion of independent reviews in the scope. We believe reference to the regulations is sufficient to infer that the guide assists the independent reviewer in considering reportable irregularities in terms of the regulations.
Para 13.5 & 13.6	Expand to include reference to letter of guarantee, letter of support and letter of comfort.
Para 15	Please refer to the actual date of publication, instead of just saying the guide is effective "from its publication date"
Para 19	We like this wording because it gives opportunity to debate what is "reasonably expected to be available".
Para 23	We agree with the link between the guide and the standard, as is shown in footnote 3 iro para 23. We would recommend that this be more consistently done for other requirements that are linked directly to ISA 570.
Para 23	Include reference to funding available from letters of guarantee.
Para 24	There are many pieces of text that are critical to the reading of the guide that are hidden in the footnotes. In order to reduce misinterpretation these key descriptions should be included in the body of the text. A quick read would not necessarily includes detailed reading of the footnotes. This applies to the following: • Footnote 4 iro para 24, Here, please also clarify what tax impacts should be considered. The discussion of "notional revaluation" is not clear. • Footnote 28 iro para 50 • Footnote 31 iro para 56

Building a better working world

Para 24	Our going concern assessment in terms of ISA 570 is required to assess a period of 12 months from the date of our audit / review report and to consider whether circumstances may change thereafter. If this is a guide for auditors, we need guidance on measuring that 12 month from date of audit report as required. It is not clear from the wording of this paragraph that the "date of assessment" is always the same date as --the balance sheet date or --the date on which we sign our audit / review opinion. Footnote 5 says "but is not limited to 12 months" -- this is very important and so should be included in the main part of the guide in para 24. Not in a footnote.
Para 26	This paragraph is unnecessary.
Para 33	We propose deleting "This is objectively measured in the context of the notional reasonable person in business, but subjectively to postulate this person with similar knowledge and background to the actual directors". Auditors are not required to have a legal background and thus may not understand the legal difference between "objectively measured" and "subjectively to postulate". This is needlessly complex.
Para 34	The discussion of an "honest belief" is an important concept. We believe that it is important to explain the auditor's role in having an open and frank discussion with management to assess their "honest belief".
Para 41	While we agree with the points in para 41, we believe that the last sentence is too rigid in its interpretation of the facts. The sentence should be amended to state "Without clarity and commitment on the ability to pay its creditors without group support and the amount and duration of support available from group, it is likely that one would conclude that it is neither reasonable nor responsible to take the risk that trade creditors may might not be paid." The guide makes certain very brief points from the Philotex case. However to RAs who are not familiar with the case will not necessarily understand the points of commercial law principle being made. The guide should perhaps elaborate to clarify.
Para 43.3	This paragraph should read "the profit (or loss) after interest which is illustrative of the ability to pay debts
Para 43.4	If we can consider the overdraft to not be payable on demand, are there any other types of current loans that could be determined to be longer term in nature based on past history or industry practice or group intention? The guide should caution the RA in considering the application of this principle.
Para 43	Other relevant matters should also list, as para 43.5, "the availability of cash and other assets that can be readily converted to cash that can be used to settle debts as they fall due".

Building a better working world

Para 48	Sec 128(1) (f) use the word "reasonably". The guide should provide more explanation to the RA as to how to understand the import and application of this word.
Para 49	This states that section 129(7) says "...that if a company is financially distressed as defined and the board has not resolved...". That is not what the section actually says. Rather provide an exact quotation of the words used in the section. The board only has to deliver the notice if the BOARD has agreed that the company is financially distressed. If the BOARD resolves that it is not then no notice is required. The guide should alert RAs to the fact that a company in clear financial distress where the board resolves that the company is not financially distressed may have committed a material breach of fiduciary duty.
Para 56	The footnote 30 has the incorrect reference to regulation 29(1)(b)(ii). It should reference to regulation 29(1) (b) (i). In addition the guide says that "factual insolvency" is what "insolvent circumstances" is meant to be. This is not in our opinion correct. Insolvent circumstances may be interpreted to INCLUDE factual insolvency however it may not exclusively be so. We also point out that CIPC guidance notes are not authoritative. Also using the word "suggests" in the footnote 31 is inadvisable. Clearer guidance is needed.
Para 68.3	It is not clear what is meant by "in breach of legislation" in this context. The fact that trading is "reckless or fraudulent" is already an unlawful act, which is concluded on before one considers financial loss or fraud as sub paragraphs of the reportable irregularity definition. If the guide shows "breach of legislation" as a third sub-bullet in para 68 it implies that the definition is considered in a different manner than intended by the APA.
Para 70	Para 70 contains the wording "If a company continues to trade whilst it is factually insolvent, and it has not complied with section 129(7) of the Companies Act, then that non-compliance is unlawful i.e. the failure by the board to deliver written notice to each affected person explaining that the company is ~~factually insolvent and thus~~ "financially distressed" in terms of the Companies Act, and setting out their reasons for not voluntarily beginning business rescue proceedings". We recommend deleting the text that has been marked with strikethrough. As indicated above we also suggest the guide deals with the situation which often arises where the BOARD formally resolves it is not financially distressed when in fact to all reasonable observers it is.
Para 76	This guide specifically states that it applies to companies but may be used for other types of legal entities. We do not believe that these other entities should be dealt with at all in this guide if not included in the scope. We suggest that this paragraph be removed as it attempts to deal with a complex situation in one simple paragraph.
Para 80 and 81	These paragraphs are misplaced. They should be linked to their relevant sections or deleted.

Building a better working world

Para 82	HEADING Should not refer to "Factual" insolvency but just "Insolvency".
Para 90	It is not correct to say that on insolvency subordinated liabilities will be "excluded as liabilities". This view is legally not supportable.
Para 91	We believe it is necessary to provide case law reference if this view is to be substantiated. It is always a liability. It is just that it will stand at the end of the queue when creditors are paid.
Para 98.9	*We recommend adding a new paragraph, either as paragraph 98.9 or just before paragraph as a separate bullet (i.e. not as a sub bullet to para 98), which states "An auditor considers* whether any other terms have been included in or omitted from the subordination agreement that we believe may substantially alter, or in particular lessen, the strength of the subordination agreement. For example, the omission of a cancellation clause that requires the grantor to give sufficient notice to creditors on cancellation of the subordination agreement, would lessen the effectiveness of the subordination." In addition the legal principle of Stipulatio Alteri is a critical component of a subordination agreement if the subordination is to deal with recklessness and fraud risk.
Para 101	The guide will be issued at a time when IFRS9 will almost be effective. Footnote 39 refers to IAS39 but does not deal with IFRS 9.
Para 105	The sentence needs additional context to its wording to add on the underlined text here: "The letter of comfort has no effect on factual insolvency <u>but may be considered in supporting the directors' honest belief that they are able to continue to pay their creditors as they fall due. The letter of comfort may also be considered in determining whether an entity is financially distressed as it has a bearing on the company's ability to settle debts as they fall due</u>". The guide should assist the RA in considering the various factors which need to be taken into account when considering the impact of a comfort letter.
Para 113	It is not true to say that a letter of guarantee "would not cover the broad body of creditors" . This is where the Stipulatio Alteri clause is so important and should be included.
Para 120.4	It is not clear why this paragraph refers to profits and losses. Surely only subsequent profits would be considered a response to factual insolvency, and not losses. We recommend removing the words "or losses". Also what about cash flows ?
Para 122	Add the underlined words to the sentence ".....of an audit of a company whose liabilities exceed its assets <u>or whose debts are not being settled when due</u> , an auditor:"
Appendix 1	The illustrative letters for reportable irregularities issued in terms of Regulation 29 should be compared to the guide that SAICA issued recently titled "Illustrative reportable irregularity letters for independent reviews".
General	In the light of the numerous amendments that are required to the guide we recommend that is be re-exposed for comment.
General	The issue of "material breach of fiduciary duty" has not been explored in this guide to any extent. It is just as important a consideration as recklessness or negligence.

Building a better working world

ATTACHMENTS TO BE CONSIDERED FOR INCLUSION IN THE GUIDE

1. **Letter of guarantee**
2. **Letter of support**

Building a better working world

Appendix A

Illustrative letter of guarantee

[Date]
[Name]
[Designation]
XYZ (Proprietary) Limited
[Address]

Dear Sirs

1. We, ABC Limited, hereby confirm that as of the date of this writing, we indirectly own a share of 75% in the share capital of XYZ (Proprietary) Limited ("XYZ"). We acknowledge that we are fully aware of XYZ's financial situation as reflected in the financial statements submitted to the Audit Committee of XYZ on 19 March 2008.

2. We do hereby confirm that we will ensure that XYZ is or will be put in a position to meet its financial obligations as they fall due and that XYZ will duly perform and comply with all its financial obligations. In this respect, we undertake to provide XYZ, as our subsidiary, with the funding and/or other support needed to make it possible for XYZ to meet its financial obligations.

3. In addition, we confirm that we shall exercise our rights as indirect majority shareholders of XYZ in such a manner so as to support it in accordance with the principles of sound business practice in the fulfillment of its financial obligations.

4. Upon your acceptance of the terms of this letter it will constitute a contract for the benefit of all creditors of XYZ, present and future, and that benefit will be capable of acceptance, express or implied, by any or all of those creditors, who may then enforce the undertakings that we have given in this letter.

5. These undertakings will remain of full force and effect as long as the liabilities (including contingent liabilities) of XYZ exceed its assets, fairly valued, and will lapse forthwith upon the date that the assets of XYZ, so valued, exceed its liabilities (including contingent liabilities) and will not be reinstated if, at any time thereafter, the liabilities of XYZ again exceed its assets unless there is a further undertaking in writing by us.

   For the purposes of this paragraph the liabilities of XYZ will be deemed to continue to exceed its assets unless and until the statutory independent auditors of XYZ have reported in writing that they have been provided with evidence which reasonably satisfies them that the aforementioned liabilities of XYZ do not exceed its assets.

6. No claim, demand or request of whatever nature or source may be submitted against ABC Telecom Limited in respect of this Letter of Guarantee after this agreement lapses as indicated in paragraph 5.

Building a better working world

7. We undertake, and XYZ undertakes if it accepts this letter, that if this agreement is cancelled or varied in any respect the parties to this letter will immediately advise the registered auditors of XYZ of the cancellation or variation, provided that no cancellation or variation shall be effective within a period of less than 6 months from the date on which notice of such cancellation or variation is given.

8. These undertakings, given by us by way of comfort, will be construed under South African law and will be interpreted accordingly. We submit to the jurisdiction of the South African courts having jurisdiction for the resolution of any disputes arising under this letter of comfort.

Yours faithfully

_____

For and on behalf of **ABC Limited**
[Name and designation]

We accept the terms of this letter of comfort and confirm that, upon such acceptance, a binding agreement will come into force in the terms of this letter.

_____

For and on behalf of **XYZ (Proprietary) Limited**
[Name and designation]

Commentary on letter of guarantee

1. Such an agreement must be guaranteed by a party that has the financial ability to meet its obligations in terms of this letter.
2. The financial statements should include mention of this guarantee in the going concern note.
3. The practitioner can in terms of the stipulatio alteri rule accept the undertaking from ABC in terms of para 4 since the practitioner is usually a creditor of the company. (important clause : This right, known as a ius quaesitum tertio, arises where the third party (tertius or **alteri**) is the intended beneficiary of the contract, as opposed to a mere incidental beneficiary (penitus extraneus))
4. This letter on its own does not mean that we have discharged our obligation to modify our audit report in circumstances in which there is uncertainty or disagreement with the use of the Going Concern assumption in drawing up the financial statements on which we are expected to report.
5. Such an agreement would assist with resolving commercial solvency. Though it would not mitigate factual insolvency, it can be argued that a company that has an adequate guarantee in place is no at risk of needing business rescue albeit factually insolvent.

Building a better working world

Appendix B

Illustrative letter of support

[Date]
[Name]
[Designation]
XYZ (Proprietary) Limited
[Address]

Dear Sirs,

Company (Proprietary) Limited

We are aware that according to the annual financial statements for [COMPANY NAME] for the year ended 31 December 20XX, the company is technically insolvent to the extent of RXXX.

[SUPPORTOR CO NAME] as the shareholder of the entity listed above, hereby confirms that it will continue to support [COMPANY NAME] for the time being by providing or procuring the provision of working capital to the extent that the company is unable to meet its debts and obligations in full.

Yours sincerely,

Director
For and on behalf of [SUPPORTOR CO NAME]

Commentary on letter of support

1. The letter of support is not legally binding, and as such does not create an obligation for the supporter to provide any findings for the company. Although the letter does provide an indication of the current intention, it does not mitigate factual or commercial solvency because it does not create a contractual obligation and can be set aside at any point.

<End>

OPINION

on

PROPOSED GUIDE FOR REGISTERED AUDITORS:

CONSIDERATIONS FOR AN AUDITOR OR A REVIEWER OF A COMPANY

WHICH IS FACTUALLY INSOLVENT

For:
Mrs K Gawith
Webber Wentzel

Chris Loxton SC
Duncan Turner
29 September 2016

Introduction

1 Our consultants are four auditing firms: PriceWaterhouseCoopers, EY, Deloitte and KPMG. Our opinion is sought in relation to the correctness of certain parts of a document recently published by the Committee for Auditing Standards ("CFAS") of the Independent Regulatory Board for Auditors ("IRBA") – Proposed Guide for Registered Auditors: Considerations for an Auditor or a Reviewer of a Company which is Factually Insolvent ("the Guide") - which has been prepared in draft and published for public comment.

2 In the Guide, consideration is given to various elements of the Companies Act, 71 ("the Companies Act" or "the 2008 Act") and the Companies Regulations[1] as well as the Auditing Professions Act, 2005 ("the APA") and particular interpretations are placed on the provisions of this legislation. Our advice is sought in relation to the manner in which the Guide addresses sections 128 and 129 of the Companies Act and Companies Regulation 29.

3 Sections 128 and 129 of the Companies Act fall within Chapter 6 dealing with Business Rescue and Compromise with Creditors. Regulation 29 falls within part C of Chapter 2 of the Companies Regulations dealing with "Transparency, accountability and integrity of companies".

4 Our consultants wish us to consider the provisions of paragraphs 50 and 56[2] of the Guide and to provide our views on the correctness of what is recorded there:

[1] Companies Regulations published under GN351 in GG34239 of 26 April 2011 as amended.

[2] Our instructions refer to paragraph 49, which introduces paragraph 50, and to paragraph 54, but quote paragraph 56

> *"50. If a company is factually insolvent, then it falls within the definition of 'financially distressed' in section 128(1)(f), and the company is required to act in the manner set out in section 129(7)."*[3]
>
> ... ...
>
> *"56. Regulation 29(1)(b)(iii) is considered to deal with factual insolvency".*

Factual insolvency v commercial insolvency

5 The Guide sets out by distinguishing what it regards as "factual insolvency" from "commercial insolvency" with the intention of focussing its guidance on circumstances of factual insolvency only.

6 For simplicity, it is useful to consider the following situations:

6.1 Situation 1 – where the company's total assets exceed its total liabilities and it is able to pay its debts as they become due.

6.2 Situation 2 – where the company's liabilities exceed its assets and it is unable to pay its debts as they become due.

6.3 Situation 3 – where the company's assets exceed its liabilities but it is unable to pay its debts as they become due.

6.4 Situation 4 – where the company's liabilities exceed its assets but it is able to pay its debts as they become due.

7 The first two situations ought to give rise to no difficulties: the first describes a solvent company; the second, an insolvent company. Using the definitions

---

[3] Section 129(7) requires the company to issue a notice to "all affected persons" recording that the board of the company "has reasonable grounds to believe that the company is financially distressed", but the board has not adopted a resolution placing the company in business rescue."

employed in the Guide: situation 3 would be described as both *factual solvency* and *commercial insolvency*; situation 4 would be described as both *factual insolvency* and *commercial solvency*.

8 One can immediately see the ambiguity that can arises where only the word "solvent" or the word "insolvent" is used. Ordinarily, these words would antonyms and mutually exclusive. However, using the labels "commercial insolvency" and "factual insolvency", the company in situations 3 and 4 is both solvent and insolvent at the same time.

9 While it is correct that a distinction has been drawn between "factual solvency/insolvency" and "commercial solvency/insolvency" in our courts[4], these labels are not exhaustive of the concepts which may be relevant in interpreting the relevant statutes. This is particularly so where these labels are not employed in the legislation, where different words are used.

10 In our view, the appropriate approach to assessing the obligations set out in section 129(7) and Regulation 29 involves an analysis which goes beyond an evaluation of the words themselves and invokes the "unitary exercise" identified by the Supreme Court of Appeal,[5] taking into account all of the relevant factors in order to ascertain the meaning of the language of these provisions.[6] Following the dicta of Wallis JA in *Natal Joint Municipal Pension Fund v Endumeni Municipality* ("*Endumeni*"), consideration is given to each of the following factors without over-emphasising any one over the others:

---

4 See, for example, *Ex Parte De Villiers & Ano NNO : In re: Carbon Developments (Pty) Ltd (in liquidation)* 1993 (1) SA 493 (A) at 502 C-E

5 See *Bothma-Batho Transport v S Bothma & Seun Transport* 2014 (2) SA 494 (SCA) at para 10-12

6 See *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) at para 20

10.1 the language of the provision;

10.2 the context in which the provision is recorded;

10.3 the purpose of the provision;

10.4 an objective evaluation of the different possible meanings; and

10.5 consideration of what would constitute a sensible or business-like result (rather than an insensible or un-business-like result).[7]

11 The anomaly which appears in section 129(5) was addressed in *Panamo Properties.*[8] As was pointed out there, with reference to *Endumeni*,

> *"... the court must consider whether there is a sensible interpretation that can be given to the relevant provisions that will avoid anomalies. In doing so certain well-established principles of construction apply. The first is that the court will endeavour to give a meaning to every word and every section in the statute and will not lightly construe any provision as having no practical effect. The second and most relevant for the present purposes is that if the provisions of the statute appear to conflict with one another are capable of being reconciled then they should be reconciled."*

12 Although the concepts relevant to the discussion in respect of paragraphs 50 and 56 of the guide are similar, we deal with them separately.

Section 129 read with section 128

13 Section 129(1) identifies the jurisdictional facts that must be present before the board of a company may voluntarily begin business rescue proceedings, namely that: the board has reasonable grounds to believe the company is financially distressed; and there is a reasonable prospect of "rescuing the company". The

---

[7] *Natal Joint Municipal Pension Fund* (supra) at para 18

[8] *Panamo Properties (Pty) Ltd & Ano v Nel & Others NNO* 2015 (5) SA 63 (SCA). See paras 25 – 28.

obligation on the board to deliver a written notice to each "affected person"[9] in terms of section 129(7), arises only in circumstances where the board has "reasonable grounds to believe that the company is financially distressed" but has resolved not to begin business rescue proceedings as contemplated in section 129(1).

14 Whatever interpretation is to be applied to the term "financially distressed" it must permit of application to both section 129(1) and 129(7) and, where more than one interpretation is possible, the most sensible, businesslike interpretation following the purpose of the provision and the Act should be preferred.

15 "Financially distressed" is defined in section 128(1)(f) as follows[10]:

> *"(f) **'financially distressed'** in reference to a particular company at any particular time, means that-*
>
> *(i) it appears 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; or*
>
> *(ii) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months;"*
>
> (emphasis added)

16 The CFAS has taken a view in the Guide that the provisions of section 128(1)(f)(ii), read with section 129, mean that a company that is factually insolvent (but not commercially insolvent) must be considered to be "financially distressed" so that business rescue proceedings can be commenced, alternatively if they are not commenced, a notice should be delivered in terms of section 129(7).

---

[9] This includes shareholders, creditors, employees and trade union employees

[10] We note that the introduction to the definition has been omitted from the quotation in paragraph 48 of the Guide. As set out below, that introduction plays an important role in the interpretation.

17 In our view, there are a number of reasons why this is unlikely to be correct and why it is unlikely to be the interpretation adopted by our courts. We set these out below.

Plain meaning of the words

18 Although the Act provides the statutory definition for particular words, it is useful, in context, to consider the dictionary definitions for some of the relevant words[11].

18.1 **Distress** n. **1** severe pressure of trouble, pain, sickness, or sorrow; anguish affliction; hardship, privation, lack of money or necessities. Also, an instance of this, a misfortune, a calamity;

18.2 **Distressed** a. **1** exhibiting or pertaining to distress; afflicted with pain or trouble; spec. living in impoverished circumstances.

18.3 **Solvent** adj. **1** able to pay one's debts or meet ones liabilities; financially sound.

18.4 **Insolvent** adj. **1** unable to pay one's debts or meet one's liabilities; bankrupt.

19 The ordinary meaning of the words, although defined in the statutes, does assist in the interpretation as it is unlikely that the legislature would have chosen these words without reference to or consideration of their ordinary meaning. The use of the word "financially" in the long title of the Act and in section 7, to qualify the word "distressed", suggests that the Legislature had in mind the natural and ordinary grammatical meaning of the word "distressed" in relation to a company,

[11] New Shorter Oxford English Dictionary

namely one in severe financial trouble. Adopting the above dictionary definitions and a purposive approach to the business rescue provisions (discussed below), one is able to identify the class of companies to which and for which those provisions have been enacted, namely those in financial trouble. Companies that are not in financial trouble should not need to consider the provisions of Chapter 6.

Judicial interpretation of the words

20 The Supreme Court of Appeal has recently had to consider the interpretation of the words "solvent" and "insolvent" as they are used in the Companies Act and particularly in relation to the provisions dealing with liquidation of companies[12].

21 The provisions of the 2008 Act address[13] the liquidation of a "solvent" company. The schedules to the Companies Act note that the liquidation of insolvent companies is governed by Chapter 14 of the 1973 Companies Act ("the 1973 Act").[14] In *Boschpoort*, the SCA was faced with an application to wind up a firm which was factually solvent (i.e. its assets exceeded its liabilities) but was commercially insolvent (i.e. it was in such a state of illiquidity that it was unable to pay its debts[15]). The question arose as to whether the 2008 Act or chapter 14 of the 1973 Act should be applied.

22 The Court concluded[16] that whether the company is factually solvent or factually insolvent is not determinative of whether a firm is considered, for purposes of the Companies Act, to be solvent or insolvent. A "solvent company" is one that is

[12] *Boschpoort Ondernemings (Pty) Ltd v Absa Bank* 2014 (2) SA 518 (SCA)

[13] In section 79-81 – read with specific provisions in the 1973 Act

[14] Companies Act 61 of 1973 made relevant by the provisions of item 9 of Schedule 5 to the 2008 Companies Act

[15] At paragraph 16

[16] at paragraphs [22]-[24]

"commercially solvent". As such, the Court held that despite it establishing that the value of its assets exceeded its liabilities (i.e. factual solvency), the fact that the company could not pay its debts meant that it was, for purposes of the provisions of the Companies Act, "insolvent" and therefore liable to be wound up in terms of Chapter 14 of the 1973 Act.

23 When interpreting a statute, there is a presumption of legislative consistency, so that unless the context gives a clear indication to the contrary, the legislature is presumed to have intended that a term/word would bear a consistent meaning throughout an Act.[17] There is a close association between the provisions of the Companies Act dealing with business rescue and those dealing with winding up. As the SCA has pointed out:

> "*Business rescue is a process aimed at avoiding the liquidation of a company if it is feasible to do so.*"

24 Consequently, it is appropriate when interpreting the business rescue provisions of the Act and concepts of solvency / insolvency, that those terms be interpreted in a manner consistent with the way they are interpreted in matters dealing with liquidation.

The purpose and context of Chapter 6

25 In order to consider whether factual insolvency, in the absence of commercial insolvency, triggers the definition of "financially distressed" it is important to interrogate the context in which the term "financially distressed" is used in the

[17] Singer v The Master 1996(2) SA 133 (A) at 139F

Companies Act. The term is used only where business rescue proceedings are contemplated. In both section 129(1) (dealing with voluntary proceedings) and section 131(4) (dealing with applications made by third parties), two jurisdictional requirements are juxtaposed:

25.1 It must be established that the company is financially distressed;

25.2 There is a reasonable prospect of "rescuing the company".

26 The necessary inference is that a company in financial distress requires "rescuing". This resonates with the ordinary meaning discussed above - a company in financial trouble. This interpretation is reinforced by section 7(k) where the purposes of the Act are said to include:

> *"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;"*

Here it is expressly anticipated that a company qualifying for business rescue requires "recovery" – restore to health, strength, restore to a good or proper condition[18] - which presupposes that the state it is in when it qualifies for business rescue is not normal.

27 The definition of "rescuing the company" set out in section 128(1)(h) means "*achieving the goals set out in the definition of 'business rescue' in paragraph (b)*". The definition of "business rescue" then sheds light on what the provisions of chapter 6 seek to achieve.

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

[18] The New Shorter Oxford English Dictionary

(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

(iii) the development and implementation, if approved, of a plan to rescue the company by structuring 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;"

28 These three items that are provided as part of the intended remedy give a good indication of the nature of the ailment that is being treated. If there is no reason to replace management, if the company is able to pay its debts as they arise and if its affairs are structured in a manner that permits it to continue to operate and pay its debts, there ought to be no reason to and no justification for commencing business rescue proceedings.

29 In our view, weight must be given to the practical and business reality that a large number of businesses and, particularly new businesses, operate in circumstances where their total liabilities exceed their total assets. This "leveraged" position is common in private companies where shareholders will fund the company through a loan structure rather than equity and where loan financing is arranged with the expectation that revenues generated will pay the company's debts as and when they fall due. This reality was recognised by the Appellate Division in *Carbon Developments.*[19] In our view, this reality, recognised by our highest courts, together with the presumption that the Legislature did not intend to alter the law or

[19] *Ex Parte De Villiers* (supra) at 503 G-H

to ignore judicial interpretations, weighing heavily in the interpretation of these provisions.[20]

30 Entrepreneurship, enterprise efficacy, innovation and investment all fit squarely within the types of businesses discussed by the Appellate Division in *Carbon Developments*. These are also among the other stated purposes of the Companies Act as set out in section 7 – which include "encouraging entrepreneurship and enterprise efficacy; creating flexibility and simplicity in the formation and maintenance of companies; promoting innovation and investment in the South African market."[21]New businesses and innovative businesses ordinarily require start-up capital (whether as equity or loan capital) and require that the control of the business and the development of the business remain within the hands of the entrepreneur or the chosen management. Importantly, new businesses will generally start life as factually insolvent but, because of credit they have secured in the expectation that the business model will succeed, are commercially solvent. In short, they are not financially distressed and both they and their funders would be surprised if they were to be described as such.

31 If the interpretation proposed by the CFAS were correct, the business rescue provisions would undermine these key purposes of the Act and strike out at companies that could never have been intended to be placed in business rescue.

31.1 This would require a start-up entrepreneur who had raised long term subordinated loan finance to commence business rescue proceedings and relinquish control over his business or issue a notice in terms of section

[20] See *Boschpoort Ondernemings (Pty) Ltd v Absa Bank* 2014 (2) SA 518 (SCA) at [19]

[21] Companies Act section 7 (b) and (c)

129(7) recording that the company was "financially distressed". This is an immediate disincentive to innovation and investment and would also undermine the confidence which employees and creditors had in the business.

31.2 It would create an environment in which the entrepreneur, who should be focussing on innovation and making decisions to develop his business, is focussing instead on whether a business rescue practitioner should be appointed to make the decisions in the business.

31.3 It would raise and maintain a spectre over all leveraged businesses which would render them vulnerable to applications for business rescue in terms of section 131 where their ability to pay their debts on time was not questioned.

31.4 It would dilute the effectiveness of subordination and other debt structuring arrangements which are implemented in the ordinary conduct of business in South Africa.

32 For purposes of interpreting the words "*become insolvent*" in section 128(1)(f) and considering the circumstances to which they would apply, it is also necessary to consider the Legislature's the primary goal of business rescue proceedings and whether that could be relevant to a company that is leveraged but otherwise healthy[22]- namely, "*to rescue the company by structuring 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*"

[22] *Oakdene Square Properties & Others v Farm Bothasfontein (Kyalami) (Pty) Ltd & Others* 2013 (4) SA 39 (SCA) at para [22] – [23]

33 If the company has good management, a thriving business and has a financial structure in place that allows it to pay its debts when they become due, the intended consequence of business rescue would have no effect or benefit for that company. The only consequences of subjecting that company to business rescue would be negative: the imposition of additional costs and unknown expertise through the appointment of a business rescue practitioner (if section 129(1) or 133(4) applied); or the negative ramifications attendant on issuing a distress notice in terms of section 129(7).

34 In our view, a firm that was leveraged (its liabilities exceeded its assets) when business rescue commenced is highly unlikely to have reversed that situation during the business rescue period. The debts would remain owed and it is unlikely that the assets would increase during this period. The mechanisms contemplated by the Act are those of a "restructuring" nature which, in the ordinary course, would involve subordination of debt, rearranging payment plans etc. This being the case, it would allow the company to pay its debts as they fall due but would not remedy its factual insolvency. Consequently, the reference to "*continuing in existence on a solvent basis*" must be a reference to the company being able to pay its debts not to its total assets exceeding its total liabilities.

Making sense of the definition "financially distressed"

35 The word "or" appears between (i) and (ii) of the definition "financially distressed" in section 128(1)(f). The ordinary interpretation would be that the company would be found to be financially distressed if either of these provisions (i) or (ii) applied.

36 The interpretation adopted by the CFAS, that (ii) is a reference to factual insolvency, appears to be influenced by a belief that if "insolvent" as it is used in (ii) referred to a form of "commercial insolvency", there would be a redundancy because (i), which addresses an inability to pay debts already addresses commercial insolvency. However, in our view, this is not correct.

37 At the outset, we note that it is unhelpful and incorrect to import alternative words, such as "commercial insolvency" as a substitute for the words actually used in (i). As noted above, that term does not have a fixed meaning and we are unaware of an occasion where the precise words used in (i) have been used to define "commercial insolvency".

38 We also note that the circumstances contemplated in sub-paragraph (i) do not exclude the possibility that the company is also factually insolvent when it is found to be reasonably unlikely to be able to pay its debts. Consequently, it is not correct to assume that sub-paragraph (i) addresses commercial insolvency exclusively or that it follows axiomatically or even logically that sub-paragraph (ii) addresses factual insolvency.

39 An analysis of the words actually used, with reference to cases where these words have been addressed, reveals that while the words used in (i) and (ii) both relate to the ability to pay, they address different things:

39.1 The introduction to the definition requires that the necessary analysis be undertaken at a particular time.

39.2 The relevance of this lies in the distinction drawn in the authorities between "debts" on the one hand, which are due and payable at the particular time, and "contingent or prospective liabilities" which are not due at that particular time[23].

39.3 The ordinary meaning of a "debt" is a "firm obligation to pay" and excludes "contingent and prospective liabilities[24]. Applying this ordinary meaning to (i) allows a simple evaluation of the criteria in (i): the company will be able to evaluate what its "firm" debts are and assess whether it is unlikely that the company would be able to pay all of those debts in the ensuing 6 month period.

39.4 The assessment of the criteria in (i) does not include an evaluation of the company's contingent or prospective liabilities.

39.5 Whether a company is insolvent, in terms of the Companies Act (read with chapter 14 of the 1973 Act), depends on whether the company is unable to pay its debts as contemplated in section 345 of the 1973 Act. That section requires an assessment of more than just the "firm" debts and includes a deeming provision in s345(2) which applies only to the assessment in terms of section 345(1) – this deeming provision requires that contingent and prospective liabilities be taken into account.

39.6 In our view, sub-paragraph (ii) contemplates the situation where, notwithstanding the expectation that the company could pay all of its

[23] see *Joint Liquidators of Glen Anil Development Corporation Ltd (in Liquidation) v Hill Samuel (SA) Ltd* 1982 (1) SA 103 (A) at 110 -111 – *Taylor & Steyn NNO v Koekemoer* 1982 (1) SA 374 (T) @ 379-381

[24] *Joint Liquidators of Glen Anil (Supra)*

"firm" debts in the ensuing six months, the board is aware of a contingent or prospective liability which:

39.6.1 Is not yet a "debt" but in the board's view is reasonably likely to become a debt in the ensuing 6 months; and

39.6.2 If it happens will cause the company to become insolvent – unable to pay its debts as they become due.

40 The above interpretation also explains the unusual use of the words "reasonably unlikely" in (i) and "reasonably likely" in (ii). The Legislature decided to postulate the first provision in the negative – unlikely to be able to pay known debts - and the second in the positive – likely that the contingent/prospective liability will materialise.

41 In our view, it is more likely that section 128(1)(f) addresses form of commercial insolvency in both sub-paragraphs (i) and (ii). The former addresses a situation were commercial insolvency is realised having regard to the debts known at the "particular time" while the latter addresses circumstances where the board considers it likely that a contingent or prospective liability may eventuate causing commercial insolvency within the immediately ensuing six months.

42 This interpretation is consistent with the overall purpose of Chapter 6 which permits a company to use the business rescue proceedings before it is too late for those proceedings to have the intended beneficial impact.

43 It is also preferable to the unbusinesslike result of an interpretation that defines every leveraged company as "financially distressed" and that requires a leveraged

company automatically and continuously to be required to have regard to the business rescue provisions of the Companies Act, despite the fact that it remains able to pay its debts as they fall due.

Companies Regulation 29

44 A "reportable irregularity" is a term defined in Regulation 29(1)(b):

> "***'Reportable Irregularity'*** *means any act or omission committed by any person responsible for the management of a company, which –*
>
> *(i) unlawfully has caused or is likely to cause material financial loss to the company or to any member, shareholder, creditor or investor of the company in respect of his, her or its dealings with that entity; or*
>
> *(ii) is fraudulent or amounts to theft; or*
>
> *(iii) causes or has caused the company to trade under insolvent circumstances."*

45 Regulation 29 then sets out what must be done by an auditor or an independent reviewer if a "reportable irregularity" is found.

45.1 Regulation 29(6) requires an Independent Reviewer to submit a written report to the Commission giving particulars of the alleged reportable irregularity.

45.2 Regulation 29(7) requires that the same report be submitted to the company's board of directors.

45.3 Regulation 29(8) requires the Independent Reviewer then to take reasonable measures to discuss the report with the board, to give the board an opportunity to make representations and then to send another report to the Commission recording: that no "reportable irregularity" has taken

place; or that it is no longer taking place; or that it is continuing, together with particulars.

45.4 Regulation 29(9) places an obligation on the Commission to report a continuing irregularity to the appropriate regulator to investigate any alleged contravention of the Act.

46 As noted above, the CFAS considers that Regulation 29(1)(b)(iii) includes a circumstance where the company is factually insolvent (its liabilities exceed its assets) but is commercially solvent (it is able to pay its debts as they arise). The result being that a report would be required and the above process followed on the review of every company that has liabilities that exceed its assets.

47 It also considers that trading when the commercially insolvent is "fraudulent or amounts to theft"[25]. We are unable to understand the basis for this statement in footnote 30 and consider this to be clearly wrong.

Meaning of the word "insolvent"

48 For all of the reasons set out above, it appears clear to us that the word "insolvent" when used in the Companies Act involves an evaluation of commercial insolvency not factual insolvency. There is no reason to suggest that the word when used in the Regulations would bear a different meaning from the Act.

48.1 First, as pointed out above with reference to the cases,[26] there is nothing irregular in business in South Africa for a company to be leveraged and for

[25] This is stated in footnote 30 to paragraph 56

[26] *Carbon Developments, Boschpoort (supra)*

its total liabilities to exceed its total assets. This is particularly so in respect of a start-up company. As it is not irregular, in the ordinary sense of the word, it is unlikely that such conduct would be expected to be considered a reportable irregularity;

48.2 Second, as set out in *Boschpoort*[27], the words "solvent" and "insolvent" as used in the Companies Act are words which relate to commercial solvency (an ability to pay debts, not to factual insolvency).

Reckless

Purpose and context

49 Certainly, there can be no purpose served by the above reporting procedures being followed in respect of a company which is leveraged and commercially solvent. The purpose of this regulation is clearly to uncover and report unlawful, fraudulent and reckless conduct so that it can be investigated and stopped. It is not to maintain a record of which companies are leveraged.

50 The regulation provides a mechanism through which the Commission can receive information that it needs to exercise its own powers. For example, section 22(2) of the Companies Act contemplates

> *"If the Commission has reasonable grounds to believe that a company is engaging in conduct prohibited by subsection (1), or is unable to pay its debts as they become due and payable in the normal course of business, the Commission may issue a notice to the company to show cause why the*

[27] supra

company should be permitted to continue carrying on its business, or to trade, as the case may be."

51 The mechanism created through regulation 29(1)(b)(iii) provides a channel for information describing this conduct to be communicated to the Commission. If the communications were not restricted to these instances but included all instances of factual insolvency (which is normal and not prohibited) the information necessary for implementing section 22 would not be received or would be lost in the deluge of submissions.

Sensible meaning

52 Applying regulation 29 to all instances of factual insolvency would not lead to a sensible or business-like result.

53 First, a company's balance sheet (reflecting liabilities exceeding assets) is not something that can easily be remedied within 20 business days and after a discussion between the directors of the company and an Independent Reviewer (as contemplated in section 29(8)). If the factual insolvency of the company were to be considered a "reportable irregularity" it would always (or in most cases) be dealt with in terms of Regulation 29(8)(c)(i)(cc) because it could not be remedied within 20 days and therefore follow the procedure contemplated in Regulation 29(9).

54 Second, an interpretation that required the Commission to report to the regulator every instance of a company which may be classified as "factually insolvent" would overwhelm the system and undermine the very purpose of the system – being to weed out unlawful, fraudulent or reckless conduct. The deluge of reports that

would be submitted through the Commission to the Regulator would prevent the Regulator and the Commission from attending to the important matters that they ought to attend to. There could be no conceivable purpose achieved by the Commission or the Regulator or the legislation by such reports being submitted in this manner.

55 In our view, the reference to trading "under insolvent circumstances" in Regulation 29(1)(b)(iii) is restricted to circumstances where the company is unable to pay its debts as contemplated in section 345 of the 1973 Act, and the obligation on the Independent Reviewer to report (in terms of Regulation 29(6)) is restricted, for purposes of Regulation 29(1)(b)(iii) to a situation where the Independent Reviewer "is satisfied or has reason to believe that" the company is trading in circumstances where it is unable to pay its debts as contemplated in section 345 of the 1973 Act.

56 This interpretation aligns with the interpretation of the term "insolvent" in the Companies Act and with the provisions in the Act which address reckless trading and particularly section 22(2).

Conclusion

57 In the circumstances, it is our view that the definition of "financially distressed" in section 128(1)(f) of the Companies Act does not include a situation where a company is factually insolvent but commercially solvent. While factual insolvency may be an indicator of a company's insolvency (inability to pay all its debts and meet all liabilities), factual insolvency does not, without more, constitute grounds on which a company can be found to be financially distressed.

58 Consequently, it is our view that where a company is commercially solvent and able to pay its debts and does not expect to become unable to pay its debts (as contemplated in section 345 of the 1973 Act), it is not open to that company to resolve to place itself under business rescue in terms of section 129(1) and consequently, the board of that company is not under an obligation in terms of section 129(7) to issue a distress notice when business rescue proceedings are not commenced.

59 Insofar as Regulation 29 is concerned, we are also firmly of the view that the "insolvent circumstances" contemplated in Regulation 29(1)(b)(iii) is a reference to commercial insolvency only – circumstances in which the company is unable to pay its debts as per section 345 of the 1973 Act - and is not a reference to factual insolvency in the absence of commercial insolvency. It would not, in our view, be required of an independent reviewer to issue a report in terms of Regulation 29(6) or 29(8) to the Commission where the reviewer finds commercial solvency but that the total liabilities of the company exceed the total assets.

60 The reporting mechanism created by regulation 29 has been established in order to unearth and permit the investigation of unlawful conduct which is likely to cause material financial loss; fraudulent conduct, theft or circumstances where the directors of the company are incurring debts which they are unlikely to be able to repay. It was not created to require mandatory reporting of ordinary business practices.

CDA Loxton SC
DA Turner

Chambers, Sandton
29 September 2016