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Mr Imran
The Director: Standards Independent Regulatory Board for Auditors'
PO Box 8237,
Greenstone, 1616
Johannesburg

6 October 2016

Dear Imran

Comment letter on IRBA's Proposed Guide for Registered Auditors – Considerations for an Auditor or Reviewer of a Company which is Factually Insolvent

We appreciate the opportunity to comment on the *Proposed Guide for Registered Auditors - Considerations for an Auditor or Reviewer of a Company which is Factually Insolvent* (the proposed Guide), issued by the Independent Regulatory Board for Auditors (IRBA). We have consulted within the KPMG network in respect of this letter and this represents the collective views of KPMG Inc.

We support the IRBA's idea to introduce a guide to assist registered auditors, who are auditors or reviewers of factually insolvent companies. We acknowledge that the focus of the proposed Guide is on factual insolvency. However, we believe that the proposed Guide should deal with the considerations the auditor or reviewer of the company should take into consideration when dealing with a company in a commercial insolvent position.

Factual insolvency and commercial insolvency is defined as the following:

- The company is factually insolvent when its total liabilities exceeds its total assets.
- The company is commercialy insolvent when the company is unable to pay its liabilities as and when they fall due in the normal course of business.

This view seems to be supported by the opinion issued by Chris Loxton SC and Duncan Turner and is attached for your reference.

We have set out our detailed responses to your specific questions as well as our general comments in the appendices to this letter.

Please contact Thingle Pather +27 (0) 11 647 7366 if you wish to discuss any of the issues raised in this letter.

Yours sincerely,

Pather

Thinglemony Pather

Director: Department of Professional Practice

Appendix

Part A – responses to specific questions

i. **With respect to paragraphs 48 to 50 of this proposed Guide, respondents were asked to consider the implications of the interpretation of "financially distressed" as defined in section 128(1)(f) of the Companies Act.**

   We do not agree with the definition of financially distressed companies as per 128(1)(f)(i). However, we are of the opinion that this deals with commercial insolvency rather than factual insolvency, as the focus is on whether or not the company is able to pay its debts as and when they fall due.

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

   We do not agree with the interpretation of the definition of Regulation 29(1)(b) relating to factual insolvency. We are of the view that this should make reference to commercial insolvency, since "trading under insolvent circumstances" refers to the inability of a company to pay its debts as and when they fall due in the normal course of business.

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

   We do not agree with the identifications, descriptions of and distinctions between the various types of common responses to factual insolvency. However, with the exception of the issue of share capital for cash and the capitalisation of parts or all amounts owing to creditors, all the other responses do not restore factual solvency. Therefore the sub titles "Responses to factual insolvency" and "Other responses to factual insolvency" should be more appropriate titled "Responses to insolvency" and "Other responses to insolvency".

iv. **The proposed Guide contains an illustrative subordination agreement in Appendix 3. Respondents were asked to comment on whether or not an illustrative subordination agreement should be included in the proposed Guide.**

   We agree that an illustrative subordination agreement should be included as this is an example of a legally binding document and will serve as a guide for companies in drafting a similar agreement.

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 variation thereof in practice?**

   Letter of guarantee
   We believe that the proposed Guide should include an illustrative letter of guarantee as this is a legally binding document and would assist companies in drafting similar letters of guarantee.

   Letter of support
   We appreciate the fact that a letter of support has many variations because of different circumstances, however, we believe that an illustration would be helpful to companies in drafting an appropriate letter. We have attached an illustrative letter of support in Appendix 2, as issued by SAICA, with example statements that can be included in a letter of support.

Part B – general comments

- The definition of solvency and insolvency should be clearly stated in the introduction of the proposed Guide.
- Paragraph 24 of the proposed Guide should also consider giving guidance on assets measured at value in use.
- The case law summaries in paragraphs 27 – 33 should be moved to the introduction section of the proposed Guide. This should rather be explanatory in nature and not combined with the guidance.
- Paragraphs 61 to 81 should also address considerations for auditors who audit public sector entities or state owned companies as the reporting requirements for those auditors may differ.
- Paragraph 104 should consider situations where the letter of support is issued by a related party to the company.
- Paragraph 120 should read "… can materially affect factual insolvency…"
- There should be mention of management bias considerations in paragraph 122.2.
- There should be mention of documentation about consideration of reportable irregularity in either paragraph 122.2, 122.3 or 122.8.
- The illustrative communications in terms of Companies Regulations 29 in Appendix 1 of the proposed Guide should be updated to reflect SAICA's Circular 3/2016.
- The illustrative communications in terms of section 45 of the Auditing Profession Act in Appendix 2 of the proposed Guide should be updated for the revised Reportable Irregularity Guide issued in May 2015.
- The term "funding" differs significantly from "financing". Whereas funding infers that there is no obligation to pay, financing infers to an obligation to pay back an amount borrowed. Therefore the most appropriate terminology should be used in paragraph 115.

ILLUSTRATIVE REPORTABLE IRREGULARITY LETTERS FOR INDEPENDENT REVIEWS

Caution

Members are requested /encouraged to seek legal advice with regard to the implication of the Protection of Personal Information Act (POPI Act), pertaining to the engagement, as well as any other legislation that may be applicable.

Introduction

.01 In terms of Regulation 29(6) of the Companies Regulations, 2011 (the "Regulations"), an independent reviewer of a company that is satisfied or has reason to believe that a reportable irregularity has taken place or is taking place in respect of that company must, without delay, send a written report to the Companies and Intellectual Property Commission ("the Commission").The report must give particulars of the reportable irregularity and must include such other information and particulars as the independent reviewer considers appropriate.

.02 Regulation 29(7) of the Regulations requires an independent reviewer to notify the members of the board of the company, in writing, within three business days of sending the report to the Commission. A copy of the report to the Commission must accompany the notice.

.03 Regulation 29(8) of the Regulations states that the independent reviewer must, as soon as is reasonably possible but not later than 20 business days from the date on which the initial report in terms of Regulation 29(6) was sent to the Commission:

- take all reasonable measures to discuss that initial report with the members of the board of the company;
- afford the members of the board of the company an opportunity to make representations in respect of that initial report; and
- send another report (i.e. a second report) to the Commission, which must include a statement that no reportable irregularity has taken place or is taking place, or that the suspected reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant, or that the reportable irregularity is continuing.

This second report is required to include detailed particulars and information supporting the statement referred to above.

.04 To assist members, the South African Institute of Chartered Accountants (SAICA) has provided in: [1]

- Appendix A, an illustrative reportable irregularity letter to the Commission in accordance with Regulation 29(6) of the Regulations, which is the initial report to the Commission (i.e. the first report to the Commission);

- Appendix B, an illustrative reportable irregularity letter to notify members of the board of the company in accordance with Regulation 29(7) of the Regulations; and
- Appendix C, a subsequent letter to the Commission in accordance with Regulation 29(8)(c)of the Regulations (i.e. the second report to the Commission).

Johannesburg **Willie Botha**
July 2016 **Senior Executive: Assurance and Practice**

[1]The report should be converted to a PDF format prior to being issued.
Where the same reportable irregularity is being reported for a group of companies, the letter can be adapted to deal with all companies in the group, by individually specifying the name and registration number of each company in the group.

APPENDIX A

Template letter to the Commissioner

First Report: Reportable Irregularity

[Firm Letterhead]

[*Date*]

The Commissioner
Companies and Intellectual Property Commission
P O Box 429
Pretoria
0001

Email: independentreview@cipc.co.za[2]

Dear Sir/Madam

FIRST REPORT: REPORTABLE IRREGULARITY
NAME OF COMPANY: [*INSERT THE NAME OF THE COMPANY*]
REGISTRATION NUMBER: [*INSERT THE COMPANY'S REGISTRATION NUMBER*]

This letter is in accordance with the requirements of Regulation 29(6) of the Companies Regulations, 2011 (the "Regulations").

I/We have been engaged by [*insert name of company*] to independently review the annual financial statements of the company for the year ended [*insert reporting date*].

I/We have reason to believe that a reportable irregularity, as defined in the Regulations, has taken, or is taking place. I am /We are not able to make any legal determination, as may be applicable, in respect of the act or omission, but have exercised professional judgement, based on the evidence or information which has come to my/our knowledge, including undertaking further investigations of information as were considered necessary in the circumstances.

Particulars of the reportable irregularity are:

[*Provide particulars of the reportable irregularity and include such other information and particulars as the independent reviewer considers appropriate. This section should also set out the reportable irregularity clearly and concisely, including stating the actual section of the legislation that is allegedly being contravened, for example the relevant section of the Companies Act.*]

As required by Regulation 29(7) of the Regulations, I/we will within three business days of sending this report to you notify the members of the board of the company in writing that I/we have sent this report to you. A copy of this report will accompany the notice.

[2] The Commission has a dedicated e-mail address that should be used for purposes of submitting reportable irregularity reports.

Please acknowledge receipt of this report.

Yours faithfully

[*Name of Independent Reviewer*]
Partner / Director [*Delete if not applicable, or whichever is not applicable*]
Chartered Accountant (SA) / Associate General Accountant (SA) [*Delete whichever is not applicable*]

[*Independent Reviewer's direct email address*]
[*Independent Reviewer's direct telephone number*]

APPENDIX B

Template letter to the members of the board of the company: Reportable Irregularity

[Firm Letterhead]

[*Date*]
[*Members of the board of the company*]
[*Name of company being independently reviewed*]
[*Address*]

Dear Members

REPORTABLE IRREGULARITY

This letter is in accordance with the requirements of Regulation 29(7) of the Companies Regulations, 2011 (the "Regulations").

Regulation 29(1)(b) of the Regulations defines a reportable irregularity as any act or omission committed by any person responsible for the management of a company, which:

- 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
- is fraudulent or amounts to theft; or
- causes or has caused the company to trade under insolvent circumstances.

I/We have reason to believe that a reportable irregularity has taken or is taking place and, as required by the Regulations, I/we have reported particulars of the irregularity to the Companies and Intellectual Property Commission ("the Commission") in a written report dated [*insert date*], a copy of which is attached.

As indicated in that report, I am not able to make any legal determination, as may be applicable, in respect of the act or omission, but have exercised professional judgement, based on the evidence or information which has come to my knowledge, including undertaking further investigations of information as were considered necessary in the circumstances.

Regulation 29(8) of the Regulations requires me/us as soon as is reasonably possible, but no later than 20 business days from the date on which the initial report was sent to the Commission, to:

- take all reasonable measures to discuss the attached report sent to the Commission with the members of the board of the company;
- afford the members of the board of the company an opportunity to make representations in respect of the report; and
- send another report to the Commission, which report must include:
    - a statement that I am/we are of the opinion that
        - no reportable irregularity has taken place or is taking place; or

    - the suspected reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant; or
    - the reportable irregularity is continuing; and
- detailed particulars and information supporting the statement.

If I am/we are to report to the Commission that the reportable irregularity is continuing, the Commission has a responsibility to notify any appropriate regulator in writing of the details of the reportable irregularity concerned and provide it with a copy of our final report. Furthermore, the Commission may investigate any alleged contravention of the Companies Act.

I/We invite you to discuss my/our report to the Commission, at a meeting to be arranged as soon as possible, and at that meeting I/we will afford you the opportunity to make representations in respect of my/our report.

[OR] [*Delete whichever paragraph is not used*]

Please contact me/us as soon as possible to discuss my/our report to the Commission, and in order for the board of the company to have an opportunity to make representations in respect of my/our report.

If the members of the board fail or decline to engage in discussions with us, the matter will proceed in conformity with the requirements of Regulation 29 of the Regulations.

Please acknowledge receipt of this report.

Yours faithfully

[*Name of Independent Reviewer*]
Partner / Director [*Delete if not applicable, or whichever is not applicable*]
Chartered Accountant (SA) / Associate General Accountant (SA) [*Delete whichever is not applicable*]

[*Independent Reviewer's direct email address*]
[*Independent Reviewer's direct telephone number*]

APPENDIX C

Template letter to the Commissioner

Second Report: Reportable Irregularity

[Firm Letterhead]

[*Date*]

The Commissioner
Companies and Intellectual Property Commission
P O Box 429
Pretoria
0001

Email: independentreview@cipc.co.za[3]

Dear Sir/Madam

SECOND REPORT: REPORTABLE IRREGULARITY
NAME OF COMPANY: [*INSERT THE NAME OF THE COMPANY*]
REGISTRATION NUMBER: [*INSERT THE COMPANY'S REGISTRATION NUMBER*]

This letter is in accordance with the requirements of Regulation 29(8) of the Companies Regulations, 2011 (the "Regulations").

I/We refer to my/our first report dated [*insert date of first report*]. I/We have included a copy of the written notice which was sent together with the above mentioned report to the members of the board of the company.

I/We have discussed that report with the members of the board of the company and have afforded them an opportunity to make representations in respect of the report. I/We have also undertaken such further investigations as I/we considered necessary. I/We have included written representations made by members of the board of the company in respect of the report.

[OR] [*Delete whichever paragraph is not applicable*]

Although I/we have taken all reasonable measures to communicate with the board of the company in respect of the suspected reportable irregularity, the board has failed or declined to engage in discussions with me/us. However, I/we have undertaken such further investigations as I/we considered necessary. [or] I/We have also been unable to undertake such further investigations as I/we considered necessary. [*Delete whichever sentence is not applicable.*]

I/We report that in my/our opinion no reportable irregularity has taken place or is taking place [or] the reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant [or] the reportable irregularity is continuing. [*Delete the conclusions which are not applicable.*]

[3] The Commission has a dedicated e-mail address that should be used for purposes of submitting reportable irregularity reports.

Details and information in support of my/our statement above are as follows:

[*Provide detailed particulars and information supporting the independent reviewer's conclusion as stated in the previous paragraph.*]

Contact details of reference person of the company[4]

- [*Insert name of contact person*]
- [*Insert title of person that can be contacted – a director or manager*]
- [*Insert telephone number of contact person*]
- [*Insert email address of contact person*]
- [*Insert postal address of company*]

Please acknowledge receipt of this report.

Yours faithfully

[*Name of Independent Reviewer*]
Partner / Director [*Delete if not applicable, or whichever is not applicable*]
Chartered Accountant (SA) / Associate General Accountant (SA) [*Delete whichever is not applicable*]

[*Independent Reviewer's direct email address*]
[*Independent Reviewer's direct telephone number*]

[4] The contact details of a reference person of the company are only required when the independent reviewer's conclusion is that the reportable irregularity is continuing.

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:

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[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 be 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

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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 <u>will become insolvent</u> 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 <u>at a particular time</u>.

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 <u>insolvent</u>, 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

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[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