Mr Imran Vanker
Director: Standards - Independent Regulatory Board for Auditors
standards@irba.co.za

5 October 2016

Dear Mr Vanker

Subject: The Proposed Guide for Registered Auditors: Considerations for an Auditor or a 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 a Reviewer of a Company which is Factually Insolvent (the Proposed Guide).

The Proposed Guide contains useful guidance for auditors and we acknowledge the efforts of, and time, invested by the Task Team and the Standards Department in drafting the Proposed Guide. We however do not agree with two important interpretations contained in the Proposed Guide, as explained in our responses to the specific questions posed to respondents. We have sought a legal opinion from a respected senior counsel, Advocate Chris Loxton SC on these issues and this opinion has largely informed our views on the interpretation of these important aspects in the Proposed Guide. On consideration of the potential impact on business in South Africa, we request the IRBA to keep the dialogue on these matters open, and to give due regard to opinions that may differ from that which is contained in the Proposed Guide.

If you have questions or would like to discuss our response, please do not hesitate to contact Michiel Engelbrecht (011 797 4421) or Annerie Pretorius (012 429 0299).

Yours sincerely,

Michiel Engelbrecht
Director

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Request for specific comments

(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 do not agree with the interpretation of "financially distressed" in the proposed Guide and are particularly concerned about the potential impact that the Proposed Guide's interpretation could have on businesses, entrepreneurship, enterprise efficacy, innovation and investment in South Africa. The Proposed Guide postulates a view that if a company is factually insolvent, it falls within the definition of "financially distressed", and the company is accordingly required to act in the manner as set out in Section 129(7) of the Companies Act, 2008 (the Act). It is this contention that we disagree with for the reasons set out below.

We are of the view that "financially distressed" should be interpreted in a manner that will give effect to the purposes of the Act and the purposes of business rescue in particular. We believe that the interpretation postulated in the Proposed Guide will not achieve these objectives, and that it might even have the implication of *causing* companies that are not in need of being "rescued" to fail.

Section 129(7) of the Act provides for the situation where the board has reasonable grounds to believe that the company is "financially distressed", but does not resolve to begin business rescue proceedings. In such a case, the prescribed notice must be given to all "affected persons". The notice must record that the company is "financially distressed", identify the applicable financial distress criteria set out in section 128(1)(f) and must also give the board's reasons for not commencing business rescue proceedings. Such a notice is likely to cause some concern among the recipients and is likely to harm the company's reputation.

'Financially distressed' is defined in Section 128 (1)(f) in reference to a particular company at any particular time, to mean that:

a) 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

b) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months.

We obtained an opinion from Advocate Chris Loxton SC from the Johannesburg Bar on the preferred interpretation of "insolvent" as referred to in section 128(1)(f)(b).

The underlying premise of the SC opinion is that the Act must be interpreted and applied in a manner that gives effect to the purposes set out in section 7 of the Act, and particularly, in a manner that gives effect to the purposes of Chapter 6 of the Act. Those purposes include the provision for the efficient rescue and recovery of companies in financial difficulty, in a manner that balances the rights and interests of all relevant stakeholders (section 7(k)). This provides context for the interpretation of Chapter 6 of the Act, namely "*... to provide for efficient rescue of financially distressed companies*".

We have reproduced certain sections from the opinion in this comment letter, but we attach the full opinion, with permission from Chris Loxton SC, to this comment letter. We are willing to discuss the opinion with you at a mutually convenient time.

Pertinent extracts from the opinion:

"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, namely one in severe financial trouble."

"Companies that are not in financial trouble would not need to consider the provisions of Chapter 6."

"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 purpose 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 relevant stakeholders;"* "

"An analysis of the words actually used, with reference to cases where these word 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."

The SC opinion concludes as follows:

"In our view, it is more likely that section 128(1)(f) addresses (a) form of commercial insolvency in both sub-paragraphs (i) and (ii). The former addresses a situation w(h)ere 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 immediate ensuing six months.”

For these reasons, we disagree with the contention that the Proposed Guide does not invite alternative interpretations or a preferred interpretation of “insolvent” in section 128(1)(f)(ii) that promotes the purposes of the Act, and particularly, Chapter 6 and the principles of business rescue.

(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.

We don’t agree with the interpretation of Regulation 29(1)(b) and believe that Regulation 29(1)(b)(iii) should be interpreted in the same manner as Section 128(1)(f) as referring to forms of commercial insolvency.

Regulation 29 is to be interpreted in such a manner that would lead to a commercially sensible result.

The opinion from Advocate Chris Loxton SC indicates (with regard to Companies Regulation 29) that:

“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.”

The SC opinion concludes as follows:

“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 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.

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.”

(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 agree with the identification of and distinctions between letters of support, letters of comfort, guarantees and subordinations.

However, guarantees are not extensively dealt with in the Proposed Guide if compared to the other types of common responses. We propose that the following should be addressed regarding guarantees:

- Effect on factual insolvency;
- The auditor's considerations regarding a letter of guarantee; and
- Effect on commercial solvency and going concern.

We furthermore recommend the following:

- The sections in the Proposed Guide that deal with letters of support, letters of comfort and guarantees should address whether or not these measures should be accompanied by a subordination agreement for the measures to have value; and
- The section on subordinations should address considerations of the auditor when the subordination agreement is received from a creditor that is not a South African resident. It may be useful to consider SAICA Circular 2/2002 *Subordination Agreements* for this purpose.

(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.

We agree that an illustrative subordination agreement is useful and should be included in this Guide. We agree with the caveat that accompanies the illustrative subordination 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 variations thereof in practice?

We agree with the approach taken in the proposed Guide of not including an illustrative letter of guarantee or letter of support. It would however be useful if the Guide contained an indication of the elements that a letter of guarantee or letter of support should contain for it to be a legally binding contract.

For example, the elements that would be required for a letter of guarantee to be legally binding:

- Formal assurance, in writing, that certain conditions will be fulfilled, typically, that the guarantor will guarantee the debts or obligations of the company as and when they fall due;
- Acceptance by the company of such guarantee;
- Legal capacity to enter into the guarantee (i.e is the guarantee on the guarantor's letterhead, is it signed by someone with authority/ representing to be signed by someone with authority)

Other comments

Responses to factual insolvency and reportable irregularity reporting considerations

The last sentence in paragraph 120:"... up to the date of issue of the financial statements, and the date of the audit report." may create the impression that the Proposed Guide provides the auditor or independent reviewer with an extension of reporting a reportable irregularity, i.e. that the auditor or independent reviewer's reporting obligations only arise at the date of issue of the financial statements and the date of the audit report. To avoid possible confusion, we suggest that the following be added as a new paragraph 121:

"The responsibility to report a reportable irregularity arises when the auditor or independent reviewer is satisfied or has reason to believe that a reportable irregularity has taken place or is taking place, in which case the auditor or independent reviewer must report *without delay* to the IRBA or the Commission, respectively. A reportable irregularity reporting obligation may thus arise at a date prior to the issuance of the financial statements or the date of the auditor's report."

References to "IFRS" in the Proposed Guide

The Proposed Guide refers to "IFRS" in a number of paragraphs in a manner that could be read as being indicative that IFRS is the only acceptable financial reporting framework that could be applied by South African companies in the preparation of their annual financial statements. For example:

"101. An auditor considers whether the terms of the creditor's subordination have been disclosed in the debtor company's financial statements in accordance with IFRS."

The Proposed Guide has relevance to all companies as defined in the Act. The Act permits the application of IFRS, IFRS for SMEs or financial reporting standards as determined by the company, as applicable in the circumstances of each particular company. The Proposed Guide should therefore refer to a company's applied financial reporting framework in general terms, rather than only referring to "IFRS".

To illustrate our suggestion, we propose the following changes to paragraph 101:

“101. An auditor considers whether the terms of the creditor’s subordination have been disclosed in the debtor company’s financial statements in accordance with the company’s applicable financial reporting framework, for example IFRS. Similarly, the terms of the subordination agreement may have to be disclosed in the subordinating creditor’s financial statements, in accordance with the company’s applicable financial reporting framework ~~IFRS~~. The subordination may affect the measurement of the amount receivable in the creditor’s financial statements, measuring in accordance with the company’s applicable financial reporting framework ~~IFRS~~.”

Similar changes should be made throughout the Proposed Guide, as and where applicable.

Reference to “prudent judgement”

The Proposed Guide refers to the obligation on the auditor to exercise his or her “prudent judgement” in a number of paragraphs.

For example, paragraph 112 of the Proposed Guide states:”Ultimately, the auditor exercises his or her own prudent judgement to determine the effect and value of the letter of comfort, and what action should be taken by the auditor.”

We propose that, in all relevant instances, “prudent” should be replaced by “professional” to align the Proposed Guide with the language used in the ISAs.

Inclusion of illustrative reportable irregularity letters in Appendix 2 of the Proposed Guide.

The Guide for Registered Auditors: Reportable Irregularities in terms of the Auditing Profession Act (the RI Guide) already contains the illustrative letters in Appendix 2 to the Proposed Guide. To facilitate the maintenance of IRBA Guides we recommend that duplication in Guides should be avoided, and therefore recommend that the illustrative letters in Appendix 2 of the Proposed Guide be removed and replaced with a reference to the RI Guide.

Drafting convention of the Proposed Guide

We recommend that the Committee For Auditing Standards should standardise the drafting conventions used in its Guides. The Proposed Guide for example contains a number of “present tense” statements - a practice that was done away with in the Clarity ISAs as it could result in ambiguity and inconsistent application.

For example, paragraph 118 of the Proposed Guide states:” An auditor examines and considers any letter of support (and any other response to the factual insolvency) on its own merits and in the particular circumstances - considering the practical effect of the actions taken on the company and its

creditors, and the enforceability of the actions taken." It is not clear whether this sentence is a statement of fact, or whether it is intended to convey an action that is required of the auditor.

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

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[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:

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[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

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[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*

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[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