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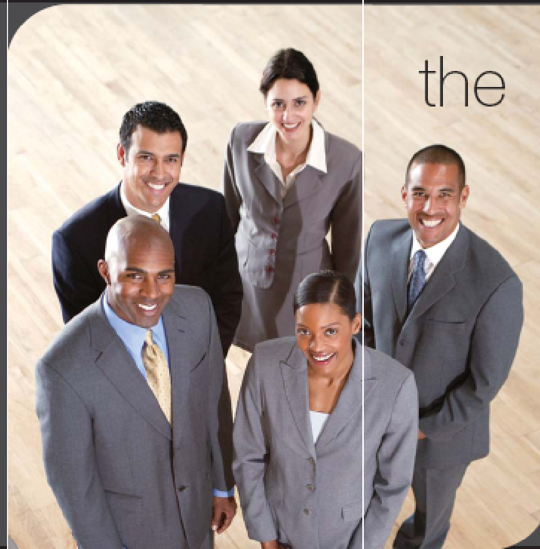

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Comments from the IoD and King Committee on the

Companies Bill, 2008

2008

THE BUSINESS LEADERS

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Introduction

These comments represent the views of the Institute of Directors in Southern Africa, and the King Committee.

Notwithstanding the significant improvements that have been made to the first version of the Bill, we are concerned about the short comment period, and the limited time allocated to the parliamentary committee for deliberation and finalisation. We believe that there are many sections that contain fatal flaws and would require an in-depth and constructive discussion and debate.

We believe that it is vital that as a country we should conduct regulatory impact assessments before enacting new legislation. This is important if we are to learn from the experiences particularly in the United States where the Sarbanes-Oxley Act has had a detrimental effect on the US capital markets. The objective of the impact assessment is to ensure that the cost of doing business in South Africa is reduced and that the impact of these fundamental changes will not outweigh the benefits.

It is the unintended consequences that may result in the negative impact, which often relate to impractical requirements and unforeseen discrepancies with other legislation.

We appreciate the opportunity to comment on the Bill, however we wish to emphasise that the consequences of these amendments will be far-reaching and fundamental. A comment period and parliamentary consideration period which is too short will detract from the public support that is needed for such significant changes and may detract from the positive objectives of a two-year drafting process.

Our comments, contained in this submission, are structures as follows:

General comments: Comments of key concerns not linked to any specific sections of the Bill band are considered 'fatal flaws'.

Main comments: Comments on specific sections that constitute 'fatal flaws'.

Appendix A

Secondary comments: Comments on specific sections that constitute errata, amendments or matters for further clarification.

Business rescue: Concerns to be address in the Insolvency and Business Recovery Bill.

General comments

Key concerns

We believe that the second draft of the Bill represents a significant improvement from the first version and appreciate the commitment and effort of the Department of Trade and Industry to incorporate a broad range of comments and embark on a consultative process.

There is no doubt that South Africa's corporate legislation needs to be updated to bring our legal processes in line with international trends, recognising that South Africa is in many respects ahead of the world trends with regards to corporate governance.

Director education and training

We recommend that formal training and education of directors should form part of the qualification criteria to serve as director.

An issue of concern for the IoD and the King Committee is the matter of training and education of directors. We appreciate that many companies and boards take this matter seriously and ensure that all their board members embark on rigorous training and induction programmes.

We believe that this needs to be further strengthened and in fact it should be part of the qualification criteria that directors have been trained through suitable providers and are aware of their responsibilities and duties.

We believe that this type of requirement will instill a great sense of security for investors (both local and foreign) in the South African markets and will ensure that all companies and state-owned enterprises are controlled by individuals who not only have the reputation and authority, but also the requisite knowledge and training to be effective directors.

Director Internship Programme

We recommend that the dti creates a mechanism to enable companies to implement a Director Internship Programmes for inexperienced directors.

Investors in Africa are prepared to pay a 34% premium for well governed companies.[1].

[1] 2006: McKinsey global investor survey, 2006

Although a natural percentage of both growth and attrition can be expected, the real concern for the IoD and the King Committee is the fact that new business developments, changes in the corporate law reform and the country' s growth targets will directly impact the need for qualified, experienced directors.

Although knowledgeable, the question posed is how these relatively young board members can gain the experience needed to operate as effective board members.

The IoD are launching a Director Internship Programme to accommodate and facilitate the transfer of skills and knowledge to the next generation of directors and we would encourage the legislator to consider incorporating these principles into the legislation either in the Companies Bill or in separate legislation.

Deemed directors

We suggest that individuals should be permitted to serve on board committees without serving on the board, provided the standard of conduct and liability is appropriately set out contractually, and on the understanding that the board still remains ultimately accountable for decisions.

The definition of director in section 1 refers to a member of the board of a company, as contemplated in section 66, or an alternate director of a company.

Sections 75, 76 and 77 broaden this definition to include “a person who is a member of a committee of a board of a company, or of the audit committee of a company”.

This implies that these individuals will not have the benefit of board discussions and deliberations, yet will carry the same liability as any other member of the board. This situation is further complicated by the fact that section 72(2)(a)(ii) does not allow such a committee member to vote on any matter decided by the committee.

We do not believe that this requirement is feasible in the context of the South African unitary board structure. It is unlikely that companies will be able to source many individuals that will subject themselves to such liability without full board disclosure and participation and more importantly adequate reward for the risk carried.

Companies often appoint non-director members to committees for the experiences and subject matter expertise that these individuals provide on an ongoing basis. Ordinarily these individuals are not considered directors, as the board will ultimately be accountable for decisions taken and the standard of conduct and liability of these individuals is set and enforced contractually.

The unintended consequence of these sections will be that companies will not be able benefit from the experience and input of subject matter experts as these individuals will probably not be willing to serve as a ‘deemed director’ without the benefits of being a ‘true’ director.

It is also not feasible or practical to suggest that companies should just appoint these individuals to the board as this will have significant cost and governance implications.

Business rescue

We suggest that the business rescue provisions be removed from the Bill with the necessary and required amendments being incorporated into the Insolvency and Business Recovery Bill, currently in draft format from the Department of Justice and Constitutional Development.

One of our major concerns relating to the Business Rescue provision is the placement of the provisions in the Companies Act and the non-alignment of business rescue provisions with South Africa's Insolvency Laws.

Despite the overwhelming majority of stakeholders supporting the drive towards totally unified insolvency legislation in South Africa, the dti fought hard to have the business rescue provisions removed from the draft unified Insolvency Act and to have it placed in the Companies Act. The argument was that corporate rescue has nothing to do with insolvency law, and that it would create negative perceptions about the new procedure by including it in insolvency legislation. We do not consider this to be a convincing argument, and we are still convinced that the Companies Act is not the correct place for these provisions to appear, especially having regard to the events that trigger the commencement of this procedure.

From the Bill's own definition of the term "financially distressed", it is clear that it is in fact a procedure which only kicks in when insolvency is imminent. "Financially distressed", to all intents and purposes, amounts to both factual and commercial insolvency in that a company is unlikely (within the next 6 month period) to be able to pay its debts as they fall due *and* the company's liabilities exceed or are likely to exceed its assets within the next six months. This double-barrelled test clearly has insolvency as its basis, confirming that the procedure itself is an insolvency procedure.

Another problem of not aligning the business rescue model with South Africa's insolvency law is the anomalies it will create.

One example illustrates this point: In terms of section 38 of the Insolvency Act 24 of 1936, all contracts of employment are suspended once a company is placed in liquidation. The workers are not paid, and they do not have to work. In these circumstances the workers will obtain a priority for arrear salary, wages and leave pay owing to them prior to liquidation, and if their contracts are eventually terminated they will receive an additional priority for retrenchment benefits granted to them retrospectively. However, if a company is placed under business rescue in terms of the provisions of Chapter 6, the employees' contracts of employment are not terminated. In fact, the employees' contracts have to be maintained on the same terms on conditions that applied prior to the business rescue procedure commencing (see clause 136). In addition, employee salaries and wages rank equal to (and are treated as) post-commencement financing, and this priority spills over into liquidation should the company subsequently be liquidated (see clause 135(1) and (4)).

Main comments

Section 2: Related and inter-related persons, and control

We suggest that the definition of related be amended to include only spouse, spousal equivalent and dependent children.

The definition of related individuals includes individuals who “live together in a relationship similar to marriage”. It is unclear if this definition aims to extend the existing term “spousal equivalent” used in the Income Tax Act, the Corporate Laws Amendment Act and the Constitution of South Africa.

We suggest that the definition be amended to include only spousal equivalents to avoid any confusion and interpretation issues.

The inclusion of 3 degrees of natural or adopted family affinity also broadens the ambit of the Bill beyond what is reasonable.

The result of this broad definition will exclude many experienced directors from serving on audit committees as they are unlikely to be considered independent. It is unlikely that directors are in contact with, and have knowledge of the investments held by their grandchildren and uncles or aunts. It may even be unlikely that directors are aware of the investments of their brothers, sisters or even children.

Practically and realistically directors will have knowledge of the investments of their spouses, spousal equivalents and dependent children.

This definition of ‘related’ should apply to Chapter 5 only and not to the entire Bill.

Section 4: Solvency and liquidity test

We suggest that no reference is made to any specific documentation to be used, but rather emphasis be placed on a “fair and complete” valuation.

We commend the decision to change the capital maintenance regime to one based on solvency and liquidity.

However, subsection 2 requires the determination of the solvency and liquidity test to be performed on accounting records that are complete and accurate as prescribed by section 28 AND financial statements that satisfy the financial reporting standards and audit and verification requirements.

Firstly, the Bill provides relief for certain private companies, not for profit companies and incorporated companies that their financial statements can be issued as unaudited. This may result in some of these companies not even preparing financial statements, although we believe that such a situation will have significant negative impacts on governance.

Secondly, the appropriate information required to determine solvency and liquidity is often not contained in financial records or financial statements and therefor we recommend that no specific documentation should be specified.

Section 8: Categories of companies

We recommend that the issue of Public Interest Companies be revisited to ensure that proper governance principles are applied to these companies.

We recognise and commend the dti on the changes it has made to the categorisation of companies. As many commentators highlighted the previous definition of Public Interest Companies was likely to create many issues around interpretation and application.

The categories of companies are also very different from the newly enacted Corporate Laws Amendment Act (CLAA) which established Widely Held and Limited Interest Companies. This change will result in many companies having incurred the cost and the application of resources to comply with the CLAA and will now have to change back to the definitions and categories essentially established in the Companies Act of 1973. Consideration should be given on the transition that will be allowed for these companies.

The definition of private companies includes where the Memorandum of Incorporation restricts the transferability of securities. It is unclear if this restriction related to the pre-emptive rights of all shareholders, across all categories of shares and for every share issue, or if the restriction of transferability can be contained within share categories and still be regarded a private company.

Finally, we also believe that the issue of significant private companies has not been addressed adequately. Section 30(2) allows for the Commission to issue an administrative notice to require private companies to prepare annual financial statements. This notice will be based on annual turnover, size of the workforce and nature of its activities. The absence of clear guidelines on these thresholds may result in inconsistent application and in fact uncertainty for stakeholders.

The Bill does not require these significant private companies to appoint an audit committee and this will be done presumably on a voluntary basis.

Although we agree in principle that certain companies do not have to be subjected to an audit, this ‘blanket’ exemption implies that the only interested parties in financial statements would be the shareholders of a company. This principle contradicts the objectives of the remainder of the Bill, which introduces the concept of stakeholders in the form of employees, creditors, regulators etc.

Companies of significant public interest should not be exempted from preparing financial statements and subjecting these financial statements to an external audit, regardless of the number of shareholders.

We support the relief that is granted to closely held companies as we strongly believe that entrepreneurship and hence the development of the South African economy will be enhanced if it is easier for small businesses to be established and to operate in the simplistic but effective legislative and regulatory framework. This requirement should, however, not defeat the objectives of serving the public interest.

Although the exemption from preparing financial statements and the audit of such financial statements may provide cost savings in the short term, the result in the longer term will be poor financial management and reduced governance. The directors still remain responsible for evaluating the solvency and liquidity of such companies, and the absence of proper financial reporting may bring their duty of care, skill and diligence into question.

Section 26: Access to company records

We recommend that all requests must be made in accordance with the Promotion of Access to Information Act and that subsections (i) and (ii) should be read in conjunction i.e. change the "or" to an "and".

Section (1)(c) allows a shareholder access to company records by direct request to the company **or** in accordance with the Promotion of Access to Information Act.

We support the concept that shareholders should be in a position to access the information they require to protect their rights. However, the mechanism provided for in section 26 may be particularly problematic as it is not clear how companies are required to deal with requests received as envisaged in section (1)(c)(i) and if this section will prevail section (1)(c)(ii).

Section 26 provides no "defence" to the company against a shareholder's request, such as confidentiality, sensitivity of the information concerned or the effort that may be required in obtaining the information sought. There is also no mechanism to ensure that the shareholder keeps the information confidential, once it has been received. Bearing in mind that this information could possibly include minutes of meetings of audit and remuneration committees, the blanket right of shareholders to request this information may infringe on the company's ability to conduct its affairs.

Section 30: Annual financial statements

We recommend that criteria be drafted as part of the legislation, focusing on private companies with a significant public interest.

Section 2(b) allows for the Commission to issue an administrative notice to certain companies with a public interest to prepare annual financial statements. The criteria on which

this decision will be based are unclear, as well as if the administrative order will be public knowledge through disclosure in the Government Gazette, for instance.

Should the criteria be unclear, we believe it will be very difficult for the Companies Ombud to provide a ruling on cases where companies have applied to have the ruling set aside, and inconsistencies may arise.

We suggest that the criteria for significant public interest companies should be defined and suggest that appropriate measures for size and activities should be formulated. For example companies operating in the financial services market, including micro lenders, should, in our opinion, be considered as operating in the public interest.

Section 35: Legal nature of company shares and requirement to have shareholders

We recommend that section 35 be amended to allow wholly owned subsidiaries or remove the provision completely.

Section 35(3)(b)requires at least 1 share of a company to be held by a natural person, which implies that a company cannot have a wholly owned subsidiary. From a practical perspective this requirement will be impossible to achieve as many companies are structured with wholly owned subsidiaries. The logic of this section is unclear as it will create unnecessary administrative issues without any obvious benefit.

Section 69: Ineligibility and disqualification of persons to be directors

We believe the Bill should seek to not only protect shareholders, but also employees, creditors and the community from disqualified directors and maintain the criteria for qualification for all directors.

Section 69(12) states that despite being disqualifies, a person may act as a director of a company if all the shares are held by that disqualified person alone or by persons related to that disqualified person.

This requirement conflicts with the stated intention of the Bill to create additional transparency and accountability based on public interest. No protection is provided to creditors, employees and other stakeholders of these private companies in dealing with potentially disqualified directors.

Section 72: Board committees

We recommend that the membership of the audit committee in terms of directors and non-directors should be clarified.

Section 72(2)(a) allows committees to consist of persons who are not directors of the company. Section 94(4) however states that every member of the audit committee must be a director. It is unclear if the audit committee should comprise only of directors or if non-director members may serve on the audit committee.

Section 72(2)(a)(i) further states that a non-director member of a committee has no vote on any matter decided by the committee, however such a person will carry the same liability as any director.

It is unrealistic to expect a person to serve on an audit committee, without any right to vote and yet carry the same liability as any other member of the board.

Section 76: Standards of Directors conduct

We recommend that the common law principles should be read in conjunction with the Bill and in cases of conflict, the Bill should prevail.

As regards directors' standard of conduct, the reference to the application of the common law in conjunction with the provisions of the Act as per the 2007 Bill has been removed. Although we were in disagreement with the specific wording in the 2007 Bill that dealt with this issue, it needs to be addressed in the interest of providing clarity on whether or not the common law on directors' duties is replaced by the provisions of the Act.

In view of our well developed common law principles on the subject of directors' duties which makes it undesirable to simply discard it, we propose that the section in the Bill dealing with directors' standards of conduct be qualified by stating that it should be read in conjunction with the common law except to the extent that the common law cannot be reconciled with the Act, in which case the Act provisions of the Act will prevail.

Section 76(3)(a) of the Bill does refer to the fact that directors must exercise their powers and functions "for a proper purpose" but it does not explain what this means. Retaining the common law means that this phrase will continue to carry the connotations attached to it through the developed jurisprudence. Another example is that there is no reference in the Bill to a director's duty to exercise unfettered discretion which is recognised in common law to be part of the fiduciary duties.

The concept of unfettered discretion goes beyond the director's personal financial interests as provided for in section 75 of the Bill to situations where a director for instance seeks to promote the interests of the shareholder who nominated that director to the board. Again, retaining the common law principles will prevent a void in the law in this important aspect.

Section 77 &128: Liability of directors and prescribed officers

We recommend that section 218 be reviewed to ensure that directors cannot be held liable for any losses or damages suffered and that this liability is restricted to liability to the company.

It is noted that the personal liability of directors is in section 77 of the revised draft of the Bill restricted to the company with the effect that third party claims cannot any longer (as per the previous draft) be brought directly against a director personally. We welcome this change, however, question whether section 218 does not to a lesser or greater degrees negate this to the extent that it will still deter capable and skilled directors from accepting appointment. We cannot afford to exclude this scarce resource from our economy. Section 128 states that "any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention".

The requirement for a director to have been present (subsection 3(e)) when a decision in contravention was passed, may lead to deliberate non-attendance at meetings where controversial decisions are to be considered. Common law currently binds directors to decisions whether they are present or not and we believe that this principle should prevail. A possible solution is to make involvement in material decisions when meetings cannot be attended part of the due diligence requirement. Section (3)(e) also states that directors will be liable for losses incurred regarding to certain decisions that they “failed to vote against”. This may lead to board members opting to vote against difficult or contentious issues to absolve themselves of possible liability which clearly cannot be in the best interests of the company or the economy. Business is all about the undertaking of risk for reward and to encourage Boards to make companies risk adverse and investment shy would be contrary to the spirit of enterprise. We think that (3)(e) should be limited to failure to vote against a known fraud or known contravention of an applicable Act

Subsection 9: “Wilful misconduct” to be defined. “Wilful breach of trust” rather to read: wilful breach of fiduciary duties.

Section 92: Rotation of auditors

We recommend that the cooling off period for auditors and designated auditors be reduced to two (2) years in line with the Corporate Laws Amendment Act.

Section 92(2) requires that an auditor or designated auditor that has served two more consecutive years may not be appointed again as the auditor or designated auditor of that company until after at least a five further financial years have lapsed.

We agree that it is vital to the preservation of auditor independence that auditors and designated auditors serve a 'cooling-off' period between rotations. A cooling-off period similar to the period actually served is not a widely-applied practice internationally and in fact only the United States applies such a stringent cooling off period for the most senior audit partners on SEC Listed companies.

We believe that such a stringent requirement will not serve the best interests of the South African profession and businesses as South Africa is already facing a shortage of experienced auditors.

The Bills does not contain a definition of auditors or designated auditors, and we suggest that these be included on that the Bill clarifies that these definitions should be read in conjunction with the Auditing Profession Act, 2005.

Section 94: Audit committees

- **We suggest that audit committee comprise of a minimum of 2 non-executive directors.**
- **We believe the audit committee should be appointed by the board and not by the shareholders.**
- **We suggest further clarification in this section that specifically allows the audit committee to delegate the duty to pre-approve contracts for non-audit services.**

Section 94(2) requires an audit committee to comprise of 3 non-executive directors. We believe that in many smaller companies, this requirement will be impractical to apply and will deter companies from voluntarily appointing an audit committee, which in turns does not encourage good governance.

We suggest that audit committees comprise of at least 2 non-executive directors and that the same definition of 'non-executive' that is applied in appointing directors to the board is used for audit committee members. This will ensure that there are not difference definitions and criteria applied.

Section 94(2) further requires the shareholders to appoint the audit committee at the Annual General Meeting. We do not believe that this requirement is practical and will result in significant unintended consequences that will severely impact and detract for corporate governance.

The audit committee's role is to operate a sub-committee of the board and in terms of this relationship the board may delegate specific duties to the audit committee. These duties include oversight over the financial reporting process, oversight over the internal and external audit process and oversight over risk management and internal controls.

The principle of delegation is that the board may delegate, but cannot abdicate responsibility over the decisions of the audit committee. This relationship is one of trust and it is vitally important for the effectiveness of both the board and the audit committee that the board trusts that recommendations by the audit committee have been duly considered, and that the audit committee members have the necessary skills and experience to fulfill these duties.

Should the shareholders appoint the audit committee, it will result in the board not necessarily having the required confidence in the members of the committee and in fact in may result significant conflicts between the board and audit committee.

Section 94(7)(e) requires the audit committee, as part of its statutory duties, to pre-approve any proposed agreement with the auditor for the provision of non-audit services.

Although this requirement is in line with the requirements of the Corporate Laws Amendment Act, this provision is open to interpretation differences and the Bill may be utilised as an appropriate vehicle to clarify the intention.

It is unclear if this legislation envisages that the audit committee meet prior to the commencement of any non-audit services to approve the letter of engagement (agreement) or if this responsibility may be delegated to the chairman of the audit committee.

We believe that it is impractical for the audit committee to coordinate their meeting schedule with the commencement of non-audit services and recommend that the Bill clarifies that this duty of the audit committee may be delegated to the chairman of the audit committee. It would constitute proper governance principles if this delegation is performed in terms of an approved non-audit services policy and ratified by the full audit committee at the next appropriate meeting.

Section 94(7)(i) states that one of the audit committee duties is to "perform other functions determined by the board, including the development and implementation of a policy and plan for a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes within the company".

Although the international definition of internal auditing has been included, we suggest, however, that this paragraph should be reworded to reflect the *oversight* role that the Audit Committee should play in the activities of internal audit to ensure independence and performance of the activity. The wording currently used in the Bill infers *operational* responsibilities related to governance processes in companies which is a function of management.

Section 162: Application to declare director delinquent or under probation

We recommend that applications should be lodged with the Ombud for an assessment of the validity of the application before escalating to the Court.

We commend the dti on the inclusion of this section as additional protection for stakeholders against abuse by directors. The success of this requirement depends on the diligence and consistency with which it is applied and that public confidence is maintained in the process.

We are concerned that the section may be open to abuse as the persons/bodies permitted to make these applications may use this as an opportunity to lodge vexatious claims and in the process cause reputational damage to the directors.

It is not justified that a single shareholder, employee or representative of an employee may lodge an application for such serious offences. It is also questionable whether the legitimate expectations of stakeholders will be the same as employees and it is conceivable that employees, trade unions and representatives of employees may not be satisfied or agree with decisions taken by the board in the best interests of the company.

We recommend that all applications to have directors declared delinquent or to be placed on probation should be lodged with the Ombud first. The Ombud should be responsible for assessing the validity of these applications based on the evidence presented by the applicant and once satisfied that the application was made in good faith and has merit, a certificate for Court proceedings should be issued.

Appendix A

Secondary comments

Section 1: Definitions

The definition of "financial statements" refers in subsection (a) to annual financial statements. The Bill does not contain any definition of what constitutes annual financial statements. We suggest the definition be referred to the International Financial Reporting Standards as adopted by the Financial Reporting Council.

Section 5: General interpretation of the Act

Section 5(4)(b)(ii) states that the provisions of this Act prevail in all situations where companies are unable to comply with other national legislation. This will specifically apply to financial institutions regulated by the Banks Act and insurance companies regulated by the Long Term and Short Term Insurance Acts as well as State-Owned Enterprises regulated by the Public Finance Management Act.

We understand and support the view to regulate these types of companies/entities in a simpler manner, but must caution that until other legislative frameworks such as those listed above make it clear when the Companies Act will apply, it will be difficult for these entities to determine the correct legislation with which to comply.

Section 10: Modified application with respect to non profit companies

The cross-reference in subsection (2)(c) is incorrect. The section refers to section 67 (9) and (10). Section 67 does not contain sections (9) and (10). We believe the reference should be to section 66 (9) and (10). It is unclear if the second reference to section 68 is correct or if it should have been section 67.

Section 29: Financial statements

Section 29(4) states that the Minister, after consulting with the Financial Reporting Standards Council (FRSC), may make regulations prescribing financial reporting standards which must be consistent with the International Financial Reporting Standards.

We are concerned that the functions of the FRSC have been scaled down significantly from what is included in the Corporate Laws Amendment Act, to an advisory function only to the Minister as opposed to it being a standard-setter, as initially envisaged.

We recognise the creation of a mechanism in the Bill to fast-track the issuing of financial reporting standards, as set out in section 223(3). However, this provision calls for ministerial approval and it is anticipated that it would only be implemented in exceptional circumstances.

It is vital for credibility of South Africa's reporting that South African companies adopt every new IFRS in line with international effective dates for these standards to enable these companies to claim compliance with IFRS.

Section 33: Annual transparency and accountability report

We are very pleased with the inclusion of the annual transparency and accountability reporting requirements for all companies. We believe that this is a very positive move towards international best practice in governance and takes into account the need for companies to communicate with their broader stakeholders and issue more than purely financial information.

The Bill is unclear about the prescribed information and we would suggest that financial and non-financial matters affecting the company's community be adequately addressed in an open and transparent manner.

Section 79: Winding up of solvent companies

In discussions with the dti regarding business rescue it was generally envisaged that all legislation relating to insolvency (including both consumer (individual) insolvency and corporate liquidation) would be included in a unified statute. It was agreed that all insolvent entities would be dealt with in the unified Insolvency Act, but that the new Companies Act should deal with the winding up of *solvent* companies.

Since it is envisaged that the new Companies Act will probably be promulgated before the unified Insolvency Act, transitional measures have been put into place in order to deal with the winding-up of companies in the meantime.

In order to deal with the winding-up of solvent companies, clauses 79 to 83 have been included in the Companies Bill. The provisions are rather confusing, as the heading to Part G of Chapter 2 states that it deals with the "w*inding-up of solvent companies and deregistering companies*", and yet the clauses clearly provide for a voluntary winding-up by the company's creditors (which is an insolvency procedure) and by the court, also in cases where the supervisor in a business rescue proceeding applies for the liquidation of a company.

We believe that further clarity is needed to guard against confusion between the various types of voluntary winding-up procedures.

Section 87: Juristic person or partnership may be appointed company secretary

The requirement in subsection (1)(a) that EVERY employee of that juristic person (or partner and employee of a partnership) must satisfy the requirements contemplated in section 84(5) is completely unreasonable. There can be no justification for placing such an onerous burden on the company secretary while no similar requirement is specified for the external auditor, for example. This should be amended to refer to directors/designated

officers/executive management of the juristic person or partners of the partnership, to ensure that the requirement is applicable only to senior staff members in the organisation.

Section 155: Compromise between company and creditors

When the dti took the decision to draft the business rescue provisions, it was on the understanding that the Department of Justice and Constitutional Development would take responsibility for the drafting of a unified Insolvency Act (minus, of course, the business rescue provisions). It was also agreed that all aspects of insolvency law, including compromises and arrangements in terms of the current section 311 of the Companies Act 61 of 1973 would be included under the new unified insolvency legislation.

However, shortly before this Bill was submitted to Cabinet for its approval, a new procedure for a compromise between a company and its creditors was included as clause 155 of the Companies Bill. We understand that this new procedure will replace section 311 compromises, the new procedure being aimed at streamlining the process.

We recommend that section 311 should be retained in its current form, excluding any references to schemes of arrangement with creditors. There is a significant volume of case law relating to section 311 compromises, which is firmly entrenched in our legal framework, and we believe there will be no value added by 'scrapping' the existing section.

The only amendment to section 311 would be to include and update compromises with unknown creditors.

Section 159: Protection of whistle-blowers

Section 159(1) clarifies that any right created in this section of the Bill is in addition to, and not a substitute for, any right or protection established by the Protected Disclosures Act, 2000. We believe that this section creates unnecessary confusion and creates disproportionate obligations for companies or State-Owned Enterprises regulated by this Bill, and other co-operatives or close corporations.

We recommend that protection of whistleblowers be removed from the Bill and the necessary amendments be made to the Protected Disclosures Act.

Section 159(4)(a) refers to the term "qualified disclosure", yet the Bill does not clarify the definition of this term. We recommend a definition be included for further clarification.

Section 128(b): Applications and definitions applicable to Chapter 6

The dti has itself described the procedure of business rescue as contained in Chapter 6 of the Bill as one where the company largely remains in control, but is aided in the business rescue by an independent supervisor. The question that needs to be asked here is whether this is warranted given that South Africa does not generally have a debtor-friendly approach to companies experiencing financial difficulty.

The provisions in the Companies Bill are not always entirely clear as to who is in fact in charge of the business rescue procedure. In countries such as Australia and the UK, the management of the company is replaced in totality by an independent administrator, who is a registered insolvency practitioner.

The approach in the United States, under their Chapter 11 procedure, is that the company remains in control and negotiates its own way out of its financial distress (hence the reference to a "debtor-in-possession" procedure). Under the South African model it appears that the existing management remains in place, while the business rescue procedure would largely be driven by the independent supervisor under the direction of the company's existing management. Even if this last statement is not completely accurate, the line between the powers and duties of the existing management of the company and the supervisor remains unclear.

Section 128(e): Creditors

One question that arises is whether the business rescue provisions in Chapter 6 of the Companies Bill adequately address the possibility of pre-packaged deals emanating from informal creditor workouts, or do the provisions still bar the person brokering the deal to be appointed as supervisor under the provisions of Chapter 6? This was a concern raised by practitioners that are currently in the informal creditor workout market, and since I believe that pre-packaged deals are going to become more popular in future, this concern needs to be addressed.

In terms of clause 128(1)(a), registered trade unions and individual employees (if not represented by a trade union) are regarded as "affected persons", which places them in a very strong position as only affected persons are allowed to take certain actions in terms of the business rescue procedure.

Section 129 - 131: Commencement of business rescue proceedings

While we support the idea of both a voluntary and a compulsory route (dual gateway) into the business rescue procedure, there is some concern about the onerous requirements that have been set in order to have a company resolution (to place the company under business rescue) set aside by the court (see clause 130 in this regard).

Since it is relatively easy for a company to enter the business rescue procedure, one should be aware of the risk that this procedure could be abused by the management of a company in order to obtain the benefit of a moratorium while at the same time appointing a supervisor of choice to oversee the business rescue procedure. In a nutshell, it is clear from the provisions of the Bill that a company can be easily manipulated by its management, or by its management acting in collusion with creditors, to the detriment of its (other) creditors.

While the supervisor has relatively wide powers to investigate pre-business rescue transactions, there are insufficient sanctions available in order to reverse these transactions should they be found to exist. Likewise, the provisions dealing with reckless and fraudulent trading do not appear to have much power behind them, and these aspects need to be examined in light of all the provisions in the Companies Bill. See for example clause 22 of the Bill which prohibits reckless and fraudulent trading. This clause also prohibits insolvent trading, but fails to describe what insolvent trading amounts to. Clause 77 deals with the liability of directors and "prescribed officers" of the company. The question arises as to whether these clauses provide adequate protection.

It is submitted that the publication requirement provided for in clause 129(3) is totally unrealistic. Likewise, we are concerned that the provisions of clause 131, dealing with an application for a compulsory business rescue order may be abused in practice by, for example, employee organisations, who would be able to intervene in liquidation proceedings by seeking a business rescue order instead of allowing a company to proceed into liquidation. The immediate benefits for employees under business rescue as opposed to liquidation are obvious if one looks at the different manners in which employment contracts are dealt with under these two procedures (see the example provided in comments under Business rescue – General).

Section 136: Effect of business rescue on employees and contracts

The business rescue does not terminate the employment contracts of the employees of the company, and these contracts have to be maintained for the duration of the procedure (see clause 136(1)(a)) unless different terms are agreed to in terms of the "applicable labour laws" (see clause 136(1)(a)(ii)). Any downsizing of the workforce has to take place in terms of sections 189 and 189A of the Labour Relations Act 66 of 1995 (see clause 136(1)(b)).

Section 138: Qualifications of supervisors

One of the greatest concerns about the new business rescue procedure must without doubt be the question of who will be appointed as supervisors. From the initial drafts of the business rescue provisions, and from the discussions at the workshop held at the DTI thereafter, it was clear that the intention was that this new profession would be open to all.

This appears to have changed after calls were made, especially by TMA-SA and ABASA, for the proper regulation of supervisors.

Although clause 138 would appear to cover all the bases by providing for persons belonging to a profession that is subject to regulation by a regulatory authority, from clause 138(2) it is clear that the Minister may only designate one person or association that complies with very rigid requirements (see clauses 138(2)(a)-(c)). From an initial reading of clause 138(1)(a) it appeared that any professional subject to a regulatory authority (such as attorneys and accountants) would be able to be designated, but on a further reading of the clause read with clause 138(2), we are no longer sure that this is the case.

From clause 138(3)(b)(i) it is clear that the Minister may make regulations prescribing minimum qualifications for the admission of a person “to the practice of a business rescue supervisor”. However, no indication is given as to what these minimum qualifications might be. Considering what has happened in the liquidation industry, it is unthinkable that just any person will be able to participate in this industry.

We are concerned about the fact that the company can appoint their own supervisor if the management are going to largely remain in control of the company for the duration of the business rescue procedure (although when looking at the provisions of clause 140, one has to wonder if the existing management will in fact retain control).

Although it is possible to have the supervisor replaced, the grounds for removal do not include reservations about the supervisor’s appointment by the company. There have to be material grounds for removal as set out in clause 139(2), and these may be difficult to prove. Besides, a court application, an expensive and possibly convoluted procedure, has to be followed in order to do so. This may hamper an interested party from bringing such an application, and even if the interested party does decide to follow this onerous procedure, the delay brought about by such proceedings may derail the attempt at rescuing the company.

We admit that the court cannot appoint an interim supervisor where the company has been placed under the business rescue procedure on the basis of a resolution passed by the board of a company, but we recommend that the appointment of a supervisor by the management of a company also an interim appointment until the creditors can ratify the appointment at the first meeting.

Section 137(2)(d): Effect on shareholders and directors

Although we understand the rationale behind this provision, we disagree that directors are exempt from section 76 and to a degree section 77 to the extent that they followed the supervisor’s instructions. This provision is tantamount to discarding the healthy dissent that is

part of the nature of any board and that could add much value to the efforts of the supervisor and improve decision making. A company that is under business rescue proceedings will usually need the commitment of its directors more than ever.

The nature of directors' liability is such that a director has personal liability for personal actions or breach. As such, a director cannot be held liable for a decision that the director disagreed with. The aim of this provision can still be achieved by holding directors fully liable as in the normal course of business, but to provide that when they disagree with actions/decisions that they are bound to under instruction of the supervisor that they have the right to have the dissenting view formally noted.

Section 140: General powers and duties of supervisors

To state that the supervisor substitutes the board and management strictly implies that the board and management are relieved of their duties except to the extent that they merely have to follow the instructions and assist the supervisor. If the board and management in their collective wisdom could not save the company it is unrealistic to expect of the supervisor to do it on his/her own.

It is in accurate to make the assumption that it is always the board and management incompetence or fraudulent actions that had led to the company's financial trouble. In the event that this is the case, the supervisor has the recourse to remove management or a director. It is our submission that although it may be necessary for the board and management to act under the supervision and instruction of the supervisor, they should continue to execute their duties in the interest of the company. By reducing the role of a bona fide board and management to a passive one will not assist the aim of the business rescue.

Section 140(2) is but one example of where urgent access to courts would be required. We support the recommendation by Mervyn King for specialised statutory tribunals.

Although this section 140(3)(b) states that the supervisor has the responsibilities, duties and liabilities of a director of the company, it is not clear what the role is of the supervisor in the pursuit and conducting of business. There is for instance no reference to emergency management by stabilising the business through cash flow management, establishing short-term performance targets, etc. It is our view that emergency management to stabilise the company should be part and parcel of the duties of the supervisor.

As the liability of the supervisor is covered in sub-paragraph (b)'s reference to section 77, we do not consider it necessary to expand on the liability of the supervisor in section 140(3)(b)(ii). It is not entirely clear why a supervisor has been made an officer of the court for the duration of the business rescue proceedings (see clause 140(3)(a).

We agree with the notion in section 140(4) that the supervisor is not allowed to take up appointment as liquidator in the interest of independent oversight of pre-liquidation business. It is not clear whether a liquidator would be eligible to be appointed supervisor. We submit that it should be possible.

In this regard it should be considered that the supervisor be compelled to provide security for his appointment similar to directors and officers indemnity insurance.

Section 141: Investigation of affairs of company

In terms of clause 141(2)(c) of the Bill, the supervisor must investigate the affairs of the company and if it is found that there is evidence in the dealings of the company pre-business rescue of voidable transactions or reckless and fraudulent trading, then the supervisor "must direct the management to take any necessary steps to rectify the matter".

One can only imagine what will happen if the management do not take the necessary steps to rectify the matter, as there is no sanction built into the provisions should they ignore such a request. The question that needs to be addressed here is whether or not the following should have been included in the provisions:

- the same powers as a liquidator to have voidable transactions set aside in terms of sections 26 to 34 of the Insolvency Act 24 of 1936;
- the same powers as a liquidator to interrogate office bearers of the company regarding the affairs of the company; and
- personal liability similar in nature to the current provisions of section 424 of the Companies Act 61 of 1973.

Section 143: Remuneration of supervisor

We are pleased that the original suggestion of a company and the supervisor being able to determine the supervisor's fees by agreement has been scrapped, and replaced by a provision that states that the supervisor's remuneration must be determined in accordance with a tariff (see clause 143(1)). Unfortunately, such a tariff has not been determined and has not been published as part of the proposals. One can therefore only speculate as to what the basis of the tariff fees will be, and hope that there will be proper consultation before a decision is made.

Considering the opposition to percentage-based fees in liquidation, it is safe to assume that a time-based fee will probably be introduced as a basis for determining the supervisor's remuneration. Until such time as the tariff is published, nothing can really be discussed in this regard.

Clause 143(2) appears to be the result of a suggestion made at the workshop held at the DTI, and is based on a contingency fee depending on the success achieved by the supervisor in saving the business. This is a sensible provision, especially as it requires creditor approval, and should encourage supervisors to develop and implement a workable business rescue plan.

Section 144: Rights of employees

While we are completely aware of the priority given to most things related to organised labour or employees in South Africa, and the sensitivity surrounding these issues, the preferential treatment afforded employees under the new business rescue procedure should be addressed.

Insolvency law is about balancing the rights of the various stakeholders, and while there are inevitably going to be losers in the process, it is important to strive to keep a balance as far as possible. It is our view that the rights accorded to employees under the business rescue procedure do not adhere to this principle, resulting in the procedure being skewed in favour of only one group of stakeholders, namely the employees.

It is interesting to see clause 144(2) where the priority rights of employees for amounts owing prior to the business rescue procedure are clearly set out (they qualify as “preferred unsecure Creditors”) and that claims by SARS are not afforded any preferential treatment. This in effect creates a “super-preference” for employees, and is carried over into liquidation should the business rescue procedure not achieve its objective of saving the company - see the whole of clause 135 in this regard, and clause 135(4) as regards the failure of a business rescue procedure and subsequent liquidation.

Section 150: Proposal of business rescue plan

From the provisions of the Bill it does not appear that the actual business rescue plan has to be in any tangible form. One assumes that in practical terms the plan will be in the form of a document, termed “the Business Rescue Plan”. The thought that comes up here is whether an instrument, such as the Deed of Company Arrangement used in Australia’s voluntary administration procedure, should be employed in order to give effect to the business rescue plan.

The timeframes within which meetings must be held and a business rescue plan approved, despite the court being able to grant an extension in the latter instance, are unrealistic.