

# The International Comparative Legal Guide to: **Corporate Recovery & Insolvency 2007**

A practical insight to cross-border Corporate Recovery & Insolvency



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### 1 Issues Arising When a Company is in Financial Difficulties

#### 1.1 How does a creditor take security over assets in your jurisdiction?

Security in respect of corporeal movable property (i.e. tangible property) can be taken in the following manner:

1.1.1 a special notarial bond which lists the assets over which the bond is registered. This creates a statutory pledge in favour of the mortgagee;

1.1.2 a common law pledge. The creditors must be placed in possession of the assets subject to the pledge which is then held as security. This is uncommon in practice due to the practical constraints; and/or

1.1.3 a general notarial bond registered over the movable property of the debtor. This is essentially an agreement between the creditor and the debtor which entitles the debtor to take possession of the debtor's movable assets upon the happening of a specified event, such as default. Once the creditor takes possession, which is normally pursuant to a Court order, his security is converted to a pledge.

Security in respect of immovable property (i.e. land) is taken in the form of a mortgage bond which is registered over the property.

Security in respect of incorporeal property (i.e. intangible property such as rights) is taken in the form of a cession. The cessionary holds the rights as security for the indebtedness of the debtor. The most common form of cession is a cession of book debts.

#### 1.2 In what circumstances might transactions entered into whilst the company is in financial difficulties be vulnerable to attack?

The following types of transactions may be set aside where a company in financial difficulties is subsequently placed in liquidation: (a) dispositions made without value; (b) voidable preferences; (c) undue preferences; (d) collusive dealings; and (e) voidable sales of a business or of a property forming part thereof.

Transactions which are found by a court to have constituted dispositions made without value, voidable preferences, undue preferences and collusive dealings are voidable at the instance of the liquidator of the company but until such time as the transactions are set aside by the court they stand. Where a liquidator has reason to believe that a transaction may be impeachable, it is the liquidator's duty to investigate the transaction and, if authorised by creditors, the liquidator may launch court proceedings to set the

transaction aside. The prerequisites of the voidable transactions are as follows.

**A disposition made without value:** a court may set aside a transaction where a liquidator proves that more than two years before liquidation the company disposed of an asset and immediately following such disposition the company's liabilities exceeded its assets and the disposition was not made for value; alternatively the liquidator proves that within two years of liquidation the company disposed of an asset not for value, unless the person claiming under or benefited by the disposition proves that the company's assets exceeded its liabilities at the time of the disposition.

**Voidable preferences:** the court may set aside a transaction where the liquidator proves that within six months before liquidation and immediately after the disposition the liabilities of the company exceeded its assets, unless the person in whose favour the disposition was made proves that it was made in the ordinary course of business and that it was not intended to prefer one creditor above another.

**Undue preferences:** the court may set aside a transaction where the liquidator proves that after the disposition the company's liabilities exceeded its assets and the disposition was made with the intention of preferring a creditor and the company was thereafter liquidated.

**Collusive dealings:** the court may set aside such transaction where the liquidator proves that the asset was disposed of in such manner which had the effect of prejudicing creditors or preferring one creditor above another and the disposition was effected by the company in collusion with another.

**Voidable sale of business:** where the company disposes of any business or goodwill belonging to it and the sale is not properly advertised to creditors in terms of the relevant provision of the Insolvency Act, the sale will be void against creditors for a period of six months after disposition and will be void if the company is liquidated any time within that period.

The provisions of the Insolvency Act relating to impeachable transactions do not apply to dispositions effected in accordance with the rules of a securities exchange or clearing house.

In addition to the statutory provisions referred to above, there is a common law remedy which applies to a disposition which is made in fraud of creditors.

#### 1.3 What are the liabilities of directors (in particular civil, criminal or disqualification) for continuing to trade whilst a company is in financial difficulties in your jurisdiction?

There is no civil or criminal liability that arises automatically in

relation to directors trading in a company in financial difficulties. On liquidation, directors are by law divested of their powers and authority in relation to the company. After liquidation and after investigation into the affairs of the company have been conducted by the liquidator (which investigations may include formal enquiry proceedings in terms of the Insolvency Act or the Companies Act), the liquidator may sue the former directors for reckless or fraudulent trading within the provisions of the Companies Act. When it appears that the business of a company was or is being carried on recklessly with intent to defraud creditors of the company, the court may on the application of a liquidator, a creditor or a member declare that any person (not just a director of the company) who was or is knowingly a party to the carrying on of the business in the fraudulent or reckless manner, will be personally liable without any limitation of liability for all or any debts or other liabilities of the company as the court may direct. Where the liquidator finds evidence of fraud such evidence may be turned over to the relevant authorities for criminal prosecution.

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#### 1.4 Is it common to achieve a restructuring outside a formal procedure in your jurisdiction? In what circumstances might this be possible?

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It is not common for a company to achieve a material restructuring outside the formal procedures because other creditors are not bound thereby.

## 2 Formal Procedures

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### 2.1 What are the main types of formal procedures available for companies in financial difficulties in your jurisdiction?

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#### 2.1.1 Scheme of Arrangement

A company may enter into a formal, court sanctioned compromise or arrangement between itself, its members and creditors. Such compromise or arrangement must be agreed to by a majority in number representing three-quarters in value of the creditors or a class of creditors or a majority representing three-quarters of the votes exercisable by the members or class of members. If such compromise or arrangement is sanctioned by the court then it is binding on all creditors or classes of creditors or on all members or classes of members. It is also binding on the liquidator if the company is already in the process of being wound up. Such compromises or arrangements are effected in terms of section 311 of the Companies Act. Compromises or arrangements in terms of section 311 may be made in an attempt to avoid liquidation or judicial management proceedings in respect of the company by creditors effectively agreeing to limit their claims in order to enable the company to continue trading.

#### 2.1.1 Judicial Management

When a company, usually by reason of mismanagement, is unable to pay its debts and is thereby prevented from becoming a successful concern, and there is a reasonable probability that if placed under judicial management it may be enabled to pay its debts and become a successful concern, the court may on just and equitable grounds order that a company be placed under judicial management. A judicial manager (usually a liquidator acting in that capacity) will be appointed by the court and will seek to trade the company out of its difficulties by reaching a compromise or arrangement with creditors and by proper management of the company. Judicial management is uncommon as it has almost always been found to be ineffective in saving a company.

#### 2.1.3 Liquidation

Most companies placed in liquidation are wound up by the court after application has been made, by the company itself (authorised by its own directors and members) or by a creditor. In certain circumstances the company may be wound up by special resolution which resolution is registered in the office of the registrar of companies in Pretoria. A liquidation may be either voluntary or involuntary.

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### 2.2 What are the tests for insolvency in your jurisdiction?

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The tests for insolvency relating to individuals and trusts are different and more onerous than the test for insolvency in relation to a company. The test for the insolvency of a company is “commercial insolvency” (as opposed to actual insolvency), that is, whether the company is able to pay its debts as and when such debts arise in the ordinary course of its business.

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### 2.3 On what grounds can the company be placed into each procedure?

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A company may be wound up by the court if the company is unable to pay its debts, if it appears to the court that it is just and equitable that the company be wound up, if the company itself has resolved by special resolution that it be wound up by the court, if the company commences business before the registrar of companies certified that it was entitled to commence business, if it does not commence business within a year from incorporation or has suspended its business for a year, in a case of a public company if the number of members has been reduced below seven, if 75% of the issued share capital of the company has been lost, and, in the case of an external company, the company is dissolved in the country in which it was incorporated.

The main grounds on which companies are placed in liquidation by the court are the company’s inability to pay its debts and on just and equitable grounds. “On just and equitable grounds” confers on the court a wide discretionary power taking into account all relevant circumstances. An applicant who relies on just and equitable grounds must come to court with clean hands, that is, the applicant must not itself be wrongfully responsible for the circumstances which have brought about the state of affairs alleged in the application. The five broad categories of just and equitable grounds for the winding up of a company are: the disappearance of the company’s substratum, illegality of the objects of the company and fraud committed in connection therewith, deadlock (between members or directors), grounds analogous to those for the dissolution of partnerships and oppression (usually minority oppression).

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### 2.4 Please describe briefly how the company is placed into each procedure.

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The court may order that the company be placed in liquidation where application to court is made by the company itself, by one or more of its creditors, by one or more of its members, jointly by any or all of the above parties, and, in the case of a voluntary winding-up, by the Master or any creditor or member, or in the case of the discharge of a judicial management order by application by the judicial manager. Application is made on one or more of the grounds set out in question 2.3 above. Where the liquidation application is not opposed, an order of liquidation may generally be obtained within days of issuing the application at court. Where the liquidation application is opposed either by the company itself or by

the intervention of another creditor, the court hearing will be delayed by a number of months for the filing of further affidavits. The date of liquidation is deemed to be the date on which the application is issued out of Court. The directors are divested of their powers and authority on liquidation. The liquidator who is appointed shortly after liquidation thereafter takes control of the affairs of the company and acts on its behalf.

In the case of a voluntary liquidation by way of resolution, the winding up commences on the registration of the resolution in the office of the registrar of companies.

### 2.5 What notifications and meetings are required after the company has been placed into each procedure?

A director files a statement of affairs in the prescribed format setting out, *inter alia*, the asset and liability position of the company. The statement of affairs is a sworn statement which the director is obliged to furnish to the liquidator. The former directors of the company are furthermore under a duty to assist the liquidator in the winding up of the company.

As soon as a final winding up order has been made by the court or the resolution for a voluntary winding up has been registered, the office of the Master of the High Court calls a first meeting of creditors and members whereat the statement of affairs is considered, claims against the company are submitted for proof and the formal nomination of persons for appointment as liquidator occurs. The Master will appoint the final liquidator(s) based on the nomination and voting at the first meeting of creditors. Approximately two months later a second meeting of creditors is convened by the liquidator. At the second meeting the liquidator's resolutions which grant the liquidator authority *inter alia* to enter into compromises or arrangements with creditors, borrow funds to continue trading and sell off the company's assets without obtaining the prior sanction of the court, will be passed by members and creditors.

The former directors of the company are obliged to attend the first and second meetings and may be called on to answer the questions of the liquidator, the Master of the High Court or a creditor at such meetings. The second meeting may be adjourned for formal enquiry proceedings. The liquidator may also institute formal enquiry proceedings after application to court in terms of the Companies Act. At such enquiry proceedings a commissioner will be appointed and persons including directors of the company may be summonsed to give information or documentation concerning the trade, dealings, affairs or property of the company. Such an enquiry may only be convened where the company is unable to pay its debts.

### 2.6 How does somebody establish whether the company has been placed into one of these procedures?

A search conducted on the database of the records of the registrar of companies will reveal whether a company is still in business or whether it has been placed in liquidation. The offices of the Master of the High Court in the relevant jurisdiction will also have records of the liquidation.

## 3 Creditors

### 3.1 Are unsecured creditors free to enforce their rights in each procedure?

Unsecured creditors are not free to enforce their rights on

liquidation. Court process against a company in liquidation is also suspended. Creditors including unsecured creditors may lodge their claims against the company in liquidation in the hope of receiving a dividend payment in due course. Dividends are paid out in the legal order of preference of creditors set out in the Insolvency Act.

### 3.2 Can secured creditors enforce their security in each procedure?

Secured creditors are not free to enforce their security on liquidation. Creditors including secured creditors may lodge their claims against the company in liquidation and may rely solely on their security to avoid being levied with a contribution for costs in the liquidation.

### 3.3 Can creditors set off sums owed by them to the company against amounts owed by the company to them in each procedure?

A creditor may not set off a sum owed by it to the company in liquidation subsequent to the date of liquidation. Where a set off has already been effected between a creditor and a company that is placed in liquidation within six months of the set off, the liquidator may set aside the set off if it was not effected in the ordinary course of business. The creditor may then prove its claim against the company as if no set off had occurred.

## 4 Continuing the Business

### 4.1 Who controls the company in each procedure? In particular, please describe briefly the effect of the procedures on directors and shareholders.

The liquidator controls the company. On liquidation, directors are divested of their powers and authority to act on behalf of the company. Directors are obliged to assist the liquidator in winding up the affairs of the company. A liquidator may continue to employ a director or employees of the business to assist him or her in the winding up. Upon liquidation, shareholders are also divested of any powers they may have, for example, to call a meeting of the company.

### 4.2 How does the company finance these procedures?

The costs of the liquidation are paid from the realisation of the assets and the business of the company in liquidation. Where the liquidator requires funding that is not readily available to the company but which may accrue to it in due course either through the sale of assets or through post-liquidation trading by the liquidator, the liquidator may borrow such funds on authorisation by creditors or the court.

### 4.3 What is the effect of each procedure on employees?

The contracts of employment of the company's employees are automatically suspended on liquidation and employees are no longer required to tender their services although the liquidator may continue to employ some or all of the employees to assist in the winding up or post-liquidation trading. Employees' contracts are finally terminated by the liquidator after giving employees notice to this effect. Employees enjoy a limited statutory preference for payment of their claims against the company for unpaid salaries and

other benefits and rank just below secured creditors. In the event that the liquidator sells the business of the company as a going concern, the contract of employment of the employees are automatically transferred to the purchaser. The liquidator can negotiate with employees to regulate the number of employees whose contracts are transferred to the purchaser.

#### 4.4 What effect does the commencement of any procedure have on contracts with the company and can the company terminate contracts during each procedure?

In respect of executory contracts (that is, contracts in which performance is still outstanding by one or both parties), the liquidator has the election whether the company in liquidation will abide by the terms of the contract or whether the contract will be cancelled. Where the liquidator elects that the company will perform its obligations in terms of the contract, the other party is also obliged to perform its obligations under the contract, save where an accrued right to cancel the contract existed prior to liquidation in which case the other party may cancel the contract. Certain contracts, for example, contracts of agency terminate automatically on liquidation.

## 5 Claims

#### 5.1 Broadly, how do creditors claim amounts owed to them in each procedure?

The creditor will depose to an affidavit incorporating supporting documentation which sets out the creditor's claim against the company in liquidation. The claim affidavit will be submitted for proof at a meeting of creditors. A claim admitted to proof at such meeting will subsequently be examined by the liquidator who will perform his or her own reconciliation of the claim from the books and records of the company in liquidation. Where the liquidator does not dispute the claim, the creditor becomes a proved creditor and may receive a dividend in due course. Damages claims are submitted to meetings of creditors but may not be proved against the company in liquidation until a liquidator authorised in terms of the second meeting resolutions has compromised such claim or until such claim has been settled by court process instituted by the creditor.

#### 5.2 What is the ranking of claims in each procedure? In particular, do any specific types of claim have preferential status?

5.2.1 The ranking of claims is governed by the Insolvency Act.

5.2.2 In respect of assets over which security is held, the proceeds of such assets are first utilised to settle realisation costs and any other costs of liquidation which are applicable to such asset as thereafter the surplus is utilised to settle the secured creditor's claim. Any surplus is transferred to free residue.

5.2.3 In respect of unencumbered assets (i.e. free residue) the

proceeds of such assets are applied as follows: costs of realisation and cost of liquidation, thereafter in settlement of creditors who enjoy statutory preferences such as employees and internal revenue, and thereafter in payment to concurrent creditors (i.e. unsecured creditors).

#### 5.3 Are tax liabilities incurred during each procedure?

Where a liquidator continues for a time to trade in liquidation then ordinary tax liabilities will be incurred in the course of trading. Income tax would be payable on any income earned by the liquidator post liquidation. Such interest on the bank account is taxable.

## 6 Ending the Formal Procedure

#### 6.1 Is there a process for "cramming down" creditors who do not approve proposals put forward in these procedures?

Creditors vote by number and value in liquidation proceedings. A creditor may not vote on a matter in which it has a direct interest. There is no special process for "cramming down" creditors.

#### 6.2 What happens at the end of each procedure?

The winding up of a company is complete when the liquidator has realised all the assets and completed his investigations (and any action that may have arisen therefrom) into the affairs of the company. The liquidator will draw a final liquidation and distribution account and make the final dividend payment to creditors (if any). The registrar of companies will de-register the company. Alternatively, a company may be discharged from liquidation by court sanction where creditors enter into a compromise or arrangement with the company in terms of section 311 of the Companies Act.

## 7 International

#### 7.1 What would be the approach in your jurisdiction to recognising a procedure started in another jurisdiction?

A foreign representative may apply to a South African court for recognition of the foreign proceedings in which the foreign representative has been appointed. The South African court may recognise the foreign proceedings. Alternatively, the foreign representative may request from the South African court that proceedings commence under the laws of South Africa relating to insolvency or the right to file claims in such proceedings. On recognition of foreign proceedings, the foreign representative has standing to initiate any legal action to set aside a disposition that is available to a liquidator under South African insolvency law. The foreign representative may also intervene in any proceedings in which the debtor is a party.

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Edward Nathan Sonnenbergs was established in 2006 as the result of a merger between two of South Africa's most prominent and leading law firms, Edward Nathan and Sonnenberg Hoffmann Galombik. As a full service law, tax, forensics and business advisory services firm, ENS offers a level of legal competence that sets a new standard in Africa, both geographically and in terms of service, skills and expertise. ENS is based in Johannesburg, Cape Town and Durban. ENS's Insolvency, Business Rescue and Debt Recovery department assists clients in proactively managing insolvency and financial exposure. When insolvency is inevitable, however, the strategy becomes one of minimising loss, maximising returns for creditors and developing and implementing a recovery strategy for viable business activities.