Southern Africa
Accounting & Auditing

# The Companies Act
## When is a company financially distressed, and what does it mean?

Chapter 6 of the Companies Act, 2008 (the Act) deals with business rescue. Business rescue is largely self-administered by the company, under independent supervision within the constraints set out by the Act, and could be subject to court intervention, at any time, on application by any of the stakeholders.

For purposes of business rescue, it is important to understand the meaning of “financial distress”, as the requirements of Chapter 6 of the Act are triggered as soon as a company is in financial distress. Where a company is in financial distress, and the company failed to either adopt a resolution to go into business rescue, or provide written notice to shareholders, employees and creditors that it decided not to adopt business rescue, the company is in breach of the Act, and the auditors may have to report this as a reportable irregularity.

### Financial distress

The Companies Act defines “financially distressed” in section 128(f), to mean that it appears to be:

i. reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months, or

ii. reasonably likely that the company will become insolvent within the immediately ensuing six months.

The first part of the test seems clear. A company will be in distress if there is a reasonable likelihood that the company may reach a position within the next six months where it will no longer be able to pay its debt as it becomes due and payable. “Reasonable likelihood” implies that there must be a rational basis for the conclusion that the company may not be able to pay its debt within the next six months. This conclusion amounts to an educated prediction, based on the current financial position of the company, and considering all relevant factors that may impact the company’s liquidity in the foreseeable future.

The second part of the financial distress query deals with insolvency, and here the question often arises as to whether this refers to factual (technical) insolvency or commercial insolvency. There are conflicting views. Some argue that because part (i) clearly deals with commercial insolvency, part (ii) must deal with factual insolvency (i.e. a balance sheet test). In terms of this approach, a company is regarded as technically insolvent (and thus financially distressed) if the liabilities of the company exceed the assets. This approach does not take into account subordination agreements, or any other management action. On the other hand, others believe that one must consider the definition in conjunction with the definition of business rescue and the objectives of the Act pertaining to business rescue.

Section 5(1) of the Act requires that the Act must be interpreted and applied in a manner that gives effect to the purposes set out in section 7. As such, when interpreting these particular provisions one needs to consider the purpose of the Act in this regard i.e. 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. In turn, “rescuing the company” means achieving the goals set out in the definition of “business rescue”. Business rescue is defined in section 128(1(b) as “proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for:

- The temporary supervision of the company, and of the management of its affairs, business and property;
- A temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and
- The development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximizes 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.”

It should be clear from the above that business rescue is meant to be employed only where a company requires 'rehabilitation', and where there is a need to 'rescue' the company. If the purpose of the Act and the purpose of business rescue are considered, it seems unlikely that a company which is factually insolvent, but still able to service its debt, can be regarded as 'failing' or financially distressed.

If this approach is accepted, part (ii) of the financial distress test should consider the complete financial position of the company rather than merely pure technical insolvency. In order to adhere to the purpose of the Act, and in light of the definition of business rescue, one must consider the complete financial position of the company when determining whether there is a "reasonable" likelihood that the company will be insolvent within six months. In terms of this approach a company will only be regarded as in "financial distress" where it is insolvent even after all other circumstances were considered, including considering alternative fair values of the assets and liabilities, factoring in reasonably foreseeable assets and liabilities, as per the solvency and liquidity test in section 4, as well as considering any other proposed measures taken by management such as subordination agreements, recapitalisation or letters of support. This approach was confirmed in a recent Supreme Court decision in the United Kingdom (*BNY Corporate Trustee Services Ltd v Eurosail* [2013] UKSC 28) where the court found that the "balance sheet" test for insolvency must take account of the wider commercial context, and that courts must look beyond the assets and liabilities used to prepare a company's statutory accounts when deciding whether or not a company is "balance sheet" insolvent.

By employing the narrower definition of "financial distress" (i.e. the factual insolvency test which excludes subordination agreements and other management actions) one arrives at an answer that may not serve the best interests of affected parties (shareholders, creditors and employees). There is very little point in writing to affected parties, informing them that the company is financially distressed when it is in fact perfectly able to continue to do business. Furthermore, start-up companies are generally factually insolvent in the first few years of trading and applying the narrower definition would impair their continued existence. This approach does not support the purpose of the Act, which also purports to promote the economic development of South Africa, entrepreneurship, investment and innovation, and may have a detrimental effect on both the company and its stakeholders.

## Does the Supreme Court of Appeal provide a possible answer?

In *Boschpoort Ondernemings (Pty) Ltd v Absa Bank Ltd* (936/12) [2013] ZASCA 173 the Supreme Court of Appeal looked at the meaning of the term "solvent' with respect to the interpretation of sections 79 to 81 of the Act (winding up of solvent companies). Although the judgment was given with specific reference to these particular sections, one may ask whether the Court will follow a similar thought process (and perhaps reach a similar conclusion) with respect to the meaning of the terms ‘solvent’ and ‘insolvent’ used elsewhere in the Act.

The court explained the difference between factual solvency (where on the balance sheet the assets exceed the liabilities) and commercial solvency (where the company is able to pay its debts), and confirmed that the principle that a company’s commercial insolvency is a ground that will justify an order for its liquidation has been a reality of law which has served us well through the passage of time. The court continues to state that “[W]ere the test for solvency in liquidation proceedings to be whether assets exceed liabilities, this would undermine there being a predictable and therefore effective legal environment for the adjudication of the liquidation of companies: one of the purposes of the new Act, set out in s 7*(l)* thereof”.

The court further stated that “it must be presumed that the legislature deliberately refrained from defining ‘solvency’. It must have done so with a view to ensuring that the well-oiled machinery of the courts in matters of company liquidations should not stall. The legislature must have been content that prevailing judicial interpretations of solvency and insolvency respectively should continue to have effect. The meaning of those terms must be one that leads to a sensible and business-like result”.

The court explained the inter-relation between the Act and sections 344 and 345 of the 1973 Companies Act, which address the circumstances of when a company may be wound up and when a company is deemed unable to pay its debts, and concluded that section 345 should be used to determine whether or not a company is ‘insolvent’ for purposes of section 79 of the (new) Act.

## Conclusion

If one assumes that the court will follow similar reasoning when interpreting the meaning of the word ‘insolvent’ in the definition of financial distress in section 128(f), it would confirm the view above that the legislature intended that business rescue be applied in instances where there is a reasonable likelihood that a company may be commercially insolvent (unable to pay its debt) within the immediately ensuing six months, and as such business rescue can be used to rescue or rehabilitate the failing company (as per section 7).

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