In business rescue, where do you rank?
By Eric Levenstein, director, and Lauren Barnett, associate

LEGAL BRIEF | JUNE 2013

Introduction

With the promulgation of new legislation, it is interesting to follow the jurisprudence that develops with it. Since the inception of the Act, numerous judgments dealing with the business rescue provisions, as well as related matters, have been handed down by our high courts in the various provinces. Judgments have been handed down by our courts have by and large been informative and instructive in paving the way for the efficient application of business rescue.

One such judgment that will be carefully considered is that which was handed down by Kgomo J in the South Gauteng High Court on 10 May 2013, in the case of Merchant West Working Capital Solutions (Proprietary) Limited v Advanced Technologies & Engineering Company (Proprietary) Limited & Gainsford (Unreported, Case no 2013/12406). In this case, Merchant West Working Capital Solutions (Proprietary) Limited (“Merchant West case”) launched an application to perfect its security, while the business rescue proceedings of Advanced Technologies and Engineering Company (Proprietary) Limited were ongoing.

Whilst the judgment highlights and restates a number of seminal principles related to business rescue, it sets out in no uncertain terms the order in which the claims of creditors rank during business rescue proceedings. The ranking of the claims of creditors has been much debated and thus this deliberation by the court (although not strictly relevant to the issue before the court) is a welcome addition to the development of the current jurisprudence on the topic of the ranking of claims - and in turn the waterfall of payments in a business rescue.

Ranking of claims

Section 135 of the Act sets out the order in which the claims of creditors rank during business rescue. In terms of this section, post-commencement financiers are preferred in the order of preference created by the Act. Importantly, however, section 135(3)(b) does not stipulate whether or not the claims of secured post-commencement financiers will rank ahead of the claims of unsecured post-commencement financiers. It merely states that post-commencement financiers will have preference “in the order in which they were incurred over all unsecured claims” of the company.
Further, one of the major issues that is not clear from the Act relates to where creditors, who are secured (as understood in insolvency law) prior to the commencement of business rescue, rank in the order of preference delineated by section 135 of the Act. Section 135(3)(a)(ii) of the Act states that the claims of post-commencement financiers (whether secured or unsecured) will rank ahead of the claims of all “unsecured” creditors. This has led academics, attorneys and practitioners alike to conclude that the claims of secured creditors, prior to the commencement of business rescue, will rank ahead of the claims of post-commencement financiers.

Kgomo J, in the Merchant West case, stated in unequivocal terms that creditors rank in the following order of preference during business rescue proceedings –

- the fees and expenses (including legal and other professional fees) of the business rescue practitioner incurred during business rescue proceedings (section 135(3));
- the fees of employees which become due and payable after the commencement of business rescue (section 135(3)(a));
- secured lenders or creditors for any loan or supply made after the commencement of business rescue (i.e. secured post-commencement financiers) (section 135(3)(a)(i) and section 135(3)(b));
- unsecured lenders or creditors for any loan or supply made after the commencement of business rescue (i.e. unsecured post-commencement financiers) (section 135(3)(a)(ii));
- secured lenders or creditors for any loan or supply made before the commencement of business rescue;
- claims of employees (for instance for remuneration) which became due and owing prior to the commencement of business rescue; and
- unsecured lenders or creditors for any loan or supply made before the commencement of business rescue (i.e. concurrent creditors).

The above makes it clear that the claims of secured lenders prior to the commencement of business rescue rank after the claims of both secured and unsecured post-commencement financiers.

Practically, this makes sense. If a lender or creditor wants to provide post-commencement finance to a company in business rescue, it should be clear to such financier that it will rank before secured pre-commencement creditors who may in a liquidation be paid in full from their security.

Post-commencement financiers can thus seek comfort in that the court has, at least for now, settled the much-debated position of the ranking of creditors who hold security for their claims prior to the commencement of business rescue.

Anomalies with the ranking of claims

Whilst the aforesaid judgment clears one of the major issues that have arisen with the interpretation of the ranking of claims in business rescue, there are further issues which need to be determined by our courts.

One such issue relates to whether or not the ranking created by the business rescue provisions of the Act, which remains of force and effect even if the company is subsequently liquidated, gives rise to a new order of preference to that delineated by the Insolvency Act 24 of 1936. If the latter is answered in the affirmative, then a further question arises about the treatment of secured lenders (such as banks) in a subsequent liquidation.

There are at least two competing interests that come to mind when considering the aforesaid.

On the one hand, the protection afforded to creditors who are secured prior to the commencement of business rescue will be rendered nugatory in a liquidation; in that if their claims are not satisfied out of the security that they hold, they will receive payment of their claims only after the various creditors (i.e. post-commencement financiers, practitioners and employees) who rank ahead of them in the order of preference conferred by a business rescue. This would undermine the very reason why lenders take security; to protect them (or at least mitigate their exposure) from an eventuality such as liquidation. If the aforesaid is the consequence of the business rescue order of preference, time will tell whether or not lenders will apply stricter credit terms when lending money.

The difficulty that lenders will have is that the prospect of a business rescue, followed by liquidation, is difficult or even impossible to consider when funds are initially advanced.

On the other hand, if the fees and costs of business rescue practitioners, the salaries of employees and the claims of post-commencement financiers are not preferred in business rescue (and in a subsequent liquidation), then there will be little incentive for practitioners, employees and new or current lenders to take appointments and to support the business rescue process, respectively. Business rescue practitioners will always face the risk that in a liquidation, their claims will not be satisfied once secured creditors’ claims are paid. This is supported by the fact that the Act (and the economy) needs practitioners, employees and lenders to support the business rescue process in order to give effect to one of the objects of the Act; namely the efficient rescue of companies.

Conclusion

It is our view that until such time as another court pronounces otherwise, that the order of preference during business rescue determined by Kgomo J in the Merchant West case must be applied.

This judgment has (at least for now) settled the position of secured creditors (who were secured prior to the commencement of business rescue) during business rescue proceedings as well as the order in which secured and unsecured post-commencement financiers will rank in business rescue.

The Act, and the order of preference delineated by section 135, however, retains many anomalies which will require determination by our courts in time. Until such time as we receive such direction...into the woods we go!
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About Werksmans Attorneys

Eric Levenstein

Title: Director
Office: Johannesburg
Direct line: +27 (0)11 535 8237
Fax: +27 (0)11 535 8737
Switchboard: +27 (0)11 535 8000
Email: elevenstein@werksmans.com

Eric Levenstein has been a director of Werksmans Attorneys since 1993 and is currently the joint head of the firm’s Insolvency, Business Rescue & Restructuring Practice. He specialises in litigation and dispute resolution with a particular focus on banking and finance, forensics and intellectual property in addition to business rescue, insolvency and restructuring. His expertise extends to consumer protection and director liability issues. He regularly delivers seminars and writes for various publications on these topics among others. He is a member of the Association of Insolvency Practitioners of South Africa (AIPSA) and of INSOL, a worldwide group of insolvency practitioners and attorneys. He is named as a recommended lawyer in restructuring and insolvency by PLC Which Lawyer and has BCom and LLB degrees, Higher Diplomas in Company Law and Tax and a Diploma in Insolvency Law.

Lauren Barnett

Title: Associate
Office: Johannesburg
Direct line: +27 (0)11 535 8196
Fax: +27 (0)11 535 8796
Switchboard: +27 (0)11 535 8000
Email: lbarnett@werksmans.com

Lauren joined Werksmans as an associate in 2012, working in Litigation & Dispute Resolution with a focus on Insolvency, Business Rescue & Restructuring, and General Litigation. She graduated from Wits with two cum laude degrees; Bachelor of Arts and LLB. She is the recipient of many awards and recognitions, including: the Philip Friedland Prize for Most Successful Candidate in the Attorneys Admission Examinations (2009/2010); Best Overall Performance – School for Practical Legal Training (2009); PQR Bobberg Memorial Prize - Independent Research Report (2008), and Certificate of Merit - Top Competition Law Student (2008).