Distressed debt recovery methods used by South African banks

A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, in partial fulfilment of the requirements for the degree Master of Business Administration

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ABSTRACT

The way banks recover distressed debt has become an important subject locally as well as on international level. Dedicated conferences are held annually on the benefit derived by using methods other than liquidation to recover distressed debt and many forums advocate that alternative methods could yield better returns than liquidation. Many first world countries around the world have adopted legislation (such as the well known chapter 11 in the United States) to provide the necessary protection and time for a business rescue plan to be developed and implemented as an alternative to liquidation.

Legislation to this end in South Africa is contained in the Companies Act and is known as judicial management. However, as set out in this research report, judicial management proved to be unsuccessful as a distressed debt recovery method and, historically, banks used liquidation as their only alternative to recover distressed debt.

Lately, however, in the wake of international developments in the area, banks in South Africa have become very innovative in the way they recover distressed debt. Banks realise that liquidation as the sole distressed debt recovery method does not yield acceptable returns and have been exploring other alternatives to yield better results.

To this end, this research report identifies the various distressed debt recovery methods that are available to and used by South African banks, as well as the impact of key factors on the selection of one method above another to recover distressed debt. As such, this research report developed a framework that can be used by South African banks to identify the most appropriate distressed debt recovery method given the impact of these key factors.

DECLARATION

I, Jan Vorster van der Walt declare that this research report is my own, unaided work. It is submitted in partial fulfilment of the requirements for the degree Master of Business Administration in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in this or any other university.

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Jan Vorster van der Walt

21 April 2008

DEDICATION

To Marita, for the way in which you supported me during the entire MBA programme.

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1. INTRODUCTION

1.1 Purpose of the Research Report

This research report analyses the impact of key factors on the selection of distressed debt recovery methods by South African banks in order to develop a framework to assist South African banks to select the most appropriate recovery method given the presence of these factors.

1.2 Background

There is no doubt that the recovery of distressed debt is an important subject to banks in South Africa, as well as internationally, as the non payment of interest and/or capital on the one hand and the diversion of time from business development to the collection of distressed debt on the other hand can have a severe impact on the profitability of banks (Gopinath, 1995). For this reason, banks in South Africa have dedicated departments staffed with skilled employees who dedicate their time and effort to recovering distressed debt and assisting creditors with business turnaround and restructuring in order to minimise possible losses that could be suffered by the bank and to ensure that creditors do not end up in liquidation.

1.3 Context of the Research Report

Almost all commercially developed societies confer upon a creditor, who has a claim against a debtor of a minimum amount, the right to liquidate the insolvent debtor in order to recover its debt (Kloppers, 2001; Rajak, 1995). To this end, bankruptcy laws, historically, were geared towards the maximisation of the recovery of creditors' claims through the orderly liquidation of the estate of an insolvent after which the insolvent is discharged from his/her debt. As such, bankruptcy laws were not concerned with the rehabilitation or rescue of debtors or the restoration of their financial health. These laws were, however, justified because they provided the most orderly and efficient means of dealing with an insolvent and the claims to its estate and provided an efficient means of dealing with a debtor's fraud (Smits, 1999).

However, various considerations have caused economies around the world to question the effectiveness of liquidation as the sole method to recover distressed debt. To this end, Rajak (1995) argues successfully that liquidation destroys the potential of a debtor, renders employees redundant and reduces the value of work-in-progress substantially to the detriment of customers and trade creditors. The outcome of such a course of action is more often than not that creditors receive only a small liquidation dividend (or none at all) whilst directors and shareholders forfeit an investment which may have flourished had the debtor been granted an opportunity to repay its debt while, unable to do so at that time, would clearly have been able to do so later (Rajak, 1995). Smits (1999) confirms this by stating that liquidation, as the sole purpose of bankruptcy laws, has been questioned as not yielding the largest recovery to creditors in many cases.

It is for this reason that most modern industrialised nations have created statutory regimes that protect insolvent debtors where insolvency is believed to be temporary of nature and where the debtor is believed to be capable, with assistance, to return to normal commercial life as an active and successful entrepreneur. This course of action is widely supported as a means of saving jobs, enabling work-in-progress to be completed, of protecting investment and ensuring debts are repaid either in full or at least to a greater extent than in liquidation (Rajak & Henning, 1999).

It is fascinating to note that, whilst most countries have enacted their business rescue regimes in the last twenty-five years, South Africa was one of the first countries to introduce such a regime as far back as 1926 when judicial management was legislated into existence by the Companies Act of 1926 as a business rescue provision. In addition thereto, South Africa also has the statutory regime created by section 311 of the current Companies Act, 36 of 1973 ("**the Companies Act**") known as compromises which have important business rescue functions (Rajak & Henning, 1999).

Unfortunately, for reasons that will be discussed later in this report, judicial management did not have the intended business rescue impact and compromises were severely hampered as a business rescue method and, as a result, creditors in South Africa (specifically banks) had no option but to find alternative ways to recover distressed debt.

In practice, various methods are used by South African banks as alternatives to liquidation, judicial management and compromises to recover distressed debt as these alternatives, in many instances, yield better returns than liquidation. There are, however, various factors that have an impact on the selection of a specific distressed debt recovery method and this research report identifies and analyses those factors.

1.4 The Problem Statement

This research report analyses the impact of key factors on the selection of distressed debt recovery methods by South African banks in order to develop a framework to assist South African banks to select the most appropriate recovery method given the presence of these factors.

1.5 The Sub-Problems

Below, this research report sets out the various sub-problems contained in the problem statement above.

1.5.1 The First Sub-Problem

The first sub-problem is to identify the range of distressed debt recovery methods that are available to South African banks.

1.5.2 The Second Sub-Problem

The second sub-problem is to identify all the factors that influence the selection by South African banks of distressed debt recovery methods.

1.5.3 The Third Sub-Problem

The third sub-problem is to analyse the impact of key factors on the selection of distressed debt recovery methods by South African banks.

1.6 The Delimitations

Whilst the research problem states what a researcher intends to do, the delimitations set out what the researcher is not going to do (Leedy & Ormrod, 2004).

This research report is delimited to the impact of key factors on the selection of distressed debt recovery methods by South African banks as opposed to the selection of distressed debt recovery methods by creditors other than South African banks or by the debtor itself.

Furthermore, and with regards to those recovery methods used by South African banks, the common process in terms whereof a bank issues summons to recover a debt will not be considered.

This research report is further delimited to the recovery of distressed debt in respect of companies with a minimum turnover of R40m although many principles can be applied to other entities and to entities with a turnover less than R40m.

This research report does not attempt to investigate whether or not there is a cause-and-effect relationship between causes of business decline or failure and concomitant business rescue strategies.

This research report is not about the development of the content of a business rescue strategy (or the adjudication thereof by a bank where it was developed by the management of the debtor company). To the contrary, it rather focuses on the selection of distressed debt recovery methods and the impact thereon of certain key factors.

This research report does not attempt to highlight the preferences of different stakeholders as to the selection of a distressed debt recovery method as only the views of banks are presented.

The research report does not investigate the combinations of recovery strategies followed by banks in order to recover distressed debt.

1.7 Significance of the Research Report

Bearing in mind the time and effort associated with the recovery of distressed debt and/or business turnaround, this research report is significant in that it identifies the various methods that can be used by banks to recover distressed debt as well as the factors that have an impact on the selection of a specific recovery method. Accordingly, the framework that is developed in this research report will assist South African banks to be more efficient in recovering distressed debt which, in turn, may enhance their profitability.

A bank's efforts to safeguard its funds often require the client to take actions to suit the bank. This represents an external influence on the debtor company and such intervention in a declining company suggests that the company's turnaround strategy is not entirely in its control (Gopinath, 1995). The research that will be performed as set out in this research report may assist researchers to improve their understanding of the turnaround process and may also assist company executives to manage the situation by knowing the variables affecting this inter-organisational dependence.

The results of the research will hopefully be of value to academia, especially due to the fact that business rescue is a new and developing concept in South Africa with proposed legislation contained in chapter 6 of the new Companies Bill. The research will provide a base understanding to academia on alternatives available to creditors as opposed to liquidation. It may help researchers to understand a distressed debt recovery process better and may also assist executives of distressed companies to manage the distressed situation better.

1.8 Assumptions

There are certain factors that have an impact on the selection of distressed debt recovery methods available to South African banks.

The participants that will be selected will be experts in the field of distressed debt recovery in South Africa and will, therefore, provide a sufficiently complete list of factors and their influence on the selection of a recovery method.

The level of efficiency by which distressed debt is recovered is dependent on the method used to recover distressed debt.

Not all methods that are available to recover distressed debt are equally applicable to all circumstances as certain methods are better suited than others in a specific circumstance.

In-depth, semi-structured interviews and a content analysis allow the data analysis to yield consistent results.

A 75 minute interview will be sufficient to generate enough information and knowledge without loss in validity.

1.9 Definition of Terms

In this research report, the following words or expressions will have the meanings as set out under each of the following headings:

Distressed Debt: Distressed debt, as used in this research report, includes both loans where a debtor is in default of capital and/or interest payments as well as loans where a debtor has breached any of the covenants regulating that loan whether or not the debtor defaulted in paying interest and/or capital (Gopinath, 1995).

Bankruptcy Laws: Reference to bankruptcy laws is a reference to both legislation concerning the sequestration of the estates of individuals, as well as the winding-up or liquidation of companies. Sequestrations of individuals are dealt with in terms of the Insolvency Act, 24 of 1936 ("**Insolvency Act**") whilst the liquidation and winding-up provisions of companies are dealt with in terms of the Companies Act. The Companies Act nevertheless extends many of the principles of insolvency laws to companies. To this end section 339 of the Companies Act states that, in the winding-up of a company unable to pay its debts, the provisions of the law relating to insolvency must, in so far as they are applicable, be applied in respect of any matter not specifically provided for in the Companies Act (Sharrock, van der Linde & Smith, 2002).

Ranking of Claims: The Insolvency Act stipulates the order in, and extent to, which claims against an insolvent estate must be paid. For purposes of distribution, an insolvent estate consists of the proceeds of both encumbered and unencumbered assets that have been sold by the liquidator which must be applied to the claim. The proceeds of each encumbered asset are used to pay the claim secured by that asset with any balance being paid to preferent creditors together with the proceeds of unencumbered assets. Any free residue after preferent creditors have been paid is available to the concurrent creditors (Sharrock, Smith & van der Linde, 2002).

In other words, a secured creditor is paid first, after which preferent creditors are paid. Concurrent creditors are paid last from the free residue (if any).

Secured Creditor: A secured creditor is a creditor who holds security for its claim against a debtor company in the form of a bond over fixed property, a special notarial bond over movable property, a pledge of movable property, a cession of incorporeal property, a right of retention and a landlord's legal hypothec (Sharrock, Smith & van der Linde, 2002).

Preferent Creditor: A preferent creditor is a creditor who holds security for its claim against a debtor company in the form of an unperfected general notarial bond over movable assets, but also includes creditors such as the Receiver of Revenue and employees who do not hold any security for their claims (Sharrock, Smith & van der Linde, 2002). In short, a preferent creditor is a creditor that is entitled to be paid after payment of all secured creditors but before payment of concurrent creditors (Sharrock, Smith & van der Linde, 2002).

Concurrent Creditor: A concurrent creditor is a creditor who has no security for its claim, who does not have a preferent claim and who is paid from the free residue after all secured and preferent creditors have been paid (Sharrock, Smith & van der Linde, 2002).

Concursus Creditorum: A winding-up application establishes what is known as a *concursus creditorum* at which point in time it is said that the claims of the various creditors against the estate of the debtor company are crystallised. After a *concursus creditorum* has been established, no creditor may do anything to alter the rights of other creditors and no set off of claims between the creditor and the debtor company may take place (Sharrock, Smith & van der Linde, 2002).

Moratorium: From the moment that an application for liquidation of a debtor company is granted, it establishes a moratorium which is something different from a *concursus creditorum*. The effect of a moratorium is that all civil proceedings by or against the debtor company are suspended pending the appointment of a liquidator.

1.10 Subsequent Chapters

A literature review is provided in Chapter 2 which commences with a discussion of the various distressed debt recovery methods that are available to banks in South Africa, followed by a discussion of key factors that influence their selection.

Chapter 3 deals with the research propositions and research question derived from the literature review, followed by a discussion of the research methodology in Chapter 4.

Chapter 5 deals with the evaluation and discussion of results followed by the conclusion in Chapter 6.

2. LITERATURE REVIEW

The purpose of this chapter is to review the literature from which the propositions and research question are derived that guide the research.

In doing so, this chapter commences with a discussion of the various methods that are available to banks in South Africa to recover distressed debt.

This is followed by a review of the literature relating to factors that influence the selection of distressed debt recovery methods by South African banks.

2.1 Methods to Recover Distressed Debt

There are various methods used by South African banks to recover distressed debt, some of which are regulated in terms of legislation.

Reference to the recovery of distressed debt in this research report is not limited to actions employed by banks aimed at receiving an actual repayment of a debt, but also includes actions employed by banks that assist a debtor company to improve its credit profile thereby enhancing its ability to repay a debt. In other words, the recovery of distressed debt includes both repayment of a debt and the improvement of the ability of a debtor company to repay a debt in future.

Below, this section of the research report discusses each of these recovery methods as presented in the literature.

2.1.1 Liquidation or Winding-Up

At the outset it is important to distinguish between the sequestration of the estate of an individual and the liquidation of a company. Sequestrations are dealt with in terms of the Insolvency Act whilst the Companies Act deals with the liquidation of companies, although section 339 of the Companies Act makes certain provisions of the Insolvency Act applicable to companies in respect of matters not specifically provided for by the Companies Act (Sharrock, van der Linde & Smith, 2002).

The winding-up or liquidation of a company, in essence, is the process whereby its assets are sold and its debts are repaid with a distribution of whatever is left to its members (shareholders) in accordance with their rights after which the company ceases to exist. There are two ways in which a company can be wound-up. The first is by way of an application to court by a creditor (also referred to as a compulsory winding-up) and the second, by way of a special resolution by either the members of the company or its creditors (also referred to as a voluntary winding-up). Invariably, a bank (as a creditor) will have to apply to court for a winding-up order if it can prove that the company is unable to pay its debts. If a bank is successful in proving this fact, a court has a very limited discretion to refuse an application for liquidation (Sharrock, van der Linde & Smith, 2002).

A winding-up order is deemed to commence upon lodgement of the application to the registrar of the court if the application turns out to be successful. From this date a *concursus creditorum* comes into existence which is aimed at ensuring that the property of the company is collected and distributed among creditors in the order of preference as provided for in the Insolvency Act. No creditor may thereafter do anything to alter the rights of other creditors. With effect from the winding-up of a company, the powers of directors cease, the property of the company is deemed to be under the control of the Master of the High Court (until a provisional liquidator is appointed) and the company may not continue with its business. In addition, once a winding-up order is made, all civil proceedings by or against the company are suspended until the appointment of a liquidator (Sharrock, van der Linde & Smith, 2002).

As is clear from the above, liquidation is not concerned with the rehabilitation or rescue of a debtor company or the restoration of its financial health, but provides an orderly and legislative means of recovering debts. It is for this reason that liquidation has been questioned as not yielding the largest recovery to creditors in many cases (Smits, 1999). To this end, Winer, Levenstein & Gewer (2004) hold that, for a number of years now, there has been a growing recognition among the world's financial institutions that, as creditors, they can achieve better returns through supporting an orderly and expeditious rescue or workout of a business in financial difficulty than by forcing it into formal insolvency.

As mentioned previously, most modern, industrialised nations have created statutory regimes that provide protection for insolvent debtors where insolvency is believed to be temporary of nature and where the debtor is believed to be capable, with assistance, to return to normal commercial life as an active and successful entrepreneur. One such well known statutory regime is Chapter 11 of the United States of America's Bankruptcy Act of 1978 that provides a mechanism whereby a debtor may apply for protection against creditors to enable it to present a business rescue plan to creditors for acceptance by them. This course of action is widely supported as a means of saving jobs, enabling work-in-progress to be completed satisfactorily, of protecting investment and ensuring debts are repaid either in full or at least to a greater extent than in liquidation (Rajak & Henning, 1999).

2.1.2 Judicial Management

Judicial management can be used when a company is in financial trouble but has the potential to recover, the underlying idea being that the judicial manager (upon appointment by the court) will rectify the financial state of the company to enable it to become a successful concern. Unfortunately, in practice judicial management does not always achieve the desired results and many companies placed under judicial management are eventually wound-up (Sharrock, van der Linde & Smith, 2002; Winer, 2002).

In terms of section 427(1) of the Companies Act, a judicial management order may be granted by a court where:

- the company, because of mismanagement or any other cause, is unable to pay its debts or is probably unable to meet its obligations;

- the company has not become, or has been prevented from becoming, a successful concern;
- there is a reasonable probability that, if the company is placed under judicial management, it will be able to pay its debts or meet its obligations and become a successful concern;
- it appears just and equitable to grant a judicial management order.

Due to the fact that a judicial management order is a special concession and is only granted in exceptional circumstances, the court (even where it appears that a judicial manager would probably be able to rescue the company financially) has the discretion to refuse such an order. To this end, the court will probably not grant an order if the rescue will take unreasonably long or if a major creditor is opposed to it (Sharrock, van der Linde & Smith, 2002).

The same parties that may apply for a liquidation order may apply for a judicial management order and once an order is made, the property of the company is deemed to be in the custody of the Master of the High Court and, once appointed, in the custody of the provisional judicial manager (Sharrock, van der Linde & Smith, 2002). As is the case with liquidations, once a judicial management order is granted there is a moratorium on all claims and enforcement processes against the debtor (Rajak & Henning, 1999).

The requirement for a successful application for judicial management is that there must be a reasonable probability that the company will again become a successful concern. This implies that the company must eventually be able to meet its debts and obligations in full, which has been the subject of criticism as being outdated, unrealistic and often contrary to the wishes of creditors. After satisfying the court that there is a reasonable probability that the company will recover, the court still has to consider whether it would be just and equitable to grant an order for judicial management (Kloppers, 2001).

In addition to the criticisms already mentioned above, judicial management as a business rescue method has various further shortcomings. First is the heavy reliance on court procedures compared to similar regimes internationally where commencement of a business rescue regime does not require the involvement of a court. Not only must application be made to the court for a provisional and final judicial management order, but also to lift the judicial management order when the business rescue attempt has been successful (Rajak & Henning, 1999; Kloppers, 2001). This increases the cost of the procedure, especially with regard to small and medium-sized businesses (Kloppers, 2001).

Second, the debtor must be able, or likely be able, to pay all its debts in full. However, in virtually all jurisdictions around the world today creditors will accept an amount less than their claim on the basis that a reduced payment is more beneficial than what would have been recovered if the debtor was liquidated and liquidator fees been incurred in the process. In addition, the benefits to debtors, suppliers and employees flowing from the fact that the debtor is restored to commercial effectiveness outnumber its removal from commercial life (Rajak & Henning, 1999).

Third, judicial management requires that a company is unable to pay its debts. This raises the question of whether a company should be insolvent before it applies for judicial management. Kloppers (2001) submits that this should not be a strict requirement as the earlier a company recognises that it should reorganise itself because of a potential financial disaster, the better the chances of avoiding eventual liquidation and the greater the possibility of successful reorganisation (Kloppers, 2001).

Fourth, judicial management is seen as an extraordinary measure as a creditor of a company who is unable to pay its debts is primarily entitled to liquidation as a means of recovering its claims (Kloppers, 2001; Rajak, 1995). Furthermore, courts are generally of the view that it would seldom, if ever, be just and equitable to grant a judicial management order against the wishes of creditors unless the court is persuaded that it will be in the interests of all creditors and/or the shareholders to grant such an order (Kloppers, 2001).

Fifth, the appointment of a judicial manager lacks statutory regulation laying down suitable provisions for qualification, competence and suitability. This increases the probability of incompetence and fraud in an area of commercial practice that requires a considerable amount of business acumen and skill (Rajak & Henning, 1999).

Sixth, judicial managers often lack the industry expertise necessary to perform a turnaround (Winer, Levenstein & Gewer, 2004).

Seventh, companies placed under judicial management are required to deal with the stigma associated therewith and the resultant reluctance of suppliers to continue supplying the debtor company (Winer, Levenstein & Gewer, 2004).

Eighth, the debtor company may also experience difficulty in obtaining access to funding which, obviously, results in the company's restored financial viability being highly unlikely (Winer, Levenstein & Gewer, 2004).

2.1.3 Compromise

Under a compromise, a company on the one hand and its creditors (or any class of them) on the other hand enter into an agreement, called a compromise, whereby the existing contractual relationship between them is restructured (Kloppers, 1999; Rajak & Henning, 1999).

As such, a compromise provides an effective mechanism whereby a class of creditors can be bound where it is impractical for the debtor company to negotiate with each creditor individually. A compromise is, therefore, an effective procedure to negotiate with creditors collectively as opposed to negotiating with each one individually (Kloppers, 1999).

It is clear that a compromise can assist as a business rescue provision by enabling the approval of a plan that provides for the survival of the debtor company to be prepared and voted on by all those with interests in or claims against the debtor company. A compromise does not contain any provision to the effect that the debtor undertakes to pay all its debt in full although it may include such a provision (Rajak & Henning, 1999).

Application for a compromise is made to the High Court of South Africa to convene a meeting of creditors to consider the proposed compromise. The application for a meeting may be brought by the company itself, any creditor, the liquidator (if the company is being wound-up) or the judicial manager (if the company is under judicial management) (Sharrock, van der Linde & Smith, 2002). The necessary vote required at the meeting before a court will sanction the compromise is a majority in number representing 75% in value of the creditors or class of creditors present and voting (by person or proxy). Once the court sanctions the compromise it is implemented and binds all creditors (Rajak & Henning, 1999).

Although it is seen as the only effective legislative business rescue method in South Africa today, it is also not without criticism, the first of which corresponds to that of judicial management in terms whereof the process relies heavily on the court and, as a result, is extremely costly (Rajak & Henning, 1999). Coupled with this, the applications to court may occasion delays and a company in distress may not be able to survive these delays (Winer, Levenstein & Gewer, 2004).

Second, a compromise does not provide for a moratorium on creditors to institute claims against the company, nor does it provide a moratorium on enforcement processes until such time as the compromise is sanctioned by the court. This procedure, therefore, makes no provision for the interim period during which the company awaits the sanction of an offer of compromise by the court (Winer, Levenstein & Gewer, 2004). This is commonly overcome in practice by the company filing for provisional liquidation or provisional judicial management in order to impose a moratorium after which the company is then able to apply to the court to convene the necessary meetings to present the proposal to creditors and to vote thereon (Rajak & Henning, 1999).

Third, a compromise can be very disruptful to a business and can be extremely time consuming (Rajak & Henning, 1999).

2.1.4 Informal Creditors' Workout

An informal creditors' workout is not formally regulated in terms of legislation but, over the last couple of years, has become entrenched in South African commerce. According to Burdette (2004), these workouts take the form of large organisations joining forces to provide ailing companies the necessary financial assistance to trade themselves out of financial difficulty. It, however, also includes cases where large organisations allow the debtor company to wind itself up over a period of time ensuring that creditors recover more than they would in liquidation.

By joining forces, the risk is spread and no single institution has to carry the full burden if such workouts turn out to be a failure (Burdette, 2004). A further major benefit of informal creditors' workout is the fact that costs are generally lower than in liquidation due to the unpredictable costs and uncertainties of a formal insolvency (Winer, Levenstein & Gewer, 2004).

Practices such as the above are severely hampered by the fact that no legislative protection is offered in the form of a moratorium on the enforcement of claims against the debtor company. It also does not bind all creditors and they are, therefore, free to apply for the liquidation of the debtor in appropriate circumstances, putting any additional lendings to the debtor at risk, thereby discouraging creditors in general to assist (Burdette, 2004; Winer, Levenstein & Gewer, 2004).

In addition, directors of a debtor company and other parties involved (such as financiers) may face allegations of reckless trading as a result of their restructuring efforts and may, accordingly, be disinclined to support these rescue initiatives (Winer, Levenstein & Gewer, 2004).

Dispositions of the company's assets which may be a prerequisite to any successful restructuring may also be set aside in terms of the relevant provisions of the Insolvency Act as having been made without value or in the preference of certain creditors in the event of the company subsequently being wound-up (Winer, Levenstein & Gewer, 2004).

A further factor to consider is that these types of workouts do not result in the crystallisation of the claims of all creditors against the company in question (*concursus creditorum*) and the possibility may arise of creditors unknown at the time of the restructuring later asserting claims which vitiate any reorganisation plan (Winer, Levenstein & Gewer, 2004).

2.1.5 Debt Restructuring

In order to remedy financial distress, a debt restructuring can be used to replace an existing debt agreement with a new agreement providing for a reduction in the required interest or principal payments, extend the maturity of the debt and/or provide equity to creditors (whether common share capital or securities convertible into common share capital) (John, 1993; Gilson, John & Lang, 1990; Gilson, 1990; Thain & Goldthorpe, 1989b). In addition, debt restructuring in certain instances also includes debt forgiveness to reduce the debtor company's finance charges and release cash for necessary investments (Thain & Goldthorpe, 1989b).

Debt restructurings can be achieved both informally and through a formal court-adjudicated process (such as compromises as discussed above), depending on the relative cost and benefit of each mechanism.

2.1.6 Asset Sales

The non-performing or non-core assets of a company in distress can be liquidated in whole or part to generate additional liquid assets to meet its current obligations. However, premature liquidation of those assets may result in the destruction of the going-concern value of the debtor company and involves the substantial cost of liquidation (John, 1993).

The overall evidence, however, seems to suggest that although asset sales are used to deal with financial distress, in most case they are used in conjunction with debt restructuring (John, 1993). In addition, the consent of a company is required to sell its assets.

2.1.7 Debt Forgiveness

Debt forgiveness includes those circumstances where a bank either writes off a portion of the interest that accrued on a loan or a portion of the debt capital. As mentioned above, in virtually all jurisdictions around the world today creditors will accept an amount less than their claim on the basis that a reduced payment is more beneficial than what would have been recovered if the debtor company was liquidated and liquidator fees been incurred in the process. In addition, the benefits to debtors, suppliers and employees flowing from the fact that the debtor is restored to commercial effectiveness outnumber its removal from commercial life (Rajak & Henning, 1999).

This notion is confirmed by Thain & Goldthorpe (1989b) who hold that a debt restructuring, in certain instances, may include debt forgiveness to reduce the debtor’s finance charges and release cash for necessary investments.

2.2 Factors that Influence the Selection of Recovery Methods

To date, various international studies have been performed in the realm of business rescue and recovery, more specifically in respect of establishing a link between causes of business decline or failure and concomitant business rescue strategies that are developed by these ailing businesses (see Thain & Goldthorpe, 1989a; Thain & Goldthorpe, 1989b; Thain & Goldthorpe, 1990) and investigations, usually by way of case study, of those factors that affect the choice of strategy adopted by the management of ailing companies to address the decline (see especially O'Neill (1986)).

Further studies in this domain have focused on areas such as changes in corporate ownership when a debtor company defaults its debt obligations, common syndromes and causes of business failure, incentives of financially distressed companies to restructure their debt, conflicting interests of stakeholders in declining companies, bank influence on management changes in respect of distressed companies, circumstances under which a debtor company will be forced into liquidation, and so on (see Gilson, 1989; Gilson, John & Lang, 1990; Gilson, 1990; Stiglitz, 1985; Grinyer & McKierman, 1990; Miller, 1977).

From the above it is clear that past research either focused on the development of strategies by ailing companies themselves on the one hand or on the level of stakeholder influence on the other. What seems to be missing is research regarding bank strategies or actions taken by banks (as opposed to strategies developed by the ailing companies themselves) to recover distressed debt and factors that have an impact on the selection of a specific distressed debt recovery method. This is supported by Gopinath (1995) who states that a bank's actions to deal with distressed loans represent an area of operation that has largely been ignored. Hax & Majluf (1991) as quoted in Gopinath (1995) agree where they state that these are functional strategies that have received little attention from strategy researchers.

Gopinath (1995), however, partly addresses some of these questions in research conducted regarding strategies formed by banks to recover distressed debt. In doing so, he found that causes of business decline assist in explaining strategies adopted by banks to recover distressed debt, with different causes of decline leading to different strategies. Also, he found that in addition to causes of decline there are other variables that affect the strategy adopted by banks, with a level of interaction between these variables and the said causes of decline.

However, as noted under the delimitations, this research report does not focus on establishing a cause-and-effect relationship between causes of business decline and the development of bank strategies, but rather focuses on specific distressed debt recovery methods that can be used by a bank and the impact of key factors (other than causes of decline) on the method selected.

One further study that provides some insight into this line of study was done by Bulow & Shoven (1978). However, this particular study focuses only on factors that contribute to a decision of whether or not a debtor company is placed into liquidation or not and does not consider alternative distressed debt recovery methods. Some insight will, however, be derived from this study.

2.2.1 Early Detection

According to Kloppers (2001) and Thain & Goldthorpe (1989a), the earlier a company recognises that it should reorganise itself because of a potential financial disaster, the better the chances of avoiding eventual liquidation and the greater the possibility of successful reorganisation. This is confirmed by Winer (2002) where he states that there is no doubt that time is the most crucial factor as any delay prolongs commercial uncertainty which increases the costs of a turnaround process and erodes value.

According to Gopinath (1995), because a bank is interested in identifying a distressed loan early on, there are presumably more alternatives available at this point to recover the distressed debt.

2.2.2 Security

The extent of security seems to be an important consideration that has an impact on a bank when deciding on a distressed debt recovery method. Gopinath (1995), in studying the strategies employed by banks while responding to financial difficulty of its clients, states that the protection of the funds advanced by banks to their clients is of great concern. He states that if the loan is not fully secured, the bank would try to strengthen its position by ensuring adequate security is taken thereby avoiding liquidation if possible.

2.2.3 Severity of Decline

Banks generally manage their distressed debt as part of a separate portfolio (referred to in the banking industry as a 'watch list' or 'high risk portfolio') where these clients are closely monitored and proposed action plans tracked. Gopinath (1995) confirms this and states that where the decline of these clients is severe, banks generally respond in a drastic way.

2.2.4 Co-operation

Another factor impacting on the strategy or method that Gopinath (1995) has found banks to employ in recovering distressed debt is the level of co-operation between a bank and its distressed client and the nature of their relationship. He holds that, where a bank perceives a co-operative attitude of a debtor company, it signals to the bank an interest to address the decline and work out the loan as well as a willingness to work with the bank to achieve this.

According to Winer, Levenstein & Gewer (2004), a co-ordinated response by the creditors of a debtor company gives them time to help manage the impact of struggling cash flow positions and trading in insolvent circumstances.

2.2.5 Turnaround Ability of Management

The ability of management to perform a turnaround is another important aspect listed by Gopinath (1995) that may influence the strategy choice of a bank to recover its distressed debt, especially as it will be management that will have to implement the strategy to address the decline.

In a study performed by Thain & Goldthorpe (1989b) that investigated why companies experience decline and why they were able to turn themselves around found that new management was a main contributing factor as a different kind of leadership and experience was required to address the financial difficulties. They also held that the change in management was symbolic signalling to employees that the company was taking decisive action; the change was a punishment for management mistakes and that the company evolved from one stage in its development to the next with key management lacking the necessary skills.

O'Neill (1986) compared companies that were able to turn themselves around to those that were not and found that turnaround efforts were usually preceded by a change in top management as most failures are due to management defects. However, while he found that a decline in business is likely to reduce management's credibility and this lack of credibility exacerbates the decline, not all turnarounds require a change in management. The survival of management depends on the cause of decline especially where the decline has been the result of unpredictable and unmanageable external events.

2.2.6 Onus of Proof

Another factor that influences the selection by banks of a recovery method and, more specifically, whether or not judicial management should be used, is onus of proof. As previously mentioned, onus of proof to convince a court to grant a judicial management order is extremely high. According to Sharrock, van der Linde & Smith (2002), judicial management is a special concession and is only granted in exceptional circumstances. Furthermore, the court has the discretion to refuse such an order even where it appears that a judicial manager would probably be able to rescue the debtor company financially.

2.2.7 Skill

Sticking to judicial management for the moment, skill (as mentioned previously) is another important factor that comes into play. As the appointment of a judicial manager lacks the necessary statutory regulation laying down suitable provisions for qualification, competence and suitability it increases the probability of incompetence in an area of commercial practice that requires a considerable amount of business acumen and skill (Rajak & Henning, 1999).

2.2.8 Cost

Cost is always an important factor that needs to be taken into account when a distressed debt recovery method is considered. To this end, judicial management is heavily reliant on court procedures compared to similar regimes internationally where commencement of business rescue or debt restructuring does not require the involvement of a court. The same applies to a compromise as a distressed debt recovery method whereas the cost in respect of an informal creditors' winding-up is generally lower than the fees of liquidators in liquidation (Rajak & Henning, 1999; Kloppers, 2001; Winer, Levenstein & Gewer, 2004).

2.2.9 Number of Creditors

The number of creditors of a debtor company can play a significant role in the selection of one distressed debt recovery method above another. To this end, a compromise provides an effective mechanism whereby a class of creditors can be bound, where it is impractical for a debtor company to negotiate with each creditor individually and, thereby, provides an effective procedure to negotiate with creditors collectively as opposed to individually (Kloppers, 1999).

2.2.10 Moratorium

The existence or not of a moratorium that stops a creditor instituting a claim against a debtor company is another important factor identified by Winer, Levenstein & Gewer (2004) when the applicability of a distressed debt recovery method is considered. Whereas both liquidation and judicial management provide for a moratorium, there is no legislative provision for a moratorium in a compromise and an informal creditors' winding-up (Burdette, 2004; Winer, Levenstein & Gewer, 2004).

2.2.11 Legislation

Disposition of a debtor company's assets, which may be a prerequisite to any successful restructuring, may be set aside in terms of the relevant provisions of the Insolvency Act, as having been made without value or in the preference of certain creditors in the event that the debtor company is placed in liquidation, and are therefore important factors to consider during any distressed debt recovery exercise (Winer, Levenstein & Gewer, 2004).

2.2.12 Attractiveness of Business

Thain & Goldthorpe (1989b) compared the attractiveness of the business and the ability of management in order to ascertain whether or not to stick with a business, in other words to liquidate or to support a business rescue or debt restructuring. Although this was done from the perspective of management, the study contains important information regarding factors that banks could take into account in selecting a proposed method for the recovery of a distressed debt.

The study held that when a business is unattractive and the ability of management is low, disposal of the business is the viable option. When either business attractiveness or management ability is good and the other poor, either a new strategy is required or management should be changed. When both variables are good, the business should be retained.

2.2.13 Concursus Creditorum

Not all distressed debt recovery methods provide for a *concursus creditorum* in terms of which the claims of creditors against the estate of a debtor company crystallise. Accordingly, the possibility always exists that creditors unknown at the time of a restructuring of the business of a debtor company later assert claims which vitiate any restructuring plan (Winer, Levenstein & Gewer, 2004).

2.2.14 Ranking of Creditors

In their study, Bulow & Shoven (1978) derived conditions under which the necessary funds for the continuation of a distressed business will not be forthcoming from its lender and thereby the circumstances under which a distressed company will be forced into liquidation. They found that the bankruptcy choice depended on several variables, such as the firm’s net worth position, the cost of bankruptcy, the maturity of debt, the priority structure of creditors and the ownership of the company’s debt.

3. RESEARCH PROPOSITIONS AND QUESTION

3.1 Research Propositions

The following propositions flow from the literature review and will be the statements against which the research will be conducted.

3.1.1 Research Proposition 1

The range of distressed debt recovery methods that are available to South African banks are as follows:

- **Liquidation**

For example:

> Liquidation is the process whereby a company's assets are sold, its debts are paid and any money left over is divided amongst its members (shareholders) according to their rights [Sharrock, van der Linde & Smith, 2002]

- **Judicial Management**

For example:

> Judicial management can be used when a company is in financial trouble but has the potential to recover [Sharrock, van der Linde & Smith, 2002; Winer, 2002]

- **Compromise**

For example:

Under a compromise, a company and its creditors enter into an agreement restructuring the existing contractual obligations between them [Kloppers, 1999; Rajak & Henning, 1999]

- **Informal Creditor Workout**

For example:

Unregulated financial assistance by creditors joining forces to assist debtor companies by providing financial assistance [Burdette (2004)]

- **Debt Restructuring**

For example:

The replacement of an existing debt agreement with a new one providing a reduction in interest or capital [John, 1993; Gilson, John & Lang, 1990; Gilson, 1990; Thain & Goldthorpe, 1989b]

- **Asset Sales**

For example:

The sale of part or all of the non-core assets of a debtor company [John, 1993]

- **Debt Forgiveness**

For example:

Banks writing off a portion of either the interest or the debt capital [Rajak & Henning, 1999; Thain & Goldthorpe, 1989b]

3.1.2 Research Proposition 2

Factors that influence the selection by South African banks of distressed debt recovery methods are as follows:

- **Early Detection**

For example:

> Early detection enhances chances of avoiding liquidation and the possibility of successful reorganisation [Kloppers (2001); Thain & Goldthorpe (1989a); Winer (2002)]

> Early detection enhances available alternatives to recover the distressed debt [Gopinath (1995)]

- **Security**

For example:

> Extent of security held by banks is an important consideration [Gopinath (1995)]

- **Severity of Decline**

For example:

> Where a decline is severe, banks generally respond in a drastic way [Gopinath (1995)]

- **Co-operation**

For example:

> The level of co-operation of a borrower signals to the bank an interest and willingness to address a decline [Gopinath (1995)]

Co-ordinated responses by the creditors of a debtor company give them time to help manage the impact of struggling cash flow positions [Winer, Levenstein & Gewer (2004)]

- **Turnaround Ability of Management**

For example:

The ability of management to perform a turnaround [Thain & Goldthorpe (1989b); O'Neill (1986)]

- **Onus of Proof**

For example:

The onus of proof to convince a court to grant a judicial management order is extremely high [Sharrock, van der Linde & Smith (2002)]

- **Skill**

For example:

Judicial management is an area of commercial practice that requires a considerable amount of business acumen and skill [Rajak & Henning (1999)]

- **Cost**

For example:

The cost in respect of an informal creditors' winding-up is generally lower than in liquidation [Rajak & Henning (1999); Kloppers (2001); Winer, Levenstein & Gewer (2004)]

- **Number of Creditors**

For example:

A compromise provides an effective mechanism whereby a class of creditors can be bound [Kloppers (1999)]

- **Moratorium**

For example:

Whereas both liquidation and judicial management provide for a moratorium, there is no legislative provision for a moratorium in a compromise and an informal creditors' winding up [Burdette (2004); Winer, Levenstein & Gewer (2004)]

- **Legislation**

For example:

Disposition of a debtor company's assets may be set aside in terms of the relevant provisions of the Insolvency Act [Winer, Levenstein & Gewer (2004)]

- **Attractiveness of Business**

For example:

When both business attractiveness and ability of management are good, the business should be retained [Thain & Goldthorpe (1989b)]

- **Concursus Creditorum**

For example:

The possibility always exists that creditors unknown at the time of a restructuring of the business of a debtor company later assert claims which vitiate any restructuring plan [Winer, Levenstein & Gewer (2004)]

- **Ranking of Creditors**

For example:

The bankruptcy choice depends on several variables, including the priority structure of creditors [Bulow & Shoven (1978)]

3.2 Research Question

The literature that was reviewed in the preceding chapter addresses, *inter alia*, the research propositions on the key factors that influence the selection of distressed recovery methods by South African banks. In doing so, they provide some insight into the extent that these key factors impact on the selection of a specific distressed debt recovery method.

3.2.1 Research Question 1

What is the impact of key factors on the selection by South African banks of distressed debt recovery methods?

4. RESEARCH METHODOLOGY

4.1 Qualitative Research Paradigm

The purpose of this research report is to analyse the impact of key factors on the selection of distressed debt recovery methods by South African banks in order to develop a framework to assist South African banks to select the most appropriate recovery method given the presence of these factors.

A qualitative research paradigm was used to conduct this research. According to Leedy & Ormrod (2004) qualitative research is about getting an in-depth understanding of the phenomenon that is studied. It is about the collection of numerous forms of data and their examination from various angles that assist a researcher in the construction of a rich and meaningful picture of a complex and multifaceted situation.

Qualitative researchers tend to focus on phenomena that occur in the real world in all their complexity. They rarely attempt to simplify their observations but rather acknowledge that the issue they are studying has many dimensions and layers and so they attempt to portray the issue in its multifaceted form. They believe the researchers' ability to interpret and make sense of what they see is critical for understanding the phenomenon and, as such, researchers are instruments in much the same way that sociograms, rating scales or intelligence tests are instruments (Leedy & Ormrod, 2004).

Leedy & Ormrod (2004) identify a number of characteristics that distinguish qualitative and quantitative research. These include the purpose of the research, the nature of the research process, the data and basis upon which it is collected, how the data is analysed and how findings are communicated as shown in more detail in Table 1 below:

Table 1: Distinguishing characteristics of qualitative and quantitative designs

Question	Quantitative	Qualitative
What is the purpose of the research?	• To explain and predict • To confirm and validate • To test theory	• To describe and explain • To explore and interpret • To build theory
What is the nature of the research process?	• Focused • Known variables • Established guidelines • Predetermined methods • Somewhat context free • Detached view	• Holistic • Unknown variables • Flexible guidelines • Emergent methods • Context-bound • Personal view
What are the data like and how are they collected?	• Numeric data • Representative, large sample • Standardised instruments	• Textual and/or image-based data • Informative small sample • Loosely structured or non-standardised observations and interviews
How are data analysed to determine their meaning?	• Statistic analysis • Stress on objectivity • Deductive reasoning	• Search for themes and categories • Acknowledgment that analysis is subjective and potentially biased • Inductive reasoning
How are the findings communicated?	• Numbers • Statistic, aggregated data • Formal voice, scientific style	• Words • Narratives, individual quotes • Personal voice, literary style

Leedy & Ormrod (2004:96)

From the above, a qualitative research design was chosen for the following reasons as informed by Leedy & Ormrod (2004) and Creswell (2003):

- The purpose of the research was to seek a better understanding of the complex and subjective area of distressed debt recovery and the factors that influence South African banks in selecting a specific method, all of which require exploration and interpretation of findings;

- The nature of the research process involved a natural setting that required an open mind and a researcher that was prepared to immerse himself in the complexity of a situation to obtain the personal views of participants through open-ended observations and interviews. To this end, key variables were unknown and exploratory research was required to identify them;

- The data was collected from a small sample of highly-skilled and qualified individuals who are at the forefront of distressed debt recovery in South Africa and, as such, the researcher acted as the research instrument as the data collection was dependent on the personal involvement of the researcher in the setting;

- Inductive reasoning was used and subjective inferences were drawn from the interviews with the participants;

- The findings of the research are interpretive narratives and attempt to capture the complexity of the phenomenon that was studied.

4.2 Descriptive Research Design

The research design that was used in this research report was a content analysis. Leedy & Ormrod (2004:142) define a content analysis as “a detailed and systematic examination of the contents of a particular body of material for the purpose of identifying patterns, themes or biases”.

The body of material that was studied constituted transcripts of interviews conducted with the participants as identified in **Appendix 1** to this research report. These transcripts were compiled from semi-structured in-depth interviews that were conducted between the researcher and the various participants.

Semi-structured in-depth interviews were selected as the data collection method as the research was interpretative and the variables largely unknowns and it enabled the researcher the flexibility to take advantage of unforeseen data sources as and when they surfaced (Leedy & Ormrod, 2004). According to Emory & Cooper (1991), an important value of personal in-depth interviews lies in the depth and detail of information that can be secured. It also allows the researcher control over the line of questioning and allows the participant to provide historical information that may have influenced a certain phenomenon (Creswell, 2003). Furthermore, the researcher has direct access to the unique form of expertise and experience of participants which are not accessible by means of other research methods (O'Sullivan, Rice & Saunders, 1994).

Ultimately, semi-structured interviews do contain certain disadvantages. These include the fact that a novice researcher may not always know what things are most important to look for and, as a result, may waste considerable time observing and recording trivialities while overlooking those aspects that are central to the research (Leedy & Ormrod, 2004). By the researcher being present, he or she may alter what people say and do and how significant events unfold or bias responses (Leedy & Ormrod, 2004; Creswell, 2003). "Recording the events can be problematic as well. Written notes are often insufficient to capture the richness of what one is observing." (Leedy & Ormrod, 2004:145). As the researcher obtains different information from different people he or she may not always be able to make comparisons among the interviewees, which may impact on consistency. Lastly, interviews provide indirect information as it is filtered through the view of the interviewee (Creswell, 2003).

The following functions were performed to mitigate some of these disadvantages:

- The researcher carefully explained the purpose of the research and its context so as to ensure that the participants had a clear understanding of the subtleties of the research and the research questions;

- The researcher, during the interview, continuously summarised the views expressed by a participant so as to ensure that the researcher had an accurate understanding of the points put across by the participant;

- The researcher recorded all the interviews on cassette, which recordings were typed so as to ensure that the context would not be lost in the process;

- The findings of the research as contained in Chapter 5: Evaluation and Discussion of Results were provided to each participant so as to ensure that the results correctly and accurately reflect the views of participants.

4.3 Population and Sample

The population of this research report included all South African banks (especially those employees working in the applicable departments dealing with the recovery of distressed debt), liquidators (who are regularly appointed by South African banks to recover distressed debt in liquidation), turnaround or business rescue professionals (acting regularly on behalf of South African banks to assist in the most effective way to recover distressed debt), attorneys (in advising South African banks as to the appropriate legal implications of a suggested course of action to recover distressed debt) and auctioneers (that are appointed by South African banks to dispose of the assets of distressed companies) - all of whom have an interest in the way South African banks recover distressed debt.

The sample that was collected from the above population included an expert or two within each of the fields of practice identified above, being bank employees, liquidators, business rescue professionals, attorneys and auctioneers. The wide range of stakeholders contained in the sample adequately addressed triangulation.

The sampling technique that was used was purposeful. Leedy & Ormrod (2004) describe purposeful sampling as the selection of those individuals that will yield the most information about the topic under investigation. As de Ruyter & Scholl (1998:8) succinctly put it, “the usefulness of qualitative research is not determined by how many customers say something but by what is being said and how it is being said.” He goes further to say that a careful target group selection is needed to make sure all possible views and opinions are expressed. Representativeness of the results in accordance with the subject of the investigation, not the research population, is what counts (Ruyter & Scholl, 1998).

The size of the sample included fourteen participants across twelve organisations, as set out in **Appendix 1**.

4.4 Data Collection

The process that was followed in conducting the interviews followed the protocol as suggested by Leedy (1989):

- A prospective participant was contacted telephonically at least two weeks prior to the start of the interview process and an interview lasting between 45 and 75 minutes was requested. The interview request clearly set out the purpose of the research, the reason for the interview and the subject that was to be covered, following the telephone protocol in **Appendix 2**;

- Upon acceptance, a confirmatory e-mail was sent to the participant thanking him/her for his/her co-operation and confirming the date, time and venue of the interview. A copy of the proposed interview questions was attached to this e-mail. An e-mail confirmation is enclosed as **Appendix 3** and the interview questions in **Appendix 4**, the latter of which is based on an example in Leedy & Ormrod (2004) as used by Zambo (2003);

- A master chart of appointments was continuously updated setting out the name of the company, the name of the participant, the address where the interview was to be conducted, the contact details of the participant and the time and date of the interview. A few days prior to the interview, a reminder was sent to the participant;

- On the day of the interview, the researcher arrived at least 30 minutes prior to the start of the interview which he used to familiarise himself with the environment. During the interview, the researcher was prompt, following the agenda and had a copy of the interview questions available in case the participant had mislaid his/her copy.

The interviews were conducted at the sites of the participants. Each interview was recorded by audio equipment.

The protocol suggested by Creswell (1994:152) as used by Harrison (2002) was followed for each interview (see **Appendix 4**). The components of the protocol contained a heading, instructions to the interviewer, the key interview questions that were asked, probes that followed the key questions, transition messages for the interviewer, space for recording the interviewer's comments and space in which the researcher recorded reflective notes.

4.5 Data Analysis

Data analysis is concerned with converting data into a format that answers the research questions or propositions. Data processing generally begins with the editing and coding of the data. Editing involves checking the data collection form for omissions, legibility and consistency in classification. The editing process corrects problems such as interviewer errors before the data are transferred to a computer or readied for tabulation (Zikmund, 1984).

As opposed to quantitative research where data analysis and data interpretation are in large two separate steps, "in most qualitative research, however, data analysis and interpretation in qualitative research are closely interwoven and both are often enmeshed with data collection as well" (Leedy & Ormrod, 2004:150).

The typed recordings of the in-depth semi-structured interviews were content analysed. Similar themes were grouped together.

The data analysis was done using the spiral steps of Creswell (1998) as described in Leedy & Ormrod (2004):

- The data was organised by breaking large bodies of text down to smaller units, sentences or phrases;
- The data was perused several times in order to get a sense of the larger picture and possible categories and interpretations;
- General categories, themes or groupings were noted, as well as sub-themes or categories if they emerged. This indicated patterns of "what the data means";
- Data was then integrated and summarised. The categories were organised to relate back to the propositions and research question.

4.6 Validity and Reliability

According to Leedy & Ormrod (2004), the following considerations should be taken into account when the validity of a research project is considered:

- The first consideration is whether the research report has sufficient controls to ensure that the conclusions are truly warranted by the data;
- The second consideration is whether the observations can be used to make generalisations about the world beyond that specific situation.

These two considerations address the issue of internal and external validity, both of which were addressed in this research report (Leedy & Ormrod, 2004). Reliability, on the other hand, is the consistency with which a measuring instrument yields a certain result when the entity being measured has not changed.

4.6.1 Internal Validity

"Internal validity of a research report is the extent to which its design and the data it yields allow the researcher to draw accurate conclusions about cause-and-effect and other relationships with the data." (Leedy & Ormrod, 2004:97).

To ensure internal validity of a research report, precautions need to be taken to eliminate other possible explanations for the results that are observed. One commonly used method in qualitative research is triangulation. Triangulation is when multiple sources of data are collected in the hope that they all will converge to support a particular hypothesis or theory (Leedy & Ormrod, 2004).

Triangulation, as a method to address internal validity, was used in that semi-structured in-depth interviews were conducted with various participants from a wide range of expertise. In addition, the findings of the research as set out in Chapter 5: Evaluation and Discussion of Results were provided to each participant so as to ensure that the results correctly and accurately reflect the views of participants. To this end the format of the validity request is enclosed as **Appendix 5**.

4.6.2 External Validity

"The external validity of a research report is the extent to which its results apply to situations beyond the study itself – in other words, the extent to which the conclusions drawn can be generalised to other contexts" (Leedy & Ormrod, 2004:99).

There are various strategies that a researcher can follow in order to address external validity, such as conducting research in a real life setting, obtaining a representative sample and replication of the research in a different context.

The research as set out in this research report was conducted in a real-life setting with participants from a wide range of disciplines all of whom are seasoned professionals with years of experience in their respective fields. In addition, the feedback is described in sufficiently rich, “thick” detail to enable readers to draw their own conclusions from the data presented (Leedy & Ormrod, 2004).

4.6.3 Reliability

As set out above, reliability is the consistency with which a measuring instrument yields a certain result when the entity being measured has not changed. As such, reliability has to do with the accuracy and precision of a measurement procedure. Reliability can be improved if external sources of variation are minimised (Emory & Cooper, 1991).

As is the case with validity, various strategies can be followed to address reliability. These include the administration of the measuring instrument in a consistent fashion, i.e. standardisation in the use of the measuring instrument from one situation or person to the next. To the extent that subjective judgments are required, specific criteria should be established that dictate the kinds of judgments the researcher makes and any research assistant using the research instrument should be well trained so that he or she can obtain similar results.

Although the research report is limited in respect of reliability, the conditions under which the measuring instrument was conducted were, as far as possible, standardised and the method in which the interviews conducted, systematic as suggested by Emory & Cooper (1991).

5. EVALUATION AND DISCUSSION OF RESULTS

In this chapter, the results of the in-depth, semi-structured interviews are evaluated and discussed.

This chapter commences with a discussion of the results relating to the various distressed debt recovery methods used by South African banks other than those already identified in the literature review. This is followed by a discussion of the factors that have been identified by participants that have an impact on a decision by a South African bank to use a specific distressed debt recovery method. This chapter then concludes by discussing the impact of key factors on the selection of distressed debt recovery methods by South African banks.

5.1 Distressed Debt Recovery Methods

All participants confirmed that the recovery methods identified in the literature review are used by South African banks. To this end, most participants indicated that more often than not a hybrid of these methods is used in order to recover distressed debt. In other words and as an example, debt restructuring may be used as part of an informal creditors' workout, which may also include the sale by the debtor company of non-core assets in order to reduce total leverage with a possible right to convert debt into equity being granted to creditors.

In addition to those distressed debt recovery methods identified in the literature review, the participants also identified additional methods that are used by South African banks to recover distressed debt. Each of these methods will be discussed below.

5.1.1 Debt to Equity Conversions

As a distressed debt recovery method, a debt to equity conversion entails the issue by a debtor company of a portion of its authorised share capital to a creditor in exchange for a reduction by the creditor of its claim against that debtor company.

To this end, section 221 of the Companies Act provides that a company, in a general meeting, may authorise its directors to issue shares to current or prospective shareholders. In practice, however, most shareholders' agreements contain minority protections that require a special resolution to issue shares.

It goes without saying that a debt to equity conversion reduces the total interest bearing liabilities of a debtor company which goes a long way in addressing its viability. A reduction in the debt liability of a debtor company also boosts the equity of that company which assists it in procuring new facilities from a bank.

According to the participants, the starting point for a bank to calculate the portion of debt to convert into equity is the expected liquidation dividend (excluding liquidators' fees) it expects to receive if a debtor company is wound-up. For purposes of illustration only, if it is assumed that a bank would recover only 60 cents of each Rand of debt when a debtor company is wound-up, a bank will negotiate a right to convert at least 40 cents of each Rand of debt into equity. The upside for the bank is that it now owns an instrument which, if all goes well and the debtor company pulls through, will provide a return that matches the risk profile of that company. That return will be well in excess of the debt return previously received by the bank prior to converting its debt into equity.

5.1.2 Private Equity

Closely linked to debt/equity conversions as a distressed debt recovery method are private equity transactions.

As opposed to a debt/equity conversion where a debtor company issues authorised share capital to a creditor in exchange for a reduction of its claim against that debtor company, a private equity transaction typically involves the sale by current shareholders of a portion of their shareholding to third parties or creditors. In other words, the main difference between a debt/equity conversion and a private equity transaction is the fact that the former involves the issue of shares by the debtor company (thereby diluting the shareholding of current shareholders) whereas the latter involves the sale by shareholders of a portion of their shareholding in the debtor company.

Most shareholders' agreements contain minority protections to the extent that if a majority shareholder is selling its shares in a debtor company, the purchaser of such shareholding is contractually bound to also offer to purchase the shares of the minority shareholders on equal terms.

The effect of a private equity transaction is that a new shareholder may be able to recapitalise the business by way of new shareholders' loans to the debtor company or, by providing a suretyship, assist the debtor company to procure new financing from a bank. In effect, a new shareholder can give the necessary credibility to a debtor company who has lost its credibility due to it being in distress.

5.1.3 Sale of Business/Assets

Another method identified by participants as a distressed debt recovery method is the sale by a debtor company of its business or assets (or a portion thereof). As was the case under a debt to equity conversion, the effect of a sale of business or assets is that the proceeds can be used to reduce the total interest bearing liabilities of a debtor company which could free up a significant amount of cash flow which is the life blood of an ailing business, whereas the reduction in debt capital boosts equity levels which assist the debtor company in procuring new facilities with a bank.

5.1.4 Controlled Winding-up

The last method identified by participants as a distressed debt recovery method not identified by the literature review is the controlled winding-up of a debtor company. Participants indicated that a controlled winding-up is the process whereby a debtor company, with the support and approval of its creditors, undertakes to sell its assets or business (or portions thereof) in a controlled and organised fashion with a view to repay its creditors either in full or in part in the same order of preference as in liquidation as if a liquidator was attending to the winding-up of the estate in accordance with the provisions of the Insolvency Act.

5.2 Factors Influencing the Selection of Recovery Methods

The semi-structured in-depth interviews revealed various factors that have an impact on a bank when it selects a distressed debt recovery method. Each of these factors will be discussed in the section that follows below.

The interviews were conducted on the basis that each distressed debt recovery method was identified after which the various factors that have an impact on the selection of that recovery method were identified and discussed.

Accordingly, the results of these semi-structured in-depth interviews are presented in the same format as in the interviews, i.e. each distressed debt recovery method will be identified below with a concomitant identification and discussion of those factors that have an impact on that specific recovery method.

5.2.1 Liquidation

Most participants indicated that liquidation is truly a last resort when it comes to the selection of a distressed debt recovery method by a South African bank. They indicated that only when all other options have been explored will liquidation be considered.

Contrary to this, however, one participant in particular felt that liquidation as a distressed debt recovery method is underrated and that, in several circumstances, liquidation should be a preferred recovery method. This participant indicated that due to the circumstances that surrounded the liquidation of a specific company (see discussion below) which portrayed banks as the villains, banks have become very cautious about the use of liquidations as a distressed debt recovery method, even where it is expected to yield the best recovery.

Yet another participant indicated that liquidation as a distressed debt recovery method should not have a ranking, as there are too many factors that play a role in a decision of whether or not to apply for the liquidation of a debtor company.

Below, each factor that has an impact on the selection of liquidation as a distressed debt recovery method is discussed.

Reputation

Banks, in particular, have become extremely cautious to use liquidation as a distressed debt recovery method especially due to their experiences with regards to the liquidation of a specific debtor company that had exposures to all four major South African banks. Many participants indicated that this matter was a turning point in the way banks used to recover distressed debt.

During the liquidation of this specific company there have been allegations of corruption in the office of the Master of the High Court, the unauthorised involvement of the Minister of Justice at the time in the appointment of provisional liquidators and allegations of financial institutions acting in their own best interests at the expense of the general body of creditors.

As a result, various bank employees were subpoenaed under section 417 of the Companies Act to testify about the events that led to the liquidation of the particular company, followed by reports in the printed media that vilified banks as the cause for its demise. This made banks realise that there is a considerable amount of reputational risk associated to the liquidation of any company and, as a result, liquidation as a method to recover distressed debt became a 'dirty' word in the banking industry and banks more readily pursued alternative methods to recover distressed debt.

Participants indicated that, closely related to reputational risks associated to being seen as the driving force behind the liquidation of a debtor company, protection of jobs (which is a stated priority of Government) also plays a significant role in any decision where liquidation is an option. Banks indicated that where a debtor company employs a substantial workforce, all other distressed debt recovery methods will be assessed and considered first due to the reputational issues that may arise if a bank blindly applies for the liquidation of such a company.

As indicated in the introduction to this section, certain participants indicated that a bank needs to act in the best interest of its shareholders and needs to accept that banks will always be accused one way or the other as being the reason for the demise of a debtor company where the fault, in most cases, clearly lies with the debtor company's management. They indicated that, barring possible reputational repercussions where a decision to liquidate is made hastily without due consideration of alternative methods especially where the debtor company employs a substantial workforce, banks have an obligation to their shareholders to use the distressed debt recovery method that will yield the best financial result for that bank, especially where an alternative distressed debt recovery method may result in substantial costs and management time to see through. They indicated that even where a bank may do everything in its power to assist a debtor company to avoid liquidation and to restructure its business, a bank has no guarantee that it will not in any event be accused of underhand dealings.

Cost

Part of the cost associated with liquidation is the fees charged by liquidators. Participants indicated that the basis for calculating liquidators' fees is a significant factor that needs to be considered before a decision is made to liquidate a debtor company.

To this end, liquidators' fees are charged in terms of Tariff B on the Second Schedule to the Insolvency Act which provides for a fee equal to a fixed percentage of the gross proceeds per asset class sold by a liquidator. It, therefore, follows that fees paid to liquidators especially in bigger estates add up to a significant amount of money, all of which rank prior to the claims of creditors. For this reason, participants indicated that banks would carefully consider alternative distressed debt recovery methods to enhance the probability of them making a better recovery if these fees are not incurred.

In addition, the time value of money aspect of their claims also plays a role that needs consideration as estates can take a substantial amount of time to be brought to finalisation, as discussed further below.

Fraud

One factor that seems to sway the balance heavily in favour of using liquidation as a preferred distressed debt recovery method is where a debtor company has committed fraud against a bank.

This is so for several reasons. Firstly, if a debtor company acted fraudulently before, a bank has no guarantee that it would not attempt to defraud the bank again. As a result, a bank would be extremely cautious to assist a debtor company that was involved in fraudulent activities to restructure its business as the bank may end up losing more than it would have if the company was merely liquidated. In addition, certain participants indicated that clients also expect a bank to act against a fraudulent debtor company especially where the fraud has also been committed against other creditors.

Secondly, an urgent application for liquidation can be used by a bank to preserve whatever documentary evidence may exist as proof that a debtor company acted fraudulently in order to bring the fraudulent operators of the debtor company to justice before they can dispose of such documentary evidence.

Thirdly, where a bank has security in the form of a cession of debtors or general notarial bond over the movable assets of a debtor company, liquidation becomes a preferred distressed debt recovery method in order to preserve as much of the security as possible. For example, fraudulent operators of a debtor company could very easily instruct its debtors to make payment into an account other than the nominated account held with that particular bank or move its movable assets under the general notarial bond to undisclosed premises.

Participants, however, indicated that where there was clear evidence of fraud, the bank would still, in certain instances, consider alternative distressed debt recovery methods on condition that the bank could not worsen its position in the process, where the proposed restructuring method would yield a better return to the bank than liquidation and as long as there was no risk of undue preferences to certain creditors in the process.

Ranking of Claims

According to participants, another factor that needs careful consideration is the type of security held by a bank and its concomitant ranking as a creditor, especially if the main source of a bank's security consists of a general notarial bond over the movable assets of the debtor company.

As the holder of a general notarial bond and for as long as a bank has not perfected its bond, it has a preferent claim against the estate of a debtor company. As a result, the bank not only ranks behind secured creditors but also behind other preferent creditors such as the Receiver of Revenue and employees.

In order to have a secured claim against the debtor company, the holder of a general notarial bond needs to perfect the bond which effectively means it has to take possession and control of all the movable assets under the bond in order to establish a pledge over those assets. In order to retain possession a bank, after it obtained an order to perfect, needs to take control of the premises where the movable assets (normally in the form of trading stock) are held which makes it impossible for the debtor company to keep trading. If the bank loses control over the assets (i.e. loses its pledge), it will also lose its secured claim. A decision to perfect is thereby effectively a death warrant for the debtor company with a liquidation that normally follows shortly after an order for perfection, either by another creditor or by the debtor company itself.

Enquiries

Section 417 of the Companies Act provides for an enquiry method into the affairs of a company. A liquidator, on instruction from a creditor, can summon any person deemed capable by the Master of the High Court of giving information concerning the affairs of the company to testify at a hearing.

However, section 417 of the Companies Act is only available where a company is wound-up due to it being unable to pay its debts and is not available where, for example, a winding-up order was granted on just and equitable grounds or where a company is not in the process of being wound-up at all.

Accordingly, if a bank wants to use the enquiry provisions of section 417 of the Companies Act, it will have to apply for the liquidation of a debtor company on the basis that it is unable to pay its debts.

Time

The process whereby application is made for a liquidation order, the appointment of provisional and then final liquidators, the process in terms whereof the estate is wound-up and the eventual distribution of a final liquidation dividend to creditors can take a substantial amount of time. All of this is aggravated by the number of liquidators that are appointed in an estate.

Liquidators are appointed in accordance with votes of creditors. Creditors with the highest value of claims are entitled to appoint one liquidator whereas creditors with the highest number of claims are entitled to another appointment. In addition, the Master of the High Court of South Africa may make a further appointment from a pool of previously disadvantaged individuals. However, in practice it is not uncommon for up to seven or eight liquidators to be appointed to the detriment of creditors.

As certain decisions require the consent of all appointed liquidators, it can literally take weeks if not months to get a decision endorsed by all liquidators, let alone getting all liquidators to agree to a specified course of action.

Skill

The Master of the High Court of South Africa appoints liquidators from a panel. In order for a person to qualify for addition to the panel, such person merely has to be a suitable, fit and proper person. It is therefore needless to say that this provides the Master of the High Court with an unfettered discretion as to who is allowed on the panel. The result is that liquidators that do not posses the necessary skill and training are appointed.

This is another factor that banks keep in mind before a decision is made to support liquidation as a preferred method to recover distressed debt as liquidators that do not proclaim the necessary skill will not achieve the best recovery and will probably be ineffective in the execution of their duties, the effect of which is long delays in finalisation of the estates to the detriment of creditors.

Concursus Creditorum

Liquidation brings about the establishment of a *concursus creditorum* in terms whereof no creditor may do anything to alter the rights of other creditors and in terms whereof their claims are crystallised.

This provides a creditor with certainty as to the quantum of its claim and preserves its security. It also enables the provisional liquidator to raise funding against the creation of new debtors or against other unencumbered assets where creditors have instructed the liquidator to keep the business operational.

Certainty

Due to the fact that liquidations are regulated in terms of statute it provides for an extremely organised (although slow) process that provides certainty to creditors regarding their claims and preservation of their security and provides an organised basis in terms whereof assets are sold and proceeds distributed to creditors in accordance with their ranking in terms of the Insolvency Act.

It therefore reduces the risk of collusive dealings between the debtor company and a specific creditor, takes care of voidable dispositions and creates a fair basis upon which proceeds are distributed.

Control

A bank loses a considerable amount of control once an order for liquidation is granted. Upon the granting of a winding-up order, the powers of directors cease and the assets of the debtor company are deemed to be in the custody and under control of the Master of the High Court until the appointment of a provisional liquidator (Sharrock, Smith & van der Linde, 2002).

Accordingly, and due to the fact that a *concursus creditorum* has been established, a bank is no longer at liberty to negotiate a repayment plan or the execution of new security to strengthen the position of the bank as the liquidator has now assumed full operational control of the debtor company and will only act in accordance with the instruction of all creditors based on the value and number of their claims.

Size

Generally speaking, and as will be discussed further below, a bank cannot attend to the debt restructuring of every single lending that goes into distress. Banks, generally, will consider alternative recovery methods where the bank stands to lose a substantial amount of money and where there is a time versus cost benefit in attending to the debt restructuring.

Where the size of a lending is small and there is no clear indication that a debtor company will become a viable concern without too much intervention by a bank, a bank will consider liquidation as a preferred distressed debt recovery method.

5.2.2 Judicial Management

All participants indicated that judicial management as a distressed debt recovery method is used very rarely. The majority of participants indicated that either they have never been involved in a judicial management or they were not aware of an instance where judicial management turned out to be successful. However, two participants in particular indicated that they have been involved with successful judicial management exercises before.

Notwithstanding the above, all participants agreed that judicial management more often than not was a precursor to winding-up as it rarely results in the debtor company becoming viable and with the benefit of hindsight all participants agreed that the results of judicial management have been far from satisfactory.

The factors that have an impact on judicial management as a distressed debt recovery method by banks in South Africa are discussed below.

Cost

Participants indicated that judicial management as a distressed debt recovery method is especially unsuitable for smaller companies due to the high cost involved as it is a highly court-driven process in terms whereof application must be made to the High Court of South Africa. This means that counsel must be appointed supported by attorneys and the drafting of a suitable recovery plan that needs to prove that the distress is temporary and that the debtor company will soon become able to repay all its debts.

Skill

Most judicial managers that are appointed are from the same panel from which liquidators are appointed, notwithstanding the fact that their interests are directly opposite.

To this end a judicial manager's objective is to carry on trading the business of the debtor company, whilst the main objective of a liquidator is to cease trading (except in extraordinary circumstances) and to sell the assets of the debtor company to ensure creditors are repaid from the proceeds thereof.

Although the participants acknowledged that there are many liquidators with the required skill to perform a successful judicial management exercise, due to the opposite skill sets that are required, most liquidators do not possess the necessary skill and competence to fulfil the role of judicial manager.

Onus of Proof

Section 427 of the Companies Act sets out the circumstances under which a court will grant a judicial management order. A court will only grant such an order if it is shown that (1) by reason of mismanagement or another cause the debtor company is unable to pay its debts, or (2) although the debtor company is probably unable to meet its commitments it has not become, or is prevented from becoming, a successful concern, or (3) there is a reasonable probability that if the debtor company is placed under judicial management it will be able to pay its debts or meet its obligations or become a successful concern.

Bearing the aforesaid high onus of proof in mind and, as mentioned before, the fact that judicial management is seen as a special concession that is only granted in exceptional circumstances, very few applications are granted.

Concursus Creditorum

Whilst a judicial management order does provide for a moratorium of claims by creditors for as long as the order is in existence, it does not establish a *concursus creditorum* as under provisional liquidation.

The effect of this is that the position of creditors is not crystallised and should a debtor company keeps on trading unprofitably it will be to the detriment of its creditors as the assets of the debtor company (such as debtors) may reduce in value. In addition, due to the lack of a *concursus creditorum*, interest is not suspended which increases the debt obligation of the debtor company whereas under provisional liquidation interest is suspended.

This has the further effect that new funding under judicial management is extremely difficult to obtain. Under provisional liquidation (where a provisional liquidator keeps on trading) new debtors are created daily that could be used as security for new funding whereas such newly created debtors under judicial management will fall under the cession of the original cessionary due to the fact that claims of creditors have not crystallised.

Vested Interests

One of the reasons participants mentioned why so many judicial management exercises ended up in liquidation was due to vested interests of liquidators in the judicial management process. To this end the fee structure under liquidation is much more beneficial than under judicial management with the effect that it is more beneficial for a judicial manager to rather wind-up the estate of the company.

5.2.3 Compromise

As discussed previously in this research report, a compromise is a procedure under section 311 of the Companies Act in terms whereof a company and its creditors (or any class of them) enter into an agreement whereby the existing contractual relationship between them is restructured (Kloppers, 1999; Rajak & Henning, 1999).

Notwithstanding the fact that all participants indicated that compromises provide much better legislative provisions for debt restructuring compared to judicial management, they also indicated that the number of compromises has reduced substantially over the last few years.

Below, this section will discuss the factors that impact a decision to select compromises as a distressed debt recovery method.

Legislation

Historically, compromises were used much more regularly than today, notwithstanding that creditors now, more than ever before, need formalised legislation that can assist in the debt restructuring and business rescue of debtor companies. To this end, and as indicated before, compromises possibly provide the best legislative provisions to effect a business rescue. However, its popularity as a business rescue or distressed debt recovery method has decreased over the past few years.

To this end participants indicated that the reason for the reduced popularity of compromises has to do with the introduction of legislation that makes it extremely difficult if not untenable to use a compromise as a distressed debt recovery method.

The first such legislation is the Income Tax Act 58 of 1962 (as amended) ("**the Income Tax Act**"). To this end, section 103(2) of the Income Tax Act provides that where an agreement is entered into (of which a compromise is one) mainly for the purpose of utilising an assessed loss, such utilisation may be disallowed by the Receiver of Revenue. Participants indicated that, historically, many compromises were used as a mechanism to acquire the assessed loss in a debtor company whereas today it is no longer possible if that is the only purpose of such acquisition.

The second set of legislation is contained in the Eighth Schedule to the Income Tax Act dealing with capital gains tax. In terms thereof, a debtor company will be liable for capital gains tax where that debtor company entered into a compromise with its creditors to the extent that the creditors granted the debtor company a discount on their claims against the debtor company. This is an additional cost that needs to be taken into account when a compromise is considered as a distressed debt recovery method which could well render the scheme ineffective.

The third set of legislation is contained in the Value Added Tax Act, 89 of 1991 (as amended) ("**the VAT Act**"). The effect of the VAT Act is that in any compromise, a return of no less than 14 cents in each Rand needs to be achieved to provide for the receipt by a debtor company of input tax credits prior to it having paid the full purchase price to a supplier. By way of example, if a debtor company purchases trading stock of say R100 from a supplier, an amount of R114 will be due and owing by the debtor company to that supplier (the R14 being the value added tax portion at 14%). At the end of the month, the debtor company can claim an amount of R14 from the Receiver of Revenue as an input tax credit. If, however, subsequent to the receipt of the input tax credit of R14 the debtor company goes into liquidation prior to it having paid the supplier, not only will its trade creditor have a claim of R114 against it, the Receiver of Revenue will have a claim of R14 against the debtor company. If a compromise does not provide payment in full of the R14 to the Receiver of Revenue, it may vote against the compromise with the result that the compromise may not be sanctioned.

Lastly, legislation contained in section 38 of the Insolvency Act and section 197A of the Labour Relations Act, 66 of 1995 ("**the Labour Relations Act**") had an adverse effect on the use of compromises as a distressed debt recovery method. Previously, before the amendment of section 38 of the Insolvency Act, employment contracts concluded between an employer and its employees were terminated upon liquidation the employer. Subsequent to its amendment, section 38 now provides that employment contracts are suspended as opposed to being terminated upon liquidation (Boraine, van Eck & Burdette, 2002).

In addition, section 197A of the Labour Relations Act, 66 of 1995 ("**the Labour Relations Act**") provides that, in the event of insolvency of an employer, or if a compromise is entered into to avoid liquidation of an employer for reasons of insolvency, a new employer is automatically substituted in the place of the old employer in all contracts of employment in existence immediately before the old employer's provisional winding-up.

Prior to the amendment of section 38 of the Insolvency Act and section 197A of the Labour Relations Act, compromises were used as a mechanism to acquire a debtor company after it had gone into provisional liquidation due to the fact that all employment contracts would have been terminated at that stage which caused a substantial cost saving to a proposed purchaser (proposer of the compromise).

The aforesaid amendment to section 38 of the Insolvency Act and the introduction of section 197 of the Labour Relations Act ended this practice and thereby the use of compromises as a distressed debt recovery method where the aim was to acquire a business without the cost of employees.

Time

A compromise is a time intensive process. Besides the fact that the High Court must be approached to sanction creditors' meetings, a Receiver must be appointed to convene these meetings for creditors to vote in favour of or against the proposed compromise after which the company has to approach the High Court a second time to sanction the compromise if creditors voted in favour thereof. In addition, nothing prevents a rogue creditor who believes that its rights are prejudiced to approach the court for an order to interdict the process.

Where a compromise is used as a distressed debt recovery method it speaks for itself that during this period the debtor company is in severe distress and in urgent need of funding which will only be forthcoming upon the High Court sanctioning the compromise, which may well lead to the restructuring being unsuccessful due to a lack of interim funding.

Cost

Due to the fact that a compromise is a court intensive process, the associated legal costs are extremely high, especially in the case of smaller companies. Besides the appointment of legal counsel to approach the High Court to sanction the meetings and eventually the compromise, the drafting of the necessary legal agreements could cost anything between R75 000 and R150 000 depending on the size and complexity of the matter with a further fee payable to the Receiver who conducts the meetings.

Nature of Claims

As a compromise binds all creditors (actual and contingent) it thereby provides a mechanism whereby a purchaser can acquire the shares in a debtor company without the risk of assuming unknown contingent liabilities which is a feature of sale of shares transactions.

To this end participants indicated that a compromise is especially useful in the construction industry that is known for the contingent nature of its liabilities.

Number and Composition of Creditors

As mentioned previously, compromises provide a mechanism whereby a purchaser (proposer) can negotiate with creditors collectively as opposed to individually. To this end it is especially useful where a debtor company has numerous creditors and where it will be impossible to negotiate with each creditor individually.

In addition, the composition of the debtor company's creditors plays in important role that needs to be taken into account. In order to sanction a compromise, 75% in number and value of each class of creditors present and voting either in person or by proxy is required. To this end it is extremely beneficial if there are one or two major creditors that can be lobbied prior to a compromise to ensure that the necessary support will be forthcoming to avoid a situation where cost and time are incurred where there is a lack of support for the compromise.

Moratorium

An important factor raised by participants to consider is that a compromise does not establish a moratorium as with liquidations and judicial management orders.

This means that any creditor at any time until sanctioning of the scheme by the High Court can institute legal action or even apply for the liquidation of the debtor company. This fact makes compromises extremely difficult to pull off, especially where certain creditors such as banks hold security in the form of general notarial bonds over the movable assets of the debtor company which, if unperfected when an application for liquidation is brought, will render their claim preferent as opposed to secured. The effect is that banks are extremely cautious to support a compromise under such circumstances which deprives the debtor company of much needed finance.

For this reason participants indicated that most compromises are done out of provisional liquidation which provides for a moratorium.

Viability of Business Plan

It speaks for itself that in order to consider a compromise as a distressed debt recovery method there must be a core and viable business with a viable plan going forward to make the acquisition thereof attractive.

Benefit to Creditors

The last point mentioned by participants as important in considering a compromise as a distressed debt recovery method is the fact that a proposer must be able to show that the offer is fair and reasonable and to the benefit of creditors. In practice, a proposer usually needs to show that a creditor would be in a better position financially if it accepts the offer of compromise than it would have been if the debtor company was liquidated. More often than not this requires that the proposer of a compromise has to raise additional capital to ensure benefit to creditors.

5.2.4 Controlled Winding-up

A controlled winding-up is the process whereby a debtor company, with the support and approval of its creditors, undertakes to sell its assets or its business (or portions thereof) in a controlled and organised manner with a view to repay its creditors either in full or in part in the same order of preference as would have been the case had the debtor company gone into liquidation by application to court and a liquidator been appointed to wind-up the estate in accordance with the provisions of the Insolvency Act.

Below, the factors that need to be considered before a controlled winding-up is chosen as a distressed debt recovery method are discussed.

Cost

As previously discussed, cost associated to liquidation is high due to, especially, the fee structure in accordance with which liquidators are paid as well as the impact of time value of money on the recovery as it can take a considerable amount of time to wind-up an estate. To this end, and excluding any factors that may favour liquidation as a distressed debt recovery method, it seems logical that where these costs can be avoided, a controlled winding-up should always be preferred above liquidation.

Participants, however, indicated that there is an important counter argument that needs careful consideration when it comes to cost. In liquidation, employment contracts are suspended in terms of section 38 of the Insolvency Act and upon the final winding-up order being granted, employees have a preferent claim against the debtor company limited to a prescribed amount as provided for in the Insolvency Act (currently R12 500) as well as a concurrent claim for the remainder.

As opposed to liquidation, employees need to be retrenched under a controlled winding-up. This implies that each employee must be given due notice of the proposed retrenchment and must be paid a minimum retrenchment package as prescribed for in the Labour Relations Act based on the number of years that an employee has been in the employment of the debtor company, all of which substantially increase the costs of a controlled winding-up.

In comparing liquidation to a controlled winding-up, it becomes clear that the cost associated with retrenching employees plays a major factor in deciding which method is preferable and, to this end, a debtor company may find that it is much more expensive to perform a controlled winding-up as opposed to liquidation due to the cost aspect of retrenchments.

In addition, indirect costs associated with an informal winding-up also have to be taken into account, such as management time needed to negotiate with unions, losses suffered as a result of a reduction in efficiencies due to low employee morale, the appointment of advisors (where applicable) to advise the bank of the risks associated with a controlled winding-up and the cost incurred to keep the company running on a daily basis (burn rate).

Ranking of Claims

As mentioned earlier as a factor that has an impact on whether or not to select liquidation as a distressed debt recovery method, the type of security held by a bank and the ranking of its claim plays an important role in whether or not to consider a controlled winding-up as a recovery method.

This is especially true where a bank (or any other creditor for that matter) relies on a general notarial bond which grants the bank a preferent claim as opposed to a secured claim if the bank perfects its bond, the issue being that a perfection order is normally followed by liquidation due to the fact that a debtor company cannot trade once an order is granted (see more detailed discussion under liquidations).

However, participants indicated that it is important, even where a bank relies on a general notarial bond, to quantify its reliance on that bond. There may be instances where the bulk of a bank's facility is secured by a cession of debtors with only a small reliance on the general notarial bond. Taking into account the high costs relating to perfecting a bond (appointment of an attorney as well as counsel to approach the High Court with an application) it may well be that it is not feasible in the circumstance to apply for such an order. Also, where a debtor company only employs a small number of employees and where all payments to the Receiver of Revenue are up to date, there will be no significant preferent creditors' ranking ahead of the bank which substantially reduces the risk to the bank not perfecting its bond.

Co-operation and Trust

Where a controlled winding-up is considered, co-operation and trust between the debtor company and its creditors are important to keep in mind. A bank needs to have faith in the good intentions of the debtor company to dispose of its assets or business in accordance with an agreed action plan and timeframes.

A bank needs to be convinced that the debtor company is not merely using its agreement to perform a controlled winding-up as a delaying tactic to win some time in the hope that the business could be turned around or that it may in fact achieve a sale at an amount in excess of what it agreed to accept for an asset or for its business.

Moratorium

A major downside of a controlled winding-up is the lack of a moratorium. A bank in support of a controlled winding-up might, as part of the process, have to approve interim bridging finance to assist the debtor company to finalise work-in-progress which may lead to a far better recovery for all creditors. Due to the lack of a moratorium, any creditor at any time can decide to approach the court for a liquidation order which effectively means that the bank's claim for the interim bridging finance will rank concurrent with other creditors' claims to the detriment of the bank.

Number and Composition of Creditors

Participants indicated that another important factor to be taken into consideration is the number and composition of creditors involved in a controlled winding-up. The smaller the number of creditors, the fewer the number of agendas and the easier it is to perform an informal creditors' workout and to make decisions.

One participant, however, did indicate that in a specific informal creditors' workout (that turned out to be very successful) there were in fact hundreds of creditors involved. What they did in that specific matter was to appoint a manageable number of creditors' committees with a spokesperson for each who attended the consortium meetings representing the creditors in their committees. The specific participant also indicated that the reason why it worked so well in that specific instance was due to the fact that there were many experienced creditors around the table with a strong chairman of good standing in the industry whose views carried a lot of weight with all creditors concerned.

5.2.5 Debt Restructuring

As mentioned before, a debt restructuring as used by banks is a distressed debt recovery method in terms whereof an existing debt agreement between the bank and a debtor company is replaced with a new agreement providing for a reduction in interest or capital payments or the extension of the maturity of the debt obligation (John, 1993; Gilson, John & Lang, 1990; Gilson, 1990; Thain & Goldthorpe, 1989b).

Debt restructurings, however, are very seldom limited to the above definition and more often than not include aspects such as the sale of non-core assets by the debtor company (the proceeds of which are used to reduce its debt obligations) which, in turn, can be said to constitute a downsizing of the business of a debtor company.

Debt restructurings can be performed where one or more banks are involved, with or without the involvement of trade creditors. Where more than one creditor is party to a debt restructuring and their rights and obligations regulated in terms of an agreement the process is commonly referred to as a consortium.

The outcome of the semi-structured in-depth interviews was that similar factors that have an impact on the selection of debt restructuring in a narrow sense have an impact on debt restructuring in the wider sense, and as a result all those factors are discussed here. Where certain factors only relate to a sub-section of debt restructuring (such as a downsizing or a consortium), such factor will clearly be identified as such.

All participants initially indicated that debt restructuring as a method to recover distressed debt should always be pursued and considered as a preferred method to liquidation, but as will be set out hereunder, there are various factors that play a role in such a decision before this can merely be assumed.

Viability of Business Plan

The main factor (together with ability of management which is discussed next) identified by participants that influences a decision to use debt restructuring as a distressed debt recovery method is the viability of the debtor company's business plan. In assessing whether a business plan is viable, participants indicated that good leadership and an effective strategy are important considerations. Without a viable business plan, any debt restructuring exercise is doomed for failure and at best will delay the inevitable winding-up of the debtor company.

In order to assess a debtor company's business plan, participants indicated that it is preferable to use someone other than the bank (such as an outside consultant) to ensure objectivity. The possibility always exists that a bank employee in fear of failure may elect not to support a business plan as it will be very difficult to fault such a decision where a company as a result thereof goes into liquidation as opposed to where he or she supports the business plan only for it to fail.

Management Ability

Together with viability of a business plan, participants indicated that an equally important factor that needs to be considered is the ability of management to steer the debtor company out of financial difficulty. Depending on the nature of distress, a bank might have lost faith in the ability of management as it was under its leadership that the debtor company failed in the first place. To this end a bank may make further financial support subject to the appointment of a consultant.

A related factor is desirability of the debtor company, i.e. whether its management team can be trusted. Participants indicated that no business rescue exercise should be undertaken if there is any indication that management is undesirable. Many a good business has failed due to bad and unreliable management whereas marginal businesses have succeeded due to excellent and trustworthy management.

When participants were prompted as to whether banks will support a debt restructuring by making the appointment of a new management team conditional to their support, they indicated that it is very rare, if not impossible and undesirable for a bank to replace a whole management team. At best, participants indicated that a bank would make the appointment of a key person (such as the chief executive officer, the chief operating officer or the financial director) conditional to its further support.

Early Identification

The earlier distress is identified the better the chance that a bank can assist a debtor company to perform a viable debt restructuring. Unfortunately, most debtor companies that end up with recovery departments of banks are beyond the point where anything meaningful can be done to assist, as a severely distressed business cannot be fixed overnight.

Shareholder Commitment

Banks are generally extremely hesitant to support a debtor company where shareholders are unwilling to capitalise a distressed business or where they refuse to sign suretyships for the obligations of the debtor company towards the bank. To this end, banks expect shareholders, to the extent possible, to first capitalise the business before a bank will consider further debt funding. An injection of additional equity funding by shareholders indicates their commitment and belief in their turnaround plan.

Extent of Loss

Mixed responses were received when participants were prompted as to whether or not the size of a lending or possible loss is a factor that banks take into account in determining their support of a debt restructuring.

Most participants indicated that banks are generally more inclined to consider support where they stand to lose a considerable amount of money if the debtor company was liquidated. However, most participants also indicated that even where a bank was at risk to lose a substantial amount of money it would not support a debt restructuring when the business model is not viable, where management is incapable or where fraud played a role in the distress of the debtor company.

Where a bank is fully secured and expects to be repaid in full upon the winding-up of a debtor company, participants indicated that although a bank will be less inclined to support a debt restructuring under these circumstances, it will still favourably consider its support if there is no chance whatsoever that it may become worse off during the process. In other words, where a bank does not risk losing its security, where no additional financing is required of it and where a debtor company remains in a position to service interest, a bank would support the debt restructuring.

Reputation

As discussed earlier in this research report, in a country such as South Africa where job creation and protection is a stated government priority, banks will generally go out of their way to assist with a debt restructuring even where they are fully secured and where the only other alternative is liquidation, as long as there is a viable business plan with able management to implement it.

Reputation is also an important consideration where a bank makes ongoing financial support subject to the appointment by the debtor company of a consultant, especially due to the growing number of allegations against banks regarding alleged shadow management of debtor companies. As a result, banks have become extremely cautious in making such appointments conditional to their ongoing support. Participants, however, did indicate that where banks do make such appointments, it is done on the basis that a panel of appointees with which they are comfortable is presented to a debtor company from which the debtor company must select a suitable appointment.

The same principle applies when a debtor company uses the sale of non-core assets as a mechanism to restructure its facilities with a bank. A bank cannot advise a debtor company which assets to sell as a debtor company may have a claim against the bank if it can prove that it suffered damages due to it having to sell such asset on advice from the bank or where the value of such asset increased substantially subsequent to such sale. The basis upon which a bank should approach this is to make de-gearing a condition for further financial support, thereby leaving it up to the debtor company as to how it will meet such condition.

Capacity

When participants were prompted to consider the impact of limited resources on a decision to support debt restructuring as a distressed debt recovery method where a bank is fully secured, participants responded in different ways.

Certain participants responded that capacity could become a real issue, especially in the wake of further interest rate hikes. They indicated that due to the upswing in the economy for the last five years since 2002 many distressed debt departments lost their personnel to the front line of the business due to relatively low action on the distressed debt front, which left banks with much smaller distressed debt departments.

Accordingly, when there is an increase in distressed debt, banks may find that they do not have adequate capacity to deal with the influx of distressed debt and may have no choice but to only support larger debt restructurings where the possibility of a substantial loss is greater.

Other participants indicated that capacity should never become an issue and that distressed debt departments need to increase their headcount and capacity to accommodate the expected flurry of distressed debt in the next few years. To this end participants indicated that front line personnel could be used with success when the credit cycle turns as an increase in distressed debt normally means that there will be a decrease in front line activities.

Experience and Background of Creditors

When a decision is made to support a debt restructuring as part of a consortium of creditors, participants indicated that one of the main factors to consider is the experience of other creditors around the table. As time is of the essence in any debt restructuring, it is important to be able to make quick decisions and to get upfront agreement on contentious subjects such as interim funding and the principles that will be applied to share in the risk of such funding. Other than banks, many trade creditors do not have specialised departments that deal with distressed debt on a daily basis and therefore lack the necessary skills that are required to perform a successful debt restructuring.

On an international level and in order to assist decision making in consortiums, rules have been developed that serve as a blue print of best practices that have been followed around the world for years. When creditors around the table have been exposed to consortiums where these rules have been followed previously, it makes the execution of a consortium much easier and effective.

With regards to consortiums, even where creditors are experienced, participants indicated that where a consortium is made up of creditors from different industries, it can create various complexities that are not evident where, for example, a consortium is made up of banks only. Banks know each other's businesses well and have been working together in consortiums for years, whereas it is a relatively new field for trade creditors.

Co-operation and Trust

Various participants referred to 'the earlier days' when consortiums were only made up of banks and where especially smaller banks would use undesirable tactics by threatening with liquidation if the major banks did not make sufficient facilities available to a debtor company to enable it to repay the smaller banks especially where the smaller banks knew that the major banks stood to lose significant amounts of money if the debtor company ended up in liquidation.

Tactics such as these, however, have the ability to work against a short-sighted creditor as it will be a matter of time before the table is turned and where such a creditor desperately needs the support of other creditors around the table. This raises the issue of trust between creditors that is paramount in deciding to support a debt restructure in a consortium.

No consortium rule or set of agreements can regulate trust between creditors as there are many loopholes that creditors can exploit in order to limit their liability in relation to other creditors in a consortium. For example, if a decision is made to provide additional financing to a debtor company, consortium rules dictate that such funding is done on the basis of a creditor's unsecured position as a percentage of the total unsecured position of all creditors. Only that creditor is in a position to reveal its true unsecured position which will have a major effect on the sharing of risk if the debtor company defaults on the new facility.

It furthermore speaks for itself that without the necessary co-operation between creditors on the one hand, and between creditors and the debtor company on the other hand, any debt restructuring will be a painful process.

Number and Composition of Creditors

As was the case under a controlled winding-up, participants indicated that the number and composition of creditors involved in a debt restructuring plays a significant role. The smaller the number of creditors, the fewer the number of agendas and the easier it is to perform a debt restructuring where more than one creditor is involved.

Labour

If a debt restructure involves the restructuring and downsizing of a business with the effect that parts of the labour force have to be retrenched, it is paramount to involve the unions in the discussion as, without their buy-in into the process, it will not be worth attempting the restructuring and downsizing of the debtor company's business.

Legislation

Participants indicated that a detailed knowledge of the Insolvency Act is required in any debt restructuring, especially with regards to sales of assets (section 34), dispositions without value (section 26), voidable preferences (section 29), undue preferences (section 30) and the registration of bonds over fixed property (section 88).

Section 34 of the Insolvency Act provides that where a debtor company fails to advertise the sale of assets forming part of its business in accordance with the provisions of this section, the transfer of such assets or business will be void against its creditors for a period of six months after the said transfer.

In terms of section 26 of the Insolvency Act, a disposition without value is made where, for example, a debtor company provides additional security for existing debt without it receiving any additional financing for such security. Such new security can be set aside by a liquidator if a debtor company is placed into liquidation.

In terms of sections 29 and 30 of the Insolvency Act, voidable and undue preferences relate to instances where a debtor company disposes of property which has the effect of preferring one creditor above another. If such dispositions are made within six months before the liquidation of the debtor company or at a time when its liabilities exceed its assets, such disposition can be set aside by a creditor applying for the liquidation of that debtor company.

Section 88 of the Insolvency Act provides that where a bond over fixed property is registered within a period of two months from the date upon which a debt was incurred, such security is invalid for a period of six months after the registration thereof in the Deeds Office.

Any debt restructuring that may trigger any of the above provisions should be considered carefully.

Security

Participants indicated that a debt restructuring can only be successful if the debtor company has adequate security available that will enable it to effectively restructure its debt, especially where creditors are unsecured and expected to approve additional facilities.

To this end, especially in the smaller corporate market, private residences of shareholders are often used as a valuable source of security to ensure the success of a debt restructuring.

Ranking of Claims

The same considerations apply here as those that apply to ranking of claims as discussed as a factor under liquidation and controlled winding-up. As mentioned earlier, the type of security held by a bank and the ranking of its claim play an important role whether or not to consider a debt restructuring as a distressed debt recovery method as opposed to a decision to perfect its claim where, nine times out of ten, such an order is followed by the liquidation of the debtor company. To this end and as mentioned before, banks need to quantify their reliance on such a bond and the value of other preferent claims.

Cost

The cost versus benefit aspect of a debt restructuring is a further facet that needs consideration. A consultant may have to be employed to advise the bank together with an attorney on the many pitfalls as contained in the Insolvency Act relating to aspects mentioned above. In addition, the indirect cost associated to management time needs to be taken into account as well.

5.2.6 Sale of Distressed Debt

Participants indicated that, other than in first world countries such as the United States of America and countries in Western Europe, South Africa does not have a debt capital market for the sale of distressed debt. Save for the sale of retail debt, sale of distressed corporate debt is still in its infancy in South Africa.

Participants indicated that in most cases where corporate distressed debt is sold in South Africa, it is normally the surety of a debtor company who turns out to be the purchaser of a bank’s claim. The reason seems to be that such surety wants to take control of the recovery process by rather paying the bank and taking cession of the bank’s claim which, in turn, entitles it to institute action against co-sureties.

This is especially the case where a bank believes that it can recover its full indebtedness from that surety only without having to spend the time and costs to go after other co-sureties as well.

Participants also indicated that certain so-called distressed debt investors mistakenly believe that if they purchase and take cession of a bank's claim that they are entitled to control the winding-up process of the debtor company by voting for the appointment of their liquidator. However, as became clear during the interviews, a ceded document does not confer upon the cessionary the right to vote at creditors' meetings.

Below, the factors that play a role in deciding whether or not a bank will sell its claim are discussed.

Reputation

Participants indicated that there is a measure of reputational risk involved where a bank sells a claim against a debtor company to a debt collections agency that uses undesirable debt collection methods outside the legal framework provided for debt recovery.

In order to address this, banks need to satisfy themselves that the reputation of a distressed debt purchaser is above any doubt and must furthermore regulate the sale of the debt in a legal agreement detailing the procedures that may be used for the collection thereof which is in line with the procedures normally used by that bank.

Buyers

As mentioned above, there are very few local players buying corporate distressed debt in South Africa. With regards to international players, participants indicated that their presence in South Africa was driven by the flurry of liquidity that had existed internationally up to recently, all of which changed during the July 2007 sub-prime crisis which resulted in investors pulling their funds out of sub-investment grade bonds. The result may well be that it will take some time before international distressed debt buyers will become actively involved in South Africa again, and when they become involved again, the general feeling is that they will target the top end of the large corporate distressed debt market only.

Cost

Time value of money is an important cost consideration that needs to be taken into account in a decision of whether or not to sell distressed debt. Banks generally have huge departments that manage the recovery of debt that has gone into liquidation. These departments cost a lot of money to sustain and participants mentioned that the time has perhaps come for banks to consider selling their debt to a company with the necessary infrastructure and skills to recover it. This will also relieve the cost of capital that banks are required to hold against these non-performing loans.

5.2.7 Debt Forgiveness

As mentioned before, debt forgiveness is a distressed debt recovery method in terms whereof a bank or creditor writes off a portion of its claim against a debtor company, reducing its finance charges and releasing much needed working capital to pull the debtor company through a difficult period (Thain & Goldthorpe, 1989b).

Participants indicated that whilst trade creditors will normally consider some sort of debt forgiveness due to high margins earned by them on the supply of goods and services, some participants indicated that a bank would rarely consider forgiving debt as a distressed debt recovery method whereas certain participants held an opposite view.

Those participants that indicated that a bank should never forgive debt held the view that instead of writing of a bad debt, it should rather convert such debt into some sort of equity, be that preference shares or a revenue share in order to participate in the success of the debtor company at a return commensurate with the risk that the bank is taking in supporting that company.

Below, the various factors that play a role in the selection of debt forgiveness as a distressed debt recovery method are discussed.

New Business

Participants that supported the view that banks should consider debt forgiveness as a distressed debt recovery method indicated that a bank should take a view on future revenue if a client is given the opportunity to keep trading as opposed to being liquidated.

An issue raised by one of the participants against merely writing off a debt in the hope that the debtor company will pull through is the fact that if a bank agrees to forgive debt and subsequent to that decision the debtor company is placed in liquidation, the bank would have lost a portion of its claim, especially where the net asset value of the debtor company may have increased during that period.

Participants furthermore indicated that a bank should rather postpone the repayment of a portion of the debt (even at zero interest) which will effectively have the same effect as debt forgiveness with the exception that a bank will retain the full value of its claim if the debtor company goes into liquidation.

Benefit to Creditors

An important consideration to take into account with debt forgiveness is the calculation of the proceeds it expects to receive if the debtor company is liquidated. Any amount that may be written off by a bank should not exceed the value of the aforesaid expected liquidation dividend.

5.2.8 Investing Activities

As similar factors play a role when a bank converts debt into equity or where it subscribes for an equity stake in a debtor company with or without a debt to equity conversion, all of these factors will be discussed under this heading and will be referred to as investing activities.

In addition to a bank subscribing for an equity stake in a debtor company, consideration also has to be given to the role a bank can play in introducing a debtor company to a potential equity investor, thereby reducing the risk of loss to the bank.

Regarding banks that convert debt into equity or subscribing for an equity stake in a debtor company whilst, at the same time, also fulfilling the role of debt provider to the same debtor company, participants had divided opinions as to the desirability of such practice. One group of participants believes that there will always be conflicts of interest whereas the other group felt that this has been standard practice for many years now and that banks in the past always found ways to deal with this problem.

Below, the various factors that have an impact on a decision by a bank to pursue one of the aforesaid investing activities are discussed.

Maturity of Shareholders

According to participants, whether or not an investing activity will be successful depends on whether the debtor company has shareholders who believe that, if they do not agree that the bank or if a third party investor converts debt or subscribes for equity, they will realise less value than when they agree to a dilution or reduction of their shareholding. This is identified as one of the greatest challenges banks face. Shareholders generally do not believe that new equity is required to address the distress in their business, especially in smaller family-controlled companies who do not always understand the relationship between an equity and debt return.

Many examples were offered during interviews with participants of companies that had an offer on the table either from a bank or a third party investor at a certain price which was rejected only for it to sell three months later at a fraction thereof when the debtor company was on the brink of liquidation.

Debtor companies generally do not realise that it is beneficial to rather take a dilution and end up with a viable company with strong shareholders as opposed to a company in distress with no outside shareholding heading for liquidation.

Viability of Business Plan

As was the case under debt restructuring, a bank or third party will not merely invest in any debtor company as a way of recovering distressed debt. Even where a bank stands to write off money in a debtor company, it will not attempt to convert debt into equity nor will a third party investor subscribe for equity if the debtor company does not have a viable business plan.

Management Ability

In addition to a viable business plan, a debtor company needs good management before a bank will convert debt into equity or before the bank or a third party investor will subscribe for equity in that debtor company.

As was mentioned earlier in this report, what banks will be looking out for is a good business with good management. Banks will even consider a good business with elements of bad management that can easily be replaced.

However, a bad business (even where it has good management) will, in the longer term, turn out to be an unsustainable investment.

Equity Mandate

A main challenge for banks that want to take equity in debtor companies as a distressed debt recovery method is the old debate regarding equity mandates.

Normally, banks have specialised divisions within their main business identifying possible target companies in which to take up equity positions. Generally, fast-growing and highly profitable companies will be the main target for these specialised divisions as opposed to companies that are in distress.

If the distressed debt department in a bank does not have an equity mandate or the specialised private equity division does not change its hurdle rate in respect of distressed companies, it will be virtually impossible for a bank to convince its committees to take up an equity position in a distressed company.

Relationships

Following from the above, where a distressed debt department in a bank does not have the required mandate to convert debt into equity or take up equity without any form of conversion, it is important to build up established relationships with second or third tier private equity investors that are looking for opportunities to invest in distressed businesses. Such an investment may recapitalise a distressed debtor company and reduce the risk for a bank which will also address the mismatch between the risk and return earned by the bank on its debt exposure to that debtor company.

One of the reasons mentioned why the specialised private equity departments in South African banks do not target equity investments in distressed companies is due to the level of economic growth experienced in South African during the last five or so years and the flurry of good companies to invest in.

Size

Participants mentioned that the same amount of work is necessary in the form of due diligences and financial projections for an equity stake in a small and larger company.

Accordingly, the size of a debtor company will be a factor to consider before a debt to equity conversion or a private equity transaction is considered. It will typically only be your larger companies that will be targeted.

Co-operation and Trust

Participants indicated that the choice of a partner is an extremely important consideration in any business dealing. Banks should elect their partners very carefully so as to avoid any potential reputational or other risk that may arise due to its partner being involved with undesirable business dealings. To this end, trust and reputation of a bank's partners play an extremely important role in a decision of whether or not to invest in a debtor company.

Reputation

As referred to above, there is a fair amount of reputational risk involved for a bank to become a shareholder in a company with undesirable partners. Furthermore, when a bank calls up a facility whilst at the same time offering to take up an equity position, it may easily result in a conflict of interest.

As mentioned at the outset, participants were clearly divided into two camps as to whether banks should be a debt and equity provider to the same debtor company or whether banks should at all take up equity in a debtor company where it has called up the lending. To this end, the one camp believes there will always be a conflict of interest whereas the other camp felt that this has been standard practice for many years now and that banks have found ways in dealing with this problem.

Banks who indicated that they are active in this market said a bank should never threaten a debtor company to call up its lending if it is not allowed to convert some of its debt into equity. The way this should be approached is to document the fact that the debtor company is in distress with proper reasons being provided for such view (perhaps after a consultant prepared a proper report based on an in-depth investigation) and that it believes that the business needs to be recapitalised.

To this end the bank must indicate that it is willing to consider a debt to equity conversion at a specified price, keeping such offer open for a specified period of time in order to allow the debtor company ample time to consider it. The bank must also make it clear that they do not have to accept the bank’s offer and that the debtor company is free to approach third party equity investors on the same basis.

Legislation

There are many forms of legislation that could complicate an investment by a bank or a third party in a debtor company.

The Competition Act, 89 of 1998 (“**the Competition Act**”) requires that all transactions in terms whereof one company acquires control over another must be reported to the relevant competition authorities and is subject to approval before the transaction can be implemented.

To this end "change in control" as defined in the Competition Act includes aspects such as taking up of a majority of the shareholding in the target company, the appointment of the majority of directors, the appointment of a chairman with a casting vote, etc. Also, even where the new investor will have joint control over the target company it constitutes "change in control". For this reason a bank will normally take up between 25.1% (to avoid that majority shareholders can take a special resolution) and 49% of the target company to avoid the control provisions of the Competition Act.

The Banks Act, 94 of 1990 ("**the Banks Act**") provides that a bank needs to acquire the approval of the Registrar of Banks if it acquires an interest in a subsidiary company as provided for in the Banks Act.

Exit Mechanism

The last important consideration for a bank when it considers taking up an equity position in a debtor company is to ensure that it can exit that position in future.

With regards to listed entities it is relatively easy as the bank can merely sell its shareholding in the open market as long as the share is liquid (i.e. as long as there are buyers for that share).

The position is more complicated with regards to private companies. Banks will normally negotiate a put option against the other shareholders after a period of three years and, if the company addressed its problems, the bank would consider funding such as acquisition as a leveraged buy-out.

5.3 Impact of Key Factors on the Selection of Recovery Methods

The previous section dealt with the various factors that have an impact on the selection of distressed debt recovery methods by South African banks. These factors were identified in conjunction with a specific distressed debt recovery method to which they applied, together with a detailed discussion as to why and to what extent they are applicable. To this end, a total of 34 common factors were identified across the range of distressed debt recovery methods.

As these factors were identified in conjunction with a specific distressed debt recovery method, the previous section (to a large extent) already dealt with the theme of this section with one exception: this section only focuses on key factors as identified in the semi-structured in-depth interviews and their concomitant impact on the selection of a specific distressed debt recovery method to the exclusion of other methods, as they tend to carry more weight when a distressed debt recovery method is selected. In order words, this section attempts to develop a framework that can be used by South African banks to assist them in selecting a preferred distressed debt recovery method given the impact of these key factors.

Throughout this discussion it needs to be kept in mind that it is extremely difficult (if not impossible) to accurately predict which recovery method will yield the best result on the basis of the existence of a particular key factor as the process can be highly subjective and dependent on the circumstances in each case. For example, a best result may well be based purely on the present value of the amount that is recovered while, in another instance, the best result could be for a bank not to be seen as placing a debtor company into liquidation based on the number of employees employed by that debtor company, notwithstanding the financial result.

Due to the difficulty of accurately predicting the most appropriate distressed debt recovery method in a particular instance, the discussions that follow will only consider the mainstream distressed debt recovery methods as indicated by participants as being liquidation, controlled winding-up, debt restructuring (with or without asset or business sales and where the bank on its own or in conjunction with other creditors are involved) and investing activities. Accordingly, sale of distressed debt and debt forgiveness will not specifically be addressed again.

Eleven key factors were identified from the original 34 factors as being more important and which carry more weight when a specific distressed debt recovery method is selected. These are: reputation, fraud, ranking of claims, labour, number and composition of creditors, moratorium, viability of business plan, co-operation and trust, management ability, early identification and extent of loss.

Below, the evaluation and discussion of the results pertaining to the impact of these key factors will be discussed. In doing so, the first section below considers the key factors that play a role when liquidation is the preferred recovery method. In doing so it is assumed that where a decision needs to be made as to whether to liquidate or not, a debtor company has been in distress for a while. This is followed by a discussion of the key factors that support a decision not to liquidate, after which key factors that support a specific distressed debt recovery method other than liquidation is explored.

5.3.1 Liquidation as Preferred Method

Participants indicated that the existence of two factors supports liquidation as a preferred distressed debt recovery method, being fraud and ranking of claims. Their impact is discussed below.

Fraud

Participants indicated that, when there is evidence of fraud against the bank, liquidation is always preferred as a distressed debt recovery method for several reasons. The most important is the fact that a debtor company that previously committed fraud at the expense of a bank will not hesitate to do it again and banks, as a result, regard their first loss as their best loss in such instances. Participants felt that any attempt by a bank to use another distressed debt recovery method may expose the bank to lose an amount in excess of the amount they expect to write off in liquidation.

Ranking of Claims

As previously discussed, an unperfected general notarial bond conveys only a preferent claim in liquidation to the holder thereof, whereas a perfected bond gives a creditor secured status. Unfortunately, an order for perfection is also effectively a company's death warrant and any decision by a bank to perfect its bond is effectively a decision to end the commercial life of that company as it will probably be followed by liquidation.

However, before a bank blindly applies for an order to perfect its general notarial bond, it has to consider its reliance thereon. To this end, if a bank's claim is fully covered by other security, there is no reason for it to apply for a perfection order. In addition, where preferent claims by other creditors (such as employees and the Receiver of Revenue) are minimal, there is little benefit for a bank to perfect its bond.

5.3.2 Where Liquidation is not Preferable

Participants indicated that the existence of certain factors supports the view that liquidation may not be a preferred distressed debt recovery method. These are viability of a debtor company's business plan, ability of its management, expected co-operation and trust, the impact of liquidation on labour and concomitant reputational risks a bank faces and a bank's expected loss if liquidation would in fact follow.

At this stage, the impact of these factors will purely be considered as a decision not to liquidate, whereas the next section will discuss specific distressed debt recovery methods given these and other key factors.

Viability of Business Plan

Participants indicated that where a debtor company has a viable business plan, a bank will generally consider options other than liquidation, subject to certain considerations. Whereas certain factors in addition to a viable business plan need to exist before a bank will consider such further options, participants indicated that without a viable business plan, liquidation remains the only preferred option as, without it, it will be a matter of time until a debtor company ends up in liquidation in any event.

Ability of Management

In addition to the existence of a viable business plan and although slightly less important, participants indicated that in the absence of management that is able to implement and execute a business plan, liquidation still remains the preferred option. With the exception where a debtor company went into distress as a result of an external factor, management needs to take full responsibility for the fact that the company went into distress under its guidance and, as a result, banks will have serious questions regarding the ability of that management team to steer the company out of distress. In addition, it is a well-known fact that a different kind of management is needed when a company is in trouble.

Co-operation and Trust

The third factor that is required before a bank will consider options other than liquidation is the level of co-operation and trust it can expect from management. Participants indicated that where there is an indication that management will not co-operate or where they have a history of untruthful conduct, a bank will not risk supporting a debt restructuring as it could easily result in the bank losing more than it would in liquidation.

Labour & Reputation

Where all of the above factors in this section are in existence, a further factor that will heavily influence a bank to consider a recovery method other than liquidation is the impact of liquidation on labour.

The existence of a large workforce and the concomitant reputational risk a bank faces if it applies for liquidation of that debtor company have become an important consideration for all banks. All participants from the banking fraternity in particular indicated that this is an extremely important issue to consider before a decision is made to apply for liquidation. However, all of them also indicated that, without a viable business plan, able management that is co-operative and trustworthy, the existence of a large workforce alone is not enough to support a course of action other than liquidation.

Extent of Loss

The last major factor identified by participants as a key factor that banks take into account when a decision is made not to liquidate is the extent of the loss a bank expects to suffer if a debtor company goes into liquidation. Banks will generally be much more cautious to merely approach the court with a liquidation application of a debtor company where it stands to lose a considerable amount of money. However, in the absence of a viable business plan, able, co-operative and trustworthy management liquidation may still remain the preferred distressed debt recovery method.

5.3.3 Options other than Liquidation

Where all of the above factors have been considered and a decision is made not to liquidate a debtor company, there are various distressed debt recovery methods available for selection by a bank. However, participants indicated that the selection of one method above another depends a great deal on early identification of distress. The earlier distress is identified, the better the chances of succeeding with a debt restructuring of some sort and the better the chances that a bank or third party investor will consider taking up equity in a debtor company.

The various distressed debt recovery methods other than liquidation are discussed below.

Controlled Winding-up

As mentioned earlier, a controlled winding-up is similar to liquidation but without the formal and costly court processes in terms whereof a liquidator is appointed who is paid a percentage of total assets sold as a fee.

The main factor that supports a controlled winding-up is cost. As previously mentioned, although a bank needs to be cognisant of the high cost involved in respect of a controlled winding-up where a debtor company employs a large workforce due to the cost of retrenchment, barring such cost, a controlled winding-up normally yields a significant cost saving due to the absence of liquidator fees.

Participants indicated that a controlled winding-up as a preferred distressed debt recovery method becomes a real consideration where a bank is not fully secured and stands to lose even more due to the exorbitant fees charged by liquidators in winding-up an estate as well as the time it takes to receive a final liquidation dividend.

It speaks for itself that factors such as viability of business plan and able management are not required to perform a controlled winding-up, although all other factors as identified in the previous section that are required to consider a recovery method other than liquidation must be in existence. In other words, there should be no fraud, the bank should not rely on an unperfected notarial bond and management should be co-operative and trustworthy.

Debt Restructuring

As indicted before, debt restructuring really includes various sub-sets of distressed debt recovery methods, such as sale of assets/business, downsizing and the involvement of more than one creditor around the table (consortium).

It is safe to say that, where distress is identified very early and barring that the distress was caused by a fatal business plan or fraud by management, banks will generally always support a debt restructuring in a limited form such as the restructure of current facilities to relieve cash flow pressure in order to address a short-term liquidity problem.

However, if distress was not identified early and a debt restructuring includes aspects such as asset sales or the sale of parts of its business (in order to downsize an existing business) within a consortium or not, there are additional factors to the ones already mentioned earlier that come into play.

One such factor is the availability of additional security (especially where additional funding is required) or at the very least a reasonable expectation to become better off by assisting with a debt restructuring. Also, where a bank is fully secured, liquidation will always remain an option to avoid having to spend the time and resources associated to a debt restructuring unless a bank is comfortable that it cannot become any worse off in supporting the process or where there are reputational risks in liquidating the debtor company.

In addition, to emphasise what has been identified above as an important consideration not to liquidate, where a debtor company employs a large workforce, participants from the banking fraternity indicated that, even where a debt restructuring may prejudice a bank's position, a bank will, within reason, support such a debt restructuring due to the emphasis of government on job creation and retention.

Regarding a debt restructuring in the form of a consortium of creditors, there are a few factors that have an impact on a decision by a bank to support such a course of action. These are the number of creditors that are involved, as well as their various backgrounds and experience.

More often than not, if the need exists to form a consortium, a debtor company has been in distress for some time and a bank, acting on its own, would have already assisted with a minor debt restructuring to relieve cash flow pressure on the debtor company. When a consortium is formed, a debtor company is usually already in serious financial difficulty.

It has been mentioned before in this research report that where a debtor company has many creditors, it is extremely difficult to act as a consortium in order to support a debt restructuring, especially where additional funds are required due to the various backgrounds and agendas of these creditors.

A further aspect that needs careful consideration in a consortium is the experience of creditors around the table and the level of trust and co-operation that exists between them. As mentioned before, there are fairly standardised rules that have been developed internationally to guide consortiums in a debt restructuring, especially where new funding is required. If creditors in a consortium have been exposed to these rules before, it improves the chances of success.

Investing Activities

As previously indicated, investing activities include debt to equity conversions as well as private equity. Participants indicated that the earlier distress is identified, the better the chances of a bank converting debt into equity or for a third party to purchase shares in that debtor company. For a debt/equity conversion to become an option from a bank’s point of view, all factors identified above need to be in existence. Participants indicated that if distress is identified early, a first course of action will normally be a minor debt restructuring with or without additional security being taken normally from shareholders so as to avoid the provisions of the Insolvency Act as discussed earlier. If this does not address the problem, a bank at that stage will consider a debt to equity conversion on the basis as discussed earlier in this research report.

5.4 Summary

From the evaluation and discussion of the results in this section it is apparent that there are various distressed debt recovery methods that are available to banks in order to recover their distressed debt. The methods that have been identified include liquidation, judicial management, compromise, controlled winding-up, debt restructuring (without or without asset sales or sale of business within a consortium or not), sale of distressed debt, debt forgiveness and investing activities (which may include a debt to equity conversion or private equity). This section identified 34 factors that play a role in the selection of a distressed debt recovery method. These various factors are summarised in Table 2 below in relation to a specific distressed debt recovery method.

Table 2: Summary of distressed debt recovery methods and factors

	Reputation	Cost	Fraud	Ranking of Claims	Enquiries	Time	Skill	Concursus Creditorum	Certainty	Control	Size	Onus of Proof	Vested Interests	Legislation	Labour	Natue of Claims	Number and Composition of Creditors	Moratorium	Viability of Business Plan	Benefit to Creditors	Co-operation and Trust	Management Ability	Early Identification	Shareholder Commitment	Extent of Loss	Capacity	Experience and Background of Creditors	Security	Buyers	New Business	Maturity of Shareholders	Equity Mandate	Relationships	Exit Mechanism
Liquidation	X	X	X	X	X	X	X	X	X	X	X																							
Judicial Management		X					X	X				X	X																					
Compromises		X				X								X		X	X	X	X	X														
Controlled Winding Up		X		X													X	X			X													
Debt Restructuring	X	X		X										X	X		X		X		X	X	X	X	X	X	X	X						
Sale of Distressed Debt	X	X																											X					
Debt Forgiveness																				X										X				
Investing	X										X			X					X		X	X									X	X	X	X

In addition, from the list in Table 2 above, participants identified certain key factors that carry more weight in a decision to use one distressed debt recovery method to the exclusion of another. These factors are: reputation, fraud, ranking of claims, labour, number and composition of creditors, moratorium, viability of business plan, co-operation and trust, management ability, early identification, and extent of loss.

Figure 1 below summarises the impact of these key factors on the main distressed debt recovery methods used by South African banks and thereby creates a framework to assist South African banks to select an appropriate distressed debt recovery method given the existence of these factors.

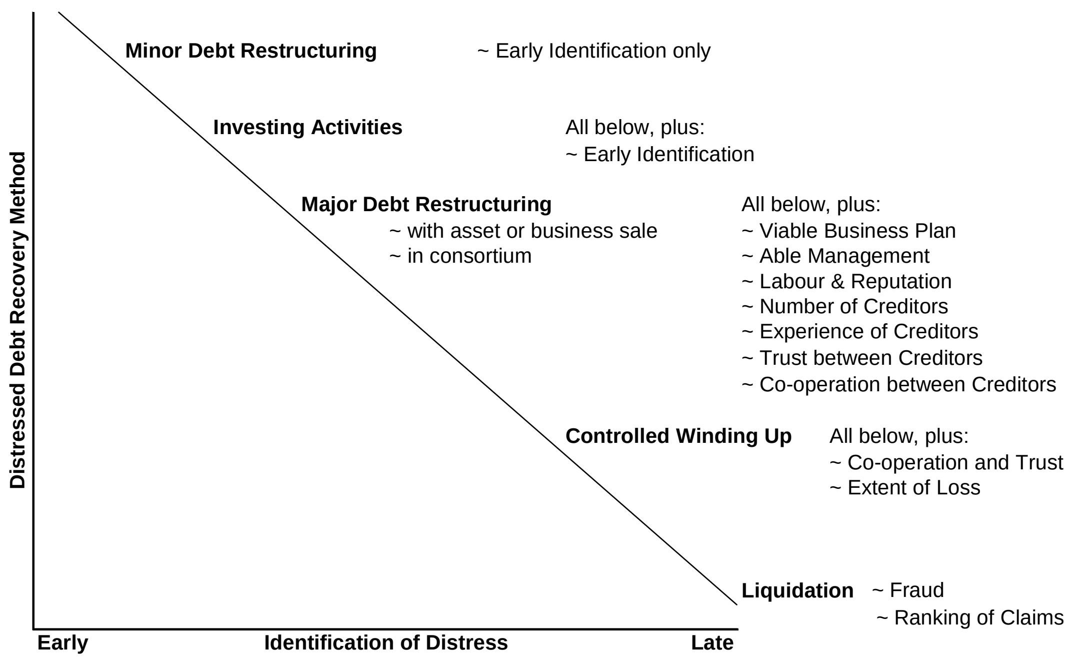

Figure 1: Impact of key factors on the selection of distressed debt recovery methods

6. CONCLUSION

In this final chapter the results of the research are tested against the propositions and the research question that were formulated at the commencement of this research report. More specifically, the propositions are tested against, and the research question answered from, the evaluation and discussion of results in Chapter 5: Evaluation and Discussion of Results. This chapter closes on areas that have been identified for further research.

6.1 Strength of Support for Research Proposition 1

The range of distressed debt recovery methods that are available to South African banks include:

- Liquidation;
- Judicial Management;
- Compromise;
- Informal Creditors' Workout (Consortium);
- Debt Restructuring;
- Asset Sales; and
- Debt Forgiveness.

From the results that were presented in Chapter 5: Evaluation and Discussion of Results, participants confirmed the existence and use by South African banks of the abovementioned distressed debt recovery methods. The first proposition is, therefore, supported by the results as set out in Chapter 5: Evaluation and Discussion of Results.

In addition to the distressed debt recovery methods as contained in research proposition 1, participants also identified additional distressed debt recovery methods that are used by South African banks. These include:

- Conversions of debt into equity;
- Private equity;

- Sale of assets / business; and
- Controlled winding-up.

Furthermore, participants indicated that it is very rare that only one distressed debt recovery method will be used in a particular instance. They indicated that, usually, a combination of various distressed debt recovery methods are used, such as the restructuring of bank facilities to relieve cash flow pressure with or without a sale of assets to reduce leverage and a possible conversion of debt into equity.

As indicated in Chapter 5: Evaluation and Discussion of Results, not all these distressed debt recovery methods are used by all South African banks. Certain participants indicated that they will not consider debt forgiveness as a distressed debt recovery method for the reasons as highlighted before, but would rather consider converting debt into equity or postponing the repaying of a debt instrument than forgiving debt and writing off a claim.

On another level, certain participants from the banking fraternity indicated that they would not consider debt to equity conversions or private equity by the bank itself as a distressed debt recovery method for the reasons indicated previously. Those participants indicated that there are a multitude of reputational issues that come into play when a bank is both an equity and debt provider to the same debtor company.

6.2 Strength of Support for Research Proposition 2

Factors that influence the selection by South African banks of distressed debt recovery methods are as follows:

- Early detection;
- Security;
- Severity of decline;
- Co-operation;
- Turnaround ability of management;

- Attractiveness of business;
- Onus of proof;
- Cost;
- Skill;
- Number of creditors;
- Moratorium;
- Legislation;
- Concursus Creditorum; and
- Ranking of claims.

From the results that were presented in Chapter 5: Evaluation and Discussion of Results, participants confirmed that all the above factors except severity of decline have an influence on the selection by South African banks of distressed debt recovery methods. The second proposition (with the exception of severity of decline) is, therefore, supported by the results as set out in Chapter 5: Evaluation and Discussion of Results.

With regards to severity of decline as a factor that influences the selection by South African banks of a distressed debt recovery method, whilst banks do respond drastically as set out by Gopinath (1995) it is not necessarily indicative of which distressed debt recovery method a bank will use. Severity of decline should rather be used in conjunction with early identification of distress to the extent that earlier identification will require a less drastic response.

In addition to the factors that influence the selection by South African banks of distressed debt recovery methods as contained in research proposition 2, participants also identified additional factors. These include:

- Reputation;
- Fraud;
- Enquiries;
- Skill;
- Certainty;

- Control;
- Size;
- Vested interests;
- Labour;
- Nature of claims;
- Benefit to creditors;
- Shareholder commitment;
- Extent of loss;
- Capacity;
- Experience and background of creditors;
- Buyers;
- New business;
- Maturity of shareholders;
- Equity mandate;
- Relationships; and
- Exit mechanism.

6.3 Answer to Research Question 1

What is the impact of key factors on the selection by South African banks of distressed debt recovery methods?

From the results that were presented in Chapter 5: Evaluation and Discussion of Results, 11 factors out of the original 34 factors were identified as carrying more weight than others in having an impact on the selection by South African banks of distressed debt recovery methods. These factors are as follows:

- Reputation;
- Fraud;
- Ranking of claims;
- Labour;
- Number and composition of creditors;

- Moratorium;
- Viability of business plan;
- Co-operation and trust;
- Management ability;
- Early identification; and
- Extent of loss.

In addition, the impact of these key factors on the selection by South African banks of distressed debt recovery methods was identified. In order to have done this, participants were asked during the semi-structured in-depth interviews to identify those factors that supported a specific distressed debt recovery method as well as those factors that did not support such a recovery method. From this, the key factors that support liquidation as a preferred distressed debt recovery method versus those factors that do not support liquidation were identified first.

After this, and based on the feedback received from participants, additional key factors were identified that first supported a controlled winding-up, with the identification of additional key factors that support a major debt restructuring. This process was followed until all factors required for investing activities and a minor debt restructuring were identified. The results of this exercise are summarised in Figure 1 above. Accordingly, this research report successfully answered the first research question.

In addition, the purpose of this research report as set out at the outset has been achieved in that a framework to assist South African banks to select the most appropriate distressed debt recovery method given the impact of key factors has been developed successfully.

6.4 Recommendations

Whilst there are a plethora of factors that have an influence on the selection by South African banks of a distressed debt recovery method, it is recommended that banks follow a similar approach as the one set out in this research report to identify the most appropriate recovery method given the impact of key factors. The first step in such identification process is to consider, given the existence of the key factors that have been identified, whether or not liquidation should be used as a preferred recovery method. After the above question has been answered can a bank consider which alternative distressed debt recovery method should be used. By identifying additional key factors that are in existence, a bank can be guided as to when a controlled winding-up becomes viable, followed by a major debt restructuring, investing activity and minor debt restructuring.

The research also indicated the benefit of dedicated departments within banks whose sole purpose is the recovery of distressed debt. It is recommended that a bank should be innovative in continuing to identify new ways to recover distressed debt in order to ensure that the risk a bank is taking in providing ongoing financial assistance to a distressed company is commensurate with its return.

Banks should become extremely efficient in deciding which distressed debt companies they will support by way of assisting with a debt restructuring and which ones should be liquidated. It is submitted that, although banks are fast to shy away from liquidation, liquidation still has its place as a distressed debt recovery method and a bank should develop a policy in line with this research report to decide when it will be supportive of a debtor company and when it will not be. It is submitted that too much time is wasted assisting debtor companies with a debt restructuring that has no chance of survival.

As became clear from the interviews, banks should become better in the early identification of distress, as it increases the alternatives that are available to recover distressed debt. Early identification will also assist South African banks to retain clients. A client that is successfully restructured remains a client forever. This is an important consideration for banks in South Africa given the difficulty to increase market share, especially in the larger market segment.

6.5 Possible Areas for Further Research

South Africa is currently in the wake of a new era with regards to business rescue. Business rescue legislation will in future form part of the new Companies Act which is currently in bill format. Chapter 6 of the new Companies Bill provides for business rescue legislation, and the impact of this legislation on a bank's ability to recover distressed debt could form the basis of a research report.

As this research report focused on distressed debt recovery methods and the factors that have an impact on banks in selecting a specific method with regards to distressed companies, there is a need to investigate the various alternatives available with regards to entities other than companies such as close corporations, trusts, individuals and non-governmental organisations.

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Appendix 1: Participants

Name	**Institution**	**Designation**	**Sector**
Les Matuson	Credit Management Solutions	Director	Turnaround / Business Rescue Professional
David Gewer	Credit Management Solutions	Director	Turnaround / Business Rescue Professional
Alistair Moffat	FRM Strategies	Director	Turnaround / Business Rescue Professional
Martin Leigh	Standard Bank	Director Credit: Business Solutions (Personal and Business Bank)	Banking
Trevor Murgatroyd	ABSA	Head: Wholesale Business Support and Recoveries	Banking
Robin Taggard	Nedbank	Credit Executive: Special Portfolio	Banking
Fred van der Westhuyzen	First National Bank	Head: Corporate Recoveries	Banking
Catriona Robertson	Rand Merchant Bank	Acquisition and Leveraged Finance	Investment Banking
Rael Levitt	Auction Alliance	Managing Director	Auctioneer
Norman Klein	West Trust	Director	Liquidator
Paul Winer	Werksmans Attorneys	Director	Legal

Gary Oertell	Edward Nathan Sonnenberg Attorneys	Director	Legal
Mike Gee	Credit Guarantee	Senior Manager: Risk Evaluation	Credit Insurance
Gideon Botchedi	Credit Guarantee	Manager: Salvages	Credit Insurance

Appendix 2: Guideline of initial telephone conversation with interviewee

Good morning/afternoon Mr/Ms [include name]

My name is Jan van der Walt, and I am a MBA student at Wits Business School. As part of my MBA degree, I am conducting research to analyse the impact of key factors on the methods selected by South African banks to recover distressed debt in order to develop a framework to assist South African banks to select the most appropriate recovery method given the presence of these factors.

Please advise whether your organisation will be able to participate in this study. The study will take the form of an in-depth interview with the owner and/or financial manager of your organisation. The duration of the interview will not exceed 90 minutes and your contributions will be anonymous.

If you are amenable to participate in this study, please provide me with a date and time to conduct the interview, as well as an e-mail address where I can confirm the date, time and venue in writing and to which address the questionnaire can be sent to.

Thanks very much for your willingness to participate.

Appendix 3: E-mail confirmation

Dear Mr / Madam ………………………..

Thank you for agreeing to contribute to the research study “The impact of key factors on the selection of method by South African banks to recover distressed debt”.

This e-mail serves to confirm the following interview details:

Date: ………………………………..

Time: ………………………………..

Venue: ………………………………..

Please note that your contributions will be anonymous and neither your name nor the name of your company will be linked to any statements or comments made in the research report. The interview will be recorded and typed, which data will then form the basis of this research report. Should you wish that the interview should not be recorded, please contact me as soon as possible in order for me to arrange an alternative recording mechanism.

I enclose a copy of the purpose and context of the research, as well as interview questions that will be asked during the interview for ease of reference.

Please do not hesitate to contact me if you require any further information.

Kind regards
Yours sincerely

Jan van der Walt

Appendix 4: Interview protocol

Details of Participant

Name of Participant:

Title:

Organisation:

Contact Telephone Number:

E-mail Address:

Date:

Time:

Duration of Interview:

Opening Statement to Respondent

Thanks for meeting with me and your willingness to contribute to this research. Your contributions will at all times be kept anonymous.

As previously mentioned, the purpose of this study is to analyse the key factors that impact on the method used by South African banks to recover distressed debt.

Interview Questions

<u>Interview Question 1</u>

What range of recovery methods do you use or advise banks of using to recover distressed debt?

Probe

- Legislative Methods
    - Prompt
        - Liquidation
        - Judicial Management
        - Compromises in terms of section 311 of the Companies Act

- Non-Legislative Methods
    - Prompt
        - Debt Restructuring
        - Sale of Assets
        - Informal Creditor Workout
        - Debt Forgiveness
        - Debt / Equity Conversions
        - Sale of Distressed Debt

<u>Interview Question 2</u>

Which key factors have an influence on the selection of a recovery method by South African banks to recover distressed debt?

Probe

- Role Players
    - Prompt
        - Secured Creditors
        - Preferent Creditors
        - Concurrent Creditors
        - Shareholders
        - Directors
        - Receiver of Revenue
        - Unions
        - Credit Guarantee
        - Service Providers
- Current Environment
    - Prompt
        - Basel II
        - Existing Legislation
        - Proposed Legislation
        - Internal Capacity

        - BEE
        - Fraud
        - Litigation Funding
        - Overseas Players
        - Reputational Risk
- Challenges
    - Prompt
        - Key Performance Index
        - Service Providers
        - Risk Appetite
        - Moral Dilemmas
        - Politics
        - Unemployment
        - Debt Buyers

Interview Question 3

Which of these factors will impact (positively or negatively) on your selection of a distressed debt recovery method and to what extent?

Closing Statement to Participant

Thanks very much for your time and effort in participating in this research. The information gathered today is extremely valuable. As soon as the results have been reduced to writing, I will let you have a copy for your perusal and comment to ensure accuracy. Thank you once again and good bye.

Interviewer's Comments

Reflective Notes

Appendix 5: Validity request

Dear ………………………………..

I enclose a copy of Chapter 5: Evaluation and Discussion of Results. This chapter forms part in my research report titled: *Distressed Debt Recovery Methods used by South African Banks*. The chapter discusses the results of the interviews conducted with all participants who contributed to the abovementioned research.

As part of the research validation process, I would like to ensure that the results correctly and accurately reflect the views of participants. If you wish to comment on any of the findings as set out in Chapter 5: Evaluation and discussion of results please provide me with your comments by no later than 31 January 2008.

It is important to understand that the results reflect the aggregate view of participants. In other words, the results cover the contributions of 14 participants across 11 organisations. These organisations include four financial institutions, one credit insurer, one liquidator, one business rescue consultant, one business strategy consultant, two attorneys and an auctioneer. Accordingly, you may find diverging views represented in the findings. If so, rather than noting the diverging views please restrict your comments to highlighting the views which have not been taken into account or which you believe I may have misinterpreted.

This chapter is only one of six chapters that constitute the research report. A copy of the full research report, detailing the literature review, research methodology, propositions and research question, evaluation and discussion of results and conclusions will be provided to you once the report has been submitted to the Faculty of Management, University of the Witwatersrand. This should be by no later than 29 February 2008.

I would like to thank you again for your contribution and time that you made available to contribute to this research.

If you require any additional information please do not hesitate to contact me.

Kind regards

Yours sincerely

Jan van der Walt