REPORTABLE (102)

Judgment No S.C.124\02

Civil Appeal No 180\01

SHAGELOK CHEMICALS (PRIVATE) LIMITED v (1) INTERNATIONAL FINANCE CORPORATION (2) ZIMBABWE DEVELOPMENT BANK (3) GREG NEELY (LIQUIDATOR OF SHAGELOK CHEMICALS)

SUPREME COURT OF ZIMBABWE
CHIDYAUSIKU CJ, CHEDA JA & GWAUNZA JA
HARARE SEPTEMBER 23 2002 & FEBRUARY 20, 2003

W. Ncube, for the appellant

A.P. de Bourbon S.C., for the first and second respondents

No appearance for the third respondent

GWAUNZA JA: On 23 August 2000, the High Court granted a provisional winding up order in respect of the appellant, with the third respondent being appointed provisional liquidator.

Confirmation of the provisional order was delayed due to a number of developments, among which was an unopposed application by the appellant for a provisional order placing itself under judicial management. The latter order was discharged on the same day that the provisional winding-up order was eventually confirmed, i.e. on 28 June 2001. The appellant now appeals against that confirmation order.

The facts of the matter are largely common cause. The real dispute is whether, given those facts, the court *a quo* should have confirmed the provisional winding-up order, or as contended for the appellant, it should have issued an order placing the appellant under judicial management in terms of sections 299 and 300 of the Companies' Act [Cap 24:03].

The respondent is an international financier operating from Harare, while the second respondent is a development bank incorporated in terms of the Zimbabwe Development Bank Act [Cap 24:14].

The appellant is a company registered according to Zimbabwean law, and operates from Kadoma. Its main business is the manufacture of a chemical called sodium silicate, which is used as a flotation agent in water treatment, manufacturing of soaps and detergents and pigment manufacture. It is asserted for the appellant that it is the sole manufacturer of sodium silicate in the country.

After a study conducted by the first respondent in 1996 concluded that the project to manufacture sodium silicate was technically feasible and the market viable, the first respondent invested in the project to the tune of US$864 000 in loans while the second respondent did the same in an amount of US$779 000. Using the then applicable exchange rate of US$1 = Z$38 and with interest and other charges, the appellant, as of 16 June 2000, owed the first respondent over Z$47 million and the second respondent over Z$44 million. These loans were secured in favour of the respondents by Mortgage Bonds registered over the appellant's immovable property and in the case of each respondent by a Notarial Covering Bond registered in respect of the appellant's movable property.

Although the appellant charged that some of the debts that the respondents were calling for were not yet due and that the loan owed to the second respondent should have been calculated as at 30 September 2000, (not June 30th) it is not in dispute that the appellant owed substantial amounts of money to the respondents. While the respondents aver the appellant's total liabilities in relation to them came to Z$92 216 257,27 the appellant concedes to Z$84 978 372,22 being the total owed to the respondents.

The appellant also had other creditors. One of them, Zimchem, had at the time the application was filed, succeeded in having the appellant's immovable property attached. The sale in execution had, however, been postponed upon the appellant's undertaking to pay $200 000,00 weekly to Zimchem.

The parties' calculations of the appellant's liabilities vis-a-vis its assets reflect incompatible results. Supporting their assertions with documentary evidence the respondents charge that the appellant's total assets, both movable and immovable, are worth $4 984 000 which value they calculated was exceeded by its total liabilities by some Z$87 million. The appellant, on the other hand, denies its assets are exceeded by its liabilities and quotes the amount of Z$103 162 190 as the total value of its assets. This would, by the appellant's calculations, exceed its total liabilities by some Z$18 million. The appellant's calculations include on the credit side the value of its movable assets ($251 290) and immovable property ($102 081 700,00) as well as Z$829 200,00 which it said is owed to it by debtors. These figures are disputed by the respondents, who aver firstly that all amounts advanced had fallen due upon the appellant's failure to service its loans and secondly that even by the appellant's own calculations, the total owed to the respondents and other creditors by the appellant had ballooned to over Z$142 million leaving a debit balance of over

Z$40 million. I can find no meaningful challenge from the appellant to this serious charge. According to the respondents, the appellant had not made any payments to its creditors for over two years. A report compiled by Kudenga & Co, Chartered Accountants, states that the company's financial statements showed that the company had incurred a net loss of $51 350 61,65 for the year ended 31 December 1998.

The appellant does not deny it has serious viability problems. It blames its poor business performance and consequent failure to service its debts firstly on factors to do with the economic conditions prevailing in the country, (devaluation of the dollar, shortage of diesel and electricity etc) secondly, on certain conduct on the part of both respondents and, thirdly, on financial mismanagement.

The first respondent is blamed for stopping the appellant's Managing Director, Sipho Mhlanga ("Mhlanga"), from procuring a plant for the business from a United Kingdom based company, and referring him instead, to a United States of America company from which the appellant had then obtained the plant. Unlike with the first plant, Mhlanga did not have the opportunity to first inspect the United States of America plant. It is not in dispute that the plant failed to perform to expectations and that following complaints from the appellant the supplier acknowledged that the plant was indeed defective. The supplier offered to, and did pay US$14 000 as compensation. The appellant was of the view that this amount was way too inadequate, (since it was considering US$1.3 million) and indicated it would institute legal action against the supplier for damages. According to the appellant the poor performance of the plant was exacerbated by the lack of adequate spares and an operational manual or detailed instructions on how to operate some of its various components, such as the furnace. The appellant's technicians, who lacked the requisite expertise to operate the machinery without the manual, were therefore forced to teach themselves how to operate it. As Mhlanga admits, this might have resulted in the technicians unwittingly damaging some of the plant's parts. The evidence before the court includes detailed accounts of the many defects of the plant, the spares required for its different parts and what such spares, and the requisite repairs would cost. The amounts run into millions of dollars.

The appellant accuses the second respondent (an accusation that, in my view, was successfully refuted), of acting contrary to an understanding reached between the parties, that all sales proceeds generated by the appellant would be channeled through the second respondent to enable it to assist the appellant with its cash and capital management.

The appellant alleges that the second respondent, instead, liquidated the foreign currency channeled through it in this way, at rates fixed by itself and proceeded to "wrongfully" pay themselves and other creditors of the appellant without consulting it. This, it is averred for the appellant, had a damaging effect on the appellant's viability.

The appellant attributes its problems to a number of other factors that I do not consider it necessary to set out. Suffice it to say that from the foregoing, it is evident that the appellant is under no illusions as to the serious predicament it finds itself in, whatever its true cause. All this, however, does not alter the fact that the appellant owes millions of dollars to its creditors, has failed to service its debts and has not shown how it will manage to repay them.

It is evident that the directors, shareholders and creditors of the appellant have, separately and together since the problems started, considered many different options for rescuing the appellant from its financial doldrums. These efforts were inspired by the conviction that the appellant had the potential to be viable under the right conditions. These efforts by and large come to naught. The appellant continued to experience viability problems. The two respondents called in the total outstanding amounts and threatened legal action. Mhlanga, as guarantor of the loan, was also threatened with legal action.

The legal action taken by the two respondents was an application for the winding up of the appellant and the appointment of a provisional liquidator. They contended that the appellant's liabilities exceeded its assets by some $87 million dollars, that the appellant was no longer capable of trading itself out of its debts and that it was, therefore, and for all intents and purposes, insolvent. The respondents contended further, that an organised and orderly programme of winding up of the respondent would benefit all creditors.

It is pertinent to note here that before the provisional order was confirmed, the learned judge in the court *a quo* requested a review and report from the provisional liquidator, L.G. Neely ("Neely"), with respect to the appellant's ability to continue as a viable concern. This was in the light of the appellant's opposition to the application, and its contention that the appropriate order should be one for the appointment of a judicial manager.

In his first report the provisional liquidator listed a number of problems faced by the appellant both operational and financial. He noted in his findings:-

> "Those problems resulted in Shagelok incurring significant operating losses amounting to approximately $87 million over a three year period, showing Shagelok to be an extremely unprofitable entity. This is in spite of its

> apparent monopoly on the local supply of sodium silicate to the local market and a large potential profitable market."

He also noted that the company had net liabilities of some $50 million. He concluded that under the right conditions and providing that all the considerations for recovery specified in this report were satisfactorily addressed, the appellant "could become" a viable entity. Neely however cautioned that while it may appear to give the creditors a glimmer of hope, judicial management might leave them in a worse position subsequently than that which liquidation could offer them "presently."

The appellant vehemently opposed the application for its liquidation. Mhlanga asserted that the appellant was on the road to recovery, had started to produce in bulk, and had secured reputable customers who had placed orders, showing that there was a ready market for its product. He also submitted documentary evidence showing the appellant's actual and potential foreign currency earnings, even though, according him these earnings had been "adversely affected" because local banks would liquidate them at their own rates, usually below market rates. Mhlanga added, however, that this situation was due to change dramatically because the appellant could now open his own foreign currency account. He cited future rather than current events as indications of the appellant's potential viability. Based on these future happenings Mhlanga projected (i) "that in a year or two" at the most, the appellant would have paid off its debts; (ii) that after five months it would have paid off the debt owed to Zimchem and be able to make "substantial" payments to its creditors, and (iii) that after two months, that is, October and November 2000, it would be able to start paying off its major debts from payments expected from customers who had placed certain orders with the appellant. There are no indications in these projections that major and necessary running expenses had been taken into account, for instance, the cost of repairing the many defects said to exist in the plant, the cost of spare parts and the cost of adequately training its technicians in the proper use of the plant. The evidence before the court shows that the appellant failed to live up to these projections

In confirming the provisional order of liquidation the learned trial judge had this to say:-

> "I also agree with Mr Gijima that there is nothing in the proposals mentioned in the reports as to how to deal with the continued operations of Shagelok in order to make it a viable entity. It is clear to me that in order to become a viable entity, substantial amounts of money would have to be invested in the company.

There is nothing in the papers to show how and when the applicants who are owed substantial amounts by Shagelok will be paid. Shagelok's obligations are increasing dramatically every month because of the interest charges that are being incurred and the depreciation in the value of the Zimbabwe Dollar. The applicants should have been paid long ago. They are still waiting for their money. It was clear that if the provisional order is not confirmed, the applicants will have to wait for a long time for the repayments which are owing to them. In my view, it is not right to the court to make them wait so long before they repaid. The debts are outstanding and have been due for a long time."

Given the background outlined above I agree with the learned trial judge's assessment.

All that the appellant does is speculate on the potential for its viability, based on the fulfillment of certain conditionalities. It has not demonstrated any concrete trend towards its recovery. To the contrary, there is a lot of evidence before the court to show that the appellant continued to incur great losses, failed to service its loans and had a working capital shortage. The appellant places considerable reliance on the draft business plan for the year 2001, and, in particular, the projected cash flows for the 2001, 2002 and 2003, that were prepared by Mr Madondo, the judicial manager. According to that plan the appellant, if given the opportunity, could operate profitably and be very viable. One of the opportunities referred to was the implementation of an operations agreement between a company called Gibous Chemicals (Pvt) Ltd ("Gibous") and the appellant, and brokered by Madondo. In terms of that agreement, the appellant was to process all raw materials delivered to it by Gibous in return for a production fee of $5 000 per tonne, that would enable the appellant to service its major debts at the rate of $3.5 million per month. The agreement was to last for an initial period of five years and would be renewed for another five at the instance of Gibous. The business plan and cash flow projections were based on this agreement.

In his second report, which followed an analysis of the business plan submitted by Madondo, Neely made the observation, in my view, valid, that Madondo's calculation of expected receipts, or income, for the three years in question were based on the assumption that the plant would operate at full capacity, since no allowance was made for spillage, shrinkage or plant inefficiencies. As is evident from the evidence before the court, these were real problems which, according to various assessments, had dogged the plant. According to Neely, the business plan therefore included maximum revenue achievable by the plant, with a minimum of expenditure. That these projections are unrealistic is shown by the fact that, while varying in their estimates of the actual cost of rehabilitating the plant to viable levels, the parties are agreed that the exercise would entail considerable capital outlay.

Having attacked the business plan on a number of other grounds, among which was the fact that it projected a year on year increase of 25% for expenses in an environment where inflation was rising at 51% at the time of his report, rendering it economically unviable, Neely concluded the agreement was not in the best interest of the creditors of the company and should not be implemented. Taking this together with his finding that the judicial manager had incurred a loss for the three-month period ended January 2001, of over Z$4 million, Neely also advised that he had no option but to draw the conclusion that the provisional liquidation order should be confirmed.

Mr *de Bourbon*, for the respondents, correctly observes that the projected cash flow, in terms of which the appellant was to be able to make monthly repayments of its debts of $3.5 million, was to be contrasted with the reality that a loss of over $4 million was in fact incurred in the first three months.

The issue that has to be determined, given this contrast, is whether the court *a quo* was correct to order that the company be wound up rather than be placed under judicial management. It is important to stress the difference in effect between liquidation and judicial management of a company. In the former case secured creditors are paid out of the proceeds from the disposal of the assets over which security is held, while preferent creditors are paid out of other assets in order of preference. Concurrent creditors then share anything left over on a *pro rata* basis. In the case of judicial management the control and management of the company is placed in the hands of a judicial manager. During the period of judicial management, all actions, proceedings and executions of process against the company are stayed. The expectation is that during judicial management, conditions are created that would enable the company to pay off its debts. There would thus be no immediate payment of such debts and where the judicial manager fails to turn the fortunes of the company around, the creditors would, in effect, have been made to unnecessarily wait for their payments.

Mr *Ziweni*, for the appellant, gives more specific grounds for the appellant's opposition to liquidation; firstly, that the appellant's inability to pay its debts was temporary and that the consequence of winding up would be seriously disproportionate in its prejudicial effect upon the appellant company. Secondly, Mr *Ziweni* contends that the court should not place reliance on the respondent's assessment of the appellant's solvency since they did not have access to its books of account. Thirdly, Mr *Ziweni* cites s 205(b) of the Companies' Act [Cap 24:03] which provides as follows:-

> "A company shall be deemed to be unable to pay its debts …
>
> (a) …
>
> (b) if the execution of other process issued on a judgment decree or order of any competent court in favour of a creditor falls on the basis of *nulla bona*."

He contends in this respect that in *casu*, the appellant had not failed to satisfy any writ and that the respondents have not procured any judgment for the sums claimed.

There is little in the evidence before the court to support the contention that the appellant's inability to pay its debts was only temporary. On the evidence of Mhlanga himself, the company experienced viability problems right from the outset, stemming largely from the many defects of the plant sourced through a reference from the first respondent, the lack of expertise within the appellant to operate certain parts of the plant without a manual and inadequate spare parts. Both the supplier of the plant and those who subsequently undertook inspections thereof reported major defects requiring millions of dollars to rectify. Thereafter or alongside this problem other viability problems presented themselves, resulting in the company incurring huge losses. These included unfavourable economic conditions in the country, shortage of diesel and electricity, the devaluation of the dollar and on the appellant's part and as indicated in Madondo's business plan, lack of strong Financial Management skills. In addition to this, and again as stated in Madondo's plan, the company from the beginning faced a "serious shortage" of working capital, thereby greatly undermining its operations. I do not recall any evidence in the record before the court, suggesting there ever was a time when the company realised comfortable profit margins. What is significant is that many options for revitalizing the performance of the appellant were considered but yielded no positive results. To suggest, against this background, as Mr *Ziweni* does, that the appellant's problems were only temporary is clearly to go against the weight of the evidence that is before the court.

While the appellant may entertain the sincere hope that its fortunes can be turned around, and has adopted certain measures it considered would lead to the achievement of that goal, there is no doubt that such efforts have had very little, if any, impact. As the learned trial judge correctly observed, the appellant's obligations are increasing dramatically every month because of interest and other charges that are being incurred. The argument that the consequence of winding-up would be seriously disproportionate in its prejudicial effect upon the appellant therefore finds little support from the evidence that is before the court.

The evidence placed before the court to show that the appellant is in serious financial problems, has failed to pay its debts and does not seem to have immediate prospects of recovery did not come only from the respondents. In addition to what the appellant itself concedes in this respect, there is, as already shown, other evidence not necessarily flowing from its books of accounts, that leave little doubt in anyone's mind about the seriousness of the appellant's financial and operational problems. Madondo, in any case, showed in his business plan that the appellant incurred a loss of over $4 million during the first three months of his judicial management of it. I, therefore, find no merit in Mr *Ziweni's* contention that no reliance should be put on the respondents' assessment of the appellant's insolvency because they did not have sight of its books of account.

Section 205(b) of the Companies' Act, cited by Mr *Ziweni*, does indeed provide that one indication of a company being unable to pay its debts would be a *nulla bona* return following an attempt to attach the company's property in satisfaction of a judgment against it, of a competent court. Mr *Ziweni,* however, omitted to mention that paragraph (c) of the same section provides for another indication, as follows:-

> "(c) if it is proved to the satisfaction of the court that the company is unable to pay its debts and, in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities of the company."

I find this provision to be relevant to the case at hand. No one, even the appellant itself, disputes that it is unable to pay its debts, that such debts are substantial and run into millions of dollars and more importantly, that for it to have any chance of recovery, other substantial amounts would have to be applied towards refurbishment of the plant, not to mention the generation of fresh working capital. KGPM Chartered Accountants indicate in their report that $50 million would be required for this purpose. Taken together, these contingent and prospective liabilities of the appellant are a strong indication of its inability to pay its debts.

Mr *de Bourbon,* for the respondents, makes the pertinent observation that it had, for a long time, been the approach of the courts to consider a debtor's ability to pay its debts as and when they are due, as the best proof of its solvency. Conversely, failure to pay one's debts, as has happened with the appellant, is strong proof of the debtor's insolvency.

Mr *Ziweni* advances a number of other arguments to support the appellant's call for judicial management and not liquidation. He makes much of Neely's failure to prepare a detailed report, as requested by the court *a quo*, as to whether the appellant should be liquidated or placed under judicial management. While Neely may have failed, in his first two reports to categorically state that liquidation rather than judicial management would be the best cause of action to take under the circumstances, the tone of the reports leave little doubt that was the inevitable conclusion. He, in any case, put matters beyond any doubt when in his third and final report, which was considered by the court *a quo*, he stated he had no option but to draw the conclusion that the provisional liquidation order should be confirmed.

It is contended further for the appellant that, following upon Neely's first report, the appellant should be given the opportunity to address the issues catalogued in that report and that this can only be done if it was allowed to be regenerated under judicial management. Reference has already been made to the weaknesses in the business plan that Madondo drew up, and in terms of which he intended to operate in his endeavour to get the appellant to trade itself out of its financial difficulties. These weaknesses were borne out by the substantial loss – albeit understated, according to the respondents – that Madondo himself recorded in the first three months that he was the judicial manager. When these shortcomings are taken together with the unsuccessful efforts taken by the appellant to revitalise its operations, the conclusion is inevitable that the appellant has failed to place before the court evidence that suggests that it is capable on its own or under judicial management, of being converted from a loss making enterprise to an economically viable one. As correctly contended for the respondents, the effect of an order for judicial management in the face of overwhelming evidence of the appellant's inability to trade profitably would be to prevent the respondents from receiving early payment of what is due to them.

Both counsel make reference to s 300(a) of the Companies' Act, which provides that:-

> "The court may grant a provisional judicial management order in respect of a company if it appears to the court, that, it is unable to pay its debts due to mismanagement or any other cause; and,
>
> That there is a reasonable probability that if the company is placed under judicial management, it will be enabled to pay its debts or meet its obligations and become a successful concern, and also that it would be just and equitable to do so." (my emphasis)

In *casu* mismanagement on the part of the appellant is blamed only in part for its financial woes, most of the blame being placed on other factors and agents. Even were the appellant's problems attributable only to mismanagement I am not satisfied, given all that has been said, that there would have been a reasonable possibility of the appellant becoming a viable enterprise. Nor, in my view would it have been fair and equitable to place the appellant under judicial management when the effect would have been to make its creditors wait longer than they had already done for their money. The debts owed continued to mount due to interest and other charges.

One other matter calls for comment.

The appellant, as already said, placed part of the blame for the predicament it finds itself in, on the first respondent. It seeks to rely on the principle that a liquidation order will not be granted where the court is satisfied that the applicant (for the order) is to blame in this way. Both Mr *Ziweni* and Mr *de Bourbon* rely on *Croc-Ostrich Breeders of Zimbabwe (Pvt) Ltd*[1] to, respectively, support and dispute the applicability of this principle to the circumstances of this case. Both counsel correctly contend, as the learned judge in that case did, that the court has the discretion to refuse to order liquidation notwithstanding the proven existence of grounds for liquidation. The learned judge went on to say at page :-

> "The discretion is regarded as a narrow one. (*Service Trade Supplies (Pvt) Ltd v Dasco & Sons (Pty) Ltd*[2]. Narrow in the sense that a creditor is entitled to a winding-up *ex debito justitiae* <u>save in exceptional circumstances</u> (*Cf Tuckers Land and Development Corporation (Pvt) Ltd v Soja (Pty) Ltd*[3])) The essence of the discretion is a decision as to whether to withhold relief objective grounds for the granting of which have been exhibited. The factors to be considered in any case do not differ depending on the grounds advanced for winding-up. The discretion is a judicial value judgment to be made on all the relevant factors (*Henochsberg op cit* 582)." (my emphasis)

The appellant charges that there is *mala fides* on the part of the first respondent. It is argued for the appellant that this *mala fides* is demonstrated by the fact that, after prevailing upon Mhlanga to abandon the order he had made for a plant in the United Kingdom, and to place the order with its contact in the United States of America, the first respondent went on to apply for the appellant's liquidation well knowing that much of its trouble stemmed from the defective plant.

[1] 1999 (2) ZLR 410 (HC)
[2] 1962 (3) SA 424 (T) R 428
[3] 1980 (3) SA 253 (W) at 257C

I am not persuaded that this, *per se*, establishes *mala fides* on the first respondent. The appellant does not allege that the appellant, with full knowledge that the plant sourced through its contact in the United States of America was defective, nevertheless went on to recommend to the appellant's Mr Mhlanga that he should order it. Nor does the appellant allege that the first respondent had done so with the specific intention of ruining the appellant financially and applying for its liquidation. Indeed, had that been its intention, it would not have invested so heavily in the appellant, nor gone to the trouble of adopting different options to rescue the appellant from its troubles. Without these allegations, it cannot be said that the first respondent bore primary responsibility for the predicament the appellant finds itself in, nor that by that token special circumstances existed for denying the liquidation order sought.

Even had the first respondent been to blame, the point is, in my view, well made that it was, in any case, not the only creditor of the appellants. Apart from the second respondent, which successfully disproved the allegation that it had breached the agreement between the parties to receive payments and structure repayments to creditors on behalf of the appellant, Mhlanga himself was owed several million dollars, as indeed were other creditors not party to these proceedings. The appellant would, therefore, in any case have had difficulties in evading an order for its liquidation.

I find, in the final analysis, that the appellant is so deeply mired in debt, and has such serious viability problems that - even by its own admission - it would take a number of years (and only under the best of conditions,) for it to recover, if ever. The conditions that the appellant suggested would have been conducive to this recovery have either failed to survive close scrutiny (e.g. the business plan and the Gibous agreement upon which it is based) or have failed to materialise (e.g. anticipated profits from the substantial orders said to have been received).

In view of the foregoing, I find the decision of the court *a quo* to have been justified. The appeal must accordingly fail.

It is in the premises ordered as follows:

"The appeal is dismissed with costs."

CHIDYAUSIKU CJ: I agree

CHEDA JA: I agree

Ziweni and Company, appellant's legal practitioners

Sawyer & Mkushi, first and second respondents' legal practitioners