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IN THIS **ISSUE**

Indemnities and simulation in the context of preference share funding

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Indemnities and simulation in the context of preference share funding

It has become market standard for funders to request a company issuing preference shares to indemnify the funders against any loss they may incur on account of non-payment of dividends or returns of capital.

Preference shares serve as a popular funding alternative to debt facilities, given the cost benefit they present to the company issuing the instrument.

This arises from the fact that, certain exceptions aside, the holder of preference shares earns a return in the form of dividends, which is exempt from income tax, as opposed to interest, which is taxable. This tax benefit allows the holder of preference shares to charge a lower funding rate than would otherwise have been charged had the funding been advanced in the form of a debt facility.

An intrinsic, but disadvantageous, feature of preference share funding is the fact that the funder does not have an absolute right to a return of capital and dividends, since such payments constitute "distributions" as defined in s1 of the Companies Act, No 71 of 2008 (Companies Act), accordingly requiring the company to pass the solvency and liquidity test in accordance with s46 of the Companies Act before paying such amounts to the holder of the preference shares. If the funding is rather advanced in the form of a debt facility, the funder would be a creditor of the company, thereby being able to enforce payment of the amounts owed to it under the debt facility against the company, regardless of the solvency and liquidity status of the company.

It has become market standard for funders to request a company issuing preference shares to indemnify the funders against any loss they may incur on account of non-payment of dividends or returns of capital. The funder is thereby provided with a contractual indemnity claim against the company, placing it in the same position as a creditor of the company and allowing the funder to enforce payment notwithstanding the solvency and liquidity status of the company. In this article, we argue that, in the context of preference share funding, the aforementioned non-payment indemnity clause is either (i) unenforceable, or (ii) if intended to be relied upon, opens the door to a simulation challenge by the South African Revenue Services (SARS).

Based on the case of *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd 1941 AD 369*, the doctrine of simulation can be summarised as follows:

(i) the parties to an agreement normally prepare it in order to reflect their true intention;

(ii) however, sometimes the parties to an agreement cast it in a form that is aimed at disguising, rather than revealing their true intention;

(iii) the disguise is typically adopted in order to secure a benefit that the law would not otherwise allow; and

(iv) if a court is of the view that the parties to a transaction have a definitively ascertainable intention which differs from the intention expressed by them in their agreement, the court must ignore the label that the parties have assigned to their agreement and give effect to that definitively ascertainable intention.

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Indemnities and simulation in the context of preference share funding*...continued*

The funding should accordingly be treated as a loan and the dividends should be taxed by SARS as if it were interest.

In the case of *Lawson and Kirk v South African Discount and Acceptance Corporation Pty Ltd 1938 CPD 273 at 282*, Davis J utilised the following illustration to emphasise that, in order to detect the presence of simulation, the court should pay particular attention to "slip ups" and inconsistencies to that which is purported by the parties:

> *"If a man is thought to have been working industriously to make a loan appear to be a sale, it is obvious that not much heed can be paid at any appearances of sale, unless perchance, they be so consistent that it is possible to say: "This must in truth have been a genuine sale: no man could so consistently and so successfully have simulated all its features: he was bound to have slipped up somewhere." But it is the places where he has slipped up which must necessarily be of paramount importance, for if it were a genuine sale, then there was no possible reason why he should ever have slipped up at all. A Parisian cripple is suspected of being a German spy in disguise: that he habitually speaks French and limps on two sticks matters not at all: that he was once heard speaking fluent German and was seen to run may well be conclusive."*

If the doctrine of simulation were to be applied to the non-payment indemnity described earlier in this article, SARS could possibly make the following simulation argument:

(i) the parties' purported intention is that funding is to be made available to the company in the form of preference shares, on the basis that the funder is to receive a return on its investment in the form of dividends and return of capital through the payment of redemption prices, payment of which is conditional upon the company passing the solvency and liquidity test;

(ii) the non-payment indemnity provides the funder with an absolute right to enforce repayment of the amounts advanced (together with any other amounts scheduled to be paid), which is a feature intrinsic to a loan and inconsistent with the parties' purported intention;

(iii) this inconsistency points to the parties' true intention, being that the funders advanced a loan that must be repaid by the company and that the parties simply cast agreements in the form of preference shares in order to obtain favourable tax treatment;

(iv) the court must ignore the form in which the parties cast it and give effect to that true intention; and

(v) the funding should accordingly be treated as a loan and the dividends should be taxed by SARS as if it were interest.

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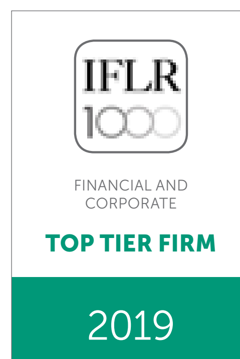
Indemnities and simulation in the context of preference share funding*...continued*

If the company gives the holder of preference shares a non-payment indemnity the preference shares could possibly be challenged by SARS on the basis that it is a simulated loan.

If the company gives the holder of preference shares a non-payment indemnity, with a view to the holder relying on that indemnity and enforcing repayment of capital and returns against the company notwithstanding its solvency and liquidity status, the preference shares could possibly be challenged by SARS on the basis that it is a simulated loan, for the reasons set out above. If, on the other hand, the parties' true intention is in fact for the funding to take the form of preference shares, it follows that the payments which the funder receives from the company must be subject to the passing of the solvency and liquidity test by the company. Enforcing a non-payment indemnity clause against the company in instances where the solvency and liquidity test cannot be passed is therefore imposing an obligation on the company with which it cannot lawfully comply. We accordingly conclude that the non-payment indemnity serves no real purpose in such circumstances and should be abandoned in the context of true preference share transactions.

Ludwig Smith and Jess Reid



2018 1ST BY M&A DEAL FLOW FOR THE 10TH YEAR IN A ROW.

DealMakers

2018
1st by M&A Deal Flow.
1st by M&A Deal Value.
2nd by General Corporate Finance Deal Flow.
1st by BEE M&A Deal Value.
2nd by BEE M&A Deal Flow.
Lead legal advisers on the Private Equity Deal of the Year.

2017
2nd by M&A Deal Value.
1st by General Corporate Finance Deal Flow for the 6th time in 7 years.
1st by General Corporate Finance Deal Value.
2nd by M&A Deal Flow and Deal Value (Africa, excluding South Africa).
2nd by BEE Deal Flow and Deal Value.

2016
1st by M&A Deal Flow.
1st by General Corporate Finance Deal Flow.
2nd by M&A Deal Value.
3rd by General Corporate Finance Deal Value.

2015
1st by M&A Deal Flow.
1st by General Corporate Finance Deal Flow.

2014
1st by M&A Deal Flow.
1st by M&A Deal Value.
1st by General Corporate Finance Deal Flow.

2013
1st by M&A Deal Flow.
1st by M&A Deal Value.
1st by Unlisted Deals - Deal Flow.

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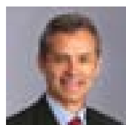

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