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CORPORATE & COMMERCIAL **ALERT**

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Preference share funding: crossing bright lines

Section 12 defines a merger as the acquisition of control by one person "over the whole or part of the business of another firm".

A typical feature of a preference share funding structure is that the company (Issuer) in which the funder (Funder) will subscribe for preference shares is required to be a ring fenced special purpose vehicle (SPV). Funding preference shares typically do not give the Funder voting rights in the Issuer. However, upon the occurrence of an event of default, the Funder becomes entitled to exercise the majority of the voting rights in the Issuer (Enhanced Voting Rights). The critical question then becomes whether the Funder's entitlement to the Enhanced Voting Rights constitutes a change of control for the purposes of the Competition Act.

To ensure that the issue of the preference shares does not trigger competition merger control provisions as contained in the Competition Act, No 89 of 1998 (the Act), Funders often require that the total number of ordinary shares issued to any existing ordinary shareholder be significantly higher than the number of preference shares to be issued to the Funder.

In terms of the Act, parties are required to notify the Competition Commission of intermediate and large mergers. Section 12 defines a merger as the acquisition of control by one person "over the whole or part of the business of another firm". Section 12(2) goes on to list a number of examples of control. One of such examples is the beneficial ownership of more than half of the issued share capital of a firm as contained in s12(2)(a). The effect of s12(2)(a) is that the holder of the majority of issued shares in a company will have control over that company for the purposes of s12 of the Act, whether those shares enable the holder to vote or not. In view of this, Funders opt to subscribe for fewer preference shares than ordinary shares in order to avoid falling within the scope of s12 of the Act.

Merger notification requirements

There is a debate to be had about the substance of the position taken by Funders in respect of ensuring that the number of preference shares is significantly lower than the number of issued ordinary shares. There are, in fact, two requirements for merger notification. The first being that the Funder would need to acquire control over the Issuer in a way listed in s12(2) or otherwise, and the second, that the merger must either be an intermediate or a large merger. In other words, the question of whether parties to a preference share transaction are required to notify the Competition Commission is dependent on whether the acquisition of the shares can be categorised as control and whether the transaction meets the prescribed thresholds.

Currently the lower threshold is a combined turnover (of the Funder and of the Issuer) of at least R600,000,000.00 and the Issuer's turnover/asset value must be at least R100,000,000.00. Where the Issuer is an SPV, it is unlikely that the asset value/turnover of the Issuer would exceed R100,000,000.00 at the time that the preference shares are issued, unless the SPV in turn controls additional firms that together meet the thresholds. As such, the issue of the preference shares would qualify as a small merger and would not be subject to the notification requirements in terms of s13(1) of the Act. It must be

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It can be argued that in instances where the Issuer has a turnover/ asset value below the lower threshold, the parties do not run the risk of triggering mandatory merger control provisions in terms of s12 of the Act.

noted that the Competition Commission is entitled to require parties to a small merger to notify the Commission of such merger in terms of s13(3) of the Act, anytime within six months of implementation.

In light of the above, it can be argued that in instances where the Issuer has a turnover/asset value below the lower threshold, the parties do not run the risk of triggering mandatory merger control provisions in terms of s12 of the Act. As such, the Funder is able to subscribe for preference shares in a number that exceeds the number of the issued ordinary shares, and will consequently acquire control over the Issuer for the purposes of the Act, without being obliged to notify the Competition Commission.

Enhanced voting rights upon default

The concept of control in preference share funding is critical in light of standard preference shares terms which entitle the Funder to acquire the majority of the voting rights in the Issuer upon an event of default on the part of the Issuer (Enhanced Voting Rights). It is important to note that voting rights do not typically attach to funding preference shares, the Enhanced Voting Rights only become accessible to the Funder upon the occurrence of an event of default. Where the funder does not hold the majority of the issued shares in the Issuer, the Enhanced Voting Rights will result in a change of control in terms of the Act, specifically s12(2)(b) where the Funder is "entitled to vote a majority of the votes that may be cast at a general meeting of the firm". An additional layer of complexity is that the preference share subscription price may be substantial in quantum and the acquisition of assets from the proceeds of the funding may result in an increase in the Issuer's turnover/asset value (above the lower threshold). In these circumstances, the parties will be required to notify the relevant authorities of the change of control and more importantly, await approval from the Competition Commission before the Funder will be entitled to exercise its Enhanced Voting Rights. It is crucial to bear in mind that upon default, the Funder's primary objective is to recover the funding and any delay in exercising its Enhanced Voting Rights could compromise its ability, practically, to recover the amounts owed to it.

Worth noting the recent *Constitutional Court judgment in the case of Competition Commission of South Africa v Hosken Consolidated Investments Limited and Another* [2019] ZACC 2, in terms of which Hosken Consolidated Investments Limited (HCI) intended to increase its shareholding in Tsogo Sun Holdings Limited (Tsogo). The resultant shareholding was more than half of the issued shares as contemplated in s12(2). It is important to note that HCI had previously notified the Competition Commission in respect of its initial acquisition of control over Tsogo in terms of which it had acquired a different form of control (it controlled the majority of the votes on a de *facto* basis). The Constitutional Court echoed the sentiments of the Competition Tribunal in the case of *Ethos Private Equity Fund IV v The Tsebo Outsourcing Group* (Pty) Ltd Case No: 30/LM03 (Ethos), confirming that an acquisition of control is a once-off event. In other words, once a person acquires control in terms of s12, any further control acquired by that

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We note that in instances in which the Issuer has a high turnover/asset value, the subscription for a number of preference shares which exceeds the number of ordinary shares in issue will trigger merger control provisions.

person, as envisioned in the Act, does not constitute a merger for the purposes of the Act. The Constitutional Court eloquently commented that in instances where a person had previously acquired control 'the crossing of a further "bright line" does not result in the acquisition of control that it did not have before...Where the quality of control over the firm which was already controlled changes, it will not constitute a "merger"'.

Similarly, the Competition Tribunal in *Cape Empowerment Trust Ltd v Sanlam Life Insurance Ltd* Case No: 05/X/JAN06 (Cape Empowerment Trust), addressed the question of whether a preference share funder who acquired majority shares in an issuer before s12 and s13 of the Act came into effect, and subsequently acquired a different type of control as listed in s12(2) would be required to notify the Competition Commission when the subsequent change in control occurred. The Competition Tribunal took the view that "there was no change of control, but merely the super-imposition of another one or more forms of control contemplated by the Act". The Tribunal did, however, state that it will judge each case on its merits in assessing whether notification is necessary upon the acquisition of further or a different kind of control.

The question which remains is whether the acquisition of further control triggers the mandatory notification requirements where the parties had not previously notified the relevant authorities of the initial change of control. As such, it is unclear from the decisions reached in Cape Empowerment Trust and Ethos whether a Funder who holds the majority of the issued shares in the Issuer will be required to notify the relevant authorities at the point at which the Funder becomes entitled to the Enhanced Voting Rights and consequently acquires additional control. It is critical to note that upon subscription for the preference shares, the Funder will have joint control over the Issuer (along with the ordinary shareholders). However, this joint control will fall away upon an event of default, making the Funder the sole controller of the Issuer. In light of this, and despite the Funder having previously acquired control, the parties may still be required to notify the relevant authorities of the additional acquisition of control.

We note that in instances in which the Issuer has a high turnover/ asset value, the subscription for a number of preference shares which exceeds the number of ordinary shares in issue will trigger merger control provisions. As such, the current position of Funders is justified. However, as stated above, it must be noted that in the event of default, and upon the Funder (who does not have control over the Issuer) exercising the Enhanced Voting Rights – the parties will be required to notify the relevant authorities of the change of control which will inevitably delay the exercise of the Funder's Enhanced Voting Rights.

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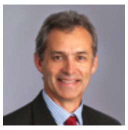

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR

Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 1 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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