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# FINANCE & BANKING ALERT

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### Cession in security: Notice to the debtor

In previous articles we stated that in South African law, cession is a bilateral juristic act whereby by agreement, a cedent transfers its rights, because of an underlying *causa*, to a cessionary. There are two types of cession, namely, an out and out cession and a pledge and cession in *securitatem debiti*, the latter known as a cession in security or a security cession.

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## Double security? Assessing the role of direct agreements and security cessions in project finance transactions

A defining feature of project finance is that it is ordinarily limited recourse funding, which means the lenders rely only on the revenue of the project itself and the assets thereof, to recover their investment.

The COVID-19 pandemic has proved to be more than a global health crisis but an economic one too. There is no question that while the lockdown was essential, it has created uncertainty about completion of projects, and the status of facility agreements, specifically the trigger of default provisions. The closure of a large number of businesses affected the ability of companies to complete projects and generate revenue, and accordingly, the ability of borrowers to repay their debt facilities, which have been raised for purposes of such projects.

A defining feature of project finance is that it is ordinarily limited recourse funding, which means the lenders rely only on the revenue of the project itself and the assets thereof, to recover their investment. For that reason, project finance transactions present a high risk for lenders, particularly in respect of greenfield projects. Due to such risk, principally during the pre-operational stage of a project, a good security package which mitigates risk to the greatest extent possible, is essential to protect lenders' interests.

In addition to finance and security documents, a project finance transaction also includes project documents such as construction agreements, operation and management agreements and equipment supply agreements. One of the finance documents typically applicable in project finance transactions are direct agreements in respect of the material project documents. Direct agreements are ordinarily concluded between the lender, or in the case of a syndicate of

lenders, the security agent, the borrower and the counterparty to the project document. Such agreements provide the lender(s)/security agent with step-in rights in the event of the failure by the borrower to fulfil its obligations in terms of the relevant project document. Accordingly, before a counterparty can terminate a project document on account of the borrower's breach, the lender(s)/security agent will be given an opportunity to "step in" and fulfil the borrower's obligations thus ensuring the continuity of the agreement and consequently the project.

In addition, project finance security packages often include the cession of project documents by the borrower in favour of the lender(s)/security agent. Cession of project documents ordinarily takes the form of a cession in *securitatem debiti* (security cession) as opposed to an out and out cession. In terms of a security cession, the borrower will cede its personal rights in respect of the project documents to the lender(s)/security agent as security for its obligations under the debt facility. While the borrower will retain ownership of the ceded rights, the lender(s)/security agent will obtain the right to enforce such rights against the project document counterparty in the event of an occurrence of an event of default under the facility agreement.

Direct agreements and security cessions aim to ensure that notwithstanding the borrower's default, the project can continue in order to reach an operational stage and generate revenue. Given that both direct agreements and security cessions provide the lenders with a form

## Double security? Assessing the role of direct agreements and security cessions in project finance transactions...continued

Direct agreements give lenders a direct relationship with the counterparties which enables them to facilitate continuity of the project.

of step-in rights, it would appear that concluding both documents constitutes "double security". A question which might arise is why would lenders need both? As indicated above, the aim when preparing a security package, is to mitigate the risk borne by lenders to the greatest extent possible. An assessment of the characteristics of direct agreements and security cessions, as summarised above, will reveal that while both agreements relate to the lenders' rights in respect of the project documents, they offer different protections which are complementary as opposed to repetitive. While on one hand, direct agreements allow lenders to step-in and fulfil the borrower's obligations in the event of breach of a project document by the borrower, security cessions on the other hand, provide lenders with the option to step-in and enforce the borrower's rights against the counterparty in the event of breach of the facility agreement by the borrower.

From an enforcement perspective, direct agreements give lenders rights in the event of a breach of the project document in order to prevent the counterparty from terminating same should the borrower be unable to remedy such breach, whereas

a security cession gives the lenders rights on the occurrence of an event of default under the facility agreement. Even though it has become market practice, to draft facility agreements such that breach of a project document will constitute an event of default under the facility agreement, the counterparties to the project documents are not party to the facility agreement and accordingly facility agreements do not have a mechanism in place to prevent the counterparty from terminating the relevant project document or ceasing to perform in relation thereto. Direct agreements and security cessions give lenders a direct relationship with the counterparties which enables them to facilitate continuity of the project.

Although including both direct agreements and security cessions in the transaction documents package may appear repetitive, they each play a different role and provide the lenders with more comprehensive security. The two documents complement each other in creating the lenders' rights and combined they give lenders favourable options regarding the project.

*Kuda Chimedza and  
Preshan Singh-Dhulam*

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## Cession in security: Notice to the debtor

In practice, much emphasis is placed on the cedent issuing a notice to the debtor informing it of the cession in security, and the debtor acknowledging receipt thereof.

**In previous articles we stated that in South African law, cession is a bilateral juristic act whereby by agreement, a cedent transfers its rights, because of an underlying causa, to a cessionary. There are two types of cession, namely, an out and out cession and a pledge and cession in securitatem debiti, the latter known as a cession in security or a security cession.**

In this article, we discuss the role played by notice to the debtor in a cession in security. In practice, much emphasis is placed on the cedent issuing a notice to the debtor informing it of the cession in security, and the debtor acknowledging receipt thereof. In fact, the issuing and acknowledgement of the notice is typically a condition precedent to loan and cession in security transactions, often because the principal agreement (explained immediately below) contractually restricts either party from ceding its rights thereunder.

In a cession in security, the cedent pledges or encumbers its personal rights against its debtor and transfers such rights to the cessionary (ceded right(s)) to secure the fulfilment, by the cedent or a related party, of an obligation owed to the cessionary. The ceded rights arise from the contract between the cedent and its debtor which is the principal agreement while the indebtedness or the obligation arising there from is known as the principal debt. The obligation arising from the contract

between the cedent and the cessionary is typically the repayment of a loan or the payment of a price for goods sold or services rendered, and is known as the secured debt as security is provided for the debt. As in previous articles, we mention that the issue as to whether the cedent cedes in security an aspect of a right, or the entire right, has been a controversial subject in South African law for more than a century, and is governed by competing theories that are beyond the scope of this article. We base this article on the pledge theory of cession in security.

As cession in security is a bilateral juristic act between the cedent and the cessionary, notice to the debtor, or for that matter the debtor's consent to the cession, is not a requirement in South African law to constitute a binding cession. [*National Sorghum Breweries Ltd v Corpcapital Bank Ltd* 2006 (6) SA 208 (SCA) at paragraph 1; *Van Staden and Another v Firstrand Ltd and Another* 2008 (3) SA 530 (T) at paragraphs 28 and 29] A cession in security becomes operative when the cedent and the cessionary agree to the essential terms of the cession, whether or not the debtor was informed thereof or consented to the cession. A cession in security that complies with the common law requirements for cessions, and in the instance of listed securities ceded in security that complies with the Financial Markets Act 19 of 2012 (Financial Markets Act), is enforceable between the parties despite the debtor being unaware of the cession.

## Cession in security: Notice to the debtor...*continued*

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In some instances, a debtor may, despite notice of the cession in security, decline to render performance to the cessionary out of concern for defaulting on its contract with the cedent.

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However, notice to the debtor is often included as a contractual condition in the form of a condition precedent to a loan and cession in security transaction. The reason for doing so has to do with mitigating risk, including overcoming any contractual restriction in the principal agreement on the parties ability to cede the ceded rights, rather than a legal requirement for a valid cession in security. A debtor, unaware of the cession in security and who, in good faith, renders performance to the cedent under its contract with the cedent, is immune from suit. In circumstances where the cedent defaults on the secured debt by, for example, failing to repay the loan, and the debtor unaware of the cession, renders performance to the cedent in the ordinary course, the cessionary will have no claim against the debtor for any loss it may suffer because performance was rendered to the cedent. The cessionary will therefore suffer the loss. It is therefore in the cessionary's interests that the debtor be notified of the cession in security of the ceded rights, and that the debtor agrees to render performance due under its contract with the cedent, to the cessionary, if it notifies the debtor to do so.

In some instances, a debtor may, despite notice of the cession in security, decline to render performance to the cessionary out of concern for defaulting on its contract with the cedent. In *Van Staden* it was held *obiter* that the onus of proving knowledge of the cession rests with the cessionary, that the knowledge could be either actual or constructive and that, "A court will impute constructive knowledge to a debtor where it has reasonably shut its eyes to the truth by not heeding indicators of that truth." [*Van Staden*, paragraph 29]

It is therefore conceivable that a court may impute knowledge of the cession in security to a debtor who received notice of the cession but declined to abide by it. Consequently, a debtor with knowledge of the cession, who makes payment to the cedent instead of the cessionary where the cessionary is entitled to payment under the cession, may, depending on the circumstances, be held liable for the cessionary's loss. The cedent of course cannot compel its debtor to render performance to the cessionary on the cedent's default of the secured debt, but its consent may persuade the debtor to abide by the instruction in the notice of the cession in security. Such instruction typically requires the debtor to make payment of the amount otherwise due to the cedent under the principal agreement, to the cessionary on notice from the cessionary. The parties would need to negotiate a mutually acceptable outcome should the debtor decline to render performance to the cessionary, bearing these principles in mind.

The role of notice to the debtor in a cession in security raises the issue of notice to third parties of the cession in security. Unfortunately, South African law, unlike the laws in other jurisdictions, has no legal requirement that obliges the parties to notify third parties such as debtors, of cessions in security of personal rights to book debts, moneys in bank accounts, insurance policies or unlisted shares, except in the case of the cession in security of listed securities. Typically, in certain jurisdictions, third parties are notified of a cession in security or the creation of a security right, by the mandatory registration of the cession

## Cession in security: Notice to the debtor...*continued*

Section 39(1)(d) of the Financial Markets Act states that a cession in security or pledge that complies with the requirements aforesaid is effective against third parties.

or security right in a central registry administered by a regulator. The absence of such a legal requirement is, we submit, a systematic deficiency of South African law.

However, listed securities are treated differently in that section 39 of the Financial Markets Act requires that the cession in security or pledge of listed uncertificated securities or an interest therein, must be effected by entry in the central securities account or the securities account, as the case may be, of certain information stipulated in the section 39 of the Financial Markets Act related to the cession in security or pledge. Entry is defined in the Financial Markets Act as the electronic recording of *inter alia* any cession in security, pledge or other instruction in respect of securities or an interest therein. Section 39(1)(d) of the Financial Markets Act states that a cession in security or pledge that complies with the requirements aforesaid is effective against third parties. An interesting issue is whether section 39(1)(d) renders notice of

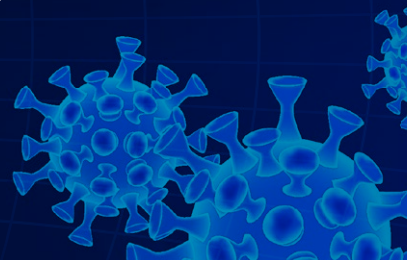
the cession in security superfluous since the section deems the registered cession or pledge of listed securities as being effective against third parties such as the debtor. It is though probably safer to err on the side of caution by sending a notice of the cession to the debtor despite the effect of section 39(1)(d).

The South African common law position is that notice to the debtor of the cession in security is not a requirement in law to constitute a binding cession, but it pre-emptly the debtor from rendering performance to the cedent if the cessionary is entitled to the performance due to the cedent defaulting on the secured debt. However, the legal requirements to cede in security or pledge listed uncertificated securities or an interest therein are regulated by section 39 of the Financial Markets Act and are different.

*Adnaan Kariem*

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## OUR TEAM

For more information about our Finance & Banking practice and services, please contact:



**Deon Wilken**  
National Practice Head  
Director  
T +27 (0)11 562 1096  
E deon.wilken@cdhlegal.com



**Stephen Boikanyo**  
Director  
T +27 (0)11 562 1860  
E stephen.boikanyo@cdhlegal.com



**Adnaan Kariem**  
Director  
T +27 (0)21 405 6102  
E adnaan.kariem@cdhlegal.com



**Bridget King**  
Director  
T +27 (0)11 562 1027  
E bridget.king@cdhlegal.com



**Jacqueline King**  
Director  
T +27 (0)11 562 1554  
E jacqueline.king@cdhlegal.com



**Izak Lessing**  
Director  
T +27 (0)21 405 6013  
E izak.lessing@cdhlegal.com



**Mashudu Mphafudi**  
Director  
T +27 (0)11 562 1093  
E mashudu.mphafudi@cdhlegal.com



**Preshan Singh Dhulam**  
Director  
T +27 (0)11 562 1192  
E preshan.singh@cdhlegal.com



**Pierre Swart**  
Director  
T +27 (0)11 562 1717  
E pierre.swart@cdhlegal.com

**Vusiwe Ngcobo**  
Senior Associate  
T +27 (0)11 562 1329  
E vusiwe.ngcobo@cdhlegal.com

**Kuda Chimedza**  
Associate  
T +27 (0)11 562 1737  
E kuda.chimedza@cdhlegal.com

**Stephanie Goncalves**  
Associate  
T +27 (0)11 562 1448  
E stephanie.goncalves@cdhlegal.com

**Jordan Maze**  
Associate  
T +27 (0)21 481 6361  
E jordan.maze@cdhlegal.com

**Andile Sangweni**  
Associate  
T +27 (0)11 562 1046  
E andile.sangweni@cdhlegal.com

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### JOHANNESBURG

1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa. Dx 154 Randburg and Dx 42 Johannesburg.  
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

### CAPE TOWN

11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.  
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

### STELLENBOSCH

14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.  
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com

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