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FINANCE & BANKING ALERT

IN THIS ISSUE

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The "double decker structure" - creating valid security for preference shares

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Notwithstanding a positive credit analysis at the onset, occasionally businesses or projects are unsuccessful and this sometimes leads to liquidation. Given the potential for liquidation, funders should carefully consider whether they will provide funding through loan facilities or by subscribing for preference shares in investees. While both methods of funding have their respective advantages, they have disparate legal consequences in the event of liquidation, because of the difference in the nature of the funding, that is, debt and equity.

The Insolvency Act 24 of 1936 (Act), provides a hierarchy for payment of claims in the event of liquidation. In terms of the Act, priority for payment lies with secured creditor claims. These are the claims of creditors who have a secured right over particular property of an insolvent estate by reason of a special mortgage, landlord's legal hypothec, pledge or right of retention (Secured Claim). Secured Claims are paid from the proceeds of realising the particular property securing such claims, including fruits derived therefrom after the date of liquidation, such as interest or accrued rent.

Thereafter, preferent claims are paid. The Act provides that preference in relation to any claim is the right to payment of that claim before others. Preferent claims that are not Secured Claims, are discharged after Secured Claims but before the claims of non-preferent creditors, and are paid from the free residue of the estate. Free residue comprises the balance remaining after deducting the costs of liquidation, other charges provided for in the Act, and payment of Secured Claims combined with the proceeds of the unencumbered assets.

Subsequently, the balance of the free residue is distributed amongst (i) creditors whose claims are neither secured nor preferred, (ii) secured creditors who have included reliance on the free residue for the balance of their claims in terms of section 89 of the Act, and (iii) preferent creditors, for the non-preferred balance of their claims.

The balance of the free residue is distributed in proportion to creditors' claims that are unpaid at that stage, and any remaining amount is applied proportionately to the payment of interest on the respective claims from the date of liquidation to the date of payment. Once

The "double decker structure" - creating valid security for preference shares*...continued*

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all the proved creditors' claims and the costs of liquidation have been discharged, any remaining proceeds of the estate are distributed among the shareholders of the investee in accordance with their rights and interests. In exceptional circumstances, shareholders may not be the last to be paid, for example, where they have shareholder loan claims that are secured as contemplated in the Act.

What is apparent is that debt is preferred to equity in respect of payment of claims after liquidation, and shareholders have no claim against the insolvent estate until all the creditors' claims have been satisfied. Moreover, the main distinction between creditors and shareholders for purposes of liquidation is that although creditors are entitled to have their claims satisfied from all the assets of the insolvent estate, shareholders are entitled only to the excess assets of such estate.

When investors provide funding through preference shares as opposed to a loan, they acquire equity in the investee as opposed to a debt claim against the investee. While preference shares replicate the economics of a loan, our courts have distinguished them from debt and emphasised that are still equity. Further, although, for purposes of payment of claims, preference shares generally rank above ordinary shares, depending on the preferences, rights and limitations to which they are subject, they rank below debt in the event of liquidation. Accordingly, investing through preference shares presents a risk, as in the event of liquidation, shareholder claims, are discharged last, and proportionately out of the free residue.

The question is therefore, how can funders enjoy the benefits of preference share funding but mitigate the risk highlighted above? One solution is to interpose an entity between the company that will issue the preference shares (Issuer) and the target investee, so that such entity can provide a guarantee for the obligations of the Issuer and pledge its shares in the target investee as security for its performance under that guarantee. The structure will therefore comprise the Issuer, its subsidiary (the interposed entity) and the target (which will be a subsidiary of the interposed entity). This is referred

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The "double decker structure" - creating valid security for preference shares*...continued*

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to as the "double decker" structure. In this instance, the funds can flow from the Issuer to the target in various ways. For example, the Issuer can capitalise the subsidiary by subscribing for ordinary shares in the subsidiary for a subscription price equal to the preference share subscription price.

Once the funder has subscribed for preference shares, it will have an equity claim against the Issuer. To secure this claim, the funder can conclude various security agreements with the Issuer. However, in our law, security must have a lawful underlying causa, and is accessory to a valid primary obligation. Due to the ancillary nature of security, if the primary obligation it is ancillary to, is subordinate to another, such security will similarly be subordinate and the aforementioned risk remains. However, pursuant to implementing the double-decker structure, the preference share subscriber can protect its investment by concluding independent security arrangements for the payment of the redemption amount, such as guarantees or pledge and cession agreements among others, with the Issuer's related entities (the aforementioned subsidiary and target).

In terms of section 46(4) of the Companies Act 71 of 2008 (Companies Act), a distribution as contemplated in part (b) of the definition of a distribution set out section 1, will be subject to the application of the the solvency and liquidity test contemplated in the Companies Act (Test), only at the time that its board resolves to make such distribution. It specifically provides that the Test need not be passed for any subsequent action of the company in satisfaction of that distribution. A guarantee issued by a company for the benefit of a related party would constitute a distribution as contemplated in part (b) and will therefore, be subject to the Test, only at the time that its board resolves to provide such security. This is in contrast to the requirement for the Issuer to pass the Test at the time of each performance in terms of issued preference shares. This is because performance by the Issuer in terms of preference shares falls under part (a) of the definition of a distribution whereas performance by a guarantor falls under part (b) of the definition of a distribution. On liquidation of the Issuer, the funder will still be able to proceed against the Issuer's related entities who have provided guarantees for the redemption amount, pursuant to the security arrangements.

The effect of the double decker structure is it creates better security for funders as it underpins the funder's equity claim against the Issuer with a debt claim against the subsidiary and/or target which has provided a guarantee for the Issuer's obligations under the preference shares. In that way, if the Issuer is liquidated, while the equity claim against the Issuer will be subordinate to creditors' claims in terms of the Act, the debt claim against the Issuer's related parties who have provided guarantees remains unaffected. Thus, the double decker structure presents a means for funders to mitigate the risk presented by liquidation and still enjoy the advantages of preference share funding.

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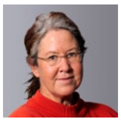

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