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Default interest: a borrower and a lender perspective

When borrowers and lenders negotiate loan agreements, an issue that is frequently the subject of significant debate between them is whether default interest should be payable by the borrower in instances where the default does not relate to the borrower's payment obligations under the loan.

A borrower may argue that interest is the cost of borrowing money and where the borrower has not breached its payment obligations under the loan agreement (for example, where it may instead have breached a warranty or an undertaking), such default interest should not then be payable.

A borrower may also argue that there are any number of events in a loan agreement that, although strictly speaking constitute events of default, will unlikely result in an acceleration of the loan by the lenders as - viewed on the whole - they are minor in the context of the loan, particularly when the borrower is otherwise performing acceptably and meeting its financial covenants and loan repayment obligations as they fall due.

Unless the point has already been stipulated by the lender, and was not contested by the borrower, at term sheet stage the lender should be prepared for the borrower to make such a point during the negotiation process if this is a provision that the lender customarily includes in its loan agreements.

An argument that a lender could put forward to counter a request by a borrower that it only be charged default interest for payment defaults is that, regardless of a borrower's opinion as to whether a default is major or minor, a lender does not view any default under a loan agreement lightly, regardless of the fact that it may not be a payment related default.

Even if a lender concedes that it is not a default that will necessarily cause it to call up the loan, it still requires the borrower to remedy that default, and what better incentive does a borrower have to remedy a default than to save itself having to pay default interest for any extended period that the default remains unremedied. In other words, by charging default interest, a lender may consider that it has the attention of a borrower and a certain level of comfort that the borrower will try to remedy that default as quickly as possible.

If a lender is sympathetic to a borrower's position, a possible middle ground for a lender to, on the face of it, concede to, is the right to elect whether or not to charge default interest in such an instance.

While perhaps appearing as a concession, this does not really alter the lender's position as even if the loan agreement provides for automatic default interest, a lender would be free to waive this right if it wanted to do so. The perception from a borrower perspective, however, is that default interest is not automatic.

A lender, while then appearing to make a concession to the borrower, still retains a stick should it not be satisfied that a borrower is giving the default due attention. If this were to happen, a lender can then decide that default interest should apply.

Alternatively, a lender could agree that default interest will only apply if its elects to call up the loan but this would be a more meaningful concession by a lender.

It is interesting to note that the latest versions of the loan agreements prepared by the African Loan Market Association provide that default interest is payable only where the borrower (or any other obligor) fails to pay any amount payable by it under a finance document on its due date. Although a lender is not bound by the provisions of the ALMA loan agreements, if such a provision becomes increasingly accepted as the market norm, it may place pressure on lenders to accept the principle that default interest may only be charged for payment defaults. In the meantime, it remains fairly commonplace for South African banks to still insist that default interest be payable in all instances of default.

Stephen Gie

Ringfencing

BEE share deals are often financed through issuing preference shares. In such transactions, a BEE party will typically incorporate a company (SPV) that will purchase shares in the company in which the BEE party wishes to invest (target company). Funding is made available to the BEE party for this purchase of shares in the target company through funders subscribing for preference shares in the SPV.

A common condition for funders' subscribing for these preference shares is the ringfencing of the SPV. Ringfencing limits a company's capacity and powers through amending its constitutional documents. For BEE share deals, this would normally entail restricting the SPV to performing only those acts and functions necessary for the acquisition of the shares in the target company.

However, ringfencing does not mean that the SPV is incapable of acting outside of the ambit of its limited powers and capacity (outside actions). Section 20 of the Companies Act, No 71 of 2008 (Act) states that no action of a company is void by reason only that the action was prohibited by a limitation, restriction or qualification provided for in the company's constitutional documents, and so such actions may remain valid despite their exceeding the company's ringfenced capacity.

Section 20 goes on to provide that each shareholder of a company (including therefore a funder as a preference shareholder in the SPV) has a claim for damages against those who "intentionally, fraudulently or due to gross negligence" cause a company to perform outside actions, unless those outside actions are ratified by the shareholders of the company.

Although section 20 on the face of it would seem to provide a remedy to funders, not only could it be difficult to show that the criteria of "intentionally, fraudulently or owing to gross negligence" have been fulfilled, but worse, the ringfenced SPV's shareholders may subsequently ratify outside actions performed by the SPV, and this ratification would then seem to prevent a claim by a funder.

One possible solution to such a potentially adverse situation arising in relation to a funder would be for the funder to obtain an undertaking from the SPV's other shareholders, in favour of the funder, not to ratify the performance of any outside actions. Should such shareholders of the SPV subsequently ratify any outside actions performed by the SPV, those shareholders will be liable for breach of the undertaking provided to the funder. The undertaking therefore provides an independent basis for a claim by a funder against the shareholders should the SPV engage in outside action, and could also serve as the basis for interdict proceedings to prevent any such attempted ratification taking place in the first instance.

Stephen Gie and Philip Williams

Is a Subordination Agreement binding post the insolvency of a debtor?

In providing funding to a borrower, banks often require that the claims of the borrower's other creditors be subordinated in favour of the bank's claims. The desired effect is that no other creditor may claim payment of monies owed to it by the borrower, until the bank has been paid.

Sometimes the subordination only comes into effect on the happening of a future event, for example, if the borrower defaults on its loan. What if that future event is the insolvency of the debtor? Is the liquidator bound by the provisions of the subordination agreement?

In a judgment handed down in 1929 in *Lind v Lefdal's Pianos, Limited (in liquidation) and Others 1929 TPD 241*, the then Transvaal Provisional Division of the Supreme Court said no. The agreement in question was between a company and certain of its concurrent creditors, and it provided that the funds of the company should be applied as between its creditors in a certain order of priority and that such order should remain binding on the parties in the event of a liquidation. The court held that the liquidator was precluded from giving effect to such priority, and that the agreement was one between the creditors themselves, with which the liquidator was not concerned.

However, in 1993 in *Ex Parte De Villiers and Another NNO*: In re *Carbon Developments (Pty) Ltd [1993] 1 All SA 441 (A*), the Appellate Division said yes, the liquidator is bound. In that case, the loans were subordinated by the loan grantors in favour of the other creditors of the company until such time as the assets of the company exceeded its liabilities.

The court distinguished that agreement from the one in the Lind case on the basis that the latter sought to re-arrange the order in which certain creditors would be paid, whilst the former subordinated the debt. It was held that in the case of debt subordination (as opposed to a re-arranging of the order of payment), the subordinated creditor has no claim unless the other creditors receive payment in full. The court held that the liquidator would be obliged to have regard to a subordination agreement which was valid and in force as at the date of the winding up.

This has since been applied by the Supreme Court of Appeal in the 2002, in *Cape Produce Co (Port Elizabeth) (Pty) Ltd v Dal Maso and Another NNO 2002 (3) SA 752 (SCA)*, where it was held that a subordination agreement does not extinguish a debt, but puts its enforceability into abeyance, subject to certain conditions.

The next question that arises is when the winding up occurs. In the case of an application to court for the liquidation of a company, the winding up occurs when the application is lodged with the court (assuming that the winding up order is ultimately granted). On the winding up, a *concursus creditorum* is instituted. This has been described by *Innes J in Walker v Syfret 1911 AD at 166* as "the hand of the law is laid upon the estate, and at once the rights of the general body of creditors have to be taken into consideration. No transaction can thereafter be entered into with regard to estate matters by a single creditor to the prejudice of the general body. The claim of each creditor must be dealt with as it existed at the issue of the order".

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In order to be valid and in force as at the date of the winding up, the subordination agreement must have been concluded prior to the launching of an application for the liquidation of the borrower.

What of a clause providing that the subordination will take event "upon the liquidation of the borrower"? Our courts have held that a clause in an agreement intended to take effect in the event of, or after, the institution of the concursus creditorem is not effective (*Administrator Natal v Magill Grant & Nell (Pty) Ltd (in liquidation) 1969 (1) SA 660 AD)*. The reasoning in these cases rests on the prejudice that the remaining creditors will suffer if one creditor is preferred by such a clause.

Whether such a clause would be upheld in circumstances where the creditors that would be prejudiced by it are the very creditors that agreed to it does not seem to have been considered by our courts yet.

Our suggestion would be to avoid the debate and ensure that the subordination agreement:

- amounts to more than a simple order of priority for payment, and rather makes the payment of amounts to the subordinated creditors conditional on the discharge of all debts owed to the primary creditor; and
- is effective prior to a winding up, and not only on the happening of a winding up.

Jenny Stolp

Under what circumstances should a borrower be permitted to be a party to an intercreditor agreement

An Intercreditor Agreement is an agreement among lenders that regulates the seniority of debt, the rights and obligations of the lenders and hedge counterparties (if any) and the security enforcement procedure to be adhered to by the parties in the event that the borrower defaults on the facility made available to it.

A situation can arise where a borrower requests to be party to an Intercreditor Agreement. There can be various reasons why the borrower may want to be a party to the Intercreditor Agreement, which can include:

- a mechanism by which the borrower can ensure strict compliance by the lenders with technical or procedural matters, such as standstill periods; and/or
- a mechanism by which a borrower can be made aware of or prohibit any amendments which may be made to the Intercreditor Agreement.

By permitting a borrower to be party to the Intercreditor Agreement, the borrower may have the power to circumvent or delay the lenders rights to enforce the principles of the Intercreditor Agreement. By way of examples:

- If the Intercreditor Agreement provides for a 10 day notice period and the lenders choose to waive and shorten this notice period, the borrower may prohibit such waiver and extension thereby causing a delay in the lenders rights to enforcement.
- If the lenders make a decision to amend the percentage of what constitutes 'majority lenders', which influences the voting rights of the lenders, the borrower may prohibit such amendment in the event that such amendment is not in its favour or delay the enforcement rights as set out in the Intercreditor Agreement.

Therefore, ideally the borrower should not be a party to the Intercreditor Agreement, which is standard practice, unless exceptional circumstances exist, in which event the borrower should have limited rights and this can be achieved in a few ways, which include:

- The lenders can provide a separate stipulatio to the borrower that addresses the borrower's limited rights over clauses that the borrower has an interest in or concern over, such as a standstill clause or the definition of 'majority lenders'. This should be the preferred option as there will be no need for the borrower to be a party to the Intercreditor Agreement should a stipulatio be provided.
- The borrower may be made a party to the Intercreditor Agreement and the agreement can provide a general clause dealing with the borrower's rights, which will provide that the borrower has no rights under the Intercreditor Agreement save for rights under certain specified clauses.
- The less preferred option is for the relevant clauses of the Intercreditor Agreement to be drafted in a way that makes reference to 'lenders', which term excludes the borrower as opposed to 'parties', that term includes the borrower, save for the general specified clauses under which the borrower may have a right to receive notices of or require to consent to. This option may be tricky as each clause will have to be carefully considered and drafted and the risk is that an important clause may be overlooked.

The borrower should therefore be requested to motivate why it wishes to be a party to the Intercreditor Agreement and assuming such reasons are legitimate and acceptable to all the lenders, a workable drafting solution can be achieved which will still sufficiently protect the lenders and their rights of enforcement under the Intercreditor Agreement.

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