Practical considerations when enforcing pledges and cessions of shares

When providing funding to a borrower, lenders will typically require some form of collateral or security as credit support for the funding to be provided. One form that the security can take, is a pledge and cession by the borrower (or by a related party) of the shares that it holds in underlying subsidiaries or investee companies.
A security cession will typically cater for certain realisation rights which allow the cessionary to realise or exercise certain rights in respect of the pledged shares on the occurrence of an event of default. Typical realisation rights will include, without limitation, the right of the cessionary to:

- effect transfer of the pledged shares into the cessionary’s own name, with the intention to do so not as a beneficial owner but as a temporary repository pending disposal of such pledged shares; ¹
- to effect transfer of, or an out-and-out cession of the pledged shares into the cessionary’s own name;
- sell, assign, transfer, realise or otherwise dispose of the pledged shares to a third party; and
- exercise all the rights, powers and privileges attaching to the pledged shares (including any voting rights attaching to the pledged shares).

In terms of South African common law, assets held in security must be taken over or disposed of by a cessionary at their fair market value, and funders should be cognisant that a failure to transfer or dispose of the pledged shares at less than their fair market value may leave such transfer or disposal open to attack by the cedent if the cedent has been prejudiced. Funders should, likewise, give special consideration to any process or timelines prescribed in the security cession with respect to the determination of the fair market value of the pledged shares as these can present obstacles to a cessionary expeditiously executing on its security.

Funders should also bear in mind the considerations below when concluding security cessions.

¹ This is applicable where a cessionary may want to take registered (but not beneficial) ownership of the pledged asset, to house them as nominee until an appropriate beneficial owner is identified – for example, where the cessionary does not, itself, want to bear the tax consequences of beneficially owning the pledged shares.
ownership of more than one half of the issued share capital, or the right to determine the majority of votes at a general meeting (so called “de jure” control). Moreover, control may also be established on a “de facto” basis where there is an ability to “materially influence” the operations of the firm in question – this brings so-called “step-in rights” of security into the ambit of the merger control provisions under the Competition Act.

Consequently, exercise by a cessionary of its rights in terms of a pledge of the majority of the shares, or other controlling rights, would need to be notified to the competition authorities where the financial thresholds are met, given that an enforcement by the cessionary of its rights could arguably result in the cessionary acquiring control over the company that is the object of the security cession. A notifiable merger may not be implemented unless and until it is approved by the competition authorities.

However, a limited reprieve is contained in the Competition Commission’s Practitioner’s Update (Issue 4 – The application of merger provisions of the Competition Act 89 of 1998, as amended, to risk mitigation financial transactions). In terms of the update, where a registered bank or state-owned finance institution acquires an asset or a controlling interest in company through the exercise of security, notification of the transaction would only be required where the bank fails to dispose of the asset or controlling interest with 24 months of it having acquired control. Importantly, this concession does not apply to any other lenders or holders of security.

It should be noted that a failure by a cessionary to obtain prior competition approval, when applicable, may result in penalties equalling up to 10% of the annual turnover of the merging parties being levied. The transaction could also be interdicted pending approval and, if it offends competition or the public interest, set aside.

All intermediate and large mergers are subject to notification to and prior approval by the Competition Commission. An intermediate merger is triggered where the combined assets or turnover of the merging parties equal or exceed R600 million and the assets or turnover of the target firm equal or exceed R100 million. A large merger is triggered where the combined assets or turnover of the merging parties equal or exceed R6,6 billion and the assets or turnover of the target firm equal or exceed R190 million.

<table>
<thead>
<tr>
<th>THRESHOLDS</th>
<th>COMBINED TURNOVER/ASSET VALUE</th>
<th>TARGET TURNOVER/ASSET VALUE</th>
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</thead>
<tbody>
<tr>
<td>LOWER</td>
<td>R600 million</td>
<td>R100 million</td>
</tr>
<tr>
<td>HIGHER</td>
<td>R6,6 billion</td>
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ENFORCEMENT
A disadvantage of acquiring shares in a company through enforcement is that the cessionary or third party acquires their interest in the company whose shares were pledged without any representations, warranties or indemnities in respect to the state and viability of the company and its operations. Funders, instead, could seek to acquire the shares by way of a consensual sales process in an effort both to preserve value for all stakeholders and to benefit from the added protections that an acquiror would have under typical sale agreements.

A parallel, non-consensual, enforcement sale process can then simultaneously be run to ensure that funder interests are protected where the consensual sales process fails (for instance, where any requisite shareholder approvals in respect of the disposal of the assets are not obtained). Where an event of default has occurred and has not been remedied, the borrowing company would typically be in distress and the non-consensual sale process can, in such instances, be implemented through business rescue with an agreed “pre-packed” sale being place. This means that the funder and the borrower work together to prepare the necessary documentation so that the sale can be given effect through the implementation of an adopted business rescue plan. Borrowers ordinarily try to avoid business rescue, and this could serve as a further incentive to implement the consensual sale process.

While this article outlines some high-level considerations to be borne in mind when dealing with pledges and cessions of shares, we strongly encourage funders to seek appropriate legal advice to ensure that their interests are adequately protected, and their risks are mitigated.

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