Corporate & Commercial

ALERT | 2 May 2024

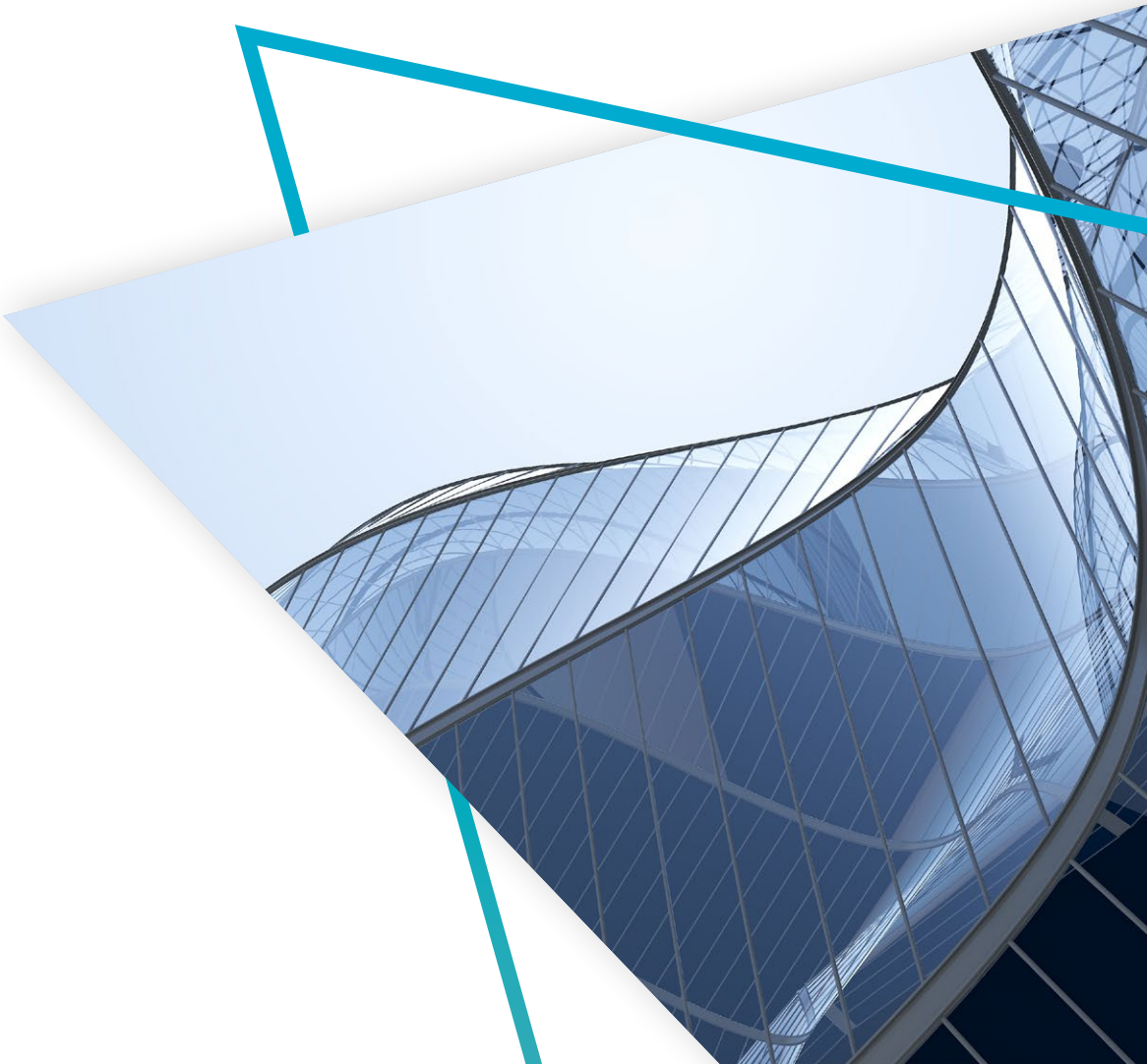
CDH INCORPORATED

In this issue

SOUTH AFRICA

- General considerations when providing or taking security
- Embracing privatisation of the rail industry in South Africa: Transnet's Network Statement

For more insight into our expertise and services



General considerations when providing or taking security

All commercial agreements have varying degrees of risks associated with them – how those exposures are mitigated, underwritten and secured is crucially important for the sustainability any transaction. This article seeks to identify some practical considerations that should be taken into account when taking or providing security. These include key principles on how to keep security simple and focused on its purpose, as well as guidance on how best to mitigate risks, ensuring sustainable and commercially viable agreements, particularly in funding transactions.

Last things first: "*Perfection*" and the removal of obstacles to enforcement

Lawyers often find themselves trawling through corporate constitutions to verify the powers and capacity of a borrower to take on external funding and provide security for their repayment obligations. Although restrictions on external borrowings and related security over company assets do still find their way into some memoranda of incorporation or similar constitution documents, this is the exception rather than the rule – the modern corporate constitution is generally permissive, except in some cases. For example, where shareholder minority protections require replication in the memorandum of incorporation in order to be enforceable under South African law.

That may all be good and well, but what lawyers sometimes miss in the process are the embedded hurdles in a corporate constitution that could obstruct enforcement of security if that ever becomes necessary. Although the notion of "*perfected*" security is not a legal term in South Africa, it does have a somewhat loose practical meaning associated with it. Generally, lawyers understand it to imply that mortgages and notarial bonds are required to be registered in order to be enforceable. It is also sometimes taken to mean that the steps required to ensure that obstacles to enforcement have been removed, have in fact been taken (before the exposure which is being secured against actually arises, e.g. prior to disbursement of a loan to a borrower). One example of this is often found in standard private company memoranda of incorporation or similar constitution documents, namely the embedded right of directors to refuse to recognise a transfer of shares and have the register of members updated for such a transfer (with the historic reason for the restriction being the need to protect 'private company' status through a limitation of transferability). The implications for security over shares are self-evident – at a time when financiers need it most, the borrower or its board, is able to frustrate a transfer of its shares, or at least to dilute the threat of imminent enforcement and therefore the leverage of lenders (not so much leverage against the borrower itself as leverage against fellow creditors).

Assessing constitutional documents for possible limitations

Recently, we concluded a cross-border lending transaction where the security included pledged shares in a company. Upon closer inspection, the very last article on the final page of the articles of association of the company in question contained a typical private company restriction where the board of directors could refuse registration

General considerations when providing or taking security

CONTINUED

of a transfer of shares. This meant that the lender would have risked delay, potential litigation expense or even loss as a result of valuation movements before being able to ultimately enforce the security. To resolve that, the company had to amend its articles to remove the restrictive wording.

It is imperative that lawyers always properly assess constitutional documents for possible limitations of this nature. Founding documents may contain restrictions in relation to (i) borrowing powers, (ii) guarantees, (iii) prohibitions on financial assistance, (iv) limitations on encumbrances on assets, (v) shareholder consents or notifications for specific transactions, (vi) voting thresholds for special and ordinary votes, and (iv) ring fencing provisions where the company is to serve a very narrow and specific purpose. These all actually go to the powers and capacity of the company to engage in transactions of this nature. A restriction in the form of a right in favour of directors to refuse to recognise a transfer of shares in the company would not, but this does in fact pose a potential problem upon enforcement.

The general practice in the South African debt markets is to require that the applicable board adopts a resolution where it recognises the existence of security and undertakes to give effect to a transfer of shares that might occur if the security is ever enforced. The potential problem with this is that board resolutions are capable of revocation without much complication – while this may constitute and event of default at that time, it would merely add to an existing list of defaults and create scope for obstructionism. There might be a robust basis for challenging such a revocation, but that would cost time and money and the first prize would always be to avoid such a situation in the first place. South African lawyers should consider whether the practice in certain overseas jurisdictions of removing the restriction in the articles, is worth following here.

Security must not be restrictive over the business of the borrower

Keeping things simple, security must be limited to its purpose, with actual restrictions on the business of the security provider set at a level which is appropriate and necessary – operational interference can be counterproductive for a lender that ultimately wants its money back and doesn't want to spend its days monitoring loans and related borrower operational matters. Here is an example from a standard loan agreement of the typical *"negative pledge"* provided by a borrower and/or guarantor in relation to its assets:

"A borrower or security provider may not:

- *sell, transfer or otherwise dispose of any of its assets;*
- *sell, pledge, transfer or otherwise dispose of any of its receivables on recourse terms;*
- *enter into or permit to subsist any title retention arrangement;*
- *enter into or permit to subsist any arrangement under which money or the benefit of a bank or other account may be applied, set-off or made subject to a combination of accounts; or*
- *enter into or permit to subsist any other preferential arrangement having a similar effect."*

General considerations when providing or taking security

CONTINUED

It is sometimes said that the negative pledge is the 'Holy Grail' of senior loan financing. They are found in every properly drafted senior loan agreement, whether investment grade or leveraged finance – and everywhere in between. At the same time, they are by their nature restrictive. Foreseeably, depending on the nature of the business, these provisions could impede its ongoing operations and decisions. Normally, assets that are provided as security include shares, movable and immovable property, bank accounts, insurance proceeds, certain contractual rights, and intellectual property; each with its own specific formalities and requirements for creating security and perfection requirements. Therefore, in as much as security needs to be tight, when negotiating the negative pledge and related security provisions, careful consideration must be given to the terms of those provisions. The best examples of assets potentially affected by these provisions are trading stock, debtors and cash – all working capital or "*floating capital*" which presupposes a continuous movement in the balances of these assets (if there were not, one would be concerned). Borrowers need to dispose of stock, transfer cash and sue or otherwise collect debtors, which in the last case is not possible where a security cession of the debt remains in place without a re-cession to the borrower in order to establish locus standi. Accordingly, it is important that the typical negative pledge and security documents allow flexibility in this regard.

Risk must be allocated to the party best capable to take it on

A simple basis for contractual risk allocation generally is said to be that risks must always be allocated to and, where appropriate, secured by, parties best capable of doing so. This principle becomes abundantly clear in more complex transactions such as structured project finance deals, where risk arises across a wide spectrum of counterparts and areas, government as a counterparty or permitting agent, land, construction and operations – to name a few. Normally in these complex arrangements, one has to take a step back and put together a risk matrix to ensure that the risks are secured by the appropriate party. The proper approach therefore is to say:

- What is the risk?
- Who is the risk taker, the risk allocation?
- Identify the risk mitigant, the appropriate party best capable to mitigate the risk.

The examples below practically demonstrate this principle – the risk category, the risk allocation and pass-through to the party most capable to secure the risk.

General considerations when providing or taking security

CONTINUED

Financial risks: These include insolvency risk, asset risk and taxation risk. Insolvency is a lender risk and is best managed by early events of default triggers, financial covenants and guarantees, and security documents may include a letter of credit, guarantee and security assets. Asset risk is secured by maintenance covenants and residual value guarantees, or even repossession.

Construction risks: These could occur in the form of delay, insolvency of a contractor, or failure to build to specification. The borrower normally bears the construction risk. In mitigation, the best party capable to take that risk is the contractor, via pass-through mechanisms from the borrower to the contractor and an added layer of security such as performance guarantees or bonds provided by the contractor, borrower indemnities and other measures such as draw stops.

Operational risks: These encompass asset loss or damage, environmental risk or third-party liability, etc. At a minimum these risks are best managed though an insurance policy provider, at the back of borrower indemnities or covenants, or via maintenance reserve facilities to ensure that the operational assets of the project remain covered. Pass-through of the risk to the operator could entail the provision of guarantees or letters of credit by the operator or its parent.

Political risks: Political risks include adverse government policies or actions, civil strife, war or political events that depreciate the value of an asset or business. These are events that fall outside the hands of the parties to a financing and are best mitigated by political risks insurance (PRI) provided by either a national export credit agencies or private PRI insurance providers.

This is not an exhaustive list of risks that can be identified in commercial transactions, the main point is to demonstrate the principle that whenever we look at risk, we need to think about the best party capable to secure that risk.

Johan de Lange and Zipho Tile

CONSISTENTLY EFFECTIVE

DealMakers

2023
1st by M&A Listed Deal Flow.
2nd by M&A Unlisted Deal Flow.
by M&A Unlisted Deal Value.
by M&A Listed & Unlisted BEE Deal Flow.
by General Corporate Finance Deal Value.
4th by General Corporate Finance Deal Flow.

2022
1st by M&A Listed Deal Flow.
3rd by M&A Listed Deal Value, M&A Unlisted Deal Value, M&A Unlisted Deal Flow and General Corporate Finance Deal Value.

2021
1st by M&A Deal Flow.
2nd by General Corporate Finance Deal Flow.
2nd by BEE Deal Value.
3rd by General Corporate Finance Deal Flow.
3rd by BEE Deal Flow.
4th by M&A Deal Value.

2020
1st by M&A Deal Flow.
1st by BEE Deal Flow.
1st by BEE Deal Value.
2nd by General Corporate Finance Deal Flow.
2nd by General Corporate Finance Deal Value.
3rd by M&A Deal Value.
Catalyst Private Equity Deal of the Year.

Embracing privatisation of the rail industry in South Africa: Transnet's Network Statement

In a move geared towards transforming the rail sector, Transnet SOC Limited (Transnet) issued its draft Network Statement (Statement) for public comment on 19 March 2024, outlining the means for privatisation of its rail network. This Statement gives effect to the rail reform set out in the National Rail Policy (adopted by Cabinet in 2022), the Freight Logistics Roadmap and the Private Sector Participation Framework. However, several elements are contentious, including the proposed minimum access fee to the rail network, proposed security measures, and the means of allocation of capacity.

The Statement delineates the requirements and application process for private train operator companies (TOCs) to access Transnet's rail network overseen by Transnet's Infrastructure Manager (IM). It also sets out the functions and powers of the IM.

The application process is detailed, including minimum requirements such as completing self-screening checklists, conducting site visits and providing undertakings to participate in the IM's "*Community and Social Development Plans*", "*Supplier Development Plans*" and "*Skills Development Plans*". Successful TOCs must submit a "*Risk Analysis*" of their intended operations and sign the TOC-IM Interface Agreement. TOCs must have a "*Railway Safety Regulator Rail Safety Permit*" and a "*License to Operate*" before being allowed access to the network.

The Statement provides that TOCs shall be granted, under equitable, non-discriminatory and transparent conditions, the right to access railway infrastructure for "*Transport Services*". This includes access to infrastructure connecting maritime ports, inland terminals and other service facilities offered by the IM. Capacity is stated to be allocated by the IM in a "*fair, transparent and equitable manner*" and by fulfilling objectives such as maximising Transnet's rail network utilisation; enabling growth objectives of critical strategic economic sectors; migrating traffic from road to rail; achieving full cost recovery; and injecting infrastructure investment through access tariffs. Unfortunately, no further context or detail is given to these equity principles.

Additionally, the IM has the power to temporarily withdraw infrastructure capacity or part thereof where they are out of use due to technical malfunctions, accidents or damage. The IM will offer the TOCs alternative train paths "*where possible*" and must compensate TOCs for any damage arising from such disruptions (unless otherwise agreed to in the Rail Access Agreement). The IM is also entitled to take away capacity not used at 75% over a pre-defined three-month period and to allocate such capacity to the next ranked TOC based on the outcome of the evaluation of applications for capacity.

Embracing privatisation of the rail industry in South Africa: Transnet's Network Statement

CONTINUED

Proposed minimum access fee

The proposed minimum access fee from Transnet, set at a rate of 19,79 cents/gross ton per kilometre, has drawn significant attention in the rail industry. This fee is based on gross weight, which includes the weight of the train, rather than net weight, consequently increasing transport costs and costs across the supply chain. The IM is said to set tariffs for three to five years with provisions for minor annual reviews (in limited parameters, for inflation, interest rates and energy prices) and major reviews every five years.

Interestingly, in terms of Transnet's Rail Access Tariff Methodology 2024/2025 Discussion Paper released with the Statement, it is stated that Transnet's Freight Rail Operator declared this minimum access fee to be unaffordable, which inherently contradicts Transnet's position in the Statement. The discussion paper also states that the IM may consider phasing in the tariff over a five-year period, though funding may be required to ensure that the IM has adequate funds for its short-term requirements. Given this incongruence, there is a possibility that Transnet may revise the minimum access fee.

Security issues across the rail network

Transnet has also attempted to address the widespread theft and vandalism across the rail network, and notably has included *"acts of theft"* as an event of Force Majeure. This effectively allows any train to be cancelled due to *"acts of theft"* and Transnet's (and the IM's) obligations to be suspended – a concerning provision given the prevalence of theft across the network. Additionally, the Statement provides that matters or circumstances beyond the IM's control may force the IM to make deviation management intervention decisions, including cancellations, staging, replanning, rescheduling or rerouting of trains without input from all stakeholders.

In respect of the security issues that have been a burden for the rail industry for years, the Statement only provides a standard proviso to address this without adequate detail, namely that *"security service providers will enforce a mix of physical guarding, armed response teams, and interventions to address organised crime groupings behind the illicit copper market"*. Additionally, each TOC must have its own security plan that covers cargo. These provisions do not adequately address the issues faced by Transnet in respect of security, which has created immense costs for Transnet, operational delays in the network and the loss of thousands of kilometres of its railway tracks. These issues have also resulted in the network being unreliable for the rail industry (and the economy at large), a decline in freight volumes in the network and weakening of the economy due to disrupted shipments, among other things. These provisions will need to be detailed by Transnet in order to give effect to the National Rail Policy and provide adequate comfort to industry stakeholders as to the reliability of the network for future private use.

Embracing privatisation of the rail industry in South Africa: Transnet's Network Statement

CONTINUED

Conclusion

Ultimately, the Statement represents a crucial step forward for the rail industry (and commodity providers reliant on rail services) which has been monopolised by Transnet, now opening the door to private investment. This also presents a means for Transnet to reduce its vast debt, increase the freight volumes in the network, which have been at a decline due to Transnet's underperformance, and ultimately improve the economy. However, substantial consultations and amendments are needed to appease industry stakeholders before privatisation of the rail sector can be effectively implemented, particularly to account for the negatively received minimum access fee (which seems to be recognised as "*unaffordable*" by Transnet itself), as well as several challenges identified and undertakings made in the National Rail Policy, such as competitive price setting and to adequately address the security issues (including theft and vandalism) in the network.

Interested parties should submit written comments on the Statement by 20 May 2024.

Vivien Chaplin and Gaby Wesson

Chambers Global 2024 Results

Corporate & Commercial

Chambers Global 2021–2024 ranked our Corporate & Commercial practice in: **Band 1**: Corporate/M&A and in

Chambers Global 2024 ranked our Corporate & Commercial practice (Kenya) in Band 4 Corporate/M&A.

Chambers Global 2024 positioned our Private Equity sector in the "**spotlight**".

Ian Hayes ranked by Chambers Global 2022–2024 in **Band 1**: Corporate/M&A.

David Pinnock ranked by Chambers Global 2022–2024 in **Band 1**: Private Equity.

Peter Hesseling ranked by Chambers Global 2022–2023 in **Band 2**: Corporate/M&A and in **Band 3**: Capital Markets: Equity in 2023–2024.

Willem Jacobs ranked by Chambers Global 2022–2024 in Band 2: Corporate/M&A and in **Band 3**: Private Equity.

Sammy Ndolo ranked by Chambers Global 2021–2024 in **Band 4**: Corporate/M&A.

David Thompson ranked by Chambers Global 2024 in **Band 5:** Corporate/M&A.

Vivien Chaplin ranked by Chambers Global 2024 in **Band 5**: Corporate/M&A.

Chambers TOP RANKED Global 2024
Cliffe Dekker Hofmeyr

OUR TEAM

For more information about our Corporate & Commercial practice and services in South Africa and Kenya, please contact:

Ian Hayes
Practice Head & Director:
Corporate & Commercial
T +27 (0)11 562 1593
M +27 (0)83 326 4826
E ian.hayes@cdhlegal.com

David Thompson
Deputy Practice Head & Director:
Corporate & Commercial
T +27 (0)21 481 6335
M +27 (0)82 882 5655
E david.thompson@cdhlegal.com

Sammy Ndolo
Managing Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E sammy.ndolo@cdhlegal.com

Kate Anderson
Director:
Corporate & Commercial
T +27 (0)11 562 1105
M +27 (0)82 418 3784
E kate.anderson@cdhlegal.com

Tessa Brewis
Director:
Corporate & Commercial
T +27 (0)21 481 6324
M +27 (0)83 717 9360
E tessa.brewis@cdhlegal.com

Vivien Chaplin
Sector Head: Mining & Minerals
Director: Corporate & Commercial
T +27 (0)11 562 1556
M +27 (0)82 411 1305
E vivien.chaplin@cdhlegal.com

Clem Daniel
Director:
Corporate & Commercial
T +27 (0)11 562 1073
M +27 (0)82 418 5924
E clem.daniel@cdhlegal.com

Johan de Lange
Deputy Practice Head:
Finance & Banking
Director: Projects & Infrastructure
T +27 (0)21 481 646
M +27 (0)78 642 5573
E johan.delange@cdhlegal.com

Andrew Giliam
Director:
Corporate & Commercial
T +27 (0)21 481 6363
M +27 (0)83 359 7069
E andrew.giliam@cdhlegal.com

John Gillmer
Joint Sector Head: Private Equity
Director: Corporate & Commercial
T +27 (0)21 405 6004
M +27 (0)82 330 4902
E john.gillmer@cdhlegal.com

Allan Hannie
Director:
Corporate & Commercial
T +27 (0)21 405 6010
M +27 (0)82 373 2895
E allan.hannie@cdhlegal.com

Peter Hesseling
Director:
Corporate & Commercial
T +27 (0)21 405 6009
M +27 (0)82 883 3131
E peter.hesseling@cdhlegal.com

Quintin Honey
Director:
Corporate & Commercial
T +27 (0)11 562 1166
M +27 (0)83 652 0151
E quintin.honey@cdhlegal.com

Willem Jacobs
Director:
Corporate & Commercial
T +27 (0)11 562 1555
M +27 (0)83 326 8971
E willem.jacobs@cdhlegal.com

Rachel Kelly
Director:
Corporate & Commercial
T +27 (0)11 562 1165
M +27 (0)82 788 0367
E rachel.kelly@cdhlegal.com

Yaniv Kleitman
Director:
Corporate & Commercial
T +27 (0)11 562 1219
M +27 (0)72 279 1260
E yaniv.kleitman@cdhlegal.com

Dane Kruger
Director:
Corporate & Commercial
T +27 (0)21 481 6362
M +27 (0)74 914 1402
E dane.kruger@cdhlegal.com

André de Lange
Sector Head: Agriculture, Aquaculture
& Fishing Sector
Director: Corporate & Commercial
T +27 (0)21 405 6165
M +27 (0)82 781 5858
E andre.delange@cdhlegal.com

Martha Mbugua
Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E martha.mbugua@cdhlegal.com

Jaco Meyer
Director:
Corporate & Commercial
T +27 (0)11 562 1749
M +27 (0)83 477 8352
E jaco.meyer@cdhlegal.com

Anita Moolman
Director:
Corporate & Commercial
T +27 (0)11 562 1376
M +27 (0)72 252 1079
E anita.moolman@cdhlegal.com

Wayne Murray
Director:
Corporate & Commercial
T +27 (0)21 405 6018
M +27 (0)79 691 0137
E wayne.murray@cdhlegal.com

OUR TEAM

For more information about our Corporate & Commercial practice and services in South Africa and Kenya, please contact:

Francis Newham
Executive Consultant:
Corporate & Commercial
T +27 (0)21 481 6326
M +27 (0)82 458 7728
E francis.newham@cdhlegal.com

David Pinnock
Joint Sector Head: Private Equity
Director: Corporate & Commercial
T +27 (0)11 562 1400
M +27 (0)83 675 2110
E david.pinnock@cdhlegal.com

Allan Reid
Director:
Corporate & Commercial
T +27 (0)11 562 1222
M +27 (0)82 854 9687
E allan.reid@cdhlegal.com

Jess Reid
Director:
Corporate & Commercial
T +27 (0)11 562 1128
M +27 (0)83 571 6987
E jess.reid@cdhlegal.com

Megan Rodgers
Sector Head: Oil & Gas
Director: Corporate & Commercial
T +27 (0)21 481 6429
M +27 (0)79 877 8870
E megan.rodgers@cdhlegal.com

Ludwig Smith
Joint Sector Head:
Financial Institutions, Services & Fintech
Director: Corporate & Commercial
T +27 (0)11 562 1500
M +27 (0)79 877 2891
E ludwig.smith@cdhlegal.com

Tamarin Tosen
Director:
Corporate & Commercial
T +27 (0)11 562 1310
M +27 (0)72 026 3806
E tamarin.tosen@cdhlegal.com

Roxanna Valayathum
Joint Sector Head: Pharmaceuticals
Director: Corporate & Commercial
T +27 (0)11 562 1122
M +27 (0)72 464 0515
E roxanna.valayathum@cdhlegal.com

Roux van der Merwe
Director:
Corporate & Commercial
T +27 (0)11 562 1199
M +27 (0)82 559 6406
E roux.vandermerwe@cdhlegal.com

Andrew van Niekerk
Head: Projects & Infrastructure
Director: Corporate & Commercial
T +27 (0)21 481 6491
M +27 (0)76 371 3462
E andrew.vanniekerk@cdhlegal.com

Njeri Wagacha
Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E njeri.wagacha@cdhlegal.comm

Charl Williams
Director:
Corporate & Commercial
T +27 (0)21 405 6037
M +27 (0)82 829 4175
E charl.williams@cdhlegal.com

Alistair Young
Director:
Corporate & Commercial
T +27 (0)11 562 1258
M +27 (0)84 676 1171
E Alistair.young@cdhlegal.com

Emma Hewitt
Practice Management Director:
Corporate & Commercial
T +27 (0)11 562 1635
M +27 (0)82 896 1332
E emma.hewitt@cdhlegal.com

Alecia Pienaar
Counsel:
Environmental Law
M +27 (0)82 863 6272
E alecia.pienaar@cdhlegal.com

Christelle Wood
Counsel:
Corporate & Commercial
T +27 (0)11 562 1372
M +27 (0)83 498 2850
E christelle.wood@cdhlegal.com

BBBEE STATUS: LEVEL ONE CONTRIBUTOR
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.

PLEASE NOTE
This information is published for general information purposes and is not intended to constitute legal advice. Specialist legal advice should always be sought in relation to any particular situation. Cliffe Dekker Hofmeyr will accept no responsibility for any actions taken or not taken on the basis of this publication.

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

NAIROBI
Merchant Square, 3rd floor, Block D, Riverside Drive, Nairobi, Kenya. P.O. Box 22602-00505, Nairobi, Kenya.
T +254 731 086 649 | +254 204 409 918 | +254 710 560 114
E cdhkenya@cdhlegal.com

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

©2024 13416/MAY

CDH INCORPORATED