Finance & Banking

ALERT | 29 February 2024

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SOUTH AFRICA

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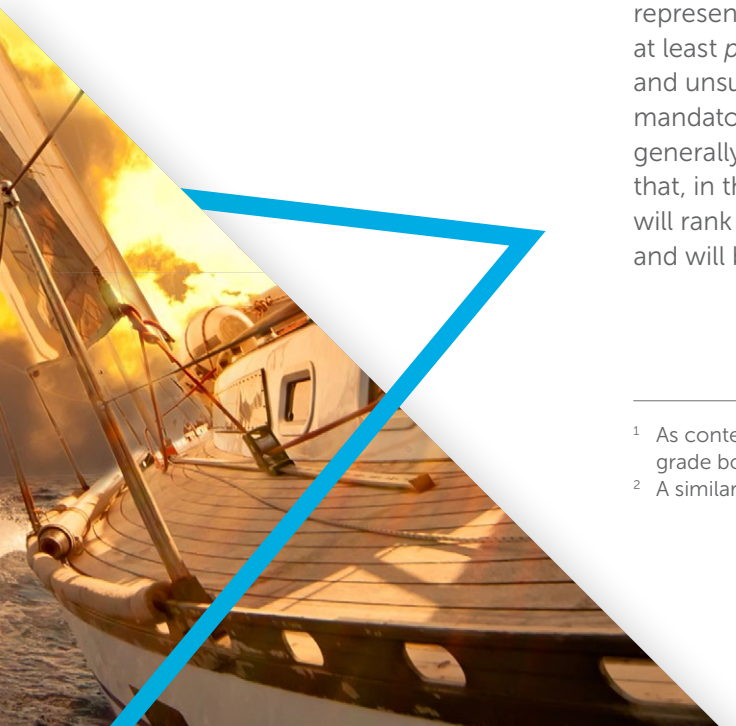
The *pari passu* principle in loan transactions



An important, yet undervalued principle in loan transactions is the *pari passu* principle. The principle concerns the ranking of lenders' claims and concomitant security rights in loan transactions. In this article, the meaning and scope of the *pari passu* principle in loan transactions is discussed.

Our courts have interpreted the term *pari passu* to mean *equally* and *without preference*. The judgments in *Nulliah v Harper* 1930 AD 141, *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Collieries* 1979 (3) SA 713 (W) and *Absa Bank Ltd v Moore and Another* 2017 (1) SA 255 (CC) are some of the judgments that deal with the *pari passu* principle.

In a typical loan transaction,[1] the borrower usually makes a representation that its obligations to repay that loan, rank at least *pari passu* with the claims of all its other unsecured and unsubordinated creditors, except for obligations mandatorily preferred by law applying to companies generally. The borrower thereby effectively represents that, in the case of an unsecured loan,[2] the lender's loan will rank equally and without preference to other loans and will be repaid rateably along side all its other debt, with the exception that the law may determine a different order for the ranking of claims. A borrower making such a representation ought to satisfy itself that this is in fact the case, and that other lenders do not enjoy preferential payment rights. Such a *pari passu* clause gives the lender the comfort that legally, there is a parity of claims, and that no claim will be paid in preference to its claim.

There is usually a further representation by the borrower that any security provided by the borrower or any other obligor, has or will have the ranking in priority expressed in the security documents, or first ranking priority, and it is not subject to any prior ranking or *pari passu* ranked security. The borrower thereby represents that the security has the ranking, or status in law, that the borrower professes it has, including that it does not rank equally and without preference to other security rights, that is, it ranks ahead of other security. Similarly, a borrower making such a representation ought to satisfy itself that this is in fact the case, and that other lenders do not enjoy preferential security rights. The *pari passu* clause in the context of security gives the lender the comfort that legally, the security rights have the ranking that the borrower represents they have.

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[1] As contemplated in the Loan Market Association's Single Currency Secured Term Facility Agreement dated 21 December 2018 written for investment grade borrowers in the South African market.

[2] A similar representation is usually made in respect of loans for which security is given.

The *pari passu* principle in loan transactions

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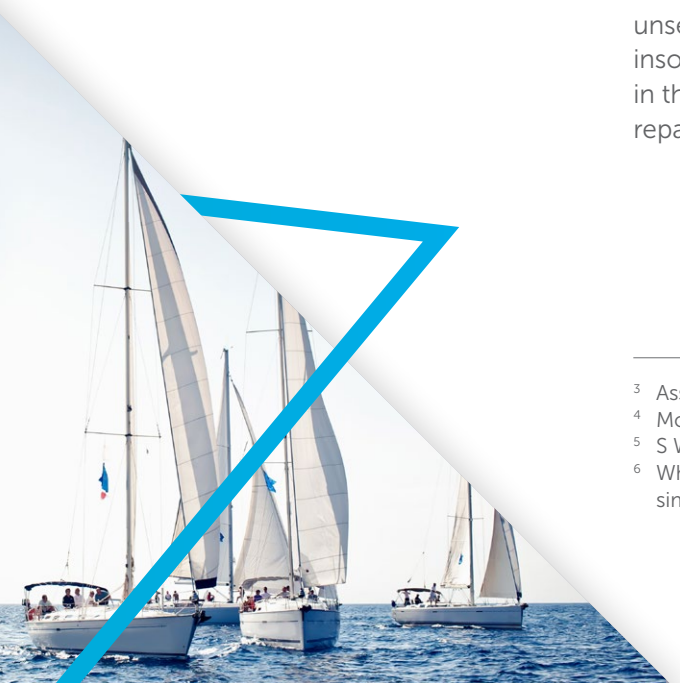

When payment rights are enforced

The recommended due diligence investigation by borrowers as to the legal and factual correctness of their *pari passu* representations is especially necessary for borrowers who have taken out many loans with different lenders. It is submitted that the *pari passu* representation in respect of both loans and security rights ceases to be factually true and loses its value at the point in time when an aggrieved lender successfully enforces its payment rights (whether pursuant to a contractual demand with which the borrower complies or by obtaining a court order) against a borrower because it defaulted on its loan repayment obligations as the aggrieved lender's loan will be repaid ahead of any other unpaid loans.

The taking of security establishes a priority of claims as between lenders and appears practically to render the *pari passu* clause in respect of loans somewhat oblique on the borrower's insolvency as between secured lenders and unsecured lenders. The reason is that on the borrower's insolvency, the lenders that hold security as contemplated in the Insolvency Act 24 of 1936 (Insolvency Act), will be repaid first from the proceeds of the sale of the assets over which security is held before preferent creditors and concurrent creditors are paid. In these circumstances, there will be no payment rights or security rights that rank equally and without preference. It has been held in English law that the *pari passu* clause applies on the borrower's insolvency, not before,[3] and that it is consequently incorrect to interpret the clause as meaning that the borrower is prevented from making payments to another creditor before the advent of its insolvency, unless the borrower simultaneously pays the lender whose facility agreement contains a *pari passu* clause.[4]

The *pari passu* representation in respect of both loans and security rights may be framed as a repeating representation, which is designed to ensure that certain basic facts relating to the *pari passu* ranking of the loan repayment obligations and the related security rights, remain as they originally were.[5] Repeating representations are typically required to be true on each draw down date of the facility and on the first day of each interest period. It is for this reason that a *pari passu* repeating representation applies both prior to, and on, the borrower's insolvency.[6]

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[3] Assuming the clause is worded as described in the third paragraph of this article.
[4] McKnight, Paterson & Zakrzewski *The Law of International Finance* 2 ed (Oxford University Press, 2017) 182 paras 3.18.10 and 3.18.10.1.
[5] S Wright *The Handbook of International Loan Documentation* 2 ed (Palgrave Macmillan, 2014).
[6] Whether that means that the borrower is prevented from making payments to another creditor before the advent of its insolvency unless the borrower simultaneously pays the lender whose facility agreement contains *a pari passu* clause is an open question to be decided by our courts.

The *pari passu* principle in loan transactions

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The borrower will commit an event of default under the facility agreement if its *pari passu* representation in respect of the loan or security rights ceases to be true in any of the abovementioned or other circumstances.[7]

An interesting legal question is whether lenders who each hold different forms of security rights, such as, for example, bonds, cessions in *securitatem debiti*, guarantees (a form of *quasi* security as it is not mentioned in the definition of *security* in section 2 of the Insolvency Act) and pledges, can be said to hold *pari passu* security as between or amongst each other. It is submitted that each form of security will need to be assessed and compared to the other forms of security in order to determine its relative ranking as against the other security, so as to arrive at a legally defensible answer. Considerations when making such a determination may include, amongst others, the legal structure and substance of the security, the ease or difficulty of enforcing the security and the lenders' respective legal positions on the borrower's insolvency.

Dr A Kariem

[7] See clause 22.3 (titled *Other obligations*) of the Loan Market Association's Single Currency Secured Term Facility Agreement dated 21 December 2018 where it is an event of default if an obligor does not comply with any provision of the finance documents (other than clause 22.21 (titled *Non-payment*) and clause 22.2 (titled *Financial covenants and other obligations*)), and fails to remedy it within any applicable grace period.

OUR TEAM

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

Mashudu Mphafudi
Practice Head & Director:
Finance & Banking
T +27 (0)11 562 1093
E mashudu.mphafudi@cdhlegal.com

Johan de Lange
Deputy Practice Head:
Finance & Banking
Director: Projects & Infrastructure
T +27 (0)21 481 6468
E johan.delange@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

Sabelo Goma
Director:
Finance & Banking
T +27 (0)11 562 1602
E sabelo.goma@cdhlegal.com

Dr Adnaan Kariem
Director:
Finance & Banking
T +27 (0)21 405 6102
E adnaan.kariem@cdhlegal.com

Mbali Khumalo
Director:
Finance & Banking
T +27 (0)11 562 1765
E mbali.khumalo@cdhlegal.com

Jacqueline King
Director:
Finance & Banking
T +27 (0)11 562 1554
E jacqueline.king@cdhlegal.com

Pitso Kortjaas
Joint Sector Head:
Consumer Goods, Services & Retail
Director: Finance & Banking
T +27 (0)11 562 1589
E pitso.kortjaas@cdhlegal.com

Phetole Modika
Director:
Finance & Banking
T +27 (0)11 562 1625
E phetole.modika@cdhlegal.com

Deon Wilken
Director:
Finance & Banking
T +27 (0)11 562 1096
E deon.wilken@cdhlegal.com

Kuda Chimedza
Senior Associate:
Finance & Banking
T +27 (0)11 562 1737
E kuda.chimedza@cdhlegal.com

Koketso Maake
Senior Associate:
Finance & Banking
T +27 (0)11 562 1618
E koketso.maake@cdhlegal.com

Brian Muchiri
Senior Associate | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E brian.muchiri@cdhlegal.com

Stephanie Goncalves
Professional Support Lawyer:
Finance & Banking
T +27 (0)11 562 1448
E stephanie.goncalves@cdhlegal.com

Michael Bailey
Associate:
Finance & Banking
T +27 (0)11 562 1378
E michael.bailey@cdhlegal.com

Damaris Muia
Associate | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E damaris.muia@cdhlegal.com

Thato Sentle
Associate:
Finance & Banking
T +27 (0)11 562 1844
E thato.sentle@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

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

CDH INCORPORATED