Chambers
Global Practice
Guides

Definitive global law guides offering
comparative analysis from top-ranked lawyers

Acquisition Finance 2022

South Africa: Law & Practice

Ulrike Naumann, Alison Mellon,
Joshua Janks and Theunis Claassen
Bowmans

practiceguides.chambers.com

SOUTH AFRICA

Law and Practice

Contributed by:
Ulrike Naumann, Alison Mellon, Joshua Janks and Theunis Claassen
Bowmans see p.19

CONTENTS

1. MARKET

1.1 Major Lender-Side Players

The South African market has several local commercial and investment banks responsible for the vast majority of arranging and underwriting of acquisition financing in South Africa. These banks will usually syndicate the debt to other local banks and other institutional investors, such as pension funds, insurance companies and asset managers. These institutional investors may become involved directly in acquisition financing but these transactions comprise a smaller percentage of acquisition financing in South Africa.

State-owned lending institutions also play a role in financing acquisitions in a development context, such as a transaction which promotes "transformation" policies. It is common for acquisition finance transactions where the target is a South African company to be structured to meet transformation objectives as set out in legislation and policy. The Broad-Based Black Economic Empowerment Act, 2003 and accompanying codes (BEE) often require ownership by black persons (as such term is defined in legislation). There will often be special financing arrangements by banks or, at times, the target company to ensure the acquisition of equity by the black shareholders.

International banks play a role in acquisition financing domestic transactions, although the domestic financing transactions are mostly led by South African commercial and investment banks. We may be required to advise international banks in transactions which, notwithstanding the target being located in a different jurisdiction, involve target group companies providing security over assets in this jurisdiction.

1.2 Corporates and LBOs

As in other markets, acquisition transactions in South Africa involve either corporates or private equity buyers. The South African economy continues to experience slow growth rates, despite the lifting of the lockdown regulations recently. As a result, South African companies do not receive significant attention from international private equity buyers. Acquisition transactions in these circumstances are more likely to be pursued by corporates.

Because of the COVID-19 pandemic, there has been a slight increase in interest in undervalued South African companies by private equity buyers. Corporates with strong cash reserves also pursued several large and significant acquisition transactions indicating that 2021 was a successful rebound year from the lows of 2020. See **1.3 COVID-19 Considerations**.

1.3 COVID-19 Considerations

Like most jurisdictions, in the early months of the COVID-19 pandemic, South Africa saw a slowdown in planned and new acquisitions. Private equity firms and corporates shifted their focus to more immediate cash-flow concerns. Practically, in the pandemic and continuing into 2021, parties to acquisition transactions may also have experienced initial challenges in obtaining regulatory approval when regulatory offices were closed intermittently due to COVID-19 cases. These issues appear to have improved in 2022 with the lifting of the national state of disaster.

However, since the latter part of 2020 in the aftermath of the COVID-19 pandemic, opportunities for acquisitions have increased. This is evident by the spike in both local investment and foreign direct investment in South Africa during 2021. For companies with cash on their balance sheets and a desire to grow their business, it remains an opportune time to invest in an emerging market such as South Africa. Certain companies that

struggled to respond to the operational challenges posed by lockdown regulations have become undervalued. Other sectors (such as fintech) proved to be resilient and benefitted from a broader shift to technology empowered business. This trend is likely to continue in 2022, as low growth rates are predicted for the South African economy.

The shift to remote work has not affected transaction timelines. It has, in fact, created an opportunity for the accelerated adoption of legal technology in facilitating and closing transactions online, and executing transaction documents using electronic signatures.

2. DOCUMENTATION

2.1 Governing Law

The governing law for most documents in acquisition financing transactions (regardless of whether the transaction is a corporate loan or leveraged buyout) will be South African law.

There are a few exceptions to this principle. Where a South African target company has subsidiaries in other jurisdictions providing security, those specific documents may be governed by the law of a foreign jurisdiction. In addition, certain types of financing which are less typical in South Africa, such as payment-in-kind (PIK) notes or PIK loans, are sometimes governed by the laws of a different jurisdiction.

In addition, transactions may involve a target company located in a different jurisdiction. The reason to involve South African counsel may be either that the purchaser is incorporated in South Africa or South African companies are providing security to financiers for the acquisition finance. In these instances, the financing arrangements are likely to be governed by the laws of the relevant jurisdiction. Only the security documents would be governed by the law of South Africa.

Note that South African courts will generally uphold the choice of a foreign governing law for financing agreements (save in certain circumstances such as illegality under South African law).

2.2 Use of Loan Market Agreements (LMAs) or Other Standard Loans

The LMA facilities agreements for the South African investment grade market, or simpler derivations from these LMA documents, are often used in acquisition financing transactions, particularly if the lenders involved are banks or financial institutions. However, these are not guaranteed as the starting point for the facilities documentation and there are unique market standards for the terms of documents in the South African market. Aspects of the English law-governed LMA documents for a senior facility agreement for a leveraged acquisition finance are also useful to incorporate into South African documents.

Private equity sponsors may request simpler loan documentation than the LMA documents or request to use their own versions of documents. There are no other standard form agreements which apply to acquisition financing transactions.

2.3 Language

There are no requirements relating to the language used in documentation. Despite there being 11 official languages in South Africa, documents for acquisition finance transactions are drafted in English.

2.4 Opinions

It is customary for the legal counsel for the lenders to provide a legal opinion on the validity and enforceability of the senior finance documents, and if a security SPV structure is used (see **5.**

Security, on the capacity and authority of the security SPV).

Legal counsel for the borrower – being, usually, the target company or a newco in the target group – will provide a legal opinion on the capacity and authority of the borrower and any other obligors to enter into the finance documents and any acquisition transaction documents. The senior lenders may also require a legal opinion from the local counsel for the target group on the legality and enforceability of the acquisition transaction documents.

Other legal opinions may include legal opinions provided by local counsel from other jurisdictions on the capacity and authority of obligors in that jurisdiction to enter into the finance documents and acquisition transaction documents, and the legality and enforceability of the applicable finance documents governed by the laws of that jurisdiction. The senior lenders may also require tax opinions on particular aspects of the transaction such as the deductibility of interest paid on the senior facilities, depending on the transaction structure.

3. STRUCTURES

3.1 Senior Loans

The exact structure of the financing arrangements will depend on the purchaser, creditors involved and target group. Senior lenders usually comprise South African commercial and investment banks. Leveraged acquisition finance transactions involve a combination of debt and equity financing. The debt financing is usually made available directly to a newly incorporated company or acquisition vehicle, which uses it to acquire the target company. Aside from the acquisition vehicle, the senior debt may also be made available to the target in order for the target to refinance existing debt and for working capital purposes. The target group is expected to provide security and may be required to enter into hedging arrangements.

The senior lenders establish their priority by ensuring that other creditors lend to a target group company at a higher level in the group structure (ie, by structural subordination). The senior lenders also rely on protections provided in an intercreditor agreement with other creditors (see **4.1 Typical Elements**).

In South Africa, as in other jurisdictions, corporate acquisition transactions are not as complex as leveraged acquisitions. They may be financed either by using pre-existing loan facilities or arranging special facilities.

3.2 Mezzanine/Payment-in-Kind (PIK) Loans

Mezzanine funding in South African acquisition finance transactions can take the form of pure debt, a combination of debt or equity such as redeemable preference share funding or a debt instrument with an equity kicker. In South Africa, redeemable preference share funding is a popular choice for acquisition funders because of the favourable tax treatment of preference shares where the purpose of the funding is to acquire equity in an operating company.

PIK loans or notes are not common. If used, they are often governed by the laws of another jurisdiction. It is also expected that any PIK loans or notes are structurally subordinated in the group structure of the borrowing group.

3.3 Bridge Loans

Bridge facility loans are frequently used in South African acquisition finance transactions, both corporate and leveraged acquisitions, as short-term financing to allow for the acquisition transaction to be completed. These loans are made available for a limited period and may

even be given as intraday loans. The tenor of bridge loans does not normally extend beyond 12 months. The bridge loan is refinanced on or shortly after the implementation of the acquisition finance transaction, usually through the provision of the senior long-term debt.

3.4 Bonds/High-Yield Bonds

High-yield bonds are not commonly used in South Africa for cross-border acquisition financing transactions, largely due to the high cost and inherent currency risk where the bond is issued in another currency. Domestic secured bond and high-yield bond structures are seldom used for domestic acquisition financing transactions.

3.5 Private Placements/Loan Notes

As with PIK loans and notes, loan notes are not commonly used in South African acquisition transactions. However, transactions where a South African company is acquiring a target incorporated in another jurisdiction may involve the provision of loan notes governed by the laws of another jurisdiction.

3.6 Asset-Based Financing

Asset-based financing or lending is on the increase in South Africa. South African businesses tend to require greater flexibility for their financial needs in the current climate. Asset-based financing is more common for borrowers in the manufacturing and services sectors in South Africa.

Structures differ based on the asset being lent against but are similar to those used in other markets. For example, it is common for a company to use its trade receivables to receive financing through an invoice discounting arrangement with lenders. Lenders in South Africa do at times make borrowing base facilities available, in respect of inventory. However, these are not commonly used as part of acquisition finance transactions.

Fixed assets are typically financed through an amortising term loan, which may form part of an acquisition finance transaction.

4. INTERCREDITOR AGREEMENTS

4.1 Typical Elements

Intercreditor agreements deal with various aspects of the relationship between the creditors in the transaction. In an acquisition finance transaction, the parties to the intercreditor agreement would typically be the senior lenders, hedge counterparties, a security SPV (see **5.1 Types of Security Commonly Used**) and, if applicable, any entities providing intra-group loans. There may also be a lender in respect of a general banking facility.

The form of intercreditor agreement most often used in South African transactions follows ideas derived from the LMA format. However, it contains several changes for South African law and practice and, overall, tends to be a simpler document. In addition, and depending on the structure of a transaction, it is common in South Africa for finance providers to agree to a separate subordination agreement in which junior or other creditors subordinate claims against the target or group companies in favour of senior lenders before and on insolvency.

An intercreditor agreement outlines the ranking between the creditors and governs the agreed distribution of proceeds following the enforcement of security. The finance providers agree on the manner in which decisions should be made by all or a majority of the senior lenders, or all finance providers, and matters can only be decided by certain types of finance providers such as a hedge counterparty or the provider of any general banking facility. Examples of decisions which typically require the consent

of all senior lenders would be amendments to key definitions in the senior facilities agreement, and any amendments or waivers which amend the interest rate on those facilities.

Parties other than the senior lenders are generally restricted in the intercreditor agreement regarding any steps upon default or event of default and any enforcement of security, or from receiving payments prior to the scheduled date. Hedging parties are usually in the same position as the senior lenders with respect to security provided by the target group. However, the circumstances in which hedge providers can close out their hedging arrangements are typically subject to restrictions (see **4.3 Role of Hedge Counterparties**).

The intercreditor agreement will typically contain claw-back provisions which enable the facility agent to recover amounts received by a creditor in excess of what that creditor is contractually entitled to receive according to the intercreditor agreement. The intercreditor agreement will also usually govern the appointment, powers and resignation of the administrative or facility agent for the acquisition finance transaction.

4.2 Bank/Bond Deals

High-yield bonds are not generally used in acquisition transactions in South Africa. To the extent that they are used, the structure generally follows that of the New York law-governed high-yield bond documentation.

4.3 Role of Hedge Counterparties

Hedge counterparties are typically party to the intercreditor agreement. A hedge counterparty is restricted from several actions in the intercreditor agreement, such as closing out any hedging arrangements prior to the scheduled date or receiving payment of any amounts prior to a scheduled date. The intercreditor agreement also governs the rights and powers of a hedging counterparty once a default has occurred or security is enforced. A hedging counterparty only participates in the making of certain limited decisions that primarily relate to amendments or waivers to the intercreditor agreement. Importantly, a hedge counterparty does not normally participate in decisions regarding events of default and enforcement of security.

5. SECURITY

5.1 Types of Security Commonly Used

In South Africa, acquisition finance transactions will typically be both guaranteed and secured. It is possible that certain investment grade acquisition finance may be provided on a guaranteed but unsecured basis. Generally, security will be taken over any and all assets of the target group, provided that it is legally permissible, practical and cost-effective to do so.

The security to be provided will be set out in the term sheet agreed between the parties.

Security can be taken over assets in a variety of ways in South Africa. In acquisition finance transactions with multiple lenders, security SPVs are commonly used to structure security provided by obligors. One of the reasons for the popularity of the security SPV structure is that it is uncertain in South African law as to whether security can be created in favour of a security trustee acting as trustee for a group of lenders. The security SPV structure involves the establishment of a newly incorporated company as a security SPV. The security SPV issues a guarantee in favour of the finance parties in respect of the obligations of the borrower (and other obligors) under the finance documents. The obligors provide an indemnity and security in respect of their obligations under the indemnity to the security SPV. The shares in the security SPV are held by an independently administered trust.

Secured acquisition finance transactions could involve security being given over a range of assets. The manner in which security is taken over the assets of a company depend on the nature of each asset. Under South African law, there is no single method pursuant to which security can be taken over all assets simultaneously. The following explanations highlight common types of security given in acquisition finance transactions, according to the nature of asset over which security is to be given.

Security over Immovable Property

Security may be given over immovable property. Immovable property is a broad concept under South African law. The following items are always considered to be immovable property:

- land, minerals in the soil, trees (unless being felled) and growing crops of fruit; and
- a building annexed to the land or an object attached to immovable property, if the attachment in question is so secure that its separation would involve substantial injury to the land, building, object or property, as applicable.

The question of whether the separate identity of an annexed item is preserved, and the annexed item can be detached with relative ease depends on the intention of the item's owner. If the owner intends that the items or buildings should be annexed permanently then those items or buildings are considered immovable property.

An intangible asset is immovable if the tangible asset to which it relates is itself immovable property (for example, mineral rights in land).

Security over immovable property (excluding mineral rights) can only be effected by a special mortgage of immovable property as set out in the Deeds Registries Act, 1937 (DRA). A mortgage bond does not transfer title in the mortgaged immovable property to the party in whose favour the mortgage bond is registered (mortgagee). It creates a limited real right in favour of the mortgagee to have the immovable property sold in execution, and the proceeds applied to settle, or reduce, the debt secured by the mortgage bond.

Security over Tangible Movable Property

Movable property is any property which can be moved from place to place without damage to itself. Generally, all property which is not classified as immovable property is considered to be movable property. A further distinction should be drawn between:

- tangible movable property, which can be handled and touched; and
- intangible movable property, which cannot be handled and touched – common examples are intellectual property, book debts and shares.

Aircraft and ships are considered tangible movable property. However, there are unique legislative requirements for taking security over aircraft and ships.

The most common forms of security that can be granted over tangible movable property are described below.

Pledge

A pledge is a type of mortgage of movable property provided by a borrower (pledgor) in favour of a lender (pledgee) as security for a debt or other obligation. A pledge can be utilised as security for both tangible and intangible movable property.

General notarial bond

A general notarial bond is a mortgage provided by a security provider of all of its tangible movable property in favour of a lender as security for a debt or other obligation. A general notarial

bond does not (in the absence of attachment of the property before insolvency) make the lender a secured creditor of the security provider. Consequently, it is merely a means of obtaining a limited statutory preference above the claims of concurrent creditors in the borrower's insolvent estate, not a true mortgage of movable property.

Special notarial bond

A special notarial bond is a mortgage which:

- is created over the tangible movable property (which can be specifically identified) of a borrower in favour of a lender as security for a debt or other obligation; and
- meets the requirements outlined in the Security by Means of Movable Property Act, 1993 and is registered under the DRA.

The effect of the special notarial bond (once registered) is to constitute real security in the mortgaged property as if it had been expressly pledged and delivered to the lender, despite the absence of actual delivery. Since property subject to a special notarial bond must be specifically identified, it is not appropriate for creating security over changing (fungible) assets (eg, inventories). Title to the relevant tangible movable property remains with the borrower but is subject to the lender's security interest.

Landlord's hypothec

If any rental payments in respect of a leased immovable property are due and payable, but unpaid, the lessor of the leased property has a hypothec (an encumbrance giving a creditor a security interest in any movable property of the debtor that is on the leased property), unless the contrary is agreed. The hypothec provides the lessor with a real right of security, permitting the lessor to attach and execute the lessee's property to satisfy payment of the rental arrears.

Aircraft

Security over an aircraft can only be effected by a deed of mortgage in the prescribed form under the Recognition of Rights in Aircraft Act, 1993, as stipulated in the Mortgaging of Aircraft Regulations, 1997.

An international interest in an aircraft can be registered on the International Registry. The Convention on International Interests in Mobile Equipment 2001 (Cape Town Convention) and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment 2001 were promulgated as law in South Africa by the Convention on International Interests in Mobile Equipment Act, 2007. As a result, an international interest in an aircraft can be enforced by third-party creditors where the aircraft is located in South Africa.

The South African government has also confirmed that it will recognise and act on IDERAs ("irrevocable de-registration and export request authorisations"), a concept established under the Cape Town Convention. While IDERA should be sufficient, a practice has developed in South Africa in terms of which the creditor obtains an undated but signed deregistration power of attorney from the debtor. This power of attorney enables the lender to direct the South African Civil Aviation Authority to deregister the aircraft.

Ships

Security over a South African ship (or a share in a South African ship) can only be created by a mortgage in the format prescribed pursuant to the Ship Registration Act, 1998 and the Ship Registration Regulations, 2002.

Intangible movable property

Security over intangible movable property is usually given by way of a cession in security. It is created by the debtor (cedent) granting security by way of cession over the relevant intangible

movable property in the creditor's (cessionary's) favour. It can be structured as either:

- a cession in securitatem debiti where title to the property remains with the cedent (similar to a pledge); or
- an out-and-out cession, where title to the property is transferred to the cessionary, subject to the right of the cedent to have the property transferred back to it by the cessionary once the debt, or other obligation secured, is discharged.

There are several common types of intangible movable property which are provided as security in acquisition finance transactions.

Financial instruments

Security is often granted over financial instruments such as shares and debt securities. This security is typically created by either a pledge or a cession in security (or a combination of these).

Claims and receivables

Security over claims and receivables is commonly granted in South Africa. These terms are defined to include book debts and other rights under contracts such as insurance contracts. This security is created by a cession in security.

Cash

Where security is to be taken over cash, it can also be created by a cession in security of the security provider's bank account.

Intellectual property

Under South African law, intellectual property is understood to comprise patents, trade marks (both registered and unregistered), copyright and designs. Security over any intellectual property can generally be taken by a cession in security. However, legislation has provided for a special registration of a security interest over patents, registered trade marks or registered designs called a "hypothecation". In particular, security over patents can be taken by registering a hypothecation under Section 60(5) of the Patents Act, 1978. Security over registered trade marks can be taken by a hypothecation of trade marks under a deed of security under the Trade Marks Act, 1993. Security over registered designs can be taken by a hypothecation under Section 30(5) of the Designs Act, 1993.

Note that in the absence of a registered hypothecation, intellectual property can be validly transferred to a third party despite a lender's security interest. If the hypothecation has been specifically registered against the intellectual property right, then the proprietor cannot voluntarily license the right to third parties.

5.2 Form Requirements

Mortgage Bond

A special mortgage of immovable property is created by a mortgage bond. The DRA does not prescribe a form for a mortgage bond; however, the mortgage bond must be in writing. Typically, a mortgage bond contains both:

- an acknowledgement of debt by the mortgagor for the amount of the bond; and
- a declaration binding the mortgagor's movable property in favour of the lender as security for the debt acknowledged.

A mortgage bond is perfected by its registration at the same deeds registry office where the immovable property over which the bond is purported to be granted is registered.

Pledge

A pledge is created by agreement between the pledgor and the pledgee (which agreement need not be in writing) together with delivery of the pledged movable property to the pledgee (or its agent). Title to the movable property remains with the pledgor, subject to the pledgee's secu-

rity interest. There are no registration or notification requirements.

General Notarial Bond

The DRA does not prescribe a form for a general notarial bond. The bond must, however, be in writing and prepared by a notary public. It must be executed either:

- by the owner of the movable property subject to the bond; or
- by a notary public under a formal power of attorney granted to him by the mortgagor.

Typically, a bond contains both:

- an acknowledgement of debt by the borrower for the amount of the bond; and
- a declaration binding the borrower's movable property in favour of the lender as security for the debt acknowledged.

A general notarial bond must be registered at the deeds registry within three months after the date of its execution. Failure to do so will result in application of the hardening period – ie, in the event of insolvency arising within six months of the date of when the bond was lodged for registration, it will not confer any security.

Special Notarial Bond

A special notarial bond for tangible movable property must identify and describe the property secured in a manner which makes it readily recognisable. The DRA does not prescribe a particular form for this bond. It must be registered in the manner prescribed in the DRA and registered at the deeds registry within three months after the date of its execution. Failure to do so will result in the application of the hardening period.

Aircraft

The Director of Civil Aviation will record a mortgage over an aircraft on the production of a deed of mortgage and payment of the prescribed fee. The mortgage is recorded in the register kept by the Director of Civil Aviation. There are no prescribed formalities for an international interest, which is registered according to international practice. IDERAs are not registered with the Director of Civil Aviation; however, it is common practice to file them together with the deed of mortgage.

Ships

A deed of mortgage over a ship must be presented to the Registrar of Ships and registered in the South African Ships Register.

Cession in security

There are no formalities for a cession in security, which is validly created (and in general, perfected) once the agreement to cede security has been concluded. This means that it is relatively simple to give security over most intangible movable property such as claims, shares and cash.

In the case of financial instruments which are evidenced by certificates, these certificates are delivered with a transfer form to evidence the security and facilitate enforcement, where necessary. Delivery is not required to constitute a valid cession.

Where financial instruments are uncertificated, notwithstanding that security over these financial instruments can be validly provided pursuant to a cession in security (or a pledge, as the case may be), the security is only perfected by recording the existence of the cession in security as an electronic entry in the securities account of the security provider with the financial institution where the financial instrument is registered. In relation to securities which are listed on a stock exchange, the securities account of the borrower is considered flagged in accordance with the Financial Markets Act, 2012. The same

process applies when uncertificated financial instruments are pledged.

Intellectual property

Various formalities need to be followed in order to register a hypothecation in respect of a patent, registered trade mark or design. A hypothecation must:

- be recorded in writing;
- be lodged with the Companies and Intellectual Property Commission, with an application in terms of form P16 for patents, form TM6 for trade marks or form D7 for designs to record the hypothecation; and
- have the application served on the registered proprietor of (or applicant for) the patent, as well as any parties recorded on the register as having an interest in the patent. Proof of service must be provided to the Registrar of Patents.

There are no formalities or perfection requirements for taking a cession in security over intellectual property.

5.3 Registration Process

The requirements relating to registration and perfection, as appropriate, of mortgage bonds, pledges, general notarial bonds, special notarial bonds, security in respect of aircraft and ships, cessions in security and security over intellectual property are outlined in **5.1 Types of Security Commonly Used** and **5.2 Form Requirements**.

5.4 Restrictions on Upstream Security

In accordance with South African law, the restrictions and considerations (as outlined in **5.5 Financial Assistance** and **5.6 Other Restrictions**) apply to the provision of upstream security.

5.5 Financial Assistance

Except to the extent that the company's constitutional documents provide otherwise, the board may authorise the company to provide financial assistance by way of a loan, guarantee, the provision of security or otherwise to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company, subject to certain requirements (Section 44, Companies Act, 2008). The board cannot authorise financial assistance unless both:

- the financial assistance is pursuant to either:
  (a) an employee share scheme that satisfies the requirements of section 97 of the Companies Act, 2008; or
  (b) special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient, or generally for a category of potential recipients with the specific recipient falling within that category; and
- the board of the company granting financial assistance is satisfied that:
  (a) immediately after providing the financial assistance, the company providing the financial assistance will satisfy the solvency and liquidity test (as set out in Section 4 of the Companies Act, 2008); and
  (b) the terms under which the financial assistance is proposed to be given are fair and reasonable to the company.

The board must ensure that any other specific requirements for financial assistance contained in the company's constitutional documents are adhered to.

Section 45 of the Companies Act, 2008 which regulates the granting of financial assistance to a related or inter-related company as well as loans or other financial assistance to directors, imposes largely the same requirements as Section 44 of the Companies Act, 2008 set out above.

5.6 Other Restrictions

Corporate Benefit

Directors breach their fiduciary duties, and may be held liable, if they allow the company to enter into a transaction (such as the issue of a guarantee or grant of security) which is not in the best interests of the company (Section 77 of the Companies Act, 2008). This is not usually problematic in downstream guarantees (guarantees made by a holding company to its subsidiary), as the holding company can usually show that it derives some benefit from its subsidiary's increased financial strength.

Application of the National Credit Act, 2005

The National Credit Act, 2005 governs the extension of credit by credit providers unless a transaction, inter alia, falls into one of the following exemptions provided for in the Act:

- the consumer is a juristic person whose asset value or annual turnover, together with the combined asset value or annual turnover of all related legal persons, at the time the agreement is made, equals or exceeds ZAR1 million; or
- there is an agreement for a principal sum in excess of ZAR250,000, and the consumer is a juristic person whose asset value or annual turnover is, at the time the agreement is made, below ZAR1 million.

Given the low threshold amounts, the National Credit Act is highly unlikely to be applicable to acquisition finance transactions.

Exchange Control

Where security over movable or immovable property is to be granted in favour of a non-resident or an affected person (each as defined in the Exchange Control Rulings) by a South African resident, the prior approval of the Financial Surveillance Department of the South African Reserve Bank (SARB) (or in some cases, the authorised dealer bank directly) is required for the security to be validly given.

The prior approval of an authorised dealer bank (and in some cases the Financial Surveillance Department of the SARB) is also required before:

- creating a loan from a foreign lender to a South African resident;
- creating a loan from a South African resident to a foreign borrower;
- granting a guarantee from a South African resident in favour of a non-resident, or granting a guarantee from a non-resident in favour of a South African resident.

Payments to foreign creditors arising from loan agreements, guarantees or security documents require exchange control approval at the time the loan or guarantee is granted, or the security is given. Where exchange control approval has been granted in respect of a transaction, an authorised dealer in foreign exchange will permit the repatriation of the proceeds of any appropriate realisation.

5.7 General Principles of Enforcement

Security is an accessory obligation – ie, dependent on the existence, or coming into existence, of a valid and effective principal obligation. A secured creditor in an acquisition finance transaction can, in theory, enforce its security on the default of the underlying principal obligation.

A secured creditor can in respect of certain types of security (including security pursuant to a ces-

sion in security, a pledge and a special notarial bond), without prior judgment against, or pursuit of, the security provider, procure the sale of the secured assets and apply the proceeds to satisfy the underlying principal obligation.

However, in respect of mortgage bonds or general notarial bonds, the secured creditor must first take possession of the secured assets in order to perfect the security. In order to acquire possession, the secured creditor must obtain a court order which directs the sheriff of the High Court to attach the relevant assets. The secured creditor can then procure a sale of the assets, and apply the proceeds of the sale of the relevant assets to discharge the principal obligation.

In some cases, known as parate executie (being the right of a creditor to realise a borrower's property without first obtaining a court order), the secured creditor can simply agree with the borrower that the secured assets are sold without the need for judicial execution. Provided there is no prejudice to the security provider, an agreement of parate executie dealing with movables pledged and delivered to the secured creditor is valid. However, an agreement of this nature is invalid in relation to security over:

- immovable property; and
- secured assets not in the possession of the secured creditor at the time it wishes to enforce its rights.

6. GUARANTEES

6.1 Types of Guarantees

Guarantees are normally given by the target and all material group companies in acquisition finance transactions. These companies may be named in some transactions but are normally identified as subsidiaries that have a certain percentage of the group's earnings before interest, tax, depreciation and amortisation or of the group's gross assets or turnover.

The security SPV structure also necessitates the giving of a guarantee by the security SPV. For more detail, see **5.1 Types of Security Commonly Used**.

6.2 Restrictions

The restrictions which apply to the provision of security (see **5.5 Financial Assistance** and **5.6 Other Restrictions**) also apply to guarantees.

In addition, the board of each South African company providing a guarantee for the benefit of holders of the shares in that company, or another company within the same group of companies, is required to approve the provision of a guarantee pursuant to Section 46 of the Companies Act, 2008. This approval requires the relevant board to ensure that the company will continue to meet the solvency and liquidity test as set out in the Companies Act, 2008, immediately following the provision of the guarantee. Note also that a company's constitutional documents may impose restrictions on the provision of guarantees.

6.3 Requirement for Guarantee Fees

There is no requirement for guarantee fees in South Africa.

7. LENDER LIABILITY

7.1 Equitable Subordination Rules

South African law does not contain equitable subordination rules which apply on insolvency. It does, however, recognise the concept of subordination (see **3.1 Senior Loans** and **4.1 Typical Elements**).

In addition, under the Insolvency Act, 1936, a liquidator can apply to a court to set aside certain

transactions entered into by an insolvent person, prior to its liquidation. These transactions are known as impeachable dispositions. Disposition means the transferring or relinquishing of the right to property by the insolvent person. Therefore, these provisions of the Insolvency Act pose a risk to acquisition finance transactions where an obligor goes insolvent.

In terms of the Insolvency Act, 1936, the court may set aside the following dispositions.

Disposition without Value

For the court to set aside a disposition without value, the liquidator must prove that – more than two years before the liquidation of the insolvent's estate – a disposition of property was made by the insolvent and, immediately after the disposition, the insolvent's liabilities exceeded its assets and the disposition was not made for value. Alternatively, the liquidator must prove that within two years of the liquidation, the insolvent made a disposition of property not for value. In the latter case, the disposition will not be set aside if the creditor who benefited from the disposition can prove that, immediately after the disposition was made, the insolvent's assets exceeded its liabilities.

Voidable Preferences

The court can set aside a disposition if:

- it was made within six months of the date of liquidation;
- has the effect of preferring one creditor over another; and
- immediately after the disposition, the liabilities of the insolvent exceeded the value of its assets.

However, the court will not set aside the disposition if the person in whose benefit the disposition was made can prove that the disposition was made in the ordinary course of the insolvent's business and it was not done with the intention to prefer one creditor over another.

Undue Preferences to Creditors

The court can set aside a disposition when an insolvent, before its liquidation, makes a disposition of its property when the insolvent's liabilities exceed its assets, with the intention of preferring one creditor over another.

Collusive Dealings

The court can set aside a disposition where an insolvent, before its liquidation, in collusion with another person, disposes of its assets, in a manner which prefers one creditor over another.

7.2 Claw-Back Risk

Aside from the concepts discussed above in **7.1 Equitable Subordination Rules**, there are no claw-back rules which could apply in acquisition finance transactions in South Africa.

8. TAX ISSUES

8.1 Stamp Taxes

South Africa does not impose stamp taxes.

8.2 Withholding Tax/Qualifying Lender Concepts

A withholding tax on dividends is levied on dividends declared by domestic companies, and non-resident companies listed in South Africa, at a rate of 20%. Dividend payments to domestic retirement funds, PBOs and domestic companies, among others, will be exempt, and non-residents may be eligible for relief under a double taxation agreement. Dividends Tax is relevant where the acquisition finance transaction includes equity financing.

A more common tax consideration in acquisition finance transactions is the application of any withholding taxes on the payment of interest.

According to South African law, a withholding tax on interest (Interest Withholding Tax) will be levied on the cross-border payment of interest to or for the benefit of a "foreign person" at a rate of 15%. Certain exemptions will be available, and the rate may also be reduced in terms of the application of a double taxation agreement. The foreign person is responsible for the tax, but it must be withheld by the person making the interest payment to or for the benefit of the foreign person.

There are various exemptions from the interest withholding tax. If, eg, the interest is paid by the South African government, a South African bank or in respect of any listed debt, the interest will not be subject to the withholding tax on interest.

A party relying on a double taxation agreement to reduce the interest withholding tax rate would have to submit a declaration and undertaking to the debtor, to enable the debtor to withhold at the reduced rate.

8.3 Thin-Capitalisation Rules

Transfer Pricing Rules

The focus in South African law is on transfer pricing provisions which incorporate thin-capitalisation rules. The transfer pricing provisions of the Income Tax Act, 1962 (which are generally in accordance with the guidelines of the OECD) apply only to affected transactions. Affected transactions, broadly speaking, refer to cross-border transactions between connected persons (or associated enterprises with effect from 1 January 2023), and in respect of which any term or condition is not arm's-length.

In the event that such a term or condition results or will result in a tax benefit for any person that is a party to the transaction, then the taxable income of or tax payable by the person that derives the tax benefit has to be calculated as if the transaction was concluded on arm's-length terms and conditions.

In the past, a 3:1 loan funding to equity ratio was regarded as acceptable in terms of thin-capitalisation guidelines (the so-called "safe harbour" provisions). However, South African transfer pricing rules, including the thin-capitalisation rules, were amended with effect from 1 April 2012, providing (among other things) that the general transfer pricing (arm's-length) provisions will be applied to determine whether a company is thinly capitalised. Therefore, the safe harbour provisions cannot be relied upon any more to determine an acceptable debt-to-equity ratio.

The acceptable amount of debt must be determined on an arm's length basis, which is inherently a detailed factual enquiry and takes into account a wide range of factors particular to the specific taxpayer concerned. In assessing the arm's length nature of a loan, South Africa's Tax authorities follow the guidance on the application of the arm's length principle as contained in the OECD Transfer Pricing Guidelines, which involves a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances.

Where the terms and conditions of the loan are not arm's-length and to the extent that there is a difference in the calculation of the taxable income under arm's-length conditions and the calculation in respect of the loan, the excess interest paid by the debtor will be deemed to be a dividend in specie declared by the debtor where the debtor is a resident company, and where the debtor is a person other than a company, the excess will be deemed to be a donation by the debtor.

The above-mentioned dividend or donation will be deemed to have been paid on the last day of the period of six months following the end of the year of assessment in respect of which that adjustment is made.

Generally, dividends in specie are subject to a 20% withholding tax and donations are subject to a 20% donations tax, subject to certain exemptions. In addition, that portion of any interest expenditure incurred which is considered not to be arm's-length will be disallowed as a deduction.

Specific Interest Deduction Limitations

In addition to the transfer pricing measures described above, South Africa also has provisions (Section 23M of the Income Tax Act) that place a restriction on interest deductions where:

- the creditor is in a controlling relationship with the debtor;
- the creditor obtained the financing from a person in a controlling relationship to the debtor;
- the creditor forms part of the same group of companies as the debtor; or
- the creditor is in a controlling relationship with the debtor and that creditor, directly or indirectly through another creditor that is in a controlling relationship with that creditor, obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that creditor or that other creditor; and
- the amount of interest so incurred (or related interest) is not subject to tax in the hands of the person, creditor or other creditor to which the interest or related interest accrues.

A controlling relationship will exist where a person (whether alone or together with any connected persons) or persons that are connected persons in relation to that person, directly or indirectly holds at least 50% of the equity shares or exercise 50% of the voting rights or participation rights in a company.

In summary, the interest deduction allowed under this provision will be calculated as interest received by the debtor plus an amount calculated with reference to a formula, amounting to approximately 30% of EBITDA, less taxable interest incurred by the debtor in respect of other parties as exceeds any amount not allowed to be deducted in terms of section 23N below.

South Africa also has provisions that limit interest deductions on debt used to finance, or refinance certain reorganisation and acquisition transactions (Section 23N of the Income Tax Act).

Companies must first apply the arm's-length test to financial transactions, followed by the interest limitation rules under section 23N and finally section 23M – ie, the interest limitation rules should apply to the net interest expense that has already passed the arm's-length test.

9. TAKEOVER FINANCE

9.1 Regulated Targets

In terms of the Companies Act, 2008, a regulated target includes:

- a public company;
- a state-owned company; or
- a private company to which the Fundamental Transactions and Takeover Regulations (the "Takeover Regulations") apply – each incorporated in South Africa.

The Takeover Regulations apply to a private company only if such company's memorandum of incorporation (MoI) expressly specifies this, or if more than 10% of the issued shares of the company have been transferred within 24

months prior to the relevant affected transaction. If these requirements are met, the Takeover Regulations apply in the same manner as for public or state-owned companies (as set out below in **9.2 Listed Targets**). The Takeover Regulation Panel (TRP) regularly exempt private regulated companies from needing to comply with the Takeover Regulations where the transacting parties consent to this.

9.2 Listed Targets

The TRP regulates affected transactions and offers in terms of the Companies Act, 2008 and the Takeover Regulations. In addition, acquirers and targets that are listed on the Johannesburg Stock Exchange (JSE) need to comply with the Listings Requirements of the JSE Limited (the "JSE Listings Requirements") in certain circumstances. The extent of compliance will depend on the nature of the transaction and its size relative to the listed entity.

Where a transaction involving a regulated target constitutes an "affected transaction" for the purposes of the Companies Act, 2008 (see Section 117(1)(c) for a full list), the transaction must comply with the Takeover Regulations.

Examples of affected transactions in a regulated takeover scenario include:

- a scheme of arrangement, between the regulated company and its shareholders;
- the disposal of all or a greater part of the assets or undertakings by a regulated company;
- an amalgamation or a merger where one of the parties is a regulated company; and
- mandatory offers.

From a financing perspective, banks should take notice of the TRP guarantee requirement in the Companies Regulations 2011, which provide as follows: where an offer consideration is wholly or partly in cash, the offeror offer circular must include either:

- an irrevocable unconditional guarantee from a South African bank; or
- an irrevocable unconditional confirmation from a third party that sufficient cash is held in escrow, in favour of the holders of the securities to be acquired, for the sole purpose of satisfying the cash consideration in full.

The guarantee or confirmation must empower the TRP to exercise the guarantee or confirmation if the offeror has failed to pay the cash consideration by the due date.

Importantly, a bank guarantee issued for this purpose cannot be subject to any further conditions in addition to the conditions of the offer itself. Further, the TRP will not accept conditions to the offer that are founded on subjective assessments or permit the bank to withdraw too easily, as the TRP is looking for firm commitments from the bank and offeror. In this regard, given the unconditional nature of the guarantee, banks should ensure that the offeror's funding arrangements to purchase securities in the target are agreed and settled prior to issuing the guarantee. However, funding terms are not publicly available to the TRP or target shareholders in South Africa.

10. JURISDICTION-SPECIFIC FEATURES

10.1 Other Acquisition Finance Issues

There are no other jurisdiction-specific features that are important to consider and have not already been mentioned.

Bowmans is a leading African law firm providing integrated legal services across Africa from Ethiopia, Kenya, Mauritius, South Africa, Tanzania and Uganda. Bowmans' finance practice is recognised as a leading finance practice in Africa and a market-leader in innovation, efficiency, documentation standards and best practice. The firm's specialist financing and funding expertise includes acquisition, assets, commodities, corporate, ECIC export credit, leveraged, mining and resource, preference share, real estate, secured lending, structured, subordinated and mezzanine, syndicated, trade/commodity and venture capital. Clients continue to instruct the firm on their most complex transactions which require innovative and, in many cases, bespoke transaction documents to reflect their commercial objectives.

AUTHORS

Ulrike Naumann heads Bowmans' finance practice and is recognised as a leading lawyer in South Africa. She has significant experience in advising banks, financial institutions and corporates with which she holds strong relationships, on secured and syndicated lending, structured finance, mezzanine finance and preference share funding transactions, as well as acquisition finance, property finance and leveraged finance (particularly LBOs, both as adviser to senior and mezzanine funders) for more than a decade in South Africa and further afield. She is admitted to the Law Society of South Africa and is a member of the International Bar Association's Banking Law Committee.

Alison Mellon honed her skills as a finance lawyer during her tenure as senior associate in Bowmans' finance practice, where she advised banks and financial institutions in secured and syndicated lending and particularly in relation to preference share funding and leveraged finance. She applies this expertise in her current designation as Bowmans' knowledge lawyer in the finance practice. In addition to transactional banking experience, Alison has worked at one of South Africa's largest asset managers as in-house counsel. She has lived and worked in South Africa and England and is admitted to the Law Society of South Africa.

Joshua Janks practises as a partner in the corporate department at Bowmans. He specialises in mergers and acquisitions, banking and finance, private equity, venture capital and general corporate and commercial law. Joshua advises on public and private mergers and acquisitions, finance transactions, fund formations, and various other corporate and commercial matters. His private equity practice covers all aspects of private equity work, including fund formations and acquisitions, and extends to the venture capital space. Joshua is a member of the Law Society of South Africa and actively involved in the South African Venture Capital Association.

Theunis Claassen is a senior associate in Bowmans' tax practice, where he specialises in tax dispute resolution, international and domestic corporate tax and exchange control. He has advised banks and financial institutions on a variety of tax disputes and issues associated with structured financing and preference share funding. He holds accounting and law degrees from the University of Stellenbosch, an LLM in commercial law and a master's of commerce in international tax, both from the University of Cape Town. He is admitted to the Law Society of South Africa and is a registered tax practitioner.

Bowmans

11 Alice Lane
Sandton
Johannesburg
2146
South Africa

Tel: +27 11 669 9000
Fax: +27 11 669 9001
Email: info-jhb@bowmanslaw.co
Web: www.bowmanslaw.com

BOWMANS
THE VALUE OF KNOWING

Chambers Global Practice Guides

Chambers Global Practice Guides bring you up-to-date, expert legal commentary on the main practice areas from around the globe. Focusing on the practical legal issues affecting businesses, the guides enable readers to compare legislation and procedure and read trend forecasts from legal experts from across key jurisdictions.

To find out more information about how we select contributors, email Katie.Burrington@chambers.com