Practitioner

Update

Issue 4
The application of merger provisions of the Competition Act 89 of 1998, as amended, to risk mitigation financial transactions

1. Preface

1. In terms of section 79 of the Competition Act 89 of 1998, as amended ("the Act"), the Competition Commission ("the Commission") may prepare and publish Guidelines ("Updates") to indicate and clarify the Commission's policy approach to any matter within its jurisdiction. These Updates are not binding on the Commission, the Competition Tribunal or the Competition Appeal Court in the exercise of their respective discretions, or their interpretations of the Act.[1]

2. The objective of this Update is to set out the Commission's policy approach to the application of the merger control provisions of the Act to a specific class of risk mitigation financial transactions outlined below.

3. This Update does not apply to other financial transactions not covered in this Update such as preference share funding[2] and may be updated from time to time to account for future developments.

2. Definitions

"bank" means a public company registered as a bank in terms of the Banks Act 94 of 1990, as amended[3] ("Banks Act"), including any subsidiary (as defined in section 3 of the Companies Act 71 of 2008, as amended) of a bank;

[1] Section 79 (2) (b) of the Act.
[2] When preference shares are used as a funding tool.
[3] Section 1(1) of the Banks Act.

"state-owned finance institutions" means a firm that is directly or indirectly owned by the State including its subsidiaries and is authorised[4] to provide finance in the ordinary course of its business but is not registered as a bank in terms of the Banks Act;

"sale and leaseback" means the sale of property on the understanding or with the express term that the seller leases the property from the buyer immediately upon conclusion of the sale;

"security" means collateral given or pledged to guarantee the fulfillment of an obligation or assurance that a creditor will be repaid any money or credit extended to a debtor;

"pledge" means the act of providing security for a debt or obligation.

3. Introduction

1. Registered banks and state-owned finance institutions play an important role in providing finance in the economy and utilise risk mitigation techniques to secure their interests in finance transactions. The utilisation of risk mitigation techniques may, upon default by the debtor of its obligations in terms of the finance agreement, result in the bank or the state-owned finance institution acquiring control over the business or assets of the debtor and such acquisition would technically fall within the purview of section 12(1) of the Act. The Commission recognises that the principal objective of risk mitigation techniques in such circumstances is to secure the interests of the financier in the finance transaction and to enable the financier to recoup the capital advanced to the debtor. Consequently, if the acquisition of the business or assets of the debtor occurs within the context of securing the interests of the financier and the financier disposes of the business or assets of the debtor within the time period provided for in this Update, the Commission will not require notification of such

[4] The firm may be authorised to provide finance in terms of its enabling legislation or its Memorandum of Incorporation.

transactions. This dispensation shall only apply to risk mitigation transactions entered into by registered banks and state-owned finance institutions providing finance in the ordinary course of business.

2. In drafting this Update the Commission examined and considered the approach of various other jurisdictions to these transactions and the possible negative competition and public interest impact that may arise due to these transactions. This Update aims to articulate the approach the Commission is likely to take in respect of financing transactions entered into in the ordinary course of business of banks and state-owned finance institutions and include the following classes of transactions:

   (i) *The general exercise of a security interest*

   In the ordinary course of business, banks and state-owned finance institutions mitigate the inherent risk involved in money lending by taking security from their borrowers. A security interest in an asset is granted to the financier, who acquires the asset in the event of default by the borrower. Inherent in the manner in which these transactions are formulated are the following aspects:

   - *The taking of security at inception of the finance agreement:* The taking of security is generally one of the principal clauses in these agreements, aimed at ensuring that banks and state-owned finance institutions can take effective control over the specified assets or business interests of the borrower, including management control, over the specific entity.

   - *The exercise of a security interest in a financial asset:* A situation where a default by the borrower arises and where recourse as set out in the "initial taking of security" clause in the agreement is executed, or where management control is exercised for the purpose of preventing a default or other failure of the borrower.

(ii) Sale and leaseback transactions

These transactions constitute the sale of a key asset or assets to a financier for a "lump sum" cash price. The financier simultaneously leases the asset back to the seller, with rentals being payable over a period of time. At the end of the lease the seller will be entitled to either acquire the asset or continue leasing it. These transactions allow the holders of assets to acquire finance in a relatively cost effective manner. Normally, upon default in repayment of the loan, the financier would be entitled to exercise its ownership rights in respect of the asset.

(iii) Government concessions in infrastructure development

Generally a project is advertised for tender and government then offers a concession to a private sector developer. These government concession agreements allow infrastructure development to draw on private sector funding. Banks and state-owned finance institutions provide finance to the concession company and "take security". To provide for the completion of the project in the event of the failure of the original concessionaire, the agreement often provides for a substitution of concessionaires in the event of default by the original concessionaire. The agreement may also provide for the financier to exercise temporary management control in the event of default by the concessionaire.

4. The effect of the merger provisions of the Competition Act 89 of 1998, as amended

1. Section 12(1)(a) of the Act defines a merger as occurring when one or more firms directly or indirectly acquire or establish direct or indirect control over the whole or part of the business of another firm. Such merger may be achieved in any manner, including through purchase or lease of shares, an interest or assets of

the other firm in question, or amalgamation or other combination with the other firm in question.

2. As risk mitigation financial transactions result in the acquisition of an interest in the assets or the business of another company at the time of sale and/or upon default by such firm, they would technically fall within the ambit of the merger control provisions. The acquiring party will, as a result of the said transaction acquire control over the business, part of the business or business assets wherein no control was exercised previously. Where the threshold requirements are met, notification of these transactions would be required.

3. The definition of a merger in the Act does not distinguish between short and long term acquisitions of assets or controlling interests. In its current form the definition of a merger covers all transactions, irrespective of their temporary nature. However, it could not have been the intention of the legislature to include transactions, which occur in the ordinary course of business of banks and state-owned finance institutions, within the ambit of the merger provisions.

4. Thus, in the application of the Act, consideration ought to be given to transactions that are purely financial in nature and occur in the ordinary course of business of banks and state-owned finance institutions, as well as to the fact that the acquisition of control over the assets of the firm in the circumstances outlined in points (i) to (iii) above is on a temporary basis, with the intention to dispose of the acquisition to recoup the initial capital outlay. In the case of sale and leaseback transactions, the rental in terms of the lease agreement constitutes repayment of the finance provided by the bank or state-owned finance institution. The acquisition of the property is generally maintained until the repayments cover the finance outlay of the bank or state-owned finance institution through the initial sale agreement.

5. Due to the inherent potential for banks and state-owned finance institutions to maintain control of securitised interests for extensive periods, it is necessary for the Commission to adopt a flexible yet prudent approach to these transactions. The approach adopted considers the nature and increasing volume of these

transactions, current global economic environment, as well as the approach adopted in other jurisdictions.

5. The Commission's approach

1. The Commission does not wish to burden itself and the parties involved in such agreements in regulating transactions that could not have been intended to fall within the ambit of the Act. However, it would not be prudent to adopt an approach that would ultimately encourage evasion of the Act by parties who intentionally structure transactions in this manner.

2. In balancing these concerns, the Commission would in the case of assets acquired in terms of a security interest or the assumption of management control impose a restriction on the time period for which the asset or controlling interest is held. This would provide an indication of whether the bank or state-owned finance institution intends holding the asset or controlling interest permanently or not. If the bank or state-owned finance institution holds the asset or business for a longer period, it may be in a position to strategically influence the direction of the business, thereby possibly giving rise to competition concerns.

3. Thus, in respect of transactions outlined in points (i) to (iii) above, where a bank or state-owned finance institution acquires an asset or controlling interest in a firm in the ordinary course of its business in providing finance based on security or collateral, the Commission would not require notification of the transaction at this point. Similarly, if upon default by the firm, the bank or state-owned finance institution takes control of the asset or controlling interest in that firm with the intention to safeguard its investment or on-sell to another firm or person to recover its finance, a notification would not be required.

4. However, if the bank or state-owned finance institution fails to dispose of the assets or the controlling interest within a period of twenty-four (24) months, notification would be required upon the expiry of the twenty-four-month period. This twenty-four-month period commences only when the bank or state-owned

finance institution assumes control over the security interest. The expiry of this period in itself will trigger notification of that acquisition if thresholds are met. In seeking an extension of this period, the institution concerned bears the onus of providing a substantial basis for non-disposal of the asset or control over the firm in question. The Commission would then exercise its discretion in granting such an extension on a case-by-case basis.

5. Failure to notify the transaction upon expiry of the twenty-four-month period or the extended period will be construed as an implementation of a merger and the penalties in terms of Section 59(1)(d) and (2) of the Act will be applicable.

6. With respect to leaseback transactions in point (ii), this guideline will apply only to the extent that the financier is a bank or state-owned finance institution providing finance in the ordinary course of its business and that the transaction is *bona fide* entered into, in the institution's ordinary course of business. In establishing *bona fides*, the Commission may consider whether or not the borrower retains possession of the assets. The twenty-four-month restriction period does not bear any reference to the terms or period of the lease agreement. Generally, sale and leaseback transactions entered into by other business entities would be notifiable to the Commission.

7. In respect of Government concessions or other project finance arrangements for infrastructure development the twenty-four-month period would apply where the bank or state-owned finance institution assumes control of the project. Furthermore where the original concessionaire is substituted, in an event of default, with another party, notification of the substitution will not be required.