SAA BOARD SUBMISSION

To:	SAA Board of Directors
From:	Acting Chief Executive Officer
Date:	6 November 2015

ADVICE ON THE LEGAL IMPACT OF THE CORRESPONDENCE FROM AIRBUS DATED 2 & 26 October 2015 RELATING TO THE PREDELIVERY PAYMENTS UNDER THE A320-200 PURCHASE AGREEMENT

PURPOSE

To advise the Board of South African Airways (SOC) Ltd ("SAA") on the legal impact of the correspondence from Airbus G.I.E ("Airbus") dated 2 & 26 October 2015 ("Correspondence") relating to the Predelivery Payments ("PdPs") under the A320-200 Purchase Agreement ("Purchase Agreement").

BACKGROUND

On 29 October 2015 during a meeting of the SAA Group Executive Committee ("Exco"), the Chief Financial Officer ("CFO") advised the meeting that he had received correspondence requiring SAA to pay Predelivery Payments in terms of the Purchase Agreement. The letter of 2 October 2015 stated that these were outstanding payments. The letter of 26 October 2015 required payment of the further PdPs by 2 November 2015. In the Correspondence Airbus also gave notice of an initial reservation of its rights under the Purchase Agreement.

In a subsequent Exco meeting of 30 October 2015, the CFO advised that SAA's current financial position is such that SAA does not have sufficient cash resources to pay the PdPs

as requested by Airbus in the Correspondence as well as paying all its other debts currently due and payable.

In light of the CFO's advice Exco requested the General Manager: Legal, Risk and Compliance ("GM: LRC") to advise on the impact of the CFO's statements and the Correspondence to SAA under the Companies Act, No. 71 of 2008 ("Companies Act").

Exco stated that this advice would be sent to the Board in order to notify the Board of SAA's legal position under the Companies Act and notify the Board of the urgency to address the Correspondence and any triggering events and actions.

This advice will be provided against the background of the original transaction to purchase A320-200 aircraft, subsequent negotiations and interactions between SAA and Airbus to enter into a swap transaction. The advice will provide a review of the Purchase Agreement, sample debt and other covenants, and the Companies Act.

DISCUSSION

Purchase Agreement and Subsequent Swap Transaction

SAA and Airbus concluded the Purchase Agreement in 2002 initially to purchase 15 (fifteen) A320-200 aircraft, amongst other provisions. The Purchase Agreement was subsequently amended between 2007 and 2008 to increase the number of aircraft to 20 (twenty) and to add leasing other aircraft types. Between 2013 and 2015, Airbus delivered 10 (ten) of the 20 A320-200. SAA sold and leased back these 10 aircraft to Pembroke Aircraft Leasing 4 Limited ("Pembroke"), a subsidiary of Standard Chartered.

The remaining 10 (ten) aircraft, ranked Aircraft 11-20, were due to be delivered from Quarter 2 of 2015 until Quarter 4 of 2017 ("Aircraft"). The advice is confined to a discussion on the Aircraft which are due for delivery to SAA and the PdPs applying to these Aircraft, since the parties have discharged their obligations in respect of the first set of 10 A320-200 aircraft.

Clause 5.3 of the Purchase Agreement specifies a PdP schedule for the due dates of the PdPs, as well as the percentage of the PdP amounts due. This payment schedule is linked to the delivery dates of each of the Aircraft and also specifies a Total Payment due prior delivery.

Clause 5.3.4 provides that if a PdP is not received within 30 (thirty) days following the relevant due date specified in clause 5.3.2 Airbus, in addition to any other rights and remedies available, has the right to set back the Scheduled Delivery Month by 1 (one) month for each 30 days such payment is delayed. Airbus is entitled to claim default interest under Clause 5.7 and under Clause 20.2 may terminate all or part of the Purchase Agreement if SAA does not remedy its default on the PdPs within 30 (thirty)days from the date when the PdP became due.

In March and April 2015 SAA and Airbus concluded a Letter of Intent to swap the Aircraft for a lease of 5 (five) A330-300 ("A330s"). The Board resolved on 21 April 2015 that SAA may enter into negotiations with Airbus to swap the Aircraft for the A330s ("Swap Transaction"). The Board approved the Swap Transaction "*to be achieved through amendment to the legacy A320 purchase transaction whereby the last ten A320-200 aircraft (still to be delivered) be cancelled and replaced by the five A330-300 wide-body aircraft to be leased directly from Airbus*".

The parties negotiated the terms and conditions and agreed on the final execution versions of the agreements for the Swap Transaction on 30 July 2015. The approval of the Minister of Finance in terms of section 54(2) of the Public Finance Management Act, No. 1 of 1999 ("PFMA") was received on 31 July 2015, with conditions ultimately the Minister gave final unconditional approval. In terms of the Delegation of Authority Framework dated 2012 ("DoA") the authority to conclude and execute this transaction rests with the Board. Accordingly, on 31 July 2015 the CFO and Acting CEO signed the agreements for the Swap Transaction and subsequently sought Board ratification for the terms and conditions agreed between the parties and the delegation to the Acting CEO and CFO signatories. The request to the Board in August 2015 to ratify the terms and conditions and signatories under the current transaction structure failed because of a lack of quorum. Instead the Board proposed a different transaction structure directly to Airbus during various meetings with and correspondence to Airbus representatives. In the absence of the ratification by the Board, the Swap Transaction agreements are not in effect and the Purchase Agreement remains the operative agreement between the parties.

At all times, SAA and Airbus tacitly agreed that the provisions of the Purchase Agreement in relation to the Aircraft, including the payment of PdPs and the delivery of the Aircraft, the first of which was due in Quarter 2 of 2015 would be terminated and replaced by the Swap Transaction. This tacit agreement also was addressed in the final execution versions of the transaction documents of the Swap Transaction ("Transaction Documents"). Therefore, it

can be argued that the parties' conduct in entering into negotiations and concluding the Transaction Documents indicating a clear intent to suspend the Purchase Agreement in relation to the Aircraft and eventually terminate the applicable provisions of this Purchase Agreement. However, courts may rule differently on this issue. Accordingly, independent legal advice from external counsel qualified and practising in English law should be obtained to confirm SAA's legal position in this regard.

In the Correspondence Airbus stated that various PdP payments were due from 1 June 2015, on 1 August 2015 and now on 2 November 2015. The parties have not discussed the cancellation of the Swap Transaction since SAA still wants to continue with the Swap Transaction, albeit under a different transaction structure. In addition, the parties have not discussed the resumption of deliveries of the Aircraft to SAA. On 2 October, 2015, Airbus issued a formal letter to SAA listing the various PdP payments and the due dates; describing these as "Overdue Amounts" and reserving all rights and remedies under the Purchase Agreement and at law.

Financial Position

As stated above, the CFO advised that SAA currently does not have sufficient cash resources to meet the newly imposed PDP obligations by Airbus in addition to its current cash flow obligations either the PdPs due to Airbus or all its other debts, but not both. From the CFO's financial forecasts, it appears that on 30 October 2015, SAA's cash resources would have been extremely low, assuming that PdPs of $17m (USD) were paid on 23 October 2015 (see Consolidated Cash flow forecast attached as Annexure "**A**"). The forecast also appears to indicate that from 9-16 November 2015 SAA will have no more cash available. The forecast further appears to indicate that on 10 November 2015 SAA is required to honour a loan commitment. The forecast also includes a comment that SAA is, based on the current information with regard to the newly anticipated transaction, required to pay an additional $100m in PdPs within 30 days of signature of the new transaction. From previous forecasts from the Finance department (excluding PdPs), it appears that SAA would have low, rather no cash available on 10&16 November 2015, and no cash available on 30 November 2015 (see Annexure "**B**").

The CFO also provided a 24 month outlook of SAA's financial position (see Annexure "**C**"). It appears from the outlook that SAA is not in a position to pay its debts until such time as the current funding process has been finalised – estimated finalisation is January 2016, as

advised by the CFO. The CFO advised that in the interim he is undertaking initiatives to try and secure bridge funding.

SAA's financial statements for the previous year have not been signed off by the external auditors due to the fact that SAA is not a going concern. Consequently, SAA has had to postpone its AGM, which allows for the shareholder to approve the annual financial returns, until such time as the auditors can confirm SAA's going concern status. Similar to previous years and as a further consequence, SAA has not submitted its audited annual financial returns to the national treasury within the prescribed timeline and Parliament, as required by section 55(1)(d)&(3).

SAA currently has going concern guarantees of approximately R14bn. The CFO further advised that while the going concern guarantee provided by the Government still has room for further borrowings of approximately, R3bn, SAA is experiencing challenges in raising this funding as lenders are increasingly wary of assuming additional SAA risk. Further, SAA's borrowing plan and projections excluded the PdP payments. There are also delays regarding the current funding process for SAA and worsening SAA's going concern status. SAA is currently engaged in initiatives to raise R15bn in long-term funding, consolidating its debt; a R3bn term loan and R1bn bridge facility. Until the newly required going concern has been approved and is available, only R3bn is available under the current guarantees.

Debt and other relevant Covenants

SAA has a number of debt covenants contained in its operating leases and funding agreements with lenders. The majority of SAA's finance agreements, including those concluded recently in the last few years, contain debt covenants (which include warranties), to varying degrees. Previous legal opinions obtained by SAA in this regard confirm this state, which still applies since the majority of these finance agreements remain valid even today and arguably are enforceable against SAA (see opinion attached as Annexure "**D**").

The language generally used in the finance/leasing agreements in stipulating when an Event of Default takes place is open to a degree of subjective interpretation. For example, there is room for disagreement about what the terms "material effect" or "substantial part of SAA's business" may mean in the context of the relevant transactions or a particular financial situation.

In general, the covenants relate to objective issues such as, *inter alia*, rental payments, other payments, insurances, breach of warranties, consents and approvals not being maintained, judgements or orders against SAA, insolvency (including failure to pay debts as they fall due) or compromise and an inability to pay air traffic control levies and other similar amounts. With regard to the majority of covenants and/or warranties and/or events of default, the largest area of risk for SAA lies with regard to the insolvency related events and the "subjective" covenants/events of default relating to its financial position. This is particularly so in relation to the clauses dealing with Material Adverse Events and Financial Indebtedness/cross-default.

The former category of covenants/events of default provides that, if there is a material deterioration, after the date of the relevant agreement, in the financial position of SAA, which the lender/lessor reasonably believes will materially prejudice the ability of SAA to perform its obligations under the agreement or any other relevant document to which SAA is a party, the loan may be accelerated. The latter category of covenants/events of default provides that, if a specified amount (typically $10m) of Financial Indebtedness is not paid by SAA after being declared due, repayment of the debt may be accelerated.

The wording of these clauses differs in the various finance/leasing agreements, which are subject to foreign law. Accordingly, it is not possible to provide a definitive opinion on this wording. However, it can be said that a recurring theme in all of the Material Adverse Event clauses is that this belief of the lender should be "reasonable", which concept introduces in South African law a degree of objectivity and the lender should at least be of the view that there is a real threat to SAA's ability to fulfil its obligations under the agreement in question.

Furthermore, in relation to the Financial Indebtedness clauses, it is generally required that SAA's failure to pay the indebtedness must have a material adverse effect on the ability of SAA to perform its obligations under the agreement; almost all of the finance/leasing agreements are subject to a Cross Default clause so that, if SAA is in default of one loan document/financial indebtedness, this will cause a default in all the finance/leasing agreements. However, in many instances the Cross Default provisions are linked to the Material Adverse Event clauses and therefore in such instances it is also required that SAA's failure to pay the indebtedness must have a material adverse effect on the ability of SAA to perform its obligations under the agreement; the remedies available to an aggrieved party vary from transaction to transaction. If a proposed action constitutes an Event of Default as

defined in a finance/leasing agreement, then the aggrieved party is generally entitled to require acceleration of the debt repayments and full indemnification. Such a party may also be entitled to call upon any security arrangements, if applicable, or seek additional comfort in the form of further security.

In summary, owing to the significance of the amounts involved and the existence of insolvency related, Cross Default, Material Adverse Event and Financial Indebtedness clauses, the risks involved for SAA, as a consequence of the situation with Airbus, in potentially breaching any of its debt covenants/triggering events of default in other agreements are considerable. There are a number of possible remedies which may be taken by the lender upon the occurrence of a breach or an Event of Default. These depend upon the type of transaction, the type of proposed action and the specific remedies provided for.

Where a specific remedy is not provided for, remedies under common law would include the ability to give SAA notice to remedy the breach within a reasonable period and to seek specific performance and/or damages if it is not remedied, or is not remediable. Depending on the severity of the breach, the aggrieved party may be entitled to cancel the relevant agreement and seek damages.

If any one party takes action to enforce its rights that could lead to action by other parties – and once such action starts, it can be very difficult to halt things and restore order.

The majority of these finance agreements relate primarily to lenders, lessors and the cross default provisions apply primarily to "Financial Indebtedness", which is defined in relation to borrowings, including money raised in the debt and capital markets, counter-indemnity obligations relating to guarantees, indemnities, bonds, letters of credit or other financial instruments from banks or financial institutions. It may be arguable from the face of these agreements that the cross default would not apply in respect of the Purchase Agreement.

However, as discussed above, the definition and treatment of "Material Adverse Effect" is a catch-all that is so wide as to extend to SAA's inability to pay the PdPs under the Purchase Agreement, which are forward obligation. Arguably, a purposive interpretation could be adopted that the wide and all-encompassing nature of these agreements intended to cover all instances of a debt or liability owed by SAA, including any default by SAA under agreements such as the Purchase Agreement. However, it is unclear how a court of law would rule, particularly since these are governed by foreign law. The Purchase Agreement

itself is governed by English Law. Therefore independent advice from external counsel qualified and practising in English Law should be obtained.

Consequences of non-payment of PdPs

Should Airbus issue a notice of default or seek to terminate the Purchase Agreement for breach, this may trigger an Event of Default allowing lenders and lessors to accelerate their debts, terminate leases and take other enforcement actions. All could further trigger financial distress and/or insolvency for SAA.

In addition, under the Purchase Agreement Airbus may institute legal action against SAA for breach of contract and claim damages. Airbus may withhold payment of any sums due or claimable by SAA unless and until the Default is cured or remedied. Airbus may also retain all of the existing PdP sums paid by SAA, apply any PdP amount it holds in respect of any Aircraft or any other funds, credits and credit memoranda available to SAA under the Purchase Agreement as it wishes, including compensating for losses or damages suffered due to the non-payment of PdPs. All these are in addition to any other rights Airbus has under the Purchase Agreement and at law.

Companies Act

Section 22 (1) of the Act provides that "*a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.*" In terms of section 22(2) the CIPC may issue a notice to a company to show cause why it should be permitted to continue trading if the CIPC has reasonable grounds to believe that a company is trading recklessly or "*is unable to pay its debts as and when they become due and payable in the normal course of business*".

Section 77(3)(b) states that any director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director "*acquiesced to the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22(1)*".

The Companies Act defines "financially distressed" in section 128(1) (f), to mean that, *at any particular point in time, it appears to be:*

i. *reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months* [Commercial insolvency – own emphasis], or

ii. *reasonably likely that the company will become insolvent within the immediately ensuing six months"* [technical insolvency – own emphasis].

Section 129(1) allows a Board to resolve to begin business rescue voluntarily, subject to there being no liquidation proceedings and the filing of such resolution in terms of section 129(2).

Section 129(7) requires a board to deliver written notice to affected persons (defined in section 128(1)(a) as shareholders, creditors, registered trade unions and employees) where the board has reasonable grounds to believe that the company is financially distressed, but has not adopted a resolution to file for business rescue. The written notice must set out applicable criteria in terms of section 128(f) and the Board's reasons for not adopting a resolution to file for business rescue.

Section 131(1) allows an affected person to apply to court for an order for the company to be placed under supervision and to begin business rescue provision.

Application of Law

Reckless Trading

As stated above the CFO has advised that SAA will be unable to pay its debts as and when they become due and payable should SAA pay the PdPs. SAA does not have money to pay both. While the Companies Act does not define "reckless trading" the meaning of the term can be construed from section 22(2) and (3) to mean where a company cannot pay its debts as and when they become due and payable in the normal course of business. The statement of "reasonable grounds" under South African common law means an objective test where a reasonable person in the shoes of the CIPC would believe that SAA cannot pay its

debts as a normal course of business. The normal course of business for SAA is the carrying of passengers and cargo using the tool of an aircraft. Airlines generally buy or lease aircraft in order to undertake their normal business and this also can become part of the airline licensing and other regulatory requirements for the normal conduct of an airline business.

The question is whether SAA can pay its debts as and when they become due. It appears from the forecasts that SAA may be able to pay these debts as it has raised funding to do so. An ameliorating fact for the PdP payment required now is that SAA had undertaken commercial discussions for the Swap Transaction with Airbus, which were intended to suspend and, upon successful execution, ultimately terminate the requirement for further PdP payments. However, it is unclear how an English court could rule on this issue, as discussed above.

If SAA continues to incur debts, where, in the opinion of a reasonable business person standing in the shoes of SAA's directors, there would be no reasonable prospect of the creditors receiving payment when due, it can be inferred that the business of the company is being carried recklessly or negligently as contemplated by section 22 (1) of the Act.

Financial Distress

In terms of section 128(1) (f) a reasonable business person standing at a point in time would have to consider if SAA is commercially or technically insolvent. With regards to commercial insolvency the reasonable person would have to consider whether or not there are commercial interventions, including financing activities and reducing operating expenses, such as terminating loss-making routes, that could mitigate the commercial solvency, hence the going concern guarantees and debt funding.

The question that arises is whether any trading under such circumstances constitutes "trading under insolvent circumstances" as contemplated under the Companies Act. The term "trading under insolvent circumstances" is not defined under the Companies Act but case law has been accepted to mean that a company does not meet the "solvency and liquidity test" criteria. Solvency relates to the assets of the company, fairly valued, being equal or exceeding the liabilities of the company, while Liquidity relates to the company being

able to pay its debts as they become due in the ordinary course of business for a period of 12 months.

Based on the reliance on a going concern guarantee and the inability of the auditors to sign off on the annual financial statements, SAA has been and remains technically insolvent. Accordingly, SAA is financially distressed and trading under insolvent circumstances. Any further trading under the current circumstances constitutes reckless trading in terms of section 22 of the Act.

Consequently, the Board is obliged to pass a resolution for a company's business rescue or alternatively, resolve to wind up or liquidate the company as soon as they become aware that the company is either financially distressed or is trading in insolvent circumstances, both factually, in that its liabilities exceeds it assets, or commercially, in that it cannot pay its debts to creditors as and when they fall due.

The decision by the Board to pass a resolution for business rescue needs to be done urgently to enable a business rescue practitioner to take control for the purposes of having a business rescue plan approved and thereafter implemented.

If the Board decides that there is no prospect for business rescue, the directors are obliged to file for liquidation on an urgent basis.

Furthermore, any creditor of SAA may apply for the company to be placed under business rescue or liquidation and the administrator or liquidator appointed will be selected by the creditors. The result is that the directors and the Shareholder relinquish any control they have over the company if the proceeding were initiated by the Board.

SAA currently has financial commitments with a number of service providers, Lenders, Regulators and suppliers. As per the attached financial projections, SAA will not be able to honour some of its commitments resulting in cross default and subsequent legal actions (including but not limited to liquidation applications by creditors) and a call on the government guarantee.

Sanctions under the Companies Act

Section 214 (1)(c) of the Act provides that "a person is guilty of an offence if the person was knowingly a party to an act or omission by a company calculated to defraud a creditor or employee of the company, or a holder of the company's securities, or with another fraudulent purpose". Any person convicted of an offence in terms of the Act, is liable to a fine or to imprisonment for a period not exceeding 12 months, or to both a fine and imprisonment.

Conclusion

SAA is financially distressed and currently trading under insolvent circumstances and consequently trading recklessly. While the Correspondence does not induce a new risk with respect to the reckless trading and financial distress, it introduces a new risk of a breach of an agreement and consequently a potential trigger of material adverse effect and potential cross default under the funding and aircraft lease agreements. This exacerbates an already weak financial position and compounds SAA's financial issues. SAA has always had this PdP liability under the Purchase Agreement. The Correspondence accelerates the issue.

The Companies Act requires the Board to file for business rescue or liquidations. Alternatively, any creditor or employees may apply to court to place SAA under business rescue. Creditors may also apply to court for liquidation of SAA. Failure to comply with these provisions of the Companies Act can result in statutory sanctions and a possible fine or imprisonment against a person found guilty of an offence to defraud a creditor, employee or shareholder.

Under the Purchase Agreement Airbus can take action – including to terminate the Purchase Agreement, retain all existing PdPs paid by SAA and seek damages against SAA in an English court. Additionally, SAA is required to notify its lessors and lenders of potential events of default arising under other loan/lease and material contracts, which can result in enforcement action by relevant lenders/lessors/other counterparties. The Board should consider alternative options to remedy the situation and workshop these with ExCo.

Recommended actions to address situation

It is recommended that the Board should immediately:

1. request the shareholder for an equity injection whether through capitalisation, sale of shares or other applicable and appropriate corporate finance mechanisms to arrest

the financial decline and resolve SAA's going concern, financial distress and reckless trading concerns and comply with the Companies Act;

2. finalise its decision regarding the Swap Transaction;
3. engage Airbus and seek to reach agreement on the agreed transaction structure between the parties, including the withdrawal of the Correspondence and the suspension of all the obligations under the Purchase Agreement pending agreement on the revised Swap Transaction; and
4. Establish a transaction team to negotiate the Swap Transaction under the agreed transaction structure.

SIGNATURES:

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