

BUSINESS RESCUE, RESTRUCTURING & INSOLVENCY NEWSLETTER

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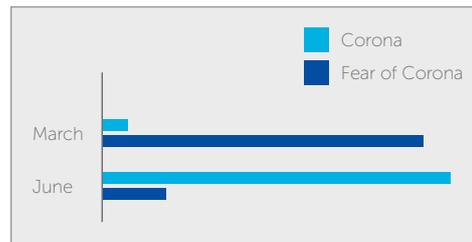


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I recently saw this graph which compared the notion of the “fear of the Coronavirus” to the “actual impact and devastation of the Coronavirus”.



The graph is not based on factual information of the infection or death rates. It merely illustrates the psychological effect of lockdown and in fact, the utter irony of it. This graph provoked a few questions. Was lockdown enforced too early? If so, does the prematurity mean that it was all for nothing? Also, is it by choice or are we forced not to fear the virus anymore? Personally, I think the graph illustrates our current reality. It is tough out there and retrenchments and salary cuts have become the order of the day.

I trust that everyone has by now unpacked their online wine purchases. I am still amazed at how conditioned we have become. The simplest things, like the delivery of an online alcohol purchase, brings so much joy to our lives. As we moved into level 3, we heard school bells ring for the first time in months and we are about to hear and see aeroplanes again.

In the last two weeks since the publication of our previous edition, we introduced and broadcast our first [podcast](#). We joined forces with our colleagues from CDH's employment practice and we discussed the rights of employees in business rescue and liquidation. We also dealt with the effect of the recent Labour Court decision pertaining to

the business rescue proceedings of SAA. We are working on some interesting topics and will shortly be releasing more podcasts.

In this week's edition, we revisit the topic of lease agreements during business rescue and we delve into and consider the landlord's tacit hypothec. When does the hypothec become legally enforceable? Does the hypothec automatically provide security for the debt owing to the landlord or is action required to perfect the security?

We have realised that many businesses are considering corporate restructuring techniques. For some, these techniques may include a subordination of their debts so as to alleviate the financial pressures occasioned by the lockdown. Directors should pay attention to the enclosed article on subordination agreements and specifically take note that a subordination of the company's debts will not exempt them from potential directors' liability, nor will it clean up the company's actual liability to its creditors.

I end off this edition with some good news. Jackwell Ferris (Director) and Pauline Manaka (Senior Associate) in our Dispute Resolution Department have been selected by the Association of Young Arbitrators as members of Africa's 50 Most Promising Young Arbitration Practitioners in 2020. Pauline is also a member of the Business Rescue, Restructuring and Insolvency sector at CDH. Congratulations Jackwell and Pauline on this prestigious achievement.

Until next month.

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Lease agreements revisited: The landlord's hypothec in financially distressed times

In dealing with the affairs of financially distressed lessees, the question has been raised as to the rights of creditors, particularly landlords, in respect of outstanding rentals and fees.



The landlord's hypothec

The landlord's tacit hypothec is a form of real security. The hypothec secures the lessee's obligation to pay rent in terms of the agreement of lease. It does this by allowing the landlord to burden the movable property present on the leased land or while in transit to a new destination subsequent to the removal from the land. What this means is that the landlord can obtain a lien or limited real right in the movable goods present on the property on the date that rent is in arrears until payment is made.

However, this right does not accrue to the landlord automatically, it must first be perfected. This involves the intervention of a court process.

In a situation where a lessee company is placed in business rescue, the landlord's hypothec is affected by the general legal moratorium on civil proceedings in terms of section 133(1) of the Companies Act 71 of 2008 (the Companies Act). The moratorium prevents the landlord from taking legal action to perfect its hypothec after the commencement of the business rescue process, as this would constitute legal action in respect of company property which is prohibited by the moratorium, unless the business rescue practitioner or the court consents to the perfection.

It is highly unlikely for a business rescue practitioner to consent to the perfection of the landlord's hypothec, as it may negatively impact on the successful business rescue of the company. In order for a landlord to perfect its hypothec (after business rescue proceedings have been commenced), it would have to approach the High Court (when the outstanding rental exceeds the monetary jurisdiction of the Magistrate's Court and/or when the lease agreement provides for the High Court to have jurisdiction) on an urgent basis for the following relief:

- for an order authorising it to institute legal proceedings against the company in business rescue;
- for an order perfecting its landlord's hypothec and authorising it to attach all movable assets at the leased premises.

It is important to take cognizance of the fact that a landlord cannot attach property that has already been encumbered by another creditor and therefore which property is subject to another creditor's security. A landlord also cannot attach property where ownership of the property has been reserved to another creditor. In other words, a landlord is not entitled to perfect its hypothec over encumbered property (for example in the form of a notarial bond) or property where ownership has been reserved.

The ranking of a landlord's claim in business rescue

Section 135 of the Companies Act deals with the ranking of creditors in business rescue proceedings. Section 135 sets out the order in which the claims of creditors rank during business rescue. In terms of this section, post-commencement financiers are preferred in the order of preference created by the Companies Act. This was confirmed by the court in *Merchant West Working Capital Solutions (Pty) LTD v Advanced Technologies and Engineering Company (Pty) Ltd and Another* (13/12406) [2013] ZAGPJHC 109 (10 May 2013) (Merchant West). The position pursuant to this judgment was that, even if a creditor has a secured claim against the company, post-commencement financing takes preference over those claims, whether the post-commencement financing is secured or unsecured.

The court in *Diener N.O. v Minister of Justice and Others* (926/2016) [2017] ZASCA 180; [2018] 1 All SA 317 (SCA); 2018 (2) SA 399 (SCA) (1 December 2017) limited this to the extent that the SCA ruled that business rescue proceedings do not dilute the security of pre-business rescue secured creditors in terms of section 134(3) of the Companies Act. Accordingly, the correct position is that post-commencement financier claims rank only in priority to all

Lease agreements revisited: The landlord's hypothec in financially distressed times...continued

unsecured creditors and that pre-business rescue creditors' rights to their security must be respected in terms of section 134(3) of the Companies Act and they can therefore not rank below any post-commencement financiers who hold no security.

Arrear rental, however, is currently not considered as post-commencement financing, as confirmed in *South African Property Owners Association v Minister of Trade and Industry and Others* (2018) 2 SA 523 (GP). Therefore, the landlord's unperfected hypothec ranks as a concurrent claim in business rescue. Should the landlord however perfect its security by way of court order as explained above, the landlord's claim becomes secured and will move up in ranking in business rescue proceedings, but will remain below secured post-commencement financiers' claims.

Important considerations

Landlords need to be aware that it is not as simple and there is no 'quick fix' when it comes to enforcing their hypothec against financially distressed tenants (whether they be natural or juristic persons). Landlords need to understand that they do not have an automatic hypothec over property on which they can rely. Landlords first need to take steps to 'perfect' that hypothec (as explained above).

As already indicated, a landlord is also not entitled to perfect its hypothec over encumbered property (for example in the form of a notarial bond) or property where ownership has already been reserved to another creditor. It is likely that due to the very troubling times that South Africa finds



itself in, and in particular the retail industry, that all stock or movable property situated on the leased premises may have already been encumbered to other financiers (or creditors generally). If this is the case, a landlord cannot simply attach those encumbered assets and the landlord would therefore have to explore other remedies to protect its rights.

Our advice to our landlord clients is to consult with our Business Rescue, Restructuring and Insolvency team as soon as their tenants (whether natural or juristic persons) find themselves in financial distress, so that the necessary

action can be taken to ensure that they are sufficiently legally protected (both before or after business rescue proceedings have commenced).

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CHAMBERS GLOBAL 2017 - 2020 ranked our Dispute Resolution practice in Band 1: Dispute Resolution.

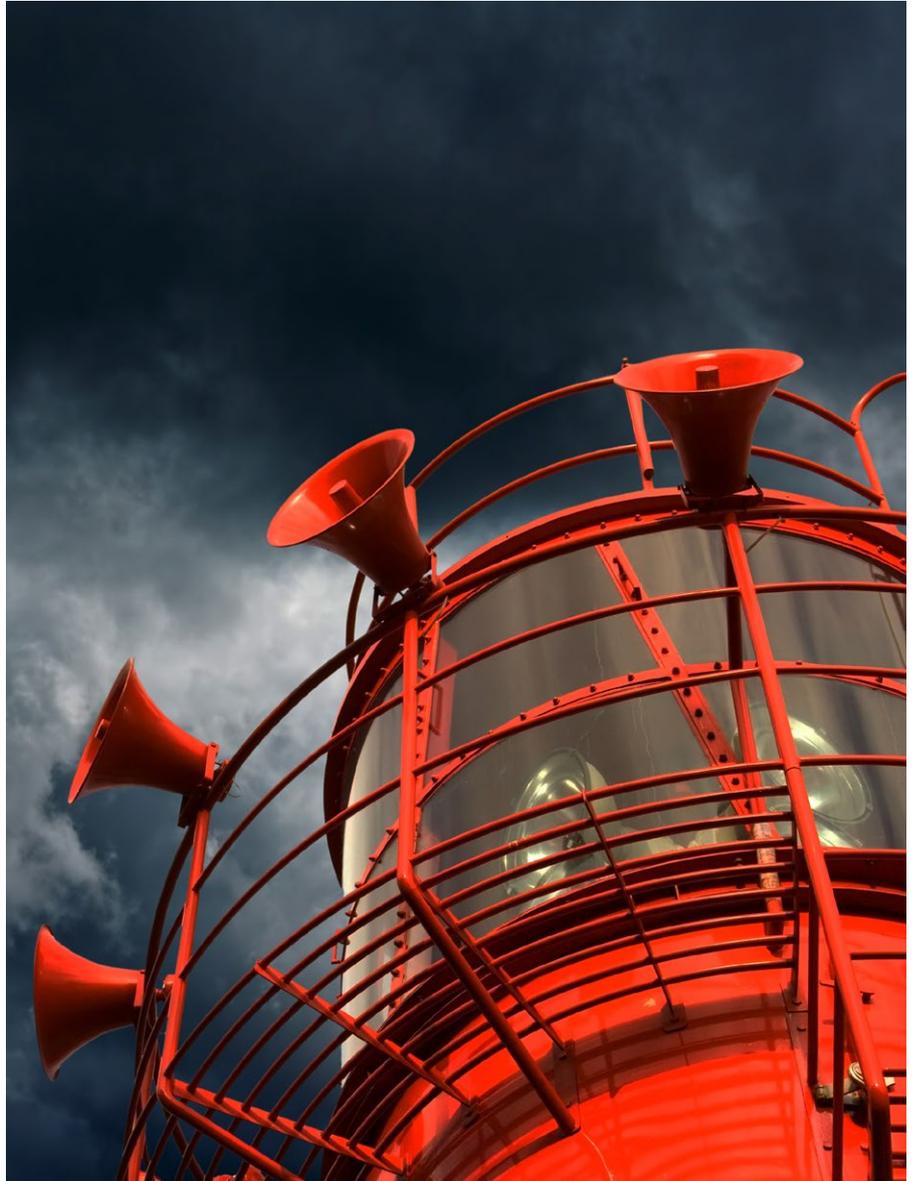
CHAMBERS GLOBAL 2017 - 2020 ranked our Dispute Resolution practice in Band 2: Restructuring/Insolvency.

Tobie Jordaan ranked by CHAMBERS GLOBAL 2020 as an up and coming Restructuring/Insolvency lawyer.



Subordinated debt in business rescue

The financial impact of COVID-19 will depend on how long it lasts and the depth of the fall in output. The main cost of COVID-19 will no doubt be unemployment occasioned by the inevitable financial distress of companies (a conservative prediction currently estimates the number of people to become unemployed to be in the millions). In order to survive, companies and lenders alike will have to weather the storm, demonstrate a level of agility and solidarity as well as consider corporate restructuring techniques to combat the effect of this pandemic. These techniques may include a subordination of debts.



First, back to the basics: A subordinated debt is a type of debt that receives a lower priority level in terms of its claim to a company's assets when the company is unable to pay its debts and becomes insolvent. If a company defaults on its debts, the debts have an order of priority that determines when or if they will receive payment. The generally accepted view is that subordination happens by way of a written subordination agreement wherein a creditor formally subordinates its claim/s to either one particular creditor or all of the creditors of a company.

In considering whether to subordinate any of their debts, lenders must grapple with a number of issues including the impact of subordination on their voting interests in business rescue. The importance of voting interests and the extent thereof in any business rescue cannot be overstated. It can wittingly shape and nudge the business rescue process in a particular direction, hopefully for the benefit of all stakeholders.

The starting point is section 145(4)(a) and (b) of the Companies Act 71 of 2008 (the Companies Act). It says that a secured or unsecured creditor has a voting interest equal to the value of the amount owed to that creditor by the company in business rescue. It also says that a concurrent creditor who would be subordinated in a liquidation has a voting interest (as independently and expertly appraised and valued) equal to the amount, if any, that the creditor

Subordinated debt in business rescue...continued



could reasonably expect to receive in the liquidation of the company. For example, if a subordinated, unsecured creditor stands to receive a dividend of say 50% in the event of liquidation of the company, such a creditor will have a voting interest equal to 50% of its claim in the business rescue proceedings of the company. In the same way, if such a subordinated unsecured creditor stands to receive no dividend in a liquidation of the company, it will have zero voting interest in the business rescue proceedings.

Therefore unsecured creditors with subordinated debts face a risk that their voting interests could have a zero-voting interest in business rescue. That is so because in a liquidation, an unsecured subordinated creditor will in all likelihood not receive a dividend. One way of addressing this would be for creditors to take security, to the extent possible, for their debts as the risk identified above will only materialise if

a lender is a concurrent creditor. This may in itself be self-defeating as is it unlikely that many companies (many who are financially distressed) will have any tangible assets to be encumbered, post the pandemic.

Although subordinating loans has the benefit of assisting a company with its financial distress, directors must be cognisant of the fact that it will not exempt them from directors' liability under the Companies Act. For example, if the effect of the subordination is that the company is no longer financially distressed because the particular debt which has been subordinated is no longer due and payable, the debt remains owing and remains included amongst the company's liabilities. Therefore, a subordination of debt does not affect a company's factual solvency position. Should the company remain factually insolvent, directors may still be held liable for trading recklessly under insolvent circumstances.

As society weathers the financial impact of the COVID-19 pandemic, the subordination of unsecured debts is one of the measures that companies and lenders alike are starting to consider in order to kickstart their businesses and avoid the inevitable financial distress of the company. However, such subordination does come with associated risks, especially should a debtor company be placed under business rescue proceedings (i.e. being unable to vote on a business rescue plan) and further being open to directors' liability. Therefore, there is no quick fix and clients should consult us as to the best course of action in the circumstances.

Vincent Manko
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OUR TEAM

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BBBEE STATUS: LEVEL TWO CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

PLEASE NOTE

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

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