

How do we fare in Real Estate during the South African lockdown and beyond

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Declared by the World Health Organization on 11 March 2020 as a global pandemic, the Coronavirus outbreak (“COVID-19”) is having far-reaching consequences for all states affected by this pandemic. Amidst the lockdowns and other precautionary measures that governments are trying to implement globally, we find ourselves confined to working from home. However, for individuals, one-man business owners or small, medium to large corporations that effectively operate from premises other than their homes, lockdowns inevitably equates to lost time, lost revenue and increased costs.

Productivity across multiple sectors has declined drastically, let alone the real estate sector, which is facing a number of issues from delays in construction, loss of income, partially due to defaulting tenants, investment declines due to subdued market activity and alas a drastic decrease in investor market confidence during this time of uncertainty. The South African Government (“SA Government”) took a decision to implement its nationwide lockdown at 23:59 on 26 March 2020 until 23:59 on 16 April 2020 – a cumulative period of 21 days (“SA Lockdown”). Uncertainty remains around whether this 21-day lockdown will be sufficient to curtail the spread of COVID-19, and whether this may in fact be extended. Declared as a national state of disaster, the SA Government has implemented certain regulations in terms of the Disaster Management Act, 2002 (“DMA Regulations”) which, at face value, caters only to the retail industry, to the exclusion of any other asset class comprising the nation’s real estate sector.

DMA Regulations impact on various real estate sectors in South Africa

The DMA Regulations released by the SA Government on 18 March 2020 (and as further amended on 25 March 2020) permits only certain places and premises recognized for the provision of “*essential goods and services*” to be open and operational during the SA Lockdown. This limitation has far-reaching consequences for many industries in the real estate sector.

Hospitality and leisure

With the implementation of the coined term “*social distancing*” as a preventative measure aimed to curb the spread of COVID-19, the SA Government initially implemented the rule of no more than 100 people at a gathering. These numbers were further restricted to 50 people per gathering and at present, to a position where social gatherings are strictly prohibited. The SA Government has only permitted tourists who are currently restricted from travelling or who are in quarantine to remain in hotels, lodges, guest houses, private and public game reserves and holiday resorts during the SA Lockdown. The hospitality industry has otherwise been severely impacted, and has been required to close its doors amidst the COVID-19 pandemic. Needless

to say, the hospitality sector has been hard hit by the lockdown being implemented globally, as this relates not only to local tourism, but rather travel bans being imposed globally restricting inward and outward movement in South Africa and elsewhere as a result.

The SA Government has not, at present provided any relief mechanisms to the hospitality sector, however, it remains to be seen whether any mechanisms will be put in place post the SA Lockdown to assist the sector in its recovery.

Retail industry

Somewhat cushioned in terms of the DMA Regulations and further exemptions granted by the SA Government is the retail industry sector. Food products, cleaning and hygiene products gas, fuel, coal, airtime and electricity are recognized as “essential goods” and are permitted to be retailed in selected stores generally, whether those stores are located in retail malls, strip malls or stand-alone stores.

In a further attempt to minimize the impact of COVID-19 on the retail property sector, the Minister of Trade, Industry and Competition has issued the COVID-19 Block Exemption for the Retail Property Sector, 2020 Regulations in terms of section 10 (10) of the Competition Act, 1998 (effective as of 24 March 2020 and will remain effective until the national disaster status is rescinded) (the “Block Exemption”). These regulations aim to enable the retail property sector to minimize the negative impact on the ability of designated retail tenants, including small, independent retailers, to manage their finances during the pandemic national disaster and to ensure business survival and continuity beyond the national disaster.

These regulations further exempt a category of agreements or practices between designated retail property tenants and retail property landlords from the application of section 4 (*agreements between competitors*) and section 5 (*agreements between suppliers, firms and customers*) of the Competition Act at the request of and in coordination with the Department of Trade, Industry and Competition. The Block Exemption applies only to agreements or practices in respect of:

- (a) payment holidays and/or rental discounts for tenants;
- (b) limitations on the eviction of tenants; and
- (c) the suspension or adjustment to lease agreement clauses that restrict the designated retail tenants from undertaking reasonable measures required to protect viability during the national disaster.

The exemption extends to all South African retail tenants in the designated retail lines, including small and independent retailers, unless otherwise authorised by the Minister or the Competition Commission. The designated retail tenants covered by this Block Exemption are identifiable by the designated trading lines, namely:

- (a) clothing, footwear and home textile retailers;
- (b) personal care services (i.e. hairdressers, health and beauty salons); and
- (c) restaurants.

Industrial, logistics and essential tenants

All businesses and other entities involved in the manufacturing, supply or provision of an “essential good or service” are permitted to operate and trade during the SA Lockdown. The manufacturers, suppliers and distributors of these essential goods and services are still permitted to operate “normally” amid the pandemic. The SA Government has, however, taken strict measures to ensure that the operations are controlled, and will require the head of such institution (being the CEO or similar person) to determine: (i) the essential services provided by the company and (ii) the essential staff required to perform those services. Essential staff are required to complete an essential work services permit during this time, and the company itself is required by the Minister of Trade and Industry to register its company as an essential service provider.

Due to the fact that the aforesaid companies are allowed to operate during the SA Lockdown, such tenants will not be entitled to a reduction in rental, payment holiday or rental suspension. If companies in these

affected industries voluntarily take the decision to close down in order to protect their employees and reduce the spread of the virus, they are still required to pay rent to the landlord, and a failure to do so will constitute a breach of the lease agreement, entitling the landlord to enforce whatever rights it may have in terms of the lease agreement. In the event of such early termination, the tenant may also be obliged to pay damages to the landlord. However, the parties may agree to enter into negotiations amongst themselves to review the terms of the lease or to a rental reduction. It is important to note that there is no automatic right to review the terms or reduce the rent amount payable in terms of the lease.

The tenant may wish to terminate the lease if it decides not to make use of the leased premises due to the pandemic national disaster. As mentioned above, the parties need to review the lease agreement and determine whether it provides for the termination of the lease due to the pandemic national disaster. Unless the lease agreement specifically caters for the termination of the lease agreement in the circumstances of a pandemic, there is no automatic right to terminate the lease agreement, save however of the tenant elects to rely on its early termination provisions in the lease agreement (consequences of which are discussed in more detail below).

It is much to the disappointment of other entities involved in the manufacturing, supply or provision of goods and services regarded as *non-essential* that they have not been granted any legislative nor interim relief for this period of the SA Lockdown. It remains uncertain at this point as to whether the SA Government will implement measures to grant interim relief to businesses in the non-essential goods and services sector.

Commercial property and non-essential tenants

As a consequence of the SA Lockdown, all commercial business offices, other than those in the “*essential goods and services*” industry are mandated to lockdown and either implement a work from home policy or temporarily cease operations (depending on the nature of the business and the resources available). There are two categories within the commercial property sector that would likely face harsh consequences as a result of the SA Lockdown: (i) property developments that are still in its construction phase and (ii) commercial property let by the non-essential goods and services tenants. In respect of the latter category, in absence of any interim legislation in place to regulate the scenario, consideration would need to be given to the underlying lease agreements, remedies that may be available to the respective contracting parties during the SA Lockdown and possibly the common law. With regard to property developments that are still in its development/construction phase, the consequences are likely to extend beyond landlord and tenant.

Set out below are a number of legal, contractual and practical considerations that the affected parties are likely to opt for as recourse to their affected contractual position.

Practical considerations

Should a tenant be unable to meet its rental obligations, the tenant would be in breach of a material term of the lease agreement. As discussed, given the financial pressures and loss of or reduced income that businesses and individuals alike may be facing as a result of COVID-19, it is likely that tenants may or may not be able to meet their current and or future rental obligations. This would inevitably result in a breach of a material term of the lease agreement affording the landlord the right to either: (i) terminate the lease agreement; (ii) demand specific performance; or (iii) claim damages as a result of the tenant’s failure to perform thereunder.

In contrast to the tenant’s likely default of the lease agreement is the landlord’s interest in: (i) ensuring or assisting their tenant to survive the COVID-19 pandemic and (ii) having a tenant occupying the leased premises. It would be recommended in the circumstances that the tenant and landlord engage at an early stage should the parties be amenable to negotiate a form of temporary relief that would be beneficial to the interest of both parties. A landlord’s obligations towards its financiers can also not be ignored as funding obligations (if still in place) need to be discharged if no consequential relief has been afforded by the financier or the terms of the underlying loan agreement.

Landlords reliant on financing will remain under pressure to fulfill their payment and other obligations to their financiers. Landlords and financiers alike would need to look to the provisions of their loan agreements to determine if there are any interim relief or other measures that could be relied on to afford grace to the landlord and to defer payment obligations under the respective financing documents. The same holds true for any guarantors, sureties or other obligors.

Should parties agree to amend their lease agreements to cater for interim relief, parties are to be mindful of the relevant requirements of the lease agreement and whether any such amendments are required to be reduced to writing. In the South African context, most long-term leases are registered in the Deeds Registries Office, and such amendments would need to be lodged with the relevant Registrar of Deeds.

Early termination of lease agreements are likely in circumstances where the tenant is unable to fulfill its obligations or the landlord is unable to meet its financial obligations to its financiers, which may result in funding being accelerated and cancelled. Landlords and tenants alike should be mindful of the consequences of early termination and the potential effect it could have on their respective business if this does occur.

Legal considerations

Force Majeure: Force majeure clauses regulate the liability of the parties and the effect on the contract when an extraordinary event or circumstance, beyond the control of the parties (e.g. war, strike, riot, natural disaster etc.), or an event described by the legal term “*act of God*” (e.g. flooding, earthquake, volcano etc.) prevents one or both parties from fulfilling their obligations under the contract. In the context of a tenant-landlord leasing arrangement whether in the retail, commercial or industrial sector, reliance will have to be placed on the underlying contractual agreements between the parties, and whether either party can temporarily be absolved from fulfilling its obligations thereunder. A party seeking to rely on a force majeure clause due to the COVID-19 pandemic must ensure that the provisions of the agreement governing the relationship between the parties are wide enough to include this pandemic. If the lease agreement includes such a force majeure clause, the parties will have to rely on the relief set out in the specific provisions of the agreement thereto. However, if the agreement is silent on force majeure, the parties will have to rely on the common law principle of supervening impossibility of performance (as discussed below).

Construction agreements would more than likely include a force majeure clause, the relief of which would generally go further than just contractor-developer relief and may well extend to relief under supply agreements and off-take agreements. Relief for force majeure is possible, however, it may very well depend on how the provisions of force majeure are drafted. A developer reliant on finance for his development would likely look to his loan agreement for force majeure relief under the circumstances. Should force majeure not be passed-through to the financing documents, a developer should look to other forms of relief as discussed below.

Supervening Impossibility of Performance: As a general rule, if after the conclusion of the contract, performance becomes objectively impossible without any fault on the part of either party as a result of an unavoidable and unforeseen event, the party’s failure to perform is excused. The impossibility of performance that arises after the conclusion of the contract is called supervening impossibility of performance. The relief that the parties are able to claim for supervening impossibility of performance, is one to be agreed and discussed between the parties, however it remains to be a common law principle which should not however be overlooked.

Breach of Financial Covenants: Although some real estate financing transactions are covenant-lite, maintenance cover ratios are generally included and there will be increased inclusion of this ratio, looking forward. Depletion of rental income, or in the case of an upcoming development a decrease in the amount of pre-sales and pre-sales deposits will negatively affect the landlord/developers ability to meet its obligations in its underlying finance documents.

Material Adverse Change or Material Adverse Effect: It is likely that COVID-19 would adversely affect some or all of the business, operations, performance and assets of the landlord/developer. The landlord/tenant’s ability to meet its obligations under the finance documents could be a material adverse effect resulting from a material adverse change. Financiers and landlord/developers alike should be mindful of the potential implications of this and the potential relief that may follow through from the underlying finance documents.

Insurance: Landlords/developers and tenants need to review their respective insurance policies to determine whether they have business interruption coverage. Claims may potentially be made for non-damage business interruption, which may cover the payment of rent in the event that the leased premises are forced to close by the SA Government due a pandemic national disaster. However, standard business interruption cover does not include forced closure by governmental authorities, as such coverage is typically used for physical damage to the property, which results in the business being unable to continue its business operations. The

parties therefore need to look at the specific wording of their respective policies to determine whether COVID-19 is a “covered peril”.

Access Restrictions: Lease agreements typically reserve the right for landlords from time to time to prevent or restrict access to any of the common parts if reasonably required in case of an emergency. Retail leases typically contain an obligation on the part of the tenant to comply with all laws, by-laws, ordinances, proclamations or statutory regulations relating to the property. The tenant would therefore be obliged to vacate the leased premises due to the SA Lockdown, together with other limitations imposed by the SA Government such as the limitation on operating hours of shopping malls.

Suspension of Rights: In the case of retail tenants, the Block Exemption provides that the landlord must allow payment holidays or a rental reduction and must limit the evictions of tenants during this national disaster period. Therefore, the landlord's right to terminate the lease agreement due to non-payment or to bring other claims such as a damages claim for early termination of the lease agreement due to non-payment is suspended during this period.

Looking forward

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- finding possible solutions to exposed risks, including being at the forefront of representing our clients and their interests in a given transaction;
- engaging with lenders and/or borrowers on next steps in possible restructures or debt reorganization;
- engaging with tenants and/or landlords on next steps in possible lease restructurings and/or payment rearrangements;
- assisting with drafting the necessary as it relates to addressing our client's needs in a particular situation, be it amendments to development documents and/or financing agreements, deferrals to and/or restructuring of offtake agreements, providing notices under the applicable agreements or generally just providing legal support during a time of unprecedented crisis.

Given the global reach of this pandemic, our offices have been engaged globally by various clients for advice on various matters related to the Real Estate Industry, and we have the ability to understand, from a global standpoint, where the international market is currently placed, and what is seen to be global “*best practice*” as it develops.

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