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Real Estate

Germany
Trends and Developments

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Trends and Developments

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One year after the outbreak of the COVID-19 pandemic, we assess the legal and factual repercussions on the real estate transaction market in Germany.

Overview of the Market

Looking back with the benefit of hindsight, it is evident one year after the outbreak of the COVID-19 pandemic that the German real estate market has demonstrated its continued stability for both private and institutional investors.

Although certain differences may have emerged in individual asset classes, the COVID 2020 year was eminently successful overall, registering a total transaction volume of around EUR79 billion (cf CBRE Real Estate Market Outlook). We are certain that the German real estate market will continue to attract investors, given that there are virtually no other alternative investment opportunities with comparable security and returns in the face of the high investment pressure exerted by many investors. This trend will be significantly reinforced by the sustained low interest rate policy, as a result of which, investors will continue to search intensively for investment opportunities in the German real estate market. Above all, newly emerging opportunities will offer foreign investors, especially, the option to enter the German real estate market.

The differentiation which has already begun between different asset classes, and even within them, will continue.

Certain asset classes were more substantially hit by the COVID-19 pandemic than others. It therefore comes as no surprise that investors have developed a preference for the "asset winners" emerging in 2020. This particularly includes properties for living, healthcare and logistics, as well as retail in the food and pharmaceutical segment.

Opportunities exist even in asset classes which have come under greater pressure due to the COVID-19 pandemic and which therefore, at first glance, appear riskier. After all, a higher risk usually entails better returns, even more so if one recognises existing problems and applies customised solutions.

Impact of the Pandemic on the Acquisition Process and the Purchase Agreement

We outline below the issues that need to be taken into consideration since the outbreak of the COVID-19 pandemic, and probably will for some time thereafter, particularly in the context of legal due diligence and purchase agreements. In this context, we make a distinction between existing properties on the one hand, and properties under project development on the other.

Existing properties

The purchase price factor relevant to real estate depends upon macro-location and micro-location as well as on the intended use of the property. To determine the purchase price of a property the respective purchase price factor is multiplied by the annual net cold rent. Against this backdrop, it is evident that the respective net cold rent obtainable from the property is a decisive factor for the purchase price. Depending on the asset class, the COVID-19 pandemic may have direct repercussions (at least temporarily) in this regard.

Lease adjustments in conjunction with Section 313 of the German Civil Code (BGB)

The operations of many retailers, restaurant owners, hoteliers, etc, were severely impacted due to the measures taken to combat COVID-19. Restaurant owners and hoteliers were the first to be affected after the first lockdown in March/April 2020, and then had to close their businesses again as early as November 2020 ("lockdown light"). From the middle of December, most retailers were then also forced to close their establishments and introduce new sales models (eg, "click & collect" etc).

Many tenants used the government restrictions as an opportunity to reduce their rents and/or ask their landlords for rent reductions/deferrals. As expected, the courts then also had to deal with the upsurge in legal disputes concerning the tenants' obligation to pay rent. While rulings by the Federal Supreme Court do not yet exist, the local and regional courts have mostly denied claims for reduction/deferral of rent by tenants.

A law to further shorten the residual debt discharge procedure was passed on 17 December 2020 by the German parliament (*Bundestag*) as a supplement to the COVID-19 Act of March 2020. By simplifying the application of Section 313 BGB during the COVID-19 pandemic, one of the intentions of this law is to strengthen the negotiating position of tenants, which can also be viewed as a political signal for more tenant-friendly legislation. This must also be taken into consideration against the backdrop of the second lockdown having led to a longer period of imposition, and in some cases, with even more stringent measures.

Pursuant to Section 313 (1) BGB, amendment of the contract can be demanded if:

- the circumstances which became the basis of a contract have significantly changed since the contract was entered into;
- the parties would not have entered into the contract at all or only with different content had they foreseen that change; and
- taking account of all the circumstances of the specific case, in particular, the contractual or statutory distribution of risk, one of the parties cannot reasonably be expected to uphold the contract without alteration.

As outlined, Section 313 BGB assumes an unforeseen significant change in circumstances which was not even considered at the time the contract was entered into. Therefore, Section 313 BGB generally does not apply in the case of rental/lease agreements which were concluded subsequent to the onset of the pandemic.

The recently incorporated Section 7 of Article 240 of the Introductory Act to the German Civil Code (EGBGB) now provides for a revocable presumption that the contractual circumstances have significantly changed since the conclusion of the contract (first requirement of Section 313 BGB), if the rental object cannot be used or can only be used with considerable restrictions due to government measures to combat the pandemic. The applicability of Section 7 extends to all rental/lease relationships pertaining to industrial premises, commercial space, land and property, with the exception of residential premises.

There is regularly a significant restriction in state regulations if no part or only a specified part of the commercial space may be used for public traffic or if only a limited number of people may occupy a specified area. If, on the other hand, an operation which involves public traffic loses

customers due to a decline in the willingness to consume, the presumption does not apply, because this is deemed to be part of the tenant's operating risk.

In simplified terms, a claim by a commercial tenant pursuant to Section 313 BGB therefore still requires that there are actual requirements/restrictions governing the specific operation of the tenant which result in it being unreasonable for the tenant to adhere to the original, unamended contract. Whether it is actually unreasonable for the tenant to adhere to the existing contract is to be decided on a case-by-case basis, and must be proven by the tenant. In this regard, factors such as a decline in sales compared to previous years, any entitlement of the tenant to state support and possible reserves, must specifically be taken into account.

Depending on the assessment with regard to the afore-described reasonableness, rent deferral, rent reduction and termination rights may be considered as adjustment options. At present, it is probably best to assume that the parties will only have the right to terminate the lease in very exceptional cases. Deferrals would be conceivable, particularly if the tenant is basically entitled to sufficient state benefits, but payment of the same is delayed and there are therefore temporary liquidity bottlenecks. In most cases, however, it would be fair to assume that, at best, an adjustment in the form of rent reduction can be claimed.

The adjustments (deferral or rent reduction) will only be temporary in nature, namely, specifically for the duration of the lockdown, provided that the situation reverts to normal within a short time due to a vaccine becoming available. If, however, landlords have to enter into long-term rent reduction agreements due to the financial circumstances of tenants, this will probably have an impact on the purchase price of property.

Tenants of properties in other asset classes who are not directly affected by the COVID-19 measures, but who may nevertheless feel the effects indirectly (eg, providers of office space), are in any case not entitled to a contractual adjustment, since the premises can continue to be used without restriction. A general economic crisis or a decline in sales due to the economic situation does not justify a contractual adjustment, as this is fundamentally a matter of tenant's risk.

Acquisition process/provisions in the purchase agreement

It is clear from the above that the due diligence process should enquire specifically whether tenants have asserted claims in connection with the COVID-19 pandemic and, if so, to what extent rent reductions/deferrals have already been granted, or whether there is indeed a question of termination. The tenant's payment history (irrespective of the amount of rent owed) should also be examined. In addition, legal due diligence should focus to an even greater extent on the rental securities provided and their effectiveness. This also incidentally applies to asset classes that may be only indirectly affected by the COVID-19 measures (eg, office premises).

Finally, today more than ever, in addition to legal due diligence, tenants should also be reviewed from a business perspective. After all, despite government aid, an increasing number of tenants, at least in the restaurant/hotel or retail sectors, are likely to find themselves in a crisis that threatens their existence, whilst some of them could ultimately go bankrupt.

In this context, there might be a risk that, if the landlord is aware of the tenant's insolvency and/or excessive indebtedness, the tenant may face an insolvency challenge with regard to the rental instalments already paid, if the tenant actually becomes insolvent at a later date. One conse-

quence could be that rental payments which have been made up to four years prior to the insolvency application can be contested, and thus could include payments that fall within the period of possession and ownership of the purchaser. In principle, only the rental from the time when the obligation to file for insolvency actually arose and the landlord was aware of the same, or such knowledge on the part of the landlord is assumed, can be contested in each case. As a rule, however, so-called "cash transactions" (ie, payment of rent for the current month during the current month) are excluded from being contested.

Such risks must be recognised and, if necessary, incorporated into pricing as part of the due diligence process.

Risks identified in the course of the due diligence process can also at least be minimised by appropriate provisions in the purchase agreement. For example, purchase agreements usually include a Material Adverse Change (MAC) clause. Such clauses enable a buyer to withdraw from the contract if a disadvantageous material adverse change (eg, destruction due to fire through no fault of the buyer) occurs with regard to the property in question, between the time the contract was entered into and the due date of the purchase price (usually a period of several months). In these times of the COVID-19 pandemic, this clause should be supplemented by the insolvency of the tenants (or at least the anchor tenants). This would ensure that the insolvency risk of the tenant is borne by the seller at least for a few months subsequent to the conclusion of the purchase agreement. As an alternative to withdrawal from the contract, the purchase price can be adjusted in the purchase agreement by means of a price variation formula to be agreed upon. This is especially relevant if, despite the insolvency of a tenant, the property as a whole remains attractive to the investor.

Properties in the project development phase

The current COVID-19 pandemic has led to so-called "force majeure clauses" or even "corona clauses" becoming commonplace in project development contracts. Prospective buyers must therefore pay special attention to the various forms of such clauses when negotiating contracts. It is very important, in this context, to understand the background and the requirement for contractual provisions of this type.

If a final handover deadline has been agreed upon in the framework of project development and this deadline cannot be met due to construction stoppages or delivery failures caused by the pandemic, the question inevitably arises as to what rights the parties are entitled to and what risks have to be taken into account.

The COVID-19 pandemic as a force majeure circumstance

The current COVID-19 pandemic can be deemed to constitute a force majeure circumstance even in connection with a project under development. The question as to whether the requirements of force majeure are met must be assessed on a case-by-case basis, taking into account the overall circumstances and the agreed allocation of risk.

It can be assumed that a force majeure event will affect a project under development, especially if official orders are issued or quarantine measures are adopted at the construction site, causing shutdown of the site, entry restrictions or supply bottlenecks due to disruption of supply chains, as a result of which, the contractor responsible for fulfilling contractual obligations is prevented from doing so.

On the other hand, force majeure is not deemed to exist if the impairment is based on a (voluntary) precautionary/safety measure without a corresponding official order. In such cases,

the characteristic of "inevitability" is lacking. A force majeure circumstance can also not be deemed responsible if the contractor's foreign workers no longer come to the construction site for fear of soon being unable to return to their home country. Looking at the big picture, a decisive factor is whether the specific effects of the COVID-19 pandemic were avoidable on the part of the contractor. The characteristic of "inevitability" is generally not fulfilled in cases where the contractor could, for example, have compensated for a supply bottleneck by obtaining supplies elsewhere, deploying different personnel on the construction site or deploying a different sub-contractor. The procurement of a replacement material or the obligation to compensate is, however, subject to the condition of reasonableness; the precise point at which this limit lies depends on the distribution of risk and the circumstances in the individual case.

In accordance with the provisions of Section 313 BGB, force majeure will also probably not count as a factor if the contract was concluded only after the outbreak of the pandemic in complete awareness of the situation.

The requirements governing the burden of demonstration and proof that such an impairment exists are relatively stringent. In this context, the notice of impairment must specifically list the facts that resulted in a concrete impediment to the fulfilment of the contract. Information must also be provided as to precisely which work is impeded or is imminently facing such impediments. Generally formulated notices of impediment from a contractor do not meet these requirements, as was the case at the beginning of the pandemic.

Extension of the construction period on the grounds of force majeure

If the fact of force majeure is established in an individual case, and the parties have not reached a contractual agreement on how to deal with this, the question arises as to how the delay affects the contractually agreed handover deadline.

In the context of project development, a distinction must be made here between the legal relationship between the seller as the developer and the companies carrying out the construction work, and the legal relationship between the seller and the buyer.

Relationship between seller and buyer

If the purchase agreement (with a construction obligation) provides for a handover deadline and this deadline is not met, the seller is in default. This also applies in cases where the delay is due to force majeure. The BGB does not contain a provision on "extension of construction period" comparable to Part B of the German Construction Tendering and Contract Regulation (VOB/B). The buyer can therefore either adhere to the contract and continue to demand contractual performance by the seller or withdraw from the contract.

However, according to statutory law, in the absence of fault on the part of the seller, the buyer has neither a claim for contractual penalty nor for damages against the seller. Damages due to delayed handover to a tenant are therefore not to be compensated, just like financing damages/interest damages (in particular, commitment interest).

Therefore, from the buyer's point of view, care should be taken when drafting the contract to link non-compliance with the latest handover deadline to the obligation to pay a contractual penalty or something similar.

Relationship between the seller as developer and the construction companies

In contrast, the situation is different as regards the relationship between the seller as the devel-

oper and the construction companies as contractors.

If the principal and the contractor have agreed on the applicability of the VOB/B (which will usually be the case), the contractor is entitled to an extension of the construction period pursuant to Section 6 (2) no 1 c) VOB/B to the extent that the hindrance is caused by factors including "(...) force majeure or other circumstances which are beyond the contractor's control".

As far as the seller is concerned, this means that there is no concurrence between the construction contracts on the one hand and the purchase agreement on the other hand. While the seller must therefore accept an extension of the construction period on the part of the contractor without compensation in the event of force majeure, the seller is exposed to the risk of withdrawal and possibly even a claim for payment of a contractual penalty on the part of the buyer. It is therefore essential for the seller to also agree to a corresponding provision in the purchase agreement, according to which, an extension of the construction period due to force majeure leads to an (automatic) postponement of the contractually agreed latest handover deadline.

Contract negotiation and drafting

Several options are available when negotiating and drafting a "force majeure clause" or "corona clause". From the buyer's point of view, it is particularly important that the requirements for the burden of proof for the existence of force majeure circumstances are not diluted by the contractual provision. Moreover, it should be made clear that only delays which could not be avoided or compensated despite the seller's best efforts, and which could not be made up for or compensated for by other measures available to the seller, will result in a postponement of the handover deadline by the period of the delay which could not be avoided by the seller. It is also possible to agree on a maximum period by which the handover deadline is postponed. In the event that the seller has already leased the property and the lease agreement provides for a handover deadline, it must be ensured that the tenant has agreed to the divergent handover deadline in the form of a written addendum to the lease agreement.

Summary

In conclusion, Germany continues to be a secure location for investors. The COVID-19 pandemic has not fundamentally changed this situation and has even brought certain asset classes (eg, healthcare and logistics properties) increasingly into the focus of investors.

If the issues mentioned above are addressed within the scope of a sound legal due diligence process and tailored to the needs of the respective investor, it is still possible to achieve attractive investments across all asset classes.

The disruption of the market caused by the COVID-19 pandemic may even give new investors a unique chance to get into the German real estate market.

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