

COVID-19 NEWS OF INTEREST

German Real Estate Law: Legal Considerations for Entering into New or Amending Existing Agreements

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The COVID-19 pandemic has created new challenges for global economies. When considering the effects of the COVID-19 pandemic, a variety of legal questions arise in connection with amending existing agreements and entering into new agreements. In the following, we provide a brief overview of what we think should be considered for the main provisions of agreements in the real estate sector in Germany. Please contact us for any further details.

Force Majeure provisions are relevant for all agreements

- Due to the effects of the COVID-19 pandemic, existing agreements of all kinds currently raise numerous questions regarding contractual adjustments, temporary suspension of performance obligations, or even cancellation or termination. We have discussed this in our previous COVID-19 memos.
- The legal issues result, amongst other things, from the fact that many agreements do not contain provisions on pandemics or *general force majeure* provisions.
- The legal allocation of risk or liability in case of *force majeure events* is generally unknown in German law and also generally not reflected in statutory law applicable to the different legal types of agreements. *Force majeure provisions* are, however, included in statutory provisions for travel or transport.
- Under German tort law, courts generally define *force majeure* as an "event outside of the regular business operations, which is caused externally by natural forces or by the actions of third parties, and which is

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unforeseeable pursuant to human mind and experience, and that cannot be prevented or mitigated by economically bearable measures, even when applying the utmost care that could reasonably be expected considering the circumstances, and, due to the infrequent occurrence of such an event, can also not be borne by the business owner".

- *Force majeure* provisions allocate the risk of the occurrence of such events to one of the parties, generally accompanied by a (temporary) suspension of performance obligations and the granting of secondary rights after expiry of time (e.g. withdrawal, termination, adjustment of the agreement).
- The inclusion of *force majeure* provisions in German real estate related agreements has so far been not very common. To determine the legal rights upon the event of unexpected developments, existing warranty rights regimes, adjustments based on the doctrine of frustration or termination or withdrawal rights have regularly been used. The German VOB/B regime, however, already contains a *force majeure* provision, although it is not clear whether or not, and to what extent, this provision covers pandemics.
- This contractual practice will have to change. It will be important to include precise provisions in the respective agreements to address pandemics such as the COVID-19 pandemic or similar exceptional situations in the future and in particular to define what is to be considered *force majeure* in individual cases – if so desired by the parties – and what legal consequences should apply in the respective case (e.g. contractual adjustments, temporary, partial or complete suspension of performance obligations, existence or exclusion of damages, granting or exclusion of termination rights, adjustments of deadlines).
- There may also be a need to address the question to what extent future events, however based on the current COVID-19 pandemic, should be considered *force majeure* events and should result in a suspension or adjustment of performance obligations and liability regimes.

Additional points to be addressed in lease agreements

- Explicit contractual risk allocation in the event of closures and prohibitions of operations by authorities.
- Specific provisions for mitigation, adjustments of damage claims, termination rights and contractual adjustments in case of *force majeure* and/or resulting statutory or administrative orders.
- For not yet completed leased properties: Provisions to adjust contractual deadlines and milestones, e.g. regarding the receipt of building permits and the receipt of other operating permits; and long-stop dates, e.g. regarding the completion and approval of construction services or the rectification of remaining defects.
- If necessary, flexible provisions relating to the beginning of the lease.

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- Provisions relating to rent adjustment rights.
- Provisions relating to the exclusion or grant of termination or withdrawal rights.
- Rent deferral provisions including provisions relating to applicable interest accrual.
- Provisions relating to increased rental collateral, agreement on cash deposit instead of a bank guarantee or letter of comfort, grant of option right for the lessor to convert such collateral into cash deposits.
- Provisions relating to indexation of rental payments (e.g., annual adjustment).
- Provisions relating to the respective obligations to be performed by the tenant in the event of a pandemic (e.g. hygiene, information and cooperation procedures).
- Provisions relating to the respective obligations to be performed by the landlord in the event of a pandemic, including obligations relating to changes of the building and the leased real property.
- Provisions relating to the event of insolvency of the landlord or tenant (to the extent legally permitted).

Additional points to be addressed in purchase agreements

- Regarding the sale of project development projects: Provisions relating to the adjustment of contractual deadlines, e.g. for the establishment of building rights, completion and approval of construction services, and transfer of the object of purchase.
- Provisions relating to the exclusion or grant of rescission rights and other "MAC" (*Material Adverse Change*) provisions.
- Provisions relating to potential purchase price adjustments.
- Adjustments of long-stop dates with regard to the occurrence of the requirements for applicable maturity dates, including the completion of the project.
- Provisions relating to the application or exclusion of the doctrine of frustration and the adjustment of warranty regimes.
- Provisions relating to the responsibility in the event of applicable law changes, changes in the relevant technical standards or other changes in individual cases.
- Provisions relating to warranty obligations of the seller upon the occurrence of a pandemic or a similar event.

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- Provisions relating to potential extensions of post-closing undertakings.
- Additional provisions relating to risk allocation (e.g. transfer of responsibility).
- Provisions relating to the event of insolvency of the landlord or tenant (to the extent legally permitted).

Additional points to be addressed relating to real estate related service agreements (e.g., property management, asset management)

- Provisions relating to the suspension or adjustment of performance obligations in the event of a lock-down or other administrative or statutory restrictions.
- Provisions relating to the effects on remuneration or on applicable risk allocation principles.
- Inclusion of contractual performance obligations in the event of pandemics, e.g. (i) preventive measures on site, (ii) emergency management, (iii) adjusted tenant management, (iv) crisis communication or (v) hygiene provisions or concepts.
- Mechanisms for the adjustment of deadlines for the performance of certain services, e.g. service charge invoicing, conclusion of lease agreements and site inspections.
- Provisions relating to the termination or adjustment of the respective agreement, default and default consequences, suspension of obligations and, if necessary, adjustment of the term of the agreement.
- Provisions relating to withdrawal or termination rights.
- Provisions relating to the event of insolvency of the landlord or the tenant (to the extent legally permitted).

Additional points to be addressed relating to construction service and other work service agreements

- Mechanisms for the adjustment of contractual deadlines and milestones provisions (in particular completion dates).
- Fee adjustment provisions, if applicable, in particular in case fees and premiums have been agreed to for meeting certain deadlines or milestones, or in case of penalty provisions for missed deadlines.
- Mechanisms for the adjustment of agreed deadlines and milestones.
- Provisions relating to withdrawal or adjustment rights of the parties in relation to the agreement, warranty regime applicable to the service recipient in case of default, or to the suspension of performance obligations.

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- Provisions relating to risk allocation in the event of pandemic-related (also future) administrative orders/use prohibitions.
- With regard to the application of the VOB/B regime: Clarification that a pandemic constitutes *force majeure* within the meaning of VOB/B.
- Provisions relating to the event of insolvency of either party (to the extent legally permitted).

What should be considered for real estate financing

- Check existing agreements whether the borrower considers itself sufficiently protected by the applicable assignment/transfer restrictions in order to prevent certain lenders to become syndicate members, avoid debt transfers by existing lenders and enforcement or *loan-to-own* strategies. If a respective strong negotiating position exists for future agreements, it should be considered whether the assignment/transfer restrictions included in the proposed loan agreement are sufficient or whether further restrictions become necessary.
- Avoidance of *cash sweeps* or *covenant breaches*:
 - The deferral of lease payments, justified or unjustified, may result in significant liquidity problems for the landlord/borrower. Depending on the extent of the deferral, interest payments and/or loan repayments may be at risk.
 - Even if the landlord has sufficient liquidity buffers, compliance problems with financial covenants may arise in the context of larger scale property financing agreements.
 - Some loan agreements do not only provide for financial testing of historical rental income against interest payments or loan repayments, but also, or exclusively, for forward-looking testing, in particular in case of commercial property financings.
 - Depending on the results of the individual negotiation of the agreements, lease payments from borrowers who are "only" one, two or three months in default may be considered as defaulting for the entire testing period (projected on an annual basis).
 - This could then result in so-called *cash sweeps* or *covenant breaches*, even if liquidity is still available for interest payments or loan repayments.
 - In relation to existing loan agreements, borrowers and lenders should jointly address such issues at an early stage.

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- For future agreements, it should be considered whether more detailed provisions should be included in respect of defaults on lease payments or the underlying reason for such defaults.
- In relation to valuation issues, it should be considered to include explicit provisions for short-term effects, e.g. resulting from pandemics.
- Currently these issues result in considerable tensions between lenders and borrowers in other jurisdictions and , for example, drawdowns are refused based on MAC provisions. In Germany, lenders and borrowers currently seem to follow a more collaborative approach and try to find a joint solution for these issues. This evidences the fact that it is advantageous to select debt sources based on long-term relationship aspects.

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If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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