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Trends and Developments

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A Market Under Pressure – Growing Interest in Project Developments at Increasingly Early Stages – The Basics of Forward Funding (Deals)

Market Overview

2019 was an excellent year for the German real estate sector, with the market for commercial real estate investments achieving record results. According to the spring report of the German Property Federation (ZIA), EUR72.6 billion was invested in commercial real estate in 2019, which is far above the investment volume of around EUR65 billion invested in the previous record year of 2007.

2020 started out very strong, but then, the COVID-19 pandemic hit the European market with full force. The real estate industry as well as the entire economy is trying to find a way through the COVID-19 crisis.

Against this background, it is no surprise that the transaction market is currently slowing down. According to a survey conducted by Engel & Völkers Investment Consulting (Evic) in March 2020 47% of the responding investors continue their transactions, 43% are suspending ongoing transaction processes and 10% have cancelled processes in the last two weeks.

The long term consequences of the COVID-19 crisis remain to be seen. But, apart from the stock and bond market, real estate will remain the most important asset class. It is therefore likely that the real estate market will continue to be of utmost importance for national and international investors. This assumption is backed up by various expert reports (eg, by Prof. Dr. Michael Voigtländer, head of the German Economic Institute; bulwiengesa, “Coronavirus Crisis: 10 Expert Statements”, etc) which hold the opinion that the German real estate market will presumably face a “V-shaped” recession, ie, a fast drop and recovery of the economy, supported by the numerous state aid programmes and by solidarity among the market players. Some asset classes, such as logistics, food-anchored local supply centres or industrial facilities, might even come back stronger.

It is more than unlikely that the European Central Bank (ECB) will raise its key interest rates in the near future, the European Union as well as the European countries are even pumping more money into the market. The general attractiveness of Germany as a real estate location and the perception of real estate as a safe and stable investment harbour will also continue to play

an important role. But above all, the unchanged lack of investment alternatives will presumably reinforce this trend in a few months’ time.

However, in times of a remaining shortage of real estate on the market, especially of available existing buildings, real estate investors will continuously have to be prepared to take risks in order to get ahead. One effective way to achieve this is to buy real estate at an early development stage. This is where forward deals come into play. In certain segments, there have been more acquisitions of project developments than existing buildings in the last few months.

Forward Purchase vs Forward Funding

What is a forward deal?

Forward deal purchase contracts are so-called mixed-type purchase contracts and contracts for work and labour. The seller sells the buyer a plot of land and also owes him or her a work/service: building the property. At which project stage the buyer acquires the development varies from case to case. Often, the purchase contract is concluded after the building permit has been obtained, construction has begun and the first rental agreements have been signed. However, the purchase contract can also be concluded much earlier, sometimes even before the building permit for the project has been issued.

There are two common types of forward deals: forward purchase deals and forward funding deals. In a forward purchase deal, the buyer pays the purchase price after the project development has been completed and accepted and, if necessary, only once a certain occupancy rate has been reached. In a forward funding deal, on the other hand, the buyer pays the purchase price “MaBV-like” (in line with the German Brokers’ and Commercial Developers’ Ordinance applicable to developer contracts with consumers): according to the progress of the construction work. With the exception of the final instalment, the tranches are due before construction is complete.

In a forward purchase deal, the construction risk is almost entirely on the seller. The buyer does not pay the purchase price until after acceptance. Before paying the purchase price, the buyer can verify whether the building project has been completed in its entirety and without defects. If this is not the case, the buyer may refuse acceptance or – if the project is generally ready for acceptance – at least retain a portion of the purchase price. This is a safe position for the buyer to be in.

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In practice, forward purchase deals are more complex than transactions of existing properties. In particular, the details of the completed building project and acceptance must be well defined. It must be very clear what the seller has to build by when, when the buyer has to pay the purchase price and how the buyer is indemnified.

In a forward funding deal, buyers bear an even higher risk because they are paying purchase price instalments before the building project is completed. Forward funding agreements are therefore considerably more complex than forward purchase agreements.

Why should I consider forward deals at all?

Forward deals offer the great advantage of early planning security for both the seller and the buyer.

The seller has already sold his property before construction is completed (sometimes even before construction has begun). The risk of having to find a buyer is eliminated early. The seller has nothing more to do than to “just” erect the building in accordance with the agreement. The buyer scoops the property from the market at an early stage. In these times of real estate shortage, this is an especially decisive advantage. Many project developments do not even make it onto the market for existing buildings any more; if you do not buy them by way of a forward deal, you cannot buy them at all.

From the sellers’ perspective, the financing side is also important. It is often easier for sellers to obtain financing in a forward purchase deal. After all, they have already secured a buyer who will pay a fixed (minimum) purchase price. In a forward funding deal, the financing aspect goes a significant step further. The investor can replace the bank as he is paying the tranches. Ideally, the investor will be making the payments in the same “rhythm” as the sellers fulfil their obligations vis à vis the contractors. This means that – if set up well – financing can be replaced altogether. But why would investors do that? It allows them to secure a property and place investor money earlier.

The fact that the purchase price is determined well before construction is complete is both an opportunity and a risk for both parties. They build up a “long” or “going short” position, depending on how they anticipate market developments. For example, sellers may intend to secure the currently (still) high prices. However, if the prices go through the roof later, sellers may regret this decision afterwards. In contrast, the buyer regularly speculates on a further price increase.

Pitfalls – defining the terms of forward funding

Forward purchase deals and forward funding deals are identical in many areas. In particular, both require precise stipulation

of the property acquisition, the owed building details and the construction phase, albeit with varying levels of detail.

For instance, the parties need to define a structure that does not yet exist. A precise definition is necessary in order to be able to compare the owed building with the building that is actually constructed. This is important not only from the point of view of the buyer as the purchaser of the building project, but also from the perspective of the buyer as the future landlord. If the building project deviates negatively from the owed building agreed in the rental contract, the rental relationship is hampered before it even began. Such a situation must be avoided at all costs.

Various aspects must be taken into account when determining the owed building details. It is particularly important to clarify and regulate the planning stage. Is the project at the stage of a building application? Or has a building permit been issued already? Has the approval planning already been transferred to the implementation planning? Has the seller already concluded rental contracts that affect the owed building details?

Additionally, the agreement should provide for rules on subsequent changes made to the planning. Such changes may become necessary or desirable out of the sphere of the seller, the buyer or third parties (especially tenants).

The payment of the purchase price differs considerably between forward purchase deals and forward funding deals. A forward purchase buyer pays after acceptance, while a forward funding buyer pays in instalments according to the progress of construction. It is therefore essential to determine what happens in case of the seller’s default, particularly in the case of a forward funding deal. Refund guarantees are only provided in exceptional cases. Bank guarantees are too expensive in any case. The guarantee commissions for refund guarantees are high. Depending on the creditworthiness of the seller, they must also be backed by equity. As a result, forward funding deals are often no longer worthwhile because the costs of the guarantees and equity eat up the economic advantages of financing the project through the buyer’s tranches.

Thorough due diligence

The starting point for an appropriate purchase contract design and structure is always a thorough legal, tax, economic and technical due diligence.

In contrast to forward purchase deals where the purchase price is only due after the project has reached a state that is at least generally ready for acceptance, forward funding transactions make the buyer pay the first purchase price instalments as soon as the usual preconditions for purchase price maturity are met – ie, a priority notice has been registered, and a waiver of the

right of first refusal and, if applicable, the cancellation authorisations for land charges listed in section III of the land register that are not to be transferred have been issued. Therefore, the examination of all contracts for work and labour and all planning contracts is of even greater importance than in forward purchase deals. The financial stability of the other party and the executing contractors is also important. If the buyer enters into the general contractor's agreement (see below), forward funding deals – unlike forward purchase deals – require a thorough examination of the contract performance securities to be provided under such general contractor's agreement, in particular with regard to its compatibility with laws on general terms and conditions.

Drafting the purchase contract – purchase price

The purchase contract must primarily specify timing, the preconditions for and the amount in which the purchase price instalments are to be paid. As explained above, the first purchase price instalment is regularly due after the usual preconditions for purchase price maturity have been met and – depending on the position in the negotiations – also after additional preconditions have been met (final and binding building permit, signing the first rental contract, etc). The amount of further payments subsequently corresponds to the respective project value – ie, the value of the land and the construction project at the respective point in time. The amount of the individual tranche is normally based on the tranches owed by the seller under the general contractor's agreement. The seller's profit is paid either pro rata across the individual tranches or in total with the last tranche – ie, after acceptance of the construction project.

The synchronisation of the buyer-seller tranches with the seller-general contractor tranches is also important to avoid the need for interim financing as far as possible. If the seller owes money to the general contractor before the buyer is due to pay the corresponding tranche, the seller will have to provide interim financing or use equity for the time being.

The payment plan is therefore of particular importance for both sides, and should be prepared with the assistance of technical advisers/evaluators. This ensures that the buyer always pays only those amounts that correspond to the value of the property, the planning services and the respective construction progress.

The buyer must also be given the opportunity to verify the progress. In order to constantly maintain an overview of the project, it is common practice to agree on comprehensive rights of inspection, control and information (either by the buyer or by an experienced construction control surveyor).

Finally, the buyer should have the option of withholding a share of the respective payment in the event of poor or reduced

performance. As a general rule, the law allows withholding an amount of twice the costs required for remediation of the defects/completing the remaining services – see Section 641(3) German Civil Code (BGB). Often, however, somewhat lower retentions are agreed, such as 1.5 times the costs.

Whether or to what extent retentions are justified may be subject to disputes in individual cases. Looking at a tranche of EUR100, for instance, the seller may consider the defects to justify a retention of EUR10. The buyer, however, considers a retention of EUR30 to be appropriate. So what is going to happen with the EUR20 in dispute? Not stipulating rules for such cases is probably the worst solution because that would leave the decision to the courts, and their decision may take longer than the entire construction phase. Therefore, such cases should be covered in arbitrator clauses. This means that, in the event of a dispute, an independent arbitrator makes a decision that is binding for both parties regarding the amount of the permissible retentions. This decision does not necessarily have to be binding when it comes to the warranty-related question of whether a defect is present or not. However, the arbitrator may decide on the amount of the tranches to be paid. This considerably accelerates the execution of the purchase contract.

The arbitrator can and should be named in the purchase contract. At best, it should mention engineering offices offering specialists for all relevant trades and crafts. In addition, the arbitrator should be involved in the construction process from the very beginning, especially in order to be able to make short-term decisions, if needed. This does cause additional costs, but also creates a situation where disputes can be settled quite quickly.

In order to ensure maximum synchronisation between the instalment payments under the general contractor's agreement and the purchase contract, sellers should have the foresight to endeavour to place this arbitrator also as a binding decision-maker in case of disputes in the general contractor's agreement. Otherwise, there is a risk that, because of retentions, an instalment due as per the purchase contract will be lower than the tranche due as per the general contractor's agreement.

Beyond that, it may be useful to include a right for the buyer to make direct payments to the general contractor or the commissioned work contractors so that the buyer may fulfil the seller's payment obligations vis à vis the contractor(s). This ensures that they receive their payments on time and that the building progress is not interrupted. Finally, this also allows the buyer to reduce the risk of insolvency.

From the buyer's point of view, the total purchase price should be agreed as a fixed price. Additional costs caused by any modifications requested by the tenant are to be passed on to the

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tenants via the rental contracts. The same should also apply to the general contractor/the work contracts, even though the current market for now does not allow the easy implementation of this, making it rather expensive. This is important if the buyer terminates the work contract component due to delays in the construction process and takes over the general contractor's agreement/work contracts.

Drafting the purchase contract – buyer option to complete the project themselves/taking over the contracts/rights of termination

Forward funding purchase agreements are often very extensive. One reason for this is the need to adequately hedge against a failure of the seller “in all directions”. As an example, the parties have agreed on the latest possible completion date. Taking this date into consideration, the buyer has agreed a latest handover date with a tenant. However, in the course of construction it turns out that the seller is considerably behind schedule, contrary to the construction schedule. There is risk that the seller may not be able to keep the latest possible completion date, which may entitle the tenant to claim damages.

In such cases, it may be important for the buyer to have the option of terminating the work contract component of the purchase contract; triggering the transfer of ownership; and, if desired, taking over the general contractor's agreement/the works contracts by paying off the current project value step by step – if not yet effected by the tranches – and completing the construction himself/herself with the retained part of the purchase price.

All these points must be decidedly regulated. It is particularly challenging to find fair solutions that are in everybody's interest. Buyers, for instance, may wish to keep the conditions for termination as broad as possible in order to be able to react flexibly to a delay in construction. However, sellers will have a strong interest in keeping the termination possibilities as specific and narrow as possible because they may be of the opinion that they will be able to make up for a delay in construction throughout the further course of the project. Additionally, the COVID-19 pandemic demonstrates that there is also a need to address force majeure appropriately.

It is also important that the general contractor's agreement/work contracts provide for appropriate options for the buyer to take them over. To cover the risk of their insolvency, the contractors should also provide sufficient securities that can actually be realised if it should come to it. In addition, buyers should make sure to maintain the option of easily entering into other contracts relevant to the building project, such as neighbourhood agreements, urban development contracts, etc. In this context, it is worth pointing out an issue with rental contracts that may

already have been concluded: as the rental space has not yet been handed over, rental contracts do not transfer automatically to the buyer as they would have under Section 566 BGB, but can only be transferred after additional conditions as per Section 567a BGB have been fulfilled.

As these claims are each an assigned claim, their content and value should be ensured from the outset by means of a thorough due diligence and corresponding information and approval provisions in case of changes in the purchase contract.

Furthermore, the information, approval and participation provisions in the purchase contract are of decisive importance, if only because the buyer must be in a position to take over and continue the project immediately if the seller defaults. The buyer must know which works are to be completed next by the general contractor, which partial acceptances are coming up, which concerns the general contractor may have already addressed towards the seller, the extent to which tenants have already submitted special requests, etc. In short, the buyer must constantly monitor the project.

If the seller encumbered the property with land charges of third parties as part of the financing, the buyer must finally also have a direct claim vis à vis the third parties for cancelling these land charges, even if only part of the purchase price has been paid at that point (according to the progress of construction).

Drafting the purchase contract – securing withdrawal scenarios

In certain cases, however, it may also be important for the buyer to be able to withdraw from the purchase contract altogether. This may be the case, for example, if the project cannot be realised as planned for reasons arising from planning law, or for actual reasons.

Exercising the right of withdrawal triggers a reverse transaction obligation, which means that the services received must be returned. In the event of the seller's insolvency, however, there is a considerable risk that the seller will not be able to fully repay the purchase price tranches since they were used for the project and cannot easily be retrieved as assets.

The priority notice registered for the buyer does not help either, because the buyer no longer wants to buy the property. A provision of a bank guarantee by the seller is usually rejected because it at least partially counteracts the economic advantages of forward funding (see above).

Therefore, a land charge in favour of the buyer is then normally entered in the land register of the object of purchase. This land charge is intended to enable the buyer to realise the property

and thus recover the tranches paid, as far as possible. In this respect, the rank of the buyer's land charge is very important, also in relation to any existing (partial) financing land charge for the financing bank of the seller.

In addition, a guarantee, a letter of comfort or a suretyship of a solvent parent company of the seller (who is usually a special purpose vehicle with no or little other assets) is often provided.

Summary

Forward funding schemes offer both investors and project developers advantages that should not be underestimated. This is particularly true in a market where there is a shortage of good properties.

A careful legal and technical due diligence, a solidly drafted and structured purchase contract and consistent and close monitoring of the construction work can adequately and fairly reflect the risks for both parties.

However, regardless of this, it cannot be excluded that the seller may not complete the project. Any investor must be aware of this scenario. Investors must decide whether they are able and willing to complete the project themselves, should the case arise. This will only be possible if they have expertise of their own in this area, or if they have a reliable partner with the appropriate expertise.

Sellers, on the other hand, must be aware of the fact that they will have to co-ordinate the construction phase with a third party – ie, the investor. For example, significant changes to the planning during construction require the buyer's approval. Project developers often underestimate this fact and its practical implications.

Regardless of the challenges, however, forward funding deals are, above all, exciting projects that hold many advantages for all parties involved.

It has proven beneficial to view such deals as joint projects and to work together constructively like joint venture partners. This is particularly true in a situation like the one at hand, where all parties involved are hit more or less equally hard by an exogenous event - the COVID-19 pandemic.

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