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Real Estate 2022

Germany: Trends & Developments
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Trends and Developments

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The Third Year of the Coronavirus Pandemic – BGH decides on Tenants’ Rights!

We are now in the third year of the COVID-19 pandemic. Such a serious event has had and continues to have numerous effects on the German real estate market and to raise new legal problems for lawyers as well as the courts.

Having presented the pandemic’s effects on the German real estate transaction market in last year’s article, the focus is now on the long-awaited decision recently issued by the Federal Court of Justice (BGH) on how state-ordered operating restrictions may affect lease agreements.

However, before presenting and evaluating the landmark BGH decision of 12 January 2022 (XII ZR 8/21) in detail on the obligation to pay rent in the event of pandemic-related business closures (B), we first review the past year in real estate (A). Finally, we look ahead and venture a forecast for the year 2022 – especially in view of the BGH decision.

Overview of the Market

During the second year of the pandemic, market players seem to have become accustomed to the existing restrictions and uncertainties in many areas. Of course, this was largely because there were no more hard lockdowns.

As a result, there was an increased willingness to invest in the third and fourth quarters, especially in the more crisis-resistant asset classes (residential, office and logistics). After many large leases were initially postponed in view of the still unclear effects of the new “working from home” trend, there now seems to be a general belief that offices will not disappear altogether but may

just need to be redesigned. The asset classes residential – with the healthcare segment as a key driver – and logistics have been the winners in the real estate sector since the beginning of the pandemic and continued this success streak in 2021.

However, the hotel and (apart from supermarkets and drug stores) retail property markets, the latter of which was already struggling even before the pandemic, continued to suffer severe setbacks in 2021. In fact, pandemic-related restrictions probably had a more significant and longer-lasting effect on these markets in 2021 than in 2020. In particular, the comprehensive state aid programmes, but also the strong pre-COVID years, have helped to prevent a wave of insolvencies in the hotel sector so far. However, it remains to be seen how the decline in business travel, which is likely to be permanent, will affect the hotel market.

Federal Court of Justice Ruling of 12 January 2022 on the Obligation to Pay Rent during a COVID Lockdown

Background

The starting point for the court decision were the state-ordered closures in the spring of 2020. These measures and how they should be assessed legally instantly became the subject of heated discussions among legal experts. Did a forced closure constitute a defect of the rented property, a case of impossibility of the granting of the agreed use or an interference with the basis of the transaction (lease) according to Sec. 313 of the German Civil Code (BGB)?

In 2021, two Higher Regional Courts simultaneously ruled on this issue, specifically on the

question of whether a branch of the clothing retailer KiK was required to pay rent for the month of April 2020.

The Karlsruhe Higher Regional Court (judgment of 24 February 2021 – 7 U 109/20) rejected a claim to adjust the lease contract based on interference with the basis of the transaction. The court ruled that the assumption of unreasonableness of the rent payment in the context of Sec. 313 BGB requires an assessment of the circumstances of the individual case, considering the decline in sales, possible compensation through online sales, public benefits or state aid, saved expenses, etc. However, the tenant had not sufficiently asserted such special circumstances in that case, and the court ruled there was no claim for adjusting the lease agreement.

The Dresden Higher Regional Court (judgment of 24 February 2021 – 5 U 1782/20), on the other hand, affirmed a claim for adjusting the contract pursuant to Sec. 313 BGB, and agreed to a blanket reduction to 50% of the basic rent. According to the court, the examination of whether adhering to the contract is unreasonable or not should not be based on the economic burden on the tenant, but rather on the disruption of the equivalence relationship, ie, the relationship between performance and consideration. Unreasonableness needs to be redetermined for each month, the court ruled. It was the court's view that a closure of more than one month was so substantial that it was unreasonable for the tenant and thus resulted in a claim for adjustment of the contract. Since neither of the parties had caused or provided for the interference with the basis of the transaction, the court deemed a reduction of the rent by 50% for the duration of the ordered closure as reasonable.

It was this ruling of the Dresden Higher Regional Court that was appealed before the Federal

Court of Justice and became the immediate subject of the decision.

The ruling

The ruling essentially contains four key points.

- The closures do not constitute a defect of the rented property.
- It is not a case of impossibility (of the granting of the agreed use).
- There may be a claim for adjusting the contract according to Sec. 313 BGB, but whether this is the case or not and to what extent depends on the specific circumstances of the individual case.
- There is therefore no blanket claim for adjustment of the contract to 50% of the basic rent.

In accordance with the majority of first and second instance case law, a closure order does not constitute a rental defect, as it was not issued based on the concrete physical condition, the state or the concrete environmental conditions/location of the rental object. Instead, such an order is linked to the tenant's business operations, the type of use and the resulting public traffic, which was restricted to prevent the spread of infection. There is also no possibility of granting the use of the rental object. Both assessments apply if operation as a retail business is expressly agreed as the purpose of the lease.

With regard to the interference with the basis of the transaction, the BGH generally assumes that there can be a claim for adjustment of the contract pursuant to Sec. 313 BGB. Unless this risk is allocated in the lease agreement, government closure orders due to a systemic crisis such as a global pandemic constitute a serious change in the circumstances that existed when the contract was signed and thus a case of interference with the basis of the transaction. According to the Federal Court of Justice, such

circumstances go beyond the usual risk of use, which generally lies with the tenant.

However, not all such drastic changes necessarily lead to a claim for adjustment of the contract. The closure of a business thus does not automatically lead to a claim. Instead, a claim exists only if – taking into account all the circumstances of the individual case – adhering to the contract without changes can be considered unreasonable. It is thus possible that a tenant may be obliged to pay the full rent after a consideration of the circumstances.

The first point to be considered are the disadvantages suffered by the tenant. The starting point here is the decline in sales at the specific rental property during the closure. However, it is not only the disadvantages that need to be considered. In addition, any state aid that may have been received as well as any potential means to reduce losses as well as the landlord's interests must be taken into account. It is particularly important not to overcompensate the tenant.

It is the tenant's responsibility to demonstrate and prove that it is unreasonable for them to be expected to pay the rent. They bear the burden of presenting evidence of the disadvantages they have suffered specifically due to the closure orders and what reasonable measures they have taken to compensate for losses (eg, including applying for state support payments).

The Dresden Higher Regional Court did not originally take such a nuanced view, leading the Federal Court of Justice to overturn that judgment and refer the proceedings back to Dresden for a new hearing and decision.

Evaluation

In purely practical terms, the ruling is a double-edged sword. On the one hand, it is obvious that a blanket rule such as the one adopted by

the Dresden Higher Regional Court can never ensure justice across all individual cases. On the other hand, focusing on the individual case at hand always leads to uncertainties. Only a comprehensive assessment of the individual circumstances of the case can determine whether and to what extent a claim for contract adjustment exists, and that proves to be a rather difficult undertaking.

In principle, however, some general guidelines can be identified that may allow a preliminary assessment. These include:

- the decline in sales, taking into account alternative sales opportunities (eg, shift to online sales and/or sales increases in months not affected by the lockdown, ie, catch-up effects);
- expenses saved by the tenant (eg, reduction in costs due to short-time work benefit (Kurzarbeit), etc); and
- state aid (eg, bridging assistance, but not pure loans) or other support (eg, insurance benefits).

Landlords have an advantage in this respect because the tenant must present evidence on these points. It falls to the tenants to demonstrate that it was unreasonable to adhere to the contract without changes. The relevance of this point is illustrated by the ruling from the Karlsruhe Higher Regional Court, which allowed a claim for adjustment of the contract to fail because the tenant failed to present sufficient evidence.

It is also interesting that the Federal Court of Justice noted in a subclause that there were indications that the tenant was in a generally good economic condition and this alone fuels doubts as to whether the decline in sales was unreasonable enough for the tenant to justify reducing the rent. This comment could perhaps be interpreted to mean that the tenant's overall

economic condition, particularly whether they were able to accumulate reserves, is a further criterion to be considered.

Even if in a specific case it is concluded that it would indeed be unreasonable to adhere to the unchanged contract, the amount of the adjustment remains to be determined. A blanket rent reduction by 50% is not legal because the amount of the adjustment claim also depends on the circumstances of the individual case. A reduction of the rent by half can only be assumed if there is no sales revenue whatsoever and a complete lack of any other form of compensation. Such cases are likely to be extremely rare. However, if there is not a complete absence of sales revenue, if there is other income and/or catch-up effects, if the tenant had the option to access state aid or if it was possible to reduce costs through short-time work benefit or other reduced expenses, or if the tenant can be expected to accumulate and draw on a certain level of reserves, taking into account the duration of the tenancy and the profits of the previous few years, this reduces the tenant's claim for adjustment up to a complete refusal of a rent reduction. Consequently, a 50% rent reduction for lockdown periods represents an absolute and extremely rare maximum. According to previous case law, this adjustment claim can also be satisfied with a mere deferral, eg, if the tenant's fixed costs (and thus also the rent) are covered by state aid, but this aid takes a long time to be paid out.

Finally, we would like to add three comments regarding the scope of application of the judgment discussed above.

- First, the ruling only referred to closure orders. Other government-issued restrictions, such as a reduction of the number of customers allowed in a shop, were not the subject of the ruling. A latter Federal Court of Justice

Ruling of 16 February 2022 (XII ZR 17/21), however, meanwhile confirmed that cases of government-issued restrictions are treated accordingly.

- Secondly, the assessment only applies if no contractual risk allocation for such a case is provided in the lease agreement. In particular, agreeing on a sales-based rent could have an impact.
- And finally, the principles of the ruling cannot be applied, or at least not without some adjustments, to lease agreements that were concluded after the beginning of the pandemic.

Outlook/Summary

From the landlord's point of view, the Federal Court of Justice's ruling is certainly to be welcomed. One positive aspect is that tenants can no longer invoke a blanket 50% reduction of the rent owed. Instead, it is up to them to comprehensively demonstrate the disadvantages they have suffered. This will not be an easy task for tenants, facing the risk of a contract violation if they reduce the rent more than permitted. One drawback of the decision is the above-mentioned dependence on the circumstances of the individual case and associated legal uncertainty regarding the specific amount of the adjustment claim. This, however, negatively affects tenants and landlords equally.

As a result, we have already seen an increased willingness to settle out of court. The criteria listed above can serve as a guide for the conditions of such settlements. In addition, the parties should be aware that a 50% adjustment claim will only be accepted in extreme cases and that out-of-court settlements will likely amount to less than this. Furthermore, it must be taken into account that the judgment was only issued regarding ordered closures. If a state-ordered restriction is the cause for a conflict with the

tenant, this must also be considered as a point in the favour of the landlord during negotiations.

Additionally, so-called force majeure clauses, which provide for a contractual distribution of risk for precisely such cases, are probably going to be included in more and more commercial leases in the future – at least in the catering, retail and hotel sectors.

All in all, we believe that the Federal Supreme Court's ruling greatly helps to almost entirely eliminate the previous legal uncertainty and make rental claims that are (still) unpaid due to the pandemic assessable for both property owners and investors.

In general, the pandemic seems to have lost much of its original horror due to further research breakthroughs in this field, making at least

severe and prolonged lockdowns less likely in the future. Of course, this also has a positive effect on current or upcoming development projects, as pandemic-related delivery problems and/or labour shortages are no longer an issue.

However, due to the war in Ukraine, portfolio holders, project developers and investors once again face similar problems as they did two years ago during the onset of the pandemic. In particular, raw material supply difficulties and rising raw material prices will pose major problems for the construction industry. Rising interest rates are a burden on real estate investors. However, due to the general volatility of the global market for other forms of investment, the German real estate market is likely to remain attractive for both domestic and international investors.

We will keep an eye on these developments.

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