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## REAL ESTATE

### EFFECTS OF THE CORONAVIRUS ON EXISTING LEASE AGREEMENTS

In order to contain the risks associated with the COVID-19 pandemic, the German federal states have, among other things, ordered the closure of all retail businesses with the exception of those essential for the supply of goods and services (e.g. for the sale of food and drink). These closures – which are government ordered or, in some cases, had already been carried out voluntarily in advance as a precaution – are leading to considerable financial losses for commercial tenants who, consequently, will frequently encounter payment difficulties.

In order to mitigate the resulting consequences, on 27 March 2020 the Federal Council (Bundesrat) adopted the Act to mitigate the consequences of the COVID-19 pandemic in civil, insolvency and criminal procedure law that was resolved on 25 March 2020 by the Federal Parliament (Bundestag). The statutory regulations also contain special provisions for leases and usufructuary leases for both commercial and private use.

#### **Act on the mitigation of the consequences of the COVID-19 pandemic in civil, insolvency and criminal procedure law**

Pursuant to Article 240, section 2 Introductory Act to the German Civil Code, the right of a lessor to terminate for cause based on section 543(1), (2), sentence 1, no. 3 German Civil Code with respect to leases on properties or spaces, as well as usufructuary leases, is excluded if the lessee does not pay the rent during the period from 1 April to 30 June 2020 and furnishes prima facie evidence that the non-payment is specifically due to the impact of the COVID-19 pandemic and not any other circumstances (such as previously existing financial difficulties). The requirements for the necessary prima facie evidence are not that stringent. It is required that facts be presented on the basis of which it can be presumed that, more likely than not, the non-payment of the rent is due to the COVID-19 pandemic. It will generally be sufficient if it is pointed out that the operation of the business has been prohibited or significantly restricted by ordinance or official order within the scope of the fight against the virus.

The Federal Government also has the right to issue an ordinance extending the time period during which termination due to unpaid rent is excluded until 30 September 2020. In addition, a deviation from the resolved provisions to the detriment of the lessee by means of a contractual arrangement is excluded.

It must be noted here that all other termination rights contractually agreed upon or provided for by law will remain unaffected. The same applies to the general provisions on rent being due and with respect to default on payment. In this regard, the explanatory memorandum explicitly clarifies that the obligation to pay the contractually owed rent in full will generally remain in force irrespective of the COVID-19 pandemic.

#### **Unclear legal situation with regard to amount of rent and reduction**

The new provisions do not speak to the question of a possible entitlement to reduce the rent owed.

According to the general provisions of tenancy law it can be presumed that lessees would most likely not be entitled to completely cease payment of rent or reduce it pro rata due to the closures described above on the grounds of an assumption of a material defect or a defect in title pursuant to section 536(1) BGB. Since lessees of retail businesses are all affected by the national official closure orders in the same manner, the restriction of use is in fact not due to the condition, physical characteristics or location of the individual leased premises, which would thus most likely rule out the assumption of a defect.

However, the possibility of adjusting the rent owed according to the rules of frustration of contract (section 313 BGB) cannot be completely ruled out – at least insofar as the closures were officially ordered and did not occur voluntarily. The prerequisite for this is the presence of a relevant circumstance which the parties had not taken into consideration when concluding the contract and further, that if the parties had known about this circumstance, they would have concluded a special contractual provision in this regard. Moreover, the change of the basis of the contract may not fall solely within the sphere of risk of one of the two parties, whereby not only the contractual, but above all the statutory allocation of risk must be taken into account.

In the case of official closure orders, the usability of the leased premises for the agreed purpose will be completely eliminated for a lengthy period of time. A comprehensively ordered closure of all retail business which are not essential for the supply of goods and services throughout Germany would most likely represent such an extraordinary and unforeseen circumstance which ultimately cannot be allocated solely to the lessee's sphere of risk. But this would not be as clear in the case of closures which were merely temporary, and thus voluntary.

However, difficulties in substantiating a frustration of contract could arise in view of the provisions of the law to mitigate the impact of the COVID-19 on pandemic civil, insolvency and criminal procedure law to the extent that – as described above – the statutory allocation of risk must also be taken into account within the scope of section 313 BGB. The new provisions described above shift the statutory allocation of risk with regard to the entitlement to terminate the lease to the detriment of the lessor, thus mitigating the consequences of the COVID-19 pandemic for the lessees through the temporary exclusion of the right to terminate due to failure to pay the rent. Therefore, more effort will be needed to provide substantiation in order to demonstrate that an adaptation of the contract and/or the rent must additionally be carried out.

If the prerequisites for frustration of contract are nonetheless found to have been met, then the relevant contract must generally be adapted (section 313(1) BGB) before a termination right merely comes into consideration in exceptional cases (section 313(3) sentence 2 BGB). The manner in which the adaptation is to be carried out cannot be derived from the provisions in section 313 BGB. However, there is a certain tendency in the case law, in case of doubt – i.e. if no indications for a different allocation of risk are present – to divide the risk equally between the parties, and thus a 50% reduction of the rent would come into consideration. At the same time, the possibility cannot be ruled out that the allocation of risk provided for in the law to mitigate the impact of the COVID-19 on pandemic civil, insolvency and criminal procedure law will additionally have to be taken into account when calculating the proportionate reduction.

### **Further questions**

For lack of any farther-reaching provisions under tenancy law, additional questions also arise, apart from the question of a possible adjustment of the amount of the rent.

For example, the statute leaves open the question of what the legal consequences will be with regard to the existing rent securities. Since the rental payments will also continue to fall due and the lessees thus may enter into default if they do not meet their payment obligations, the lessors are not prevented from drawing on the existing rent securities. However, this can lead to a conflict if, for example, commercial lease agreements provide for a duty to replenish such rent securities, possibly even combined with a right of termination in the event that this does not occur. According to the explanatory memorandum, such termination rights, i.e. those which are not based on a default of payment of rent, are in fact explicitly meant to remain unaffected. There are also numerous questions with regard to the statutory lessor's lien pursuant to section 562 BGB. In this respect as well, the lessors are still able to take recourse if rent payments are not made. However, the answer to all of these follow-up questions must be given on the basis of the specific contractual agreements and require a careful analysis of the specific facts of the matter and the relevant lease agreements.

### **Outlook**

Very generally, it should be noted that it is very difficult in the current situation to conclusively assess the legal consequences of the COVID-19 pandemic with regard to tenancy law. Until the first relevant court rulings have been made and an extensive discussion has taken place among legal scholars, it is therefore to be recommended that the rent owed continue to be paid in full for the time being for the period in which businesses are not allowed to be open – albeit subject to the reservation of recovery. In any case, it would be advisable not to unilaterally cease to pay rent or reduce the rent. Doing so could also still give rise to a right of termination for the lessor and/or entitle it to exercise its lessor's lien or assert claims for damages.

It would be advisable for the contracting parties to conclude contracts by mutual agreement to mitigate the economic consequences which take the respective interests of the parties appropriately into account and are

therefore economically viable for both sides.

We assist the parties with the structuring of such negotiation strategies in this difficult situation on a regular basis. Please contact us should you require such assistance.

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