

CLIENT INFORMATION

SZA

SCHILLING, ZUTT & ANSCHÜTZ

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Effects of the COVID-19 Pandemic on the Real Estate Industry

The COVID-19 pandemic has reached the real estate industry. In the week before April 1, 2020, many companies announced that they would not pay rent due to the effects of the COVID-19 pandemic. Other companies requested deferral or reduction of rent due to the impact of the COVID-19 pandemic. Many lessees also raised the question of whether the closing down of shops and restaurants by authorities has disturbed the business basis of these leases or the contractually agreed use of the leased property to such an extent that the rent may have to be reduced completely if necessary.

I. Exclusion of termination

The legislator reacted quickly. As early as March 27, 2020, the Act on mitigating the consequences of the COVID-19 pandemic in civil, insolvency and criminal procedure law (the “**COVID-19 Act**”) was passed, which also contains a regulation for rental relationships: If a lessee cannot pay a rent due in the period between 1 April 2020 and 30 June 2020 due to the COVID-19 pandemic, the lessor cannot terminate due to this arrears. This rule applies to residential tenancy law as well as to commercial lease law. It applies to consumers as well as to large corporations. The rule is mandatory and can not be changed by a contract. This applies to already existing lease agreements as well as to lease agreements that are now being concluded. The lessee has two years (until June 2022) to make up the payments, after which the right of termination revives. The COVID-19 Act not only applies to lease (*Miete*), but also to a usufructuary lease (*Pacht*).

The new legal regulation is an exception to the general principle of civil law that inability to fulfill agreements due to economic

difficulties does not exempt from performance and thus also not from the legal consequences of untimely performance (*pacta sunt servanda*).

Under German law, in principle, the landlord can terminate the lease agreement if the lessee is in default, on two successive dates, of payment of the rent or of a significant portion of the rent, or in a period of time spanning more than two dates is in default of payment of the rent in an amount that is as much as the amount of rent for two months, Sec. 543 para. 2 no. 3 of the German Civil Code (*BGB*). In residential lease law there are different rights of termination in the event of default of payment under Sec. 569 and Sec. 573 German Civil Code (*BGB*).

These termination possibilities are now suspended if the default of payment is due to the effects of the COVID-19 pandemic. The explanatory memorandum (*Gesetzesbegründung*) of the COVID-19 Act emphasizes that if the lessee's non-payment is due to other reasons, for example, because the tenant is unwilling to pay or the tenant is unable to pay for other reasons but the COVID-19 pandemic, the termination right

of the landlord is not excluded. According to the wording of the law, the non-payment must be based on the effects of the COVID-19 pandemic. This wording is rather unspecific compared to other regulations of the COVID-19 Act.

The connection between the COVID-19 pandemic and non-payment must be credibly demonstrated by the lessee to the court (*glaubhaft gemacht*). For this purpose, the tenant must present facts from which it can be concluded that there is an overwhelming probability that their failure to perform is due to the COVID-19 pandemic. This credibility can be provided by means of an affirmation in lieu of an oath (*Versicherung an Eides statt*). Similarly, credibility can be established by submitting notifications of the granting of support measures or evidence of loss of earnings.

According to the explanatory memorandum of the COVID-19 Act, it should be sufficient under commercial lease law if the operations of the tenant in the premises have been banned or significantly restricted as part of the measures to combat the pandemic. This applies to numerous retail businesses that are no longer able to open their shops and business premises, as well as restaurants and hotels. However, it is dubious if this is sufficient to allow the tenant to refuse to pay the rent without having to fear termination. After a renown sporting goods manufacturer and several retail chains had publicly announced that they did not want to pay rent for their shops, a public discussion followed in the last weeks. In this context, the Federal Minister of Justice explained that the new regulation only applies to companies that actually get into serious payment difficulties as a result of the crisis. In fact, this is in line with the statement that termination should be possible if the non-performance is due to the tenant's unwillingness to pay. Despite the COVID-19 pan-

dem, many retail chains are able to compensate for lost sales by increasing their income from online trading. Some restaurants benefit from delivery offers. In the case of so-called flagship stores, it will be possible to ask whether the tenant does generally generate its sales independently of the sale of the goods in the respective store. In individual cases, it can be assumed that these flagship stores serve primarily marketing purposes rather than direct sales in the shop.

It is important in the context that under the COVID-19 Act the rent remains owed and due in principle. This means that interest on arrears is also due at the statutory or contractually agreed rate. The lessee is also liable for any further damage suffered by the lessor due to the non-performance. The lessor can enforce their claim in court and under certain circumstances can also make use of the rent deposit.

The Act contains an ordinance authorization that would enable the Federal Government to extend the restriction on termination due to default of payment, which has arisen in the period from July 1, 2020 to September 30, 2020 at the latest. This would create the flexibility for the Federal Government to react to the still uncertain time dimension of the crisis.

II. Claim of the lessee to a reduction of the rent?

Even before the new legislator's measures discussed above, became known, it was discussed whether the lessee could, in accordance with the principles of doctrine of frustration of contracts (*Wegfall der Geschäftsgrundlage*) or as a rent reduction, reduce or refuse to pay the rent due to the COVID-19 pandemic. The discussion on this issue is still ongoing and the handling of these cases by the courts is still uncertain, in particular as the extent of the restrictions

and economic effects of the COVID-19 pandemic are yet unforeseeable.

However, some guidelines on these questions can be developed from case law and literature. On an initial level, it must be reiterated that the new regulation in the COVID-19 Act treats the rent as due in principle (see above). It must be deduced from this that the legislator does not typically assume a frustration of contracts or a deficiency allowing a rent reduction, solely based on the shutdown of shops or restaurants by the authorities due to the COVID-19 pandemic. A possible argument against any right for rent reduction is therefore that the COVID-19 pandemic is *lex specialis* to the general rules applicable to the lease agreements.

1. Doctrine of Frustration of Contracts

In principle, a contractual party and thus also the parties to a lease agreement can demand an adaption of contract according to Sec. 313 German Civil Code (*BGB*), if circumstances which became the basis of a contract have significantly changed since the contract was entered into and if the parties would not have entered into the contract or would have entered into it with different contents if they had foreseen this change. The requirement for such right is that, taking into account all circumstances of the individual case, in particular the contractual or statutory distribution of risk, the lessee cannot reasonably be expected to adhere to the unchanged lease agreement. Such an adaption of contract would be, for example, the remission, reduction or deferral of the rent.

At the very outset, the concept of frustration of contract could not be applicable to the situation caused by COVID-19. Many scholars argue that the purpose of Sec. 313 German Civil Code (*BGB*) is not to solve

problems caused by fundamental distortions such as natural catastrophes or emergencies affecting the general public and the German economy as a whole. According to such scholars, the legislator must react in such situations. In the case of COVID-19, it can be argued that the legislator acted by passing the COVID-19 Act and therefore neither party can rely on the doctrine of Frustration of Contracts.

If Sec. 313 German Civil Code (*BGB*) is found applicable, the change to the basis of the contract must be unforeseeable in the context of the interference with the transaction basis. This is also doubtful in the case of a COVID-19 pandemic. On the one hand, it will be possible to say that probably nobody could have seriously foreseen a few months ago that a shutdown such as the one we are currently experiencing would be possible. On the other hand, a pandemic as such is certainly a foreseeable event. Many experts have been warning about the effects of a pandemic for a long time. There have also been epidemics before the COVID-19, even if the effects have not been as severe. Sec. 313 German Civil Code (*BGB*) assumes that the parties would have made a different agreement if they had foreseen the pandemic and the shutdown. This appears quite dubious in commercial lease law. Commercial leases rarely provide for rent relief in such cases as long as the leased object itself is not affected. Therefore, it could have been difficult for the lessee to negotiate a remission of the rent payment in case of a pandemic.

Furthermore, the distribution of risk laid down in the law and in the contract must be observed. The change must be so fundamental that it does not fall within the risk area of one party. In a lease agreement, the lessor is generally obliged to provide the leased object for use, while the lessee generally bears the risk that they can use the leased object as planned and actually needs

it for the duration of the lease term (usage risk). The lessee also bears the economic risk of being able to pay the rent and, for example, earning enough to pay the rent. Circumstances relating to the specific location and nature of the leased property are to be distinguished from this risk. This is the case if the leased object as such does not meet the requirements to be used as a shop or restaurant. However, this is usually not the case if the leased object is closed due to the COVID-19 pandemic. Rather, political decision-makers have come to the conclusion that containment of the pandemic requires that as little direct human contact as possible takes place. According to these decision-makers, this direct social contact usually takes place in shops and restaurants, among other places, which is why the closure orders are an effective means of combating the pandemic. These considerations usually apply completely independently of the leased object.

The situation must finally be unacceptable for the lessee. Here it depends on the economic situation of the lessee. In this context the numerous state aid measures for the companies affected by the pandemic could play a role. One could argue that the situation is not unreasonable for the lessee if they can obtain funds to bridge the gap, e.g. through the current aid programs.

2. Right to a reduction of the rent due to a defect

Quite similar considerations will have to be made when it comes to whether the lessee can invoke a right to reduce the rent because of a defect. As a general rule, if the leased object has a defect the lessee is (partially) exempt from paying the rent in accordance with Sec. 536 para. 1 sent.1 German Civil Law (*BGB*) for the period in which the suitability is eliminated. It is therefore essential whether the measures taken to combat the COVID-19 pandemic

create a defect in the leased object. A defect is to be understood as a deviation of the actual condition of the leased object from the contractually owed one, which is disadvantageous for the lessee. Both actual circumstances and legal circumstances can create a defect. The specific contractually agreed purpose of the lease will be of particular importance.

According to previous case law, a defect leading to a reduction will be present if the closure of the lessee's business is object-related (*objektbezogen*). As a general principle, the tenant bears the risk that the leased object can be used for its purpose. Therefore, according to relevant case law no defect of the leased object can be established if the impairment of use of the leased object relates to the person or activity of the tenant. A reduction will only come into question if the impairment of use is based on the specific condition of the leased object and not on the operational circumstances of the lessee.

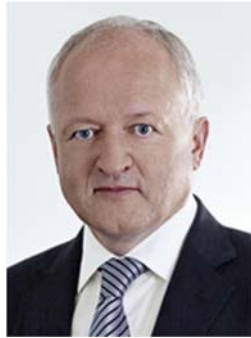
Starting from mid-march the measures largely prohibited operating non-food-shops and services such as hairdressers. The discussion if these prohibitions to operate certain businesses is object-related or use-related is ongoing. However, in many cases we see reasonable arguments that the measures such as the prohibition to operate shops with not systemic relevant products, will relate to the use of the leased object and not to the leased object itself. Another conclusion seems possible if the leased object is tailor-made for a specific use.

Starting from mid-April, in Germany shops with a smaller size than 800 sqm can reopen. Under this regulation, it is less obvious, if the closure of the lessee's business is object related or business related. Many federal states however, allowed to reopen the stores if the sales-area is reduced to 800

sqm. Nevertheless, the new restrictions relate directly to the size of the leased object

and therefore provide more room to argue in favor of a rent-reduction.

This client information contains merely a non-binding overview of the subject matter it addresses. It is no substitute for legal advice. To discuss this client information and obtain any legal advice, please contact:



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