

Briefing

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Editorial

Uncertainties have dominated our investment climate over the last 18 months. Deflation or inflation? Asset prices at bottom or not? Recovery of the economy in 2009, 2010 or 2011? Or even a Japanese decade ahead? Uncertainties discourage investors. However, there seems to be a glimpse of light in the dark, with good prospects that recovery will gain ground in 2010, that asset prices are close to if not at bottom and that over the mid-term inflation is more likely than deflation. Investors have closely watched the markets over recent months and are about to position forces. A number of institutional investors have already seized business opportunities. Chances seem good that this is the time for value-investors.



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With best wishes
Thomas Ziegler

Property, Distressed Assets

Insolvency specific risks in case of acquisition of distressed real estate



Melanie Kersting, Munich

The economic circumstances in general and increased requirements for real estate financing in particular are likely to result in increased real estate fire sales. Sales of distressed real estate offer attractive investment opportunities, but are often linked with risks of their own kind with respect to an impending insolvency of the seller. In the following we briefly describe typical constellations which bear the risk that the insolvency administrator upon the insolvency of the seller rescinds the legal acts made in connection with the sale of distressed real estate.

The insolvency law knows a multitude of constellations which entitle the insolvency administrator to rescind legal acts which have been taken prior to the opening of the insolvency proceedings. The law provides for the insolvency administrator's rescission right in a number of cases. However, an elevated risk of rescission is always imminent if the asset is sold under market value or if the purchase price is not directly paid to the seller, for instance in case of repayment of loans of the seller from the sale proceeds. In the following we briefly describe the elements which need to be fulfilled in addition to the above mentioned circumstances in order to put the insolvency administrator in the position



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to rescind the legal acts taken prior to the insolvency proceedings.

1. The three-months-period

Rescission under insolvency law due to a sale under market value or due to the sale proceeds not being directly paid to the seller in total requires that the relevant legal act has occurred not earlier than three months prior to the filing for the opening of insolvency proceedings.

2. Insolvency or insolvency filing

Furthermore, rescission requires that the seller was insolvent or an insolvency filing was pending at the time of the relevant legal act.

3. Knowledge of the purchaser

In addition, at the time of the relevant legal act the purchaser needs to have knowledge of the insolvency of the seller or of the filing for insolvency. Such knowledge is deemed to be given if the purchaser knows of circumstances which compellabl imply the insolvency respectively the insolvency filing.

4. Relevant legal acts, effects of rescission

Sale and transfer of real estate is a multistage process which typically comprises a number of legal acts:

- (a) conclusion of purchase agreement
- (b) granting of and filing for registration of priority notice
- (c) agreement of transfer of title
- (d) filing for registration of transfer of title

The rescission right is to be determined for each legal act separately. Therefore, the aforementioned legal acts are not necessarily challengeable altogether. In the following we describe to what extent this may have different effects:

a) Property purchase agreement

The right to rescind the property purchase agreement depends on whether the purchase agreement has been notarised within the relevant three-months-period and whether the seller was already insolvent at that time or whether insolvency filing was pending at the time of the notarisation, and whether the purchaser knew of these circumstances at the respective time. In case the purchase agreement became effective subsequent to the notarisation, for instance in case of representation by a representative without power of attorney and subsequent approval or due to other kind of necessary approval (e.g. location in a redevelopment area), the rescission right depends on whether the aforementioned prerequisites are fulfilled at the time of the purchase agreement becoming effective (in the above case granting of the approval).

If the insolvency administrator effectively rescinds the property purchase agreement, the purchaser has to retribute everything he has received on the grounds of the purchase agreement. In case a priority notice has already been registered in favour of the purchaser or the transfer has already occurred, the priority notice is to be deleted respectively the property is to be retransferred. The same applies for rents received. In turn the purchaser may demand restitution of the purchase price. However, he is only entitled to demand the refund as an ordinary insolvency creditor.

b) Priority notice

The right to rescind the priority notice depends on the point in time at which the filing for registration of the priority notice has been submitted to the land registry. If the filing has been made within the relevant three-months-period and the seller was insolvent at that time or if the insolvency filing has been made at the time of the filing for registration of the priority notice, and the purchaser had knowledge of this, the insolvency administrator is entitled to rescind the priority notice even after its registration. Upon effective rescission of the priority notice, the protection of the claim for transfer of the property by the priority notice terminates. The insolvency administrator is entitled to choose whether to fulfil or to reject the fulfilment of the purchase agreement. In case the purchaser has already paid the purchase price or in case the purchaser suffers other loss due to non-fulfilment, he is only entitled to demand repayment of the purchase price or payment of damages as an ordinary insolvency creditor.

c) Agreement on transfer of title (*Auflassung*)

The agreement on transfer of title in general is also subject to rescission under insolvency law. For the determination of the relevant time period the relevant point in time in general is the filing for registration of the transfer to the land registry. However, if the claim for transfer – as customary - has been secured by a priority notice, the relevant point in time is the filing for registration of the priority notice. Upon effective rescission, the property is to be restituted to the insolvency administrator.

5. Summary

The purchase of real estate from distressed sellers involves specific risks, in particular if the transaction takes place at a point in time close to the insolvency proceedings of the seller. In such cases the transaction process requires particularly diligent coordination in order to keep the relevant risks under control.

Leases

On 28 January 2009, the German Federal Court of Justice (*Bundesgerichtshof - BGH, VIII ZR 07/08*) decided that the purchaser of a property is entitled to terminate the existing residential leases with statutory notice if he intends to tear down the existing building and replace it by a new building (so-called "*Verwertungskündigung*"). This shall at least apply in case (i) at the time of the termination notice, the existing building is objectively in severe need of refurbishment and (ii) further refurbishment works would not be economically reasonable.

1. General requirements for such termination ("*Verwertungskündigung*")

Pursuant to Section 573 Subsection 2 No. 3 of the German Civil Code (*BGB*), the landlord is entitled to terminate the lease with statutory notice if otherwise he is prevented from making appropriate commercial use of the property and would - as a result - suffer substantial disadvantages. Such a termination requires:

- that the landlord intends to use the property differently, e.g. he intends to sell the property,
- that this different use of the property is appropriate, i.e. it is guided by reasonable considerations,
- that the continuing of the lease would make such different use of the property impossible and
- that - as a result - the landlord would suffer substantial disadvantages.

In practice the termination pursuant to Section 573 Subsection 2 No. 3 BGB has only played a minor role so far because up to now the courts have interpreted the requirements very restrictively.

2. The case decided by the BGH

In 2005 the landlord acquired a property with a building consisting of six lease units with a total lease area of approx. 280 sqm. The building had been constructed in 1914 and was in severe need of refurbishment. The purchase price amounted to EUR 653,500.00. Subsequently, the landlord terminated the existing lease agreements with statutory notice because - as he had planned from the beginning - he intended to tear down the existing building and replace it by a new one with a total lease area of 610 sqm. The landlord was in possession of all relevant approvals for this project. He also had already started to offer the planned condominiums for sale. The calculated sales revenues for the new condominiums exceeded the landlord's expenditures for the purchase of the property, the demolition of the building and the construction of the new building by more than 40 %. This equals a rate of return for the capital invested in the amount of 16 %. In case the landlord would carry out only the most necessary refurbishment works (minimum refurbishment), the respective costs would amount to EUR 70,000.00. A comprehensive refurbishment of the building, i.e. the gutting of the building, the renewal of parts of the shell of the building and the aggregate interior fit out works, would incur costs in the amount of EUR 580,000.00. The subsequent letting or disposal of the building after execution of either the minimum or the comprehensive refurbishment would generate a yield of only 2.5 % for the capital invested in each case.

3. The decision of the BGH

Termination of leases by the landlord for the purpose of a new utilisation of the property



Christoph Müller,
Munich

In the opinion of the BGH the requirements for a termination pursuant to Section 573 Subsection 2 No. 3 BGB were met in this case and the terminations of the leases were effective:

The project of the landlord is an **appropriate commercial utilisation of the property**. The value of the property would increase by the intended demolition of the existing building and the construction of a new one. By continuing the leases the landlord would not be able to execute his intended measures, he could only carry out a minimum refurbishment.

The landlord would also suffer **substantial disadvantages** by continuing the leases. The project of the landlord is the only economically reasonable alternative:

- In case of a **minimum refurbishment** of the existing building the landlord would have to bear significant costs for such measures without any extension of the remaining life time of the building of approximately 15 to 20 years. Furthermore, due of the bad condition of the building, there would be a high risk that further refurbishment works would become necessary in the near future which would be disproportionate to the remaining life time of the building. The landlord cannot be expected to bear this risk.
- The **comprehensive refurbishment** of the building would also be unreasonable for the landlord. The return rate for the invested capital in the amount of 2.5 % would be significantly lower than the usual yield in the market for residential buildings with more than 4 apartments in the range of 3.5 % to 4.5 %. In addition, the existing leases also would need to be terminated in such case as the ground plans would have to be changed.

By tearing down the existing building and constructing the new one, the landlord could - in contrast to a minimum refurbishment - sustainably create new living space. In addition, the landlord could achieve a return rate of more than times higher compared to a minimum or a comprehensive refurbishment. In this context also the interest of the landlord to refurbish or renew the building immediately after the acquisition of the building - and not only once the basic structure of the building is completely worn has to be considered. This also complies with the intention of the legislator who specified the demolition of the building and the subsequent construction of a new building in the explanatory memorandum to the law as an example for a termination permitted pursuant to Section 573 Subsection 2 No. 3 BGB.

It is positive that the BGH now applies more objective criteria in answering the question whether the landlord would suffer a "substantial disadvantage" in the meaning of Section 573 Subsection 2 No. 3 BGB. Pursuant to the BGH, the consideration of the landlord's interest to make commercial use of his property - as guaranteed by Article 14 of the German Constitution - and the tenant's interest to stay in his apartment - also guaranteed by the constitution - shall depend significantly on the actual state of the building. As a consequence, the landlord shall be entitled to terminate the lease agreement with statutory notice in case further refurbishment works to the existing building would be economically unreasonable due to the bad condition of the building, i.e. only a comprehensive refurbishment of the building or the demolition and the subsequent construction of a new building would be economically reasonable. We welcome the decision of the BGH: In such a case also the previous owner of the property would have been entitled to terminate the lease. It cannot make any difference whether such necessary measure is carried out by the previous or the present owner. Therefore, also the present owner must be entitled to terminate the lease.

However, the BGH has not explicitly dealt with the subject of a so-called speculative deal. Such a speculative deal shall be given if the present landlord has acquired the property knowing that it is not profitable because he intends to sell or rent the rebuilt apartments for a higher price after termination of the existing leases and completion of the structural alteration works. In such a case the landlord might not suffer a "substantial disadvantage" by continuing the lease as the property was of a reduced market value at the time of the acquisition by the

landlord due to the existing lease agreements. Pursuant to the lower courts, a termination according to Section 573 Subsection 2 No. 3 BGB shall be ineffective in such cases (Regional Court Kiel, decision dated 2 September 2008, file number 1 S 26/08, Higher Regional Court Stuttgart, WuM 2005, 658). Furthermore, it is subject of a controversial debate whether these principles shall only apply in case the landlord has paid an extraordinarily low price for the property due to the bad state of the building and the existing leases. Pursuant to the Regional Court Kiel, even an acquisition of a property at a higher purchase price is to be considered as a speculative deal, because in such a case the landlord would realise a value he was not entitled to before (Regional Court Kiel, l.c.). The BGH did not respond to these questions in its reasons for the decision. Thus, it is not possible to draw further conclusions from this decision in regard to the effectiveness of terminations pursuant to Section 573 Subsection 2 No. 3 BGB in general. In particular it remains in question whether the BGH would have decided differently if the landlord had purchased the property for an extraordinarily low price. Therefore, one has to wait and see how the BGH and the lower courts will handle the requirements of a termination pursuant to Section 573 Subsection 2 No. 3 BGB and the speculative deal in the future.

Accounting of operating costs: the landlord has the burden of proof that the tenant has received the statement in time

Pursuant to the statutory provision of Section 556 para 3 German Civil Code (*Bürgerliches Gesetzbuch - BGB*) the landlord is obliged to settle the operating costs annually. The landlord shall provide the statement within 12 months after the end of the respective accounting period. After expiration of this term any additional claims of the landlord against the tenant in respect to operating costs are - in principle - excluded. The tenant, who made additional payments in accordance with a delayed statement, is entitled to ask for repayment.



Gero Martin,
Munich

By its judgement of 21 January 2009 (VIII ZR 107/08) the German Federal Court of Justice (*Bundesgerichtshof – BGH*) has now expressly confirmed that in case of legal dispute the landlord must provide concrete evidence that the tenant has received the statement on operating costs in time, i.e. within 12 months since the end of the respective accounting period, in order to maintain existing claims for additional payments resulting from the statement.

The BGH had to decide on the following case: a landlord had issued the statement on operating costs for the year 2004. Pursuant to this statement the tenant had to make additional payments in respect to operating costs in an amount of EUR 625.71. The landlord posted the statement, by ordinary letter, on 21 December 2005 for delivery to the tenant. The tenant did not respond to this statement, in particular he did not make any additional payments in regard to operating costs. When the landlord finally filed a claim the tenant declared that he had not received the statement on the operating costs in time, i.e. by 31 December 2005 at the latest, so the landlord would not have complied with the statutory provision of Section 556 para 3 BGB. As a consequence, the landlord would not be entitled to ask for an additional payment in accordance with the delayed statement. The landlord argued that by posting the statement in due time on 21 December 2005 he would have met the time limit in accordance with Section 556 para 3 BGB.

The BGH has decided in favour of the tenant: in order meet the requirements regarding the accounting of operating costs in accordance with the statutory provision of Section 556 para 3 BGB the tenant must actually receive the relevant statement within the statutory period, i.e. within 12 months since the end of the respective accounting period. The landlord must provide concrete evidence that the tenant has received the statement in time. In case the landlord has posted the statement by ordinary letter for delivery to the tenant no prima facie evidence does exist that this statement had been delivered to the tenant in time. As in the specific case the landlord was not able to submit concrete evidence that the tenant has received the statement in time, the landlord was not entitled to demand additional payments from the tenant resulting from this statement.

In connection with the delivery of the statement on operating costs to the tenant the landlord has to make sure that he is able to submit concrete evidence that the tenant has actually received the statement within the statutory period.

As a consequence, the landlord should issue the statement and deliver it to the tenant as soon as possible after the end of the respective accounting period. In case the tenant does not respond or denies the receipt of the statement, the landlord would then be able to deliver the statement again to the tenant in a traceable way within the statutory fine period. The handover of the relevant documents to the tenant, either face-to-face or by carrier, against acknowledgement of receipt would be the best and safest way. In case of delivery by post the statement should be sent by registered mail with delivery confirmation (*Einwurf-Einschreiben*): the letter is delivered to the addressee's letterbox and the delivery is documented by the postman. In such a case the landlord is able to submit evidence on the time of delivery of the statement to the tenant by presenting the mailing receipt and the record of delivery which can be requested from the post. The time of delivery could be different if the statement is sent by certified mail with personal delivery to the addressee (*Übergabe-Einschreiben*): the letter will be delivered to the addressee only (or an authorized person). In case the postman is not able to handover the statement to the tenant, the postman will lodge the letter at the post and drop a delivery notification. In such a scenario the tenant will have received the statement – in principle – not until he has picked up the letter at the post.

Banking and Finance

Enforcement of land charges according to the "Risikobgrenzungsgesetz"



Dr. Sandra Hofmann,
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The so-called "Risikobgrenzungsgesetz" (Risk Limitation Act), which became effective on 19 September 2008 was intended to countervail the risks related to financial investments and unwanted developments in sectors, in which financial investors operate (Briefing July 2008). Especially the introduction of a compulsory notice period of six months for land charges provoked great attention and uncertainty in the banking sector. The consequences of these new rules for the granting of land charges and especially those for the realisation of (newly granted) land charges are not yet clear.

As reported in the July briefing, background of these new rules were continued reports in the media about the sale of loans and land charges by banks to investors, with the latter focusing on quick returns, which caused deep concerns amongst consumers.

It is exactly this realisation right for land charges, which shall be delayed by at least 6 months through the introduction of a compulsory six-months-notice-period (Section. 1193 Subsection 2 German Civil Code – "BGB"), in order to give the owners time for attempts of recapitalisation and refinancing, and thus reduce their pressure to act. On the other hand, this means for the bank that in case of an event of default the foreclosure of the encumbered land, i.e. its foreclosure sale or forced administration, will as a matter of principle only be possible or allowed after the respective notice has been given and the compulsory six-months-notice-period has lapsed.

In legal literature the dominating view is that these new rules, however, are of no avail as a comparable provision for land charge interest and ancillary payment is lacking.

The land charge entitles the owner to realise the land charge by forced sale of the land and to demand payment of a certain capital amount, typically also of interest regarding this amount (so-called land charge interest) and a one-time ancillary payment. This right (of land charge realisation) can be executed by the land charge owner when the land charge is *due*.

The new rules concern the question of the *due date* of the land charge and provide mandatorily that "the capital of the land charge" is due only after lapse of six-months-prior notice. The land charge interest and the one-time ancillary payment are not concerned by the wording of these new rules however. Therefore, the prevailing view in legal literature and also the view of the National Association of Notaries is that, with regard to the ancillary payment and / or the interest payments, the realisation of land charges would still be possible without prior notice (including the six-months-notice-period) so that the bank could enforce the land charge immediately with regard to due interest. At the usual interest rate of approximately 18% and with the agreement on a maturity at the end of each calendar year and a period of the foreclosure procedure of just one year, land charge interest for 4 to 5 years could be claimed and thus together

with the ancillary payment quickly reach or even exceed the capital amount of the land charge. After expiry of the notice period the bank could join the foreclosure procedure (with a typical duration of proceedings of approximately two years) initiated with regard to the interest payments also with regard to the land charge capital, and in this way compensate the loss of time generated by the new notice requirement. Instead of or besides the foreclosure sale the bank could also carry out a forced administration and thus secure the proceeds, in particular any rental proceeds. However, in this way the purpose of the new rules, to reduce the owners' pressure to act would be missed. Therefore, it cannot be excluded that this, probably unwanted result, will be corrected by the courts.

a) Amendment by way of analogue application of Section 1193 BGB

Particularly, it cannot be ruled out that the courts will apply Section 1193 BGB by way of analogy to the maturity of the land charge interest and the ancillary payment, as according to the explanatory memorandum of the new rules of Section 1193 BGB the maturity of the land charge should be tied up to the requirement of a prior notice, because otherwise the owner of the land could get into a difficult situation and into great time pressure to act. However, this applies not only to the enforcement of the land charge with regard to the main capital of the land charge, but also to the realisation with regard to the interest payments and the ancillary payment. Accordingly, in its explanatory memorandum the legislator did not differentiate whether the enforcement occurs because of the main capital of the land charge or the interest payments and the ancillary payment. This supports the view that the enforceability of land charges is to be postponed in general, and consequently the applicability of the notice requirement for the realisation of land charges with regard to the interest and ancillary payment by way of analogy can be justified.

If the courts come to this conclusion, a deviating contractual provision on the due date would be void according to Section 1193 Subsection 2 BGB.

b) Amendment by way of judicial control of General Terms and Conditions

Should a ban of the questioned provisions regarding the realisation of land charges irrespective of the notice requirement not already result from such analogous application of Section 1193 BGB, the correction of such provisions can basically also be effected by way of the rules regarding general terms and conditions. This ban could be referred to clauses according to which the one-time ancillary payment is immediately due, and the land charge interest is due at the end of each year, respectively. But as to that, the essential idea that the realisation of land charges has to be preceded by a notice and the lapse of a six-months period, would have to be concluded from Section 1193 BGB. This would, however, already result in an analogous application of Section 1193 BGB to these provisions (see a)), so that it would no longer come down to the control of general terms and conditions. Besides, the application of such control is subject to a deviation of the provision in question from a statutory legal provision (Section 307 Subsection 3 BGB). This, however, generally is not the case when the parties agree that the one-time ancillary payment shall be immediately due and that the ancillary payment shall be due at the end of each year, because such agreement corresponds to the effective statutory laws. Therefore, such agreement does not deviate from existing laws. At best, it contradicts the legislator's possible, but not enacted intention to delay the enforceability of land charges.

c) Conclusion

Notaries continue to use the bank-friendly rules for maturity of land charges regarding interest and ancillary payment. Court rulings on this subject matter are still outstanding. However, it cannot be ruled out that the courts apply the six months notice requirement of Section 1193 to the maturity of the land charge regarding the land charge interest and ancillary payment as well.

Tax

Real Estate Transfer Tax: Relevant share quotas in connection with indirect consolidation of shares



Dr. Stefan Diemer, Munich

Real estate transfer tax is also being triggered as a result of transfer of shares in a property holding company, provided that as a result of the share transfer a minimum of 95 % of the shares in the property holding company are directly or indirectly held by the transferee (so-called consolidation of shares). The consolidation of shares has a significant impact in connection with the transfer of businesses and the restructuring of groups of companies. In particular, in multi-layered group structures changes of shareholders in the upper levels of the group can trigger real estate transfer tax.

So far, it had been ruled that in multi-layered chains of share participations a confusion of shares is only given if each parent company holds 95 % or more of the shares in the subsequent subsidiary. In its ruling dated 17 September 2008 the tax court of Münster has ruled that a share holding of 95 % or more on each level of the group of companies does not necessarily result in a consolidation of shares. In the opinion of the court the calculation of the relevant threshold of 95 % for the application of real estate transfer tax needs to be based on the consideration of all share quotas on each level of the group of companies. As a consequence in the specific case no real estate transfer tax had to be paid. The ruling related to the following case:

Holding-GmbH had a share holding in the property holding T-GmbH of 97.5 %. 96.92 % of the shares in Holding-GmbH had been sold to the plaintiff.

Since on each level of the group each parent company holds more than 95 % of the shares of the respective subsidiary, pursuant to the rules applied so far by the tax authorities the transfer of 96.92 % of the shares in Holding-GmbH would trigger real estate transfer tax. However, this was denied by the tax court of Münster pursuant to which the share quotas on each level of the group have to be taken into consideration for the assessment of the 95 % threshold which resulted in an indirect holding of the plaintiff in the property holding T-GmbH of only 94.5 % (96.92 % x 97.5 %). Consequently, a real estate triggering consolidation of shares had been denied.

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