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COVID-19 Update

Impact of the German Act on Mitigating the Effects of the Covid-19 pandemic in civil, insolvency and criminal procedure law (Covid-19 Act) on lease agreements

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1. THE COVID-19 ACT

On 25 March 2020, the first chamber of the German parliament, the Bundestag, passed the draft bill submitted by the government for an "Act on Mitigating the Effects of the Covid-19 pandemic in civil, insolvency and criminal procedure law" (*Drucksache* 19/18110; the **Covid-19 Act**). The Covid-19 Act provides for various economic support measures for consumers, entrepreneurs, sole proprietors, other small, medium-sized and large enterprises and banks. It is designed as an omnibus act introducing **changes to contractual law in the field of leases and loans** in civil law in particular, which are to be made in article 240 of the Introductory Act to the German Civil Code (*Einführungsgesetz zum Bürgerlichen Gesetzbuch, **EGBGB***). In addition, a general moratorium on the fulfilment of contractual claims is to be introduced – **although this will not apply to lease and loan relationships** –, under which a deferral of their contractually owed obligations will be granted to parties unable to meet these obligations due to the Covid-19 pandemic. The Covid-19 Act was discussed and passed by the second chamber of parliament, the Bundesrat, on 27 March 2020, and the changes in civil law envisaged in it will enter into force with effect as of 1 April 2020.

The massive economic implications will in particular also affect the real estate sector.

The objectives of this briefing are:

- first to outline the somewhat unclear legal situation regarding the effects of the Covid-19 pandemic on existing lease agreements before the Covid-19 Act comes into force (see section 2 below);
- then to describe the changes in tenancy law (see section 3 below); and
- finally to briefly show the consequences these changes will have for existing lease relationships as well as the related problems (see section 4 below).

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2. RIGHTS OF THE PARTIES TO LEASE AGREEMENTS IN THE EXISTING LEGAL SITUATION

The effects of the Covid-19 pandemic and in particular the official measures taken in order to contain the spreading of the corona virus are undeniably causing considerable disruption.

The closure orders issued so far in connection with the corona crisis have mainly been addressed to the relevant business owners and tenants. While they are obliged to close down their businesses, the tenancy-law principle that the risk of use connected with a rented property rests with the tenant continues to apply, unless the individual lease agreement provides otherwise.

As a result of the closure orders, commercial tenants in particular find themselves in a dramatic situation where they have lost revenues virtually overnight while the payment obligations under their lease agreements continue to apply. In this situation, some tenants have already contacted their landlords in order to notify them of their intention to reduce or suspend rent payments, thereby invoking the statutory rules concerning defects that apply to lease agreements (section 536 of the German Civil Code (*Bürgerliches Gesetzbuch*; ***BGB***)) or the principle of frustration of contract (section 313 BGB).

However, the test for determining whether or not a defect exists in or on the leased property that would entitle a tenant to reduce the rent is generally the suitability of the property for the contractually agreed use (which the landlord is obliged to guarantee). External defects – referred to as "environmental" or "surrounding defects" (*Umwelt- oder Umfeldmängel*) –, i.e. defects which prevent the tenant from using the leased property in the contractually agreed manner but which do not lie in the nature of the leased property itself but in other legal or factual circumstances, may qualify as defects if they directly affect the leased property. The question of whether the closure orders issued are to be deemed as having such direct impact is not a straightforward one in purely legal terms. This is true at least where the landlord is in a position to continue to allow the tenant to use the leased property (i.e. the situation would probably have to be judged differently if, for example, the operator of a shopping mall were to close the mall as a whole).

One could conceivably also argue that an official ban on operations does not constitute the realisation of an operational risk of the tenants but could (also) be seen as a circumstance preventing landlords from making the leased property available as contractually agreed, and thus from performing their principal contractual obligation. Whether or not this is the case will probably depend mainly on the provisions of the individual lease agreement; landlords might possibly argue that it does not fall within their discretion to decide which types of businesses must close, unless the lease agreement provides otherwise.

In the event of a business closure, it could also be considered to assess on the basis of section 537 BGB whether a tenant could claim that the landlord saves operating, maintenance and repair costs and that the corresponding amount should be seen as benefits received by the landlord, and that consequently the tenant is no longer obliged to pay such amounts. The difficulty here would be how to prove the expenses so saved.

If the basis of contract underlying the lease agreement changes materially or completely, a claim for an amendment of the agreement based on the principle of frustration of contract (section 313 (1) BGB) could exist. A prerequisite for this would be that the parties would not have entered into the lease agreement, or not in its specific form, had they taken the serious effects of the Covid-19 pandemic into account, and that it has become unreasonable to expect the tenant to continue the lease agreement unchanged. Again, the decisive point in this assessment is whether or not one maintains the position that the closure orders issued fall within the tenant's sphere of responsibility. Another important aspect to note in the context of section 313 BGB is that the only available remedy is a claim for contractual amendment (suspension or deferral of rent payments). Should the parties not be able to agree on an

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amendment, simply withholding rent payments might nevertheless lead to the agreement being terminated.

In view of the fact that tenants may find themselves in a situation where their economic existence is threatened while the legal framework is somewhat unclear, it is to be recommended under current law that the parties to a lease agreement defuse the situation by agreeing on a deferral, suspension or reduction of upcoming rent payments (on a temporary basis).

3. CHANGES TO TENANCY LAW UNDER THE COVID-19 ACT

The legislature has not made any express statements on whether tenants already have any right to refuse performance under existing tenancy law. The explanatory memorandum, however, sets out that the planned legislation constitutes an exception to the rule for a limited time only, which does not exempt a party that is unable to render performance due to economic difficulties from the consequences of failing to render performance (on time) even if it was not responsible for the cause. This may be interpreted such that the legislature regards the closure orders issued as fundamentally falling within the respective tenants' sphere of risk.

3.1 Draft bill - new legal situation

As has already been indicated, the Covid-19 Act does not provide for a moratorium for rent payment obligations, but rather merely rules out the landlord's right to extraordinary termination with immediate effect on the grounds of rent payment arrears resulting from the effects of the corona crisis.

Under existing legislation, commercial and residential leases may be terminated with immediate effect if the tenant defaults on the rent or a not insignificant portion of the rent for two consecutive payment dates or has fallen into rent arrears over a period spanning more than two payment dates in an amount equal to two months' rent (section 543 (1) and (2) sentence 1 no. 3 BGB).

Under section 2, which is to be inserted in article 240 EGBGB under the Covid-19 Act, the following restriction is to be placed on the landlord's right of termination:

Section 2

Restricting the right to terminate lease agreements

(1) A landlord cannot terminate a lease agreement relating to land or buildings purely on the grounds that the tenant failed to pay the rent due in the period 1 April 2020 to 30 June 2020, insofar as such failure to pay resulted from the effects of the Covid-19 pandemic. The connection between the Covid-19 pandemic and the failure to pay must be substantiated. Statutory termination rights will not be affected.

(2) No deviation from paragraph (1) above to the detriment of the tenant is permitted.

*(3) Paragraphs (1) and (2) apply mutatis mutandis to usufructuary lease agreements (*Pachtverhältnisse*).*

(4) Paragraphs (1) to (3) are only applicable until 30 June 2020.

[...]

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Section 4

Authorisation to issue statutory ordinances

(1) The Federal Government is hereby authorised to issue statutory ordinances with the following effects without requiring the consent of the Bundesrat:

1. to extend the term of the right to refuse performance set out in section 1 until 30 September 2020 at the latest,

2. to extend the restriction of the right of termination set out in section 2 (1) and (3) to payment arrears arising in the period from 1 July 2020 to 30 September 2020 at the latest,

3. to extend the period specified in section 3 (1) to 30 September 2020 and the extension of the contract term governed by section 3 (5) by up to twelve months,

if it may be anticipated that the Covid-19 pandemic will continue to severely limit social life in general, the economic activity of a large number of enterprises or the working activities of a large number of people.

(2) The Federal Government is hereby authorised to issue a statutory ordinance, with the consent of the Bundestag and without the consent of the Bundesrat, extending the deadlines set out in paragraph (1) beyond 30 September 2020 if the limitations continue to apply after the ordinance pursuant to paragraph (1) was issued.

3.2 Cancellation of landlord's right to terminate lease due to corona-related payment arrears

For lease agreements relating to land or buildings, the landlord's right to terminate the lease on the grounds of rent arrears is limited by the Covid-19 Act if the failure to pay the rent results from the effects of the Covid-19 pandemic. The same applies to usufructuary lease agreements. The tenant must substantiate this connection between the failure to pay and the Covid-19 pandemic, e.g. by reference to liquidity erosion based on a significant drop in sales figures.

3.3 Only limited protection against termination for tenants

The protection against termination has only limited application (also compared to earlier versions of the draft Covid-19 Act):

- It does not apply to rent payments due in March 2020.
- Failure to pay as a result of the Covid-19 pandemic must be the only reason for termination. This could be called into doubt, for instance, if the tenant was already in rent arrears and the arrears accumulating after 1 April 2020 come on top of these.
- Other reasons for termination are not affected by this limitation of the termination right. The landlord may, in particular, give notice of termination for other reasons, such as other breaches of contract. If, therefore, other grounds for termination exist (e.g. illegitimate sub-letting), they will continue to apply despite the corona crisis.
- The months for which non-payment of rent is not a valid reason for termination have been reduced to the period from 1 April to 30 June 2020. This period could, however, be extended to 30 September 2020.

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- The limitation of the termination right will be in place until the end of 30 June 2022. Tenants, therefore, who fail to pay the outstanding rent in full by 30 June 2022 will lose their limited protection against termination.

- The tenant will be responsible for demonstrating that the failure to pay was due to the corona crisis alone.

  Although no statutory assumption exists in favour of the tenant, the connection between the Covid-19 pandemic and the tenant's failure to pay must only be substantiated in a credible fashion, which means that a plausible illustration should suffice. The tenant must therefore provide facts to illustrate that it is more likely than not that their failure to pay was caused by the Covid-19 pandemic. For the purposes of substantiation, tenants may submit corresponding evidence or an affirmation in lieu of an oath or avail themselves of other suitable means. Suitable means may in particular include proof that an application for state benefits has been filed or a confirmation that such benefits have been granted, confirmations by employers or other evidence relating to income or loss of income.

  In addition, tenants of commercial properties may, for example, generally substantiate the connection between the Covid-19 pandemic and their failure to pay by stating that the operation of their enterprise was forbidden or significantly restricted in the context of measures taken by statutory ordinance or official orders to fight the SARS-CoV-2 virus.

4. IMPLICATIONS OF THE PROVISIONS OF THE COVID-19 ACT

4.1 No right for tenants to refuse performance

The Covid-19 Act thus only limits a particular secondary right of the landlord, namely the right to terminate a lease with immediate effect on the grounds of payment default by the tenant pursuant to section 543 BGB, for a specified period of time.

However, the new legislation does not offer any further-reaching protection to tenants. Rather, it expressly states that the general provisions of the Civil Code concerning due dates and default are to remain unaffected and continue to apply to claims for rent payments also in the period during which the Covid-19 Act will apply. A tenant's obligation to pay rent thus fundamentally continues to exist; rent will continue to fall due for payment also in the period from 1 April to 30 June 2020 and will not be deferred. The grace period granted for subsequent payment of outstanding rent up to 30 June 2022 thus constitutes merely a temporary ban on termination.

In designing these rules, the legislature sought to achieve a balance between the interests of tenants and landlords and at the same time to interfere as little as possible with contractual lease relationships. In the explanatory memorandum, the new rules are therefore described as "special provisions that take appropriate account of the particular nature of the lease relationship and give priority to the interest in maintaining the lease relationship."

4.2 Further implications

In view of the aforesaid, the following points should be taken into consideration, where applicable in the individual case:

- If tenants fail to fulfil their obligation to pay rent in the period between 1 April and 30 June 2020 within the contractually agreed deadlines, they will be in default on performance and will owe the landlord statutory default interest (9 percentage points above the base rate p.a. for commercial tenants

and 5 percentage points above the base rate p.a. for consumers) as well as compensation for any damage caused by such default.

- As the legislature has made it very clear that tenants' primary obligations remain unaffected, landlords might consider – depending on the details of the individual lease agreement – taking recourse to existing rent security in order to compensate any loss of rent suffered in the meantime. For residential leases, however, the Federal Court of Justice has formulated the requirement that secured claims must be undisputed or recognised by final and non-appealable declaratory judgment, or at least not seriously contentious, in order for rent security to be realised. According to the FCJ, realisation of rent security by landlords in ongoing lease relationships merely in order to achieve "faster satisfaction of claims" is not permitted because it contradicts the concept of trust underlying section 551 BGB. Although this statutory provision does not apply to commercial leases, it is generally held that in commercial leases, too, landlords hold rent security in a kind of trusteeship. For this reason alone, any realisation of rent security in an ongoing lease relationship is to be viewed critically; in the context of the current crisis, it may be expected that such realisation of rent security on the grounds of non-payment of rent could even be regarded as constituting a breach of trust at least in the period up to the end of the temporary ban on termination, i.e. 30 June 2022 (and thus the grace period for subsequent payment).

- The legislature's intention is clearly to offer tenants some "breathing space" in the present situation. Landlords intending to assert further-reaching rights should therefore always take the principle of good faith into consideration.

Affected landlords and tenants should thus use the time until 30 June 2022 in order to develop a joint strategy for compensating any loss of rent suffered during this period. In most cases a solution that is mutually acceptable will prove the best result in economic terms in order to overcome the current crisis.

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