ALLEN & OVERY

COVID – 19 Update

Effects on Commercial Lease Law – the "Act to further shorten the residual debt discharge procedure and to adjust pandemic-related provisions in the corporate law, co-operative law, association law and the law of foundations as well as the rental and tenancy law"

22 DECEMBER 2020

1. THE COVID-19 ACT

The German Federal Parliament approved the government draft bill for an "Act to further shorten the residual debt discharge procedure" (Federal Parliamentary Doc. 19/21981, 19/22773) on 17 December 2020 in the version of the Legal and Consumer Protection Committee (the **Committee**, Federal Parliamentary Doc. 19/25251, 19/25322) in the Committee version (the **Covid-19 Act**) on the basis of the resolution proposed and the report submitted by the Committee. The path towards the speedy promulgation by the Federal President is clear, as the Federal Council raised no objections against this omnibus act (Federal Council Doc. 761/20). Apart from other regulatory areas, provisions were made through the Covid-19 Act in the civil law and the civil procedure law for **lease and tenancy agreements for land or premises which are not residential premises**, and Art. 240 EGBGB as well as the EGZPO were extended through the introduction of new sections. These provisions will enter into force after the publication of the Covid-19 Act.

The Covid-19 Act is a further reaction to the continuing spread of the Covid-19 pandemic and to the measures to combat the pandemic which have again been ordered throughout Germany in this connection. The measures for contact restrictions decided on 13 December 2020 by the Federal Chancellor and the Prime Ministers of the Federal States have by now been implemented throughout the country by means of appropriate legal regulations. As already in the spring, this also includes the closure of large segments of the retail business, the catering trade and in the hotel sector as well as the services sector. The addressees of these measures are the business operators, many of whom are lessees or tenants. The new measures are among a series of further measures which the parties to lease and tenancy agreements have had to deal with in varying degrees of intensity since March 2020.

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

The effects of the Covid-19 pandemic as well as the governmental action taken to contain it have resulted in some considerable distortions. The duty to pay the rent although the expected revenues are not being generated more often than rarely imposes an exceptional financial burden upon the lessees. The same goes for landlords who are unable to collect the rent. In many cases, lessees and landlords began to talk in order to attempt to reasonably divide up the economic consequences between the parties. It has not been seldom that agreements were reached to defer payments and in some cases to significantly reduce the amount of the rent.

In March 2020, the measures taken in connection with the so-called first "lockdown" caused the legislator to alleviate the economic disadvantages for tenants by means of a prohibition of termination for a limited period of time. The "Act to alleviate the consequences of the Covid-19 pandemic in the civil, insolvency and criminal procedural law" (Federal Parliamentary Doc. 19/18110) provided for the landlord not to be able to terminate a lease agreement for land or premises for the sole reason that the tenant did not pay the rent when due in the period of time from 1 April 2020 to 30 June 2020, provided the non-failure was due to the effects of the Covid-19 pandemic. Although the tenant remained in principle obliged to pay the rent, he did enjoy protection against termination. There was no majority for an extension of this prohibition of termination so that the existing legal provisions have been applicable since 1 July 2020 and in particular in view of the so-called second "lockdown". The Covid-19 Act changes nothing about the existing legal instruments that are available to resolve the legal issues raised, nor have any new instruments been introduced.

The court decisions taken so far in connection with the sharing of the economic burdens due to governmental restrictions have mostly attributed the restrictions of use under public law within the context of the Covid-19 pandemic to the tenant's personal and business circumstances instead of considering them to constitute a defect of the leased premises. Consequently, tenants have so far generally not been accorded any statutory right to reduce the amount of the rent pursuant to Sec. 536 BGB. However, there is greater disagreement among the courts about a right to contractual adjustments on the basis of the principles governing frustration of contract (Sec. 313 par. 1 BGB). Apart from doubts about the applicability of this legal instrument, which is in principle of a subsidiary nature, the courts have differently answered the question in individual cases whether a tenant can reasonably be expected to continue the unchanged contract.

3. CHANGES AND CLARIFICATIONS THROUGH THE COVID-19 ACT

With the Covid-19 Act, the legislator followed the Committee proposal, which extended the government draft bill by the provisions of relevance here. This implements what members of the SPD parliamentary group as well as the Federal Minister of Justice had already demanded or announced for months and was already reflected in the Federal-State Resolution of 13 December 2020.

3.1 The new provisions

Articles 1 and 10 of the Covid-19 Act added a new § 7 to Art. 240 EGBGB with a clarification relating to the applicability of the principles governing frustration of contract, and a new § 44 to the EGZPO to speed up the proceedings. These new norms read as follows:

§ 7

Frustration of contract of lease and tenancy agreements

(1) If land on lease or rented premises which are not residential premises are not useful for the tenant's business or only useful with considerable restrictions, in consequence of government measures to combat the Covid-19 pandemic, it shall be presumed that a circumstance within the meaning of Sec. 313 par. 1 of the Civil Code forming a basis of the lease agreement has changed profoundly after the conclusion of the contract.

(2) Paragraph 1 shall apply mutatis mutandis to lease agreements.

§ 44

Priority and acceleration

(1) Proceedings for the adjustment of the rent or lease for land or premises which are not residential premises due to government measures to combat the Covid-19 pandemic are to be given priority and accelerated.

(2) In proceedings pursuant to Paragraph 1, an early first hearing is to take place no later than one month after service of the Statement of Claim.

3.2 Conditions for the applicability of the legal presumption regarding Sec. 313 par. 1 BGB

The legal presumption pursuant to Art. 240 § 7 EGBGB is effective if the factual requirements for its applicability are fulfilled. A look at the Committee report on the draft bill (Federal Parliamentary Doc. 19/25322, the **Committee Report**) may facilitate the understanding of this. Especially the following points must be taken into consideration in this connection:

- The provision concerns land on lease and premises which are not residential premises. It thus applies in particular to commercial lease agreements, but also to premises rented for leisure purposes and to cultural facilities.

- What is necessary is the existence of a government measure to combat the Covid-19 pandemic. All measures at any level concerned are covered, i.e. measures taken by the Federal States, the counties and municipalities as well as any measures taken by the federal authorities in consequence of an epidemic situation found to exist by the German Federal Parliament in accordance with Sec. 5 (1) Sentence 1 IfSG.

- The government measure must restrict the tenant's business operations. It is the measure itself that is decisive, a mere reflex (e.g. the absence of customers due to a declining desire to consume) is not sufficient. It is necessary for the measures to relate to the business. A business is understood to be the actual use for the contractually agreed purpose. Non-commercial use is also covered (e.g. the use of premises by non-profit associations to pursue their idealistic purposes) and possibly also private use. To be distinguished from this are measures directed only against the tenant personally or his employees, for example quarantine orders against individuals.

- Finally, the usefulness of the land or premises must have been removed or at least considerably restricted. A typical example of complete removal is an order to shut down the business. The

Committee Report makes clear, however, that there will generally also be a considerable restriction if, for example, a government order allows only a certain part of the shop area to be used by the public or if it limits the number of persons who may be present in a particular area.

3.3 Legal consequence and reach of the clarification of Sec. 313 par. 1 BGB

The clarification announced to strengthen the tenants' position, and now anchored in the law, led in recent weeks to controversial interpretations and speculation, in particular with regard to the reach of the provision and any retroactive effects. Whereas the wording of the provision itself provides no significant gain in knowledge at first glance, a look at the Committee Report shows that it remains in the final analysis up to the courts, practically exactly as before, to find adequate solutions while considering the particular circumstances in each case. Among others, the following points must be taken into account in this connection:

- The lease law and the general provisions of the law dealing with default basically remain applicable also in view of governmental prohibitions and restrictions of use. With regard to adjustments of the amount of the rent, this also includes in particular the reduction of the rent (Sec. 536 BGB) and the right to adjust the contract in consequence of a frustration of contract (Sec. 313 BGB). This applies also to the months of April to June 2020. Especially with regard to the latter, the Committee provided subsequent clarification, legal practitioners having partly assumed the existence of a blocking effect of Art. 240 § 2 EGBGB. This was the main motivation for the clarification.

- Section 313 par. 1 BGB has a total of three factual conditions to be fulfilled. To be able to accord a contracting party a right to demand a reasonable contractual adjustment, the real, the hypothetical and the normative requirements of the norm must be fulfilled.

    - The legal presumption applies only to the real feature, i.e. that a circumstance having become a foundation of the lease agreement changed profoundly after the conclusion of the agreement. The further features of Sec. 313 par. 1 BGB remain unchanged; in the event of a dispute, their existence must therefore be shown and, if need be, proved by the party invoking the provision. The fulfilment of the further requirements is therefore not presumed.

    - The hypothetical element requires that the parties would not have concluded the agreement, or would have done so with a different content, if they had foreseen the change, here the governmental business-related measure. It is conceivable that the fulfilment of this requirement will fail due to the contractual provisions in the lease or tenancy agreement to be examined in each individual case.

    - The normative requirement will be decisive, i.e. whether one party cannot reasonably be expected to continue the unchanged contract, considering all circumstances of the specific case concerned, in particular the contractual or legal allocation of the risks. It is necessary to fully examine in this connection how strongly the governmental restrictions will impact the tenant's business operations, i.e. through significantly lower sales (e.g. in comparison with the same prior-year period) or other measurable parameters. It will also have to be taken into consideration whether the tenant received public or other grants, enabling him to at least partially compensate for the decline in sales due to the governmental restrictions, and whether the tenant saved expenditures, e.g. through short-time work or the absence of any purchasing of goods.

  The Committee Report contains three essential core statements in this context: (i) burdens due to governmental measures to combat the Covid-19 pandemic are generally attributable neither to

the landlord's sphere only nor to the tenant's sphere only, (ii) it is always the particular circumstances of the case concerned that are decisive, and (iii) Sec. 313 BGB is not to grant any over-compensation.

- The presumption according to Art. 240 § 7 EGBGB is refutable. As an example of an obvious refutation, the Committee Report refers to the cases where the lease agreement was concluded at a point in time when the pandemic spread of the coronavirus was already clear to see for the general public. It would then have to generally be assumed that a lease agreement was concluded with knowledge or more specifically with no lack of knowledge of a possibly imminent profound change of the economy. This should cause especially the lease agreements concluded during the so-called first or second lockdown to be unaffected by the presumption, and consequently the tenant must positively show and if necessary prove the fulfilment of the real factual requirement.

- There will generally be some suspense in waiting to see how the courts will deal with lease and tenancy agreements concluded after March 2020. However, it remains to be seen where and on the basis of which principles the boundary is to be drawn. Whereas the time of the conclusion of an agreement can have an indicative effect at best, the evaluation of a profound change of a circumstance forming a basis of the agreement will depend on a case-by-case view.

- Finally, the legal consequence of Sec. 313 par. 1 BGB will also remain unaffected by the new provision. A contractual adjustment can be demanded only within reasonable limits, i.e. considering both parties' interests. This will remain a decision to be weighed in each individual case. The Committee Report names as examples in this connection the deferral of rental payments or the adjustment of the amount of the rent, a reduction of the rented surface with a simultaneous reduction of the rent, and also the cancellation of the agreement. The latter answers in the affirmative the question whether Sec. 313 par. 3 BGB remains applicable.

- It is expressed furthermore that Sec. 313 par. 1 BGB is measure-related. The contractual adjustment stays in effect as long as there is a direct impairment of the business concerned, which is the case at least for the duration of the governmental measure. Any governmental restrictions (e.g. limitation of the number of guests) which remain effective or are newly imposed after the measure is lifted can cause the right to demand the contractual adjustment to remain effective, however the nature and amount of the adjustment depends on the concrete usefulness of the rented or leased premises.

- The provision of Art. 240 § 7 EGBGB allows no inverse conclusions outside its direct scope of application. It has no blocking effect, in particular for provisions of lease law such as the provision governing reductions of rent or the right to terminate without notice for cause. The provisions of the general law of obligations (e.g. impossibility of performance and removal of the counter-obligation) also remain unaffected. Furthermore, Sec. 313 BGB remains applicable in principle if the conditions of Art. 240 § 7 EGBGB are not fulfilled in case of a lease or tenancy agreement; only the legal presumption does not apply in this case.

- For contracts which are not lease or tenancy agreements, nothing changes due to the new provisions. Whether there is a frustration of contract must be evaluated – according to the Committee Report – in each individual case exclusively in accordance with Sec. 313 BGB.

3.4 Priority and acceleration of Covid-19 proceedings concerning rental or lease payments

As opposed to the clarification regarding Sec. 313 par. 1 BGB, the new provision in the EGZPO is comprehensible in itself and allows a derivation of the purpose and reach of the provision. The arguments

in this respect related largely in recent months to disputes in connection with Sec. 313 BGB, but in contrast the new provision goes much further. Here, especially the following points must be taken into consideration:

- Civil-law cases regarding the adjustment of the rental or lease payments due to governmental measures to combat the Covid-19 pandemic are to be treated with priority and to be accelerated. These requirements apply during the entire proceedings and from the court of first instance up to the highest courts. These proceedings must therefore be prioritized by the courts, and dates and deadlines must be set ambitiously to reflect this.

- The required priority and acceleration applies not only in proceedings where the tenant sues for an adjustment of the amount of the rent pursuant to Sec. 313 par. 1 BGB, but also where the tenant demands an adjustment of the rent as an objection against the landlord's action for payment, or where other bases of claim can support the adjustment of the rent (e.g. rent reduction). The same applies analogously to lease agreements.

4. OUTLOOK

The purpose of the new provisions is to strengthen the tenant's position and to make a contribution to legal certainty. However, having analysed the new provisions and read the Committee Report as the actual reasons for the legislation, it remains to be seen whether the targets can be achieved in every respect. An acceleration of the proceedings and accordingly the greater speed in gaining clarity are to be welcomed, however legal questions regarding Sec. 313 BGB remain unaffected by the legislation and therefore open. By way of example of a multitude of issues, the following should be mentioned in our opinion:

- The Covid-19 Act will enter into force on the day after its publication and, as opposed to other provisions of the law, will not have retroactive effect from 1 October 2020. Whether the legal presumption applies also to disputes already pending remains an open question. As the presumption has no blocking effect against the applicability of Sec. 313 par. 1 BGB both in case of its inapplicability and in case of the non-fulfilment of its conditions, the status quo should remain unchanged. The courts will presumably continue to seek solutions primarily through Sec. 313 par. 1 BGB.

- Another question that remains unanswered concerns the point in time from which the adjusting effects of Sec. 313 par. 1 BGB will apply. The courts basically tend to generally recognize an adjustment only for the future and to thus focus on the point in time at which the adjustment is demanded. All the same, a retroactive effect can be considered exceptionally also from the time of the actual adjustment, here the entry into force of the governmental measure concerned. What is decisive again is a comprehensive evaluation of the parties' interests. It remains to be seen how the courts will evaluate the governmental interventions caused by the pandemic and what position they will take in this respect.

- Disregarding any special facts and special circumstances in individual cases, an obvious solution should basically be to divide up the risk equally between the landlord and the tenant in case of a complete closure of the premises to the general public. In any case, this conclusion is already reflected by contractual adjustments widespread on the market and by first court decisions. It is open, however, whether the reduction relates also to operating costs. There are voices in the literature which distinguish in this respect between operating costs that are independent of consumption and such costs that depend on consumption.

- If a fixed rent is agreed on in the contract, a rental adjustment is legally possible quite easily, depending on the risk allocation decided on. However, if a sales-based rent is agreed on or if sales elements are included in the calculation of the rent, the situation may be mirror-inverted. The risk of closure is either entirely or partly upon the landlord. So far largely neglected in the discussion has therefore been the question whether the same criteria apply also to adjustments demanded by the landlord.

- Finally, the question arises what should happen if individual parameters of the adjustment decision that is taken change subsequently, e.g. because changes occur in respect of governmental compensation payments. It appears conceivable to understand such adjustments as a new connecting point for rights to demand a contractual adjustment, giving both the tenant and the landlord the right to make such demands. Whether this can be achieved through the existing legal instruments may well be doubted.

Given the situation often viewed by the tenant as a threat to his existence and at the same time a legal situation that occasionally remains unclear, the parties to the lease agreement would be well advised under the statute law now in force to defuse the situation through the (temporary) agreement on a deferral, suspension or reduction of rental payments to be made. It should be recalled that Sec. 313 par. 1 BGB does not automatically result in an adjustment of the contract, but grants only a right to demand such an adjustment of the contract. The contracting parties must agree on this. Only if that fails can this right be asserted in court.

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