ALLEN & OVERY

COVID – 19 Update

Impacts of the German Act on Mitigating the Effects of the Covid-19 pandemic in civil, insolvency and criminal procedure laws (Covid-19 Act) on real estate financings

27 MARCH 2020

1. BACKGROUND AND ISSUES

On 27 March 2020 the parliament adopted the Covid-19 Act. This act enacts various economic support measures for entrepreneurs, sole proprietors, other small, medium-sized and large enterprises and banks. In terms of civil law, the Covid-19 Act, which will take the form of an omnibus act, introduces changes to **contractual law in the field of leases and loans** which are to be made in article 240 of the Introductory Act to the German Civil Code (*Einführungsgesetz zum Bürgerlichen Gesetzbuch*). In addition, a general moratorium for the fulfilment of contractual claims under material continuing obligations (*wesentliches Dauerschuldverhältnis*) is 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 aforementioned changes will take effect from 1 April 2020.

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

The objectives of this briefing are:

- First, to set out the intervention in tenancy law which will result in repercussions to the lending relationship (see section 2 below);
- then, to show the consequences this intervention will have for the lending relationship as well as the related issues (see section 3 below);
- to offer parties a catalogue of recommended checks and actions for typical issues (see section 3.1 below); and
- finally, to identify potential amendments to credit agreements that may be required, based on the rationale of the provisions of the Covid-19 Act for consumer loans (see section 3.2 below).

© Allen & Overy LLP 2020

2. INTERVENTION IN TENANCY LAW

2.1 Prohibition of termination by the landlord

Tenants will in particular have issues paying the current rent for residential and commercial properties.

For lease agreements for land or buildings, a landlord's right of termination will be restricted under the Covid-19 Act. Landlords will no longer have the right to terminate a lease on the grounds of non-payment of rent due for the period from 1 April 2020 to 30 June 2020, provided that the failure to pay is based on the impacts of the Covid-19 pandemic. This period may in a first step be extended by legal ordinance (i.e. without a new act having to be passed by parliament) until 30 September 2020. However, the tenants' obligation to pay rent will generally continue to exist. Other rights of termination will also remain unaffected.

Both extraordinary termination without notice (*außerordentliche fristlose Kündigung*) and ordinary termination with notice (*ordentliche Kündigung*) of a residential lease on the grounds of such rent arrears will be ruled out. The same applies to extraordinary termination without notice of commercial leases for land or properties, as well as to usufructuary leases (*Pachtverhältnisse*).

The restriction of the termination right will apply until the end of 30 June 2022. This means that from 30 June 2020, tenants will have two years to pay these rent arrears that would otherwise entitle landlords to terminate the relevant lease contract.

Lenders will not be able to derive any legal remedies against the borrower as landlord based on this statutory restriction of the landlord's termination right. Since the restriction of the termination right constitutes a change in law, the borrower will in particular not be in breach of any contractually agreed lease covenants/letting controls that would require the lender's consent in the event of a waiver of rights or a similar change to a lease agreement or simply probibit any such act.

Other reasons for termination of a lease are not affected by this restriction of the termination right under the Covid-19 Act. The landlord may in particular give notice of termination for other reasons, such as other types of breaches of contract.

Insofar as it is legally permitted to ordinarily terminate a lease with notice (i.e. without having to cite any reason) – for example in the case of land leases not limited in time and leases for premises that are not residential space (section 580a (1) and (2) of the German Civil Code (*Bürgerliches Gesetzbuch*; **BGB**)) – this termination option also remains unaffected.

In this regard, the obligations of the borrower under lease covenants/letting controls agreed in the loan agreement will remain unaffected. In the case of a breach, the lender will continue to be entitled to invoke the agreed remedies provided for under the loan agreement for such a default/event of default, including acceleration of the loan.

The correlation between the Covid-19 pandemic and the non-payment by the tenant must be substantiated. The tenant must demonstrate facts on the basis of which it is more likely than not that its failure to pay is caused by the Covid-19 pandemic. For the purposes of substantiation, the tenant may submit corresponding evidence or an affirmation in lieu of an oath or avail himself of other suitable means. Suitable means may in particular include proof that an application for state benefits was filed or a confirmation that such benefits have been granted, confirmations by the employer or other evidence relating to income or loss of income.

© Allen & Overy LLP 2020

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 under legal ordinances or other official orders to combat the SARS-CoV-2 virus. Currently this would apply, for instance, to restaurants or hotels, the operation of which has been prohibited in many federal states, at least for tourism.

Where loan agreements provide for a (customary) obligation of the borrower, as landlord, to duly assert its rights under lease agreements, it should be safe to assume that the lender will now still be entitled (and perhaps more than ever) to demand fulfilment of this obligation from the borrower.

2.2 Rental payments

The general civil-law rules on due dates and default will remain unaffected by the Covid-19 Act, and thus continue to apply to rent receivables. Tenants must continue to pay the rent owed when due, and failure to pay when due will constitute a default, if applicable. This means that defaulting tenants will have to pay default interest and may be liable for damages.

In these cases, the rights of a lender under lease covenants/letting controls agreed in the loan agreement will remain unaffected. If the borrower agrees to deferrals, waives its rights or makes changes to lease agreements, thereby acting in breach of these lease covenants/letting controls, the lender remains entitled to invoke all contractually agreed remedies for such a default/event of default, including acceleration of the loan. A lender's consent may be subject to a requirement that the lender must not unreasonably withhold or delay it. Even if not, the lender may still be subject at law to a general requirement not to act against bona fide (*Treu und Glauben*), effectively requiring the lender to take legitimate interests of the borrower into consideration when exercising a lender's rights under the facility agreement. In the context of the current COVID-19 pandemic and its economic consequences, a prudent lender should exercise caution before considering refusing consent to any such changes, unless it is evident beyond doubt that the changes requested by the tenant are themselves unreasonable in the current circumstances.

3. EFFECTS ON THE LENDING RELATIONSHIP

The SARS-CoV-2 virus crisis and the loss of revenues it is going to cause will hit both tenants and borrowers as landlords hard. This means that financing arrangements and lenders will also be affected. It is to be assumed that the losses of revenues caused by the crisis, which were unforeseeable at the time a loan was taken out, will in many cases mean that the repayment or the periodic payment of principal and interest cannot be made, or at least not in full. As a consequence, the borrower faces the risk that loans will be accelerated and that the security interests provided will be realised/enforced.

As regards consumer loan agreements, the Covid-19 Act will introduce a statutory deferral provision and an adaption of the loan terms once the statutory deferral period has expired, with the parties being given the opportunity to agree a different solution for the loan if necessary. This is accompanied by a statutory protection against termination and a provision allowing an amendment of the agreement once the statutory deferral period has expired. These measures are also intended to give borrowers the time required in order to reach out for other offers of financial support and to apply for other measures the timely review and granting of which is beyond their control.

<u>However, this currently only applies to consumer loan relationships.</u>

The act limits the statutory deferral period and the protection against termination to loans between enterprises as lenders and consumers as borrowers in order to directly protect consumers from getting caught in a spiral of overindebtedness in an emergency situation caused by the pandemic, for example losing their debt-financed home and ending up in heavy debt despite security having been realised.

© Allen & Overy LLP 2020

Since enterprises may also be seriously affected by the Covid-19 pandemic and it cannot be ruled out that their economic existence will be jeopardised despite the state aid offers, the act provides that the Federal Ministry of Justice and Consumer Protection may extend the scope of application by legal ordinance, in consultation with the Federal Ministry of Finance and the Federal Ministry for Economic Affairs, to also cover additional borrower groups, in particular micro enterprises.

According to the definition established by the EU Commission, to which reference is made in the act, a micro enterprise has fewer than 10 employees and an annual turnover or balance sheet below EUR 2 million.

Should the scope be expanded by way of such a legal ordinance, additional borrower groups, in particular micro enterprises, may invoke these provisions in the same way as consumers. Whether a borrower would be able to benefit from these provisions even in the case of a commercial real estate financing would have to be assessed in the individual case, in particular by determining whether the relevant thresholds are met.

For the moment, this means that for commercial real estate financings, it is left to the parties to come up by way of negotiation with appropriate solutions for dealing with the effects of the SARS-CoV-2 virus crisis and the loss of revenues. Nevertheless, the statutory rules that are currently in the process of being enacted may serve as a model for such potential solutions.

3.1 Background

Owing to the fact that the new legislation does not intervene in existing commercial lending relationships, all of the lender's rights vis-à-vis the borrower under the finance documents will remain unaffected.

The following issues will typically arise:

(a) Lease covenants/letting controls

Please refer to 1.1 (Leases) for details. Lenders may request the borrower to duly assert its rights under the lease agreements, but they are prevented from deriving events of defaults under the loan agreement from the fact that the lease cannot be terminated.

(b) Information covenants

At the same time, the lender will usually be entitled to demand from the borrower up-to-date information on rent arrears and other material events in connection with the leases; if applicable, e.g. under the periodical property reporting. This will also include information on legal disputes with tenants, if any.

The information covenant also applies to the general income and financial situation, at any time.

Moreover, the borrower will have to provide information on applications for state aid offered to businesses to support them in overcoming pandemic-related financial shortages/liquidity issues or on financing or restructuring arrangements entered into with creditors and providers of finance.

(c) Breach of financial covenants

Breaches of the permitted thresholds may be expected to occur in future in particular in respect of interest cover ratios and debt service cover ratios, especially where they are forward-looking. Under current law, the lender is not prevented from invoking any contractually agreed legal remedies available upon the occurrence of a breach of financial covenants.

These include in particular:

© Allen & Overy LLP 2020

- cash traps/cash sweeps, i.e. trapping of surpluses and their application towards mandatory prepayments
- control/revocation of disposal rights in respect of bank accounts
- stricter lease covenants/letting controls
- (and ultimately also) acceleration of the loan,

in each case subject to remedy periods and cure rights, if any.

Moreover, the loan agreement may allow a lender to block disposals and also to disclose security assignments , although it would of course have to be considered on a case-by-case basis to what extent such measures would actually be in the lender's interest.

Nor can it be ruled out that borrowers might object to such measures claiming that they constitute a breach of the principle of good faith.

(d) Termination rights

Since under the Covid-19 Act the deferral of a lender's claims for repayment or payment of principal and interest as well as the exclusion of termination rights based on payment default or a material deterioration of the borrower's financial situation is limited to consumer loans only, the lender's acceleration rights remain unaffected in financings with commercial borrowers. Here, too, the borrower might conceivably object by citing the principle of good faith and by claiming that the termination was effected at an inappropriate time.

(e) Draw-stop

It will be quite important for borrowers whether they can continue to utilise/draw down on existing credit lines or facilities (e.g. capex facilities or working capital facilities, although the latter are not a common feature in real estate financings). The occurrence of a default or event of default typicially constitutes a draw-stop which a lender remains entitled to invoke. It will be a matter for consideration to what extent it may be in the lender's interest to make further funds available.

(f) Insolvency filing by the lender

The borrower's obligation (or that of its managing directors/management board members) to file for insolvency is suspended under the Covid-19 Act until 30 September 2020, unless the ground for insolvency (*Insolvenzreife*) is triggered by grounds other than the effects of the Covid-19 pandemic or unless there are no prospects of successfully remedying a situation of illiquidity (*Zahlungsunfähigkeit*) that has occurred. The suspension of the borrower's obligation to file for insolvency as well as the exclusion of a creditor's right to file can be expanded until 31 March 2021. For details, please see our bulletin on the Covid-19 Insolvency suspension act.

Accordingly, the right of acceleration based on an insolvency proceedings event of default might be excluded. However, acceleration on the basis of an insolvency event of default may not be excluded – the right to accelerate on the basis of an insolvency event of default is to be checked on a case-by-case basis.

Furthermore, it is important for lenders that the right of creditors to file for the commencement of insolvency proceedings is also suspended for a three-month transitional period. This will prevent for a

© Allen & Overy LLP 2020

period of three months that companies which are affected by the Covid-19 pandemic but were not yet insolvent on 1 March 2020 may be forced to enter into insolvency proceedings by creditors filing for such companies' insolvency. First, this supplements the temporary suspension of the obligation to file for insolvency, and second, the intention is to take account of the fact that the situation giving rise to insolvency can be remedied by means of other aid and stabilisation measures or other restructuring and financing measures.

It should be noted in this context that the suspension of the borrower's obligation to file for insolvency as well as the exclusion of a creditor's right to file should only apply for the benefit of borrowers which have their centre of main interests in Germany and which are thus subject to German insolvency laws. According to the applicable statutory presumption, the affected borrowers will in particular be German entities as borrowers. Foreign entities as borrowers will only be included within the scope of such suspending/excluding effect if such entities, contrary to the statutory presumption, do not have their centre of main interests abroad, but in Germany. Therefore, if it appears reasonable from the lender's perspective in exceptional cases to seek enforcement, it could be further considered for foreign borrowers on a case-by-case basis whether an insolvency filing by the lender as creditor will nevertheless remain an option.

(g) Waivers and contractual amendments

It may not be appropriate for lenders in the current situation to enforce their contractual rights, in order to enable borrowers to continue their business operations, apply e.g. for state aid offered to businesses to support them in overcoming pandemic-related financial shortages or enter into financing or restructuring arrangements with creditors and other financiers. It appears advisable in such a situation to declare waivers or to amend the loan agreement accordingly in order to prevent the occurrence of legal consequences that would otherwise occur automatically, avoid technical defaults and treat the exposure as (still) performing.

(h) Restructuring loan

Funds to be provided under existing contractual commitments do not constitute a restructuring loan (*Sanierungskredit*) and are thus not subject to otherwise applicable strict requirements that may result in risks for lenders (e.g. lender liability).

It is helpful in this context that the proposed Covid-19 Act is intended to enhance the situation, as the proposed statutory provisions aim at motivating banks and other lenders to provide additional liquidity to companies affected by a crisis. These provisions protect the providers of new loans. These parties are intended to be relieved from the risk that they may be required to return benefits or payments they have received in the meantime or to lose their right of recourse to security granted when the new loans were provided in the event that the efforts to rescue the borrower's business fail and insolvency proceedings are therefore ultimately commenced.

Lenders therefore have the option to satisfy existing liquidity requirements by granting new loans without having to face the usual risks resulting from the granting of a restructuring loan/loans in a financial crisis scenario.

(i) New shareholder loans

The Covid-19 Act seeks to motivate shareholders to provide additional liquidity to companies affected by the crisis. It is therefore clarified that the repayment of shareholder loans during the period up to 30 September 2023 is also protected with a view to incentivise shareholders to make liquidity available to a company in a crisis situation. The suspension of the subordination of shareholder loans in insolvency

 © Allen & Overy LLP 2020

proceedings, provided that these are fresh money loans, serves the same purpose. Therefore, this privilege does not exist for an extension or renewal of a shareholder loan that has so far been subordinated for the purpose or with the effect of achieving a better ranking.

We think that this protection granted to new shareholder loans removes substantial obstacles that would have prevented shareholders from providing additional liquidity if the previous legal situation had continued to apply. Although shareholder loans are typically permitted in customary finance documents, provided that they are subordinated and are assigned for security purposes, it must be ensured that the existing subordination agreement does not provide for subordination in insolvency. Should subordination in insolvency have been agreed, the relevant agreements would have to be amended accordingly.

From the lender's perspective, it is favourable that the granting of security by shareholders will not be covered by the privilege. As a result, a request for security in favour of the shareholder should not be an issue of dispute in negotiations between the parties regarding the provision of new funds by shareholders.

3.2 Potential structures/amendments to the agreement based on the model of the Covid-19 Act

As mentioned above, it is left to the parties to negotiate appropriate solutions for dealing with effects of the SARS-CoV-2 virus crisis and the resulting losses of revenues. Nevertheless, the statutory rules that are currently in the process of being enacted may serve as a model for such potential solutions. The aim of legislature is to encourage lenders to provide assistance or take interim, bridging measures.

In addition, discussions should be held with a view to continuing the loan relationship also in the longer term. Such discussions may address contractual arrangements such as adjustments to interest or repayment provisions, an extension of the term of the loan agreement, debt restructuring arrangements, etc.

In our view, such discussions could in particular also address the possibility of further shareholder loans that are intended to be protected under the Covid-19 Act from the risk of being contested and the risk of subordination (and thus loss) in insolvency (see below).

(a) Deferral of lenders' claims for repayment or payment of principal and interest

The claims of lenders for repayment or payment of principal and interest falling due during the crisis period could be deferred for an agreed period once they fall due. If appropriate, requirements could be agreed with regard to evidencing relevant losses of revenues and liquidity issues.

It should be noted, however, that this would constitute a contractual agreement, and not a deferral by operation of law. Such contractual agreement would have to be reviewed in light of jurisprudence regarding restructuring loans.

It should be noted that deferral would not result in secondary claims (e.g. default (section 286 (1) BGB), damages in lieu of performance (section 281 (1) BGB) or rescission (section 323 (1) BGB)).

In view of the above and the issues associated with restructuring loans, a standstill could be considered as an alternative.

(b) Prohibition of acceleration by the lender based on payment default or a material deterioration of the borrower's financial situation

As a supplementary measure in addition to a deferral of payment of principal and interest, the parties could exclude acceleration by the lender based on a payment default or a material deterioration of the

borrower's financial situation in the event that the requirements for a deferral are met, with such exclusion to apply for a specific period, for instance the expected duration of the crisis.

It is essential in this regard that no other acceleration rights (based on other crisis unrelated events of default) by the lender are excluded.

As a further supporting measure, the parties could agree alternative arrangements, in particular relating to possible payments in instalments or other adjustments to interest and principal payments or any other form of debt restructuring.

(c) Authorisation to make further drawings

As shown, it will be equally important for borrowers whether they can continue to utilise/draw down on existing credit lines or facilities (e.g. capex facilities or working capital facilities, although the latter are not a common feature in real estate financing). This should also be expressly agreed by the parties.

(d) Deferral of maturity dates

It may also be advisable to agree an extension of the term of the loan agreement. The relevant due dates of repayment of principal or other payments to be made under the loan agreement could be postponed for the duration of this period.

When the agreed deferral period has expired, the deferred claims and any claims that regularly become due again after that date would have to be fulfilled simultaneously. Borrowers would therefore have to bear a double burden during this transitional period. A situation in which the borrower is first granted a deferral but where the fulfilment of its obligations after the end of the deferral period will be far beyond its abilities should be avoided.

After the end of deferral period, the agreement could be continued as originally agreed, with the only exception that the maturity dates for payment or other performance would be postponed by a period equalling the deferral period. This effect could be agreed to apply to the entire agreement. As a result, the overall term of the agreement would be extended accordingly.

However, it should be noted in this context that such postponement of maturity dates also would have to be reviewed in light of jurisprudence regarding restructuring loans.

(e) Authorisation to grant further shareholder loans

The Covid-19 Act seeks to motivate shareholders to provide additional liquidity to companies affected by the crisis. It is therefore clarified that the repayment of shareholder loans during the period up to 30 September 2023 is also protected with a view to incentivising shareholders to make liquidity available to a company in a crisis situation. The suspension of the subordination of shareholder loans in insolvency proceedings, provided that these are fresh money loans, serves the same purpose. Therefore, this privilege does not exist for an extension or renewal of a shareholder loan that has so far been subordinated for the purpose or with the effect of achieving a better ranking.

We think that this protection granted to new shareholder loans removes substantial obstacles that would have prevented shareholders from providing additional liquidity if the previous legal situation had continued to apply. Although shareholder loans are typically permitted in customary finance documents, provided that they are subordinated and are assigned for security purposes, it must be ensured that the existing subordination agreement does not provide for subordination in insolvency. Should

© Allen & Overy LLP 2020

subordination for insolvency purposes have been agreed, the relevant agreements would have to be amended accordingly.

From the lender's perspective, it is favourable that the granting of security by shareholders will not be covered by the privilege. As a result, the authorisation to grant security should not be a controversial point in such negotiations between the parties regarding the provision of new funds by shareholders.

© Allen & Overy LLP 2020

Your key contacts for Real Estate Finance in Germany

Dr Olaf Meisen
Partner - Frankfurt

Contact
Tel +49 69 2648 5648
Mobil +49 160 7434378
olaf.meisen@allenovery.com

Wolfgang Melzer
Partner - Frankfurt

Contact
Tel +49 69 2648 5724
Mobil +49 175 527 72 20
wolfgang.melzer@allenovery.com

John Coburn
Partner - Frankfurt (English law)

Contact
Tel +49 69 2648 5493
Mobil +49 160 8812171
john.coburn@allenovery.com

Stefan Kuhm
Counsel - Frankfurt

Contact
Tel +49 69 2648 5706
Mobil +49 175 93 29 592
stefan.kuhm@allenovery.com

Stipe Bojanic
Senior Associate - Frankfurt

Contact
Tel +49 69 2648 5993
Mobil +49 172 3272543
stipe.bojanic@allenovery.com

Dr. Joachim Schmidt
Associate - Frankfurt

Contact
Tel +49 69 2648 5447
Mobil +49 151 14884048
joachim.schmidt@allenovery.com

© Allen & Overy LLP 2020

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. Allen & Overy LLP is a limited liability partnership registered in England and Wales with registered number OC306763. Allen & Overy (Holdings) Limited is a limited company registered in England and Wales with registered number 07462870. Allen & Overy LLP and Allen & Overy (Holdings) Limited are authorised and regulated by the Solicitors Regulation Authority of England and Wales.

The term partner is used to refer to a member of Allen & Overy LLP or a director of Allen & Overy (Holdings) Limited or, in either case, an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings. A list of the members of Allen & Overy LLP and of the non-members who are designated as partners, and a list of the directors of Allen & Overy (Holdings) Limited, is open to inspection at our registered office at One Bishops Square, London E1 6AD.

© Allen & Overy LLP 2020. This document is for general guidance only and does not constitute definitive advice. | EUS1 #2000257495