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Impact of the "*Corona pandemic*" on the rent payment obligation in commercial leases

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The *Corona pandemic* presents Germany and the world unprecedented challenges. Official measures that were unimaginable only a short time ago, such as the comprehensive closure of retail outlets, restaurants or hotels, have now become reality. The federal states, districts or municipalities have imposed further restrictions and it is not unlikely that additional measures and, as a last resort, nationwide curfews will follow. The aim of these drastic official measures is to reduce social contacts to the necessary minimum in the hope of slowing down the exponential increase in the number of infections, breaking the chains of infection and gaining time to prepare the hospitals for further intensive care patients.

This situation also has a variety of effects on the real estate industry and presents it with challenges. One of the first questions that are currently occupying landlords and tenants intensively is whether official regulations such as the closure of retail outlets, hotels, hairdressing salons etc. or the prohibition of the consumption of food and beverages within catering establishments will have an influence on the tenant's obligation to pay rent. It is a fact that the affected businesses have liquidity problems without sales revenues and are thus forced to minimize their fixed costs. These include in particular the rental and personnel costs. If rent payments are not made, this can also lead to economic difficulties on the part of the landlord. This applies in particular when the landlords themselves have to service current loan obligations from borrowed capital and/or mezzanine financing.

Priority of contractual agreements

First of all, as always, a look at the respective commercial lease agreement is advisable.

Content and conceivable legal consequences of contractual agreements

Commercial leases rarely contain provisions on how the aforementioned official orders will affect the tenant's obligation to pay rent in exceptional situations comparable to the current pandemic. So-called "*force majeure* clauses" are conceivable, which modify the legal risk allocation for cases of force majeure. Such clauses raise the question whether the outbreak of the Covid 19 pandemic constitutes a case of *force majeure*. If the clauses expressly provide that epidemics, pandemics, plagues or quarantine orders are to be classified as *force majeure*, the clauses would currently be relevant. Since the World Health Organisation (short: WHO) classified the outbreak of Covid-19 on 11 March 2020 as a pandemic and the German Robert Koch Institute (short: RKI) also agrees with this assessment, it can be assumed that a case of *force majeure* within the meaning of such clauses exists.

If the *force majeure* clause does not explicitly mention such cases, it must be examined more closely whether *force majeure* can be accepted from a legal point of view. *Force majeure* is predominantly understood as an external, involuntary and unavoidable event that has no operational connection and cannot be averted by extreme care (BGH, ruling of 16 May 2017 – reference number X ZR 142/15). In view of the measures adopted both nationally and internationally which massively affect economic trade, there are probably good reasons to classify losses suffered within contractual relationships due to the Covid 19 pandemic as a case of *force majeure* in the sense of the above - however, this question has not yet been conclusively clarified in law due to its topicality.

In addition, contractual clauses that specifically refer to closures of businesses ordered by the authorities may be considered. Whether such regulations also include closures due to pandemics depends on the contractual design of the rental agreement. This must therefore be assessed on a case-by-case basis.

Which legal consequences result from these regulations also depends on the concrete wording of the

regulation. Possible consequences include a (temporary) rent reduction, a (temporary) suspension of the obligation to pay rent, a deferment of the obligation to pay rent or even an extraordinary right of termination for the tenant. In general, such rental agreements will not stipulate legal consequences in favour of the landlord, as there is no (additional) need to safeguard the situation of the landlord.

Validity of the contractual arrangements

If the parties have stipulated a provision in their commercial leases in the sense described above, this provision is likely to be valid and thus decisive because of the principle of freedom of contract applicable in commercial lease law if it is a so called individual contractual stipulation.

If, on the other hand, the contractual provision is to be regarded as a general business condition within the meaning of §§ 305 ff. German Civil Code (hereinafter: BGB), its validity depends on whether it is formulated in favour of the "user", i.e. the party who has provided the contractual clause, or in favour of the other party. If it is in favour of the user, it is subject to content control according to §§ 307 ff. BGB, which also applies to commercial leases. The principle here also stands that such a contractual clause is invalid if it unreasonably disadvantages the contractual partner of the user of the clause. This is the case if the provision cannot be reconciled with essential basic ideas of the legal regulation from which it deviates, or if it restricts essential rights or obligations resulting from the nature of the contract in such a way that the achievement of the purpose of the contract is endangered.

If, for example, a clause to be qualified as a general business condition whose wording was provided by the tenant, and according to which the tenant does not have to pay rent in the event of business closures due to *force majeure* or even has an extraordinary right of termination, doubts about the validity of such a clause are justified. Because as will be explained in more detail below, the risk of using the rented property lies with the tenant according to the basic legal concept. A provision which exempts the tenant from his obligation to pay the rent in such cases thus deviates substantially from the basic idea of the legal regulation. As a result, there is certainly a not insignificant risk for the tenant that a corresponding stipulation in a rental agreement will not stand up to the content control of § 307 BGB and will be considered invalid by the jurisdiction in the event of a dispute.

Current legal situation

No specific legal requirements

In contrast to the jurisdictions of other countries, so far German law does not encompass any provision which contains special regulations for the tenant's obligation to pay rent in cases such as these. In particular, the Infection Protection Act (hereinafter: IfSG), on which the current drastic measures are mainly based, does not contain any regulation in that respect.

In our neighbouring country Austria, for example, the situation is different. There, §§ 1104 ff. General Civil Code (short: ABGB) are relevant for such cases. According to these, the tenant or leaseholder in Austria does not have to pay rent for the duration and extent of the inability to use the premises if rented business premises cannot be used or utilized at all due to "extraordinary circumstances". If the rented premises are partially usable, the tenant may reduce the rent proportionately. Unlike the tenant, however, the Austrian leaseholder only has this possibility if the lease is concluded for a certain period of one year (or less) and if, in addition, more than half of the usual income is lost.

General rental warranty law according to §§ 536 ff. BGB

The question of whether the tenant's obligation to pay rent continues to apply without restriction or (partially) ceases to apply when the business is closed therefore is governed by the general provisions of the BGB. In our opinion, a ceasing of the tenant's obligation to pay the rent due to impossibility on the part of the landlord according to § 275 BGB is out of the question, since the general provisions of the law of obligations are not applicable, at least after handover of the rented property to the tenant, since they are superseded by the special provisions of tenancy law in §§ 535 ff. BGB. Therefore, § 536 para. 1 BGB is to be taken into account. According to this, the tenant is entitled, among other things, to reduce the rent if a defect of the rented item arises during the rental period which cancels its suitability for use in accordance with the contract.

In the case of commercial leases, the question therefore arises as to whether it constitutes a defect of the rented item if the competent authority - in the state of North Rhine-Westphalia (NRW), for example, according to § 3 ZVO-IfSG (Regulation on the Responsibilities under the Infection Protection Act, North Rhine-Westphalia) the towns and municipalities as local regulatory authorities - takes protective measures according to § 28 para. 1 IfSG and prohibits the operation of the facility or entry into the area in which the premises are located. According to the established case law of the Federal Court of Justice, a defect pursuant to § 536 para. 1 BGB is deemed to exist in the event of any negative deviation of the actual condition from the contractually owed condition, whereby both factual and legal circumstances with regard to the rented property are considered defects.

Restrictions under public law can constitute a material defect if they relate to the usability of the leased property and specifically to the leased property and not to the person of the tenant. In contrast to this, the tenant is not entitled to any claims for defects according to § 537 para. 1 BGB if he is prevented from exercising his right of use by a personal reason. The decisive factor for the classification of a restriction or prohibition of use under public law is therefore whether the order of the competent authority is based on a property-related circumstance or on personal or operational circumstances of the tenant which fall within the tenant's area of risk. Object-related approval conditions are such circumstances which are based on the location or the condition of the leased property, such as structural defects or non-compliance with fire protection requirements.

The risk of using the leased property is generally borne by the tenant

Since the structural conditions of the buildings or parts of buildings concerned are irrelevant for the validity of an officially ordered operating ban, the operating ban usually only refers to the type of use and thus does not represent an object-related restriction of use for which the landlord is responsible. The Federal Court of Justice has already established on several occasions that in the relationship between landlord and tenant, it is basically the tenant who has to bear the risk of use with regard to the leased property.

All the more so, the infection with a virus and the quarantine order imposed as a consequence of this at the expense of the tenant or his employees is part of the general life risk and has to be borne by everyone, including the tenant, and may not be shifted to the landlord by assuming a defect of the rented premises. As long as the landlord makes the rented premises available to the extent owed, the tenant shall not be entitled by law to pay a reduced rent if he is legally unable to use the premises due to an order affecting his business operations or, in the case of a quarantine order against his employees, is de facto unable to use the premises.

Frustration of contract according to § 313 BGB?

In the current situation it might be conceivable that the contract is frustrated (in German legal terms a disturbance of the fundamental basis of business) according to § 313 BGB, which gives the tenant a claim either to an adjustment of the contract or, if this does not lead to a result in line with his interests, even to a termination of the contract. The prerequisite for this is that the circumstances that became the fundamental basis of the contract have changed seriously after the conclusion of the contract.

The *Corona pandemic* and the restrictions imposed on the basis of it could constitute such an unforeseeable serious change in the fundamental basis of the contract, as it is to be assumed that at least one of the contracting parties (usually the tenant) would have concluded the rental agreement with a different content only if it had been aware of such change. However, a claim for contract adjustment according to § 313 para. 1 BGB only exists if the disturbance does not already fall within the sole risk sphere of the contracting party that refers to the disturbance. As described above, the legal allocation of risk in commercial leases places the risk of use of the leased property on the tenant. In addition, everyone who participates in legal transactions has to bear the general life risk.

Against the background of the currently prevailing exceptional situation, however, the question arises as to whether a change in the legally stipulated risk allocation, taking into account the principle of good faith, is not to be assumed. According to the case-law of the Federal Court of Justice, the principle of good faith requires that the contract only be terminated if there is such a fundamental change in the relevant

circumstances that further adherence to the original contractual provision would lead to an intolerable result that is simply no longer compatible with law and justice.

One argument in favour of turning away from the legal model is that the operating restrictions brought about by the *Corona pandemic* represent a threat to the existence of many tenants and cannot be compared with the everyday profit and loss risk of an entrepreneur. Such restrictions, as currently experienced by public life, have never before existed in the Federal Republic of Germany. Nevertheless, it is a question of the individual case and thus depends on the respective concrete circumstances and contractual regulations whether these actually lead to such unacceptable results. In any case, such a claim for adjustment of the contract is always possible. It is true that the legal norms of equity law such as §§ 313, 242 BGB are created precisely for exceptional situations, but on the other hand they are therefore only applicable to a very limited extent and their prerequisites have very high requirements. Such a claim could be opposed in individual cases, for example, if the lease agreement at least indirectly contains provisions on risk allocation (such provisions could possibly also be included in the agreement on a turnover-based rent with a minimum rent, since the parties have agreed that the tenant has to pay at least a certain minimum rent if the turnover falls below a certain threshold).

Result of a claim for adaptation of the contract

If one considers the principles of the frustration of contract according to §§ 313, 242 BGB to be relevant - for which, in our view, good reasons can be given in principle in any case - it is still not clear, however, what the aim the tenant's claim for contract adjustment can have. In this respect, various alternatives come into consideration.

First of all, a dependence on a time component would have to be considered, so that a reduction of the rent payment obligation would not be possible from the first day of the effect of the operating ban, but only after a certain "tolerance period" has expired. This would be supported by the fact that, as explained above, according to the law, the risk of use lies initially with the tenant and the tenant could therefore have to bear the resulting risks at least until a certain risk threshold is reached. However, it would certainly be very difficult to determine such a period in concrete terms. Moreover, a reasonable solution by breaking through the legal risk allocation in the form of a tolerance period alone would appear to be very difficult. Therefore, if a tolerance period can be considered at all, it would probably have to be combined with the following arguments.

If a tenant invokes an adjustment due to a frustration of contract and if this stands up to a legal examination on the merits, the claim will only encompass an adjustment of the rent payment obligation (either immediately or after the expiry of a tolerance period). In our opinion, the original allocation of risk must continue to be taken into account when determining the amount of a reduction in the rent payable. In weighing up the mutual interests, it must also be taken into account that the landlord is also in need of protection in such an unusual situation. Because if the tenant stops his rent payments, the landlord lacks the rental income. This deprives the landlord of the basis for servicing any loan obligations from borrowed capital and/or mezzanine financing, for paying ongoing operating costs or for making distributions to shareholders etc. A claim for rent adjustment - even if the operation of the tenant's business would be completely excluded in the premises - cannot therefore lead to the complete cancellation of the rent payment obligation. Rather, in our view, a reduction of the rent payment obligation by a maximum of 50 %, but possibly only by 20 - 30 %, seems appropriate and reasonably considering the interests of the parties.

However, as there have been no rulings in this regard to date, tenants are faced with a not insignificant legal uncertainty, both with regard to the claim for adjustment of the contract due to a frustration of contract itself in accordance to §§ 313, 242 BGB and the amount of such a reduction.

In addition, it must be considered that the previously described weighing of mutual interests could also change again in favour of the landlord if the legislator should decide on special measures for the financial support of tenants in the coming weeks and months. For example, the Federal Minister of Finance has recently made several statements on public television to the effect that financial support is also planned for commercial tenants, which should enable them to meet their rent payment obligations despite the closure of their business. If such support is decided upon, there is certainly no longer any room for applying the principles of frustration of contract. The same is likely to apply if the legislator adopts regulations in the draft legislation currently being prepared to protect

tenants against termination in the event of late payment. This would demonstrate that the legislator is basically assuming that the tenant will continue to be obliged to pay rent, even if the new legal regulations do not only apply to the special cases discussed here, but to all tenancies.

Conclusion

If there are no special provisions in commercial rental agreements which also stand up to scrutiny in accordance with the protective regulations on the use of general terms and conditions, the general provisions of the BGB shall apply to the question of the effect of the relevant closure/prohibition orders on the tenant's obligation to pay the rent. Such general orders do not constitute a defect of the rental property which would entitle the tenant to a reduction of rent pursuant to § 536 para. 1 BGB. The tenant shall be entitled to a temporary reduction of the rent payment obligation in accordance with the principles of frustration of contract in accordance with §§ 313, 242 BGB. Whether this claim exists and, if so, how high such a reduction is, cannot be conclusively assessed and may also depend on what further financial or legal support measures the legislator will take. Should tenants in the current situation cease payment of rent with reference to this, this is consequently associated with considerable legal risks for them.

Irrespective of this factual and legal situation, it is assumed that many retail and gastronomy tenants affected by the current situation will (have to) temporarily suspend their rental payments for liquidity reasons. This is likely to be the case in many cases from April onwards. The question then arises for landlords as to how they can or must react to this. Our recommendation is not to take any ill-considered measures and to make any agreements with tenants or submit offers to tenants only after prior consultation. Such agreements can have different legal and, in particular, fiscal implications. For example, it is important to ensure that agreements on deferral of the rent payment obligation do not result in the deferred receivable being reclassified as a loan for tax purposes, so that any loss of receivables can continue to be allocated for tax purposes to income from renting and leasing and not to income from capital assets. In addition, agreements with tenants can also have an effect under insolvency law.

Finally, it is currently impossible to predict the extent to which the legislator will continue to intervene and provide support. Aid packages worth billions have been announced. New reports are coming in almost daily. The German government has repeatedly announced that it will provide various instruments to support the liquidity of companies that run into financial difficulties due to the effects of the *Corona pandemic*. In order to protect commercial tenants, there are considerations to limit or suspend the landlord's right to terminate the lease extraordinarily due to late payment, in addition to the financial assistance for rent payments mentioned above. According to the "Formulation Aid" on the planned legislative initiative published by the Federal Government on the evening of 20 March 2020, this should initially apply to rent debts from the period 1 April to 30 September 2020. This press release also states that the obligation of tenants to pay rent in return will in principle remain in force. The corresponding draft of the "*Law on Mitigation of the Consequences of the Covid 19 Pandemic in Civil, Insolvency and Criminal Proceedings*" is to be presented to the German Parliament as early as next week, with amendments to the previous draft version still being discussed. It is therefore important to constantly follow the current development.

Note

This overview is solely intended for general information purposes and may not replace legal advice on individual cases. Please contact the respective person in charge with GÖRG or respectively the author Dr. Markus Heider on +49 221 33660 744 or by email to mheider@goerg.de. For further information about the author visit our website www.goerg.com.

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