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Real Estate Newsletter

Welcome to the Autumn edition of our Real Estate Newsletter 2010. This edition focuses on sustainability in the real estate industry and possible implications for property law.

Our guest author is Simone Lakenbrink, who investigates the market outlook for sustainable building. Continuing the sustainability topic, Alexandra Schlicht and Bettina Krause highlight the implications of green building requirements for tenancy law and the law of real property sale.

In "Open-ended real estate funds – What next Mr. Schäuble?", Sven Zeller and Anja Breilmann explore the current state of the debate in the area of investment funds law, which includes heated discussions surrounding the partial regulation of open-ended real estate funds under the rules of the German Investment Act. Christian Trenkel and Martin Barlösius present the latest case law from the German Federal Supreme Court relating to the options for immediate enforcement with assigned land charges and the requirements for entering into a surety contract.

Last but not least, Gerold Jaeger picks up on an old favourite – the latest case law from the Federal Supreme Court on requirements for the written form in lease contracts. Fortunately, the Court has resolved one problem for good – the issue of whether delayed acceptance of a lease contract that is subsequently executed establishes a written form defect. It does not – which is good news from an investor's point of view. Thus, it appears that things are starting to look up again!

We hope that you enjoy our newsletter. Please feel free to contact us at any time with your real estate queries.

Best wishes

Christian Trenkel Gerold M. Jaeger

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Market outlook for "Sustainable Building"

Developing trends

"GREEN BUILDINGS are to the real estate industry what JEANS are to the fashion industry"

Introduction

The principle of sustainability, i.e. harmony between the ecological, economic and social spheres, is a mission concept for which there is no one-size-fits-all solution. Sustainability is a strategy that should be viewed in the relevant sector a target for all parties involved. The slogan "Think globally, act locally" also applies to the real estate industry. Buildings are first and foremost a means to an end: they protect humans from external influences and, in the process, must be affordable in terms of acquisition and running costs. A great many properties do not, however, fulfill these requirements. Humans spend most of their lives in buildings, which should be sufficient motivation for having high standards regarding real estate.

For the building and real estate sectors this means not only that, in future, buildings with a cost-effective energy budget will experience increases in value, but also that the topic of sustainability, and in particular sustainable building/certification, will influence property valuations to an ever greater extent. Corporate responsibility towards the individual, society and the environment will constitute an essential prerequisite for economic success of real estate investments.

The market relevance of sustainability

Corporate strategy – responsible property investments: In view of the environmental and social responsibility of companies towards society, the voluntary inclusion of social and environmental considerations in corporate philosophy is of increasing importance. Within the framework of Corporate Social Responsibility (CSR), companies undertake to comply with minimum social, environmental and economic standards. Due to the large ecological and social footprint of our densely built-up environment, investment decisions and property occupation and management form a part of the CSR reporting duties (responsible property investments) for companies that engage in sustainable development and, as such, determine investment strategy.

The results of a survey of investors on sustainability from 2009 are therefore not surprising:

- More than 80% of major investors in Germany believe that sustainability issues have a direct impact on company value
- More than 70% of strategic investors believe that companies that engage in sustainable development are more successful
- More than 68% of investors are convinced that sustainability issues will be important or very important in their investment decisions in the future

The decisive issues related to responsible property investments will be:

- What makes a property a sustainable property that complies with economic standards, fulfils occupier requirements and does not damage the environment over its life time cycle; and
- How can this sustainability be measured?

The answers to these questions can be found in the international property certification systems. In addition to defined qualities, these also outline requirements for valuation and measurability, transparency and comparability.

The DGNB and LEED certification systems

Two certification systems are of significance in the German real estate market today: the "*Deutsche Gütesiegel für Nachhaltiges Bauen*" (German Sustainable Building Certificate – DGNB) and the American "Leadership in Energy and Environmental Design" (LEED). While both systems have the common goal of developing instruments for measuring and assessing the quality of a property, they vary significantly in terms of content, depending on the standards set by the country of origin:

	DGNB	LEED
	Deutsches Gütesiegel Nachhaltiges Bauen	Leadership in Energy and Environmental Design
Country of Origin	Germany	USA
Organisation	Deutsche Gesellschaft für Nachhaltiges Bauen e.V.	U.S. Green Building Council
	www.dgnb.de	www.usgbc.org/LEED
Year Founded	2007	1998
Assessment Focus		
	Environmental Quality	Sustainable Sites
	Economic Quality	Energy and Atmosphere
	Sociocultural/Functional Quality	Indoor Environmental Quality
	Technical Quality	Water Efficiency
	Process Quality	Materials and Ressources
	Location Quality	Innovation and Design Process
Awards		
	Gold	LEED Platin
	Silber	LEED Gold
	Bronze	LEED Silver
		LEED Certified
Certificates		
	DGNB Provisional Certificate	
	DGNB Certificate	Post-Construction Certificate

A comparison shows that the requirements of the German system far exceed those of the American system. Particularly in terms of economic assessment, the LEED requirements are less stringent. Whilst life cycle costs and value stability are considered extensively under DGNB, these only play a subordinate role in LEED.

Certification aims

The motivations for building are manifold and often inconsistent depending on the target group. The aim of environmental certification systems should be to generate motivation by providing incentives both for the "vendor" (investor/builder) and on the "demand side" (occupier).

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Investment aims from the viewpoint of investors

- increased opportunities in the international transaction market through comparability and measurability at the international level
- certification as a marketing effect on account of the fact that currently only very few properties are certified
- minimisation of building vacancy risk
- improved opportunities for re-letting
- accessing new target groups with CSR obligations
- conveyance of a positive image through investments in sustainable properties

Development aims from the viewpoint of project developers and constructors

- increasing activity on the national and regional market for investors at home and abroad through transparency of essential product features
- increased sales and leasing opportunities through qualities that can be measured
- increased safety on returns through presentation of intended performance
- certification as a tool for negotiations with lessees, banks, authorities
- quality assurance throughout the planning, completion, occupation and deconstruction stages

Usage aims from the viewpoint of purchasers and lessees

- potential for savings with variable costs
- cost-risk minimisation through optimised used of space and building flexibility
- employee retention and recruitment through structural representation of corporate philosophy
- improved employee productivity rates through the use of low-emission materials
- high-quality working environment created by observing the highest standards of comfort

Advantages and costs of certification

The integration of sustainability aspects at the planning, completion and management stages, as well as when purchasing and selling property, means that positive effects can be expected in terms of both property performance and cash flow. While there is not yet any representative evidence of property performance improvement as a result of sustainability measures implemented, first experiences with certified properties and individual studies, particularly from the Anglo-Saxon business world, clearly demonstrate the potential of sustainable building.

The advantages of certified properties are the effects on income, sales revenues and environmental revenues. According to information from the USGBC in 2009, LEED certified buildings enjoy the following effects in the USA:

- higher occupancy rates (3.5%)
- rent increases of around 3%
- operational cost savings of 8-9%
- maintenance costs reduced by around 13%
- 10% higher sales revenues compared with traditional office buildings.

In addition to the economic and social effects, the energy savings (around 26%) also have a positive effect on occupier satisfaction while the reduction in CO^2 emissions (33%) has a positive impact on the environment. The additional costs in terms of planning and constructing that come with these benefits, are, depending on the study, estimated at between 1.5 and 16% for LEED certified buildings.

Transferability of the advantages and costs of LEED to DGNB certification

The advantages and additional costs mentioned cannot be confirmed at present as the number of DGNB certified buildings in Germany is still low. Caution should also be taken when transferring experiences from the American to the German market. Two examples highlight this:

Diverging ecological standards, particularly in the energy sector: German national political climate protection goals are significantly more ambitious than in other countries. Regular toughening of the rules in the Energy Saving Regulation (EnEV) and the Renewable Energy Sources Act (EEG) and the prospect of zero-energy buildings or indeed energy-plus-houses raise the bar very high compared with other countries, in particular the USA. As a result, it can be expected that the effects on the returns from sale or leasing will be higher in the USA than in Germany.

Language and standard systems: every certification system is based on national standards. This makes LEED-certification in Germany problematic. For one thing, the US ASHRAE standards are not based on the European standards from which the German standards derive. Secondly, all planning and construction documents to be filed in Germany for building approval are drafted in German and contain the German standards, which means that for LEED certification all these documents must be translated into English and the American equivalent to the German standards used must be determined. This results in additional procedural costs.

Costs of DGNB certification

In order to present a rough estimate of the additional costs, however, reference can be made to the first analyses of DGNB buildings, where additional costs

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ranged from between 2 and 5% right up to 10%. However, any blanket statements should be met with caution since the additional costs are dependent upon the following:

- the starting point/objective: the greater the difference between a low structural standard contemplated at an early planning stage and a high structural standard required for obtaining the certification sought, the higher the additional costs incurred.
- project size: DGNB certification is worthwhile for projects of around 5,000m² or larger. This can be put down to the fact that the smaller the project and the lower project costs, the higher the percentage of the overall costs taken up by auditor/consultant fees, which are roughly the same irrespective of the certification standards applied.
- quality certification: the higher the standard of quality certification sought, the higher the planning and building costs. This is because certification can be obtained only by exceeding legal standards.
- time of certification: the optimum point in time for a decision on whether to seek is before commissioning of the planning team. The later in the planning process this decision is taken, the less the planning can be influenced to comply with the certification criteria.

Interim conclusion: a clear market is emerging for DGNB certified projects in Germany.

LEED or DGNB certification

Which system will prevail in the German market and internationally? Experts consider it fairly unlikely that an international system will be introduced. The problem lies in adapting to regional conditions at the property location which affect building requirements and make comparability more difficult. In addition, even a system adapted to regional requirements cannot quite match the requirements of a specific local market. It is likely that various international and national systems will coexist.

The safest option is to aim for two certificates, a national and an international one. However, the decision ultimately depends on the market on which the property is to be placed.

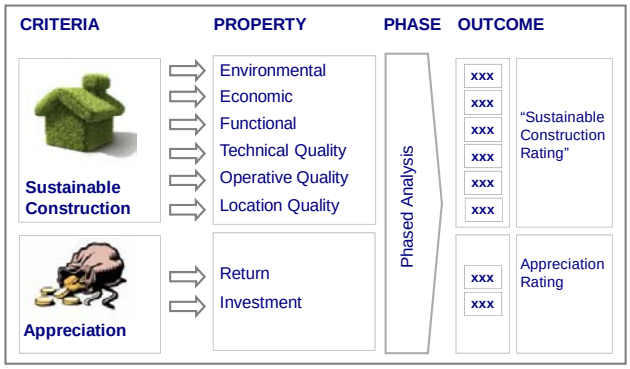
Goal-dependent decision matrix in portfolio management

The future of building lies in the existing buildings, not least because of their high number. According to a DEGI study, 60% of commercial real estate surface area is more than 25 years old and requires energy refurbishment pursuant to the current legal requirements. This corresponds to a redevelopment and modernisation bottleneck of €38 billion over the next 5 years.

In the following section, particular attention will be paid to portfolio management with the objective of increasing efficiency and improving the sustainability performance of the overall portfolio. The primary objective of the target standard includes the creation of individual concepts of holistic sustainability strategies for individual properties and entire portfolios. This comprises the following individual components:

- Sustainable Technical and Environmental Due Diligence
- Creation of integral packages of measures
- Holistic real estate sustainability consulting and project management

The strategic approach of portfolio management depends, on the one hand, on the objectives of the portfolio owner and, on the other, on the knowledge of the quality of the structure and the technical facilities. A phased analysis of the individual objects is required at the start of any portfolio valuation process to reveal the potential of individual properties or of any measures to improve their quality and the profitability by obtaining environmental certification and/or increasing their value. The diagram below illustrates the portfolio valuation process:



Source: author's illustration

The portfolio valuation result allows statements to be made regarding the potential for value increases and sustainability/certification of the individual properties in a real estate portfolio, which can be assigned to the following clusters:

- Cluster I: low sustainability and high value increase potential
- Cluster II: high sustainability and high value increase potential
- Cluster III: high sustainability and low value increase potential
- Cluster IV: low sustainability and low value increase potential

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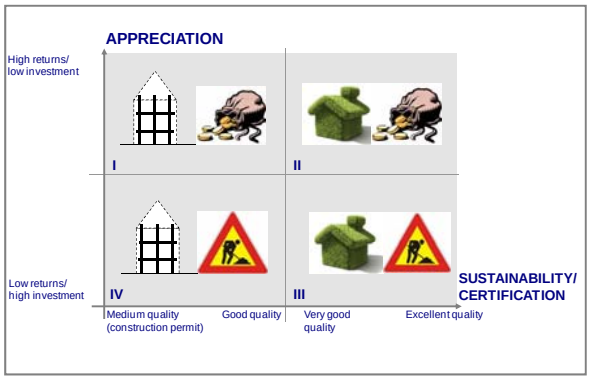

Source: author's illustration

An individual analysis is required to identify those properties which are suitable for investing in sustainable improvements. The conclusions drawn can be endorsed by recommendations for further planning processes, including profitability considerations. These form the basis for the decisions of the investor/owner to increase the efficiency and improve the sustainability performance of the portfolio as a whole.

Interim conclusion: such investment decisions can be integrated into a corporate strategy of responsible property investments that is in line with voluntary CSR commitments as referred to in the introduction.

The legal dimension

In many respects there are legal dimensions that derive from the objectives referred to above. These are neither dependent on the choice of certification system, nor on whether certification is to be obtained for a new or existing building. To illustrate this, some legal questions relating to contractual relationships and liability issues will be discussed below by way of example.

Contractual relations and liability issues in planning and construction: for all contractual negotiations and for all contracting parties it is advisable to come to a unanimous definition of terms such as "green building", "sustainable building" or "sustainability certificate". The services to be provided can only be determined if all parties involved. have a common understanding of these terms. There are also essential legal questions that arise for owners/auditors/planners/contractors regarding:

- defined interfaces and demarcation of the services of all parties involved in planning/ construction/ operation, with coordinated contractual relations
- scope of liability of auditors/planners/ contractors
- deficiencies in services provided by auditors/ planners/contractors
- agreement on quality and warranty claims
- handling of changes in certification requirements in the course of the planning and construction process
- limitation of claims for defects: if the certificate sought is refused several years after the formal acceptance (*Abnahme*) of the planning services, e.g. as a result of long construction times, the owner's claims for defects against the planners may already be time barred
- prospectus liability

Conclusion

The market relevance of sustainable buildings has grown to an ever-greater extent over recent years. This is attributable to legal, socio-political and corporate strategy reasons. At the same time, the international market has triggered pressure in the German real estate industry through the introduction of certification systems such as LEED, facilitating the successful introduction of a German certification system.

In spite of barriers to market entry cited by investors, e.g.:

- information asymmetry related to the calculation of costs and revenues
- lack of certification knowledge/experience
- occupier/investor dilemma with regard to existing buildings
- legal issues

there is a growing tendency on the market to see investments in sustainable and/or certified buildings not so much as a question of cost, but rather a question of remaining in the market. The demand is almost exclusively for certified buildings in the tense current market situation. The reasons are obvious:

Minimisation of building vacancy risk

- high energy efficiency (greater range in net rent with low ancillary costs)
- longer maintenance cycles for long-lasting products (minimisation of wear and tear)
- consideration of occupier demands (comfort, possibility of premises being used by third parties, CSR commitments)

Minimisation of the risk of changes in value

- by exceeding legal requirements (e.g. compliance with the higher EnEv 2012 standards instead of the current EnEv 2009 requirements)
- avoidance of subsequent investment in refurbishments necessary due to tighter laws
- image boost inter alia for owners and occupiers

The major challenge in the coming years will be in existing real estate (individual buildings and property portfolios). This challenge has been identified and the first strategies for improving the economic performance in property portfolios have been defined.

Due to the holistic sustainable valuation of buildings "made in Germany" under the German certification system and the dynamic developments emerging on

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the market, the theory set out at the beginning of this article can be broadened and expanded by the following call:

"SUSTAINABLE BUILDINGS are becoming a trend with a long start-up phase followed by unstoppable triumphant success – let's play a part in this together."

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"Go Green" or "Stay Grey"? Implications of Green Building Requirements for Tenancy Law and the Law of Sale

"Green Buildings" are highly topical at this time. Hardly a week goes by in which this theme is not picked up by new articles or events to discuss market relevance, the advantages and disadvantages of particular certification methods, and to make predictions about the effects of the "green trend" on the real estate industry. Property owners and developers are being forced to review the energy standards of their buildings as a result of increasingly strict legal regulations. So just what are the legal implications of green building laws for leasing or dealing in real property?

The legal framework conditions for energy balances in buildings can be found inter alia in the German Energy Saving Regulation (EnEV) 2009, the Renewable Energy Sources Act (EEG), the Renewable Energies Heat Act (EEWärmeG), and also in the revised Heating Costs Regulation dating from 2009 (which together form the "green building laws"). In the EnEV, for instance, there are two areas of regulation in particular that are relevant for lease and sales contracts: regulations on building energy efficiency and regulations on energy performance certificates.

Failure to comply with the energy standards owed under a lease contract pursuant to EnEV

Reduction in rent and damages under Sections 535 I sentence 2, 536, and 536a of the German Civil Code (BGB)?

The prerequisite for a reduction in rent is that the object of the lease contains a defect that destroys or reduces its suitability for the purpose outlined in the contract, Section 536 (1) BGB. In principle, this means that, unless the parties agree otherwise, a lessor is only obliged to ensure that the premises comply with the technical standards which were valid at the time of the construction of the building. Thus, should leased premises not meet the energy requirements of the EnEV that came into force after their construction, this does not constitute a defect of the leased premises and the lessee has no right to reduce the rent Nonetheless, In minimum standards for appropriate living or occupation must be met in any event. Some commentators argue that these minimum standards aerodynamic and should be determined on the basis of whatever may be the current energy standards required by the EnEV. These commentators are of the opinion that if such minimum standard are not met this constitutes a defects of the leased premises. However, this is only a minority opinion.

The Federal Supreme Court (BGH) has hinted at a different approach to deal with non-compliance of mandatory minimum standards set in the EnEV (see BGH NJW 2008, 142). However, this issue was not directly of relevance in the specific case and therefore not finally decided by the BGH.

Damages/ partial non-performance of the lessor's obligations due to ancillary costs being too high, Sections 280, 241 (2), 556 (3) sentence 1 BGB?

For purposes of assessing ancillary charges payable for residential premises it is stipulated in Section 556 (3) sentence 1 BGB provides for a strict requirement of cost effectiveness which prohibits that unnecessary or non-economical costs are passed on to the lessee. This requirement of cost effectiveness also applies for commercial leases.

The EnEV establishes concrete refurbishment obligations for property owners, e.g. obligations to upgrade and exchange certain boilers, storage heaters or insulation measures. The lessee cannot actually demand that such measures be taken by the lessor and, according to prevailing opinion, requirements under the EnEV are not enforceable by third-parties under private law. These refurbishment obligations can, however, be seen as defining the cost-effectiveness requirement in more detail. In the event that the lessor does not fulfill a mandatory refurbishment obligation which would lead to a (noticeable) reduction in ancillary charges, it would not be 'cost effective' to accept higher ancillary charges and the lessor would be in breach of ancillary obligation under the lease agreement (the obligation to ensure cost-effectiveness), the effect of this being that the lessor would not be allowed to require the lessee to bear the excess costs. . In such cases, the lessee may refuse to pay the full amount claims, or demand damages under Sections. 280, 241 (2), 556 (3) sentence 1 BGB. Ancillary charges already paid could be re-claimed from the lessor to the extent that the requirement of cost-effectiveness is not complied with. The BGH has hinted that ancillary charges could be uses as a vehicle to enforce modernization obligations of lessees and this idea was taken up inter alia in an opinion by BGH judge Kirsten Milger (see Milger in NZM 2008, 1 et seq.).

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Scope of action

The current legal situation still leaves open the issue of how lessees can counter lessors' non-compliance with the mandatory EnEV requirements. Nowadays, there is no longer any question that lease agreements cannot remain unaffected by these demands and that the lessor must expect a reduction in rent or a claim for damages in the event of non-compliance. What is the scope of action left to lessors in view of these risks?

It is advisable to explicitly stipulate in a lease contract that the existing condition of the leased premises as regards energy is in accordance with the contract, in particular regarding the age and condition of the heating system, building insulation, etc. Claims based on the leased premises having a "defect" can be ruled out by clearly describing their actual condition in the contract.

Another option may be to contract away the cost-effectiveness requirement. This is not possible in residential lease contracts because residential premises must always comply with the said standards, but such a clause is permissible in commercial lease contracts. It should be expressly agreed that the existing condition of the premises meets all contractual requirements, even though it may fall short of the requirements of the EnEV.

Passing refurbishment costs on to the lessee

If a lessor undertakes refurbishment work in leased premises in order to increase energy efficiency, this is supported by the law in that it is stipulated in Section 554 (2) sentence 1 in conjunction with Section 559 (1) BGB that the lessee must tolerate such measures. This obligation to tolerate applies to both residential and commercial lease contracts. Where residential premises are concerned, the lessor has a legal right to in-crease the rent by up to 11% p.a. of the cost expenditure for the residency. This covers not only measures required by the EnEV, but in principle also any refurbishment measures that result in the "saving of energy". This legal basis for rent increases is not, however, relevant to commercial leases, but there are various options for passing on refurbishment costs under commercial lease contracts, e.g. by agreeing on building cost subsidies or individual rent increase rules.

"Heat Contracting"

The term "heat contracting" refers to contractual arrangements under which certain heating services are provided for payment. For example, a lessor may cease to operate existing heating facilities and have these operated by a third party or the entire heating system may be replaced. If such changes are made during the term of a lease contract the question arises whether the lessor is entitled to require the lessee to bear any new and/or additional costs that arise.

The BGH ruled in 2007 that a lessor may require a lessee occupying the relevant premises to bear the full amount of charges invoiced by a third-party supplier, provided only that the lease contract contains a general provision stipulating that such costs shall be borne by the lessee. This is the case if the lease contract refers to the Operating Costs Regulation (see Section 2 No. 4 lit. c). Heat contracting may be an interesting solution for the lessor if the existing heating system no longer meets the legal requirements on energy efficiency. The lessor can thus comply with the legal requirements without incurring any additional costs.

Implications of the EnEV for real estate purchases

The EnEV can also have far-reaching implications for real estate purchases. Where non-compliance with the energy standards set forth in the EnEV are regarded as being a defect of leased premises, the lessee may assert legal warranty claims subsequent performance, reduction in rent, rescission, damages). In this context, a distinction must be made between new and existing buildings:

New buildings

The consequences of the EnEV are relatively clear for new buildings: pursuant to the prevailing opinion in case law and in the legal literature on this subject, non-compliance with the EnEV requirements constitutes a material defect, even if the use of the premises is not actually impaired. The decisive point in time for assessing whether certain premises correspond to the state-of-the-art and with the applicable legal requirements is the date of its formal acceptance (*Abnahme*) pursuant to Section 640 BGB (BGH NJW-RR 1995, 472 et seq., NJW 1998, 2814 et seq.).

A principal/contractor may come to be in a difficult situation if energy standards under the EnEV are tightened between the conclusion of the contract and the formal acceptance of the finished building and if such tightening up of these standards was not, or could not, be taken into account during planning and/or construction phase. This then means that the only just completed building has a defect for which the principal/contractor may be held liable by the new owner. It is therefore important to minimize or rule out this risk from the outset by including an appropriate clause in the contract documents.

Existing buildings

Where there is no quality covenant regarding the condition of the building at the time of purchase, any defect will be assessed on the basis of the usual condition of buildings of a similar age and on what would be the reasonable expectations of the Purchaser, see Section 434 (1) sentence 2 BGB. Making an express agreement on the quality as regards the energy standards is definitely advisable for the purposes of legal clarity; failure to do so may easily lead to a legal dispute.

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How important are energy performance certificates?

Under the current law, energy performance certificates (*Energieausweise*) are significant from an information point of view only. The predominant view is that the mere presentation of an energy performance certificate does not lead to an agreement on a specific quality of the property to be leased or purchased. The lessor or vendor should, however, exclude liability for the information contained in the energy performance certificate as a precaution. Seen from the lessor's/vendor's perspective it is preferable if the energy performance certificate is not mentioned in the lease or purchase contract, and it should certainly not be attached to the contract as an appendix!

Changes as a result of the new EU Buildings Directive

The revised "European Energy Performance of Buildings Directive" has been in force since the beginning of July. In comparison with the previous Directive dating from 2002, it contains more stringent rules. All new buildings built from 2021 must be constructed as lowest-energy buildings. Above all, however, the provisions on energy performance certificates were tightened. The Directive provides inter alia that lessees or purchasers must not only be shown an energy performance certificate, but must also be provided with a copy thereof. In addition, the sentence "Energy performance certificates are for information purposes only" was deleted. The Directive is expected to be implemented in Germany by means of EnEV 2012, which has been announced. It is, however, debatable whether this will be used as an opportunity to also make changes to tenancy law and the law of sale aimed at encouraging efforts to attain energy saving targets and to modify private law provisions accordingly. Corresponding announcements can be found in the coalition agreement of the German federal government (http://www.cdu.de/doc/pdfc/091026-koalitionsvertrag-cducsu-fdp.pdf, page 28), where it is stated that the government wishes to rely less on force in improving energy efficiency. However, with respect to the redevelopment of existing buildings in particular, it is planned to "reduce obstacles in tenancy law for energy redevelopment for the mutual benefit of both owners and lessees".

The deletion of the sentence "energy performance certificates are for information purposes only" could be understood by legislators as an invitation to insert the a provision into EnEv 2012 or in Art. 5a EnEG providing that in the absence of evidence to the contrary such a certificate shall be deemed to constitute a quality covenant. The lessee or purchaser would then have warranty rights in the case of information contained in such certificates being inaccurate. This must be taken into account when drawing up the contract.

It is also conceivable that a new provision could be introduced in tenancy law to stipulate that the energy standards set forth in the EnEV are mandatory. It is also likely that the obligations of lessees to tolerate refurbishment works will be extended; this has also been announced in the coalition agreement.

Conclusion

Tougher legal regulations on the energy balance of buildings have increased the pressure on investors, project developers and lessors to act. However, there is not (yet) a clear legal framework across the board. Investors, project developers and lessors should therefore ensure the greatest legal certainty possible by ensuring that contracts are specifically tailored to the requirements of the particular transaction. One thing is clear: there is only one (green) answer to the question "Go green" or "Remain grey" – at least for those wishing to enjoy continued market success in the future.

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Open-ended real estate funds – What next Mr. Schäuble?

On 22 September 2010, the Federal Government presented a draft Act[1] on the strengthening of investor protection and enhancing the functionality of the capital market ("**Government Draft**"). A discussion draft for the act was initially introduced by the German Federal Ministry of Finance (*Bundesfinanzministerium*) under the leadership of Federal Minister of Finance Wolfgang Schäuble in May 2010.

The Government Draft covers on various topics related to investor protection and capital markets currently under discussion. In particular, the Government Draft also addresses the partial revision of the regulations governing open-ended real estate funds within the meaning of the under the German Investment Act (*Investmentgesetz*). This is the government's response to the suspension of redemption of various real estate funds since the collapse of investment bank Lehman Brothers.:

Minimum holding periods

To date, real estate funds provided for daily redemption. In future, a redemption of such units will only be possible after a holding period of 24 months. An

[1] The legislative draft of the Federal Government is available for download on the BMF homepage (www.bundesfinanzministerium.de).

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exception should, however, apply to investors wishing to redeem units in an amount not exceeding EUR 5,000 per month.

However, redemption charges of 10% apply for redemptions after 24 up to 36 months after subscription, and of 5% after 36 up to 48 months after subscription.

Expert valuations

Real estate assets should initially be valued by a real estate expert before purchase, and then be routinely revalued in certain intervals while held for the account of the real estate fund. The valuation intervals will be shortened (depending of the frequency of redemption) meaning that valuations are to be carried out more frequently than every 12 months.

Redemption suspension

The Government Draft recommends contains an amended redemption suspension procedure consisting of three phases:

Phase 1: Suspension of redemption is possible for an initial two periods of six months each – i.e. one year in total – during which the investment company is to try to create liquidity through selling real estate assets even if this real estate was not previously intended for sale.

Phase 2: Suspension of redemption for another 12 months during which the investment company must sell real estate assets applying a 10% haircut as compared to the value determined by the real estate experts.

Phase 3: Suspension of redemption for another six months during which the investment company must sell real estate assets applying a 20% haircut as compared to the value determined by the real estate experts.

If there is still not sufficient liquidity available following the completion of phases 1 through 3, the investment company is to lose its right to manage the real estate fund. The custodian bank will then be responsible for the winding-up of the fund. This also applies if the investment company suspends redemption of units three times within five years.

Liquidation of a real estate fund

The Government Draft does not contain special rules for the liquidation of a real estate fund. The investment company will therefore have to wind-up the fund by suspending redemption of units and selling all assets held for the account of the fund.

Investors' co-decision rights

Investors' co-decision rights are another interesting feature of the Government Draft. It provides that during suspension of redemption rights, investors may exercise certain co-decision rights in the divestment of real estate assets. For instance, they will be able to approve sales below the value determined by the real estate experts. To date, the German regulated fund sector has no practical experience with such co-decision rights.

Transitional periods

Longer transitional periods are required due to the significant changes in store that will impact the rights of individual investors. According to the Government Draft existing investors will be grandfathered and will not have to adhere to the 24-month minimum holding period. No grandfathering is available with respect to the redemption charges (a fact that is controversially discussed by stakeholders).

In order for the changes to be effective, the fund rules of real estate funds already in existence will also have to be adjusted. The draft Act provides for a period up to the end of 2011 in this respect.

Legislative procedure

The Government Draft has to be passed by the *Bundestag* and the *Bundesrat* – the lower and upper houses of the German parliament. This is schedules for this winter, meaning that the new regulations could be applied in early 2011.

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Land charge assignment - Immediate enforcement only upon entry into the security purpose agreement

In both the Spring edition of the Clifford Chance Real Estate Newsletter and in a Real Estate Newsletter Update, we referred to the decision of the German Federal Supreme Court ("BGH") of 30 March 2010 (ref: XI ZR 200/09) on the procedure to be followed by a party that acquired a land charge, which was created to secure debt and includes submission to immediate enforcement (*Unterwerfung unter die sofortige Zwangsvollstreckung*). The reasons for the decision have since been published. In the following, we present the principal contents and the practical implications of the decision:

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Entry into the security purpose agreement

A party that acquired a land charge created to secure debt may only take measures of immediate enforcement based on the submission to such immediate enforcement by the landowner under that land charge after having become a party to the underlying security purpose agreement (*Sicherungszweckvereinbarung*).

The wording of the BGH's judgment is such that it is unclear what exactly is meant by "becoming a party". This could require "taking over" the agreement, which would mean that the party that provided security in the form of the land charge would have to agree to such transfer (apart from the "old" and the "new" land charge creditor). In practice, this procedure of taking over an agreement may often prove difficult to implement, especially if the party that provided security is not cooperative. Alternatively, what is known as an "assumption of debt" (*Schuldbeitritt*) may suffice, which would not require any involvement of the party that provided the land charge security. The old and the new creditor could agree in a "substantial contract for the benefit of a third party" (*echter Vertrag zugunsten Dritter*) that the security purpose agreement shall be binding on the new creditor with the party that provided security being entitled to benefit from and to assert claims under this agreement between the old and the new creditor.

Valid for "old cases" only?

It appears that Section 1192 (1a) BGB provides for sufficient debtor protection where registered land charges (Buchgrundschulden) were created or assigned for the first time after 19 August 2008, meaning that the decision of the BGH under consideration here would not be applicable. However, the situation may be different where a certificated land charge (Briefgrundschuld) is concerned, i.e. a land charge that is also documented by a certificate and that may be acquired in "good faith" without its transfer being entered in the land register. Land charges created before 20 August 2008 are subject to the requirements defined by the BGH in its decision of 30 March 2010.

This decision of the BGH was handed down in a case concerning a land charge that was first created in 1989 for the purpose of securing debt and which was subsequently assigned prior to the introduction of the Risk Mitigation Act on 19 August 2008. The Risk Mitigation Act *inter alia* provided for the introduction of Section 1192 (1a) BGB, under which defenses available to a debtor under the security purpose agreement remain unaffected if the land charge is transferred to a new holder. Given that the BGH was concerned here with an "old" case concerning facts that occurred prior to 20 August 2008, the BGH did not have to consider the implications of Section 1192 (1a) BGB in its decision.

As Section 1192 (1a) BGB ensures debtor protection in "new cases" – i.e. land charges created after 19 August 2008 – it can justifiably be argued that the additional requirements set by the BGH do not apply to such land charges. This may even apply to registered land charges that were created before 19 August 2008 and assigned for the first time after that date. Due to the constitutive effect of the entry of a transfer in the land register, it is guaranteed in these cases that no other *bona fide* and legally valid transfer of the land charge has taken place.

The situation is different, however, where certificated land charges are concerned, given that a land register entry concerning a transfer of such a land charge merely has a "corrective effect" and that such a land charge may be transferred with full legal effect without the transfer being entered in the land register. Section 1192 (1a) BGB does not protect the rights of debtors if a land charge is created prior to 20 August 2008 is concerned, the reason for this is that a notary public recording such a transfer has no means to verify whether the relevant land charge has not already been transferred to a *bona fide* transferee. Therefore, it seems logical and fair to apply the standards set by the BGH in its recent decision in such cases.

Evidence for entry into the security purpose agreement

Officially authenticated evidence of being a party to the security purpose agreement is required.

Evidence of the new creditor being a party to the contract on the provision of collateral security must be provided in the form of a public or publicly authenticated document. In practice, this evidence will be an agreement on the entry of the new creditor in the said agreement with the signatures being certified and due representation being confirmed by a notary. It will usually be contained the statement of assignment of the land charge and must be signed by all parties involved. Land charges that have already been transferred may have to be re-documented so that the requirements defined by the BGH are met.

Cases similar to a sale of claims coupled with an assignment of a land charge

In principle, the requirements set by the BGH also apply to debt rescheduling operations or the extension of new loans.

While the decision handed down by the BGH specifically referred to cases where loan claims are purchased, i.e. it does not explicitly apply to debt rescheduling operations or cases where new loans secured by an existing land charge are being extended, the requirements defined by the BGH should nonetheless be applicable *mutatis mutandis* in such cases. The provisions on the claims secured by a land charge may be changed by amending the original clause defining the purpose for which security is provided, or by entering into a new security purpose

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agreement, in either case provided that the debtor agrees to this. Accordingly, the conclusion of a new security purpose agreement should be certified by a notary.

Even general terms and conditions may provide for submission of a debtor to immediate enforcement

General terms and conditions authorizing immediate enforcement do not unreasonably disadvantage the debtor, where Section 307 (1) BGB) applies, even if those general terms and conditions stipulate that a land charge is freely transferable.

The BGH confirms the common practice in relation to general terms and conditions that authorize immediate measures of execution. In so doing, the BGH rejects developments to the contrary in the case law and legal literature.

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The BGH has decided: delayed acceptance of an offer to finalize a lease contract which is subsequently implemented does not constitute a written form defect.

Not long after the German Federal Supreme Court (BGH) caused a stir with its judgment of 4 November 2009 on the requirements of written form to be met when representing a public limited company, it has now handed down a decision on 24 February 2010 (XII ZR 120/06) which clarifies and creates legal certainty on an issue which is of great practical significance.

The issue at stake

One of the problems related to the written form of lease contracts (Section 550 BGB) which has caused major uncertainty for property owners and investors, was the issue of whether an offer for the conclusion of a lease contract that has not been accepted “in time” within the meaning of Section 147 (2) BGB is still considered to comply with the written form requirement if the contract is subsequently implemented. From a legal point of view, delayed acceptance of an offer, i.e. delayed countersigning and returning of the contract documents means that the lease contract is not effectively concluded. If the lease contract is subsequently implemented, however, the contract is deemed to have been concluded at this point in time. The question then arose whether a lease contract concluded in this way complies with the written form requirement. One practice-friendly opinion represented in the literature in particular spoke out in favour of observing the written form, since ultimately there is a contractual document signed by both parties which reproduces the contents of the lease contract. Another opinion put forward inter alia by the Court of Appeal of Berlin, argues against this on formal grounds, because in this case the contract is not actually concluded by means of written statements. It was generally difficult for real estate practitioners to understand why the written form should be defective, despite the fact that there was a written lease contract document in existence laying down everything that had been agreed and performed by the parties.

The BGH dealt with these issues in its decision of 24 February 2010 – XII ZR 120/06 – . Fortunately, it took a clear stance.

The judgment of the BGH

In the judgment cited, the BGH had to decide on whether a temporary lease contract was validly finalized and had full legal effect. In 1992, the parties negotiated the conclusion of a lease contract for commercial premises which were still to be built. The lease period was to be 15 years. The lease contract contained a clause whereby the first signatory was bound by its signature, constituting an offer to enter into the lease, for a period of one month as of the date of the other party's receipt of the signed contract. The period for countersignature and return of the lease contract was then extended at the request of the second party. This extension was confirmed in writing only. The second party then signed the lease contract on the latest possible date before expiry of the extended deadline. The leased property was then handed over to the lessee following a joint site inspection.

The BGH arrived at the decision that a formally effective lease contract with a term of 15 years had been concluded in the case brought before it.

Calling upon its earlier decisions, the BGH clarified firstly that for observance of the written form pursuant to Section 550 BGB, there is a requirement in principle that the fundamental contents that must be included in any valid lease contract (rent, leased property, term and parties) is contained in the contract document. A deadline for accepting an offer to enter into a lease contract or the actual acceptance of such an offer are not part of the indispensible contents of such a contract, but rather relate solely to its conclusion. The legal protection provided by Section 550 BGB clearly does not extend to the procedure of concluding a lease contract, given that the purpose of the said provision is primarily to protect future owners of the property (who will be the lessor under the lease contract). An extension of an acceptance deadline or the timely receipt of the acceptance statement are therefore not

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subject to the requirement for the written form pursuant to Section 550 BGB.

The BGH then also looked into the question set out above of whether observance of the "external form" is sufficient for meeting the formal requirements of Sections 550 and 126 (2) BGB. Its interpretation of Section 550 BGB, taking account the protective purpose and the legal consequences of this provision, led the BGH to the conclusion that beyond the requirement of observing the external form, Section 550 BGB does not require that a lease contract be concluded through written statements. In fact, a lease contract satisfies the written form requirement set forth in Section 550 BGB even where it has been concluded only by implication, provided only that its contents is identical to the contractual conditions set out in the proper external form pursuant to Sections 126 BGB.

Trends / opinion

In its judgment of 24 February 2010 – XII ZR 120/06, the BGH clarifies an issue of huge practical relevance. Without expressly stating so, the BGH rectifies an ambiguous leading statement in a judgment dated 29 April 2009 – XII ZR 142/07, in which it had stated that even though initially there was no formally valid lease contract (because the offer to conclude such a contract was not accepted in time), a formally valid supplementary agreement that referred to the original contract document then led to the conclusion of a formally valid lease contract. This ambiguous leading statement was clarified in the judgment of 24 February 2010 – XII ZR 120/06.

Note for practical application

Owners of leased property will be able to sleep more soundly following the BGH's judgment of 24 February 2010, since the legal basis of one of the rationales often cited in notices of premature termination of long-term lease contracts has now been eliminated. When concluding new lease contracts, however, care should be taken that offer and acceptance are made within a brief period. Otherwise, there is a risk until implementation of the lease contract that one party will plead that the contract has not been effectively concluded. However, once the lease contract is implemented as set out in the contractual document signed by both of the parties, then neither of the parties can invoke a written form defect on account of the offer to finalize the lease contract not having been accepted in time.

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