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Real Estate Newsletter

Welcome to the early summer issue of our Real Estate Newsletter, providing information and advice on current real estate and real estate financing issues.

In their guest contribution entitled "Real estate as a key factor in a sustainable EU energy policy", Martin Lemke, Managing Director of PATRIZIA Investmentmanagement GmbH and Chairman of the FIEC "Housing" working group (European Construction Industry Federation), and Julia Schöne, Head of the Brussels office of the BFW *Bundesverband Freier Immobilien- und Wohnungsunternehmen e.V.*, the German federation representing private housing and real estate companies, highlight the impact of EU trends and guidelines on real estate and climate protection from an economic perspective.

Dr. Gerold Jaeger and Henning Aufderhaar discuss the draft Landlord and Tenant Law Amendment Act on the energy modernisation of rented accommodation and the simplified enforcement of eviction orders from the autumn of 2010. The draft, which has not yet been formally introduced in the Bundestag, has met with strong criticism from a number of interest groups. The authors consider whether this criticism is justified and where there is room for improvement, in particular from the perspective of climate protection and notably in relation to commercial tenancy law.

Thorsten Sauerhering and Dr. Dominik Engl address the continuing trend for Federal States to raise real estate transfer tax rates – a power granted in the course of an amendment to the German Basic Law in 2006. They set out the

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available alternatives in transaction structuring whereby investors are able to minimise the disadvantages resulting from such tax increases. These trends make a share deal (i.e. the purchase of shares in a special purpose vehicle holding one or more properties) more profitable and advantageous as compared with a direct purchase, namely an asset deal.

Finally, Christian Trenkel and Alexandra Schlicht consider so-called 'agreements on satisfaction' between borrowers and lenders to limit the utilisation of real estate, except through compulsory auction. The statutory provisions substantially restrict the alternatives to compulsory auction.

We hope you find our Newsletter both helpful and enjoyable. Please feel free to contact us at any time to discuss any legal issues you may have relating to real estate.

Best regards,

Christian Trenkel Gerold M. Jaeger

Real estate as a key factor in a sustainable EU energy policy

The debate about energy policy has gained huge momentum in recent years, both in Germany and Europe as a whole. The terrible events surrounding the disaster at the nuclear reactor in Fukushima and the resulting demands by the public for action have added further impetus to the discussion. The focus of the European debate for its part is not so much on abandoning nuclear power, but on the increased use of renewable energy and a reduction in primary energy consumption with a view to withdrawing from nuclear power over the long term. The goal of reducing CO_2 emissions is clearly still on the agenda, but has somewhat taken a back seat in the last few weeks. If the goals of a 20% reduction in CO_2 emissions by 2020 and a step-by-step withdrawal from "dirty" energy sources are to be achieved, a reduction in primary energy consumption is absolutely essential and will probably have to be approached even more ambitiously than has been the case to date. The buildings sector plays a key role in this, since, according to the Commission, it is responsible for 40% of primary energy consumption. As a result of the revision of the Directive on the energy performance of buildings, which was adopted in May 2010, the energy requirements for new buildings have been regulated and major renovations[1] brought within the scope of application of the Directive. Now the greatest challenge is to adapt the existing building stock to meet the new energy requirements. In his Energy 2020 strategy, the Commissioner for Energy, Günther Oettinger, has already assigned a major role to the building sector and announced a separate strategy for existing buildings. He presented the Energy Efficiency Plan on 8 March 2011. This plan is in fact the revision of the 2006 Energy Efficiency Action Plan, which was expected in 2009 but postponed due to a change in leadership at the Commission and which, at Oettinger's behest, has now been integrated into the Energy 2020 strategy. The creation of an energy efficient Europe had already been made the top priority in the Energy 2020 strategy and the Energy Efficiency Plan details the role of the buildings sector in achieving this goal. In the course of the next few years the key role will be played by state-owned building stock. The Commission intends to propose legally binding instruments to increase the rate of refurbishment of public buildings in Member States to 3%.[2] The current average rate of refurbishment in Europe is approximately 1.5%. The European Commission wants to avoid introducing compulsory refurbishment of buildings in private ownership, preferring first to wait for legal implementation at the national level and the establishment of the current regulatory framework in the market, also because such a move would inevitably involve substantial interference in property law. However, a widening of the Ecodesign Directive to include building components such as windows, boilers, water heating equipment, and ventilation and air conditioning systems is likely to pose an obstacle to the refurbishment of private residential buildings. Just as with any tightening of the requirements for energy refurbishment measures, this will also lead to an increase in construction costs. In consequence, energy refurbishment measures will in some cases cease to be economically viable under the new framework, with the risk that such measures will not be implemented at all because it simply does not make sense financially. The fact is that for a private investor the sustainability of a property is not determined solely by how future-proof the property's structural condition is, but also how it can be rented on the market over the long term. While the structural condition is clearly of great importance in this context, the demand for a particular residential property is, in contrast, absolutely crucial.

To bring about comprehensive refurbishment in private building stock as well, the European Union is instead relying on a more extensive range of incentives. Under the Energy Efficiency Plan this not only includes removing legal obstacles (the investor/user or split incentives dilemma), but also the efficient and targeted promotion of refurbishment measures. The support measures of the German government under the CO_2 Buildings Renovation Programme (*CO_2-Gebäudesanierungsprogramm*), operated by the state-owned KfW promotional bank, are considered

[1] Renovations are considered "major renovations" where

a) the total cost of the renovation relating to the building envelope or the technical building systems is higher than 25% of the value of the building, excluding the value of the land upon which the building is situated; or

b) more than 25% of the surface of the building envelope undergoes renovation.

[2] 3% of a building's floor area.

exemplary by European experts and neighbouring countries alike. The European Union also allows money from the Structural Funds to be used for building stock. The Structural Funds are financing instruments in European regional policy aimed at promoting economic and social cohesion in the EU. They are also intended to help poorer regions to meet the requirements of the common internal market. There are three Structural Fund instruments in the 2007-2013 programming period: the European Regional Development Fund (ERDF) for the financing of regional policy structural subsidies, the European Social Fund (ESF) for the strengthening of economic and social cohesion, and the Cohesion Fund for projects in the field of the environment and trans-European transport networks. As part of the European Economic Recovery Programme, the amendment to the Structural Funds Regulation (Regulation (EC) 397/2009) of May 2009 allowed 4% of the funds from the ERDF to be released for the energy rehabilitation of buildings for the EU-15 Member States as well. In France and the UK, approximately 70% of the available ERDF budget has already been reallocated to projects for the energy rehabilitation of buildings. In Germany, the Federal States marked this new potential funding with a decision by the German Building Ministers Conference (*Bauministerkonferenz*) against a reallocation of these funds. In future, greater emphasis will be placed on promotion by means of revolving funds. Initial experiences here have been accumulated by the European Commission together with the European Investment Bank in the development of JESSICA funds (Joint European Support for Sustainable Investments in City Areas). Revolving funds allow the effectiveness of the funds from Structural Funds to be expanded through additional funds from the public and private sectors, thus providing leverage. This model is also being tested by the Commission specifically for measures and projects to increase energy efficiency. Unused funds from the EU growth programme of EUR 146 million have been made available in a new fund, intended to benefit the public sector or private players acting on their behalf. This model could be a pilot project for a new, dedicated energy efficiency fund. The Commission has thus announced in its Energy Efficiency Plan that it intends to present a new instrument to promote energy renovation of European building stock during the budget debate in the summer of 2011.

It is not only the renovation of buildings that is becoming more costly on account of the increasingly stringent requirements; inevitably, the building of new properties is also affected. This is further exacerbated by increasing financial market regulation. For large building projects in particular the Basel III requirements will lead to more expensive loans, while the same is true for owner-occupiers with regard to the recently presented proposed Directive on residential property loan agreements. Here the Commission proposes simplifying the early repayment charges (*Vorfälligkeitsentschädigung*) common particularly in Germany for long-term financing. This means reducing the planning certainty of banks and will ultimately lead to this "new" risk being refinanced by higher interest rates. This will make the path to home ownership more difficult, mean that energy policy targets are met later or not at all due to lack of new quality building stock, and make a structural adjustment of the building stock to future housing needs unnecessarily more complicated.

The key role of the real estate sector in achieving energy policy goals is reflected in various European Union initiatives. What is still lacking, however, is an across-the-board consideration of other political initiatives and regulatory plans. Particularly in the area of financial regulation it is becoming clear that real estate investments are increasingly being put on the same footing as speculative equity investments while long-term investments are discriminated against. However, this is precisely what has made a decisive contribution to the healthy stability of the German real estate market. The sustainability of a building, whether in an ecological, economic or social sense, cannot be considered in isolation and will be optimised only when all other prevailing conditions foster sustainable economies.

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Review of the draft Landlord and Tenant Law Amendment Act (*Miet-rechtsänderungsgesetz*) (particularly with regard to energy modernisation)

Introduction

In October 2010, the German Federal Ministry of Justice (*Bundesjustizministerium*) presented a draft bill on the energy modernisation of rented housing and the simplified enforcement of eviction orders (*Gesetzesentwurf über die energetische Modernisierung von vermietetem Wohnraum und über die vereinfachte Durchsetzung von Räumungstiteln*), known as the Landlord and Tenant Law Amendment Act. The bill has still to be introduced in the Bundestag, the German Parliament.

The bill is essentially concerned with the implementation of the coalition agreement of the current German government, which aims at reducing, for the common benefit of landlords and tenants, the hurdles to energy modernisation existing at present in landlord and tenant law. Above all, however, the bill is ultimately an attempt to achieve the German government's ambitious climate protection targets as set out in the energy plan of 28 September 2010.

The bill also contains provisions for the speedier eviction of rented flats and houses in the case of arrears and for preventing what is known as the "Munich model".

Modernisation measures

Since as long ago as 2001, landlords have been able to apportion to tenants some of the costs for building measures serving long-term energy or water savings.

Under the planned reform, however, tenants are also supposed to be able to share in the costs of the modernisation measures to the extent that they obtain no financial advantage measured in terms of the energy consumed. However, the precondition for the resulting increase in annual rent of up to 11% of the modernisation costs implemented for the dwelling is that the landlord is required by law to carry out these energy modernisation measures.

The bill defines energy modernisation as a measure which permanently reduces water consumption or enables primary or final energy to be used more efficiently in the long term or otherwise protects the climate. This provision is intended to cover all measures that contribute to improvements in energy efficiency and climate protection. The legal definition has been deliberately formulated in a broad way so that it will also cover future new technologies that enable energy to be used more efficiently or aid climate protection.

To ensure that actual proof of the energy efficiency of a given measure does not undermine the bill's purpose, the aim is to reduce the formal hurdles for proving energy efficiency. Thus, the landlord should be able to refer to recognised standard values both when giving notification of the required modernisation work and when making the request for the rent to be increased. However, the bill has still to define what these recognised standard values will be. The extent to which this does in fact simplify matters will thus depend on its implementation in practice.

Unconditional duty to tolerate (*vorbehaltlose Duldungspflicht*) on the part of the tenant

The bill seeks to impose on the tenant a duty to tolerate measures that are necessary for the maintenance or repair of the rented property. This established requirement is intended to enable the landlord to perform his duties of maintenance and warranty (*Erhaltungs- und Gewährleistungspflicht*). The tenant is not required to assist actively. He must provide access to the rented property to the extent required for the maintenance measures to be carried out and, if necessary, also agree to the rearrangement of the contents, including temporarily moving out, at the landlord's expense.

The bill provides for two scenarios in which a tenant must tolerate unconditionally energy modernisation measures.

In the first scenario, a tenant is required to tolerate those energy modernisation measures that the landlord is legally required to carry out. This view had already been accepted in principle in the legal literature and case law, although explicit codification in statute will provide greater clarity for those applying the law. What is new is that, because of the non-exhaustive legal definition of the term "modernisation measure", this specifically allows energy modernisation measures to be included. The bill also excludes the tenant's right to a reduction in rent (*Minderungsrecht*) for interferences caused as a result of energy modernisation work that the landlord is required by law to carry out.

However, this gives rise to the question of when an energy modernisation measure is to be considered obligatory by law. Under the law at present the scope of application tends to be restricted. While the current Energy Savings Regulation (*Energieeinsparverordnung*) has substantially increased the requirements for heating insulation and technology, a legal obligation on the part of the landlord of an existing property to carry out the energy modernisation work applies only to a limited extent, for instance, improving the energy efficiency of the roof and facade when carrying out comprehensive renovations on a property that affect more than 10% of the substance of the building.

On the whole, therefore, the current options available under statute in which an obligation is imposed on landlords of existing properties to undertake energy modernisation work are hardly likely to be sufficient to achieve the ambitious targets put forward by the German government in its energy plan.

The second category of energy modernisation measures to be tolerated unconditionally concerns measures undertaken voluntarily by the landlord where the landlord seeks a rent increase to cover the resulting costs. It is generally permissible by law to raise the rent by 11% p.a. of the costs incurred following the modernisation of a dwelling. In the case of voluntary energy modernisation measures, the landlord only has the option of raising the rent to the level of the reference rent customary in the locality. It should be noted that the duty to tolerate in the case of voluntary modernisation measures applies only to energy measures and not to any other type of modernisation work. The bill does not address the possibility of a mixed package of modernisation measures, giving rise to the likelihood of difficulties in distinguishing between the two.

The bill does not exclude either the tenant's right to a reduction in rent for interferences caused as a result of voluntary energy modernisation measures. A reduction in this case, as with other types of modernisation measures, is possible under existing legislation (and will remain unaffected by the bill) to a limited extent only or excluded altogether if the ability to use the rented property is only insignificantly reduced as a result of the modernisation measure.

It remains questionable whether, in view of these rather extensive restrictions for property owners, the investor-friendly environment needed to achieve the German government's ambitious climate protection targets will be created. Excluding the possibility of raising the rent and the absence of legal obligations at present means that the entire cost-heavy burden involved in carrying out energy modernisation measures will initially remain with the landlord. It seems reasonable to doubt whether on this basis there will be sufficient incentives for the owners of existing properties to undertake such measures. Unless the sale of the property or a new lease are in the pipeline, giving the property owner the chance of a higher sale price or rent if he were to undertake energy efficiency modernisations, it is likely that many owners will be put off making an investment of this nature.

It can be assumed from an interview with the Federal Minister of Justice (*Bundesjustizministerin*) Sabine Leutheuser-Schnarrenberger (FDP) published in the Financial Times Deutschland on 15 April 2011 that the German government has no plans to raise the rental increase permitted for modernisation work above the annual threshold of 11% of the investment cost. It remains to be seen whether in the final version of the bill the possibility of increasing the rent following modernisation measures will be extended to include at least the case of energy modernisation measures carried out voluntarily. This would certainly be beneficial in creating real incentives for investment, if only in a graduated form.

Other duties of toleration of the tenant

In the case of all other modernisation measures, such as voluntary energy modernisation in which the option of raising the rent is not waived, the tenant can continue to claim grounds of hardship. Hardship grounds will continue to apply in particular for measures that would constitute for the tenant, his family or another member of his household a hardship that is not justifiable even considering the justified interests of the landlord and other tenants in the building. In this context, including, without limitation, the work to be undertaken and the structural consequences, prior outlays by the tenant and the increase to be expected in the rent are to be taken into account. An exception to this exception is that there is no hardship if the expected increase in the rent is simply the consequence of being restored to a generally acceptable condition.

According to the bill, in assessing a hardship case it will henceforth be possible also to take account of the interests of energy efficiency and climate protection. Unfortunately, the bill does not set out how this would work in practice. Detailed regulations and a greater degree of legal certainty for the landlord would certainly be desirable for creating an investor-friendly environment.

The bill also makes it clear that the parties to a lease may reach agreements concerning certain maintenance and modernisation measures. It shall remain unanswered whether such clarification is really necessary in the area of private autonomy dealt with by the German Civil Code (*Bürgerliches Gesetzbuch*).

Duties of the landlord

According to the text of the bill, the landlord must inform the tenant in good time of maintenance measures, unless the measures have only an insignificant effect on the leased property. This means that maintenance measures, except for emergency measures, must be notified by the landlord in such a way that the tenant can prepare for them.

A more far-reaching measure, on the other hand, is the duty to announce modernisation measures. These are to be notified via a so-called modernisation notification (*Modernisierungsankündigung*) made in writing at least three months prior to commencement of the work concerned. Observance of the notice period begins upon receipt of the modernisation notification by the tenant. The notification must set out the nature and extent of the modernisation measure, as well as details of its commencement and expected duration.

Rights of the tenant

It is proposed to exclude by law a reduction in rent where energy modernisation interferes with the use of the rented property. This will only apply, however, where the landlord is legally required to carry out this modernisation and the measure has been properly carried out. The landlord is thus obliged to handle the legally binding building work so that it is completed both smoothly and quickly for the tenant. In the not infrequent case that the legally binding and properly carried out measure involves maintenance or other types of modernisation measures, the bill refers in its explanatory statement to the need, in the event of a reduction in rent, to identify which interference is caused by which measure. In the event of a dispute, the court shall estimate the proportions at its own discretion and thereby determine which interferences lead to a reduction and which must be accepted without one. In this sense, the concern is that disputes will be inevitable given the difficulties that are bound to arise in practice in distinguishing between measures leading to a reduction in rent and those that do not, thus ultimately resulting in legal uncertainty for the landlord keen to invest.

The tenant's existing special right of termination (*Sonderkündigungsrecht*) following notification of modernisation work under current legislation is also addressed in the bill. The new aspect here is the possibility of preclusion taking into account

circumstances that establish particular hardship. The aim of this provision is to make the tenant communicate his hardship grounds promptly so that the landlord can prepare for them, thereby gaining an element of certainty in planning the modernisation measures. The same notice period of one month, or almost two in the most generous case, applies as for the declaration of termination for cause (*außerordentliche Kündigung*). However, this period only commences once the landlord has given due and proper notification of the modernisation measure in writing.

Impact on commercial tenancy law

Only a few of the planned changes will affect commercial leases. While the bill also imposes duties of toleration on commercial tenants as regards the implementation of energy modernisation reforms, there is no possibility whatsoever of increasing the rent after the implementation of such a measure. It would be possible for the landlord to make such an increase in a commercial property only indirectly insofar as he gives notice of termination pending a change to the lease (*Änderungskündigung*), an option which is, however, generally not available in commercial leases, the majority of which tend not to be agreed for fixed terms. Similarly, the tenant's right to a reduction in rent is excluded only for those energy modernisation measures that the landlord is required to carry out, which under the current legal position will arise only in the rarest occasions. Therefore, provided that the lease does not contain an agreement excluding such a reduction, a tenant of commercial premises would be entitled to a reduction in the rent during work carried out on voluntary energy modernisation work whenever the nature of the interference is not merely insignificant. Landlords who, because of ongoing funding, are dependent on continual cash flow from rental earnings are particularly likely to face problems in this regard.

Thus it is probable that the incentives for many property owners to carry out energy modernisation reforms are liable to be even fewer in the commercial than the residential sector. It therefore seems questionable that the provisions set out in the bill will be sufficient to provide lasting momentum to the energy modernisation of existing properties in Germany.

Other provisions in the bill

A second area of the planned amendment to landlord and tenancy law codifies the so-called "Berlin eviction model", previously recognised only in case law. This holds that the landlord may restrict enforcement of a judgment (*Zwangsvollstreckung*) to the surrender of the dwelling if he applies his security right (*Vermieterpfandrecht*) to all the objects located on the premises.

The planned inclusion of the possibility for the landlord to terminate the lease without notice if the rent security is paid late or only in part is meant, as it were, to prevent the phenomenon of "nomadic tenants".

The aim of the reform is also to prevent protection against termination of the lease (*Kündigungsschutz*) being avoided when converting a residence from a rental to an owner-occupied property. Under the provision planned in this regard the tenant may also in the case of a change of use invoke the special protection with longer notice periods afforded to tenants where, following purchase of the property, a GbR (*Gesellschaft bürgerlichen Rechts*), a partnership under the German Civil Code, or a co-ownership association (*Miteigentümergemeinschaft*), initially formally waives the right to convert it into an owner-occupied dwelling and instead registers own use for a partner or co-owner.

To find out more about this subject, please refer to the more detailed article by the authors published in the journal Zeitschrift für Immobilienrecht (ZfIR), volume 5/6, 2011, pp. 169–182.

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Increase in real estate transfer tax (*Grunderwerbsteuer*) – tax structurings ever more important for yield

Introduction to real estate transfer tax

When the Real Estate Transfer Tax Act (*Grunderwerbsteuergesetz*, "GrEStG") came into force in 1983, real estate transfer tax became regulated nationally as federal law throughout Germany. The real estate transfer tax covers the transfer of real estate and equivalent rights. The tax base is generally the agreed consideration for the real estate, i.e. the sale price, as well as all additional payments and consideration granted.

Development of real estate transfer tax rates

The tax rate was initially 2% nationwide. The Annual Tax Act of 1997 (*Jahressteuergesetz 1997*) raised it to 3.5%, where it remained until the German Federalism Reform (*Föderalismusreform*) in the summer of the year

2006. This Reform amended the German Basic Law (*Grundgesetz*) and granted the Federal States (*Bundesländer*, the right to set the real estate transfer tax rate in their respective territories. The first Federal State to make use of this power was Berlin (as of 1 January 2007), raising its real estate transfer tax rate from 3.5% to 4.5%, equivalent to a massive tax increase of around 29%. Then, as of 1 January 2009, it was followed by Hamburg as the second Federal State – and, like Berlin, a city-state – to increase its real estate transfer tax rate to 4.5%. Other Federal States followed suit in 2010 and 2011 – this time large regional states as well – raising their real estate transfer tax rates to up to 5.0% (another incredible increase of about 43%). The main reason for the increase is the hope that this will have a positive effect on the relevant Federal State's budgetary situation.

Overview of current tax rates in the Federal States

Nine of the sixteen Federal States have now either increased their tax rate or have decided to do so. The table below shows the current state of affairs:

Federal state	Tax rate	Tax rate valid from	Increase in % (approx.)
Bavaria	3.5%	N/A	N/A
Baden-Württemberg	3.5%	N/A	N/A
Berlin	4.5%	1.1.2007	+29%
Brandenburg	5.0%	1.1.2011	+43%
Bremen	4.5%	1.1.2011	+29%
Hamburg	4.5%	1.1.2007	+29%
Hesse	3.5%	N/A	N/A
Mecklenburg-West Pomerania	3.5%	N/A	N/A
Lower Saxony	4.5%	1.1.2011	+29%
North Rhine-Westphalia	3.5%	N/A	N/A
Rhineland-Palatinate	3.5%	N/A	N/A
Saarland	4.0%	1.1.2011	+14%
Saxony	3.5%	N/A	N/A
Saxony-Anhalt	4.5%	1.3.2010	+29%
Schleswig-Holstein	5.0%	**1.1.2012**	+43%
Thuringia	**5.0%**	**7.4.2011**	**+43%**

While the other Federal States had previously chosen the beginning of a calendar month (1 January or 1 March) as the effective date, thereby allowing for a certain transition period, Thuringia has increased its real estate transfer tax at short notice with immediate effect and without any transitional regulation. Some purchasers of property might therefore be in for a surprise once the real estate transfer tax is assessed by the tax authorities and then turns out to be more than the planned amount of 3.5%. Apart from the negative impact on yield, the necessary cash must also be found, with the possibility that there was no opportunity to make provision for this.

Example of the impact of the real estate transfer tax on acquisition costs and rental yield

Example of the impact of the real estate transfer tax on yield and liquidity:

Property Investor I purchases a commercial property with rental income of EUR 5.0 million p.a. at a purchase price of EUR 50 million. At the previous tax rate of 3.5%, the real estate transfer tax amounts to EUR 1.75 million. At the increased real estate transfer tax rate of 5.0% (e.g. Brandenburg or Schleswig-Holstein), the real estate transfer tax amounts to EUR 2.5 million, a difference of EUR +750,000.

The rental yield excluding real estate transfer tax amounts in this case to 10.0% (5.0 / 50). If one includes the previous real estate transfer tax of 3.5%, the rental yield declines to approximately 9.66% (5.0 / (50 + 1.75). At an increased real estate transfer tax rate of 5.0%, the rental yield would decrease to approximately 9.52% (5.0 / (50 + 2.5)).

From a tax perspective, the real estate transfer tax qualifies as acquisition costs of a property (land and buildings), meaning that, for income tax purposes (income or corporation tax and trade tax if applicable) it is not immediately tax-deductible, but can only be deducted proportionally in the course of the depreciation deductions regarding the portion relating to buildings. The portion relating to land can only have effect as part of a sale (over an increased book value).

The higher the increase in the real estate transfer tax rate, the greater the tax's negative effects will be (pressure on liquidity, revenue and yield reductions).

Transaction structuring increasingly gaining in importance

The structuring of real estate investments has increasingly gained in importance in recent years. The reason for this is that this allows the creation not just of various desirable economic effects but also of tax effects that often cannot be realised through a direct purchase (asset deal). These structurings can also

affect the real estate transfer tax treatment, so that it is probable that they will be used much more frequently as a way of offsetting the ever-greater disadvantages resulting from the tax increases. This knock-on effect allows such structurings to be more advantageous and profitable compared with a direct purchase (asset deal) when tax rates go up.

Particularly significant in this regard are share deals as opposed to traditional straight forward asset deals. In a share deal, the property itself is not sold but rather shares (fractional where appropriate) in the company that holds the property. Although real estate transactions structured as share deals are also in principle subject to real estate transfer tax, this does not apply in every case and in particular when certain shareholding limits (95% limit) are not exceeded or the shareholding duration is not less than a certain period (5-year limit).

Any increased costs and risks involved in such structures are usually more than compensated for at the current and/or former real estate transfer tax rate of 3.5%, especially for larger transaction volumes.

Depending on the situation of the seller or the buyer, these structurings are either (i) limited to a simple share deal (as opposed to asset deal), (ii) require a restructuring of the seller prior to the sale or (iii) may require the setting up of an acquisition structure at the purchaser which has been optimised for real estate transfer tax.

Outlook

In the case of just about every Federal State that has not yet increased its real estate transfer tax rate, there have been or are constant rumours about a potential imminent increase, particularly in the run-up to budget debates.

Following the second wave of regional Federal States in 2010, the political debate on increasing the real estate transfer tax rate has intensified in some states since the last Federal State elections. In North Rhine-Westphalia, Baden-Württemberg and Rhineland-Palatinate in particular, an increase in the tax rate appears to be under serious discussion or is being planned and is indeed likely to be introduced in the near future. In the medium term, it can to be expected that practically all Federal States will put up their real estate transfer tax rate.

Structures optimised to take account of real estate transfer taxes will therefore increasingly gain in importance given that the potential costs involved in such a structure should by far compensate for the disadvantages of the real estate transfer tax, particularly in view of the increased tax rate and where larger transaction volumes are concerned. The Real Estate Transfer Tax Act allows for certain structuring alternatives, particularly in the case of share deals, which can result in the partial or full reduction of the real estate transfer tax.

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Admissibility of so-called "agreements on satisfaction" (*Befriedigungsabreden*) between borrower and lender – limits to the disposal of real estate by the land charge beneficiary except through compulsory auction (*Zwangsversteigerung*)

Non-performing real estate financings have sparked a new interest in options for the redemption of loans and alternatives to the compulsory enforcement (*Zwangsvollstreckung*) of liens on property (*Grundpfandrechten*), in particular land charges (*Grundschulden*). As a principle, statute has stipulated compulsory enforcement as the sole and exclusive means of gaining satisfaction for a lien on property. Flexible structures are consequently limited by Sections 1149 and 1229 of the German Civil Code (*Bürgerliches Gesetzbuch*, BGB), even where they are mutually agreed between the lender, the borrower and the provider of the security.

The statutory framework for agreements on satisfaction (*Befriedigungsabreden*)

Under Section 1149 BGB, agreements between the borrower and the creditor with the purpose of conveying the property to the creditor in the event that the claim is not satisfied (so-called "forfeiture agreement") or disposing of it in any other way than that provided for in Section 1147 BGB (so-called "disposal agreement") are prohibited. Section 1147 BGB stipulates compulsory enforcement as the sole means for the creditor of a lien on property to gain satisfaction from the mortgage.

The *forfeiture agreement* includes both the direct purchase by the lender itself or through an affiliated company as well as disposal to a third party, provided that this occurs in the interest of the creditor. The *disposal agreement* covers all those agreements that grant the creditor the right to a private sale out of court or to a particular type of disposal (except for

compulsory enforcement) or an irrevocable authorisation (*Vollmacht*) to dispose of the property.

Statute sees the decisive feature in the inadmissibility of such agreements as the point in time at which they are agreed: an agreement is invalid only if it was made prior to the due date of the secured claim. The premise is that the borrower might enter lightly into such agreements on the assumption that settlement will proceed as normal. The land charge (*Grundschuld*) is thus not based on the due date of the right *in rem* (*dingliches Recht*), whereby under the standard method in the past it was mostly agreed as immediate for land charges. Rather, the decisive factor is the due date of the secured claim under the loan agreement.

Section 1229 BGB is the parallel provision to Section 1149 BGB for pledges (*Pfandrechte*) in moveable property. Although both provisions have the same purpose, they are expressed differently. According to Section 1149 BGB, the agreement may not be entered into to "for the purpose of satisfaction"; in Section 1229 BGB, on the other hand, the emphasis is on the link between the agreement and non-payment: should the agreement have effect, if the creditor "is not satisfied or is not satisfied in good time", it is void. Despite the different wording, both provisions are in practice given practically the same construction.

The construction of the statutory provisions and their meaning in practice

By and large, the legal literature and case law is agreed that, despite their different formulations, Sections 1149 and 1229 BGB are to be treated identically in objective terms and that the link drawn between the agreement and "non-payment despite being due" presupposed in Section 1229 BGB must also be examined for Section 1149 BGB (on this, see BayObLG DNotZ 1993, 386 (388) with further references; BGH NJW 2003, 1041 (1042); BayObLG NJW-RR 1997, 590 et seq.; Staudinger/Wolfsteiner (2009), Section 1149 para. 9). The criteria for the inadmissibility of an agreement between the borrower and creditor (of a security or loan) are therefore, in addition to their specific content and the timing of the agreement, the purpose pursued by the agreement of satisfying the creditor and the direct link made between this agreement and non-payment when due.

Where there is a causal relationship between the lending and a forfeiture and/or disposal agreement, the criterion of "for the purpose of satisfaction" is automatically fulfilled. Only if the agreement contains a corresponding obligation on the part of the obligor independent of payment on the due date is Section 1149 BGB irrelevant pursuant to the aforementioned criteria and the obligation is legally effective (cf. RGZ 130, 227 (229); BayObLG RPfleger 1993, 58 et seq.). Thus, in practice, the question of whether the agreement is in fact contingent upon non-payment when due is often decisive for determining validity. Diverse requirements are made of this linkage in the legal literature: while the prevailing approach examines this aspect purely on the basis of the specific wording of the agreement, some scholars emphasise the economic purpose of the agreement and, in consequence, tend towards a violation of Section 1149 BGB.

In the case law, Section 1149 BGB is also construed narrowly based on the literal text. The text of the agreement must therefore explicitly intend to make a link. Despite the admittedly similar interests, the courts do not even apply the provision in this way to cases involving three parties, i.e. cases in which the creditor of the claim and the secured party are not identical (cf. BGHZ 105, 140 (143); BGHZ 130, 101 et seq.; BGH NJW 1995, 2635 et seq.; BayObLG NJW-RR 1997, 590 et seq.; BayObLG ZfIR 1997, 32 et seq.; BGH WM 2003, 157 et seq.; BGH NJW 2003, 1041 et seq.). In practice this means that a forfeiture or disposal agreement with the same content is likely to have legal validity before a court where the creditor is not also the beneficiary of security but where the lien on property has instead been registered in favour of a third party (providing the refinancing).

The controversial linkage criterion will be analysed in the two cases below.

Case A:

A German real estate portfolio has recorded a substantial drop in value. Continuing rental income means that the proper implementation of the loan secured by a land charge is assured for the remainder of the term. Investors nevertheless want to withdraw from the German business and agree with the creditor the transfer of the real estate ownership in return for release from the remaining loan debt. The values are not grossly disproportionate and so Section 138 BGB – "contra bonos mores transactions are void" – does not apply.

Solution based on the text of the statute

The scope of application of Section 1149(1) BGB (old version) is in principle provided by Section 1192(1) BGB. Whether Section 1149 BGB is in fact relevant in this case thus depends on whether or not the secured claim has fallen due with respect to the borrower. In the case of a real estate loan, this generally presupposes calling in the loan or at least the expiry of the fixed-interest period without the offer of continuation. In many cases in which the lender and the borrower jointly consider ending the financing upon transfer of the real estate, the option of calling in the loan is not yet available or is not sought at that point in time. Calling in the loan will often trigger the insolvency of the borrower.

The case outlined is located in time prior to such a due date. The validity of the transfer obligation must therefore be assessed based on Section 1149 BGB: The transfer of the property serves to repay the remainder of the debt and thus also satisfaction of the creditor. However, there is no explicit link with non-payment despite maturity of the claims under the loan. The prevalent view in the case law and legal literature

is that the obligation described – assessed based on Section 1149 BGB – can be validly entered into.

Counter-arguments in the legal literature

The situation is treated differently by a number of legal academics (for instance, Staudinger/Wolfsteiner, Section 1149 para. 9 et seq. or MüKoBGB/Eickmann, Section 1149 para. 8), who argue that such agreements should be assessed according to their economic purpose, independently of the literal text of the agreement. This view holds that, in practical experience, an agreement reached that displays external and chronological links with the furnishing of security *in rem* can only have the economic purpose of securing the creditor's entitlement. This also applies in this case. Non-payment when due may be a concern as, once the term of the loan has expired, investors in the above scenario may have difficulties repaying the remaining debt. This may be because they either cannot get a loan in the sufficient amount because of the reduction in value sustained, or because the necessary proceeds were not generated upon sale of the real estate. Such a scenario is intended to be pre-empted by means of the agreement described. In terms of the overall economic purpose, the agreement would be invalid due to the interdependence described.

Outcome

Provided that compulsory enforcement is not avoided by means of the agreement but, rather a situation is created that does not inevitably result, in the implementation of compulsory enforcement measures, it follows that the option described in Case A must theoretically be available to the parties. The freedom of the parties takes precedence over potential enforcement proceedings in the future, given that Section 1149 BGB is specifically also intended to protect the owner from an "over-zealous" restriction of his freedom to act (see also BayObLG DNotZ 1993, 386 et seq.). However, the views represented in the legal literature entail a considerable risk; hence, until clarification from the courts is forthcoming, the risk that the agreement will be invalid cannot be ruled out with certainty.

Case B:

During contractual negotiations, a foreign financial institution insists on the granting of an authorisation to sell (*Verkaufsvollmacht*) by the borrower in favour of the creditor of the lien on property. Can such an authorisation be validly issued with this content?

Different approaches (text of statute versus practice of the Bundesnotarkammer, the chamber of German civil law notaries)

The prevalent view is that an authorisation to sell also constitutes a prohibited agreement on satisfaction under Section 1149 BGB. If it is assumed that the authorisation has been irrevocably issued and the obligor may make use of it at will, i.e. irrespective of payment upon maturity, such an authorisation would have to be feasible based on what has been said so far (regardless of the formal provisions to be observed) assessed in accordance with Section 1149 BGB. This is because, in addition to the content and date of the agreement, the link with non-payment when due is also an objective prerequisite for nullity. The *Bundesnotarkammer* (Federal Chamber of Notaries) in their Circular No. 7/2008 nevertheless rejects in principle, without further explanation or providing any distinction as to content, the validity of a sale authorisation in the case of an agreement prior to maturity as a violation of Section 1149 BGB. It is not apparent why different conditions for validity should apply to a sale authorisation than to other types of agreements on satisfaction. In any case, a link is usually made with non-payment when due by the conditions that are agreed in the security agreement for the exercise of the authorisation. In that case, again, the conditions for invalidity must be found to be present.

Other obstacles to validity

To date, there is no case law on this point and it therefore remains to be seen whether the courts will follow the legal literature or arrive at a different conclusion. Invalidity could equally arise on the basis of a reasonableness test of standard business terms (*AGB-Kontrolle*) pursuant to Sections 305 and 307 et seq. BGB or under Section 138 BGB. The possibility remains that the borrower has acted from a situation of economic necessity, which has been "exploited" *contra bonos mores* by the creditor.

Outcome

If the authorisation is designed as a means of security in the event of non-payment, this certainly stretches the limits of Section 1149 BGB without the need to resort to Section 138 BGB. Thus, under German law, it appears that a sale authorisation cannot be validly issued at least not before the secured claim becomes due (on this, see MüKoBGB/Eickmann, Section 1149 BGB para. 10; Staudinger/Wolfsteiner, Section 1149 para. 14; Circular No. 7/2008 of the Bundesnotarkammer). Section 1149 BGB is mandatory within the meaning of Article 34 Introductory Act to the German Civil Code (*Einführungsgesetz zum Bürgerlichen Gesetzbuche*, EGBGB) and cannot be circumvented even by choice of law.

The case is otherwise after the claim has (partially) become due, when, under Section 1149 BGB at least, an authorisation to sell can in principle be issued. In this instance, however, other statutory limits must be observed that might arise on the basis of a reasonableness test of standard business terms and under Section 138 BGB.

Conclusion

Any agreement containing solutions by mutual consent for the realisation of real estate securities must observe the boundaries of Section 1149 BGB. The economic approach occasionally found in the legal literature holds that such agreements will invariably be problematic.

This view overstates the requirements and narrows the parties' freedom to act without grounds. Nevertheless, subject to certain narrow conditions such agreements are indeed legally valid before the courts.

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