CLIFFORD

CHANCE

Real Estate Newsletter – Autumn 2012

Welcome to the autumn edition of our Real Estate Newsletter – the Expo edition – covering hot legal topics in real estate and real estate financing.

Gerd A. Hille, CEO of LBBW Immobilien Management GmbH, has written an article entitled "Green Buildings – sustainability as a key to success in the real estate sector". He explains how "green buildings" will soon be the standard within the real estate sector and how investors and developers who fail to take account of this will find that their "non-sustainable" properties will be harder to let or sell.

In their article, Lars Thiessen and Gerold Jaeger tackle the potential legal impact of an EU member state withdrawing from the Euro and the possible effects of a currency changeover on the real estate sector. While we all hope it won't come to that, it is important to be prepared and to check that your contractual documents are up to the job in the event of the worst-case scenario.

Jutta Aichele (PVW GmbH) and Christian Keilich's article "A New Approach to Property Valuation – Auditor Valuations" also deals with a topic of current importance. They explain the changes which are likely to arise from the plan by the Institute of Public Auditors in Germany (IDW) to give auditors more of an opportunity to perform property valuations themselves. Some sceptics have said that the IDW is simply trying to drum up business for its members.

The issue of providing a guarantee payable on first demand in standard-form lease agreements provides the basis for Ulrich Flege's article. This had previously been an uncontroversial means of providing collateral, but certain figures in legal literature have begun to question its validity.

We would be delighted to discuss these issues, and any others, with you at the Expo. Join us from 10 p.m. on 9 October 2012 for drinks and cocktails at the Anna Bar.

We hope that you enjoy our Newsletter!

Christian Trenkel Gerold Jaeger

Green buildings – sustainability as a key to success in the real estate sector

According to a study carried out by the European Commission, real estate is generally responsible for 40% of all current energy demand and causes 35% of all global emissions. These staggering figures show the huge environmental and energy-saving potential still to be tapped in the property sector and also highlight the need to ensure that future development projects focus on the need for sustainability.

The term "sustainability" was originally used in the forestry sector. The German aristocrat Carl von Carlowitz was the first to notice in the eighteenth century that a forest can only remain in a healthy and balanced state if the number of trees felled for timber does not exceed the number of new trees planted or growing naturally. The concept now applies across a whole range of areas and refers to anything which meets the needs of current generations without limiting or jeopardising the options open to future generations.

Sustainability in the real estate sector means building and converting property in a way which is sustainable in economic, environmental, socio-cultural and planning terms, and ensuring that those buildings are operated and maintained in line with that principle. The aim is to optimise use of the building for its entire life cycle, thereby reducing the consumption of energy and resources and any environmental pollution, improving overall efficiency, including sociocultural aspects.

Many companies now emphasise their sustainable credentials to make them stand out from the crowd. A whole variety of certificates are available providing measurable and comparable indices for use in assessing building quality – ranging from the international LEED and BREEAM systems to the relatively new DNGB certificate awarded by the German Sustainable Building Council established in 2007.

Apart from providing evidence of good sustainability credentials, this type of certification is also a key way of helping avoid falls in property values and also offer new valuation and benchmarking options. It therefore seems likely that more and more buildings will become certified over the next few years, which could ultimately lead to a separate "green buildings" asset class.

It is also the case that developers are increasingly being asked to provide green buildings as more and more investors and lessees are applying demanding sustainability requirements to their real estate decisions. There are a number of reasons for this trend, with image and reputation being a key aspect. Buildings with high energy consumption or high CO_2 emissions are becoming increasingly unpopular and even uncertified buildings are already difficult to sell without some kind of discount. This trend is only likely to become more pronounced.

Banks, insurers and ratings agencies already take certification into account as regards the conditions and tariffs they offer. Funds tend to reject properties where sustainable energy systems cannot be introduced and focus on properties which meet certain sustainability criteria. Sustainably-built properties and properties with sustainability certification have lower overheads and maintenance costs and a longer life cycle, which makes them particularly attractive for long-term rental, ensures that lessees tend to stay on and offers better opportunities for subsequent letting. This also pushes up sales prices as lessees are generally able to pay higher base rents when overheads are lower.

It therefore becomes clear that investing in green buildings makes sense from both an environmental and an economic perspective and that

EXPO Real 2012

Clifford Chance EXPO Cocktails

Date: 9 October 2012, at 10 p.m.

Venue: anna bar,
Schützenstraße 1, 80335 München

If you would like to attend, please let us know by email via expococktails@cliffordchance.com. Our events team will be happy to answer any questions you may have with regards to the event and are contactable by telephone via +49 69 7199 2163.

they offer a clear competitive advantage over the long-term. Companies which act with long-term, sustainable interests in mind are therefore acting in an environmentally, economically and socioculturally responsible way by investing in green buildings.

LBBW Immobilien Management GmbH is an expert in green buildings. It aims to ensure that all of its investment development projects, be they commercial or residential properties, are LEED or DGNB certified.

A current example is the Urban Green residential project in Heidelberg, Germany, which is intended to meet DGNB certification requirements. The complex is due to consist of 118 homes for purchase or rent and six smaller retail/commercial units and, once it is finished, should be the only residential project in Heidelberg Bahnstadt, a completely new neighbourhood in the city, which is certified. Although it should be remembered that the entire Bahnstadt project will be one of the largest zero energy housing projects in the world.

LBBW Immobilien Management GmbH's involvement in the "Hofstatt" in Munich, another retail, office and residential project involving an entire district, has also shown that certification solutions can be found for extremely complex projects – in this case combining new buildings with historical listed buildings. The retail and office parts of the project are due to receive LEED certification.

It therefore seems that green buildings are here to stay and will soon become the standard in the real estate sector. Investors and developers who fail to move with the times can expect to find properties not meeting green requirements to be more difficult to let and more difficult to sell.

For further questions please contact:

- Gerd A. Hille, CEO, LBBW Immobilien Management GmbH

Further publications

Our "**Green Building**" guide is due out soon (in German only!) from RICHARD BOORBERG VERLAG (ISBN 978-3-415-04909-3)

Overview:

Green building certificates? Not only quite fashionable in view of last year's turn to alternative energy sources, but now state-of-the-art for new property. If you haven't got a certificate, your property is likely to lose value and you may have difficulties finding (new) tenants. Our guide can help! What does a green building certificate offer? Who's liable if it's inaccurate or incomplete? How important is sustainability to public tenders? Our guide also gives practical suggestions on how to negotiate green building provisions in any type of property agreement (including leases and construction agreements) and the role they should play in real estate transactions. Our highly experienced lawyers provide practical tips on a whole range of issues, including tax and financing, and information on planned legislation. This makes our guide indispensible for lawyers and real estate managers alike.

Withdrawal of a Member State from the European Monetary Union – Possible effects of a currency changeover on the real estate industry from a legal perspective

In view of the current conditions on the international financial markets and, in particular, the ongoing discussion about the Eurozone, the question arises what effects could a withdrawal of a Member State from the European Monetary Union (EMU) have on existing long-term debt obligations. This article focuses on the possible consequences of a currency changeover (redenomination) on real estate law, particularly with regard to financing and purchase agreements as well as leases.

I. Scenarios

With respect to the future of the Euro, there are three conceivable scenarios: (i) The Eurozone remains intact in its present form; (ii) the Euro is abolished; or (iii) one or more Member States withdraw from the EMU, either unilaterally or by unanimous consent.

It is rather unlikely that the Euro will be abolished, with EMU Member States returning to their national currencies, since at least those EMU Member States that have pursued a coherent currency policy over the past 40 years (resolution to create a currency union adopted at the The Hague Summit in 1969, establishment of the Exchange Rate Mechanism in 1972) would presumably wish to continue to operate in this manner. In addition, it should not be forgotten that the situation in the period prior to creation of the EMU with its significant currency fluctuations was considered to be far from optimal, which actually hindered the development of the common internal market. Despite many negative reports, the most likely scenario is that the Euro will continue in its present form. In response to market pressure, the European Council decided on 9 December 2011 to amend the currency union by a fiscal union. The subject of this article is the third scenario, i.e. that one or more EU Member States withdraw from the EMU and simultaneously reintroduce their national currencies. In analysing this scenario, the article will look at the immediate introduction of the national currency, as well as mixed models designed to soften the direct effect of a currency changeover on the economy. Such mixed models provide, for instance, for temporary introduction of a double currency or a dual currency system, whereby the Euro and the new national currency would both be valid for a limited period of time.

II. Ways of a currency changeover in an EMU Member State

With respect to the legal structuring of a currency changeover by an EMU Member State and simultaneous withdrawal from the EMU, there are essentially two scenarios: Withdrawal by unanimous consent and by unilateral withdrawal. As currently drafted, the European treaties do not contain provisions on the withdrawal of a Member State from the EMU and leave it unclear whether such a Member State could remain as a Member in the European Union. In the European treaties there are essentially two ways to adopt an exit clause: (i) The ordinary revision procedure, and (ii) the simplified revision procedure, which would likewise be available for amendments in the currency area.

The way in which a Member State withdraws from the EMU has a major impact on the legal consequences of withdrawal. This applies in particular to unilateral declaration of withdrawal from the EMU, which by its very nature would constitute a violation of the European treaties by the withdrawing Member State. However, should the withdrawal of a Member State from the EMU become unavoidable, it must be assumed that all political actors will do everything in their power to minimise the damage as far as possible. This would only be possible in the case of orderly withdrawal.

III. Basic conditions for, and overall economic consequences of, a currency changeover

In examining the consequences for the legal relationships within a real estate transaction structure that might be associated with a Member State's withdrawal from the EMU, it is not only important to consider the currency changeover itself and the attached sovereign fixing of the relevant exchange rate but also the related measures that a withdrawing Member State might take during the transition period. These could take the form of currency restrictions which might comprise measures such as foreign exchange controls (and thus control over trade using foreign currencies) and restrictions on the movement of capital (and thus interference by the withdrawing EMU Member State with the basic freedom of movement of capital by limiting or prohibiting its cross-border flow). Creditors located outside the withdrawing Member State would then be wholly or at least partially cut off from capital flow, including capital earnings. They would, however, still be able to reinvest the capital in the withdrawing Member State under the prevailing conditions there. Normally, restrictions on the movement of capital are not just of a temporary nature. In the case of Iceland, for example, these have remained in effect ever since the banking crisis there began in autumn 2008. Moreover, the introduction of restrictions on the movement of capital would not necessarily be a violation of current law. They would violate neither the principle of free movement of capital set forth in art. 63 of the Treaty on the Functioning of the European Union (TFEU) nor the comparable principles under the General Agreement on Tariffs and Trade (GATT), since both contain exceptions enabling a government to take measures necessary to protect public safety and order.

In addition to restrictions on the movement of capital, other related measures could include amending civil law and civil procedural rules. For example, it is conceivable that following withdrawal from the EMU, compulsory enforcement will be possible only in the new local currency at an exchange rate set by the state. Moreover, those economic consequences of a currency changeover, which can have indirect effects on legal issues must also be considered. This at least applies to an expected devaluation of the new currency that replaces the Euro which would lead to a loss of purchasing power in cross-border cases.

IV. Case scenarios

Decisive in regard of the effects of a currency changeover on a real estate transaction structure and the associated contracts are first of all the cross-border facts. As a consequence, the least problematic case is where all contracting parties are located in the EMU Member State that is changing over its currency, unless specific contract clauses prevent transition to the new currency, which would result in economic asymmetry within the real estate transaction structure. By contrast, the truly problematic scenario with respect to a currency changeover is one in which the real estate transaction structure is cross-border and where contracting parties are located in the EMU Member State that is changing over its currency or where other legal ties exist with this Member State.

V. Legal effects of a currency changeover

The withdrawal of a Member State from the Eurozone and the corresponding introduction of a new currency under the laws of this country can affect the ways in which laws work and the consequences these have. This can be seen, for instance, with mortgages, set-off and leases, which usually form the basis for a real estate investment's cash flow.

1. Mortgages

How mortgages are documented is normally subject to the law of the place where the real estate is located. For this reason, if the encumbered real estate is located in the withdrawing Member State, it is likely that mortgages will be covered by a currency changeover. This also applies where the basic relationship is subject to the laws of another Member State. If a creditor's enforcement of the mortgage is limited in terms of amount, it is possible that such creditor will receive a smaller share of the economic value of the mortgage when liquidating it after changeover and a devaluation of the new currency.

2. Set-off

In the case of reciprocal payment claims, the changeover of the currency can affect the ability of the contracting parties to rely on set-off. This would be the case where under the laws to be applied, set-off requires that the claim and the counterclaim be "equivalent" and where the currency changeover results in a loss of such equivalence.

3. Effects on leases

To the extent that a corresponding interpretation of the lease (see items VI and VII below) requires that the currency in which payments are owed is to be changed over to the newly introduced currency, the following can be expected for leases:

(a) Rent and ancillary costs

Since, in the event of a currency changeover, the legislator presumably will not provide for a transition period, under such a scenario the debtor could make rent payments solely in the new currency.

In addition, ancillary costs would generally have to be charged in the new currency. The agreement to distribute ancillary costs or to make similar advance payments would remain in the form in which it was concluded under existing leases. If such existing leases are modified to reflect the new currency, either through a corresponding interpretation of the lease or by mutual consent in the form of an amendment, this also covers agreements on ancillary costs.

(b) Rent increases

If the rent is increased, this takes place in the new currency. Should in the notice of rent increase reference be made to a rent index containing values in Euros, these values will have to be converted into the new currency and then be able to form the basis for the notice. While rent indices would remain valid even after the changeover, they will have to be converted into the new currency, as it was the case when the Euro was introduced. If comparable rents are used, these must be converted into the currency to which the notice of rent increase relates. For leases in which the rent is to be stepped up, rent is likewise to be paid in the new currency. The same should be expected for price clauses, i.e. rent adjustments based on value retention mechanisms designed to protect against inflation. In some cases, however, roundings may have to be made due to changeover of the indices.

(c) Security deposit

If a lease is changed over to the new currency, the security deposit account is automatically changed over as well. The conditions under which the account is maintained will likely remain the same. Repayment would be made in the currency in which the underlying lease is denominated. The foregoing also applies mutatis mutandis to the enforcement of a bank guaranty.

VI. Issues to be analysed in the event of a currency changeover

In the event of a currency changeover in an EMU Member State, the central issue is whether euro-denominated payment obligations in contracts concerning this EMU Member State are still to be paid in Euros or instead in the newly introduced currency. The analysis has to be made in several steps:

- It must first be established which court has jurisdiction in deciding disputes under each contract having cross-border implications, since the way in which courts of various jurisdictions respond to legal issues may differ depending on special aspects of (local) private international law and the substantive law to be applied as a result thereof. In so doing, it must be considered that a court in the country that is changing over its currency is bound by national currency laws in a manner different than a court in another country in which the issue of the substantive law to be applied is decided solely according to principles of private international law.

- Next, it must be analysed which substantive law is applicable, i.e. the *lex causae*. Following from the determination of the *lex causae* are the principles to be applied in interpreting/construing the contract.
- Once the *lex causae* has been ascertained, the interpretation principles to be applied can be used to construe those terminological definitions and contract clauses that denominate and determine the currency in which payments are to be made. This is the point in the analysis where it is determined whether payments are still owed in Euros or instead have to be converted into the newly introduced currency.

  Following from the determination of the currency is the law that was chosen by the parties to govern all issues relating to the currency, i.e. the *lex monetae*. Please note that the *lex monetae* may differ from the *lex causae*.
- If payments are to be made in the newly introduced currency rather than in Euros, it must further be analysed whether the contracting parties are entitled to other contract rights, such as rights of rescission, rights for contract modification, or special rights of termination. These questions are likewise subject to the *lex causae*.

VII. Suitability of existing contract documentation – drafting new contracts

The suitability of existing contract documentation and the drafting of new contracts should be analysed in detail in the event of a currency changeover in an EMU Member State.

To begin with, it is important to be aware that it may not be enough to evaluate contract documentation based on the current laws of a Member State that may exit the Euro, since the related measures discussed above, particularly the amending of civil law and civil procedure rules, need to be anticipated and borne in mind. In general, the legislator in a Member State exiting the Euro for economic reasons will at least be tempted to amend laws in order to compensate for the undoubtedly serious consequences of such a step for the local economy (and, indirectly, for the key aspect of tax revenues).

1. Jurisdiction clause

In accordance with the general principles of *lex fori*, the contractually agreed choice of the competent court/place of jurisdiction indirectly determines the choice of applicable civil law as well. The local court is bound by the law currently in effect, which can change in the event of a currency changeover. Against this background, the choice of the competent court has considerable significance.

As an alternative to choosing a court in a Member State that is at risk of withdrawing from the EMU, the contracting parties can agree instead to rely on arbitration.

The choice of the court of enforcement and the applicable law of enforcement cannot be influenced, since these two aspects are determined by the place where the debtor is located. The same applies to lawsuits involving *in rem* rights concerning real estate and leases. In accordance with the Brussels I Regulation (Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters), jurisdiction in such cases rests exclusively with the courts of the EU Member State in which the real estate is located.

2. Applicable substantive law

In countries in which the Rome I Regulation (Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations) is applicable (this includes all Eurozone countries), the principle of free choice of law extends to real estate contracts as well. In contrast to rights *in rem*, there are no special aspects for real estate with respect to contract law provisions dealing with rights *in personam*. In choosing the *lex causae* and the *lex monetae*, the parties thus have the ability to avoid interference by the legislator of the Member State exiting the Eurozone by intentionally choosing as the applicable law either the law of a country whose exit from the Eurozone is virtually inconceivable or that of a non-EMU country.

3. Amendment of contractual payment provisions

The key question in connection with an exit from the Eurozone is whether the currency changeover has an impact on the euro-denominated contract currency under existing contracts.

Following from the steps of analysis in the event of a currency changeover, as outlined under item VI above, after having determined the competent court and the *lex causae*, including the applicable interpretation principles, one needs to construe the terminological definitions and contract clauses that denominate and determine the currency. In accordance with the topic of this article, the payment owed is denominated in Euros. But denomination in Euros does not mean that, after currency changeover, it is the currency in which the payment must be made, especially in cross-border cases. Rather, it must be determined by construction, insofar as this has not already been done by law in a permissible manner. This interpretation/construction can have two different results:

- For instance, if the contract currency "Euro" is defined as the currency of the EMU in accordance with arts. 127 to 144 of the TFEU, this would be construed as meaning that the Euro is considered to be the "single currency", as opposed to the valid currency of the withdrawing EMU Member State. In such case, the currency changeover by a Member State would have no effect on the payment owed. Even after changeover, the payment would have to be made in Euros.
- On the other hand, it is conceivable that construction would lead to the result that the payment is owed in the currency that on the due date is the lawful means of payment in a certain country (here, the withdrawing EMU Member State). After currency changeover, the contract currency would thus have to be changed over from Euro to the new national currency of the withdrawing EMU Member State. Accordingly, the payment would have to be made in the new currency. If the payment is determined to be owed in the new national currency of the withdrawing EMU Member State, this means that the *lex monetae* of the withdrawing EMU Member State governs all issues relating to the currency.

Contracts that do not clearly define the contract currency, which is often the case, are more difficult to evaluate. In such cases, when construing the contract, the actual intention of the contract parties must be determined from other facts and circumstances or from a hypothetical intention. If in construing the contract, it is not possible to ascertain even a hypothetical intention, statutory rules of presumption under the relevant *lex causae* may come into play.

The foregoing considerations mean that when drafting new contracts, it is advisable to provide a clear definition of the desired currency.

4. Place of payment

When construing the definitions and clauses determining the contract currency, the agreed or statutory place of payment can have an impact on the question of whether a debt is subject to redenomination. From a creditor perspective, it is advisable to stipulate the place of payment in a way that counteracts a redenomination, provided that the relevant legal system and the facts and circumstances permit this.

5. Personal collateral

With regard to personal collateral, it would generally be preferable from a creditor perspective for the guarantor to have his place of residence in a country other than that of the principle debtor. If contract documentation also provides for direct enforcement against the guarantor, then in the event of a currency changeover in the country where the principal debtor is located, this would have the advantage of enabling creditors to proceed directly against the guarantor and demand payment in Euros. In this way, a number of difficulties could be avoided to which creditors might otherwise be exposed in connection with a withdrawal of a Member State from the Eurozone.

6. Value retention

With regard to obligations having to do with the payment of money, the objective of creditors when drafting contracts has to be ensuring that claims retain their value. This applies with respect to both a currency changeover and the issue of inflation, and the objective can be reached through clauses dealing with value retention and protection against inflation.

7. Rights of rescission and special rights of termination

If still possible, a currency changeover should be included in the material adverse change clause ("MAC Clause"). MAC Clauses typically contain a list of relevant events that, in the view of the contracting parties, constitute a change of the transactional basis. A MAC Clause generally grants a legal remedy in the form of a special right of termination or a right of rescission.

VIII. Summary

The parties must be sure that they have agreed on the currency desired for payment obligations. With regard to contracts to be concluded in the future, it is advisable to address the case of a currency changeover, which has often been overlooked to date.

For further questions please contact:

- Dr. Gerold Jaeger, Counsel, Real Estate, Clifford Chance
- Lars Thiessen, Maître en droit, Senior Associate, Banking & Capital Markets, Clifford Chance

A New Approach to Property Valuation – Auditor Valuations

Commercial real estate owners are repeatedly required to value their own properties or to have them valued by a third party. Valuations might be required for various reasons, including acquisition or sale, or for financing, tax or insurance purposes. Up until now, the vast majority of property valuations in Germany have been carried out by specially qualified experts, some of whom are officially appointed appraisers, and major real estate consulting firms. They usually base their valuations on one of three methods – either according to income/returns from the property, a comparative method or the intrinsic value of the property. The valuations are performed in line with the relevant statutory and other official provisions in conjunction with any specific professional standards, such as those of the RICS.

The dominance of these established providers is under threat, however. It has gone more or less unnoticed in the German property sector that the Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer in Deutschland e.V.*, IDW) has been developing its own set of standards for property valuations since 2008. The IDW felt that auditors had always been required to perform and review property valuations, particularly when reviewing accounting statements prepared pursuant to the German Commercial Code (HGB) or IFRS. Auditors used to limit themselves to checking and validating valuations which have already been prepared by other parties and do not therefore generally produce their own valuations (in the case of auditing annual accounts, for example). In fact, one could not expect auditors to do much more than this in terms of property valuations given their lack of specific knowledge of the location and the particular issues involved. This, however, is rather different when it comes to valuations of property companies. In this respect auditors can work with the IDW's principles for carrying out company valuations (*Grundsätze zur Durchführung von Unternehmensbewertungen S1*), which were originally published in 1983 (under a different name) and the 2008 version of which currently applies. But none of the existing IDW standards, including IDW S1, deals with valuations of properties as such. This is about to change.

At its conference in January 2012, the IDW presented a paper on the principles of property valuation ("*Diskussionsstand über die Grundsätze der Immobilienbewertung*"). On 13 April 2012, the IDW's special committee for business valuation and business management and its real estate committee approved a set of draft principles for property valuation ("*Entwurf eines IDW Standards: Grundsätze zur Bewertung von Immobilien (IDW ES 10*"). It sets out various standards for auditors performing property valuations or reviewing valuations made by others.

The draft contains somewhat "explosive material" for the property valuation market. This has less to do with the recognised valuation methods (income/returns, comparison, intrinsic value), which the IDW does not question, or the associated statutory provisions and delegated legislation, to which it also refers. The IDW's proposals do, however, lead to some strange outcomes in certain cases, such as the fact that any valuation of a "single property company" (*Ein-Objekt-Gesellschaft*) under IDW S1 would produce a different value to the valuation of the same property under the new IDW standards. The IDW still needs to iron out these irregularities.

The far more radical aspect is that the IDW has seriously discussed these standards in the first place and that auditors will have to produce much more valuations themselves in the future. There are some sceptics who say that the IDW is simply trying to open up a new business area for its members but, while this may well be the case, the key aspect is the need for auditors to build up resources allowing them to meet the standards for performing increasing numbers of valuations themselves going forward.

This means that auditors will pose serious competition to established valuation providers. Property owners will think twice about getting someone else to provide a valuation when the auditor doing their annual accounts is going to produce their own valuation anyway. Banks requiring valuations for granting property loans will also tend to favour auditors over existing providers for compliance reasons. The liability insurance taken out by the major auditing firms are more likely to cover larger sums than the policies of existing valuation providers.

It remains to be seen how and when the new IDW standards will be implemented, but it is already evident that they will bring considerable change to the property valuation market.

For further questions please contact:

- Jutta Aichele, German Auditor/Tax consultant, General Manager of PVW GmbH Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft
- Dr. Christian Keilich, Partner, Real Estate, Clifford Chance

The (in)effectiveness of clauses in standard-form lease agreements requiring the provision of a guarantee payable on first demand

In principle, the Federal Supreme Court (*Bundesgerichtshof*, **BGH**) does not object to collateral security being provided in the form of a guarantee payable on first demand. However, the VII Division of the Federal Supreme Court, which is in charge of construction law matters, has handed down a number of decisions according to which it cannot be validly stipulated in general terms of contract that collateral security must be provided in the form of a guarantee payable on first demand. The question therefore arises whether this Supreme Court practice will extend to collateral security provided under lease agreements. So far, no Supreme Court decision on this point of law exists, but there are a number of precedents of senior courts according to which it is legally acceptable to demand a guarantee payable on first demand as security for the proper fulfillment of claims under a lease agreement. Nonetheless, there is a risk of this view not being shared by the Federal Supreme Court, in which case tenants could refuse to provide such guarantees, or to demand that such guarantees be returned to them. The consequence would be that innumerable property owners would be left without collateral securing the proper performance of the contractual obligations of their tenants.

Commercial leases are frequently secured by bank guarantees

Where commercial premises are concerned, it is nowadays common practice that tenants furnish a bank guarantee rather than make a cash deposit as collateral security for the proper performance of their contractual obligations. Tenants prefer to provide a guarantee because this has less impact on liquidity, while property owners are usually happy to accept this form of collateral because it involves less administrative work and is easier to transfer to a new owner than a cash deposit. It is therefore likely that claims for rent amounting to hundreds of millions are secured by guarantees payable on first demand.

Principal features of a guarantee payable on first demand

Guarantees payable on first demand are a type of collateral developed by market practice to satisfy the need for a form of collateral that can be drawn upon quickly. The secured party can obtain liquid funds 'on short call' without first having to litigate and going through a lengthy process of clarifying legal issues. No conditions other than those mentioned in the guarantee document must be met to obtain payment under such a guarantee. The guarantor must pay *on first demand*, without the creditor first having to substantiate his claim. It suffices that the creditor declares that the conditions for payment laid down in the guarantee document are met. Any facts or legal issues that may be contested can then be clarified in restitution proceedings instituted by the guarantor or the debtor. The basic principle is "*pay first, litigate afterwards*". In practical terms, a guarantee payable on first demand virtually resembles a cash deposit which the creditor may draw on at any time. The guarantor is obliged to immediately pay all or part of the guaranteed amount at the simple demand of the beneficiary of the guarantee. Any objections against the justification of such demand for payment in terms of substantive law may then be raised in restitution proceedings under Section 812 of the Civil Code (*Bürgerliches Gesetzbuch*, **BGB**). Except in cases of obvious abuse, the creditor has the right to demand immediate payment without having to expose or even prove the justification of such claim for payment in terms of substantive law.

Case law of the Federal Supreme Court on guarantees payable on first demand

Back in 1979, the Federal Supreme Court first acknowledged and confirmed that guarantees payable on first demand are a permissible means of providing collateral security, provided that the guarantor is a banking institution (which is hereinafter always presumed to be the case). Therefore, where individually negotiated contracts are concerned, i.e. contracts which are not 'standard-form contracts' or 'standard terms of business' (and as such subject to special legal requirements), it is since several decades common practice to stipulate that security shall be provided in the form of a (bank) guarantee payable on first demand.

Consequently, many construction contracts contain a clause under which a guarantee payable on first demand is to be provided, be it as warranty guarantee and/or performance guarantee. However, since 1997 the Federal Supreme Court has repeatedly decided that clauses requiring the provision of a guarantee payable on first demand are void if contained in construction contracts falling under the Standard Terms of Business Act (*Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen*, **AGBG**). This case law initially only concerned warranty guarantees, but was later extended to include performance guarantees. The Federal Supreme Court is of the opinion that a guarantee payable on first demand places the contractor at an unfair disadvantage (Section 307 para 1 sent. 1 BGB) because, in contrast to a 'normal' absolute guarantee, a guarantee payable on first demand shifts insolvency and liquidity risks to the debtor/contractor to an unreasonable extent. In the opinion of the Federal Supreme Court, a guarantee payable on first demand always places the beneficiary in a position where he is able to procure liquid funds at the debtor's expense, given that the debtor is directly liable as regards restitution claims of the guarantor, irrespective of whether the claim enforced by the beneficiary of the guarantee is actually justified. The consequence of this is that the debtor is not only deprived of liquidity, but also bears a risk of the beneficiary of the guarantee becoming insolvent after having drawn on the guarantee. The Federal Supreme Court considers that this twofold risk, together with the absence of any protection against unjustified claims, amounts to an unacceptable discrimination of the debtor, especially because the debtor is not getting any advantage or benefit that might compensate for these risks.

Applicability to lease agreements?

Prima facie, these considerations of the Federal Supreme Court are also valid where lease agreements are concerned. After all, a guarantee payable on first demand may have the same liquidity effects, i.e. shift the insolvency risk to the debtor, in cases where such a guarantee is provided by tenant to secure claims of the property owner. Consequently, there are several legal authors who maintain that a clause in an adhesion contract providing for a guarantee payable on first demand should be regarded as void for the reasons set out above.

However, we are not aware of any decision by a senior court confirming this minority view. To the contrary, in line with the view dominating in legal literature, the (few) decisions on this point of law that have been published up to now all state that a clause in standard-form lease agreements requiring the tenant to furnish a guarantee payable on first demand is *per se* legally effective. One of the principal arguments for this is that the Civil Code (BGB) contains nothing about any collateral security being provided in connection with construction contracts, while Section 551 BGB does refer to such security provided by a tenant (typically in the form of a cash deposit). Therefore, in contrast to contracts for work/contractor's agreements, collateral security can be provided under a lease agreement without contracting away any provisions of the Civil Code. This is seen as being an aspect to be considered when assessing the reasonableness of contractual requirements regarding the provision of collateral. It is also argued in this connection that a guarantee merely replaces a cash deposit. It is beyond doubt that it is perfectly permissible to provide for a cash deposit being made by the tenant to secure claims of the landlord. Tenants must bear the strain on liquidity this involves irrespective of whether the statutory provisions on lease agreements apply, or whether these are contracted away and replaced by contractual stipulations. It is further argued that tenants always run a certain risk that the property owner, being insolvent or on the verge of insolvency, (unwarrantedly) draws on collateral security provided under the lease agreement, irrespective of whether such collateral is provided in the form of a bank guarantee or a cash deposit. Given that there is therefore no difference between a guarantee payable on first demand and a cash deposit in this respect, and given that even the statutory provisions refer to collateral security being provided in the form of a cash deposit, contractual clauses providing for a guarantee payable on first demand do not give rise to any additional risk to be borne by the tenant and, consequently, do not place the tenant at an unreasonable disadvantage. This line of argumentation is perfectly convincing in our opinion.

Legal consequences of standard-form clauses providing for a guarantee payable on first demand being held to be invalid

Irrespective of the above considerations, according to which the standard-form clauses under consideration here are legally valid and enforceable, there is nonetheless the question of what would be the legal consequences if this were not the case, i.e. if the Federal Supreme Court were to decide that clauses in standard-form lease agreements requiring tenants to provide a guarantee payable on first demand are void. Similar to what happened when the Federal Supreme Court handed down its first decisions stating that clauses in standard-form construction contracts providing for the provision of warranty guarantees payable on first demand are void, it is very likely that tenants who provided bank guarantees payable on first demand would not only demand such guarantee be returned, but would in most cases also refuse to provide other collateral security instead. Given the prohibition to interpret otherwise invalid standard-form clauses in such a way that their validity is maintained (*Verbot der geltungserhaltenden Reduktion*), the property owners would have to accept such refusal in a vast majority of cases. It should be noted, however, that in a judgment pronounced in 2002 the Federal Supreme Court took into consideration that standard-form clauses providing for performance guarantees payable on first demand had been quite customary until then. In view of this, the Federal Supreme Court decided that it would be unreasonable to set a precedent rendering such collateral security null and void. The Federal Supreme Court therefore ruled that such clauses concluded prior to the publication that decision could be construed by way of complementary interpretation (*ergänzende Vertragsauslegung*), the result of this being that warranty guarantees payable on first demand were to be replaced by absolute guarantees (*selbstschuldnerische Bürgschaft*). Although this did amount to interpreting standard-form clauses for the purpose of maintaining their validity, which is forbidden, the Federal Supreme Court diverged from the prohibition in order to maintain "stability of the law" (*Rechtssicherheit*) in as far as existing agreements were concerned, while this exemption did not apply to such standard-form clauses agreed after the publication of that decision. Given that judgment, it is possible that such an exemption is again made with regard to guarantees payable on first demand provided under lease agreements, but it is by no means certain that the Federal Supreme Court Division in charge of tenancy law matters (should it arrive at the conclusion that standard-form clauses in lease agreements providing for a guarantee payable on first demand are void) will also decide along the same lines as the division handling construction law matters in as far as the granting of the above-described exemption is concerned.

What is to be done?

If one wishes to be on the safe side, one must when concluding a new lease agreement determine in light of all circumstances specific to the individual case, and giving thorough consideration to all legal aspects, whether or not one should opt for collateral security which, compared to a normal guarantee, is easy to enforce, while being aware that there is also a certain risk of such collateral security being legally void. For instance, one might negotiate a clause giving the tenant the right to choose between a cash deposit and a guarantee payable on first demand. If carefully worded, especially in light of the existing case law on construction contracts, the risk of such a clause being regarded as unreasonable and therefore ineffective should be very small to inexistent, given that it is left up to the tenant to whether he prefers a guarantee payable on first demand, or rather wishes to make a cash deposit, with this latter alternative being a form of providing collateral security the propriety and legality of which cannot be challenged.

Those who may be willing to accept a somewhat greater risk may decide to rely on the fact that, while being fully aware of the supreme court practice regarding guarantees provided under construction contracts, several senior courts have nonetheless decided that a guarantee payable on first demand may be validly agreed upon.

It would be quite helpful if the Federal Supreme Court soon had the opportunity to make a decision providing final clarification regarding this point of law.

For further questions please contact:

- Dr. Ulrich Flege, Counsel, Real Estate, Clifford Chance

Contacts

Gerd A. Hille
CEO
LBBW Immobilien Management GmbH
http://www.lbbw-immobilien.de/

Dr. Gerold Jaeger
Counsel, Real Estate
Clifford Chance
E: gerold.jaeger@cliffordchance.com

Lars Thiessen, Maître en droit
Senior Associate, Banking & Capital Markets
Clifford Chance
E: lars.thiessen@cliffordchance.com

Jutta Aichele, German Auditor/ Tax consultant
General Manager
PVW GmbH
E: jutta.aichele@pvw.de

Dr. Christian Keilich
Partner, Real Estate
Clifford Chance
E: christian.keilich@cliffordchance.com

Dr. Ulrich Flege
Counsel, Real Estate
Clifford Chance
E: ulrich.flege@cliffordchance.com

Clifford Chance, Mainzer Landstraße 46, 60325 Frankfurt am Main, Germany

Clifford Chance Partnerschaftsgesellschaft von Rechtsanwälten, Wirtschaftsprüfern, Steuerberatern und Solicitors ·

Sitz: Frankfurt am Main · AG Frankfurt am Main PR 1000

Regulatory information pursuant to Sec. 5 TMG and 2, 3 DL-InfoV: http://www.cliffordchance.com/german-regulatory

www.cliffordchance.com

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Riyadh* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

*Clifford Chance has a co-operation agreement with Al-Jadaan & Partners Law Firm in Riyadh.