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Real Estate 2023

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Germany: Trends & Developments

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Trends and Developments

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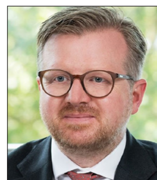

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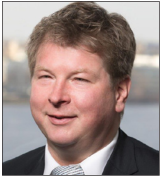

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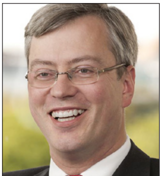

Frank Grell is the chair of Latham's German Restructuring & Special Situations Practice and helps clients navigate distressed situations related to restructuring or insolvency. He has earned a strong reputation from clients and leading publications for his empathetic approach and ability to craft pragmatic and commercial solutions in high-pressure or crisis situations. He advises companies, management, shareholders in a financial or operational crisis, creditors in all phases of financial restructurings, investors on the acquisition of distressed companies, restructurings, rescue financings, refinancing transactions, and insolvency administrators on M&A, restructurings, or disputes. He is board member of TMA Germany e.V. and of Norddeutsches Insolvenzforum e.V.

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Introduction

Current market situation

The current real estate market is characterized by an uncertain interest rate environment as the European Central Bank (ECB) has raised the main reference interest rate since July 2022 to its current 3.5%. The ECB stated that inflation is projected to remain "too high for too long" and is determined to ensure the timely return of inflation to the 2% medium-term target. These high interest rate levels are accompanied by high inflation costs, in particular construction costs, which may create a financial need to (partially) sell existing investments.

Due to the unfavourable market conditions, first market participants such as Deutsche Bank speak of a potential shift of investments in bonds instead of real estate which might increase the risk of an abrupt revaluation of residential and commercial properties. Overall, demand for office space stalled slightly in the fourth quarter of 2022. Occupiers who rented their space recently with expansion in mind are increasingly offering space to sublet, resulting in higher vacancy rates. However, rising rents are still expected for prime space.

This rather complex situation will create good opportunities for PE funds and other investors to invest as prices are at a level that could not have been foreseen a year ago. However, a robust investment requires considering insolvency law-related challenges when structuring an investment.

Factors to consider in distressed real estate transactions

Real estate transactions in a distressed situation typically follow a tight timeline due to the financially tense situation of the target/selling entity. An out-of-court solution may only be found if the management of the selling entity (or the sold entity) is not required to file for insolvency due to illiquidity or over-indebtedness resulting from lack of a (mid-term) going concern.

With regard to the transaction structure, each real estate investor should carefully consider and assess whether an asset deal or a share deal is the more favourable option. In a distressed world in particular, investors must weigh potential claw-back risks, which come into play if the relevant seller needs to file for insolvency following the transaction. Claw-back risks – depending on the relevant jurisdiction in which the seller has its centre of main interest (COMI) – exist especially in relation to legal acts (eg, transfer of ownership, all kinds of payments) in the period after a material insolvency occurs but prior to

formal insolvency proceedings. In this context, cross-border transactions imply an increase of complexity since, in particular, local insolvency law regulations differ significantly in the respective countries, even within the EU. In order to assess the overall magnitude of potential risks, the financial situation of the potential selling entity also needs to be considered.

Reasons for Deal Structuring

The following section provides an overview of claw-back rights under German Law in an insolvency situation, focusing on the various claw-back rights, the legal consequences of a claw-back, and the so-called right of choice of the insolvency administrator.

General introduction to claw-back rights under German law

Insolvency Law in Germany is based on the principle of equal treatment of creditors. A very relevant tool to fulfil this principle and establish a level playing field between the various creditors is the claw-back right of the insolvency administrator. The German Insolvency Code (InsO) provides an exhaustive number of claw-back rights (cf. Sect. 129 et seq. German Insolvency Code (InsO)). In practice, insolvency administrators examine claw-back rights thoroughly given that their remuneration depends on the size of insolvency estate.

Legal consequences of claw-back

The following section focuses on the legal consequences of a successful claw-back by the insolvency administrator. In general, assets received as a result of the void transaction must be returned to the insolvency estate, ie, retransfer of ownership. Therefore the transfer of ownership claim revives, but:

- is solely an unsecured insolvency claim;
- can only be filed with the insolvency table;
- is only satisfied on a pro rata basis, like all other unsecured claims.

If the transfer of ownership claim is to be realised, the purchase price might need to be paid again if the settlement of the initial purchase price payment was clawed back by the insolvency administrator as well.

With respect to the burden of proof, the insolvency administrator shall specify and prove:

- the existence and scope of claw-back rights, ie, the voidable transfer of asset(s) to the creditor;
- any benefits and surrogates; and
- the specific value of the assets.

Overview: grounds for claw-back

The following section serves as an overview of claw-back under German law in an insolvency situation, discusses the general requirement of a creditor disadvantage and focuses on the different grounds for claw-back.

General Requirement of Creditor Disadvantage ("Gläubigerbenachteiligung")

An objective creditor disadvantage is required for all grounds of claw-back.

Practical example: Sale of assets under market value or even the mere impairment of access to the asset.

Whether a direct, ie, immediate, creditor disadvantage is required or an indirect one is sufficient depends on the applicable legal provision for claw-backs. If third-party creditors are paid in full, there is no room for a creditor disadvantage (so-called solvent liquidation, see below).

In addition, creditor disadvantage is unlikely if the asset in question is encumbered to the full value. To answer the latter, the actual amount of the secured claims (not the nominal amount of security, in particular land charges) is decisive.

Practical hint: The German Federal Court of Justice (BGH) ruled that creditor disadvantage is not possible with regard to a property encumbered with a land charge to the full extent of its value.

Congruent Coverage (Sect. 130 InsO)

The most relevant ground for claw-back is the so-called congruent coverage (Sect. 130 InsO). A claw-back risk exists within up to three months before filing for insolvency if at the time of the relevant legal transaction (ie, the transfer in ownership) the debtor was unable to pay its debt when it was due and the creditor was aware of it at the relevant time, ie, knowledge of non-payment of claims and financial difficulties as a whole.

By law, knowledge of the illiquidity shall be deemed equivalent to knowledge of circumstances that compellingly indicate illiquidity (cf. Sect. 130 para. 2 InsO). This presumption cannot be refuted.

Practical examples: Relevant circumstances may be: knowledge of instalment and deferral requests, mere partial payments or non-compliance with payment commitments.

The calculation of the three-month period begins with the filing for insolvency.

Practical example: If the filing occurred on 4 July 2023, any transaction up to and including 4 April 2023 falls within this period if the debtor was unable to pay its debt when it was due at the relevant time.

With respect to the burden of proof, the insolvency administrator shall specify and prove the objective and subjective requirements for a claw-back under Sect. 130 InsO.

Incongruent Coverage (Sect. 131 InsO)

Another possible ground for claw-back is the so-called incongruent coverage (Sect. 131 InsO). A claw-back risk exists within up to three months before filing for insolvency for any act to which the creditor was (i) not, (ii) not in the manner, or (iii) not at the time entitled to claim.

Practical examples: Transfer of ownership before obligation to do so, or payment in kind instead of payment in cash.

The further requirements of this provision depend on the time when the transaction occurs:

- For the month before filing for insolvency, there are no further requirements.
- For the second and third month before filing (i) inability to pay its debt when it was due of the debtor, or (ii) knowledge of creditor disadvantage of the creditor at the relevant time required.

With respect to the burden of proof, the insolvency administrator shall specify and prove the objective and subjective requirements for a claw-back under Sect. 131 InsO.

Further Grounds for Claw-Back (Sect. 133, 134 of the German Insolvency Code)

Other less relevant grounds for claw-back are Sect. 133 and 134 of the German Insolvency Code.

With respect to Sect. 133 InsO, a claw-back risk exists for any transaction intended to intentionally harm creditors within up to ten years before

filing for insolvency if the creditor knew about the debtor's intent. In the case of congruency (ie, the transaction is fulfilled as contractually agreed), knowledge is irrefutably presumed if the creditor knew that the debtor was not able to pay its debt when it was due and that the transaction was detrimental to the (other) creditors.

However, the German Federal Court of Justice recently tightened the requirements for the debtor's intent to disadvantage creditors. In practice, proving the debtor's malicious intent is now significantly more difficult for the insolvency administrator.

Practical example: The creditor is aware that the transaction leads directly to insolvency and corresponding debtor's intention, given that the seller does not have sufficient funds available to continue its business or to be liquidated.

With respect to Sect. 134 InsO, a claw-back risk exists for any gratuitous performance by the debtor within up to four years before filing for insolvency. No gratuitousness exists if (i) the debtor's performance is counterbalanced by a compensatory consideration, and (ii) performance and consideration are interdependent. The objective comparison of the values exchanged generally determines whether adequate consideration exists.

Practical example: Sale (far) below market value.

Right of Choice of the Insolvency Administrator

This section explains the most important grounds for claw-back and their legal consequences, and the so-called right of choice of the insolvency administrator.

In the case of a mutual contract, the insolvency administrator may choose if it wants to fulfil the contract, if the debtor and the other party have not fulfilled the contract at all or in full at the time of commencement of the insolvency proceedings (cf. Sect. 103 InsO).

Practical example: The investor and the debtor entered into an SPA, but the SPA has not been fulfilled prior to the commencement of the insolvency proceedings.

If the insolvency administrator refuses performance, damages for non-performance are only unsecured claims in the insolvency.

An exception applies in the case of real estate: If a priority notice of conveyance ("*Auflassungsvormerkung*") is registered with the relevant land register, a creditor may demand satisfaction of its claim from the insolvency estate. In such a case, due to the secured position of the creditor, Sect. 103 InsO does not apply (cf. Sect. 106 InsO). However, the claw-back of the secured claim or of the priority notice of conveyance is still possible. Mitigation measures are therefore essential.

Potential Third-Party Claims

Third-party claims in a real estate insolvency scenario would likely be based on Sect. 826 of the German Civil Code (BGB), ie, the allegation that creditors have been impaired in a manner against good morals ("*sittenwidrig*"). The investor or the debtor may be liable pursuant to Sec. 826 BGB if the sale of the debtor or assets of the debtor was made in a manner against good morals, thereby impairing other creditors.

Possible practical example: Craftsmen have continued to work for the debtor in the belief that the debtor will continue as a going concern

because of the sale; they were not informed that a sell-off is not sufficient to avoid insolvency and is only temporarily prolonging the debtor's struggle for survival.

However, Sec. 826 BGB establishes high requirements for liability as a damage to third-party creditors must at least be tolerated by the investor or the debtor, and the other third-party creditors must prove this circumstance.

Risk Mitigation

As shown above, claw-backs by the insolvency administrator and third-party claims especially pose significant risks to a real estate transaction in a distressed scenario. This section discusses general considerations regarding risk mitigation, explains key mitigation methods, focusing on the practically relevant concept of fair market value and the liquidation agreement.

General Considerations

Typically, risk mitigation can be achieved more easily in real estate transactions compared to corporate transactions, because third-party creditors and their claims as well as cash demand in general are easier to identify. Further, the number of creditors – at least on PropCo level – is rather limited.

As a starting point, the risk of potential third-party claims must be analysed. Depending on the potential volume of these claims, the investor should assess, based on the information available, whether these claims may be satisfied in full to avoid claw-back risks. If all third-party creditors' claims are satisfied, the seller may be liquidated as a going concern. As a consequence, the relevant transaction would not be to the detriment of such creditors.

The solvency of the affected company must be carefully assessed in both a share and asset deal. In the case of a share deal, the solvency of the shareholding entity is primarily relevant since its potential insolvency administrator could claw back the share deal. On the contrary, in the case of an asset deal, the solvency of the relevant special purpose vehicle (SPV) is primarily relevant since its potential insolvency administrator could claw back the asset purchases.

In addition, the investor should consider whether an agreement with other existing creditors on the distribution of proceeds should be concluded, in particular taking into account existing collateral and non-secured creditors.

Key Mitigation Methods

In general, a thoughtful timing of the transaction with respect to the tight financial situation of the target is essential to avoid any obligation to file for insolvency. The mitigation of claw-back risks also includes a thorough deal structuring and the respective contract design.

In particular, the following tools can help depending on the individual case:

- Comprehensive due diligence prior to the acquisition that is not only limited to the assets but also with regard to the financial situation of the selling entity or the SPV (asset v share deal, see above).
- Confirmation of a restructuring expert that the solvent liquidation or going concern of the selling entity is predominantly likely; in a best-case scenario, the investor enters into a liquidation agreement with the selling entity (for more details below).
- Payment of purchase price only at the time of transfer of ownership ("Zug-um-Zug") to

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avoid the right of choice of a potential insolvency administrator.
- Registration of a priority notice of conveyance (“*Auflassungsvormerkung*”) in the relevant land register as early as possible to avoid the right of choice of a potential insolvency administrator.
- No payment of the purchase price by the purchaser during the preliminary insolvency proceedings to avoid claw-back pursuant to Sect. 130 InsO; however, a specific agreement with the insolvency administrator may be found which would protect the purchaser.
- Consideration of a legal expert opinion to limit claw-back risks and liability issues based on wilful misconduct by the investor.

Focus: Fair Market Value (“Bargeschäft”)

A practical exemption to the claw-back by the insolvency administrator is the concept of fair market value: Cash transactions (“*Bargeschäft”*, Sect. 142 InsO) are exempted in the case of an at-arm’s-length direct exchange of goods or services against payment (unless there is an intention to harm creditors). If the assets are sold significantly below book value, a market valuation should be considered to reduce claw-back risks. In a best-case scenario, an auction process should be held because it is the most secure option to prove a fair market value. That said, off-market opportunities and the generally tight schedule often do not allow for such measures.

A less time-consuming option may be to seek a shorter third-party opinion regarding the fair market value or that the seller has no reason to file for insolvency (if applicable, when the purchase price has been received).

Nevertheless, the agreement on a purchase price below market value is always possible if the target has a going concern or may be liquidated (by paying off all third-party creditors and covering the costs of the liquidation) after receipt of the purchase price. In this case, a fair market value is not decisive if filing for insolvency is avoided or is likely to be avoided.

Focus: Liquidation Agreement

In addition to the aspect of a fair market value, a liquidation agreement may serve as a practically important tool. The liquidation agreement is executed between the investor, the selling entity and potential third-party creditors, and secures the solvent liquidation process of the selling entity.

The underlying idea behind the agreement is the following: No claw-back and liability risks exist if an insolvency filing is avoided due to the solvent liquidation. Therefore a liquidation agreement could create a more secure foundation for the transaction with regard to insolvency law-related risks.

The investor should also assess whether remaining third-party claims (which are not part of the agreement, if any) are so marginal that the investor is generally willing to pay them off if necessary to avoid a filing for insolvency.

However, even if a liquidation agreement is concluded, the financial situation of the selling entity must be carefully assessed because the purchase price might not be sufficient to avoid an insolvency. Therefore, even if the investor enters into a liquidation agreement with the selling entity, the second line of defence against potential claw-back risks should be that the solvent liquidation was predominantly likely according to a third-party expert.

In general the liquidation process for a German corporation includes the following steps:

- The majority of third-party creditors are paid off as of closing.
- Some payments such as public fees, eg, taxes, may follow.

After settlement of all third-party claims, the shareholders of the relevant corporation pass a resolution on the dissolution of the entity.

Following the full pay-off of creditors and the relevant resolution by shareholders, a one-year waiting period applies in the case of a German stock company or limited liability company.

After the lapse of such waiting period, the entity can be deleted from the relevant public register and the liquidation is fully completed.

Conclusion

The current commercial environment provides great investment opportunities in the German real estate market. Investors should carefully consider any potential insolvency law-related risks if they witness a clear indication that the selling entity is in distress. The risks may be mitigated to a large extent if an investor performs thorough due diligence, which includes scrutinising the selling entity's financial situation, and on such basis selects the right deal structure.

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