

Briefing

+ Banking + Finance + Real Estate + Banking + Finance +

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Editorial

The world of finance has changed since the credit crunch. Partly, traditional refinance structures, such as the German Covered Bond, are in focus again, partly new finance sources are sought for, such as the riches of the Middle East. Therefore, we are very pleased that our colleagues from the Eversheds Islamic Finance Group contributed an Introduction to Islamic Finance to this Briefing.



*Thomas Ziegler
Practice Group
Head*

It was not earlier than spring 2006 that Heisse Kursawe Eversheds decided to set up specialised Practice Groups for Banking and Real Estate work. Therefore, we are particularly pleased that after not more than two and a half years the team has been top ranked by Chambers Europe 2008. Such award is based on our clients' confidence not less than on our performance. We therefore would like to thank you for making this possible.

We look forward to continue working with you.

With best wishes

Thomas Ziegler

Recent Amendments to German banking laws



*Dr. Sandra Hofmann,
Munich*

Banking and Finance

On 27 June 2008 the German Bundestag has passed the so-called "Risikobegrenzungs-gesetz" which aims to countervail risks involved with financial investments in general and certain investment practices in particular. The amendments aim especially at the protection of borrowers in case of sale of mortgage loans. The new law will come into operation at the date of its promulgation which is expected to occur shortly.

The new rules result from the political discussion triggered by continued reports in the media about the sale of loans and land charges by banks to investors, with the latter focusing on quick returns, which spread fear and terror amongst consumers.

The new rules provide inter alia for the following:

No (deemed) consent to change of contractual party by way of general terms and conditions



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A borrower can find himself exposed to a new creditor not only in case of (individual) assignment of claim, but also in case of transfer of the (whole) credit agreement to a new contractual party. Such transfer of agreement is subject to the consent of the (existing) contractual parties and the new (transferee) contractual party – unless the transfer occurs by way of universal succession, e.g. in case of merger of companies or spin-off of operation pursuant to the Reorganisation of Companies Act (*UmwG*). Clauses in general terms and conditions of the bank providing for the borrower to consent to the transfer of the loan agreement are now expressly excluded, unless the potential transferee is already named in the clause or the borrower is expressly entitled to terminate the agreement in case of such transfer.

The new rule, however, does not apply to loan agreements with an entrepreneur as borrower (i.e. a person or company, who or which, when entering into the credit agreement acts in exercise of his or its trade, business or profession). In case of a loan agreement with an entrepreneur as borrower it has to be assessed if such clause (in the general terms and conditions) on the deemed consent to transfers of credit agreement unduly prejudices the borrower. According to the explanatory memorandum to the new law there is a general assumption that such undue prejudice is given, because the contractual situation of the borrower may materially deteriorate in case of exchange of the contracting party. Also the confidential relationship between customer and bank is an argument for such assessment. However, the courts' view on such clauses is still outstanding.

New information obligations

In relation to loans granted to consumers (i.e. natural persons who enter into a legal transaction for a purpose that is outside their trade, business or profession), the information obligations of the banks have substantially increased:

- a) Though the law does not provide for the bank's obligation to offer non-assignable loans, it does however, in case of mortgage loans, oblige the bank to inform the borrower upon execution of the loan agreement of the assignability of the bank's claims under the loan without the need of the borrower's consent, by way of an accentuated warning in the text of the agreement. Such warning shall make the borrower aware of this matter, and allow the borrower to re-negotiate that item or to look for a bank which also offers non-assignable loans. Such warning is not necessary if the assignment has been excluded.

Furthermore, the text of the agreement needs to contain a warning note that the bank may transfer the agreement in whole to a third party. Again, the latter does not apply in case such transfer requires the borrower's consent. In general, transfer of the loan agreement in whole to a new creditor requires the consent of the borrower. According to the explanatory memorandum to the new law, however, the new rule shall oblige the bank to inform the borrower about the possibility of transfer of the agreement by way of merger of companies or spin-off of operation pursuant to the Reorganisation of Companies Act (*UmwG*), which does not require such consent.

- b) Further information obligations of the creditor (and the new creditor in case of transfer of the agreement, respectively) apply during the term of the loan agreement with a consumer as borrower: henceforth, the bank has to inform the borrower at the latest three months prior to the end of the period for which the interest rate has been fixed or to the end of the term of the loan agreement, respectively, whether it is prepared to agree again on a fixed interest rate (by also informing the borrower of the current interest rate) and to extend the loan (by also informing the borrower of the major terms of the new loan agreement), respectively.

In case of assignment of claims of the bank these obligations do also

apply to the new creditor of such assigned claims, unless the assignment is a so-called "silent" assignment, i.e. where the bank has agreed with the new creditor that despite the assignment of claims it will continue to act as (sole) creditor towards the borrower.

- c) In case of assignment of a claim under a loan agreement with a consumer as borrower or in case of other exchange of the creditor of such loan agreement, the bank shall inform the borrower without undue delay of such assignment or transfer, and of the contact details of the new creditor. Again, this does not apply if the assignment is a silent assignment (see b).

Higher threshold for extraordinary termination

Furthermore, the borrower protection in cases of delays in payment has been increased in favour of consumers. Termination of loan because of payment delays shall not be permissible but if payment of at least two subsequent (partial) rates and total arrears of at least 2.5 % of the nominal amount of the loan are outstanding. This provision, however, only applies to credit agreements concluded and/or transferred after the effective date of the new law.

No bona fide acquisition of defence-free land charges (s. 1192 par. 1a BGB)

In principle, a land charge entitles the owner to payment of the nominal amount from the property. Since, however, in case of granting of a loan, the so-called *Sicherungsgrundschuld* (land charge created to secure debt) given to the bank shall merely secure the fulfilment of its claims under the loan against the debtor, debtor and bank usually restrict this comprehensive authorisation of realisation by way of a security purpose agreement (*Sicherungszweckvereinbarung*) to certain cases of non-fulfilment of the bank's claims. The security purpose agreement is not registered with the land register. Under the old law, the person who acquired the land charge from the original lender was not subject to the restrictions agreed under the security purpose agreement, in case that acquirer had no knowledge of the latter agreement and could therefore rely in bona fide upon the fact that the debtor did not have any defences against the claims under the land charge. Under the new law, the acquirer of the land charge cannot rely in good faith on the non-existence of such restrictions under a security purpose agreement, i.e. the purchaser is also bound to the restrictions which derive from the security purpose agreement between the debtor and the transferor bank, irrespective of the acquirer's knowledge thereof. This provision does not apply to land charges which have been transferred prior to the entry into force of the new law.

Maturity of land charge (*Sicherungsgrundschuld*) only after termination with 6-months prior notice

The new law has materially changed the requirements for the maturity of a land charge created to secure debt: Already under the old law the land charge's maturity, i.e. the possibility to realise the charge by way of enforcement, has required the termination of the latter with 6-months prior notice. Deviating agreements, however, were admissible and common practice; accordingly the land charge was granted to be (immediately) due and payable or terminable without prior notice. Under the new law, in case of a land charge granted to secure obligations (*Sicherungsgrundschuld*) such deviating agreements are not permissible any more. As a result, realisation of such land charges may be materially delayed in the future. This provision does not apply to land charges created prior to the effective date of the new law.

Non-assignable loans to entrepreneurs

Under German law in principle the assignment of claims is not subject to the

consent of the debtor. Under the old law payment claims of a bank against an entrepreneur were assignable, even if the parties had expressly excluded such assignment.

Under the new law, assignment is invalid in such case, i.e. also entrepreneurs have the possibility to validly exclude the assignment of payment claims. This provision does not apply to agreements entered into before the entry into force of the new law.

Damages for unjustified enforcement

In case of mortgage loans, upon creation of the land charge on request of the bank the chargor typically submits himself (1) to immediate enforcement of the land charge and (2) to immediate enforcement against his entire assets with respect to the claims under the loan agreement and/or under an acknowledgment of debt.

Such deeds are immediately enforceable, i.e. they enable the chargee to initiate enforcement proceedings without the need to obtain an enforceable court judgement.

In case the original creditor pursues unjustified enforcement action, in general he will be liable for damages to the chargor. In case the creditor has assigned the rights under the above deed to a third party and in case this third party pursues unjustified enforcement, the debtor could claim compensation from the latter only under certain restricted circumstances. Under the new law, in case of unjustified enforcement by the transferee enforcement creditor the latter is liable for damages to the chargor, regardless of fault. This is to protect the chargor from any case of unjustified enforcement – a new provision in view of the assertions that particularly purchasers of mortgage loan portfolios had repeatedly initiated unjustified enforcement actions.

The amendments meet the expectations of consumer protection organisations and insofar have been widely appreciated. Further requests, such as an extraordinary termination right in case of assignment of claim or the exclusion of a sale of loans to investors other than financial institutions, have been rejected. It remains to be seen whether the new law will have the intended effect, otherwise further tightening of rules cannot be excluded.

Recent amendments of the German Act on Limited Liability Companies (GmbHG) – Improvements from the investors' and creditors' perspective



*Dr. Sandra Hofmann,
Munich*

The law to modernise the law governing limited liability companies and to combat abuses has been passed on 26 June 2008 and will come into operation at the date of its promulgation which is expected to occur in autumn 2008. The amendments aim at deregulation, simplification, acceleration and cost reduction of the setting up of a business and at the acceleration of the registration, all of which shall enhance the international competitiveness of the German form of limited liability company (particularly in comparison to the English limited company). Further, the amendments combat abuses in connection with the liquidation of a limited liability company, and provide for a limited liability "Unternehmersgesellschaft – (UG)" without minimum share capital as well as for the bona fide acquisition of shares in a limited liability company. In particular the following amendments are notable improvements from the investors' and the lenders' perspective:

I. Improvements from the investors' perspective

1. Raising of capital

Significantly less capital will be needed for the incorporation of a limited liability company (GmbH) if the newly introduced so-called "haftungsbeschränkte Unternehmersgesellschaft" (limited liability entrepreneurial company), a special type of the limited liability company is chosen. This type of a GmbH can be

incorporated with a share capital which falls below the minimum share capital in the amount of EUR 25,000.00, e.g. a share capital in the amount of **EUR 1.00** and will be endorsed with "Unternehmergeellschaft (haftungsbeschränkt)" (entrepreneurial company (with limited liability)) or "UG (haftungsbeschränkt)".

However, this particular type of a GmbH has to retain statutory capital reserves in the amount of a quarter of each annual net profit. This allows to achieve an increased equity capitalisation by way of retention of capital. Such reserves may also be used to cover losses in subsequent financial periods.

In case the company increases its capital by utilisation of the retained reserves or by way of capital contributions from the shareholders, and thus reaches the amount of the minimum share capital of a "regular" GmbH (EUR 25,000), the endorsement in the company's name can be changed to "GmbH" and any remaining reserves can be dissolved.

2. Mobility

Under the new law, the company still has to have its (registered) seat in Germany. Operation, management and administration, however, may be situated abroad. However, with its registered seat in Germany, the company has to file for the registration of a business address in Germany with the commercial register. The new law allows foreign entrepreneurs to choose the legal form of a GmbH and keep their business operations in their home country or elsewhere. Likewise, a German holding is now able to incorporate an affiliate with its administrative centre abroad in the legal form of a GmbH. However, in each of such cases it remains to be checked whether such structures comply with the laws of the jurisdiction where the respective business operation is located.

II. Improvements from the creditors' perspective

From a financier's perspective the following amendments will be welcomed:

1. Less restrictions for up-stream loans and securities

Under the old and the new law, assets of the company necessary for the maintenance of the share capital must not be disbursed to the shareholders, i.e. no disbursement to shareholders may result in a negative balance sheet.

Under the old law and the respective jurisprudence, loans granted by the company to shareholders and equivalent benefits which are not covered by reserves or retained profits, but derive from assets necessary to maintain the GmbH's share capital were to be qualified as prohibited disbursement, even if the granting of the loan resulted in a corresponding repayment claim against a creditworthy shareholder.

This made it necessary in case of the granting of security by the GmbH for loans to its shareholder(s) or affiliated entities to restrict the obligations of the GmbH under the security arrangement to payments which do not result in a negative balance sheet.

Under the new law, the rules for maintenance of share capital have changed insofar as disbursements and equivalent performances of the company for the benefit of a shareholder are not prohibited if

- there is subordination agreement or a profit and loss transfer agreement between the company and the shareholder, or
- the performance is covered by an adequate claim for repayment or compensation.

As a consequence, in case of up-stream loans/up-stream securities the custom-

any contractual limitations of the company's obligations will become irrelevant insofar, as the drawing of the security would result in an adequate claim for compensation against the shareholder.

The adequateness of the company's claim for compensation or recourse is to be determined in accordance with the general accounting principles: only an enforceable claim of the GmbH can be adequate. Subsequent unforeseeable developments do not lead retroactively to a prohibited disbursement. If the shareholder, however, is a special purpose vehicle with few assets or if the enforceability of the claim for compensation is questionable for other reasons the claim for recourse will need to be considered as insufficient.

Thus the new rules simplify the operation of intra-group finance arrangements such as cash pooling, as well as the granting of security by affiliated entities in connection with loans granted by third parties.

2. Disposal of shares

The legal situation in relation to the disposal of shares has been significantly improved: Assignment and pledge of shares in a limited company are subject to notarisation. However, under the old law for the lack of share certificates or an adequate shareholder register the transferee or pledgee of shares did not have certainty that the transferor/pledgor of the shares was legal owner and thus able to grant valid title. In practice the transferee/pledgee can alleviate this risk by review of all transfer deeds since incorporation; such review, however, does not exclude that undiscovered share transfers have occurred. While the transferee/pledgee can request a guarantee for the transferor's ownership such guarantee may result in a claim for damages, but does not enable the transferee to effect the share transfer against the will of the actual owner.

In order to create transparency and reasonable certainty with respect to the ownership in shares, the new law provides for a list of shareholders to be registered with the commercial register. It is the aim of that shareholder list that the identity of shareholders will always be up-to-date and traceable without any problems and without gaps. In the event of transfer or pledge of shares by a transferor registered as shareholder without actually holding title in the shares (sham shareholder), the following applies:

The list of shareholders registered with the commercial register does now allow for the bona fide acquisition/pledge of shares from the registered (sham) shareholder: purchasers shall be able to trust that the persons recorded in the list of shareholders are genuine shareholders. However, this does not apply if

- a) the sham shareholder has been registered for less than three years and the incorrect registration cannot be imputed to the true shareholder, or
- b) the purchaser knows or should know the incorrectness of the registration, or
- c) an objection against the respective entry has been raised.

Therefore, under the above circumstances the transferee bears the risk of the invalid transfer of shares by a sham shareholder also in the future, so that in such cases it will remain necessary to review the chain of share transfers and to request guarantees on title.

3. Shareholders' obligation to file for insolvency

The new law also aims for protection of creditors against delays in filing for the opening of insolvency proceedings: So far only the managing directors were obliged to file for insolvency in case of illiquidity or over-indebtedness of the GmbH. This was subject to abuse insofar as managing directors have been removed for the purpose of avoidance of that obligation. Under the new law, in case of illiquidity or over-indebtedness each shareholder is obliged to file for

insolvency if the company does not have a managing director at this point in time. This does not apply, however, if a shareholder has no knowledge of the illiquidity or over-indebtedness or the lack of a managing director.

This is to make sure that insolvency filings are made in due time, and to create an incentive for the shareholders to not leave the GmbH without a managing director.

4. Simplification of service of notice to companies

The new simplification of service of notice to companies improves the protection of creditors of a GmbH. In the case of so-called “company burials” exchange or removal of managing directors, transfer of seat and missing business addresses have been used in order to obstruct creditors’ enforcement actions because service of notice could not be made to the company itself but only to its managing directors. In cases in which the service of notice is impeded because of lack of managing directors it is now provided for the possibility to serve notices to each shareholder.

In addition to the above, in the future a German business address has to be named in the filing for the registration of the company in the commercial register, which can be viewed not only at the commercial register, but also online.

The new rules tackle the major flaws of the German limited company. It remains to be seen how the commercial registers cope with the amendments, in particular in relation to the Unternehmergeellschaft and the registration of the business address. The introduction of the Unternehmergeellschaft should stop the success story of the English limited company as an alternative to the German GmbH.

Introduction to Islamic Finance



Indraj Mangat, London

Whereas the shortage of credit supply by capital markets persists, liquidity created in the Middle East continues to look for investment opportunities in the West. Therefore, it has become increasingly important to have access to Scharia-compliant products providing for financial services to people and corporations whose faith prevents them from using the kind of products that are normally offered by Western financial institutions, as is exemplified by the GBP 195m facility provided by Qatar National Bank (with Eversheds acting as its legal advisor) for the financing of the development of the Shard of Glass in London, a landmark building designed by Renzo Piano. The facility provided was a unique combination of an Islamic equity tranche and conventional senior debt.

The Islamic form of finance is as old as the religion of Islam itself. Central to Islamic finance is the fact that money itself has no intrinsic value. As a matter of faith, a Muslim cannot lend money to, or receive money from someone and expect to benefit - interest (known as *riba*) is not allowed. To make money from money is forbidden - wealth can only be generated through legitimate trade and investment in assets. Money must be used in a productive way.



Amjad Hussain, Doha

Under Islamic principles, Scharia law (prescribed in the Koran) defines the framework within which Muslims should conduct their lives. The overarching principle of Islamic finance and banking products is that all forms of interest are forbidden. The Islamic financial model works on the basis of risk sharing. The customer and the bank share the risk of any investment on agreed terms, and divide any profits or losses between them. In addition, investments should only support practices that are not forbidden – trades in alcohol, betting and pornography are not allowed. Moreover, an Islamic banking institution is not permitted to lend to other banks at interest.

For compliance with the above principles, typically the following products are used for Islamic Finance:

- **Musharaka** means "partnership." It involves the customer placing capital with an FI (Financial Institution) and both parties sharing the risk and reward. The difference between Musharaka arrangements and traditional banking is that either party can set a profit-sharing ratio, but losses must be proportionate to the amount invested.
- **Murabaha** is a contract for purchase and resale that allows the customer to make purchases without having to take out a loan and pay interest. The FI purchases the goods for the customer, and re-sells them to the customer on a deferred basis, adding an agreed profit margin. The customer then pays the sale price for the goods over instalments, effectively obtaining credit without paying interest. Again, this is similar to many rent-to-own arrangements made in the secular financial services industry.
- **Commodity murabaha** - Islamic banks use this product to replace conventional inter-bank deposits. It involves the sale and subsequent re-purchase of a commodity (normally a base metal which is traded on a major exchange such as the London Metal Exchange). It is structured in such a way that it is essentially similar to a loan granted by the seller to the buyer. The difference in the sale and re-purchase price earns the seller a return which is broadly equivalent to interest.
- **Mudaraba** refers to an investment made on the customer's behalf by a more skilled person (Mudarib). It takes the form of a contract between the customer, who provides the funds, and the Mudarib (similar to a fund or investment manager, which could be an FI) which provides the investing expertise, where the parties agree in advance to the division of any profits. The Mudarib would make Sharia-compliant investments and share the profits with the customer, in essence charging for its time and effort in managing the investment. If no profit is made, the loss is borne by the customer and the Mudarib would not collect its fee. This is contrasted against the secular investing arrangement where the FI or fund manager charges a fee based on the number of transactions or the size of the overall portfolio, with no link to the performance of the investment.
- **Ijara** is a form of leasing. It involves a binding agreement in which the Financial Institution buys the goods and then rents them to its customer in return for a specified rental payment over the lease term. The duration of the lease and the rental payment are agreed upon by the FI and its customer. The FI retains ownership of the goods throughout the lease term and then assumes possession of the goods at the end of the lease term. This is similar to most lease agreements currently in use in the secular financial services industry.
- **Ijara-wa-iqtina** is a form of leasing similar to Ijara, except that included in the lease agreement is an obligation on the customer to buy the goods from the FI at the end of the lease term at a pre-determined price. Rental payments made during the lease period contribute towards the purchase price of the goods. Often, as a result, the final sale price at the end of the lease period will be for a minimal sum. This practice is similar to the fixed buyback option available at the end of most auto leases currently in use in the secular financial services industry.
- **Ijara with diminishing Musharaka** can be used for home-buying services instead of a traditional secular mortgage. "Diminishing Musharaka" means that the FI initially purchases the asset (typically a home) and retains legal title to the asset during the life of the lease/rental agreement it enters into with the customer. The FI then reduces its equity in the asset with any additional capital payment the customer makes over and above the rental payments agreed upon for the property. The customer's ownership in the asset increases and the FI's decreases by a corresponding amount each time the customer makes an additional capital payment. Ultimately, the FI's ownership of the asset is transferred entirely to the customer. While this is fundamentally different from the secular mortgage financing model, it is not entirely unfamiliar and may be compared to rent-

to-own programs offered by some housing developers.

With offices in the three global jurisdictions for Islamic Finance - City of London, the Gulf (Doha) and Malaysia, Eversheds have extensive experience in Islamic banking and Islamic capital market products, including project financing, debt financing, trade financing and Islamic capital market instruments. Demand for financial products and securities that respect Scharia law is surging, fuelled by high oil prices which are boosting corporate and personal wealth in the Middle East. In a global Islamic financial services industry now worth between US\$700 billion and US\$1 trillion, the Eversheds Islamic Finance team, bringing innovative interpretations of Islamic financing structures to market (including murabahas, musharakahs and ijaras), continues to be at the forefront of this dynamic sector.

Property

Pre-emptive rights of tenants of residential premises after splitting of properties into condominiums and partial plots



Gero Martin, Munich

Pursuant to the provision of s. 577 German Civil Code (*Bürgerliches Gesetzbuch – BGB*) a tenant of an apartment has a statutory pre-emptive right in case the property has been (or shall be) split into condominiums and shall be sold to a third party. If the tenant does not execute his pre-emptive right he benefits from a specific protection against eviction under ss. 577a BGB. According to the legislative statements these provisions shall protect tenants of residential premises against eviction in the course of split of a property into condominiums. The Federal Court of Justice has now ruled that these provisions shall also apply accordingly in case of a split of a property into partial plots (*Judgement of 28 May 2008, VIII ZR 126/07*).

1. The provisions of ss. 577, 577a BGB

The owner of a residential building may split his properties into condominiums, for example, in order to sell the individual condominiums to different purchasers. Pursuant to s. 566 BGB the respective purchaser will take over the existing lease as new landlord but is then entitled to terminate the lease, e.g. because of own needs (*Eigenbedarf*). The **statutory pre-emptive right** benefiting the tenant established in s. **577 BGB** shall protect the tenant of residential premises against eviction: If leased residential premises are split into condominiums (or such split is intended) after the tenant has been permitted to use the apartment, and the condominium shall be sold to a third party, the tenant has a right of preemption with regard to the respective apartment. The tenant is entitled to execute his pre-emptive right within 2 months after he has been informed (by the owner or the purchaser) about the content of the respective purchase agreement. In case the tenant executes his pre-emptive right he enters into a purchase agreement with the owner under the terms of the contract concluded between the owner and the (original) purchaser. The tenant is not entitled to a pre-emptive right in case the owner sells the residential premises to a member of his family or a member of his household. Furthermore, the pre-emptive right is applicable only in case of a **first-time sale** of the apartment after the property has been split into condominiums. In case the purchaser of a condominium resells the apartment to another buyer, the tenant is not entitled to a pre-emptive right. However, in either case the tenant benefits from a specific **protection against eviction** under **s. 577a BGB**: the purchaser of a condominium shall not be entitled to terminate the lease because of the reasons mentioned in s. 573 par. 2 nos. 2 and 3 BGB – own needs or disability of appropriate commercial use of the apartment – for at least 3 years after acquisition of the apartment. In case of several subsequent disposals of the same apartment the time period since the first sale after the split of the property into condominiums will be taken into account.

2. The judgment of the Federal Court of Justice of 28 May 2008

The Federal Court of Justice (*Bundesgerichtshof – BGH*) had to adjudicate about

the following case: the owner of a housing estate intended to split the estate into separate plots of land in order to sell the individual plots to an investor. The tenant of one house filed an action for a declaratory judgement that – in case of a sale of the house – she would be entitled to a pre-emptive right in accordance with s. 577 BGB and will benefit from specific protection against eviction under s. 577a BGB. The court of lower instance had dismissed the tenant's claim: the provisions of ss. 577, 577a BGB would not apply to this case as these provisions explicitly apply only to a sale of condominiums, not partial plots of land. The BGH has decided in favour of the tenant (*Judgement of 28 May 2008, VIII ZR 126/07*): In order to fill an unintended gap in the law the provisions of ss. 577, 577a BGB shall apply to this case accordingly. When implementing the regulations of ss. 577, 577a BGB the legislator had not considered that properties built with residential buildings can be split not only into condominiums but also into partial plots of land. However, the tenant's interests and concerns are (nearly) the same in both cases: after sale of the property the tenant will get a new contractual partner – a new landlord – who might terminate the lease e.g. because of own needs. Furthermore, also the tenant's interest in acquiring the rented premises does not depend on the fact whether the respective property has been split into condominiums or partial plots of land. Finally, in case of splitting of a property into partial plots the owner does not deserve more protection than in case of splitting of a property into condominiums.

By its judgment the BGH has filled an obvious gap in the law. The interests in case of sale of residential premises are (nearly) identical, irrespective of the fact whether the premises have been split into condominiums or into partial plots of land. As a consequence, the owner of real property, who intends to split the property into several partial plots of land in order to sell these plots subsequently, will have to consider the provisions of ss. 577, 577a BGB in the future.

Leases / Facility Management

Simplification of the settlement of operating costs for residential leases

Over the last six months the German Federal Court of Justice has rendered several judgements on the settlement of operating costs for residential leases, providing for more legal certainty and simplifying the landlord's work.

1. Requirements on structure and content of the settlement of operational costs

The landlord is obliged to settle the operating costs annually, in accordance with the applicable **form requirements**, within 12 months after the end of the respective accounting period. After expiration of this term any additional claims of the landlord against the tenant in respect to operating costs are - as a matter of principle - excluded. It is therefore of particular importance for the landlord to issue a settlement of operating cost which meets the formal requirements, in due time. However, the law does not stipulate specific requirements on the structure and the content of the settlement of operating costs. Pursuant to the courts (cf. German Federal Court of Justice (*Bundesgerichtshof, BGH*), 9 April 2008 (*VIII ZR 84/07*)) the settlement has to be clear, well arranged and self-explanatory, so that even a recipient who is not familiar with legal or economic terms is able to understand the settlement. A settlement for a building with several residential units shall - in principle - contain at least the following **details**:

- a) Summary of the total operating costs,
- b) Specification and explanation of the basis for the allocation of the costs (pursuant to the consumption, the area or the number of residents),
- c) Calculation of the portion of the total costs to be borne by the tenant,
- d) Deduction of the advance payments made by the tenant, and
- e) Overall result.



*Christoph Müller,
Munich*

2. Explanation of the settlement

Pursuant to former court rulings, the landlord was obliged to explain within the settlement any particularities and deviations from former settlements, such as peculiar cost increases or variations in the consumption. However, the BGH has now decided (*VIII ZR 261/07 dated 28 May 2008*) that the landlord is - in principle - not obliged to explain such particularities compared to former settlements. The respective settlement itself must be self-explanatory in order to meet the formal requirements; a comparison with former settlements is not required. Any deviations from former settlements might give reason for the tenant to check the correctness of the settlement, but do not affect the validity of the settlement itself. Nevertheless, the landlord is still obliged to explain all details necessary for the comprehensibility of the respective settlement. For example, in case not all service costs can be charged to the tenant, such as the costs for maintenance and repair works carried out by the caretaker, the landlord shall state the respective overall costs (caretaker) in the settlement and explain the deduction of the costs not chargeable to the tenant.

3. Accounting period

The accounting period shall not extend one year. However, it is not stipulated *which* annual period shall be taken as a basis for the settlement (calendar year, lease year or the annual account period of the supply company). In case the lease agreement does not contain a respective provision the landlord is free to determine the accounting period. Pursuant to a recent decision of the BGH (*VIII ZR 240/07 dated 30 April 2008*), the landlord is not obliged to determine the accounting period in accordance with the billing cycle of the supply companies. In general, the so-called **performance principle** (*Leistungsprinzip*) is applicable for the settlement of operating costs, i.e. the landlord settles all operating costs incurred for performances rendered within the accounting period, irrespective of the date the landlord has received the relevant invoice or has paid these costs. As a consequence, the landlord might have to wait with the settlement of operating costs until receipt of all invoices for the respective account period. By a further decision (*VIII ZR 49/07 dated 20 February 2008*) the BGH has now allowed the landlord to settle the operating costs on the basis of the so-called **outflow principle** (*Abflusssprinzip*), i.e. the landlord is entitled to settle all costs he has paid within the respective account period. This makes life easier for the landlord: when calculating the settlement he has not to consider the date of performance of the relevant services. However, a settlement on the basis of the outflow principle might be excluded, e.g. in case the tenant has changed within the accounting period. The allocation of costs incurred within the previous accounting period - such as an additional claim for land tax - to the new tenant would unfairly prejudice the new tenant since such costs have not been caused by his use of the lease object. In these cases the allocation of such costs to the new tenant is not possible and the operating costs must be settled on the basis of the performance principle.

4. Time limits for the settlement of operating costs

The landlord is not entitled to assert any additional claims against the tenant if he has not submitted a settlement in due form within 12 months after the end of the respective accounting period. However, this does not apply in case the landlord is not responsible for the subsequent assertion of additional claims, e.g. if the respective supplier has delayed the settlement for its services. In case the landlord submits a settlement which meets the formal requirements but which is not factually or arithmetically correct, e.g. because it contains a calculation error or an incorrect specification of the lease area, the landlord is entitled to correct the error even after expiration of this time limit and request additional payment from the tenant. In return the tenant has to object to the settlement within 12 months after receipt. After expiration of this time limit any objections of the tenant against the settlement are excluded. Pursuant to former legal practice this exclusion of objections only applied to operating costs the tenant had

agreed to bear under the lease agreement. All costs the landlord has unjustifiably charged to the tenant were not affected by the expiration of this time period; the tenant was still entitled to claim repayment of the respective amounts even after expiry of the time limit. However, the BGH has now decided (*VIII ZR 279/06 dated 10 October 2007 and VIII ZR 80/07 dated 5 March 2008*) that **all** objections of the tenant against the settlement shall be excluded after expiry of the time limit, including the objection that the landlord has unjustifiably charged certain operating costs to the tenant. In consequence, all mutual claims of the lease parties will be finally settled after expiry of one year following the settlement of operating costs.

5. Subsequent amendments to the cost allocation arrangement

Irrespective of the fact that – in general – a settlement of operating costs becomes binding in respect to the relevant accounting period after expiration of the above time limit it is arguable whether the underlying cost allocation arrangement included in the lease agreement has been amended by implied conduct if the accounts are settled over a longer time period. The BGH had ruled in 2004 (*VII ZR 146/03 dated 7 April 2004*) that the provision on the allocation of operating costs is amended by implied conduct in case the tenant pays additional claims of the landlord resulting from the settlement of operating costs – which contains operating costs not chargeable to the tenant under the lease agreement – over several years without objections. In consequence, the tenant was obliged to pay these additional operating costs also in the following years. However, the BGH has modified this jurisprudence in a recent decision (*VIII ZR 279/06 dated 10 October 2007*): The mere fact that the tenant does not object to the settlement does not mean that the tenant also wants to modify the underlying cost allocation arrangement for the future. Pursuant to another judgement of the BGH the same principles also apply in favour of the landlord (*VIII ZR 14/06 dated 23 February 2008*): In the particular case a new landlord settled operating costs although the former landlord had not settled operating costs for 20 years. Pursuant to the BGH, the new landlord was entitled to settle the operating costs because the lease agreement was **not** amended by implied conduct due to the fact that the former landlord had not settled the costs within the relevant time periods. In view of this new ruling of the BGH it is essential to explicitly list the operating costs to be allocated to the tenant in the lease agreement as comprehensively as possible. In particular, the operating costs not stated in the German Regulation on Operating Costs (*Betriebskostenverordnung*), the so-called “other operating costs” (such as the costs for the heating of the roof gutter), should be explicitly specified in the lease agreement since such “other operating costs” can only be allocated to the tenant by way of explicit agreement in the lease agreement. For this purpose, it is **not** sufficient to only refer to the German Regulation on Operating Costs. Additionally, it should be agreed that, in case operating costs increase or new operating costs arise, the landlord shall be entitled to charge the additional costs to the tenant with effect as of the date the respective costs have incurred. Otherwise, such costs must be borne by the landlord.

It is appreciated that the BGH has simplified the settlement of operating costs for the landlord who is now also entitled to settle the costs in accordance with the outflow principle and is no longer obliged to explain deviations from previous settlements. Furthermore, the BGH has clarified that all objections of the tenant against the settlement will be excluded after one year and that an amendment of the lease agreement by implied conduct occurs only under specific, exceptional conditions.

Enforcement

Validity of declaration to submission of immediate enforcement in case of invalidity of the underlying agreement

The Higher Regional Court Berlin had to decide a case where the sale and purchase agreement for real estate (SPA) did not comply with the applicable form requirement. Failure to comply with the form requirement leads to the consequence that the SPA is void. The notarial deed of the SPA provided for the purchaser's declaration of submission to immediate enforcement in relation to



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claims resulting from the SPA. At a later stage the vendor started enforcement measures on the grounds of this declaration. The Higher Regional Court Berlin ruled that since the SPA was void, the declaration of submission to immediate enforcement did not have any effect either and consequently the enforcement measures on the grounds of such void declaration were not permissible.

The Federal Court of Justice (Bundesgerichtshof - BGH) has now ruled that the validity of the declaration of submission to immediate enforcement in a notarial deed is independent from the substantive agreement between the parties on the underlying legal transaction (decision dated 20 March 2008). The BGH explained that the declaration of submission to immediate enforcement is a unilateral procedural declaration for which a substantive agreement between the parties is not necessary. Therefore the declaration of submission to immediate enforcement - and accordingly the enforcement measures on the grounds of such declaration - is valid even though the SPA notarized in the same deed is void.

For the avoidance of doubt it should be pointed out that the BGH in the current case did only comment on the formal validity of the declaration of submission to immediate enforcement but it did not decide about the question whether the vendor substantially is entitled to the performance intended to be realized by the enforcement measures. Insofar as the claim for payment of the purchase price, on which the enforcement measures are based on - indeed does not exist, the purchaser can assert this by way of a suit raising an objection to the enforcement measures.

In case the enforcement measures are completed - as in the scenario the BGH had to decide upon - the purchaser still has the opportunity to file a suit for repayment of the proceeds realized by the enforcement measures on the grounds of unjust enrichment.

Tax

Avoidance of the limitation of interest deductibility (*Zinsschranke*) by way of participation of a bank or a financing company in a partnership



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Pursuant to the provision regarding limitation of interest deductibility ("*Zinsschranke*") of s. 4 h German Income Tax Act (*Einkommensteuergesetz, EStG*) and s. 8 a German Corporate Income Tax Act (*Körperschaftsteuergesetz, KStG*) interest expense is only tax deductible in the amount of interest income and in addition thereto up to the amount of 30 % of the EBITDA as calculated under tax law. However, this does not apply if the amount of the interest expense exceeding the interest income amounts to less than EUR 1m p.a. or if the equity ratio of the business does not fall below more than 1 percent of the equity ratio of the whole group. In case none of the aforementioned alternatives apply, the interest costs over interest income would only be deductible to the amount of 30 % of the EBITDA.

If the business was run in the legal form of a GmbH (a limited liability company), the limitation of interest deductibility would be applicable and the taxable income of the GmbH would have to be increased for tax purposes. However, if the business was run in the legal form of a GmbH & Co. KG (limited partnership ("*Kommanditgesellschaft*") in which the general partner is a GmbH) and if the financing bank or the financing group company participated as a limited partner in the GmbH & Co. KG, the provision regarding the limitation of interest deductibility would not be applicable and the taxable profit at the level of the KG would have to be decreased by the full interest costs for statutory book purposes as well as for tax book purposes. However, for income tax purposes, the whole interest costs would have to be added back as business income of the financing limited partner at the level of the GmbH & Co. KG, which would lead to a neutralisation at the level of the partnership.

The limited partners, however, who do not grant loans to the GmbH & Co. KG and holding a majority participation will enjoy the tax deductibility of the interest cost according to their participation and profit allocation.

The financing limited partner who only holds a minority participation in the amount of e.g. 0.1 % in the GmbH & Co. KG will be allocated a respective high "interest" income as business income. However, this income is subject to trade income tax at the level of the GmbH & Co. KG. This tax is generally credited to the financing limited partner with reference to its own trade income tax liability. Furthermore, it is possible to apply for extended trade income tax exemption (*erweiterte Gewerbesteuerkürzung*) pursuant to s. 9 sub. 1 no. 1 sentence 2 Trade Income Tax Act (*Gewerbesteuergesetz*), in case of KGs that deal with mere asset management (*Vermögensverwaltung*). As a consequence in this case trade income tax does neither have to be paid by the GmbH & Co. KG, nor by the financing limited partner (bank or financing company of the group).

We are of the opinion that one can well rebut the possible argument of a potential violation of anti-avoidance regulations by choosing this structure with the argument that the minority participation granted to the financing limited partner is only supposed to secure the influence possibilities under the loan agreement also under corporate law which should be documented by a respective behaviour.

In case of involving foreign banks or group financing companies with their registered offices outside of Germany, the tax authorities might argue that the interest income of the financing limited partner was not requalified as business income under double tax treaties and thus there would not be business income taxable in Germany. However, we are of the opinion that a requalification of interest in business income under national tax law continues to exist independently of the fact as to whether it can (again) be qualified as interest income under a double tax treaty.

Example:

(amounts in thousands of EUR)

	Statutory Books:	Tax Books:
lease income:	9,000	9,000
interest expense:	./ 6,000	0
depreciation:	./ 2,000	./ 2,000
profit:	1,000	7,000
profit allocation limited partners:		
limited partner (majority):	999	999
limited partner (minority) = financing company:		
statutory income	1	1
additional business income: ("interest")	0	6,000
	1,000	7,000

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Moreover, we would like to draw your attention to a provision in connection with the Business Tax Reform Act 2009 under which a requalification of income in the catalogue of limited taxable domestic income in s. 49 par. 1 EStG is planned. This applies to property administration companies having real estate in Germany but their registered office outside of Germany. Up until now the lease of domestic property in Germany resulted in lease income pursuant to s. 21 EStG in connection with s. 49 sub. 1 no. 6 EStG, even if it was to be allocated to business activities; this did not apply if the income was to be allocated to a permanent establishment or if a permanent representative had been appointed in Germany. Thus, the lease income was calculated subject to the excess of the income over the costs and not over standard business profit calculation, including the provision of the limitation of interest deductibility. Up until now it is only the sale of a property or right within Germany that results in business income under s. 49 sub. 1 no. 2 letter f EStG. Therefore, as of 2009, a general requalification of any lease income into business income shall be effected for reasons of "unification";

thus lease income as well as capital gains of foreign property administration companies with domestic property shall principally be subject to the limitation of interest deductibility. One can face this issue in the same way as up to now by dividing the respective property businesses with making use of the threshold of EUR 1m per year.

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