



PROPERTY AND DEVELOPMENT FINANCE IN GERMANY

by Neil Murray

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Abstract

This paper looks at legal and practical issues which may arise for prospective lenders in relation to property investment and development loans concerning property in Germany. Whilst the issues discussed are necessarily subjective, and appropriate legal advice should be taken in all cases, it is hoped that the paper will provide a good guidance in respect of transactions undertaken in Germany, relative to the typical expectations of a lender in respect of a UK deal.

Key Words: Property finance, secured lending, investment and development property, Germany.

Introduction

This is the fourth in a series of papers on property, investment and development finance in certain continental European jurisdictions, previous papers having dealt with Holland, Italy and Spain. This paper deals with the position under German law.

German Real Estate Law

Germany, in common with all other jurisdictions considered in this series of papers, is a civil law country and the law is largely codified.

Absolute ownership of property, comparable to English law freeholds, is recognised under the German Civil Code. Ownership of land extends to the surface, the space above and below it (together with all fixtures), and is enjoyed subject to valid third party rights.

There are certain other proprietary rights in land which are mortgageable, notably condominium ownership in relation to residential buildings and heritable building rights whereby the beneficiary is granted the right to own a building on or beneath the relevant land, subject to paying the freeholder an annual charge. Such right might be compared, from a

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commercial perspective, to an English law long lease at a ground rent (with a capital value). Commercial rack rent leases are merely contractual rather than proprietary interests.

Ownership is evidenced by way of entry of ownership details on the Land Register (*Grundbuch*). The boundaries of the land will be shown on a Cadastral Map (*Liegenschaftskataster*, similar to the ordnance survey map in the UK). The Land Register is kept in the district courts and all ownership and third party rights must be entered in order to be valid. Access to the Register is available to all parties with a "justifiable interest" (*Berechtigtes Interesse*). Such parties would include creditors or a prospective purchaser. Notaries (see below) are deemed to have a justifiable interest.

The Register, whilst not a state guarantee of title as under English law, constitutes evidence of ownership, is deemed to be correct and complete and may be relied upon by all parties acting in good faith. Hence a party acting in good faith can acquire ownership of a property even from a seller who is not the owner in fact, but registered as such. Note that the presumption of the Register's correctness does not extend to non-legal matters such as size or location of the relevant plot, hence site investigation survey by the relevant valuer / surveyor is important. Note that in some areas within the "new states" (i.e. former Eastern Germany) the process of comprehensive land registration has not yet fully been completed.

The Register comprises registers akin to the proprietorship register, property register and charges registers at H M Land Registry. A heritable building right (see above), incidentally, would be registered against the owner of the freehold title. As under English law, the order of registration dictates priority of interests.

A Typical Property Acquisition

Before considering who might lend and what security might be available, let us look at how a purchase would proceed.

German law distinguishes agreements creating obligations (*Verpflichtungsgeschäft*), such as purchase contracts or agreements for loans, and dispositions made to fulfil those obligations (*Verfügungsgeschäft*), such as the transfer document evidencing the passing of ownership / payment of agreed price. Such transactions are legally independent (*abstrakt*) from each other and each is subject to legal formalities.

Under German law, agreements concerning land need to be officially recorded before a Notary (*Notarielle Beurkundung*). The Notary (*Notar*) is a legally trained official appointed by the federal state and obliged to be strictly impartial.

The notarisation requirement extends to the purchase agreement and related documents (e.g. sale and leaseback transactions, agreements for the purchase of a business enterprise, agreements relating to loans and payment procedures). The Notary reads out the whole agreement and explains its legal consequences to the parties where necessary. All parties, or their representatives, must be present.

The Notary is obliged to examine the entries in the Land Register including encumbrances and inform the parties of those entries, usually referring to an excerpt from the Register. Note that if any part of the transaction requiring notarisation is not duly notarised, generally the whole transaction is nullified (*Nichtigkeit*).

Purchase agreements are generally drafted by the parties using their respective external lawyers (i.e. not by a Notary), using fairly standardised provisions, although for non-complex transactions, a Notary might provide a standardised contract. In general, purchase agreements are much shorter than in common law countries as most of the relevant applicable legal provisions are set out in the Civil Code. Notwithstanding that the Notary himself has a duty to examine and explain Land Register entries (see above) the prospective purchaser and mortgagee will also have carried out independent diligence in relation to the property. They may, however, rely on the Notary's investigation of title itself, but it will not cover occupational leases, planning, environmental and other, non-title related, matters where independent diligence would be undertaken).

The transfer of title or other assurance in favour of a purchaser is in practice a fairly simple declaration whereby the

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vendor and purchaser declare the transfer of ownership and apply for registration of the purchaser at the Land Registry as the new owner. The notarised document will not need to contain extensive recitals regarding the chain of ownership.

As stated above, the purchase agreement and actual conveyance are legally independent dispositions but, as the purchaser (and his lender) would have expected to have completed the legal and other diligence at the time of execution of the contract, the two documents are invariably executed and notarised at the same time (but money will not change hands until a priority notice has been registered - see post). The UK concept of exchange with completion a month or so later is not common in Germany. However, legal title will only pass upon registration of the new owner on the Land Register. The relevant application may be filed by the vendor, purchaser or the Notary. All Land Registry entries must be in German.

The purchaser will obviously not wish to hand over the purchase price in the absence of securing legal ownership of the property. As that only happens upon registration on the Land Register, in practice, a purchaser will typically hand over the purchase price upon the registration of a "priority notice" (*Vormerkung*). This is an entry on the owner's Land Register protecting the purchaser's prospective ownership of the relevant property. Its effect is that, once entered, any disposition by the vendor (who of course retains the legal ownership pending formal registration of the purchaser on the Land Register in his place) which adversely affects the purchaser's right is invalid as against the third party seeking to benefit from such disposition. Registration of a priority notice can take between a few days to several weeks. The purchaser's interest is then protected, even though it may take several months (or even years in difficult cases!) before formal registration of the purchaser's interest on the Land Register is completed.

A prospective mortgagee is in no different position to the purchaser. It will not wish to make available the loan in the absence of satisfying itself that its position is secure, even though the relevant security (as to which, see below) will not, at the time of the loan have been formally registered at the Land Registry. It is common for banks to require a notarial confirmation that there are no obstacles to the registration of the mortgage, reflecting the agreed priorities position, to cover the situation whereby the mortgage will not have been registered prior to disbursement of the loan advance.

In reality, the above position is comparable to the position under English law, whereby legal title in the name of the purchaser, and a legal mortgage over the relevant property will not occur until registration at H M Land Registry. In practice, the acquisition loan would be made, and the purchase price handed over at the time of execution and delivering the transfer, on the basis that the parties are comfortable that registration will succeed and the purchaser and mortgagee have each secured priority (by a clear pre-completion search) in respect of its application to register. The difference is that, in Germany the contract, transfer document and mortgage would have been executed and notarised, but the money handed over not then, but upon registration of the priority notice.

Sometimes, there may be special circumstances whereby the vendor will be particularly concerned to have a financial assurance at the time of execution / notarisation of the purchase contract and transfer that the purchase price will definitely be paid by the purchaser upon registration of the relevant priority notice. Conventionally, in the event of non-payment, the vendor would seek to unwind the transaction (ie. have the property re-transferred to him). In a recent transaction, however, there were particular reasons why that remedy alone was not attractive to the vendor, notably the fact that, for tax purposes, it needed to have disposed of the property prior to the end of its financial year, even though receipt of the purchase money would have to wait until registration of the relevant priority notice which would only have occurred after such period. (Note that a disposal for tax purposes occurs at the time of signing of the purchase agreement and title transfer rather than actual receipt of funds). Furthermore, there existed a third party pre-emption right which, if validly exercisable and duly exercised, could have upset the relevant transaction between vendor and purchaser with the result that the vendor might not have been paid.

The choice for the vendor in that case was provision by the purchaser of a bank guarantee for payment of the purchase price or assignment by the purchaser to it of the purchaser's right to funds under the loan agreement with its financiers in relation to the provision of funds on the relevant date for payment (such financiers having satisfied themselves that they could provide such a commitment, having done all appropriate diligence and concluded that the possibility of the aforesaid third party right being exercised was remote). Another option might have been for the purchase moneys to have been placed into an escrow account with the Notary (*Notaranderkonto*) on the basis that it would be released to the

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vendor upon registration of the relevant priority notice.

Regarding tax, typically the Notary will inform the tax authorities of the taxable disposition in respect of the property within two weeks of the same and, provided the tax authorities are satisfied that the relevant transfer tax (see below) has either been paid or that payment is secured, a tax clearance certificate will be issued, which is presented to the Land Registry.

Notaries' fees are calculated in accordance with the Cost Ordinance (*Kostenordnung*) and remember that both the purchase contract and the transfer or other assurance of ownership need to be separately notarised. As a rule of thumb, for commercial property transactions, one would allow approximately one per cent of the purchase price in relation to notarial/land registry fees. In addition, real property transfer tax is usually paid by the purchaser although the vendor and purchaser are jointly and severally liable to the tax authorities. Such tax is also levied where ownership or economic control changes hands (eg. by way of a sale of a company owning the relevant property). Tax is levied at 3.5 per cent of the total consideration. In the case of passing of control by a share acquisition, the tax is levied on the market value of shares. Most real property transactions are VAT exempt.

The purchaser/mortgagee will also need to take care to make sure that the relevant disposition of the property does not infringe public or private restrictions on sale. Special approvals may be required under the local authority ordinances concerning protected/conservation areas (*Millieuschutzsatzung*), areas the subject of general restructuring (*Umlegungsgebiete*), designated for redevelopment (*Sanierungs- und Entwicklungsgebiete*) and under real estate transaction ordinances (*GVO*) where ownership in former East German states might still be disputed.

Who are the Lenders and what Security can be taken?

Foreign banks interested in lending in German real estate transactions will be competing with German private commercial banks, savings banks and mortgage banks.

Most banks are private commercial institutions. Some are public institutions eg savings banks (*Sparkassen*), whilst others specifically provide property finance, notably mortgage banks (*Hypothekenbanken*) and building societies (*Bausparkassen*).

The savings banks are public law institutions established for the public benefit by a local, regional or state authority. The authority is liable for claims against the relevant savings bank by its creditors although such state guarantees are expected to contravene EC legislation on state subsidies and so are to be abolished, after a transition period, in 2005.

Hypothekenbanks are subject to the Mortgage Banks Act (*Hypothekbankgesetz, HPG*). They raise money primarily by issuing mortgage-backed bonds (*Hypothekpfandbriefe*) or public bonds backed by state guarantees. In general, *Hypothekbanks* may provide mortgage finance only up to 60 per cent. of the property value. (Hence, in the UK, they are obvious takers for the so called "super senior" piece of a property finance transaction!)

Security over Property

The two most common types of security over property are mortgages (*Hypotheken*) and land charges (*Grundschulden*). The latter tend to be used to a greater extent in commercial transactions as they can be more flexible and some of the legal formalities applicable to *Hypotheken* do not apply to *Grundschulden*.

Both are registerable on the Land Register and as with other continental European jurisdictions, must secure an identified sum, i.e. UK-style "all monies" mortgages will not be effective. The maximum amount secured is typically set at a level above the principal amount of the proposed loan to ensure that the mortgage fully covers fees and interest, including default interest.

Obviously the higher the amount, the higher notarisation and registration fees. The maximum amount will comprise

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principal plus a fixed additional amount or percentage of the principal amount, typically 10-15%. Note, however, that enforcement costs themselves are statutorily recoverable as part of the mortgage debt and do not therefore need to be included in such maximum amount.

The difference between *Hypotheken* and *Grundschulden* is that the former are strictly tied to the monetary obligations secured by them. They can be transferred only together with the obligation (i.e. loan and mortgage together) and, by law, once the loan or other obligation is repaid/discharged, the mortgage is discharged and the owner will hold free from it.

The *Grundschuld*, however, is capable of existing independently from the obligation which it secures. This makes for a range of possible positions as between mortgagor and mortgagee:-

- (i) the holder of a *Grundschuld* could transfer it for value or otherwise to a third party. The owner/mortgagor could therefore be faced with a monetary obligation to the original lender and a third party transferee holding an encumbrance, now unrelated to the original loan or other obligation, over its property, which is clearly undesirable for the mortgagor;
- (ii) after repayment of an initial loan, the *Grundschuld* could be used to secure further loans or other facilities made available by the same lender, if the provisions of the *Grundschuld* so permitted. However, the amount recoverable upon enforcement would remain at the maximum secured amount set at creation of the security (see above). This has potential cost-saving advantages in the case of on-going banking facilities and is getting closer to the English law concept of an all monies continuing security, albeit only up to the specified maximum amount;
- (iii) a *Grundschuld* already registered at the Land Registry could be assigned to another creditor who could use it to secure a loan made by it (assuming that the terms of the charge so permitted), although that is unusual. Typically, if a new loan is to be made by a new lender, any existing land charges would be cancelled and the new creditor would take a new charge.

The terms of the *Grundschuld*, particularly as to what it secures, are therefore important. Invariably the parties will wish to make sure that the security created by the *Grundschuld* and the obligations secured by it are properly connected. This means:-

- (i) a loan agreement;
- (ii) the *Grundschuld* instrument itself; and
- (iii) an agreement whereby the holder of the *Grundschuld* agrees that it secures *only* the relevant loan or other obligation and may *not* e.g. be transferred independently from it (*Sicherungsabrede*). In that way, the security is linked to the underlying loan.

Conversely, the property owner might find it attractive to repay the original amount secured whereupon the *Grundschuld* would, unless discharged, remain as an entry on the register. It would have become *Eigentümerge Grundschuld* ie. a land charge which has effectively accrued for the benefit of the owner so that, if the owner wished to borrow money again, he might be able to offer that *Grundschuld* as continuing security in the hands of the new creditor, thereby saving further registration fees (and, possibly, preserving the first ranking nature of the security), liability for which would otherwise be visited upon him! However, such a technique is more likely to have application in a private, rather than commercial property lending, transaction.

Note that *Grundschulden* come in two varieties, namely certified and registered formats (*Briefgrundschuld* and *Buchgrundschuld*). Both require registration. Certified land charges make for easier transferability as transfer of the same may occur simply by written agreement and handing over of the relevant certificate. Registered land charges can only be transferred by registration of the new holder of the charge at the Land Registry. The mortgagor could not then avoid the obligation to repay the assignee the mortgage debt, whereas, in the case of certified charges, if the certificate

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was lost, it might be difficult for the certified charge holder to claim repayment. A transferee would not have the comfort of registration in his name at the Land Registry, which would put his claim beyond doubt.

Whilst *Hypotheken* and *Grundschulden* require registration at the Land Registry, there is no companies registration procedure comparable to lodgement of a Form 395 in the UK (the UK sanction being that without such registration, inter alia, the charge is void against a liquidator). There is, however, a commercial register where certain details regarding the relevant company must appear.

Other Security

The other forms of security referred to in previous papers in this series can also be taken under German law:-

- **Assignment of rental income:** as under English law, a mortgagee with a *Hypothek* or *Grundschuld* has, inherently, the right to collect rental income in the course of enforcement. The reason why a lender would wish to take a separate assignment by way of security over rental income is to avoid having to go through what is a protracted foreclosure procedure under German law (see below) in order to get its hands on the relevant rental income. The assignment by way of security, will, upon default, enable the lender to collect rent immediately upon default. As all security under German law, as with other continental European jurisdictions, is asset specific, the rental income concerned must be sufficiently identified. However, identification of "all rental income for the time being in relation to the mortgaged property" is considered to be sufficient identification, i.e. it is not necessary to refer to each and every lease, which would mean that, as further leases were granted, further specific security would need to be taken.
- **Pledges over accounts:** eg. designated rental income and other accounts. A lender may, if it wishes, require that the borrower or its rent collecting agent remits money to a blocked account, although it is not common practice to obtain a so-called "duty of care" letter from the managing agent for the property containing a direct undertaking to the lender to deal with the rent in accordance with the lender's requirements.
- **Share Pledge:** over the issued share capital of the Borrower. This is a not unusual requirement and provides the Lender with an alternative method of enforcement by way of taking control of the Borrower company. In case of a pledge over shares of a public listed company (*AG*) notarisation is not needed, whereas it is in other cases, especially private limited companies (*GmbH*) the pledge will require notarisation and is subject to a notarisation fee. There are no requirements in either case to register the pledge in a public registry.
- **Guarantees:** Shareholder or other third party guarantees do not need to be in writing in the case of a transaction involving "traders" as defined in the Commercial Code, but usually are. They do not require notarisation and there are no registration requirements.
- **Pledges over insurances :** in general, a mortgagee will have no inherent right to insurance monies unless it is a party to the insurance contract itself. Joint insurance is possible but unusual. Typically, the Borrower/property owner will assign by way of security to the Lender the benefit of the relevant insurance. In the event of damage or destruction of the mortgaged property, the assignment of the right to insurance monies, perfected by way of notification to the relevant insurer, will effectively enable the lender to control disposition of insurance monies.

In the case of property subject to leases, if the building is destroyed, performance of the lease contract becomes impossible, so the lessee does not need to continue to pay rent. The same result could be achieved by the tenant applying for a rent reduction (*Mietminderung*), even down to zero, in the case of damage.

To that extent, the Lender should be concerned with availability of loss of rent insurance, as in the UK. Also, from a marketability / value of security perspective if nothing else, the Lender will need to have regard to the state and condition of the property upon damage or destruction, which may mean using insurance monies in or towards reinstatement as opposed to repaying the mortgage debt. It is also possible that the terms of the tenant's lease would oblige the borrower / landlord to utilise the insurance monies to reinstate although, as a matter of law, the landlord is not under an obligation to do so. The terms of the policy itself might, however, specify application in or

towards reinstatement.

Cross Collateralisation is not easy to achieve. As stated above, a maximum secured amount must be inserted in the *Hypotheken/Grundschuld*, inclusive of rolled up interest, fees etc. The relevant security will therefore secure the loan which appertains to the property over which the security was created. In a portfolio situation, or an ongoing banking relationship, where different properties might be owned by different subsidiaries within a corporate group, the Lender would wish to ensure that, if, upon enforcement, there existed excess proceeds from the sale of one property owned by one subsidiary, it could be used to help pay off a loan secured on a property owned by another subsidiary which might not be adequately secured by that other subsidiary's property value i.e. cross-collateralisation would apply.

This would be achieved by putting in place a cross-guarantee structure whereby each subsidiary would guarantee the obligations of each other subsidiary in a group, coupled with all monies mortgages. However, upstream and cross-guarantees can be problematic under German law and, as we have seen all monies mortgages, in the full UK sense, are not achievable.

In the more straightforward situation where a single borrower takes out two loans from the same lender to buy two properties, provided that the maximum amount secured by each mortgage is not exceeded, it should be possible, by express terms of the security provisions (see under Grundschulden above) to use excess proceeds from one property to repay the loan in relation to the other. The problem in that regard is that, in order to keep down the amount of fees for each mortgage, it would not be likely that either mortgage would stipulate an unnecessarily high amount of the maximum amount secured by it.

Syndicated Loans

So far as holding security is concerned, if one was to look at the Land Register, one would see all of the mortgagees cited as joint holders of the security, without any specification as to relative shares (which is an internal partnership matter).

In the case of secured syndicated facilities, lenders usually form a civil law partnership: *Gesellschaft bürgerlichen Rechts* ("GBR"). In fact the law is such that a GBR will exist, de facto, merely by nature of two or more parties entering a transaction with a common goal. The relevant lenders would be well advised to regulate such a partnership by express terms (though perhaps a formal GBR agreement might be dispensed with, say, in the case of a 'club' deal where the lenders are used to dealing with each other). The lenders, as partners, would be able, through the partnership agreement to agree on their respective shares in the loan and other entitlements as well as requisite majorities for administration of the loan and enforcement of security. Transfers of partnership entitlements (ie. facilitating transfers of the whole or part of a lender's participation in the loan) could also be catered for.

As for English law partnerships, the GBR is not itself a legal entity. It is effectively represented by its component partners but the partnership's assets constitute a discrete body of assets, separate from the other assets of each partner.

One of the lenders could act as lead bank in relation to the facility (as under an English law syndicated loan agreement) if the terms of the GBR so provided. The loan agreement could also reflect such arrangements, with agreement of the borrower. Hence, one lender could, in the name of, and with the authority of, the other partners administer the facility (issue consents etc) and, if agreed, dispose of the property in an enforcement situation.

The above is not the same as the English law concept of the lead bank holding security on trust for the lenders generally, such that all lenders are thereby secured creditors, but the commercial effect is similar. The lenders as joint holders of the security, would together, be secured creditors and the GBR would govern their rights, which they could agree might be exercised on their behalf by one or more of them.

Alternatively, one lender could underwrite the whole loan and sub-participate on a contractual basis, as under English law.

Enforcement

In commenting on enforcement procedures, it is assumed that the security is valid and does not fall foul of insolvency-related legislation (i.e. akin to the rules on fraud against creditors, transactions at an undervalue, transactions capable of being set aside as preferences etc.), all of which are outside the scope of this paper.

In the case of security over land, upon default, the mortgagee will apply for the mortgaged property to be subject to compulsory sale by public auction (*Zwangsv versteigerung*) or judicial receivership (*Zwangsv verwaltung*). In each case a court order is required and the court will, upon a successful application, order an appropriate entry to be made in the Land Register relating to the relevant property.

Invariably, however, a lender will require the borrower to agree, ab initio, that immediate enforcement without a court order, shall apply (*Vollstreckungsunterwerfung*), in which case, the mortgagee could proceed immediately with the requisite auction or other realisation process. Such agreement must be notarised, together with the mortgage instrument itself.

Without such agreement on the part of the borrower, enforcement proceedings can become protracted and could easily take several years, depending on the local courts and the defence of the debtor. Where such agreement, duly notarised has been reached, the procedure is quicker, (but can still take months). This is in stark contrast to the position under English law where demand can be made immediately on default, followed by appointment of a receiver or like officer in short order!

An interesting procedure is often adopted by lender and borrower in order to mitigate the cost of notarisation of the *Vollstreckungsunterwerfung*. The notarised agreement will specify that immediate enforcement only applies to the last 10% or so of the mortgage debt (*Zuletzt zu zahlender Teilbetrag*). The applicable notarisation cost will therefore only apply to that proportion and will be much cheaper. Upon enforcement, the mortgagee will then be able to claim immediate enforcement in relation to the last 10%, which obviously will entail proceeding to recover the first 90%!

This procedure is without prejudice to the fact that the mortgage itself will need to secure the mortgage debt and related interest etc, up to the maximum amount stated in the charging document (see above).

Development/Construction Finance

We have seen in previous papers in this series how collateral warranties and duty of care agreements, including "step-in" rights are both common and important under English law, particularly having regard to the vagaries of the English law of tort (i.e. to whom is there a duty of care owed and what is the extent of liability for loss)?

Extensive express contractual provisions are less prevalent under German law as, under the German Civil Code relating to contracts, the law supplements the express contractual obligations of the parties to one another and imposes duties and warranties which, to a large extent, obviate the need for extensive express statements in that regard under the terms of the contract.

Nevertheless, it is not possible for a lender, as a third party, to claim contractual damages based on a contract (e.g. building contract, professional's terms of engagement) between the borrower / property owner and the other contracting party. Hence, the usual position is that a lender has assigned to it by way of security all the borrower / property owner's rights as security. However, the duty of care / step in agreements themselves are not common.

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