



## How tenant insolvencies affect real estate financing

# A. Introduction

## How tenant insolvencies affect real estate financing

*Particularly due to the Covid-19 pandemic, landlords of commercial space are facing a growing risk of tenant insolvencies. This is especially true for landlords of retail, restaurant and service spaces. In addition to the direct impact tenant insolvencies have on the landlord's operating business and income, there is often also the threat of an impact on the financing agreements concluded by the landlord.*

Landlords should therefore in particular examine their financing agreements with regard to provisions on compliance with financial covenants and for possible termination rights (e.g. due to payment default, good cause or due to any material adverse change) and, if necessary, proactively seek discussions with their financing partners.

Therefore, we are providing a brief overview here of the most relevant consequences of tenant insolvency for financing agreements, termination of the lease by the landlord, termination of the lease by the insolvency administrator and the recoverability of rent receivables.

## B. Termination by the landlord

If the tenant does not pay the rent, the landlord cannot exercise either contractual or statutory termination rights if the arrears result from the period before the application for commencement of insolvency proceedings (section 112 German Insolvency Code (InsO)). Also, rent arrears incurred between 1 April 2020 and 30 June 2020 and based on the effects of the COVID-19 pandemic do not entitle the landlord to any extraordinary termination until 30 June 2022. However, a termination due to arrears is possible if the arrears arose in the period after the application for the commencement of insolvency proceedings.

Therefore, if the tenant (i) fails to make rent payments on two consecutive dates or fails to pay a not insignificant part of the rent or (ii) is in arrears with an amount equivalent to two months' rent for a period longer than two payment dates, the landlord may terminate the lease by law even in the case of tenant insolvency (section 543(2) no. 3 German Civil Code (BGB)).

However, prior to any termination, the landlord should review its financing arrangements to see whether the termination issued to the tenant will trigger any termination rights or any other rights of the lender under the loan agreement.

In this regard, the following issues may be considered:

- Does the financing contain a “material lease” concept and, if so, is this triggered by the termination (thresholds regularly apply with regard to rental space, rental income or similar). What are the consequences for the financing?
- Is there a contractual ground for terminating the financing in the event that a tenancy is terminated (this regularly applies in the case of single-tenant properties or strong anchor tenants)?
- Are the financial covenants still complied with after termination (WALT, DSCR) and if not, what are the consequences for the financing?

Some financing agreements stipulate that a minor breach of the financial covenants does not lead to a termination right, but only to an increase in the interest rate.

## B. Termination by the landlord

Even a minor breach of the financial covenants may result in other legal consequences, such as the borrower's obligation to deposit free cash (cash trap/cash sweep mechanisms) or not to make any further distributions.

- Are there covenants in the financing agreement that are breached by the termination, and if so, what are the consequences for the financing?

It should also be evaluated whether grounds for termination due to any "material adverse change" or "deterioration of financial condition" could be considered (see below under [C] for more details). However, if a termination is initiated by the landlord, the landlord usually has to present good arguments to the lender that these grounds for termination are not relevant, since the landlord (as borrower) exercises the right of termination even though the landlord knows the risks in relation to the bank financing.

If the landlord (as borrower) recognizes the risk of termination by the bank according to the principles outlined above, it is in our view regularly advisable to contact the lender and explain the intended termination as well as the reasons for it.

In this respect, it can regularly be considered whether a lender, before giving notice of termination of the loan agreement, asserts or must assert a right to subsequent collateralization, as this is regularly seen as a milder means compared to a termination (and regularly takes effect if the application of the bank's T&Cs are agreed). However, the collateral package already granted must be evaluated and it must be checked whether the borrower can grant further collateral at all.

## C. Termination by the tenant

Once insolvency proceedings have been commenced with regard to the tenant's assets, the insolvency administrator or - in the case of debtor-in-possession management - the tenant itself has the right to terminate the tenancy with a notice period of three months. This special right of termination can be exercised during the entire duration of the insolvency proceedings, so it is not necessary that it is exercised within a certain period from the commencement of insolvency proceedings.

In the event of termination by the tenant, the same termination rights with regard to the financing as in the case of termination by the landlord must initially be observed.

In addition, termination of the financing is possible on the following grounds:

### **Termination due to a "material adverse change"**

Syndicated loan agreements usually entitle the lenders to terminate the contract if circumstances arise that lead or are likely to lead to any material adverse change in a

borrower's business, financial position, results of operations or earnings prospects (referred to as a material adverse effect or material adverse change [MAC]). Corresponding provisions can also be found in bilateral loan agreements.

Whether effects on the business activity or the earnings situation based on the termination by a tenant can trigger the legal consequences of a MAC depends on the specific circumstances and the MAC provision agreed in each case. It is also relevant whether according to the relevant clause the deterioration must have already occurred or is only imminent. Even if, according to the wording of the MAC provision, the lender can terminate the credit facility because of expected future developments, it must be carefully examined in each individual case whether this prognosis holds with sufficient certainty or whether the termination (or the suspension of a credit facility as a "minus" to the termination) is ultimately to be considered inadmissible because the expected deteriorations turn out to be short-term and ultimately not material.

# C. Termination by the tenant

## Termination due to “deterioration of the financial situation”

Outside of mezzanine financing, the applicability of section 490 of the German Civil Code (BGB) to loan agreements under German law is usually not contractually excluded. According to section 490 German Civil Code, the lender has the right to terminate a loan agreement without observing a contractual or statutory notice period if a significant deterioration in the financial situation of the borrower or in the value of collateral provided for the loan arises or there is a risk that such deterioration will arise, which endangers the repayment of the loan, even if the collateral is realized.

Similar provisions can also be found in the general terms and conditions of many credit institutions. If the consequences of the termination by the tenant have the effect that the borrower’s financial situation or collateral deteriorates drastically (e.g. because it is the only tenant or a very important anchor tenant), the lender may have a right of termination according to section 490 German Civil Code or due to included general terms and conditions.

The landlord’s claim for damages pursuant to section 109(1) sentence 3 German Insolvency Code in the amount of the defaulted rent payments does not change this result, as it is merely an insolvency claim that is usually not recoverable (see below under [D] on the recoverability of insolvency claims).

## D. Rent claims

Rent claims of the landlord that arose before the commencement of insolvency proceedings are usually only insolvency claims, i.e. they are only satisfied with the insolvency dividend from the estate if all preferential claims have been satisfied. Such insolvency claims can often only be serviced to a very small extent.

In contrast, rent claims arising after the insolvency proceedings have been commenced are preferential claims. These are paid in full as long as the estate is sufficient. In addition, the insolvency administrator is liable if the assets of the insolvency estate are not sufficient to meet the claims, if this was already apparent to the insolvency administrator when the claim was created.

If the tenant no longer pays rent and/or the lease is terminated, the corresponding cash flow ceases to exist for the landlord. If the landlord is then no longer able to meet its interest and/or redemption obligations, grounds for termination under the loan agreement regularly arise very quickly.

Even if the landlord/borrower still pays the interest and (if owed) redemption payments from other funds despite the loss of the rent, the loss of the rental income or the lease (especially in the case of single-tenant properties or an anchor tenant) can lead to a failure to achieve the planned corporate result. This, in turn, can lead to a breach of agreed financial covenants, which regularly leads to further consequences (e.g. creation of a termination right, increase in interest, discontinuation of collection rights).

The remedy of (anticipated) breaches of contract, including termination rights, is usually effected by means of a waiver letter in which the financier waives the assertion of sanction options.

However, waivers or associated contractual adjustments can usually only be obtained against payment of a fee or risk premium and with a certain lead time. It is important to proactively seek dialogue with the financing partners in good time and, if possible, already before the occurrence of disruptions due to tenant insolvency and/or payment defaults.

# Your contacts

Our REIG experts are there to assist you.



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