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PRESSURE POINTS: COVID-19 RELATED CLOSURES OF COMMERCIAL PREMISES RESULTING IN A FRUSTRATION OF CONTRACT (STÖRUNG DER GESCHÄFTSGRUNDLAGE) - DOES NEW LEGISLATION PROVIDE CERTAINTY?

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Legal Briefings

On 17 December 2020, the German Parliament adopted a law, which among others, includes the implementation of the following provision:

"Frustration of Contract regarding Lease Agreements
If, as a result of government measures implemented to control the Covid-19 pandemic, leased premises (except for residential premises) cannot be used for the tenant's business or can be used only with considerable restrictions, it shall be assumed that a circumstance within the meaning sec. 313 para 1 of the German Civil Code which forms the basis of the lease has changed materially after the conclusion of the agreement."

According to the legislative materials, this is intended to strengthen the negotiating position of commercial tenants. However, the applicable provisions of lease law regarding rent reduction and impossibility of performance shall have priority. Only if neither a defect nor an impossibility of performance applies, the new provisions shall be applied.

An analysis of the regional court decisions existing to date on this subject, however, raises doubts that this new provision will be able to provide the expected clarity.

The majority of the decisions to date (LG München II (13 O 1657/20) dated September 20, 2020, LG Frankfurt a.M. (Az. 2-15 O 23/20) dated October 2, 2020; LG Zweibrücken (Az. HK O 17/20) dated September 11, 2020, LG Heidelberg (Az 5 O 66/20) dated July 30, 2020) come to the conclusion that a temporary closure of the leased premises does neither constitute a defect of the leased premises nor an impossibility of performance.

The regional courts deny the existence of a defect of the leased premises due to the public measures ordering a closure not being based on the nature, condition or location of the leased premises, but rather affecting certain types of stores with public traffic all across the country. The decisions are thus in line with the previous cases – dealing with matters not related to the pandemic – handled by the German Federal Court of Justice (*Bundesgerichtshof*), which qualifies public-law restrictions regarding the use of leased premises as a defect only in cases where the restriction has its cause precisely in the nature, condition or location of the leased premises.

An exception among the regional courts is the regional court München I (3 O 4495/20 dated September 20, 2020), which qualifies the restrictions imposed due to the Covid-19 pandemic as a defect of the leased premises and assumes a reduction of rent by 80% for the period of complete closure. In the verdict, reference is made to four decisions of the Supreme Court of the German Reich (*Reichsgericht*) issued between 1913 and 1917. In each of these verdicts, the official orders had been assumed to constitute a defect of the leased premises. Although the regional Court Munich I did not completely ignore the guidelines of the German Federal Court of Justice, it assumeds without providing arguments to support its opinion that the closure had its cause in the concrete condition, location or relationship of the leased premises to the environment and referred to the purpose of the lease as per the lease agreement. In the opinion of the regional Court München I, the official restriction affects the contractually presumed possibility of use of the leased premises itself. From our point of view it is doubtful whether this verdict will be upheld by a court of appeal.

All other regional courts scrutinize whether frustration of contract applies and eventually deny this. Would this change once the draft provision becomes binding law?

The regional court München II assumed - with reference to the legislative materials - that previous legislation implemented as a response to the pandemic in March 2020 had a blocking effect regarding the legal figure of frustration of contract, as the legislator had deliberately decided against changing the due date of the rent or providing for a right of the tenant to reduce rent when introducing such provisions. This argument of a blocking effect will become obsolete with the implementation of the new provision.

The regional court Frankfurt considered it as doubtful whether the parties would really have concluded a different (long-term) lease if they had been aware of a (in this case) one-month closure. This is, however, one of the prerequisites for an adjustment of the contractual terms pursuant to sec. 313 para 1 of the German Civil Code. The court did not elaborate further on this question since in its opinion an adjustment of the lease agreement could not be claimed by the tenant in any event because the risk of making a profit with the leased premises vests solely with the tenant. This contractual distribution of the risk in the opinion of the court prevents an adjustment of the provisions of the lease agreement due to frustration of contract.

This argument will most likely no longer be valid upon the implementation of the new provisions since one of its rationales reads as follows : "However, it must be assumed that in the absence of corresponding contractual provisions, burdens resulting from government measures to combat the Covid-19 pandemic are regularly not to be allocated to either the sphere of the landlord or the tenant".

The regional court Heidelberg ruled that a closure order may constitute a frustration of contract. However, after weighing the contractual distribution of risks, in the court's opinion, an adjustment of the lease contract could only be conducted if the tenant demonstrated a threat to its existence or a comparable economic situation, which is not the case in the event of an only temporary loss of turnover.

The regional court Zweibrücken did not elaborate on the question of whether a closure order results in a frustration of contract, because the risk assessment was not in favour of the tenant. The court pointed out that, irrespective of the actual use by the tenant, the landlord regularly had to continue to honour ongoing financing and maintenance costs, which were not subject to any relief. The tenant, on the other hand, could achieve compensation via state aids and thus at least partially be reimbursed for income losses. In addition, the loss of income could be covered by business interruption insurance. The court points out that an entrepreneur could reasonably be expected to react to unforeseen losses in turnover in another way than stopping to honour its own contractual obligations, at least in the short term.

In summary, it seems not likely that the existing cases would be decided differently by an appellate court, even in light of the new legislation, unless the second lockdown leads to a hardship on the part of the tenant that threatens its existence.

As a result of the new legislation future court decisions will probably focus on whether or not the burdens imposed by closure orders are bearable. Loss of turnover, saved costs and state aids will be relevant factors. An adjustment of the lease contract will only be considered in the case of significant losses and not in the case of only temporary losses of turnover or liquidity bottlenecks. However, in cases where the existence of a tenant was threatened, even the current legislation provided room for a frustration of contract and the existing verdicts respectively acknowledged this. Thus, it may be that the new provision will for the most part be of a symbolic character. It will, however, certainly trigger new negotiations between landlord and tenant, which may lead to a mutual agreement regarding the distribution of the economic burdens.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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