THE PROJECTS AND CONSTRUCTION REVIEW

EIGHTH EDITION

Editor
Júlio César Bueno

THE LAWREVIEWS

Chapter 12

GERMANY

Nadejda Kysel, Alexander Thiermann and Maximilian Zeun[1]

I INTRODUCTION

Germany has recorded stable economic growth since 2010. Financing interest rates are at an all-time low. This is reflected in a consistently good market situation for commercial real estate, and the residential property market is also being driven by particularly high demand as a result of the financial crisis.

As a consequence, throughout the property market, including many B and C locations, demand exceeds supply. Growth is limited by a lack of real estate plots eligible for the relevant projects, but also by other factors such as newly introduced rent control regulations or building regulations on energy saving, which put further pressure on the market and drive prices. The construction industry, which a few years ago complained about the long-standing ruinous price war, is currently struggling with under capacity and supply bottlenecks.

Property prices have risen at an increasing rate in recent years, and the latest statistics, for February 2018, show a nationwide price increase of between 4 per cent and over 5 per cent compared to the previous year depending on building type and region.[2]

Owing to the favourable economic situation, a lot of project developers are active in a large number of attractive projects in major cities such as Berlin, Hamburg, Düsseldorf and Munich. The German real estate market is regarded as a safe haven in Europe and foreign investment represents about 45 per cent of capital.

In Germany the main financing institutions active in the area of real estate project finance are the covered bond banks. In addition, some pension funds and insurers provide direct lending. In terms of infrastructure financing, the state banks, such as saving banks and other public banks, and the development bank KfW, play the material role. However, alternative players and financing structures are now more important in the market.

The stable, high transaction volume and the associated high demand in the German real estate market, combined with the relatively low supply of land, mean that investors increasingly want to secure attractive properties at a comparatively early project stage (sometimes even before the building permit is granted). Consequently, market participants are increasingly favouring forward deals. Investors are therefore more open to development risks, which they used to avoid at all costs. Depending on the type of contract, this can

1 Nadejda Kysel is a salary partner, Alexander Thiermann is a senior associate and Maximilian Zeun is an associate at Arnecke Sibeth Dabelstein mbB.

2 https://de.statista.com/statistik/daten/studie/164936/umfrage/entwicklung-der-baupreise-in-deutschland, accessed 18 June 2018.

provide the project developer with financial security. However, as investors are still reluctant to take on planning and project development risks, the contract design of a forward deal is unique and highly complex, owing to the different interests involved.

II THE YEAR IN REVIEW

German banks are experiencing difficulty as a result of very strong competition and dumping conditions for straightforward loan financing, which they have to manage alongside constantly increasing regulatory requirements.

Furthermore, the German Supreme Court decided in 2017 that raising of the arrangement fees by the banks, if this was agreed as part of the general business conditions, is not valid and may be contested by the borrowers. This rule has applied to consumer loans since 2014, but with this decision the Supreme Court broadened its application to institutional borrowers. As the banks usually document the loans using the standard documentation provided by the Loan Market Association or the German Association of Covered Bonds Banks, or their standard house style document, most of the loans are based on general business conditions. Primarily, the banks were concerned about the claims raised by the borrowers, but almost no claims were raised by borrowers as the arrangement fees were considered as costs for the loan. However, there is still some risk and therefore the banks are considering reliable solutions. For example, the fees could be personally negotiated between the bank and the borrower, and the borrower could be offered an option to pay a higher margin for the loan. Another solution is to choose foreign law as the applicable law for the arrangement fee letter, but this only works if the transaction has a link to a foreign country.

Banks are concerned about the limited possibility to raise arrangement fees as in the context of low margins and high regulatory costs, this was essentially the only chance to make money with the standard lending products.

The topic that has attracted the most attention from construction lawyers and the construction industry is the reform of construction contract law in the German Civil Code (BGB) – the most comprehensive since the BGB came into force over 100 years ago – which came into effect on 1 January 2018.[3] This is addressed in Section III.

III CONSTRUCTION CONTRACTS

From the manufacturing of household furniture to the erection of a highly complex building, such as a skyscraper or even a complete airport, the BGB has basically provided the same legal provisions since its creation in around 1900: the provisions of the statutory work contract law in accordance with Section 631 ff. BGB.

The regulatory gap in the BGB with regard to construction contract law was a particular problem because the majority of the statutory provisions on contracts for work and services were unsuitable for more extensive and long-term construction projects. In view of the enormous importance of the construction industry, this was a remarkable state of affairs, particularly with regard to long-running construction projects.[4]

For cost and efficiency reasons alone, it is common practice for the planning process to be carried out during construction. The duration of a building project itself, but also

3 See Federal Law Gazette 2017 I 969.

4 See the reason for the legislature's decision, BT Drucks. 18/11437, page 1.

the planning process, regularly leads to the need for subsequent changes with regard to the services the building contractor is asked to perform. In such cases it is necessary to give the client the possibility to change or extend the construction work unilaterally.

As the BGB did not expressly grant the builder-owner the right to unilaterally modify the contract, clients had to make specific provision for this.

In construction, the need for a contractual regulation more specialised than the BGB led to the General Contract Provisions for the Performance of Construction Works (the VOB/B), which has been used since 1926. The VOB/B is a set of rules drawn up by the interest groups of the parties involved in construction (i.e., a committee composed of the client and the contractor), which contains a large number of regulations suitable for extensive and long-term construction measures.

However, the VOB/B is not statutory law, but is defined as general terms and conditions in Sections 305 ff. BGB, which, in principle, are also subject to restrictions based on the fairness of adhesion contracts.

One of the most significant renewals through the reform is the right of the customer to issue orders for changes to services. If the customer requests and orders such a change to the contract, the parties are initially obliged to seek an agreement on this. The agreement shall relate both to the changed performance and to the resulting additional or reduced remuneration. As a result of the customer's request for changes, the contractor is obliged to prepare an offer for the additional or reduced remuneration. If no agreement on the change and its remuneration is reached between the parties within 30 days after receipt of the change request, the right of the customer to unilaterally order the change arises and the contractor is then obliged to carry it out.

What was intended by the legislature as a maximum period of time in good faith, however, in practice provides the contractor with a 'torture tool'. The contractor can exploit the 30 days and, during this time, bring the site to a virtual standstill – this occurs in particular if the contractor does not carry out any work with regard to the supplementary performance under discussion during this period. This provides the contractor with the means to exert pressure to enforce favourable supplementary offers.

Both the amicable amendment of the contract and the amendment of the contract owing to a unilateral order naturally have an effect on the remuneration for work and services. Following the reform, the legislation now provides the parties to the construction contract with guidelines for the remuneration for the modified or additional services.[5]

If the parties cannot agree on the amount of the additional remuneration for the changes to the services, for example, the contractor can set 80 per cent of the additional remuneration specified in its 'amendment offer' (Section 650, Paragraph 3, BGB) for its instalment payments (the instalment payment is a partial payment by a principal on its monetary debt, which is to be paid by it in the case of partial services rendered by the contractor).

This '80 per cent rule' compensates for a considerable part of the payment risk in change orders. The clarification of the actual additional remuneration claim should then take place in connection with the final invoice.

However, this regulation has met with fierce criticism as it can be seen an invitation for the contractor to solicit fraud. A contractor, for example, who suspects that a dispute

5 Section 650c BGB; see also BT Drucks. 18/8486 page 49.

is imminent, may make an offer that amounts to 120 per cent of the actual price: with a payment of 80 per cent, it would be fully remunerated. Or if a contractor simply has payment difficulties, it might make use of this 'instrument'.

However, the customer can also benefit from the regulation: if, in the case of a construction project lasting several years, the customer does not reach an agreement with the contractor despite an acceptable supplementary price, the contractor will only receive 80 per cent of its claim until the final invoice. The client can therefore pre-finance in the amount of 20 per cent.

IV DOCUMENTS AND TRANSACTIONAL STRUCTURES

i Transactional structures

Forward deals in Germany principally consist of two components. The first component is a land purchase agreement, with the aim of transferring ownership of the land plot and the building to be erected. The second component is that the seller or project developer undertakes the obligation to construct the building (usually on a turnkey basis). With regard to the date the purchase price is due to be paid, it is agreed either that payment will be effected entirely after completion (for commercial properties after the first full rental payment received) or that it will be paid in instalments according to the construction progress on the basis of an individually negotiated payment plan. In the latter case, a specific waiver of the application of the Regulation on the Obligations of Property Brokers and Developer Ordinance (MaBV) is required. Without a proper prior waiver, the agreement of an individual payment plan is ineffective and the (more buyer-friendly) legal regulations apply.

As a rule, the seller or project developer does not erect the building itself, but usually commissions a general contractor to fulfil the construction obligation under the forward deal. To avoid liability risks, when drafting the contract care should be taken to ensure that the scope of the construction work owed to the buyer by the seller is passed on in full to the general contractor as complete as possible and without contradictions. This also applies to the dates and deadlines agreed in the purchase and general contractor agreement. The completion date and other significant deadlines should be adequate and contain a sufficient time buffer for unforeseen or unavoidable delays (e.g., to comply with problems arising from species protection regulations or other environmental issues). To minimise liability risks for the seller or project developer, it can be agreed that the seller assigns warranty claims against the general contractor to the buyer and is not liable itself. Buyers may accept this after a certain time has elapsed after completion, during which the seller or project developer should be fully liable.

In the development of commercial real estate, rental contracts are often concluded at a very early stage. The construction obligation assumed by the seller or project developer as lessor of the respective leased object must be covered by the general contractor's construction obligations and should correspond to the construction obligations owed to the buyer. Gaps in the construction obligation lead to considerable liability risks.

In project financing, a special purpose vehicle (SPV) is usually founded for the realisation of the project, which enters in all agreements in relation to the project. The SPV's purpose is strictly limited to the realisation of the project and conclusion of all project documentation, such as agreements with general constructors and all finance documents.

A project finance transaction finances a special project. Generally, most of the costs are financed by loans, including syndicated loans for larger amounts. Currently, investors

are keen to finance the entire project. The participation of the investors is limited to their equity consideration and is therefore on a non-recourse basis. However, in some situations guarantees from the investors are required. The repayment of the financing is provided from the cash flow after completion of the project. The typical real estate project financing foresees a senior loan, junior financing in the form of a mezzanine loan or corporate or project bond, and a shareholder loan or an equity injection. The usual providers of the senior loans are banks, insurers or senior debt funds. Senior financing in Germany usually covers between 60 per cent and 80 per cent of the costs of the project. Senior financing is divided into two phases: the short-term construction phase and the long-term investment phase, as described below. During the first phase no amortisation of the financing is agreed as no cash flow is generated. The interest is paid out of equity and shareholder loans, or is capitalised until the end of the construction phase.

To help project developers finance all of the acquisition and building costs, junior financing is important to close the gap between senior financing and project costs. Junior financing could be provided by mezzanine funds, private equity, or family offices or hedge funds. Furthermore, the preferred equity structures are common in the market, which are granted by special funds, hedge funds, private equity or debt funds. Alternatively, corporate or project bonds can be issued.

Junior financing may go directly to the SPV or to the holding company. This structure has an impact on the regulations of the intercreditor agreement to be entered into by the senior financing provider, the junior financing provider and the shareholders, if shareholder loans were granted. The intercreditor agreement provides for regulations in relation to the ranking of payments, prohibition of payment to the junior financers prior to completion, repayment of the senior financing, and enforcement of senior and junior security. Furthermore, this intercreditor agreement may contain the right of the junior parties to repay the senior loan and to take over the project.

The finance transaction straddles the construction phase and the investment phase. During the construction phase the financing providers bear the material risk as the project assets are not covering the liabilities, which means that the loan is used according to the necessary project steps. By this procedure the risk of the banks is mitigated as the value of the project assets rises with the progress of the construction. After the completion of the project the investment phase starts, in which the project generates cash flow, usually in form of rental income, which is used to repay the financing. However, the risks remain for the financing providers as it is not certain that the project will generate sufficient cash flow for the repayment.

ii Documentation

The contractual basis for a forward deal usually includes the legal basis of the project, in particular the building permit, the plans (floor plans, sections, etc.), the building description, the construction schedules, the payment plans and the models for collateral (sample guarantees). If rental agreements have already been concluded, these, including their facilities, in particular the landlord's building description, are also the contractual basis.

The regulations on building obligations are expected to be based on the new construction contract law and to a lesser degree on the VOB/B, which up to now were widely in use in private building projects.

iii Delivery methods and standard forms

Apart from the VOB/B, which is mandatory for public employers, but owing to its high standard is also widely used in private projects, standard forms are, unlike in many other countries, particularly the United Kingdom and the United States, barely used. The main reason for this is probably the German statutory law on General Terms and Conditions in Sections 305 ff. of the BGB, which sets very narrow limits to standard forms and can be a surprise for foreign counterparties.

An interesting development with regard to procurement models for construction projects is the revival of partnering-based construction schemes. In 2000, the construction industry tried to establish partnership models as a way out of the price war. For some years now, there has been a construction boom that is reversing the situation in the market, especially for building construction services. It can sometimes be difficult for employers to find suitable partners with whom they can realise construction projects. In many cases, the traditional tendering procedure by the owner no longer leads to sufficient and suitable bids from the construction industry, at least not if the owner adheres to a budget that it has derived from outdated price ideas.

Many employers have therefore been more open in recent years to finding partners for their projects with new approaches. Employers often try to integrate contractors into a project as early as possible in the planning phase and involve them in the development of the pricing targets and the definition of the scope of the work. Against this background, the understanding of those involved in construction for cooperative and partnership approaches (e.g., joint ventures) in the planning and execution of construction projects is increasing. In particular, the guaranteed maximum price model with partnering elements is once again being used.

V RISKS, SECURITY AND COLLATERAL

The security package project finance transactions serves several purposes:

a to secure the repayment of the loan;
b to ensure that the project will be completed; and
c to block the assets, so that they cannot be used as security for other creditors.

The loans are secured by the pledges over the project assets and the shares of the SPV, and assignment of the rights under the project agreements to the banks and, subsequently, to the junior capital providers. Furthermore, the direct agreements are concluded to enable the financers to enter into the project agreements and to complete the project in case the sponsor is not in the position or is not willing to do so.

As the security over the project is not sufficient to cover the liabilities under the finance documents during the construction phase, the investors must provide personal security in the form of sureties and guarantees. Furthermore, the investors' guarantees are usually required to cover cost overruns and delay.

Risks, liability and securities obviously play a major role in forward deals. With regard to the sold property, the liability of the seller is generally excluded as far as possible, unless explicit guarantees (e.g., no knowledge of environmental damage) are assumed in the purchase contract itself. It is normal to have a maximum liability limit for claims of the buyer.

With regard to liability for the breach of the building obligation, the new building contract law applies, unless expressly stipulated otherwise in the contract.

Under the forward deal, the provision of a performance guarantee will be agreed to secure the buyer. This guarantee extends to the fulfilment of all claims of the buyer with regard to the manufacturing obligation from the purchase contract. After acceptance of the structure, the guarantee is to be released step by step in return for a guarantee. The warranty guarantee secures the buyer's claims for defects (5 per cent of the production costs as a rule).

VI BONDS AND INSURANCE

In forward transactions, if the buyer does not owe the purchase price upon completion, but the payment obligation depends on the progress of construction, it is occasionally agreed as further security of the buyer that ownership of the purchase property is transferred to the buyer after the first (correspondingly higher) partial payment and not only after full payment of the purchase price.

To ensure that the buyer can also secure the completion of the construction work in the event of the project developer's imminent insolvency, it is granted a right of entry into the general contractor agreement under strict conditions. It can assert this in combination with the withdrawal from the building obligation from the purchase contract and thus have the building itself completed by the general contractor as builder.

Construction projects are usually secured by the following guarantees and securities: bid guarantees for the time before the project starts, advance payments guarantees and performance guarantees. In addition, banks usually ask for a cost-overrun guarantee and a guarantee for the case of delay.

VII ENFORCEMENT OF SECURITY AND BANKRUPTCY PROCEEDINGS

Insolvency proceedings can be applied for by the SPV or its creditors. The SPV is not permitted to dispose of its assets after the opening of the insolvency proceedings – only the insolvency administrator can do so. The SPV does have the option of opening a 'self-management' insolvency proceeding, which would enable it to take action itself, however this is not common in project finance transactions. The creditors have a right to separate special assets, if they have security over such assets.

The enforcement of securities in Germany depends of the type of security. In general, an enforceable deed is required to start an enforcement proceeding; however usually the standard security documentation provides for a waiver of such requirement, to the extent legally possible. The assignments of claims and rights are enforced by way of simple collection of such claims in the event of enforcement, which can be agreed in the relevant security assignment agreement. The pledge over accounts is enforced by collection of funds on the balance of the accounts, but subject to the occurrence of the preconditions of the enforcement, which are mandatorily regulated by German law. The precondition of enforcement of a pledge is a payment default, which means that the enforcement in an event of default for any other reason than payment default cannot be commenced as far as the default is not accelerated.

The pledge over shares in a German limited liability company, which is the typical legal form of a project SPV, occurs by way of sale of shares in a public auction. As the enforcement procedure in relation to shares in German limited liability companies is a difficult and lengthy procedure, the banks are keen to use foreign-law SPVs, for example the Luxembourg limited liability company.

For the enforcement of security over property, an enforceable deed is necessary and such requirement cannot be waived. Furthermore, the security is to be terminated. The enforceable deed is to be delivered to the debtor and the creditor can decide if it wants to enforce by way of forced sale or forced administration. Because it is unlikely that the real value of the property will be reached in forced sales, forced administration is the most common solution. A private sale of the property by the administrator is usually arranged.

As described above, the purpose of security is not only to ensure the repayment of the loan, but also to obtain control over the project; the usual procedure is to take over the shares and the project agreements using the granted direct rights and to complete the project.

VIII DISPUTE RESOLUTION

i Alternative dispute resolution in Germany in construction and finance disputes

Germany has a court system that is considered to function well, despite certain flaws. This is one of the reasons why alternative dispute resolution (ADR) is not as prevalent in construction and finance transactions as in many other jurisdictions. However, out-of court dispute resolution procedures are increasingly being used. In those cases, mediation and arbitration are the most commonly used form of ADR.

ii Role of arbitration

Of all forms of ADR, arbitration is the most widespread. According to Section 1030(1), sentence 1 of the Civil Procedures Law, any claim based on property rights may be the subject of an arbitration agreement. When it comes to arbitration, it is common for the parties to agree on settling a dispute in accordance with the rules of an established arbitration institution. For construction contracts, there are four rules that usually govern disputes:

a Rules for Dispute Resolution in the Construction Industry;
b Arbitration Rules of the German Institute of Arbitration;
c Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce; and
d Rules of Arbitration of the International Chamber of Commerce (ICC).

For project finance contracts, the London Court of International Arbitration (LCIA) and the International Chamber of Commerce (ICC) usually hear disputes.

iii International treaties

The ICSID Convention was signed and entered into force in Germany in 1969. The local courts, especially the district courts, enforce arbitral awards rendered pursuant to the Convention. Germany has also ratified the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958. Thus, in general, arbitration awards can be enforced by German authorities without any difficulty.

iv Role of mediation

Mediation is often used in arbitration clauses as a preliminary stage before entering into arbitration proceedings. Depending on the nature of the dispute, mediation can help to examine unresolved issues and to reduce the costs of the arbitration. In recent years, legislators

in Germany have made efforts to promote mediation by adopting the existing procedural law and passing the German Mediation Act in 2012. However, the number of mediations remains consistently low in Germany.

v Recent progress to promote the use of ADR

To make utilisation of ADR more widespread, AHO, a leading trade association for architects and engineers, founded a working group in 2016 with the objective to create an information manual about ADR for the construction and real estate industries.[6] This manual was published in March 2018. This working group became an expert commission in May 2018.

vi Recent changes in construction law

As set out above, as of the beginning of 2018, construction contract law is now partly codified in the BGB. With regard to dispute resolution, the newly incorporated Section 650d of the BGB will be important in disputes about contract changes and their effect on remuneration. Section 650(d) of the BGB expands the application of preliminary injunctions. Previously, to gain an injunction, claimants had to demonstrate that they were entitled to the claimed right (i.e., that they have a claim and urgently need an injunction or their right will be 'damaged'). Now, in accordance with Section 650(d) of the BGB, to issue a preliminary injunction in a dispute, it is not necessary that a credible reason be given for the urgent need of a preliminary injunction after construction has commenced.

IX OUTLOOK AND CONCLUSIONS

The reform of the legislation on construction contracts has incorporated a number of provisions into the BGB, which are particularly relevant for large, long-term construction projects.

However, some of the instruments created by the legislature are widely considered to be unsuitable. None of the many reforms of the BGB have achieved the legislative quality of the original provisions of 1900, in particular the reform of construction contract law (outlined in Section III). Surprisingly little of the extensive preparatory work by experts of various private bodies, including the German Construction Court Conference or the Freiburg Construction Law Conference, was included in the reform. Lawmakers and court rulings will have to work on many details and provide clarification. In German we have a saying: '*Nach der Reform ist vor der Reform*.' One reform begets another.

6 AHO Heft 37 'Konfliktmanagement in der Bau- und Immobilienwirtschaft'.

Appendix 1

ABOUT THE AUTHORS

NADEJDA KYSEL

Arnecke Sibeth Dabelstein mbB

Dr Nadejda Kysel is a lawyer at Arnecke Sibeth Dabelstein and works primarily in the fields of financing of companies and acquisitions, real estate financing and project financing.

ALEXANDER THIERMANN

Arnecke Sibeth Dabelstein mbB

Alexander Thiermann is a lawyer at Arnecke Sibeth Dabelstein and works primarily in the fields of real estate transactions, due diligence, commercial tenancy law, lease law, land law and hospitality.

MAXIMILIAN ZEUN

Arnecke Sibeth Dabelstein mbB

Maximilian Zeun is a lawyer at Arnecke Sibeth Dabelstein and works primarily in the fields of private construction law, construction and plot disputes and extrajudicial dispute resolution.

ARNECKE SIBETH
DABELSTEIN MBB

Hamburger Allee 4 (WestendGate)
60486 Frankfurt
Germany
Tel: +49 69 97 98 85 0
Fax: +49 69 97 98 85 85
n.kysel@asd-law.com
a.thiermann@asd-law.com
m.zeun@asd-law.com
www.asd-law.com

ISBN 978-1-912228-41-6