

10 THINGS YOU SHOULD KNOW ABOUT LEASE AGREEMENTS IN GERMANY / ENGLAND & WALES

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1. ARE THERE DIFFERENT TYPES OF LEASES?

IN GERMANY

German civil law differentiates between residential and commercial leases (*Mietvertrag*) and leaseholds (*Pachtvertrag*). Residential or commercial leases are more common than leaseholds: they grant the tenant a right to use the premises in return for paying the agreed rent. By contrast a leasehold entitles the tenant also to the benefits (*Fruchtziehung*) from the use of the premises. This is why leaseholds are, for example, regularly seen in the hotel sector.

German law also provides for so-called hereditary building rights (*Erbbaurechte*). These rights entitle the beneficiary to use a property for a prolonged period of time (up to 99 years) and to construct and utilize buildings on the property. In return, the beneficiary has to pay a rent to the owner of the property. Due to their nature, hereditary building rights bear more resemblance to freehold ownership than to a lease (*grundstücksgleiches Recht*).

IN ENGLAND AND WALES

The main distinctions in leasehold interests in England & Wales are based on whether the land is residential, commercial or agricultural, and whether the lease has a long or short term. A headlease is a lease granted directly out of a freehold interest and an underlease is one granted out of another lease.

In commercial leases sometimes a short lease will be described as a "geared rent" or an "occupational lease, whereas a longer lease may be called a "ground rent" lease. You might also have a periodic tenancy, a tenancy at will (where either party can walk away at their choosing) or a reversionary lease (which takes effect when an existing lease has expired).

2. WHAT IS THE LEGAL FRAMEWORK?

IN GERMANY

The provisions on tenancy law can be found in Sections 535 to 580a of the German Civil Code. Statutory provisions on leases also differentiate between residential leases, other types of leases (i.a. commercial leases) and leaseholds. Most statutory provisions directly pertain to residential leases, because residential letting is, in general, quite tenant-friendly in Germany.

Commercial leases allow for much more commercial and legal flexibility. Statutory provisions can be modified and even waived and replaced by the parties' own contractual regime. Especially in individually agreed contracts (*Individualvereinbarungen*), the parties benefit from freedom of contract (*Vertragsfreiheit*), though general contract law (and legal precedent) imposes certain restrictions and limitations.

IN ENGLAND AND WALES

As England & Wales do not have a civil code, the lease must largely contain all the conditions and rules that the tenant must abide by. That said, there are a number of Acts (and related case law) that underlie and influence real estate practice including the Landlord and Tenant Act 1954 and the Landlord and Tenant (Covenants) Act 1996.

The residential sector is very highly regulated with different sets of rules governing long-term and short-term tenancies. There are also differences between the English and Welsh regimes.

3. DO LEASE AGREEMENTS REQUIRE A CERTAIN FORM?

IN GERMANY

German Civil Code provides that a lease agreement with a term of more than one year must be agreed in written form. In a nutshell, this means that all essential elements of the lease must be stipulated in writing. However, a violation does not render a lease invalid. Rather it is deemed to have been concluded for an indefinite period of time and, as a result, can be terminated by either party with statutory notice periods. Against this background, compliance with the statutory written-form requirement is particularly relevant from an economic point of view (long-term commercial leases serve as a value-creating factor for real estate investments).

A "market standard" set of clauses/procedures has in recent times developed in the German real estate market which has prompted the legislature to embark on a project to explore a change to the extent and scope of the legal form requirement for lease agreements.

IN ENGLAND AND WALES

Leases over three years must be made by deed. If a lease is of a shorter term and the tenant is in occupation, paying a market rent, then they can be made by simple contract or orally - though this is never advised, for evidential reasons.

Most leases of over seven years must contain "prescribed clauses" at the beginning of the document. This is set information that allows the Land Registry to register the leasehold interest more easily, without reviewing the entire document. There are also a growing number of industry standard leases for use in various sectors, including a collection known as the Model Commercial Lease.

Leases should also include a lease plan which, for a registrable lease (7yr+ term) must meet the Land Registry's plan criteria.

4. IS THERE A MINIMUM LEASE TERM REQUIRED?

GERMANY?

There is no minimum (or maximum period) for commercial and/or residential leases. This means, they can be even entered into for periods of more than 30 years. In this case, they would be deemed “long-term agreements” and can be terminated by either party after 30 years. This is why fixed terms generally range between 10 – 20 years (including prolongation options).

As set out under 1., hereditary building rights regularly provide for longer durations, typically 99 years.

ENGLAND AND WALES?

There is no minimum or maximum term.

A “long lease” is most commonly granted for a 125 or 999 year term. You cannot grant a lease where the term is due to start more than 21 years after the date of the lease. You should also be careful about creating a perpetually renewable lease (ie a lease that has an option to renew in a form that will also be renewable) as this will be converted into a 2000 year term.

5. ARE THERE DOUBLE-NET/TRIPLE-NET LEASES?

IN GERMANY

Even German law does not expressly provide for Double-Net or Triple-Net leases, commercial leases – especially in the current market situation – can be drafted to be commercially equivalent to a Double-Net or Triple-Net lease. Leases where the tenant pays not only the ancillary costs, but also all maintenance and repair costs and costs for insurances are considered as Triple-Net equivalent in Germany.

Because especially such a Triple-Net lease shifts away from core principles of German tenancy law (where the obligation and responsibility to provide and maintain the lease object in the contractually agreed state generally lies with the landlord), certain limitations are in place insofar as the respective lease is not individually agreed, but rather considered general terms and conditions.

IN ENGLAND AND WALES

We don't tend to use these concepts in England & Wales. Instead we talk about “FRI” Leases and inclusive leases (which tend to be shorter term – sometimes of a flexi-workspace). An FRI lease is a Full Repairing and Insuring lease where the costs of all repairs and insurance are borne by the tenant. The insurance costs are collected through an insurance rent, whilst maintenance costs are recovered through a service charge if the building is multi-let. Inclusive leases are where a tenant will pay a single rent which will include contributions towards insurance, maintenance and sometimes business rates too. In fixing the rent the landlord is taking the risk of third party costs rising outside its control and thus affecting its profit, so may build a contingency into the rent per square foot to account for this.

6. WHAT KINDS OF RENTS ARE COMMONLY AGREED ON?

IN GERMANY

Most leases contain a fixed rent to be paid in monthly instalments together with a prepayment on ancillary costs and, where applicable, VAT. Especially in commercial leases (retail; hotel sector), turnover-related rents, sometimes combined with a fixed monthly minimum rent, are commonly seen.

IN ENGLAND AND WALES

The standard commercial rent is an open market rent that is reviewed every five years of the term (with insurance, service charge and tax charged separately). We also see turnover rents (particularly in retail and normally with a fixed minimum "base" rent) and index linked rents – generally to the Retail Prices Index or increasingly the Consumer Prices Index.

7. HOW CAN THE RENT BE ADJUSTED TO REFLECT THE MARKET THROUGH THE TERM?

IN GERMANY

To secure the value of the rent, two mechanisms are most common. Commercial leases with a term of minimum 10 years (including options) regularly contain indexation clauses, where the rent is adjusted in relation to the changes of an index chosen by the parties (most frequently CPI). In leases with a lease term shorter than 10 years, an indexation clause can be held invalid by a court. Indexation clauses should work both ways, i.e. no "upwards only".

Alternatively, a stepped rent can be agreed on, where the rent increases automatically in designated steps/periods.

Residential leases may also contain indexation or stepped rent clauses, but this is unusual and certain limitations apply under statutory laws. Most notably, rents can be increased up to the market rent for equivalent properties in the area, but in principle not by more than 20% within a period of three years (*Kappungsgrenze*). In some cities and municipalities, this cap is set at 15%. In addition, a statutory rental cap (*Mietpreisbremse*) was introduced in 2015, aiming to cap the maximum increase amount for certain congested urban areas. The respective federal state is empowered to designate such areas.

IN ENGLAND AND WALES

The market norm is for commercial lease rental increases to be upwards only and there is currently no legislation that restricts that. Indeed, sometimes you may see a rent review being the higher of the existing rent, the open market rent and the rent as indexed against the last review. You may also see a cap and collar where indexation is used so that the rent cannot ever fall below or rise above a certain, commercially agreed level.

There are some rent controls for leases of regulated ("Rent Act") dwelling houses but not generally for residential leases. From 30 June 2022 landlords of new long residential leases of single dwellings where a premium was paid on grant, will no longer be permitted to charge a valuable ground rent (as these are seen politically as unfair for residential tenants).

8. WHAT COSTS OTHER THAN RENT CAN BE PASSED ON TO THE TENANT?

IN GERMANY

In deviation from statutory law, most commercial leases contain a regime for allocating ancillary costs on to the client. Often, it is referred to the costs set out in Operating Costs Ordinance (*Betriebskostenverordnung*) and/or a bespoke catalogue of allocable costs. Especially under commercial leases deemed general terms and provisions, the ancillary costs regime needs to be detailed, transparent and carefully drafted in order to mitigate the risk of being held invalid for unreasonably disadvantaging the tenant and to avoid non-recoverable costs.

In addition, maintenance and repair costs can be allocated on to the tenant. Under commercial leases which are considered general terms and conditions, certain restrictions apply with regards to costs for roof and structure (*Dach und Fach*), which usually are with the landlord, as well as for common areas (*Gemeinschaftsflächen*), where often a cap (8-10% of the annual net rent) is agreed in order to mitigate the risk of the clause being ruled invalid.

Other notable costs are insurance costs (mostly the landlord pays the insurance premium and the tenant(s) pay(s) back a pro-rata share as ancillary costs) and utilities costs (usually contracted by the tenant directly.)

In residential leases, there is generally less flexibility and leeway to contract out of statutory provisions in order to allocate costs on to the tenant.

IN ENGLAND AND WALES

Commonly insurance and service charge (for maintenance and repair of the common parts and structure of any building where shared) will be passed onto the tenant and you will need to include detailed drafting for this in the lease. For commercial leases the insurance will generally include loss of rent so that the landlord can offer the tenant a rent cesser where there is insured damage.

The tenant will also be responsible for the business rates/council tax for their unit and for utilities where they are separately metered.

Residential service charges are regulated to try to protect tenants from unexpected/unreasonable costs. Surveyors who often manage multi-let properties such as blocks of flats or offices, are regulated by the RICS and expected to comply with a growing body of professional statements/codes of conduct setting out best practice in asset management.

9. WHAT METHODS ARE USED TO SECURE RENT PAYMENT?

IN GERMANY

Most lease agreements provide for a rent collateral to be provided by the tenant, with some exceptions in case of tenants with exceptionally strong market position or tenants from the public sector.

In commercial leases, the rent collateral usually amounts between two and three months' rent, but in general, the amount can be freely agreed on (limited only by risk of over-securitisation and principle of good faith). Stricter provisions apply in case of residential leases.

Rent collaterals are usually provided as a deposit or in the form of a bank guarantee. Parent company guarantees are also common.

IN ENGLAND AND WALES

Residential tenants on short terms and commercial tenants (particularly of unproven covenant) are often asked to provide a rent deposit as security for rent payment. On commercial leases this is generally equal to 6-9 months' rent, with less for residential tenants. On a commercial lease the deposit will generally be managed by the managing agents (with interest accruing to the tenant), whereas there are strict regulations and schemes designed to protect residential deposits.

You might also see a guarantor (often from a parent company), a bank guarantee or a letter of credit.

10. WHAT IS THE OUTLOOK FOR THE REAL ESTATE MARKET?

IN GERMANY

The outlook for the German real estate market continues to be positive for investors, with the main reasons being the following:

- Adaption of pricing is expected to lead to increased market activity by both new and existing investors.
- The German real estate market proved to be robust and sustainable, despite the COVID-19, rumours of another real estate "bubble" and the turnaround of the European Central Bank's interest policy.
- Increased demand for special asset classes, such as data centres, logistics assets, nursing/caring homes, but also residential living as well as prime office spaces in core/AAA areas.

IN ENGLAND AND WALES

The outlook for England & Wales remains positive, whilst recovery from the pandemic and backlash from the Russian/Ukraine war means there is some flux.

- COP26 accelerated concerns around the green agenda and, in particular the roadmap for the Minimum Energy Efficiency Standards which affect investment property across the sectors. A minimum rating of E will bite from 1 April 2023 with a possible B by 2030 looming – so many investors are focussing on future proofing strategies.
- Hot asset classes will include data centres, film/tv studios and the living sector (including senior living and build to rent).



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