Client Alert

April 2024

Germany: Real Estate Companies in Insolvency — The Perspective of a Financing Bank

Due to the long-standing real estate boom in Germany, the current economic downturn in the real estate and construction industry is enormous. Construction projects remain unfinished and insolvency applications are piling up. It is therefore worth taking a closer look at the legal and economic impact of this development.

It is not an easy time for the real estate industry in Germany at the moment. High interest rates, increased energy and material costs, overregulation and a shortage of skilled labour — to name just the most important factors — have a major impact. Numerous real estate companies have filed for insolvency in recent months. Prominent examples are the insolvency applications filed by Development Partner, Centrum, Euroboden, Gerchgroup, Omega, Signa, Schoofs Immobilien and One Group. It can be assumed that this trend will continue.

This development poses considerable challenges for all parties involved — but especially for financing banks. In the last 15 years of upswing in the sector, a great deal of expertise has been lost at both business and legal level. This article intends to provide a summary of the main (legal) pitfalls in connection with the insolvency of a real estate company from the perspective of a financing bank (including a focus on the currently frequently encountered situation of an unfinished and unleased property).

Starting position of the bank

The bank will regularly have a credit claim resulting from a loan (Section 488 of the German Civil Code) against the real estate company. In the case of larger construction projects, it will often be a consortium of banks united under a syndicated loan agreement. The banks' claims under the loan will usually be collateralised. Typical securities are land charges or mortgages, assignment of claims for the payment of rent (only for completed and already leased properties) and pledges on accounts and company shares.

Basic strategic options

The core collateral for the bank is usually the land charge. Under German law, the bank can generally "realise/enforce" a land charge in two ways when a default occurs: first by initiating forced receivership (*Zwangsverwaltung*) and second by forced auction (*Zwangsversteigerung*), see also Section 1147 of the German Civil Code.

Forced receivership (regulated in Sections 146 et seq. of the German Act on forced auction and receivership, "*ZVG*") is a court procedure in which a so-called receiver is appointed by the court to take over the administration of the real estate property. In a forced receivership, the bank's claim is paid from the income from the real estate property. Income usually mainly consists of rents.

A forced auction (regulated in the German Act on forced auction and receivership) is also a judicial procedure. However, contrary to the forced receivership this procedure is aimed at the sale of real estate property (land, heritable building rights, residential property and partial ownership) by public auction.

The bank can initiate and conduct both procedures not only outside of insolvency proceedings but also after insolvency proceedings have been opened.

Against this background, the bank has the following options in the event of a crisis or (imminent) insolvency of the real estate company:

- Avoidance or (active) initiation of insolvency proceedings; alternatively, forced receivership or forced auction outside of insolvency proceedings.
- Transfer of the construction project/property to the bank's own portfolio.
- Third-party administration/sales solutions within insolvency proceedings.
    - Forced receivership/forced auction.
    - "Cold" receivership (*"kalte" Zwangsverwaltung*)/private sale (both based on a private agreement with the insolvency administrator).
- Support concerning the continuation/completion of the real estate property by the financing bank or a new financier (on the basis of a "continuation agreement").

Which of these options (or combination of options) makes the most sense for the bank strongly depends on the individual case (e.g., degree of completion of the property, lease situation, etc.) and must especially be decided from an economic point of view. A general statement is not possible.

The decision must internally be prepared very carefully so that the decision-makers can form a final and reliable opinion. Knowledge of the legal options, barriers and pitfalls for decision-making is of the utmost importance. This applies in particular to the "cold" receivership/private sale in the context of insolvency proceedings (both based on a private agreement with the insolvency administrator), which have established themselves in German practice as a frequently favoured alternative to "classic" forced receivership/forced auction (see details under b). In addition, the question of support for the continuation/completion of the property by the financing bank or a new financier is very important, particularly in the case of unfinished properties (see details under c).

The following explanations, which focus on the bank's (legal) options, consider the special feature of the division of German insolvency proceedings into preliminary and main proceedings.

Initial reaction of the bank

If insolvency is imminent or an insolvency application has already been filed, the bank should first carry out a summary review of its collateral package (e.g., land charge, assignment of rental claims, account pledge, etc.) as an "urgent measure". This avoids unnecessary delays of the realisation in the (opened) insolvency proceedings and reduces potential insolvency avoidance risks (Sections 129 et seq. German Insolvency Code, "*InsO*"). It is also important that the documentation required for the realisation/enforcement of the collateral — in particular, original documents — be sought out and properly prepared (e.g., enforceable copies of the land charge).

The (pending) insolvency will regularly give the bank the option of extraordinary termination (Section 490 of the German Civil Code). If the bank does not expressly use this option, its remaining credit claim is nevertheless deemed to be due in the insolvency proceedings (Sections 41, 38 InsO). The bank can register its (secured) insolvency claim(s) with the insolvency administrator to the insolvency table for default (Sections 38, 52 sentence 2 InsO). The default is the amount remaining after payment of the proceeds from the realisation of the collateral. Once the default has been established and the insolvency administrator has been notified, the remaining amount will be included in future distributions of the insolvency estate.

Filing for insolvency

Following a debtor's insolvency application, the bank should contact the appointed (preliminary) insolvency administration to get an initial feeling for their willingness to cooperate. In extreme cases, an attempt can also be made to work towards replacing the (preliminary) insolvency administrator. In the case of locally dispersed property portfolios, the bank should continue to work towards the appointment of a uniform (preliminary) insolvency administrator to avoid "frictional" losses. It should also be examined whether the insolvency of individual portfolio companies can be avoided through "minor measures" (e.g., by not exercising cross-default provisions or guarantees, deferrals, etc.). If the requirements for a (preliminary) creditors' committee are met (see Section 22a InsO), the bank could position itself as a (potential) member at an early stage. This has numerous advantages. For example, the insolvency court may only deviate from a unanimous proposal by the preliminary creditors' committee regarding the person of the

(preliminary) insolvency administrator if the candidate is "unsuitable". In addition, the (preliminary) creditors' committee must decide on significant legal acts (e.g., sale of the company, etc.). Any potential liability arising from the bank's position as a member of the creditors' committee can be mitigated by a liability insurance.

Whether a third-party insolvency application is appropriate for the bank itself depends on the circumstances of the individual case. This may make sense if there is a risk to the legal position or collateral should the bank not file the application. Filing could be advantageous, for example, in cases in which there are signs of "forum shopping" by the real estate company to another jurisdiction that is more favorable for it at the expense of the financing bank.

However, a third-party insolvency application by the bank requires in-depth insight into the debtor's financial situation (in particular, the bank must be able to demonstrate a reason for insolvency to the satisfaction of the court). This is often also associated with an enormous internal documentation and justification effort.

Preliminary insolvency proceedings

The period of preliminary insolvency proceedings is particularly challenging for the financing bank. Filing an application often leads to a (complete) construction stop. Even the general maintenance of the real estate property is difficult. The debtor or the preliminary insolvency administrator often lacks the necessary funds or liquidity for this.

However, it should regularly be in the bank's interest to avoid (further) deterioration of the real estate property. Necessary road safety and value-preserving repair measures should be carried out. In these cases, the bank can provide assistance, e.g., in the form of a loan to the insolvency estate. Under certain circumstances, it may even be forced to pay the costs out of its "own pocket".

When concluding a loan to the insolvency estate that is to be repaid later with a preferential status from the insolvency estate, consider that a "weak" preliminary insolvency administrator (as is common in German preliminary insolvency proceedings) generally requires special court authorization to conclude such a loan. The court authorization order should specify the loan agreement and the security rights to be provided. In addition, the bank should insist on confirmation from the preliminary insolvency administrator that the insolvency estate is and will be sufficient to repay the loan and that there is no threat of the proceedings being rejected due to insufficient assets.

If the property has already been leased, particular attention must be paid to "securing" the rental income in favour of the bank. Without recourse to forced receivership, this will only work if an (at least) provisional "cold" receivership based on a private agreement with the preliminary insolvency administrator (see details under i) can be achieved quickly. This should also be confirmed by the insolvency court so that the resulting claims of the bank constitute preferential liabilities of the insolvency estate.

Finally, in exceptional cases, an "emergency sale" of the real estate property may also be appropriate during the preliminary insolvency proceedings, particularly if there is a risk of irreversible disadvantages for the insolvency estate (e.g., the existence of a temporary, above-average purchase offer with a simultaneously weakening market situation).

Main insolvency proceedings

As outlined above, the bank has the following options (or combinations thereof) in the main proceedings:

- Transfer of the construction project/property to the bank's own portfolio.
- Third-party management/sales solution within insolvency proceedings.
  - Forced receivership/forced auction.
  - "Cold" receivership/private sale (both based on a private agreement with the insolvency administrator).
- Support concerning the continuation/completion of the property by the financing bank or a new financier (on the basis of a continuation agreement).

a. Transfer to own portfolio

A takeover and transfer into the bank's own portfolio is rarely an option for the bank. It requires extensive expertise within the bank, which is often not available. It also ties up resources and costs unnecessarily.

An exception applies: If a third-party buyer is not available or is difficult to find and if the insolvency administrator considers "releasing" the property from the insolvency estate (i.e., it would be left to itself), the bank should urgently check whether a private purchase from the insolvency administrator by the bank is favourable, in particular to avoid a total loss.

b. Third-party management/sales solution within insolvency proceedings

As mentioned, the bank also has access to the statutory realisation/enforcement procedures of forced receivership/forced auction in the context of main insolvency proceedings.

While these statutory procedures offer a high degree of legal certainty, they are less flexible and often do not fully fit the individual case. They also tend to be cost- and time-intensive.

Against this background, alternative forms of realisation have become market-standard, specifically the "cold" receivership/private sale, which are both based on a private agreement with the insolvency administrator. In detail:

i. "Cold" receivership

In contrast to a private sale, "cold" receivership will generally only be considered if the real estate property is already leased and the rental income can be secured in favour of the bank.

"Cold" receivership is not regulated by statute but is recognised by case law and by legal literature (Federal Court of Justice, judgement of 19 November 2009 — IX ZB 261/08). It requires insolvency proceedings to be opened and the willingness of the insolvency administrator to carry out "cold" receivership.

As part of "cold" receivership, the real estate property is managed (in particular, the collection of rents) exclusively by the insolvency administrator (no separate forced receiver is appointed). The legal basis for "cold" receivership is an agreement under private law between the insolvency administrator and the bank (often combined with an additional sales agreement; see also private sale under ii).

In particular, this agreement includes the obligation of the insolvency administrator to pay out any income generated from the real estate property to the bank. In return, the insolvency administrator/insolvency estate receives a "remuneration"/contribution (usually lower than the remuneration of a forced receiver).

The key advantages and disadvantages of "cold" receivership (compared to forced receivership) can be summarised as follows:

Advantages	**Disadvantages**
Flexibility	Remuneration/contribution of costs to insolvency administrator/insolvency estate
Speed	Release from insolvency estate at an inopportune time is possible
Possibly lower costs (compared to forced receivership, in particular the costs of the receiver)	
Reorganisation authority of the insolvency administrator	

ii. Private sale

As part of a "private sale", the insolvency administrator sells the real estate property to a third party with the consent of the bank. A private sale is possible for both completed (and possibly already leased) and unfinished properties.

The basis for a private sale is usually a private-law agreement between the insolvency administrator and the relevant parties, in particular the senior secured bank. Without the bank's consent, an unencumbered acquisition of the real estate property would — because of the existing land charge — often not be possible.

The key advantages and disadvantages of such a "private sale" (compared to a forced auction) can be summarised as follows:

Advantages	Disadvantages
Flexibility.	Remuneration/contribution of costs to insolvency administrator/insolvency estate.
Speed.	Nuisance premium/payment in favour of subordinated creditors..
Often lower costs (compared to forced receivership, especially court fees).	
Trend towards higher realisation proceeds.	

The core provisions of a corresponding sales agreement between the insolvency administrator and the bank are regular:

- Minimum proceeds or consent clause: Sale may not take place for less than an agreed minimum amount.
- Redemption clause: Regulation on the specific use of (often insufficient) sale proceeds, in particular with regard to the redemption of the bank's land charge.
- Contribution to insolvency costs: Compensation for the risks and expenses of the insolvency administrator; usually 1-10 % of the sales proceeds.
- Declaration of indemnity: Indemnification of the insolvency administrator by the bank from all risks associated with the administration and sale.

A balanced sales agreement should always be the ultimate goal. Only in this case, all parties involved will be fully committed to the sales process and achieve the best possible outcome.

c. Support concerning the continuation/completion

In the case of unfinished real estate projects in particular, completion of the construction project is likely to be the most (economically) attractive and preferred solution for all parties involved. The legal realisation and processing are as follows:

- Agreement between debtor/insolvency administrator and (potential) purchaser regarding completion, transfer of ownership and release from encumbrances, payment of purchase price, etc. (insolvency liability)
- Agreement between the insolvency administrator and the bank on any necessary "pre-financing"
- Occasionally, agreement between purchaser and (already financing/pre-financing) bank

A potential purchaser for the real estate property will often only be willing to pay a (further) purchase price if the property is completed or if it can be assumed with a very high probability that it will be completed.

This leads to the following dilemma: Completion by the insolvency administrator will only be possible with corresponding "pre-financing". Generally, only the bank that has already provided the existing financing or a new financier can be considered as a "pre-financier".

Whether and under what economic conditions such "pre-financing" will be attractive and how it should be legally structured will depend on the circumstances of the individual case.

Conclusion/Recommendation

The insolvency of a real estate property company poses considerable challenges for the financing bank (especially in the case of unfinished/unleased properties). It requires in-depth expertise in credit, construction, enforcement and insolvency law, which has been steadily lost in recent years of upswing. This makes it all the more important for banks to once again focus intensively on this topic in order to be able to react quickly and efficiently if a crisis or insolvency occurs.

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