

# Enforcement of Security over Real Estate in Germany

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Lenders of real estate loans in distress need to understand the various options in enforcing security over real estate in Germany to achieve the desired return. This white paper explains the legal framework of judicial enforcement and the most common non-judicial alternatives. It describes the possible scenarios once restructuring has come to its end.



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The standard German security package available for enforcement consists of a land charge (mortgage), assignments of rents (and further property related claims) and account pledges. Lenders have a number of enforcement options (both consensual and forced) which can be used to put pressure on the borrower to repay outstanding indebtedness and/or to enforce security depending on the background of the default and the borrower's behavior.

## Non-Judicial Enforcement

Securing the cash-flow from the property is likely to be first priority for any lender that is looking to protect its security position. This is achieved by enforcing the account pledge by sending a notice to the account holding bank requiring the bank to transfer the balance of the account to the pledgee. This allows a quick cash-sweep in particular of the rental income account. At the same time the borrower's right to manage the account ceases to exist. To stop the borrower from diverting cash flows to different (i.e. not pledged and/or hidden) accounts to avoid this (which obviously is a breach of its obligations) the lender should serve a notice on the tenants disclosing the security assignment of rent and directing the tenants to pay the rent (usually not including service charges) directly to an account controlled by the lender. Any payment to the borrower after notice has been served will not satisfy the tenant's rent payment obligation which is usually a strong incentive for tenants to comply with the request. These simple and quickly implemented measures allow the lender to get complete control over the cash-flow coming from the property and to prevent leakages of rental income.

Getting control over the property may be the next step. In most cross-border financings, particularly originating from the UK or the US, market standards require the property manager to sign a duty of care agreement which allows the lender to either step into the property management agreement instead of the borrower or to replace the existing managing agent by an entity closer to the lender following an event of default. This allows the lender to ensure that the property is well managed, required construction/maintenance works or renovation are carried out and any vacant space is properly marketed.

All enforcement methods mentioned so far will not involve any court proceedings and are solely in the control of the lender. However, they will not allow the lender to sell the property to repay the loan. This can only be done by enforcement of the land charge.

## Judicial Enforcement

Under German law a forced sale can only be achieved by way of auction upon enforcement of the land charge. Enforcement of land charges will be carried out by the lender in accordance with the German foreclosure law (*Zwangsversteigerungsgesetz, ZVG*) by way of a forced auction (compulsory sale) of the property (*Zwangsversteigerung*).

## Prerequisites of Enforcement

Under German foreclosure law the lender has to apply for foreclosure measures at the relevant court by filing an application together with accompanying documents evidencing, amongst other things, the lender as beneficiary of the land charge, the borrower (or an obligor) as owner of the property and the details of the relevant property. Any application for foreclosure proceedings requires the filing of the original of the enforceable copy of the land charge deed (*vollstreckbare Ausfertigung der Grundschuldbestellungsurkunde*) together with a proof that a copy of the deed has been delivered to the borrower (*Zustellungsnachweis*) by a court official. The enforceable copy must show the foreclosing lender (usually the security trustee) as beneficiary of this copy. If this is not the case (e.g. one of the predecessor banks is named as beneficiary) the enforcement clause has to be changed by the public notary who certified the deed and a new delivery to the borrower will be necessary.

## Forced Auction

In the case of a compulsory sale, the relevant local court will effect a public auction of the property. The foreclosing lender has to pay or at least advance the costs of enforcement which will be added to the loan balance and included in the distribution of proceeds. Upon application the relevant court issues an initial court order which effectively opens proceedings and which appropriates the property in favor of the lender (*Beschlagnahme*) allowing the lender to sell free from the borrower's interest in the property. Other creditors may join the proceedings upon application or the lender may join foreclosure proceedings initiated by other creditors. After the order has been granted, the court starts a procedure to determine the value of the property by appointing a real estate appraiser. The appraisal will be delivered to the court and all other involved parties. Based on the appraisal the court determines the current market value of the property. This forms the basis of calculation of any auction reserves as described below.

The auction proceedings consist of the auction itself (*Bietstunde*) with the bidding ending with the highest bid, a court decision upon the acceptance (*Zuschlag*), a hearing regarding the distribution of the proceeds (*Verteilungstermin*) determining the distribution plan and its execution.

Once the value of the property had been determined the court will set a date for public auction held at court by a court official. Usually lenders try to attract potential bidders by informing them via newspaper ads and brokers about the relevant property and the auction date to ensure competitive bidding.

At auction the reserve price (*geringstes Gebot*) is set at a level which will cover the court's costs and any prior rights (Section 44 ZVG) which will not be overreached by the sale. Further restrictions will also apply to prevent low price acquisitions. For example, the lender and other creditors can refuse to accept a bid acceptance of below 70 percent of the determined market value (Section 74a ZVG). A highest bid below 50 percent of the market value will be rejected by the court automatically (Section 85a ZVG).

If the property does not sell at the auction (for example where no bids are made or the bids are below the reserve price/set limits) a new auction date will be determined by the court within three to six months after the first date. Please note that the bid limits mentioned above extinguish during later auction dates. The lenders will commonly appoint foreclosure experts to seek tactical adjournments of the proceedings (*einstweilige Einstellung*) to achieve the desired timing and maximize bids.

Once the bid of the highest bidder has been accepted the bidder becomes legal owner of the property (Section 90 Subsection 1 ZVG). No further sale and purchase agreement is necessary. Apart from certain exemptions any liens ranking behind the land charge in favor of the foreclosing lender will cease to exist (Section 52 ZVG) even though they may not been satisfied. The land charge in favor of the lender will be cancelled as well.

In the hearing regarding the distribution of the proceeds which usually takes place a few weeks after the auction the court will usually deduct the costs of the enforcement proceedings and assign any further payable proceeds to the creditors depending on the rank of their claims. All lenders shall have submitted their open claim request in writing prior to that date. The successful bid has to be paid by the bidder at latest during the distribution hearing. To the extent that the outstanding debt is repaid from the auction proceeds the debt of the borrower extinguishes. Any remaining outstanding debt will be the subject of further foreclosure proceedings regarding other securities of the borrower (to the extent enforceable).

As the foreclosing courts are usually very busy a forced auction proceeding may take a considerable amount of time – in most cases between half a year and a year between application and first auction date. However, in some cases this can be significantly longer. If timing is of the essence it is sometimes advisable to persuade the borrower to sell the property voluntarily or to grant a power of attorney to sell the property to the lender. Even though it may look like a good idea to request such a power upon signing of the loan agreement statutory law prohibits the granting of such a power before the loan becomes due and payable. Therefore to avoid lengthy public auctions it is advisable to request a sale power from the borrower once the repayment is due.

## Court Appointed Receiver (Forced Administration)

If a consensual solution is not capable of being reached the lender may apply for forced administration. Subject to the prerequisites cited above (filing of originals etc.) the court may appoint upon application of the lender a receiver for the property to administer the property on behalf of the enforcing creditors. The receiver alone is entitled to receive all income generated from the property, including all rents and insurance claims. The right of the receiver to collect rents takes priority over all other rights to the rental income. Therefore rent assignments in favor of the lender cease to exist. The administrator, subject to the supervision of the court, passes the collected monies on to the enforcing creditors after deducting ongoing costs including public charges and enforcement costs calculated in accordance with the Compulsory Administrator Remuneration Act. The enforcing creditor will receive the interest payments and under certain circumstances a limited amortization of its principal.

## Other Security

Usually, the security package includes share pledges in the borrower. In case of a German law entity such share pledges allow the sale of the shares in a (compared to the property auction outlined above) rather informal auction procedure headed usually by a German notary. Due to tax reasons in many recent transactions the borrowing entity is not subject to German law but e.g. a Luxembourg “S.à r.l.” or a Netherlands “B.V.”. In those cases, the lender may have further rights of enforcing a share pledge including replacement of management etc.

## Conclusion

The German enforcement regime, whilst not as time consuming and cumbersome as that of some of its European neighbors, is nevertheless not an instant a solution as its English law equivalent where demand can made for repayment immediately following default, followed by appointment of an insolvency appointee within a matter of days. Lenders, particularly, perhaps, those with cross-defaulting security over pan-European portfolios will increasingly need to be aware of their enforcement options.

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