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THE ONLY WAY IS UP?

PRICE ADJUSTMENT CLAUSES IN TIMES OF RISING INFLATION RATES

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INTRODUCTION

We all see inflation rates having one direction only at the moment… Up. And higher inflation rates are bringing price adjustment clauses increasingly into focus in contract drafting. They are an effective means of counteracting inflationary (and in principle also deflationary) effects when framing contractual terms of continuing obligations. Commercial tenancy law provides mechanisms for value retention though so called rent adjustment clauses that may take many forms, and have a number of limitations. Violating these limitations may result in such a clause being declared invalid at a later point in time. These issues highlight several points that should be a central focus for the parties.

VARIOUS FORMS OF RENT ADJUSTMENT CLAUSES

Graduated rent remains a popular form of value retention. However, fixed contractual rent increases often fail to sufficiently protect the interests of equivalency, i.e. the maintenance of the balance between performance and compensation, particularly with long-term leases. Indexation based rent adjustments that adjust the rent to specific parameters or indexes such as the consumer price index are a different case. Indexation clauses are divided into so-called real and artificial rent adjustment clauses. In the case of *real rent adjustment clauses*, the rent is adjusted automatically. With so called *artificial rent adjustment clauses*, additional action must be taken by the contractual parties in order to trigger the adjustment, e.g. a prior review of whether the adjustment would be appropriate, etc.

EXEMPTIONS AND LIMITS OF ADMISSIBILITY

Artificial rent adjustment clauses are admissible in principle, or in the case of the application of Section 305 ff. of the German Civil Code (*Bürgerliches Gesetzbuch – BGB*), they are “only” subject to the limitation of Section 307 para. 1 BGB.

In contrast, real rent adjustment clauses must also fulfil the specific requirements of the Price Adjustment Act (*Preisklauselgesetz – PrKG*). In commercial leasing law, there is a general prohibition of real rent adjustment clauses stipulated in Section 1 para. 1 PrKG, though there are exceptions contained in Sections 2, 3 and 6 PrKG that are particularly relevant to contract drafters.

In order for the exceptions outlined in Section 2 PrKG to apply, the lease must be covered by a long-term contract in accordance with Sections 2 para. 1, 3 PrKG. In addition to the criteria of "recurring payments" required under Section 3 para. 1 No. 1 PrKG, which is nearly always a feature of (commercial) lease agreements anyway, it is also vital that the lease stipulates a minimum term. The provisions contained in Section 3 para. 1 No. 1 lit. e and lit. d PrKG are particularly relevant. These demand a term of ten years at least. According to Section 3 para. 1 No. 1 lit. e, the creditor (the landlord in this case) must have waived its right to exercise ordinary terminate for ten years (alternative 1) or the debtor (or tenant) must be given the right to extend the term of the contract to at least ten years unilaterally (alternative 2). The calculation is based on the *start of the lease*. In contrast, Section 3 para. 1 No. 1 lit.d PrKG bases its calculation of the duration of ten years of payment on the time of *contract closure* – at least according to its wording (this is disputed, according to another opinion it is also based on the start of the lease). Problematic issues may arise in these cases where there is a breach of the written form requirement. According to Section 550 sentence 1 BGB, a lease agreement is entered into for an unspecified period and may be terminated ordinarily by either of the parties which results in the rent adjustment clause becoming void.

According to Section 2 para. 1 sentence 2 PrKG, the clause must also be specific, i.e. worded in a clear and comprehensible (third party view) way. Section 2 para. 2 PrKG provides an example of what is not permissible. This provision states that a price adjustment clause is not sufficiently specific if an owed amount is generally dependant on future price development or some other measure that does not clearly specify the prices or values that it is based on. The concrete metrics must therefore be generally accessible, and the adjustment prerequisites and the time of implementation must be clear enough to allow the tenant to calculate the scope of the rent increase. A comparable view can be found in the transparency principle codified in Section 307 BGB in relation to general terms and conditions. According to this regulation, the issuer of general terms and conditions is required to present all rights and obligations to their partners in a clear and transparent manner and to create not only legal clarity, but price transparency as well.

Furthermore, Section 2 para. 1 sentence 2 PrKG forbids unfair disadvantages. Examples of unfair disadvantages are contained in Section 2 para. 3 No. 1-3 PrKG.

- Under these stipulations, one-sided clauses that only allow for a rent increase, but not decrease, or the de facto equivalent are deemed impermissible (No. 1),
- as well as clauses under which only one party has the right to demand a rent adjustment (No. 2) are deemed unfair.

- Disproportionate adjustments, i.e. a clause which allows the rent to be adjusted by a significantly greater degree than the reference indicator (No. 3) are also deemed impermissible. This is assumed to be the case for example if an index change of five percentage points leads to a rent adjustment of 5%, i.e. the percentage points and percent are deemed to be equivalent.

In addition to the requirements of Sections 2 and 3 PrKG, Section 6 PrKG also allows rent adjustment clauses in lease agreements between domestic companies (Section 14 BGB) and foreign persons. The word “Foreign” in this case refers to any persons that have their registered business address or primary residency outside of the country, regardless of whether they are considered to be companies within the meaning of Section 14 BGB.

CONSEQUENCES OF INVALID CLAUSES

If a rent adjustment clause violates the provisions of Section 1 para. 1 PrKG in a case where none of the legal exceptions apply, Section 8 PrKG states that such a clause becomes invalid at the point in time the breach is legally determined. The clause can therefore remain in effect until this point in time unless the parties have agreed on another date.

There is some dispute as to whether Section 8 PrKG is also applicable if the invalid clause is included as part of general terms and conditions. There are good reasons that speak for Section 8 PrKG to be applicable in these cases as well. The respective provision would otherwise be ineffective in a large number of cases.

HOW TO HANDLE IN PRACTICE

In order to avoid ordinary termination provisions on a lease rendering rent adjustment clauses invalid, parties need to make sure that they adhere to the written form requirements of Section 578, 550, 126 BGB. While contractual extraordinary termination rights for the tenant does not harm the indexation and the relevant period, the inclusion of a special termination right for the landlord is possible, provided that it is linked to objectively verifiable grounds for termination.

A (not entirely obvious) written form violation can result from the actual wording of the clause. For example, a formulation that specifies that the rent adjustment may be carried out at the request of a single party could lead to a situation where a third party cannot determine whether and when the rent has already been adjusted or when the next adjustment can be expected. In order to avoid the risk of entering a situation covered by Section 550 BGB, parties may have to arrange for a written addendum to the lease. Even a tenant friendly formulation that requires any rent adjustment to be declared by the landlord may as a result lead to the invalidity of the clause, as such clause would in practice prevent a deflationary rent reduction. In order to prevent such situations, parties should pay attention to practical and low-risk wordings that are on the other hand clear enough to be enforceable.

Attention to detail is required, when it comes to broadly worded rent adjustment clauses with “foreign” tenants. Despite the permissibility under Section 6 PrKG, there remains a broad scope for the application of the rules affecting general terms and conditions – particularly the provision on surprising business terms in Section 305c para. 1 BGB should be given close consideration.

RELATED PRACTICE AREAS

- Corporate Occupiers & Tenants
- Build to Rent/Multifamily

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