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Commercial Property - Switzerland

Triple-net lease agreements

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Background

Although triple-net lease agreements are still not often implemented in Switzerland, as a consequence of the entry of foreign financial investors into the Swiss commercial real estate market, over the past couple of years such leases have become an increasingly common topic of discussion among real estate professionals, in particular in relation to sale and leaseback transactions and long-term lease agreements for new single-tenant commercial buildings. The concept of triple-net leases originated in Anglo-Saxon countries, where it is well established. In Switzerland, mandatory legal provisions which are applicable to lease agreements for residential and commercial premises contradict certain principles of triple-net leases. Nevertheless, it is legally possible to implement triple-net leases.

Concept of triple-net lease

The concept of triple-net leases originally arose from the lessors' need to generate a steady, precisely calculable and determinable cash flow and revenue from the lease of commercial properties in order, in particular, to allow the banks to finance highly leveraged acquisitions.

A triple-net lease is a lease agreement on a property in which the lessee agrees to pay:

- all taxes and charges;
- operating and ancillary costs; and
- maintenance and insurance costs.

Such leases minimise the administrative burden and lower costs for the owner of a building, resulting in a steady and foreseeable cash flow. In return for assuming the administrative burden and saving the owner these costs, the lessee may expect to pay a reduced rent.

Legitimacy of triple-net leases under Swiss law

The difficulties in implementing triple-net leases arise from Article 256 of the Code of Obligations, which aims to protect the lessee. The mandatory provision states that the lessor is obliged to maintain the lease object in a suitable condition for the predetermined use; provisions which deviate from this principle to the disadvantage of the lessee are null and void if they are included in lease agreements for residential and commercial premises. Accordingly, the lessee must generally bear only the expenses for minor cleaning and repairs, up to a specified amount, as well as for the maintenance of all tenant specific installations. The remaining maintenance of the lease object and, in particular, of the roof and building envelope is the responsibility of the lessor. These principles obviously contradict the concept of the triple-net lease, which aims to transfer fully the duty to maintain the building to the lessee.

Maintenance, repair and renovation of lease object

Hitherto, no Swiss court rulings have addressed the question of how a triple-net lease can be implemented in light of Article 256 of the code. However, in the little legal literature available, the opinion prevails that a triple-net lease is permissible if it does not disadvantage the lessee. This is the case if the lessee's additional obligations –

that is, the shifting of the duty to maintain the lease object fully – are fully compensated, in particular by stipulating a rent reduction or an increased purchase price in sale and leaseback transactions. Therefore, provisions must be established with respect to the shifting of the duty to maintain the lease object's communal areas, the roof and building envelope since, in principle, the duty of repair for these lies outside the lessee's sphere of risk. Taking into account that the additional duties of the lessee must be adequately compensated, the parties and, in particular, the lessee must be in a position to assess the additional costs and risks. While this is unlikely to prove to be a major problem in sale and leaseback transactions (in which the lessee knows the building well) and can generally be achieved for custom-made, single-tenant buildings which are occupied by experienced corporate lessees, this will not apply to multi-tenant buildings.

To the extent that the lessee is adequately compensated for the additional costs and risks involved in a triple-net lease and thus suffers no disadvantage, there is no reason for triple-net leases to be considered contrary to law.

However, the fact that parties are required to assess the additional costs and risks and the adequacy of the lessee's compensation raises questions as to whether the maintenance and repair duties for the roof and building envelope of the lease object can be fully shifted to the lessee. While there should be no problem with regard to the transferring of ordinary maintenance, repair and renovation duties to the lessee, it is questionable whether it is legally possible to transfer to the lessee all the risks associated with future legislative changes (which may require further investment in the building), or in the event of *force majeure* or an accident, since such risks are generally not assessable.

In any case, in order to avoid damages to and depreciation of the building, the lease agreement must:

- contain express provisions regarding the lessee's maintenance, repair and renovation duties, and
- give the lessor the right to request execution of such works or to carry out such works at the cost of the lessee.

Charges, public levies and insurance costs
Article 256b of the code provides that charges and public levies connected with the mere existence of a building (ie, those which are independent from the use of the lease object) are the liability of the lessor. However, this provision is not mandatory and, therefore, all costs relating to real property tax, insurance of the building, waste removal charges and development charges can be fully shifted onto the lessee, provided that the lease agreement contains a specific explicit provision to that effect.

Ancillary costs
Pursuant to Article 257b of the code, ancillary costs are defined as actual expenditures by the lessor for performances which are connected with the use of the lease object (eg, heating, hot water and other similar operating costs) as well as public levies arising from the use. Article 257b(2) of the code provides that ancillary costs can be fully shifted onto the lessee to the extent that this is explicitly agreed. According to the restrictive practice of the Federal Supreme Court, this requires that every single category of ancillary charge to be borne by the lessee is explicitly specified in the lease agreement.

Formal aspects
A triple-net lease agreement must be concluded in writing. It must explicitly specify all costs to be borne by the lessee and list all ancillary costs, charges, public levies and insurance costs.

With respect to the maintenance, repair and renovation of the lease object – specifically the structural elements of a building, the roof and the building envelope – the lease agreement must ensure that the transfer of the additional duties is not to the disadvantage of the lessee. Thus, while it is likely to be sufficient for the parties merely to keep a record of how the rent has been calculated and how the transfer of additional costs and risks to the lessee has been taken into account, it is advisable to include such information in the lease agreement, since any problems will most likely arise only when major works become necessary many years after entry into the agreement. With respect to the maintenance of the roof, building envelope and communal areas, it might be advisable to provide for a specific cost limitation and to include explicit wording confirming that, taking into account the additional risk and duties, the lessee does not consider the agreement to be to its disadvantage.

The validity of triple-net-lease agreements can only be assessed on a case-by-case basis. On the one hand, in sale and leaseback transactions a lesser level of detail is required since the lessee has in-depth knowledge of the maintenance costs of the building. On the other hand, any transfer of such additional duties to the lessee is unlikely to be valid if included in the general terms and conditions for individual lease-objects in multi-tenant buildings.

Given the difficulties in making a reliable assessment of the maintenance costs and in calculating the benefits to the lessee, parties will often be inclined to refrain from including too much detail in their agreements. However, this approach is risky and parties would be well advised to be detailed and transparent as possible. This particularly applies to the lessor, which bears the risk of having a provision deemed to be null and void if it is unable to prove – perhaps many years down the line and maybe even after the lease agreement has been transferred to a new lessee – that the provision was not to the disadvantage of the lessee.

Comment

Provided that the principles outlined in this update and in the legal doctrine available are observed, it would appear that triple-net lease agreements are permissible under Swiss law. However, due to the lack of relevant case law, a degree of uncertainty remains regarding the level of specification required in the lease agreement and over the question of whether a court might request other or additional requirements than those outlined in this update. However, since triple-net leases have only recently been adopted by the Swiss real estate market and disputes are likely to arise only when major works are due, the courts cannot be expected to provide answers in the near future.

Nevertheless, the remaining uncertainty will not prevent triple-net lease agreements from becoming increasingly common in the professional real estate market in Switzerland, in particular in relation to sale and leaseback transactions and long-term leases of single-tenant buildings. However, to limit the legal risks as far as possible, it is crucial that the relevant lease agreements be drafted with extreme care.

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