GLOBAL LEGAL INSIGHTS

Commercial Real Estate

Second Edition

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Published by Global Legal Group

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Luxembourg

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Introduction

Most Luxembourg undertakings or companies in retail, industrial or service business, and in particular companies of the financial sector, prefer to lease premises or buildings. One of the considerations for such a strategy is the flexibility to manage growth needs. Many real estate funds invest in buildings to rent them to appropriate tenants. Because of the rules of capital adequacy that apply a high consumption of equity in the determination of capital adequacy ratios, financial institutions do also consider alternatives to acquisitions. Real estate leasing (*credit bail*) is an alternative: the tenant has the option to acquire the building after a certain term.

In the industrial sector, undertakings generally prefer to buy land in order to build their production sites.

An alternative is the sale and leaseback strategy pursuant to which a company buys a plot of land, builds the building and after a certain period of time, *inter alia*, because of amortisation (*amortissement*) considerations, sells the building to a third party and leases the building back.

Other alternatives to the lease are:

- The *droit de superficie* which is a long-term (maximum 99 years, but may be renewed) *in rem* tenancy and building right granted from the landowner to a tenant against payment of a fixed rent agreed between the parties in a notarial deed, authorising the tenant to build structures on the land which will be the property of the tenant until the end of the *droit de superficie*. At the end, the property of the building is transferred to the landowner against payment of the net value of the building.
- The *bail emphythéotique* which is a long term (minimum 27 years, maximum 99 years) *in rem* tenancy right on a building against payment of a fixed rent agreed between parties in a notarial deed. The tenant may improve the building by new constructions, but he cannot claim any payment to the building owner for such constructions at the end of the *bail emphytéotique,* unless agreed otherwise.

Real estate law is mainly governed by the Civil Code and the principle of freedom of contract. Specific laws complement these general provisions on certain points, as for example the law of 25 September 1905 on registration of rights in immovable property.

The present contribution focuses on key aspects of real estate, in particular office and commercial buildings.

Leasing

Practical points

(a) Securing the premises:
In order to secure occupation of the premises, it is possible to conclude a lease contract for buildings which are still in their planning phase or under construction. In such a case, the lease is concluded under the condition precedent to the completion of the building. If the lease has been entered into for a fixed term, the tenant cannot in principle terminate the lease prior to such term. If the lease contract is concluded for an undetermined period, it may be terminated by a written prior notice as stipulated in the contract. If no prior notice has been provided for in the lease contract, it shall amount at least to six months.

(b) Taxes and fees payable:
In principle, each lease agreement shall be registered with the Registration and State Lands Authority (*Administration de l'Enregistrement et des Domaines*) within three months upon the date of the lease. For leases which are not subject to VAT, the proportional registry tax rises to 0.6% of the aggregate amount of all rents to be paid under the lease. If a lease is entered into for an undetermined period, the reference period taken into consideration is a 20-year period. If the term of the lease exceeds nine years, the lease contract has to be concluded before a notary, and an additional transcription tax of 1% has to be paid. Late registry incurs payment of double the tax, i.e. 1.2%, or 3.2% if applicable. For leases subject to VAT, a fixed tax of €12 is collected. As a general rule, the lease of immovable properties is not subject to VAT but the parties may opt to make the transaction chargeable to VAT. The VAT option declaration has to be filed for approval with the Registration and State Lands Authority and such approval must be obtained prior to the coming into effect of the lease contract. VAT can only be charged on the rent as from the date on which the option takes effect, as stated in the approval that is issued. In order to obtain the approval of VAT option, the tenant must be able to fully deduct VAT, or to deduct the same in an overall deduction percentage that amounts at least to 51%. If the tenant is not able to deduct VAT, the rent shall be adjusted by including the VAT in the rent. The payment of VAT is the tenant's liability.

(c) Fitting out works:
The Civil Code does not contain any express provisions specifying which fitting out works the tenant may carry out without the approval of the owner, and in practice, lease contracts contain specific provisions regarding works carried out by the tenant.
In case the lease contract does not contain any provisions on fitting out works done by the tenant, pursuant to case law, the tenant shall require the consent of the landlord before carrying out any important building works or modifications. In any event, building works in the sense of important changes to the leased premises carried out without the consent of the landlord may be considered as a breach of the contract and entitle the landlord to terminate the lease contract. Minor changes may be carried out without the consent of the landlord.

(d) Codes of practice:
There are only a few mandatory provisions governing commercial and office leases which may be freely negotiated between the parties. Furthermore, there are no industry codes or guidelines which would help in negotiating the lease.

Key commercial terms

(a) Rent:
The parties fix the rent for office or commercial leases by mutual agreement. The law does not impose any threshold.

In principle, rent is exempted from VAT. However, the parties may agree to waive this exemption from VAT and opt to charge VAT on the rental of the premises in order to be able to recover input VAT. A prior approval of the VAT option declaration which has to be filed by the parties with the Registration and State Lands Authority is necessary. Such approval can only be obtained if both parties are at least 51% subject to value-added tax. The activities carried out in the let premises by the tenant have to be predominantly activities that permit the tenant the full deduction of input VAT. It is common market practice that parties agree that in case conditions allowing the option to charge VAT on the lease are no longer fulfilled during the course of the lease and such non-fulfilment is due to the tenant, the ex-VAT rent is automatically increased by a sum equivalent to the VAT, in accordance with the rate then applicable.

The parties are free to fix the frequency of rent payments. Usually, rent is paid on a monthly, sometimes on a quarterly basis.

(b) Rent adjustments:

It is common market practice to have the lease linked to the consumer prices index, which is the general index linked to the basis of 1 January 1948 published by STATEC (*Service central de la statistique et des etudes économiques*, public statistics administration). Lease agreements generally specify that the adjusted rent may not drop below the rent applicable at the time of adjustment.

The index is applied, and the adjustment is made on the amount of the rent (excluding VAT if the rent is subject to VAT) in principle on each anniversary date of the lease agreement.

(c) Other occupational costs:

In principle, the tenant has to bear its share in the common charges of the building which, mostly, are fixed in accordance with the quote-parts attributed to the premises. Said common charges relate to general costs with respect to common local services and to the services related thereto, supplied to the tenant by the landlord or an appointed property manager. The landlord has to prove that he paid such costs on behalf and in the interest of the tenant.

The landlord has to bear major repairs, taxes related to the property of the building, insurances related to the property of the building, etc. In order to determine which party has to support a specific cost, a prior exam of the nature of the cost or charge has to be carried out. Abundant case law precedents exist regarding such classification of costs. Notwithstanding these principles, article 1754 of the Civil Code authorises the parties to derogate thereto. In practice, e.g. the tenant pays the taxes related to property.

In practice, the tenant pays monthly or quarterly advances on common charges concomitant with rent payments. Once a year, the landlord establishes a detailed account of common charges pursuant to which the tenant has to pay a surplus and gets reimbursement of the balance.

(d) Period of occupation:

The parties are free to determine the length of the term of the lease. Lease agreements for premises used for business or office purposes are in general concluded for a 3-6-9 year period. A longer term (above nine years) obliges the parties to conclude the lease contract before notary.

Pursuant to article 1737 of the Civil Code, the lease contract concluded for a determined duration ceases at its expiry date without any requirement of prior notice. However, if at the expiry date the landlord lets the tenant in possession of the premises without protest, pursuant to article 1738 of the Civil Code, the lease contract is tacitly renewed.

(e) Remaining in occupation:

A difference has to be made between office leases which are ruled by common law which promotes contractual freedom, and commercial leases which, besides common law, are ruled by protective rules for the tenant, as set forth in articles 1762-3 to 1762-8 of the Civil Code.

'Commercial lease' is not expressly defined by law; its definition is disputed and actually only appreciated on a case-by-case basis by analysis of the concrete activity pursuant to a cluster of criteria (contact with customers, destination of the leased premises, provisions of the contract, nature of business, etc.).

In case the contract is considered to be a commercial lease, the tenant can take advantage of the protective rules as set forth in the aforesaid provisions of the Civil Code, which can be summarised as follows:

- a clause, pursuant to which an assignment of the lease or sub-lease is prohibited, is null and void if the assignment or the sub-lease is made together with the sale of business-goodwill, provided that an identical business remains established;
- the tenant (or his assignee) who is running a business for more than three years is entitled to have a preferred renewal of his contract at the end of its term in preference to all other persons. This right ceases:
  (i) after the 15th year of the lease;
  (ii) in case the landlord justifies having received a higher actual and honest rent offer and the tenant refuses the adjustment of rent to this offer;
  (iii) in case of legitimate complaints against the tenant which are appreciated by the competent judge;
  (iv) personal occupation by the landlord or his descendants;
  (v) change of business; or
  (vi) reconstruction or transformation of the building; or
- in case the commercial lease terminates, the tenant may ask the competent judge to grant two "commercial stays" (*sursis commercial*) for a maximum duration of two times in six months. Such request will be refused if the landlord needs the premises for personal use or another serious and legitimate ground, the latter being assessed on a case-by-case basis.

For office leases, no such protective rules exist. They cease at the end of the stipulated term. If they have been entered into for an undetermined period, excepting contrary contractual provisions, they can be terminated at any moment by giving prior notice of six months.

(f) Disposing of the premises:

In case of a contract concluded for a fixed term, the contract cannot be terminated prior to such term except:

- if concrete termination events have been stipulated (*clause résolutoire*), such stipulations remain subject to a discretionary power of the judge;
- in case of gross misconduct by one of the parties, e.g. non-payment of rent, unauthorised sub-lease by the tenant… (subject to the discretionary power of the judge);
- in case the leased premises become uninhabitable pursuant to article 1724 of the Civil Code because of urgent major repairs (*cf.* hereunder); or
- in case of a lease contract concluded for a 3-6-9 year period, it may be terminated at the end of each of such period by giving prior notice, even if such prior notice has not been stipulated.

If the lease contract is concluded for an undetermined period, it may be terminated by written notice as stipulated in the contract. If no prior notice has been provided for in the lease contract, it shall amount at least to six months. In case of gross misconduct, the contract may be terminated with immediate effect, but the termination letter must contain the reasons justifying such termination.

It should be noted that insolvency proceedings are not an automatic ground of termination of the lease contract unless the parties agreed differently in the lease contract.

Lease agreements may be sublet or assigned by the tenant unless the lease agreement contains a prohibition of such subletting or assignment. In practice, it is frequently stipulated that the tenant cannot sublet the premises or assign the lease without the prior consent of the landlord to a third party, except if such subletting or assignment is made to an affiliated company of the group to which the tenant is affiliated or to a client of the tenant in case of domiciliation, the latter remaining jointly and indivisibly liable for the obligations arising out of the lease contract.

Regarding commercial leases the tenant may assign the lease or sublet the premises notwithstanding any clause prohibiting such subletting or assignment if: (i) the subletting or the assignment is made together with the sale of business-goodwill; (ii) the lease contract is a commercial lease; and (iii) an identical business is carried out in the leased premises by the sub-lessor or the assignee of the lease. In such case, the assignor remains jointly liable with the assignee or the sub-tenant for all obligations resulting from the lease contract.

(g) Alterations:

There are no legal provisions specifying which alterations of the leased premises may be carried out by the tenant and which are forbidden. In general, lease contracts contain specific provisions regarding alterations carried out by the tenant.

If the lease contract does not contain any provisions on alteration works done by the tenant, pursuant to case law, the tenant shall require the consent of the landlord before carrying out any important building works or modifications.

(h) Repair of the premises:

In accordance with the provisions of articles 1720 and 1754 of the Civil Code, only the costs of major repairs are incumbent upon the landlord.

The tenant has to maintain the premises in a good and tenable state of repair. The tenant bears the costs of maintenance and "minor" repairs except if these minor repairs are caused by dilapidation or *force majeure* (article 1755 Civil Code). The parties may, however, decide to derogate from these rules.

As there is no precise enumeration with respect to the sharing of maintenance or repair costs and in case of dispute, case law is determined on a case-by-case basis, which costs are borne by the landlord or by the tenant.

Regarding necessary or urgent repairs to be carried out by the landlord, pursuant to article 1724 of the Civil Code, the tenant has to tolerate without penalty or reduction of rent, the accomplishment of such repairs. If the repairs exceed 40 days the tenant is entitled to a rent reduction. If the premises become uninhabitable because of the repair works, the tenant may terminate the lease contract.

Without prejudice to normal wear and tear, the tenant has to return the leased premises in the original state unless agreed otherwise between parties.

In case the tenant has carried out building or modification works without the consent of the landlord, all modifications, transformations and improvements must be removed by the tenant, who shall at its own cost, return the premises to their initial state unless the landlord

requests of the tenant that it maintain in whole or in part any removable modifications, which shall become the property of the landlord in return for the payment of a price agreed between the parties. It is generally accepted that inseparable modifications from the leased premises, without prejudice to contrary contractual provisions, do not entitle the tenant to claim for compensation with respect to the added value to the premises.

The tenant, who has not returned the premises in their initial state before leaving, cannot claim any compensation. In such event, the landlord may remove the alteration works, the costs being borne by the tenant. Furthermore, he may claim a compensation for the temporary unavailability of the premises.

Upcoming regulation or legislation

A bill of law has been prepared by the government regarding commercial leases which shall provide a better protection to tenants relating to unjust rent increases by landlords.

In recent years it has been shown that the lack of protection for tenants regarding commercial leases could lead to abusive situations. Some real estate speculators have caused a continuous and significant increase of rents. A spiral of speculation has taken place, with sublets and many middlemen acting in the local rental business solely for the purpose of re-letting at a higher price. Recent events including bankruptcies of shops in Luxembourg-City have led to the drafting of the aforesaid bill of law. Excluded are tenants in galleries and shopping centres.

This bill of law sets forth:

- A minimum lease term of nine years, which breaks with the current 3-6-9 year period, which gives more security and stability to business development of the tenant.
- The ability for the tenant to terminate the lease in each three-year period, in order to provide an exit within a reasonable period.
- The option for the tenant to terminate the lease contract at any time during the first two years of operation, with three months' prior notice if there is in an irreparably compromised economic situation.
- The possibility of a three-year adjustment of rents subject to clearly stipulated criteria in the contract.
- The principle of an automatic renewal of the lease contract for a period of three years.
- A stay of execution of judgments of eviction for a period of nine months in order to arrange the transfer of the business and settle the social situation of workers.
- The principle of a right to renew the lease notwithstanding any contrary clause; the tenant may require the renewal of the lease contract twice, except in cases of misconduct of the tenant. An exception to this rule is provided for, i.e. if the landlord or a third party pays appropriate compensation to the tenant in order to avoid any financial harm.
- The prohibition of the payment by the tenant of an entrance fee (*pas-de-porte*) to the landlord. Only a rental guarantee limited to three months' rent may be requested.

Investment

Practical points

(a) Exclusivity:

The purchase of a property is generally carried out in two phases, namely a private contract between parties and a notarial deed. Although a private contract is perfectly valid between parties, such agreement is not enforceable against third parties. In this respect, a notarial deed which has been recorded at the mortgage register (*Bureau des*

hypothèques) is required. However, it is possible to register a private contract with the Registration and State Lands Authority within three months of the date of the contract. In this case, the private contract becomes enforceable against third parties as of the date of its registration. For contracts containing a condition precedent, a fixed tax of €12 is collected. For contracts which do not contain any condition precedent, the proportional registry tax amounts to 6%, plus, if applicable, a municipal surcharge of 50% on the registry tax amount for property located in Luxembourg-City. The registration of the private contract with the Registration and State Lands Authority does not exempt the parties from the registration of the notarial deed or from recording the notarial deed at the mortgage register.

(b) Restrictions on disposing of property:
There are no restrictions on transferring property, for example to foreign entities. Both natural and legal persons may hold and use immovable property for themselves or for the purpose of renting it out to someone else.

(c) Impacts on timing:
Undertakings are not free to establish their business anywhere on Luxembourg territory. The destination and use of land, i.e. commercial, residential, industrial, etc., is fixed in a general town planning scheme (*plan d'aménagement general*) drawn up by each municipality and approved by the Ministry for Internal Affairs. A particular town planning scheme (*plan d'aménagement particulier*) regulates more precisely the constructions to be built on each part of the general town planning scheme. Furthermore, each construction, transformation, demolition or modification of use [e.g.: change from residential into business or commercial] has to be authorised by the mayor of the municipality.

(d) Key milestones in the acquisition process:
Prior to the notarial deed, the parties generally conclude a preliminary sale and purchase agreement (*compromis de vente*). This private agreement is perfectly binding between parties but is only enforceable against third parties upon registration (*cf*. hereabove).
In order to register the transfer of the ownership, the notarial deed needs to be recorded at the mortgage register.

(e) Requirement for transfer of monies:
The purchase price is generally transferred to the third-party account of the notary prior to the signature of the notarial deed and is later transferred to the vendor, after deduction of any sums due to mortgagees (if applicable), fees and taxes (*cf*. hereunder).
Pursuant to the law of 12 November 2004 as amended relating to the fight against money laundering and against terrorism financing, the notary is subject to *know your customer* obligations and has to verify the source of the funds.

(f) Execution procedure:
An acquisition of real estate needs to be concluded by notarial deed. When dealing with an overseas company, lenders may request legal confirmation that the purchase agreement has been validly concluded.

(g) Other procedural requirements:
In order to be enforceable against third parties, the notarial deed must be registered with the Registration and State Lands Authority and must be recorded at the mortgage register.

(h) Taxes and fees payable:
The transfer of real estate is subject to a registry tax assessed on the purchase price or the effective value of the property, whichever is higher.

The registry tax amounts in principle to 6%, plus, if applicable, a municipal surcharge of 50% on the registry tax amount for property located in Luxembourg-City. To this is added a transcription tax (*droit de transcription*) which amounts generally to 1%.

As a general rule, transfers of immovable properties are not subject to VAT, except the transfer of ownership of real estate before construction is started. Furthermore, the parties may opt to make the transaction chargeable to VAT in order to allow the seller to deduct its input VAT on investment costs.

Furthermore, the owner of an immovable property is required to pay property taxes set by the municipality.

Key commercial terms

(a) Deposit:
The payment of a deposit is usually not required. However, most sellers ask for a confirmation that the buyer is able to pay the purchase price.

(b) Timing:
The timetable for acquiring a property depends on various factors (nature and location of the real estate, financing…) and can vary greatly.

(c) Employees:
The acquisition of an immovable property does not affect employment contracts concluded between the current owner and its employees, unless it qualifies as a transfer of undertaking (*transfert d'entreprise*) pursuant to Article L.127-1 *et seq.* of the Labour law Code. In this case, the buyer takes over the employment contracts of the personnel.

(d) Warranties for construction of buildings:
Luxembourg law provides for warranties given by the different parties involved in the construction process of a building (contractors, architects, engineers…). Said warranties are linked to the building and the buyer of the building is entitled to invoke them. If the defect concerns minor works (*menus ouvrages*), the warranty runs for two years (*garantie biennale*). When the defect concerns major works (*gros ouvrages*), the warranty lasts 10 years (*garantie décennale*).

(e) Transfer of other tax or financial benefits:
None.

Development

Practical points

(a) Land ownership and assembly:
The land register (*cadastre*) provides public information on the ownership of land situated in Luxembourg.

Owners can only be forced to sell their land on the basis of public interest declared by Grand-Ducal Decree.

(b) Land transfer:
If the developer does not want to buy the land straight away, the parties may sign an agreement by which the owner undertakes not to sell the land to a third party during a certain period of time, or by which the owner undertakes not to sell the land to a third party without offering the same conditions to the developer beforehand.

(c) Taxes and fees payable:
In addition to the taxes linked to the transfer of real estate and to the property taxes (*cf.* hereabove), municipalities may tax unoccupied buildings and vacant building land. One of the Luxembourg Government's priorities is to promote affordable

housing. Most recently, the Parliament has voted a bill of law on 8 July 2015 giving the municipal council the power to make it mandatory for real estate owners to declare unoccupied dwellings. Any person violating this obligation shall be fined up to €250. Further administrative and penal sanctions are foreseen by the law of 19 July 2004, as amended, in case of violation of the general or particular town planning scheme, or of the authorisations given by the mayor (*cf.* hereabove).

Key commercial terms

(a) Price:
The value of development land is usually determined by an independent expert. In order to assess the value of development land, the developer should bear in mind the total cost of development which may, *inter alia*, include the preparation of a particular town planning scheme or compensation measures in case of destruction of biotopes.

(b) Payment structure:
The parties may agree that the investor does not have to pay the full value of the land at the date of execution of the purchase agreement but that other payments may be made at a later stage. In this case, Article 2103 *et seq.* of the Civil Code grants the seller a preferential right over the immovable property sold. An alternative is a personal guarantee provided by a third party guarantor under the form of a first demand guarantee or, albeit less favourable for the creditor, under the form of a *cautionnement*.

(c) Deal structures:
It is common practice to conclude lease contract or purchase agreements for buildings which are still in their planning phase or are under construction.

(d) Taxes and fees payable:
(*cf.* hereabove).

Financing

Practical points

(a) Level of loan:
The amount that lenders are usually willing to advance against commercial property depends on various factors. It may go up to 80% of the purchase price.

(b) Security:
Lenders usually require that a mortgage is recorded on the real estate or that a personal guarantee is provided by a third party guarantor, either under the form of a first-demand guarantee or under the form of a *cautionnement*. In case the real estate is rented out, lenders may also ask that the rent is paid directly to them.

(c) Lender due diligence:
Lenders usually expect an investor to carry out various due diligences, e.g. technical, legal, tax, financial, tax, environmental. The due diligence process will be less extensive if it concerns an asset deal and not a share deal.

(d) Enforcement:
When the debtor fails to meet its financial obligations, the lender may terminate the loan and require its immediate reimbursement. The possible enforcement actions depend on the securities that have been granted.

Key commercial terms

(a) Length of loan:
The length of the loan is freely negotiated with the lender and amounts generally to at least 10-15 years.

(b) Interest rate and payment dates:
Interest is fixed taking into account the benchmark interest rate set by the European Central Bank. The interest rate can be either fixed or floating and is usually payable quarterly.

(c) Repayment:
The failure of the debtor to comply with its obligations entitles the lender in principle to terminate the loan agreement. In this case, the loan shall be reimbursed immediately. Instead of the direct purchase of real estate via an asset deal, undertakings may also acquire a company holding the immovable property (share deal). From a legal point of view, there is no transfer of ownership of the real estate and hence no registration or transcription duty would be due.

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