Admissibility of Triple-Net Lease Contracts[1]

by Raphael Söhlke, P+P Pöllath + Partners, Berlin

Content of Triple-Net Lease Contracts

Origin and Economic Significance

Triple-net lease contracts aim to exempt the lessor from the costs of the leased property, in order to thus secure yield realized from the lease payments. While such contracts are quite common in Anglo-Saxon countries, in Germany there is (still) some uncertainty on both the conceptualisation as well as the validity of such contracts. The term "triple-net" implies that a "threefold net" lease payment can be collected by the lessor, i.e. without (calculated) deductions concerning tax, insurance and maintenance. When concluding a triple-net lease contract, the lessor/investor has two aims in mind: firstly, to procure the lease income without cost items which reduce the yield. All operating and administrative expenses in connection with the property (in the broadest sense) are shifted to the lessee, eliminating the need for a (calculated) reduction from the expected regular lease income. Secondly, the point is to minimize the amount of work done on the property by the lessor during the term of the contract as much as possible, by making the lessee responsible for the entire maintenance, i.e. upkeep, repairs and, as far as possible, the administration of the property.

For the lessee, this at least results in the possibility of a cost reduction: in return for bearing the higher costs and risks associated with a triple-net lease contract, they pay a (in some cases significantly) lower rent. It is then up to the lessee to take advantage of the difference to bear expenses on the property and to insure against risks resulting from their maintenance obligation.

Individual Questions

Tenancy rules (Mietrecht) in the German Civil Code do not recognize the triple-net lease contract as a separate type of contract. Until now, the standard commentary and textbooks on tenancy law scarcely mention triple-net lease contracts; only the literature apart from commentary and textbooks has already dealt with this in more detail. A conclusively reinforced and consistent understanding of what characterizes a triple-net lease contract, however, still does not exist. Currently, the examination is regularly broken down into individual questions:

In financial terms, the most important criterion for a triple-net lease contract is the shifting of liability for maintenance and repair to the lessee. According to statutory provisions, the lessor is obliged to maintain the lease object in a condition which complies with the requirements of the lease contract. They thereby bear the maintenance expenses, in other words they must carry out all maintenance and repair measures, including interior redecoration, which are necessary to ensure the use of the property by the lessee according to the contract during the entire term of the lease.

However, when leasing business spaces it is common to impose a broad range of maintenance and repair obligations on the lessee (e.g. maintenance and repair of all areas exclusively used by the lessee). Nevertheless, part of the maintenance and repair obligations remains the responsibility of the lessor. This applies in particular to the maintenance of the roof and the supporting structures of the building, often referred to as "Dach und Fach" ("roof and structure").

Consequently, the lessor is obliged to fulfill maintenance and repair obligations and arrange for the necessary measures to be taken. This can lead to a significant cost burden for the lessor. In addition – particularly with long-term lease contracts – it is almost impossible to reliably predict in advance what maintenance/repair requirements may arise during the term of the lease. This uncertainty is at odds with the financial goals of lessors/investors, who rely on calculating the future revenue and expenditures as accurately as possible upon conclusion of the lease contract.

In addition to the costs for maintenance and repair, lease income will be reduced primarily by expenses in connection with the operation of the property, as far as these are not to be borne by the lessee. In order to exclude this risk, a second component of the triple-net lease contract should provide for the lessee to bear all incidental and operating expenses. The (usual) clause which determines that the lessee shall be responsible for the operational expenses pursuant to sec. 2 of the Operating Expenses Ordinance (Betriebskostenverordnung – BetrKV) does not, however, cover various other costs. Thus costs expended for the commercial and/or technical administration, for instance, are not operating expenses within the meaning of the BetrKV.
In order to ensure that all operating expenses are borne by the lessee and therefore do not reduce the stipulated lease income, it should be agreed that the lessee shall bear all further operational and incidental expenses in addition to those pursuant to sec. 2 BetrKV, and preferably also those which are incurred in the future.

By the same consideration, the lessor/investor will also wish to ensure that the lessee shall bear the costs of the necessary (or pre-agreed) insurance policies.

By referring to sec. 2 no. 13 BetrKV ("costs of property and third-party liability insurance") on the obligation to bear costs, considerable progress may be made. According to this provision, the lessee shall at least bear the costs of insurance for fire, storm, water and other elemental damages.

A further aspect is the question of which party to a triple-net lease contract shall bear the risk of (accidental) loss of the property, or which mutual obligations exist if the property is completely or predominantly destroyed, without this being the responsibility of the lessor or the lessee.

According to statutory provisions, in the case of the lease object being destroyed, the lessor is released from their obligation to relinquish the lease object (sec. 275 German Civil Code); the lessor is not obliged to rebuild or repair the property[2]. In case of a partial destruction of the lease object, the

1 The present article is an abbreviated version of an article which the author published in Transaktionen, Vermögen, Pro Bono - Festschrift zum zehnjährigen Bestehen von P+P Pöllath + Partners, Beck Verlag, January 2008, pg. 197 - 210

2 BGH v. 13.12. 1991 – LwZR 5/91, ZMR 1992, 140, 141; LG Berlin v. 28. 5. 1998 – 62 S 401/97, WuM 1998.

ALM

lessor is only obliged to rebuild or repair if this is possible during the lease term and if costs do not exceed a (financially) reasonable limit (Opfergrenze)[3]. On the other hand, the lessee is released from their obligation to make the stipulated lease payments (sec. 275 para. 4, 326 para. 1 German Civil Code). So in effect, the lessor primarily bears the risk of (accidental) property loss. Until conclusion of rebuilding, they receive no lease payments and also bear the risk of not having (sufficient) insurance for the damages incurred. In addition, they are responsible for rebuilding the lease object (including the conclusion of building and planning contracts), for which financial investors are not normally equipped.
The statutory provisions in turn do not correspond with the financial interests of the lessor/investor regarding unreduced lease income. The lessor/investor will therefore be anxious to shift the risk of accidental property loss as far as possible to the lessee, e.g. with the following provision: firstly, that the lessee is obliged to arrange for the rebuilding or necessary repairs. For this purpose, they are either assigned any insurance claims of the lessor or the lessee themselves must take out the (building) insurance. Secondly, provisions are made to ensure that the obligation to pay the rent shall only be discontinued until the point in time at which the rebuilding work could have been concluded if the lessee had properly fulfilled these obligations.

Admissibility of Triple-Net Lease Contracts

The question of the legal admissibility of triple-net lease contracts is currently answered on a case-by-case basis (Einzelbetrachtung), namely whether the clauses typical for this structure are admissible. It is important to understand this individual examination before deliberating whether an overall examination (Gesamtbetrachtung) might lead to different results.

Individual Examination According to the Requirements for General Terms and Conditions (Klauselrechtliche Einzelbetrachtung)

Whether, and to what degree, the parties may deviate from the statutory distribution of risks to the detriment of the lessee in the general terms and conditions (AGB) has been the object of countless individual court decisions. Case law in many areas is however still in flux. For the clauses/elements of triple-net lease contracts as mentioned above, the following principles may be recorded:
The question of whether general terms and conditions (AGB) may permissibly oblige the lessee to carry out comprehensive maintenance and repair (including "Dach und Fach") has not been conclusively answered. Based on two decisions of the Higher Regional Courts (Oberlandesgerichte – OLG) of Cologne[4] and Naumburg[5], a comprehensive transfer of the maintenance charges to the lessee in the general terms and conditions (AGB) is in essence invalid. The lessee would be burdened with an incalculable cost risk which could not be predetermined and the lessee could be held liable irrespective of any fault (verschuldensunabhängige Haftung) and would have to bear the expenses of any damages and wear and tear already present prior to conclusion of the contract.

In both decisions, the respective clauses were, however, each restrictively interpreted so that in effect the lessee only had to carry out maintenance and repair work necessitated by their use of the leased property[6]. However, it is doubtful whether this restrictive interpretation of general terms and conditions (AGB) is valid against the background of sec. 305 c para. 2 German Civil Code (doubts on the interpretation shall be to the detriment of the user of the respective term or condition) and the principle that an invalid provision may not be reduced to its permitted content (Verbot der geltungserhaltenden Reduktion)[7]. The OLG Dresden[8] and the Higher Regional Court of Berlin (Kammergericht)[9] have also determined that the (complete) transfer of liability for maintenance and repairs is not admissible in the general terms and conditions (AGB). Similarly to the decisions of OLG Cologne and OLG Naumburg, this is justified on the grounds that the lessee would be burdened with incalculable expenses. From the wording of the judgment, one could argue that according to the opinion of OLG Dresden and Kammergericht Berlin, the transfer of liability for maintenance of "Dach and Fach" is invalid in any case. With reference to this judgment, the specialist literature thus takes the view that a transfer of liability for "Dach und Fach" is also in principle invalid in the general terms and conditions (AGB)[10].

In 2005, the Federal Court of Justice (BGH) decided that the obligation for maintenance and repair may only be shifted to the lessee as far as it extends to damages attributable to use of the lease object or the lessee's sphere of risk[11]. The Federal Court of Justice's decision pertained to a case in which the lessee had only leased a part of the property. However, the principle as stated by the Federal Court of Justice should also be valid for the case which almost exclusively occurs in triple-net lease contracts, where the entire property is leased. On areas and facilities which are exclusively used by the lessee – in particular if the entire property is leased – the (complete) transfer of liability for maintenance and repair should thereby be admissible in the general terms and conditions (AGB), as far as it results from use of leased property or is within the lessee's sphere of risk.

In argumentum e contrario, this means firstly that the lessee may not be held liable for defects already existing upon the surrender of the leased premises to the lessee. Secondly, no liability for maintenance/repair measures may be transferred to the lessee arising from accidental loss of property (e.g. through a fire which is not the fault of the lessee)[12]. These principles should also be valid without exception for the maintenance and repair of "Dach und Fach". In its 2005 decision, the Federal Court of Justice did not expressly comment on respective provisos on "Dach und Fach". However, there should be no room for such a proviso after the Federal Court of Justice's decision in 2005. Firstly, in its decision the Court gives no indication that its stated principles should not be valid for the maintenance of "Dach und Fach". Secondly, this conclusion results from the following consideration: the decision refers expressly to the transfer of responsibility for maintenance and repair of jointly used areas and facilities. Against this background, there is no reason the (jointly used) roof should be treated differently than, say, a (jointly used) heating system.

3 BGH v. 20. 7. 2005 – VIII ZR 342/03, NJW 2005, 3284.
4 OLG Köln v. 17. 12. 1993 – 19 U 189/93, NJW-RR 1994, 524.
5 OLG Naumburg v. 12. 8. 1999 – 2 U (Hs) 34/98, NJW-RR 2000, 823.
6 Cf. also Wolf/Eckart/Ball, Handbuch des gewerblichen Miet-, Pacht- und Leasingrechts, ninth ed. 2004, para. 370.
7 Heinrichs, in: Palandt, BGB, sixty-sixth ed. 2007, „vor § 307", para. 8.
8 OLG Dresden v. 17. 6. 1996 – 2 U 655/95, NJW-RR 1997, 395 (396).
9 KG Berlin v. 23. 5. 2002 – 20 U 233/01, NJW-RR 2003, 586.
10 Schmidt-Futterer, Mietrecht, ninth ed. 2007, § 535 para. 80; Schlemminger/Tachezy, NZM 2001, 416 (416 et seq.).
11 BGH v. 6. 4. 2005 – XII ZR 158/01, ZMR 2005, 844 (846).
12 BGH v. 25.2.1987 – VIII ZR 88/86, NJW-RR 1987, 906.

The allocation of the operating expenses itself requires a defined and unambiguous agreement in the contractual provisions. The lease contract must define the operating expenses to be borne by the lessee. The lessee should be able to at least approximately determine which additional costs may be incurred[13]. Therefore, the statutory requirement of certainty (Bestimmtheitserfordernis) applying to general terms and conditions is not fulfilled by such formulations as "the lessee shall bear all operating expenses" or even "... the customary operating expenses"[14]. Similarly, a provision by which all newly resulting operating expenses are allocated to the lessee is invalid pursuant to sec. 307 German Civil Code[15].

Insurance premiums in addition to sec. 2 Nr. 13 BetrKV may also be assigned to the lessee. The expenses for special insurance policies such as, for example, glass insurance, insurance for damages to telecommunications, alarm and fire alarm systems, other electrical and electronic systems, are only transferable to the lessee if at the same time he is the beneficiary of such insurance policies[16]. Moreover, as to unusual insurance policies the respective contractual provisions may be regarded as a "surprising provision" (überraschende Klausel) within the meaning of sec. 305 c para. 1 German Civil Code, and thereby be invalid[17].

The transfer of the risk of accidental property loss may also be problematic from an "AGB perspective" based on the state of current case law. As previously mentioned, the OLG Naumburg and the OLG Cologne have determined that a transfer of the maintenance and repair obligations is limited at the point at which the danger of (accidental) loss (Sachgefahr) is transferred to the lessee and the burden of the maintenance and repair obligations therefore represent an incalculable cost risk to the lessee.

Taking into account the aforementioned legal risks relating to general terms and conditions (AGB), an array of approaches is recommended in order to validly agree upon the respective provisions. In particular, it is recommended that the contractual parties document that the assumption of all maintenance and repair obligations by the lessee results in a (substantial) reduction in the rent. This should later put the lessor in the position to argue that the assumption of the maintenance and repair obligations is part of the agreement on the rent, which is not subject to the proviso control pursuant to sec. 305 et seq. German Civil Code. This procedure may be possible if the parties seriously discuss the difference between a "normal" rent associated with restricted maintenance obligations for the lessee and a reduced rent associated with a shift of all maintenance obligations to the lessee. In this case, there is also the question of whether the contractual regulation finally agreed upon qualifies as a general term/condition (and is thereby subject to certain restrictions governing the use of these AGB) at all. In all other cases, significant doubts are raised about whether the parties may successfully argue that the respective contractual regulation is part of the agreement on the rent. In its decision of the year 2005[18], the Federal Court of Justice determined that supplementary agreements which deviate from "non-compulsory" statutory provisions may not be part of the agreement on the rent. In all other cases which solely serve to revoke the provisions on proviso controls pursuant to §sec. 305 ff. German Civil Code, the risk is relatively high that – given the actual motives of the parties – the courts will deny the validity of such clauses.

Overall Perspective

Unlike the case of the individual examination, an overall examination (Gesamtbetrachtung) of this contractual configuration, in particular a comparison with the case law on leasing, may lead to a different conclusion.

Although (real property) leasing may in principle be attributed to tenancy law[19], the Federal Court of Justice has deemed substantive deviations from statutory provisions of tenancy law to be valid[20]. It has thus seen the shifting of the risk of accidental loss and the risk of paying the rent (Sach- und Gegenleistungsgefahr) in the general terms and conditions (AGB) to be admissible[21]. In addition, for the area of leasing of goods the (complete) transfer of maintenance liability to the lessee in the general terms and conditions (AGB) is deemed to be valid. This is primarily justified with the following considerations: the lease object is often purchased or installed by the lessor according to the specifications of the lessee, so that the main interest in the property and its use may in fact be attributed to the lessee[22]. The calculation of the consideration to be paid to the lessor usually also results from the concrete purchase and credit costs (financing function of the lease).

The considerations which justify the "special handling" of leasing contracts are applicable in the same way to triple-net lease contracts, in any case on agreements which are very similar to leasing. An example thereof may be sale-and-lease-back arrangements: companies try to capitalize on the liquidity tied up in their real property by selling and utilizing the revenue more profitably in their actual core business. In order to be able to continue to use the real property, it is simultaneously re-leased. In practice, triple-net lease contracts are often seen in this connection.

The economic reasoning behind such transactions is thereby primarily a financing transaction ("repayment of the purchase price by lease payment") and not exclusively the surrender and use of the property for a period of time which characterizes the lease contract. Based on this particular proximity to leasing (if classification as a leasing agreement cannot be considered), tenancy contracts in this constellation may be treated in the same way as an atypical tenancy contract, also such as a leasing contract. The particular proximity of this contractual constellation to leasing justifies the handling of such tenancy agreements in the same way as leasing contracts as far as the admissibility of certain regulations in the general terms and conditions is concerned. The fact that this may generally be valid for triple-net lease contracts however, is not yet self-evident from this argument.

However, the triple-net lease contract, as can be seen from the aforementioned, demonstrates a particular peculiarity as opposed to a normal lease contract which justifies its privileged treatment in the same way as the leasing contract.

13 OLG Köln v. 4. 12. 1990 – 15 U 75/90, WuM 1991, 357.
14 Cf. OLG Jena v. 16. 10. 2001 – 8 U 392/01, NZM 2002, 70.
15 Cf. Kinne, GE 1999, 1540 (1544).
16 *Langenberg*, Betriebskostenrecht der Wohn- und Geschäftsraummiete, third ed. 1999, Part A, para. 102.
17 *Schmid*, Handbuch der Mietnebenkosten, ninth ed. 2005, para. 5531.
18 BGH ZMR 2005, 844 (845).
19 Cf. BGH v. 30. 9. 1987 – VIII ZR 226/86, NJW 1988, 198 (199).
20 Cf. BGH v. 30. 9. 1987 – VIII ZR 226/86, NJW 1988, 198 (200).
21 *Mörtenkötter*, MittRhNotK 1995, 329 (339).
22 Cf. BGH v. 30. 9. 1987 – VIII ZR 226/86, NJW 1988, 198 (200); Wolf/Eckart/Ball (cf. footnote no. 6) para. 1675.

The starting points in the leasing contract and in the triple-net lease contract are different, however. The leasing contract is defined by the fact that the lessor first purchases the property – according to the specifications of the lessee – in order then to grant use to the lessee. This "purchase act" does not normally take place in triple-net lease contracts. Incidentally – as with the leasing contract – the contractual constellation of the triple-net lease contract follows an overall economic concept. The triple-net lease contract is not only a lease contract for business premises which deviates from the statutory guiding principles in certain provisions and thereby constitutes an unreasonable disadvantage to the lessee. Such an examination is reduced too much to the individual provision to be examined and disregards the intended overall economic concept.

Even if individual questions on the determination/description of triple-net lease contracts are still open to discussion, their economic aims are nevertheless explicit: unlike a "normal" lease contract, a comprehensive transfer of risk to the lessee shall take place. This type of contract is quite common in some business circles (e.g. leasing of large-scale real property) and is a common contractual construct, particularly in international contexts. Through its assignment of risk, which thereby reduces the rent payments, it fulfills the respective expectations of fairness of the participating parties and, at the same time, the existing need for security with regard to calculations of particular investors.

When looking at the leasing, there is no obvious compelling reason why the economic (and practically relevant) need for a contractual model which, outside of leasing, undertakes such a comprehensive transfer of risk from the lessor to the lessee may not thereby be satisfied.

In order to comply with the statutory requirement for transparency (Transparenzgebot) which applies to general terms and conditions (sec. 307 para. 1 sentence 2 German Civil Code), it is certainly necessary to expressly designate the triple-net lease contract as such in order to identify the deviating risk assignment and its peculiarity.

With this in mind, much speaks for the recognition of the triple-net lease contract as a separate type of contract, thus withdrawing it from the "normal" test as regards compliance with the requirements for general terms and conditions.

For further information see the law firm profile at the end of the Handbook.

Raphael Söhlke

P+P Pöllath + Partners

Raphael Söhlke is a lawyer in the Berlin office of P+P Pöllath + Partners. P+P is a law firm with a strong specialization in legal and tax advice on:
- M&A transactions with the focus on private equity and venture capital;
- structuring and placing of private equity, venture capital and other closed-end or public funds;
- real estate transactions and project development; and
- asset management, including trusts and foundations, particularly for family offices, entrepreneurs and investors.

Raphael Söhlke focuses on real estate M&A and real estate private equity transactions, as well as project development. Raphael Söhlke joined P+P in 2000 after working for an international law firm in Frankfurt. He studied at the Universities of Trier and Aix-en-Provence/France; he graduated from the University of Trier. He is a lecturer for the postgraduate course "Real Estate" at the University of Münster.
For more details, please visit www.pplaw.com.