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ANALYSIS

Real estate

Agreement offsetting leasehold improvements against future commercial lease payments: third-party purchaser takes the stage

Is a set-off agreement enforceable against a purchaser seeking to collect new lease payments? One way or another, ultimately the lessee will not leave without compensation for the improvements.

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1. The dispute

This dispute is not uncommon in commercial lease agreements. It also arises in residential leases, but we will limit our analysis to the former. And it presents a problem that is not easily solved, one that is often unforeseen by the parties:

The lessor and lessee have agreed that the latter will carry out certain improvements throughout the term of the lease that, under the law, fall to the lessor. There may even be a superficies clause under which the lessee takes charge of the improvements for the duration of the lease. In exchange, it is agreed that during or after completion of the improvements, the lessee will offset the costs thereof against the lease payments due or a portion thereof. So far, there is no problem. However, during the period in which the lessee has not yet carried out or completed the offsetting, the lessor sells the property to a third party. The lessee has not registered their right in the Land Registry. We assume that the leasehold improvements have already been completed.

2. Legislative provisions

According to Article 1571 of the Civil Code, “[t]he purchaser of a leased property has the right to have the existing lease terminated upon the sale, unless otherwise agreed or as provided by the Land Registration Act. If the purchaser exercises this right, the lessee may demand the harvests of the current agricultural year and may require the seller to compensate him for any loss or damage incurred”.

Pursuant to Article 1549 of the Civil Code, “[i]n respect of third parties, leases of real property that are not duly registered in the Land Registry shall have no effect”.

Under Article 1552, “the sublessee is also liable to the lessor for the amount of the price agreed upon in the sublease that remains unpaid at the time of the demand, *with advance payments being deemed not to have been made, as they were not verified in accordance with customary practice*.”

According to Article 29 of the Urban Lease Act, in leases that do not pertain to a primary residence, the lessee may not demand a minimum term other than that agreed upon. However, the purchaser of the leased property shall take over the rights and obligations agreed upon with the lessor, unless the purchaser meets the requirements of Article 34 of the Land Registration Act.

3. Situations

Various situations may arise:

1. The lease is not subject to the Urban Lease Act. This is unlikely, unless the lessee is a “commercial lessee” or the lease involves an urban property that is not a building. If the lease is not subject to that law, Article 1571 of the Civil Code applies, rather than Article 29 of the Urban Lease Act.

2. The purchaser, whether subject to the Urban Lease Act or not, is protected by Article 34 of the Land Registration Act. Article 29 of the Urban Lease

Act does not apply. It is not certain that Article 1571 of the Civil Code applies.

3. The lessee is registered in the Land Registry. It is certain that the lessee cannot be evicted by the purchaser for the duration of the lease, but it is unclear what happens beyond that.

4. Neither right is registered. The purchaser may demand termination of the lease in accordance with Article 1571 of the Civil Code.

Note that although Article 1571 allows the lessee to remain, they may be subject to eviction by the purchaser.

> *In the absence of registered protection, the purchaser takes over the lease*

4. The rules

It is clear that, pursuant to Article 1571 of the Civil Code and all things remaining equal, "a sale does not break a lease", but the purchaser may terminate the lease agreement (not evict) on this ground. As long as the purchaser does not choose to do so, the purchaser is subrogated into the lease agreement, even though there is no provision explicitly stating this, despite the fact that Article 29 of the Urban Lease Act presupposes it within its scope of application.

However, whether or not the purchaser is subrogated into the lease, the unresolved issue is the fate of the set-off agreement. If the agreement does not affect the purchaser and the purchaser does not terminate the lease, the purchaser could perhaps file an eviction suit against the lessee for nonpayment. And, if the purchaser terminates the lease or evicts the lessee, the lessee could not raise the set-off agreement as a defence. This is evident for procedural reasons in eviction proceedings.

Let us consider, as a simpler example, Article 29 of the Urban Lease Act. It is clear that, in the absence of registered protection, the purchaser takes over the lease. But does the purchaser also assume all agreements related to the lease, including those that are not part of the lease's natural scope, such as an agreement setting off lease payments against leasehold improvements? If the purchaser does not take over such an agreement, the lessee could remain in the property, but, unless otherwise agreed with the new owner, they would have to pay thereon the lease amounts that had been offset with the former owner.

And this is already a more difficult scenario, because the Civil Code and the Urban Lease Act do not treat leases as mere claims or debts, but as complex legal positions with a degree of stability. However, agreements that are not part of the natural content of the lease are "stipulations", and these have no effect on non-contracting third parties (Art. 1257 of the Civil Code).

Nevertheless, let us attempt an analogous application of Article 1522 of the Civil Code, quoted above. In a certain sense, the set-off agreement is like a lease payment made in advance. And the dispute between the lessee and the purchaser (the new holder of the right to collect lease payments) is very similar to that of a sub-lessee who had made lease payments in advance to the sublessor, when the initial lessor retained a residual right to collect those payments.

Finally, a lessee who has made improvements that benefit the new owner is entitled to reimbursement for the cost of the improvements or the resulting increase in value and may retain possession of the property, without making lease payments, until such improvements are reimbursed.

5. Solutions

First, one must consider the terms of the lease agreement and the purchaser's conduct.

As a general rule, the lessee of commercial premises is not deprived of their rights, and the purchaser is subrogated — unless acting in good faith — pursuant to Article 34 of the Land Registration Act. It is unlikely that this will occur because the lease is an "apparent" encumbrance.

Even if statutory subrogation does not occur, the purchaser is subrogated under Article 1571 of the Civil Code if they do not choose to terminate the lease.

When the purchaser takes over the lease, they do so in respect of the entire lease and all its provisions, including the lease-payment set-off agreement.

If the purchaser does not take over the lease, the lessee may settle the cost of improvements with the purchaser, in accordance with Article 361 of the Civil Code, and may retain possession of the premises until paid. The successor in possession shall be liable for such offsetting. The successor in possession may not raise as a defence that the improvements were agreed on with the seller or that they were taken into account in setting the sale price.