

Legal issues affecting the value of real property in Sweden

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Legal due diligence has become increasingly frequent when acquiring real property in Sweden. This is due to the fact that Swedish investors have learnt from their foreign counterparts. Non-Swedish investors have a tradition of thoroughly investigating the targeted property and thus ascertaining the true value of the property. By identifying legal risks in a real property or a property portfolio at an early stage, investors have improved at valuing the properties and addressing risks in the transaction documentation. Often a purchaser will gain knowledge of the property in the contemplated transaction that is equal to, or at times even better than the sellers. In turn, this has forced sellers of properties to sometimes carry out a seller's legal due diligence prior to having the property or portfolio put on the market.

Legal risks that need to be identified when purchasing real property in Sweden include, among other things, review of leases in light of strict mandatory laws for both residential and commercial leases, encumbrances affecting a property, mortgage deeds valid in the property and general restrictions in the use of the property. It should be noted that title is proven by obtaining an extract from the Swedish Land Register from which an investor can acquire confidence in the seller's right to sell the property.

This article will identify certain legal aspects that should be considered when considering the value of real property in Sweden. Furthermore, we will briefly describe a proposed bill that will, in certain respects, change real property law and perhaps the business opportunities in Sweden. The bill enables properties to be divided three-dimensionally, which will open up new business opportunities in Sweden. It should be noted, however, that certain legal aspects are likely to create problems when such three-dimensional properties are introduced. These legal issues need to be addressed when purchasing a property which is a three-dimensional property. Also, in this article we will briefly comment upon the method of "packaging" real properties into property holding companies, which could be advantageous to investors acquiring real property in Sweden.

Real property in Sweden

What is real property according to Swedish law?

The Swedish real property law is relatively detailed and has been governed by statute for several hundred years. In Sweden, real property has until today consisted of land. The land is divided into different real properties, and each has been assigned a property designation number. The individual real properties are

registered in a special database named "the Land Registry" kept by a special public authority. The physical boundaries of the real property are determined by the Land Survey Authority. Owners or private persons have generally no power to modify the physical boundaries. If there is a building on the site, the building normally constitutes an integrated part of the real property (fixtures to real property) and the building generally cannot be separated from the real property. All in all, Swedish, real property may be defined as the land and what pertains thereto, such as buildings, permanent improvements and anything necessary for the continued use of a building.

The Land Registry contains extensive information regarding each registered unit, such as the owner of the land, mortgage deeds valid in the real property, if the real property is encumbered by easements or other rights of use etc. In principal, all information is public and is available on-line. All transfers of ownership, changes of mortgages and other matters of importance regarding a real property are registered in the Land Registry.

In Sweden a general principle of law protects a buyer who in good faith has acquired and holds possession of real property, regardless of whether the seller was in fact the owner of the property or not. The purpose of this principle is to make the Land Register reliable and trustworthy and hence promote and simplify commerce. Consequently, the prospective buyer can rely on what is registered in the Land Register and does not need to trace back and examine the prior titles to the property. In this respect it should be noted that the Swedish government guarantees the correctness of the information in the Land Register and that a person who has incurred a loss due to a faulty registration

may recover damages from the government.

Lease of Land

There are many rules restricting the rights of an owner to encumber his land by granting leases or easements. For example, a lease is not binding for a period longer than 50 years (25 years within areas subject to town planning). A specific type of ground lease and an exception to the above mentioned rule is the site-leasehold, which may only be granted by the government or a municipality. Due to specific rules, which govern the site-leasehold, the lessee will for all practical purposes be regarded as the owner of the property. In consideration for the use of the site leasehold the lessee must, however, pay an annual fee to the property owner.

In Sweden, as in other countries, it is common that buildings for commercial and industrial activities are rented. Even though the law generally considers the tenant to be the weaker party and thus should be protected, commercial ground leases are not normally subject to mandatory rules. Instead, the parties are free to agree terms for the individual lease.

Lease of a building

The Swedish legislator is concerned about leases because of their social and economic importance to the lessees. The statutory rules are accordingly, and to a great extent mandatory. Laws concerning leases, that in any way include the purpose of providing the tenant with a dwelling, are particularly detailed and far-reaching in favour of the tenant. In respect of commercial (non-residential) leases of floor-space the rents are not subject to any direct control. Subject to certain conditions the Swedish Land Code stipulates that a lessee in commercial leases shall be entitled to compensation from the lessor for damages resulting from the termination of his tenancy; even if the termination is at the expiry of the contracted term, should he not be offered to prolong the tenancy on market terms.

Legal developments affecting value

General information about valuation of Swedish real property

In Sweden, two general types of valuation are most commonly used. The first method concerns the present value of a property by comparing prices paid for equivalent properties previously sold, whereas the second looks at predictions on future cash flows. The first method is easier to apply, but projecting future cash flows if done correctly can be more accurate. The difference between the various valuation methods creates business opportunities but often future predictions are not accurate. Statistics show that costs are often higher than predicted. In order to obtain a "true valuation" of a property it is important that all

environmental, technical and legal risks are identified and assessed correctly. Below we have described the new three-dimensional properties, which will most likely be able to create as from January 1, 2004. Since this is a new kind of property, the risks are today more or less unknown. It is therefore of great importance that valuation of such new properties is carried out carefully and thoroughly.

Legal issues that arise when valuating a real property often regard leases; especially when the purchase concerns a large commercial building or a large commercial property portfolio. Swedish leases usually have a term of three to five years, which is often a matter of concern for foreign investors unfamiliar with the Swedish system. However, it should be noted that all sale and leaseback transactions that have taken place in Sweden include longer leases with a term of approximately 10 to 20 years and the trend is that large corporations and institutions sign leases that are longer than what was previously the case, but nevertheless the lease term generally is shorter in Sweden than in many other countries. Furthermore, rents are often subject to indexation according to the Swedish Consumer Price Index and surcharges are normally levied on the tenant for heating, cooling and water costs. Property tax is another cost that is often carried proportionally by a tenant. One important aspect of Swedish lease law is that mandatory provision of law enable a tenant to challenge the provisions of an individual agreement if the lease is contradictory to the mandatory law. In such cases the tenant can choose to rely upon more favourable mandatory provisions.

Another matter that often causes concern for an investor is that the use of a property may be restricted through easements. There are two kinds of easements in Sweden: official and agreed. Official easements are decided upon by the Land Survey Authority and are registered in the Land Registry. Official easements will generally prevail regardless of any third party claims. The agreed easements form an agreement between the individual owners of a property and may be registered in the Land Registry. However, if for instance a lender holds security with priority to the real property, agreed easements may become void if the lender realises its security and the property is sold through forced sale.

A purchaser is obliged to investigate the property before acquiring it, i.e. defects or liabilities are in principle the purchaser's risk. This purchaser obligation is often taken care of through the legal, technical and environmental due diligence and provisions in the sale and purchase agreement. However, in order to value the property correctly

it is necessary to ensure that the due diligence is as accurate as possible.

Bill of three-dimensional properties

At the turn of the year a new bill will most probably be implemented in Sweden making it possible to create three-dimensional properties, i.e. properties that will be limited in both height and depth. These real properties will probably be named three-dimensional properties. A three-dimensional property will differ from a normal real property in the way that it, for example, may consist of a certain part of an existing building or a garage under a property.

One of the purposes of the new bill is to create a more efficient use of land in urbanised areas. For example, it will be possible to create a specific real property on top of a rock shelter or a multi-storey car park and construct houses on this new property. Further, it will be possible to establish real estate on top of e.g. centrally located malls and build terraced houses or other structures on top of them. The new bill may also make it possible for existing property owners to separate the commercialised ground floor from the rest of a building that consists of flats and sell the commercialised part as a separate property. Another purpose of the new bill is to make it possible to facilitate the building of constructions like tunnels under existing real properties by creating specific three-dimensional properties.

The main rule will be that a three-dimensional property must contain a building or some other construction. In order to facilitate financing of not yet erected buildings and constructions an exception has been made that implies that a three-dimensional property may be established for the erection of buildings and constructions under the provision that the building or construction will actually be realised. According to the bill, another restriction is that three-dimensional properties containing apartments must involve at least five apartments.

A practical disadvantage of three-dimensional properties will be that these properties must be ensured the rights needed in order to be used in an adequate way. For example, it may be mandatory to have common staircases, boiler rooms, electricity devices, jointly for all properties in the building. As this may be complicated, from a judicial perspective, three dimensional properties will probably only be established for more extensive projects. Another disadvantage might be the possible restriction to reconstruct a damaged building on the property e.g. after a fire, as a reconstruction may be dependant on what the other owners of the property decide. According to the new bill, the three-dimensional property shall be brought back to the original condition if the building will not be reconstructed

after a total loss. Lastly, one more disadvantage, which may arise in relation to the other owners is in relation to extensive alterations or renovation to the whole property or the framework; which will acquire approval from all the property owners.

As the new bill of three-dimensional properties will create new possibilities, it will also create new problems. Problems may arise concerning valuation of a three-dimensional property compared to a common property, as an owner of the three-dimensional property to a certain extent will be dependant on measures taken by the other owners of the building and the land involved. Therefore, it is essential for an investor contemplating acquiring properties in Sweden after the turn of the year, to examine whether any three-dimensional properties are included in the purchase.

New tax legislation

From July 1, 2003 new tax legislation has become effective in Sweden, which allows for capital gains and dividends on quoted shares to be tax exempt if the shares are held for business purposes. One of the reasons for the changed legislation is that Swedish companies in the past realised losses in Sweden while using subsidiaries abroad when realising capital gains and dividends. It should be noted that the new rules apply to all Swedish limited liability companies and not only holding companies. Furthermore, the rules apply to foreign equivalents of Swedish limited liability companies.

The new rules make it possible to “package” real properties, i.e. to sell a real property to a Swedish limited liability company at the booked value which does not create any tax consequences for the seller. However, the sale does create an obligation to pay stamp duty (3% of the purchase price for commercial property) but this obligation may be postponed until the limited liability company is sold from the group. Once the real property has been transferred to the limited liability company, that company can be sold without any capital gains tax. The new rules contain exceptions and new additional rules. For instance losses due to real properties cannot be used against gains from any other business than properties sold after June 30, 2003. Due to the many exceptions, it is advisable to seek advice from a tax expert for each individual sale or purchase of a real property. If applied correctly the new legislation can lead to favourable tax treatment when acquiring and selling real property in Sweden.

Packaging of real properties into property holding companies has often been made also prior to the new tax legislation becoming effective but in those cases for other reasons, such as the possibility

to divert the property through the sale of shares in order to avoid stamp duty. When buying such a property holding company, it should preferably not have conducted any business other than to own and operate the real property. By this limitation in the use of the property holding company many liabilities that generally follow a purchase of companies, such as pensions of employees or other business liabilities can be avoided and the representations and warranties section of the sale and purchase agreement can be made shorter, simplifying negotiations.

The Swedish environmental legislation effect on the valuation

A further legal issue to consider is how the extent of the potential liability for environmental damage affects the valuation of property in Sweden. Under the Swedish Environmental Code there are specific provisions on the remediation of polluted areas. These provisions were important changes when the Environmental Code came into force 1999. They apply to land, water, buildings and structures, which are polluted to such an extent as to entail risk of damage or nuisance to human health or the environment.

The Environmental Code regulates private subjects' responsibility towards the government to remedy polluted areas. The overriding principle of the liability regime is the "polluter pays principle". Therefore, it is normally the operator, who has polluted that is liable towards the government to remedy the pollution. If the liable operator cannot be found or is not able to take necessary remedial action, anyone who after December 31, 1998 has acquired, or acquires a polluted area with knowledge of a contamination within the area in question may be held liable for reasonable remedy measures. The same rule applies if the purchaser objectively should have known about the contamination.

If a real property purchase is carried out through a property holding company, some of the environmental risks for the purchaser can be limited. This is because the environmental law often applies only to the property holding company and not its owner. Examples of such limitations of responsibility are: (i) the above mentioned property purchaser liability; (ii) the operator liability of a landowner for tanks located on a property, which is important since a landowner may become liable to take remedial or precautionary action even if it has never used the tanks or they were placed on the property long before the property was purchased, (iii) the liability to contribute to clean up costs (corresponding to the increase of value of the relevant property) that may incur regardless if the property owner was obligated to take such action, and lastly (iv) civil liability for

environmental damage under which the owner of a property where the harmful activity is conducted may become jointly and severally liable together with the operator of such activity. The above mentioned cases are all examples of situations where the liability stays with the property holding company and does not apply to an owner of such a company.

Irrespective of the liability for the legal environmental liability towards the government, pollution normally affects the: value of the property where it is situated. The value of the property will be negatively affected during the period when the question of liability towards the public is investigated. In the event no liable operator can be found or if the operator has no funds to remedy the contamination the negative effects will prevail. Hence, it is essential for an acquirer of real property in Sweden to thoroughly examine whether contamination exists on properties, which he contemplates acquiring, before the acquisition is executed. If not, it might risk paying an unexpectedly excessive price for the properties.

Conclusion

Changes in the Swedish legislation regarding both three-dimensional properties and taxes have created new business opportunities. The increase in foreign investments in real properties that have recently entered the Swedish market verifies that Sweden is a transparent and attractive place to invest in. However, since operational costs for properties often are higher than projected, the due diligence process has become more important. Legal issues regarding three-dimensional properties are bound to arise, especially since these new kinds of properties are dependent on relations with neighbours on or under such three-dimensional properties. Even though the legal requirements and investigations have become increasingly important, transaction costs may still be low compared to many other countries due to the unique Land Register which ensures a liquid and transparent market.

Since Swedish property law differs from other European legislation, it is important that the local counsels in cross-border transactions explain and clarify the differences in order to simplify negotiations.

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