SWITZERLAND

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Cyber risks and sharing economy in real estate due diligence

Introduction

To protect themselves against unpleasant surprises, sophisticated investors will carry out thorough due diligence of the target real estate. Digitisation and the sharing economy produce new risks. This makes a real estate due diligence more challenging and extensive.

Digitisation and cyber risks

Due to the increase in digitisation, cyber threats are on the rise. Until recently, nobody would have linked solid brick and mortar with soft digitisation but, increasingly, even buildings become cyber-physical systems. The various systems in a building, such as lighting, heating, ventilation, cooling, electrical wiring, plumbing, elevators, building access and security, fire protection and so on are increasingly controlled by central building management systems. Not only the facility manager and the owner, but also the system service providers, as well as the tenants, will be directly linked with the building management system through the internet. The internet of things is spreading throughout offices and apartments, production lines are increasingly controlled by robots, and all these systems will communicate through the internet with the building management system. Additionally, the entire system might be part of a smart grid. The relationship between landlord and tenant will be administered online, from the application for a new lease through to its termination. All these cyber elements of a building, as well as the facility management, have interfaces and will be linked to each other. Not only the owner's lease files contain personal data, but each of the various subsystems generates an enormous amount of data that might, at least in part, qualify as personal data.

A cyber building offers many opportunities, but it also creates new risks and threats:

- technical failure: a system may fail – because the various systems are all linked, the failure of one system can easily compromise other systems with the result that a building may, very quickly, be compromised;
- criminal attacks: there is an increased risk of criminal cyber attacks and sabotage as it becomes easier to hack the systems. Given that all systems are linked, one weak spot can suffice to enable the systems of the entire building to be hacked; and
- data protection issues: data can be lost, stolen or not processed in accordance with applicable law.

In most instances, more than two parties will be involved. Thus, there will be a chain of liability with multiple and repeated claims of recourse. This will complicate the liquidation of claims. Also, as the systems interact, often, it will not be entirely clear which system caused the damage and thus which party should be responsible for the damage.

For all these reasons, it will become more and more important in a real estate due diligence to review whether adequate precautions against cyber risks have been implemented. Depending on the outcome of the due diligence, the valuation must be adjusted or the investor should ask for indemnities.

In particular, the following areas should be reviewed in a real estate due diligence:

- data management: is there a proper documentation of all processes? Is data collected, processed and destroyed in accordance with applicable law? Have there been data protection issues in the past?;
- contracts (in particular, contracts with tenants and service providers, namely for maintenance): which party is liable for what? Which limitations of liability exist? Who can take recourse against whom? Are there rules governing data processing?;
- IT procedures: are the IT procedures documented? Which recovery and back-up procedures exist?; and
- insurances: which insurances exist against cyber risks?

Sharing economy

Another recent development is the sharing economy. An example of the sharing economy affecting real estate is the (in most cases, short-term) subletting of apartments by tenants through an online platform (for instance Airbnb).

If tenants in a building are subletting their apartments, a potential investor in this real estate faces the following risks:

- the use of the apartments may be much more intensive than anticipated and usual, shortening renewal cycles and increasing the costs of maintenance;
- the increased use may result in higher nuisance (such as more noise) for other users of the building and neighbours, which could entail claims for damages against the landlord and owner; and
- in particular in the case of a commercial subletting, the use may be in breach of local regulation, such as zoning or land use regulations.

For these reasons, it is important for an investor to know whether the tenants in a residential building are subletting their apartments so that the investor can factor this into the valuation.

Whether the subletting is permitted will depend on the applicable law in the respective jurisdiction. Under Swiss law, subletting is permitted but the tenant must seek the landlord's consent. The landlord may withhold its consent only if the terms of the subletting are not disclosed, abusive or if there is a material disadvantage for the landlord. Thus, the landlord cannot ban subletting but it has a say on the terms and may request a participation in the profits.

In a due diligence for residential real estate the following should be reviewed:

- it should be checked whether there are subletting arrangements. Since the landlord's consent is required, the seller should have all relevant documentation regarding sublets. Nevertheless, a back-up online search is recommended. If there are sublets, it should be reviewed whether the landlord is adequately compensated for the additional use and whether local law (in particular, regarding land use and zoning) is complied with; and
- the lease contracts should be reviewed. Are there terms addressing subletting? Which uses do the contracts permit?

Outlook

Digitisation and the sharing economy expand the scope of real estate due diligence. Yet, the risks identified in connection with digitisation and the sharing economy not only affect investors in real estate, but are also important in the ongoing management of the buildings. Only if the owner carefully considers these risks when entering into contracts with tenants and service providers and takes adequate precautions during the ongoing facility management will the real estate retain its value.