

DON'T HIT THE WALL: HOW TO DEAL WITH (AND PRE-VENT) DEFAULT IN REAL ESTATE PROJECTS

REAL ESTATE AND INSOLVENCY COMMISSIONS

PRAGUE, 2014

NATIONAL REPORT, DENMARK

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1. Construction Contracts

1.1. Defending Employer's interests

1.1.1. Before entering into a construction contract, how can the employer¹ check the financial standing of the contractor²? Is credit/financial information publicly available in your jurisdiction?

It is possible to obtain the financial statements of a contractor that carries on business in company form against payment of a minor fee if the contractor is subject to the rules of the Danish Financial Statements Act on public financial reporting. The duty to present financial statements generally applies to all companies unless the company fulfils two of the below criteria in two consecutive financial years:

- A balance sheet total of less than DKK 7 million;
- A turnover of less than DKK 14 million;
- Or if the average number of full-time employees does not exceed ten persons.

You may obtain financial statements e.g. from the following sources:

- www.cvr.dk (a fee is charged for the financial statements ordered)
- www.greens.dk (subscription)

Partnerships and limited partnerships are in general not obliged to publish their financial statements, just as the financial statements of personally operated businesses are not available to the public.

1.1.2. Does your jurisdiction have standard conditions for construction contracts? If yes, what type of clauses do they provide for employers in case of contractor's insolvency?

In Denmark the majority of construction contracts are made on the basis of the General Conditions for the Provision of Works and Supplies within Building and Engineering (AB92). In many cases the general conditions, which are the result of cooperation between building and construction companies, also apply as general principles where the general conditions have not been agreed. AB92 is not exhaustive in all cases and for large contracts it may be required to supplement the terms and conditions of the contract.

¹ The person, company or organization who contracts the constructor to design (if applicable), execute and complete the construction works.

² The person, company or organization hired to execute the construction works.

AB92 contains a rule that the employer may terminate the contract in the event of the contractor's bankruptcy unless otherwise stated in the Danish Insolvency Act.

The Danish Insolvency Act³, which is mandatory, entitles the trustee in bankruptcy to determine whether the estate will become a party to a bilateral agreement that has already been made and that has not been breached⁴. That way the creditors of the estate in bankruptcy get a chance to benefit from the performance of the agreement despite the bankruptcy. Similarly, the trustee in bankruptcy may choose not to affirm an agreement and thus unfavourable agreements may be eliminated. If the estate in bankruptcy does not affirm an agreement, the other party may terminate the agreement.

Whether the estate affirms an agreement or not affects the status of the other party's claim for performance of the agreement in the estate in bankruptcy. If the estate affirms an agreement, all payments become pre-preferential claims. However, the other party will only be entitled to lodge an unsecured claim with the estate if the estate does not affirm the agreement.

For contracts covered by AB92 it applies that the trustee, at the request of the other party, must decide within five days whether the estate will affirm the contract or not. If the trustee does not reply in time, the other party is entitled to terminate the contract. Pursuant to the Danish Insolvency Act, notification must be given "without undue delay". In general that means within one week, but in some cases it may take longer depending on the complexity of the contract.

Moreover, there are general conditions for turnkey contracts, ABT 93, specifying the same rules in the event of the contractor's bankruptcy.

For an English version of AB92, see the following link:

<http://www.danskbyggeri.dk/files/Servicebutik/LoveOgRegler/Byggeriets%20love%20og%20regler/17065.ab92engelsk.pdf>

For an English version of ABT93, see the following link:

<http://www.danskbyggeri.dk/files/Servicebutik/LoveOgRegler/Byggeriets%20love%20og%20regler/17070.abt93engelsk.pdf>

³ The English version of The Danish Insolvency Act can be purchased in the following website: <http://www.karnovgroup.dk/shop/products/dk-karnov-law-konkursloven-eb>

⁴ The Danish Insolvency Act, Section 55.

1.1.3. What kind of securities does the employer usually demand from the contractor?

As mentioned above, the general conditions AB92 are agreed in the majority of Danish construction contracts. Section 6 of AB92 specifies the non-mandatory conditions for the contractor's provision of security. It is stated that security must be provided in the form of an adequate guarantee from a bank or savings bank, an insurance guarantee or other adequate types of security. There is thus freedom of contract as to the type of security and in principle, one can imagine all kinds of security. However, bank guarantees and insurance guarantees are the most common types of security. If the contractor has not provided adequate security within eight days from the conclusion of the contract, the employer may terminate the construction contract.

The security must be provided for 15 % of the contract sum or for 10 % if the supplies are delivered in instalments. After handing-over, the security is reduced to 10 %. One year after handing-over, it is reduced to 2 %, and five years after handing-over it is reduced to 0.

Moreover, the contractor must have a valid general insurance policy.

The above types of security are also the most commonly used in contracts for which AB92 (or ABT 93) has not been agreed, but there is freedom of contract and security must thus only be provided if specifically agreed.

1.1.4. In case of contractor's insolvency during the project, what alternatives does the employer have in order to carry it through?

In case of the contractor's bankruptcy the trustee must decide whether the estate in bankruptcy will become a party to the construction contract and carry on the contract. If AB92 has been agreed, the employer is entitled to be informed whether the estate will affirm the contract within five days after the employer has made such request. If AB 92 has not been agreed, the employer is entitled to be informed of the trustee's decision "without undue delay"⁵. Depending on the scope and complexity of the contract, the trustee has one week, or in some cases more, to decide whether the estate will affirm the contract, provided that the trustee is in possession of all relevant documents to be able to make such a decision.

The estate's possibility of affirming a contract may in some cases be barred due to the nature of the contract⁶. This may be the case e.g. where it concerns complicated work which has just or only barely been initiated.

⁵ The Danish Insolvency Act, Section 55.

⁶ The Danish Insolvency Act, Section 54.

Another example is if e.g. the performance of the contract requires such technical capacity or financial capability that it is fair to doubt that the estate will be able to perform the contract. A third example is if e.g. the contractor's person – his special expertise – has been particularly important for the employer, e.g. if the contractor is an architect. The exception is used in very few cases, but if you are covered by the exception, the employer may terminate the contract as a result of anticipatory breach.

If the estate affirms a contract, the estate will guarantee at the preferential claims level that the contract will be duly performed according to the original agreement. If the estate does not affirm the contract or does not reply within the time limit, the other party may terminate the contract⁷.

As construction contracts often have more or less incalculable consequences for an estate, the main rule will in practice be that the estate chooses not to affirm the construction contract. It means that the employer may terminate the contract and that a status meeting must be held as soon as possible after termination to determine the progress of the construction works for the purpose of securing evidence for the subsequent financial battle, including claims on account of defects and losses incurred as a result of the bankruptcy. As regards claims for defects and/or losses incurred as a result of the bankruptcy which are not covered by security, the employer may lodge an unsecured claim with the contractor's estate in bankruptcy. Then the employer may find a new contractor to perform the work.

1.1.5. What kind of role do clauses regarding transfer of title play in construction contracts? Are clauses under which the contractor's materials, equipment and tools are deemed to be the property of the employer upon the moment the contractor brings these to the site valid in your jurisdiction and do they limit the powers of the bankruptcy estate?

The materials/assets intended for incorporation in the contract work, e.g. stone, timber or the like become the employer's property when they have been delivered to the building site.

It is also stated in AB92 that ownership cannot be reserved as regards materials delivered to the building site.

According to the general rules relating to the law of obligations, i.e. in cases where AB92 has not been agreed, the contractor may reserve ownership of the materials delivered if the general conditions of Danish law for reservation of ownership have been met. However, they will no longer form part of the reservation of ownership when incorporated into the building.

⁷ The Danish Insolvency Act, Section 58.

According to the general rules relating to the law of obligations, the contractor, however, always has a right of stoppage in transit. The contractor may thus withhold the material if the employer goes bankrupt before delivery and if the trustee does not affirm the contract. The same applies if the trustee affirms the contract, but does not pay the consideration or, if credit has been agreed, does not provide security for the performance of the contract⁸.

If the employer terminates the contract with the bankrupt contractor, the new contractor that completes the work for the employer is entitled to use the contractor's material on site if removal thereof prior to the completion of the work will inflict a loss on the employer. However, the usual fee for use of the materials must be paid. However, pursuant to Danish law this obligation to pay may be set off against the employer's possible claim against the contractor's estate in bankruptcy as the claims are connected.

1.1.6. In case of employer's insolvency or loan default of the employer, is it typical that construction contracts contain instruments (e.g. novation agreements) for the financier to take over the project and the construction contract?

Upon the contractor's bankruptcy the trustee is free to decide whether the estate is to become a party to the contract and carry on the contract. It may thus not be agreed that the financier is to take over the project in case of bankruptcy.

In cases where the employer is not subject to bankruptcy proceedings, but where the instalments on a loan are not paid, there is nothing that prevents the parties from agreeing that the financier is to take over the construction project, e.g. as part of reconstruction. However, it is a condition that it is organised in such a manner that the contract is not voidable in the event of later bankruptcy.

1.2. **Defending Contractor`s interests**

1.2.1. What kind of securities does the contractor usually demand from the employer? Are any of these securities mandatory in your jurisdiction?

If AB92 has been agreed, it follows that the employer at the request of the contractor must provide security within eight workdays for the employer's payment obligations to the contractor. Like the security provided by the contractor, this security is usually a bank guarantee or an insurance guarantee. In that case the security must correspond to the average

⁸ The Danish Insolvency Act, Section 58.

payment of a three-month period, however, not less than 10% of the contract sum.

The employer is also obliged to take out a fire and storm insurance policy for the contract work that is effective until the work has been handed over in conformity with the contract.

Although AB92 has not been agreed, the above types of security are the common ones, but it depends on the parties' agreement.

Security provided in the form of assignment of construction loans is seen, but used less often than the above types of security.

1.2.2. What other provisions (e.g. title retention, down-payment clauses etc.) are usually included in a construction contract to protect the contractor?

Construction contracts often contain provisions on prepayment and current payment as the work is completed. The clear main rule is that in large contracts it has been agreed that payments on account are to be made as the construction work is performed. However, as stated above, it depends on the parties' agreement.

1.2.3. Please describe the main effects on the contract in case of insolvency of the employer and focus on the following points:

a) Does your jurisdiction have standard rules for termination of a contract in case of insolvency of the employer? If yes, can the parties deviate from these rules in their contract?

Pursuant to the Danish Insolvency Act the trustee in bankruptcy is entitled to become a party to or not to become a party to an unperformed and unbreached contract⁹. If the estate affirms a contract, the estate is obliged to perform the contract at the pre-preferential claims level. If the estate does not affirm a contract, the contractor may terminate the agreement and lodge any claim as an unsecured claim in the estate in bankruptcy.

Any contractual provision stating that bankruptcy is a breach of contract is not valid. The trustee in bankruptcy must have the option to affirm the contract or not. The rules cannot be derogated from. Bankruptcy in itself is thus not a breach, but if the trustee does not affirm the contract and/or if there is another breach justifying termination of the contract, the contractor may terminate the contract¹⁰.

⁹ The Danish Insolvency Act, Section 55.

¹⁰ The Danish Insolvency Act, Section 58.

- b) If the contract does not end by law, who gets to decide whether the contract is terminated or not?

Pursuant to the Danish Insolvency Act, the trustee in the estate in bankruptcy decides whether the agreement is to be carried on, as the trustee must decide whether the trustee wants to affirm the contract or not. In that case the contractor may require that the trustee decides without undue delay whether the estate will affirm the contract. The response deadline must be assumed to be one week, sometimes more, depending on the complexity of the contract. If the other party requests the trustee to inform it whether the estate will affirm the contract or not, the trustee will, if AB92 has been agreed, have five days to reply. If the trustee does not reply within the time stipulated or if the trustee replies that the estate will not affirm the contract, the contractor may terminate the contract.

If the other party is entitled to terminate the contract for other reasons than the bankruptcy and the bankrupt's delay, the bankruptcy will not bar such a right. The contractor may thus choose to terminate the contract in such cases.

- c) If the contract is carried forward, is the employer still in charge or does the liquidator take over?

In bankruptcy the debtor loses control of its assets. The trustee is then entitled to act on behalf of the estate and make decisions regarding the contract. Formally, it is thus the trustee who carries on the contract, but practically it is often with the assistance of the old management and/or previous employees.

1.2.4. What happens to the claim for remuneration of the contractor towards the employer:

- a) In case of termination of the contract?

If the estate in bankruptcy does not affirm the contract, the contractor may terminate it and lodge its claim for payment and/or compensation as an unsecured claim in the estate, unless the contractor has been provided with security¹¹.

- b) In case the contract is carried forward?

If the estate affirms the contract, work performed after the date of the bankruptcy order must be paid as pre-preferential claims. It will probably give rise to liability on the part of the trustee if he carries on

¹¹ The Danish Insolvency Act, Section 97.

contracts without being able to pay the liabilities. The same probably applies with respect to any arrears or claims on account of defects from before the date of the bankruptcy order, but this is more uncertain¹².

1.2.5. During the project, who usually owns the parts of the building that have already been finished? Are there any rules in your jurisdiction that would allow the contractor to get a freehold of the construction site and continue the project with a different employer?

A building already erected, in whole or in part, belongs to the employer.

If the employer goes bankrupt during the process, it is the estate's prerogative whether the estate will affirm the contract or not. If the estate affirms the contract, the contractor may carry on the contract. If the estate does not affirm the contract, the contractor may terminate the contract, but the contractor may not continue the work (neither with another employer). It may thus not be agreed in a construction contract that the contractor may carry on the contract with another employer.

1.2.6. What kind of provisions should/can a contractor include in the contracts with his subcontractors to protect himself in case of the employer's insolvency?

Provisions on security and provisions on the trustee's deadline for notifying the other party whether the estate will affirm the contract or not are the most important provisions that may be incorporated into a contract to protect the contractor against the employer's bankruptcy.

2. Lease contracts

2.1. **Is a lease affected by the foreclosure of a mortgage or other in rem guarantee over the leased property? May the new landlord terminate the lease?**

A lease contract is in general not affected by any legal action against the landlord's property.

The rights of tenants under the Danish Rent Act are valid against anyone without registration. It means that no act of perfection must be undertaken in order for the tenant to be protected against suing creditors. This applies to e.g. agreements on prepayment of rent, premiums, deposits, etc.

¹² The Danish Insolvency Act, Section 93 and section 56.

- however, only as long as the amount does not exceed six months' rent. Any additional rights, e.g. agreed non-terminability and prepaid rent for more than six months, must be registered in order to be effective against an estate in bankruptcy or a buyer in a foreclosure sale. Agreements either directly protected under the Danish Rent Act or agreements that have been registered must thus be respected by an estate in bankruptcy and/or the buyer of a property and thus they cannot be terminated (unless they are voidable).

A new owner of a property may thus solely terminate an agreement with a tenant under the general rules of the Danish Residential Leases Act or the Danish Business Leases Act, only allowing termination subject to a few special conditions.

2.2. Does your jurisdiction afford any protection for the tenant in this case, for example, by guaranteeing the continuity of the lease agreement or a right of first refusal for acquisition of the leased property? Are there any requirements that need to be fulfilled if the tenant wishes to oppose these rights (if applicable) against his new landlord.

As stated above, a tenant of a residential unit as well as a tenant of a business unit are protected by Danish law to the effect that the tenant may remain at the premises despite the landlord's bankruptcy or a foreclosure sale of the property as long as the lease agreement is made on usual terms and in compliance with the tenancy laws. The estate in bankruptcy or a buyer of a property may thus solely terminate the lease agreement under the general rules of the tenancy laws, which only allow termination in a few special circumstances, e.g. as regards business leases when the landlord has to use the premises himself, when the landlord proves that vacation of the premises is required due to renovation/demolition, etc.

An agreement on an option to buy for the tenant in the event of the landlord's bankruptcy or foreclosure sale of a property will probably be valid and non-voidable if it has been registered on the property and if the option to buy is on market terms.

The tenant does not have to take special initiatives to be protected against suing creditors except for registering his right in the property if it is beyond the general rules of the Danish Rent Act as mentioned above.

2.3. In case of insolvency of the tenant, is the landlord entitled to terminate the lease? Are insolvency clauses common in lease agreements in your jurisdiction? Are they normally upheld in court?

Residential leases will generally not be covered by bankruptcy, i.e. the lease will continue unaffected by the bankruptcy. If the tenant defaults on payments, the landlord may terminate the agreement.

As regards business leases where the tenant has not paid the rent, the landlord may terminate the agreement as a result of the default. If a business lease has not been breached, the tenant's estate in bankruptcy may choose to affirm the agreement on the original terms of the agreement. If the trustee does not affirm the agreement, the landlord may terminate the agreement. If the trustee affirms the agreement, the agreement continues to be effective on the agreed terms.

Provisions in a lease specifying that bankruptcy is a breach or a repudiatory breach are seen in practice once in a while. They cannot be upheld against an estate in bankruptcy.

2.4. What kind of securities does the landlord usually demand from the tenant? How tenant's insolvency may affect the ability of the landlord to execute these guarantees and collect rent and other monies due to under the lease?

In leases where the tenant is a private person, the landlord may demand a deposit of up to three months' rent as security for the tenant's obligations upon vacation. The landlord may also demand payment of three months' rent in advance. The rent paid in advance is security for payment of the rent during the notice period which will in such cases usually be three months.

With respect to business leases there is no statute regulating the tenant's provision of security. There is thus neither any limitation of the security which the landlord may demand from the tenant. It depends on the parties' agreement. The agreed security to be provided may be a deposit and/or prepaid rent, but it may also be a bank guarantee or another guarantee. As regards business leases there is freedom of contract with respect to this issue, but the above types of security are the most common ones in practice.

If the tenant is a trader, the trustee in the tenant's estate is entitled to decide whether to affirm the lease agreement or not if the lease agreement has not been breached prior to the bankruptcy. When the landlord so requests, the trustee must inform him whether or not the estate will affirm the lease agreement on its terms.

With respect to business leases the landlord may require that rent is paid from the date of the bankruptcy order and until the trustee's decision to affirm the agreement or not as a preferential claim unless the trustee does not immediately inform the landlord whether the estate will affirm the lease agreement. However, this rule only applies if claimed by the landlord¹³.

¹³ The Danish Insolvency Act, Section 62.

If the tenant's estate in bankruptcy does not affirm the agreement or if the tenant has defaulted on payment already before the bankruptcy, the landlord may terminate the agreement. Any claim not covered by security is subsequently an unsecured claim in the estate, e.g. rent due, costs of vacation, rent during the notice period, etc. Please note that the notice period and/or non-terminability often may be regulated as a result of the bankruptcy to 6-12 months' termination irrespective of the agreed notice period¹⁴. If the estate affirms the agreement, rent will be paid after the date of the bankruptcy order as a pre-preferential claim. However, the estate may terminate the agreement at one month's notice with the effect that the landlord's claim will then have to be lodged as an unsecured claim in the estate.

With respect to any arrears prior to the date of the bankruptcy order and/or other loss suffered as a result of the tenant's bankruptcy, the landlord may use the deposit paid or other security to cover the arrears. The terms of the agreed security determine when the landlord may enforce the security for satisfaction of his claim. In some cases it is sufficient that the tenant's breach has been discovered, in other cases bankruptcy proceedings must have been commenced against the tenant.

Bibliography

- Konkursloven med kommentarer, 12, by Lars Lidencrone Pedersen and Anders Ørgaard
- Entrepriseret, 44. 2004 by Hans Henrik Vagner/Torsten Iversen

Note: This memorandum does not comprise the Danish rules on reconstruction for reasons of delimitation of the subject.

¹⁴ The Danish Insolvency Act, Section 61.