

Don't hit the wall: how to deal with (and prevent) default in real estate projects

Real Estate and Insolvency Commissions

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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?

The employer can check the financial standing of the contractor if he is a company, via www.infogreffe.fr website, where financial information is available as follows:

- Certificate of incorporation (Kbis);
- Bylaws ;
- Debt statement ;
- Annual accounts ;
- Public information on pending bankruptcy or insolvency proceedings ;
- registred securites such as pledges ;

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?

No standard conditions for construction contracts apply.

However, "AFNOR norms" (made by a public body) have inspired legal doumentation used in construction contracts for the public sector but also broadly used in construction for private construction contrats.

Then construction contracts are often divided in two set of rules: general conditions (Cahier des Clauses Administrative Générales – CCAG) and specific conditions (Cahier des Clauses Administratives Particulières - CCAP).

AFNOR norms are used as contractual references in private construction contracts, in particular as insurers required certain standards. Consequently, we will point out the most important rules issued from AFNOR norms. `

¹ The owner or leaseholder who enters into contracts for design (if applicable), performance and completion of the construction works.

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

For construction contracts in the private sector , some mechanisms are enforced by law to provide employers in case of contractor's insolvency.

- The law n°71-584 of July 16th 1971 authorises the employer to ask for a consignment of 5% of the contract price, but authorises too the contractor to avoid this consignment by furnishing a bank guarantee of payment (“cautionnement”).
- employer may ask for a performance guarantee “good end”, or “delivery and performance guarantee”. It may take form as a bank guarantee of payment or a first demand bank guarantee of payment (garantie à lère demande).

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

Termination provisions in the event of insolvency are often demanded but are not valid under French law.

However, a contract can authorize the employer to change the contractor when the works have been stopped for a certain time for reasons inherent to the constructor. The liability for execution of works by a new contractor would be on charge of the original constructor. Without this clause, the employer si still enttlted to claim the same before a court.

Against late payments, the employer may ask for a penalty clause which provides a certain amount of penalty immediately applicable if the contractor is late in the delivery of the works (3% of the contract price for instance).

Regarding the insurances, AFNOR norm P 03-001 specifies that the contractor shall be able to prove at any moment that he is insured for the following risks:

- Collapse and threat of collapsing before the delivery of all or part of the building,
- Water damage and fire during the execution of the works,
- Civil liability towards third parties and the employer following corporal, material and immaterial damages happening during the execution of the works,
- The ten-year statute warranty under Civil Code (article 1792).

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

To be completed with rules on insolvency

Under L 622-13 of Commercial code « Only the receiver (administrateur judiciaire) has the right to require the debtor's contracting party to perform executory contracts inexchange for the performance of the debtor's obligations. »

However « The contract shall automatically be terminated once a formal notice has been sent to the administrator that has remained unanswered within a month »

A months, to take a position :

If the receiver (administrateur judiciaire) does not make use of his right to continue the contract or he terminates it as provided for by the second paragraph, the non-performance may give rise to damages that must be claimed as liabilities due to the other party. The other party may however postpone the reimbursement of sums paid in excess by the debtor in performance of the contract until the question of damages is settled.

Notwithstanding any legal rule or contractual term to the contrary, the indivisibility, termination or rescission of the contract may not result from the commencement of safeguard proceedings alone.

In case of contractor's insolvency, the employer may ask for the execution by the contractor to a judge (Civil Code, article 1142). If impossible, the employer may require to the judge the authorisation to designate a new constructor to execute the works at the expense of the original contractor (Civil Code, article 1144).

If the employer wants to terminate the contract, he has to summon the contractor to terminate the work before. If the contract has prevented this kind of situation, the termination may be automatic after a certain period of time. If not, the employer may ask for the termination to a judge.

Whatever the solution (continuation with a new constructor or termination of the contract), the constructor shall be convicted to damages on the basis of the contractual liability he has towards the employer (Civil Code, article 1147). The contract may have fixed the amount that shall be paid by the contractor or, at least, may have fixed a minimum or a maximum. That type of clause is authorised only if the amounts are reasonable, and only if the clause does not purely private a party of compensation.

Besides, a special insurance warranties the employer in case of damages on the building observed before delivery and if (i) summons of the contractor are left without response, and (ii) if the contract is terminated (Insurance Code, article L.242-1).

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 process of construction results in the transformation of bare land into developed land. The private construction contract is not a sale but will transfer anyway the property of the goods brought by the contractor, in the frame of the french “accession theory”, as work proceeds (Civil Code, article 551).

French law makes a difference between the goods which have been incorporated into the construction, and those which remain separables without damages for the building:

- As regards the goods which have been incorporated into the construction, the accession theory no longer authorises the employer which has brought the equipments to ask for the recuperation of the goods, even if the contract provides a clause in this way.
- As regards the goods which remain separables without damages for the building: before 2006, clause authorising the contractor to stay owner of the goods until the complete payment was only valid in the scope of bankruptcy proceedings. The new law (Commercial Code, L.624-16, al.3) does not limit the application of this type of clause to the scope of bankruptcy proceedings. In such a way, the incorporation to a building shall no longer be an obstacle to the demand, if the recovery does not damage the building or the good itself.

Provision that materials, equipment and tools are deemed to be the property of the employer upon the moment the contractor brings these are valid and can limit provisions limit the powers of the bankruptcy estate, if not challenged by the bankruptcy estate.

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?

Under French law, it is uncommon for the financier to take over the construction contract and there is no specific instrument to facilitate it. The take over of the project may result from the bankruptcy proceeding but banks are rarely interested, they just act as part of the recovery plan but not in place of the purchaser.

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?

The law protects the contractor by limiting the employer's delay to pay the final price. The employer has 30 days after execution of the complete work (law n°2001-420 of May 15th 2001 – commercial code article L.441-6, I, al.8). Moreover, parties can manage this delay but it shall not exceed 60 days after the emission of the invoice.

It could exist some exceptions in building trade sector and some delays may be longer.

Another mechanism defends contractor's interests : the "payment security", created in 1994 (law n°94-475 of June 10th 1994, Civil Code article 1799-1). If the construction works are completely financed by a bank, the employer has to provide a bank's engagement which warrants the entire direct payment to the contractor by the bank. If the construction works are not financed by a loan (or only for a part of it), the employer shall provide a joint and several guarantee of payment (cautionnement solidaire) or a first demand guarantee (garantie à 1ère demande) from a bank. If the security cannot be activated, the contractor may stop to execute the works after a 15 days formal notification left without any response. He is so entitled to ask for payment and compensation directly to a judge.

When a subcontractor executes the work, he shall be entitled beneficiary of the payment 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?

Contractor often ask for down payments at the beginning of the work.

They also usually ask for late payment interests clauses in case of lateness in payment.

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?

Parties may agree any cases of termination as soon as they are precise and suppose the application of a certain procedure (e.g. a delay of insolvency, a failure notification left without response...). If a case of termination appears, the termination is due without discussion.

The existence of a bankruptcy proceeding is not a valid cause of termination for a contract, except in liquidation phase. If the bankruptcy proceeding is engaged against the employer, it does not allow the contractor to end the relationship and to stop the execution of the work. An insolvency administrator ("receiver") is entitled to decide

which contract will be continued and which one will end. If payments are already due to the constructor, the only thing he can do is to declare the debt to the proceeding and wait until the execution of a recovery plan.

The existence of a termination clause in case of bankruptcy will never be received as valid. On the other hand, the termination clause for any other cause would be accepted if the cause has occurred before the opening of the bankruptcy proceeding.

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

The employer is entitled to terminate the contract at any time without any specific reason, even if the work has begun, as soon as he pays to the contractor all the expenses the contractor may have done and all the incomes he would have won (Civil code, article 1794). But this rule is exclusively offered to the employer.

If the contractor wants to terminate the contract, he may obtain that termination if the employer does not fulfil its obligations, notably if he does not pay. But this unilateral rupture is not recommended as the employer may intend a judicial action to contest the default and to ask for damages.

Each party may also ask for termination to a judge if the other party does not fulfil its obligations (except in the scope of a bankruptcy proceeding).

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

As explained at point 1.2.3 a), in case of bankruptcy proceeding, it is the receiver (administrateur judiciaire) which is entitled to manage the company during the recovery phase. The employer loses temporarily its functions only in the scope of two proceedings: the “recovery proceeding” (redressement judiciaire) and the “liquidation proceeding” (liquidation judiciaire) which are the most serious the proceedings. On the other hand, a lightly proceeding called “saving proceeding” (procédure de sauvegarde) allows the employer to be maintained in its function while the company is under the protection of the judge.

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

- a) In case of termination of the contract?

In case of a bankruptcy proceeding and if the contract is terminated by the receiver (administrateur judiciaire), the contractor may only declare its claim to the bankruptcy proceeding. It means that until the end of the proceeding, the employer will not be paid.

The payment will depend on the end given to the procedure: if the receiver leads the company to a recovery plan, the constructor will be paid in the scope of the execution plan. If not, because the company cannot be saved, the constructor shall be allowed to claim its payment directly to the employer, after the bankruptcy proceeding, but with not much hope to obtain compensation if the employer is insolvent.

b) In case the contract is carried forward?

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?

As explained at point 1.1.5, the property of goods and equipments brought by the contractor and incorporated to the building is transferred to the employer as work proceeds, under the “accession theory” (Civil Code, article 551).

On the other hand, the construction site is the employer’s property from the beginning. If the employer is insolvent, the contractor may get back the goods separables from the building without damages, but no rules offer him the possibility to get a freehold of the construction site and to continue the project himself. If the company’s employer is bought by a purchaser, the construction site’s property is transferred to the new employer and the contractor may continue his work on the site.

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?

The contractor has to provide to the subcontractor a joint and several guarantee of payment (cautionnement solidaire) from an establishment agreed by authorities for all the sums he will owe to the subcontractor in application of the subcontract (law 75-1334 of December 31th 1975). If the contractor does not provide it, the subcontract is null and void, except if the subcontractor benefits from a delegation from the employer directly for the amount of the subcontract (Civil Code, article 1275, law 75-1334 article 14).

As the statute law n° 75-1334 has been written to protect the subcontractor, the contractor cannot include provisions in the subcontract to protect himself in case of the employer’s insolvency. If the contractor does not pay its subcontractor because of the employer’s insolvency, the subcontractor may activate the joint and several guarantee of payment (cautionnement solidaire).

Besides, in case of contractor's insolvency, the law 75-1334 gives to the subcontractor the right to ask for payment of its work directly to the employer, if its intervention has been accepted by the employer, even if a bankruptcy proceeding has been filed against the contractor.

2. Lease contracts

As regards to construction, specific lease called "construction lease or "real estate leasing" and are commonly used as financing tools :

Construction lease : a long term lease between 18 and 99 years is granted to the tenant which is committed to build the construction and pay a rent to be entitled to benefit from the construction and pay . The property of the entire construction backs to the freeholder at the end of the lease.

Real Estate / Financial leasing : The Lessee is entered into a contract with a lessor (an authorized financial company) which purchases the real estate asset and lease it to the lessee. The lessee is entitled to a purchasing option

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 is not affected by the foreclosure of a mortgage if the tenant proves that lease was entered is prior to notification of the first step introducing the proceeding (commandement de saisie). In that case, the new landlord is bound by the lease (Civil proceedings of execution code, article L.321-4). If the lease has been concluded after, the new landlord may terminate the lease.

The lease may also be terminated under the conditions of ordinary civil law (Civil code, article 1729).

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.

No specific protection such as guaranteeing the continuity of the lease agreement or a right of first refusal for acquisition of the leased property exist.

2.1. 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?

The landlord is entitled to terminate the lease if the tenant fails to perform his obligations (Commercial Code, article L. 145-41). The parties may also provide some specific specifications to allow the landlord to terminate the contract. But, first of all, these clauses do not prevent the landlord from the right to obtain the termination in court and, second of all, in case of bankruptcy proceeding, there is no automatic termination of the lease (Commercial code, article L.631-14). Any opposite specification would be void and not enforceable (Commercial code, article L.145-45).

Moreover in case of bankruptcy, it is common to see the receiver (administrateur judiciaire) requiring the continuatio of the lease even if some terms have not been paid. But if he decides the continuation of the execution, the following terms have to be paid.

The only possibility for the landlord is to terminate the lease at the first signs of bankruptcy, before the opening of a proceeding.

2.2. 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?

Usually, the landlord asks for a joint and several guarantee of payment (cautionnement solidaire) in order to protect himself from the tenant's non-payment of rent (Civil code, article 2288).

In case of bankruptcy, the landlord cannot turn his action against the person who standed security for the tenant (the guarantors) (Commercial Code, article L.622-28, al.2, L.631-14, al.1) except in case of liquidation. In the frame of a recovery plan, the court may grant guarantors a two-years delay to pay the landlord (Commercial Code, article L. 622-28 al.2).

The inclusion and consideration of the guarantors' debts suppose a specific declaration during the proceeding.