



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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National Report for Germany

Dr. H. Philipp Esser

Schultze & Braun
Eisenbahnstraße 19-23
77855, Achern, Germany
Tel: +49 7841 708-235
PEsser@schubra.de

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?

Certain information is publicly available:

1. Unless the contractor is a small business or registered abroad, its annual financial statements are available at the German public commercial register. Nevertheless, the annual financial statements only give a limited picture of the economic status of the company and only relate to a certain date in the past.

2. The employer can check the public insolvency register whether an insolvency proceeding has been commenced over the assets of the contractor. But not all insolvency events appear: for example, a mere insolvency petition or a preliminary debtor in possession insolvency proceeding are not published in the insolvency register.

3. The employer can hire commercial service providers collecting credit information on companies to issue a report on the financial standing of the contractor. The reports consist mainly on the information also available in the public register but are more easily and faster available and include a statistical assessment on the risk of default.

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?

Yes, in Germany the Construction Contract Procedures – Part B (*Vergabe- und Vertragsordnung für Bauleistungen – Teil B (VOB/B)*), a set of rules prepared by the bipartisan German Committee for Construction Contract Procedures (*Deutscher Vergabe- und Vertragsausschuss für Bauleistungen*) effectively serves as the general terms and conditions for construction contracts in large parts of the German construction market.

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.

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Sec. 8 para. 2 no. 1 VOB/B gives the employer the right to terminate the construction agreement in the event that

(i) the contractor has ceased to make payments,

(ii) the contractor has filed a petition to commence insolvency proceedings (in each case: or comparable statutory proceedings) over his assets,

(iii) the employer or any other creditor has filed an admissible petition to commence insolvency proceedings over the contractor's assets,

(iv) insolvency proceedings have been commenced over the contractor's assets, or

(v) the commencement of insolvency proceedings over the contractor's assets has been rejected by the insolvency court for lack of sufficient assets to cover the costs of such proceedings.

Following a termination, the employer must pay the services already provided (plus for additional costs incurred by the contractor but not included in the remuneration for the services provided).

The right to terminate the construction agreement is a powerful negotiation tool for the employer against the insolvency administration of the contractor which often wants to complete the ongoing projects.

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

Letters of credit (*Bürgschaften*) issued by a bank – in exceptional cases also letters of credit issued directly by a corporate parent – are very common in construction contracts. Such letters of credit generally require a letter of credit facility or a cash deposit at a pledged account held with the issuing guarantee bank.

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Another common security is the retention of partial payments (*Sicherheitseinbehalt*) by the employer until – for instance – potential warranty claims are all settled.

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

As outlined above (cf. 1.1.2), the employer may terminate the construction agreement and appoint a new contractor according to VOB/B. Outside of VOB/B, however, this exceptional termination right does not exist or (if included in construction agreements) would not be legally enforceable in insolvency. On the basis of the termination right under VOB/B, the employer has a powerful negotiation tool against the contractor or its insolvency administrator to either complete the project or to let the employer replace the contractor.

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If the employer wants the existing contractor to complete the project, the employer has to formally ask the contractor's insolvency administrator whether he will still demand performance. If the insolvency administrator does not reply promptly that he will continue to request performance from the employer, the insolvency administrator can no longer insist on performance of the agreement himself. In this event, the employer can only file its damages claims with the insolvency proceeding and retain a new contractor.

Generally, the insolvency administrator of a contractor is willing to complete a project if the remaining part of the project gives the insolvency estate overall profits.

If the contractor's insolvency administrator chooses to perform the construction agreement, any obligations and liabilities (for example: warranty claims against the contractor) in relation to services provided after the commencement of the (permanent) insolvency proceeding are *preferred obligations* to be paid directly from the estate (*Masseverbindlichkeiten*), not insolvency claims. This does not apply in relation to services provided before the commencement of the (permanent) insolvency proceeding, i.e. during the preliminary insolvency proceedings.

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In most German insolvencies the (permanent) insolvency proceeding is only commenced after an approximately three months' period of preliminary insolvency proceedings. During the preliminary insolvency proceedings, the insolvency administrator generally only supervises the assets of the debtor (here: contractor) to prevent the loss of assets. He cannot create preferred liabilities with effect for the estate. So pre-commencement warranty claims, for example, are ordinary insolvency claims.

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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?

My personal impression is that such clauses are not very usual in the market.

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Generally, once objects are solidly combined with the soil of a real property, they become part of the real estate and title is transferred automatically and unalterably to the owner of the real estate. Bringing material, equipment or tools to the site alone does not trigger the automatic transfer of title, so – at least from the contractor's perspective – protective clauses seem not to be so urgently necessary.

Any clause by which the debtor loses title of his assets limits the powers of the future insolvency estate. Nevertheless, even in case of a loss of title due to the combination “as a matter of fact” of assets with real estate (as mentioned above), the insolvency administrator can avoid such loss of title under the general conditions of the avoidance rules.

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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?

I am personally not aware of any (effective) clauses or instruments that would give the bank this authority independent of the insolvency administrator.

In general, a third party financier, e.g. a bank, cannot interfere with the insolvency administrator’s authority to decide whether to have the project completed or not.

In practice, however, banks are often the largest creditors in real estate insolvencies and are therefore entitled to some control over the insolvency administrator and its decisions and often provide the means for the insolvency administrator to complete the project.

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?

By statute, the contractor is entitled to a land charge on the relevant property. As far as I am aware, contractors in fact do not receive or insist to receive this security very often. Letters of credit are also to be seen as security for the contractor, but oftentimes contractors only have the security referred to below in 1.2.2.

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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 agreements typically provide that the contractor is paid by completed construction phase, i.e. the contractor can retain further performance (or terminate the agreement) until being paid for the previously complete construction phase.

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[@ Hilka: anything else?]

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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?

⇒ No such standard rules exist and the agreement generally continues to exist in insolvency. If the insolvent employer is in payment default, the contractor may terminate regardless of the insolvency. Otherwise, the contractor may not terminate simply on the basis of the employer's insolvency as this would limit the insolvency administrator's right to choose whether to elect performance or non-performance of the agreement.

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

⇒ Generally: the insolvency administrator. Please see above!

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

⇒ This depends on whether the insolvency proceeding in place is a regular proceeding controlled by the insolvency administrator (which is usually the case) or a special debtor-in-possession proceeding in which the old employer (at least theoretically – in practice, the creditors often force the debtor to hire a chief restructuring officer or to undergo other changes in management) remains in charge.

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

a) In case of termination of the contract?

Absent any security, the remuneration claim is an insolvency claim to be compensated pari passu with the other unsecured creditors and according to the available insolvency dividend.

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b) In case the contract is carried forward?

To the extent the remuneration claim relates to works completed after the election of the insolvency administrator to complete the contract: the

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remuneration claims are preferred claims to be paid in full out of the insolvency estate.

b) To the extent the remuneration claim relates to works already completed before the election of the insolvency administrator to complete the contract, (absent any security,) the remuneration claims are insolvency claims to be compensated pari passu with the other unsecured creditors and according to the available insolvency dividend.

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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?

Please see q. 1.1.5 above: the employer. In order to get (by force) any title or security interest in the real property the contractor would have to foreclose against the employer (which is not allowed during insolvency).

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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?

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The contractor can include termination rights together with provisions that make the remuneration of the subcontractor in case of such a termination dependent on receipt of remuneration from the employer. However, such clauses may not be effective if they constitute "general terms and conditions" subject to special mandatory statutory review and would be considered inadequately one-sided and therefore unjustified.

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?

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In general, a lease is not affected by a foreclosure into the property and continues to run with the acquirer. However, following a foreclosure sale, the acquirer and new landlord has an exceptional right to terminate the lease within generally three months.

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2.1.

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.

The (little) protection afforded to the tenant is that the lease generally continues to run in an insolvency or foreclosure.

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However, given the special termination right, if the tenant cannot reach a commercial agreement with the new landlord, he has basically not much protection. If a tenant would like to have an insolvency proof right of use, he has to get an easement, an in rem right of use, registered in the land registry.

Met opmaak: Lettertype: Vet

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?

Although insolvency clauses are common that give the landlord a termination right in the event that the tenant is insolvent, such clauses are usually invalid because German insolvency law does not permit termination rights solely on the basis of the other party's insolvency (i.e. filing an insolvency petition or commencement of insolvency proceeding). However, the landlord is entitled to terminate the lease as soon as the insolvent tenant ceases paying rent.

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One protection is available for tenants: The landlord may not terminate a rent agreement based on a payment default that occurred before the time of the insolvency petition. Accordingly, a payment default that occurred after the filing of the insolvency petition is a valid reason for a termination.

Met opmaak: Lettertype: Vet

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?

Deposit on a pledged bank account of the tenant or on a trust bank account of the landlord; bank guarantee; third party guarantee

Generally, the tenant's insolvency does not affect the landlord in enforcing his *in rem* security granted by the tenant or any security granted by a third party.

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