

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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Report on Italian Law

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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 may check on the local Companies Register for the main information concerning the contractor, including its shareholders and directors, its by-laws, whether any bankruptcy requests have been filed, the main historical corporate events, whether any seizure procedure is pending, the financial statements, its powers of attorney to its directors, employees or shareholders.

Many private commercial and information companies may render more detailed information on the financial standing of a company (e.g. relations with banks, prejudicial events, sector risk indicators, press cuttings).

From the public real estate registers it is possible to identify the real estate properties registered under the name of the company and/or under the name of its shareholders, as well as any pending mortgage or other lien over the said properties.

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?

There are no standard conditions for construction contracts under Italian law, though some standard clauses have been developed in the commercial practice.

There are however some statutory rules applicable to construction contracts, some of which are mandatory, whilst others are relied upon when the parties do not agree otherwise in their contracts. Relevant rules are contained in the following statutes:

- Civil code: rules on *contratto di appalto* (articles 1655 ff.). The civil code sets general rules applicable to services agreements, construction contracts, works contracts. Most of the rules can be derogated by the parties.

The civil code refers to the assignment of the contract and subcontracting, warranty for defects, price adjustment and changes in the scope-of-work, joint liability of the employer for payment of the salaries to the contractors' employees.

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.

- Public contracts code: public contracts must comply with the rules of the public contracts code and the technical specifications for the execution of the works.

In case of insolvency of the contractor, the contract is terminated (pursuant to the general rule of bankruptcy law) and the public contract code sets the following rules:

- (i) the employer must ask the original participants to the tender, according to the ranking from their bids, to enter a new contract for completion of the works (article 140 of the Public Contracts Code);
- (ii) for contracts awarded to temporary grouping of undertakings³, in case the leading company goes bankrupt, the other grouped undertakings may replace the leading company with any of them enjoying all the regulatory and statutory requirements, and the contract continues with the temporary grouping if the principal accepts such replacement.

In case of bankruptcy of a member of the temporary grouping (other than the leading company) the leading company must perform the works/services of the bankrupt company, directly or through other undertakings which meet the relevant technical requirements (article 37 of the Public Contracts Code);

- (iii) if the contract was awarded to a general contractor, the global performance guarantee (due in case the contract consideration exceeds certain thresholds) obliges the guarantor to require another company, having all the statutory and regulatory requirements, to continue the works (article 126 of the Public Contracts Code).

- Insolvency act: it sets the general rules according to which, in case of insolvency of any of the parties, the contract is automatically terminated, unless the trustee decides to continue the contract upon prior authorization of the creditors, informing the other party and giving adequate guarantees (article 81, § 1).

In case of bankruptcy of the contractor, if the personal quality of the contractor has been considered an essential feature for entering the contract (contracts *intuitu personae*), the contract is terminated unless the employer decides to continue the contract despite of this circumstance (article 81, § 2 of the Italian bankruptcy Act).

See also under 1.1.4. below.

³ Temporary grouping of companies are incorporated among undertakings with the goal of being awarded public contracts and fulfil jointly the financial or technical requirements set in the relevant call for tenders. The parties to a temporary grouping of companies give irrevocable power to one of them (the company) to represent the grouping before the employer.

- Other statutes set rules on joint liability of the employer for obligations of the contractor for accidents at works, payment of employees salary, social security and security contributions. In particular, the employer:
 - (i) in the event of accidents at works, is jointly liable with the contractor and its subcontractors, if any, for the damages not covered by the relevant institutions ensuring workers against accidents at work. Such liability does not extend to the damages which arise as direct consequence of the specific risks of the activities carried out by the contractors/subcontractors (article 26, § 4 of legislative decree 81/2008);
 - (ii) is jointly and several liable with its contractors and subcontractors, if any, for the payment by them of tax deductions on salaries to employees working in the contract, limited to the consideration due to the contractor and for a limited timeframe of 2 years after completion of the contract. The joint liability can be avoided if the employer gives evidence to have adopted any measure able to prevent the breach by the contractor/subcontractors, e.g. paying the contractor upon evidence of its (and its subcontractor's) compliance with payment of tax deduction (article 35, § 28 of decree no. 223/2006);
 - (iii) is jointly liable with the contractor and its subcontractors, if any, for the payment of the employees' wages, social security and insurance contributions, for 2 years after termination of the contract. The joint liability of the employer operates only if the contractor's/subcontractors' employees have first unsuccessfully acted *vis-à-vis* their employer (article 29 of decree 276/2003).

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

In the private sector, the following securities are usually demanded by the employer:

- performance bond, usually not exceeding 10% of the contract consideration. The rules and effects of the performance bond may vary according to the contractual powers of the parties;
- contractor's all risks insurance (CAR), covering any (i) damage to materials and equipment and/or to property; and (ii) injury of accidents to third parties arising out of the execution of works;
- liability insurance for any accidents and injuries to employees arising out of the execution of works.

In the public sector, the following mandatory securities are required:

- first request bank/insurance guarantee or deposit in the measure 2% of the contract consideration (as indicated in the tender), to be given at the moment of the bid. This guarantee covers the risk that the bidder does not enter into the contract once the contract is awarded to him/her (article 75 of the public contracts code);

- a performance bond (in the form of first request bank of insurance guarantee), in the measure of 10 per cent of the contract consideration. This guarantee is proportionally reduced, up to 80% of the initial coverage, at the completion of each milestone. The performance bond expires only when the contractor accepts the works by means of the test certificate or the certificate of correct performance (article 113 of the public contracts code) or in any event after 12 months from completion of the works, resulting from a certificate.

In the event of contracts exceeding certain thresholds and of contracts awarded to general contractors, the performance bond is replaced by a global performance bond, where the guarantor also undertakes to replace the contractor with another undertaking in the event of bankruptcy of the original contractor (articles 113 and 175 of the public contracts code).

- a contractor's all risk insurance (CAR) in favor of the employer for damages resulting from execution of the works, including a third-party liability policy against claims for bodily injury and/or death and/or property damage (article 129 of the public contracts code);
- only for works exceeding given thresholds (set by the Ministry), a ten-year warranty and third-party liability policy for damages resulting from destruction, in whole or in part, of the works/building or material construction defects (article 129 of the Public Contracts Code).

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 contracts between private parties, the contract terminates if the contract has been based on the personal quality of the contractor, without possibility for the trustee to succeed in the position of the bankrupt contractor, unless the employer agrees to it and decides to carry on the contract regardless of this. For the succession of the trustee to the contract is however necessary the prior authorization of the creditors (*i.e.* the continuation of the contract must be of interest for the proceeding).

In public contracts, according to the case law (which, however, under civil law jurisdictions is not binding) contracts are always considered *intuitu personae* and the employer may therefore not continue the contract with a bankrupt party, even if the judge authorizes the provisional operation of the bankrupt company.

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?

Materials, equipment and tools are generally supplied by the contractor, since, according to the civil code, the constructor carries out the task with its own organization. They remain under the property of the contractor, even if they are on site, until they are incorporated in the works/construction (for immovable property) or are

accepted by the employer (for movable property). Therefore, such goods may be acquired to the bankruptcy estate in case of contractor's insolvency.

A clause 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 would not be valid under Italian law and might be declared as void by the bankruptcy proceedings, as it would impair the *par condicio creditorum*, the principle of equal treatment of creditors.

A pledge on the materials, equipment and tools (property of the contractor) in favor of the employer may grant however to the employer the right to priority payment *vis-à-vis* non secured creditors. Pledges granted one year before the declaration of bankruptcy for debts not yet due (even if existent at the time of the granting of the pledge) are subject to claw back actions.

In case the materials, equipment and tools are provided by the employer, and this emerges from the contract, they would not be acquired to 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?

No, this is forbidden by law, pursuant to art. 2744 of the Italian civil code as this might constitute a form of a so called "agreement of forfeiture" (*patto commissorio*).

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 contractor may demand a payment bond. This is not mandatory under Italian law.

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?

All provisions concerning the protection of the contractor (excluding those mandatory provisions on joint liability already mentioned under above 1.1.2.) are open for negotiation by the parties. More specifically the contractor is likely to try to negotiate:

- no penalty clauses for delay;
- right to price adjustment if the event of any (material) variation to the construction project requested by the employer;
- no derogation from the code civil rules providing:
 - (i) the contractor's right to withdraw from the contract and obtain a reasonable indemnity in the event the execution of the works requires necessary variations exceeding an amount at least equal to 1/6 of the consideration agreed upon;

- (ii) a price adjustment in the event circumstances, not foreseeable at the time of the contract, cause a price increase in the costs of material and workmanship such as to cause an increase up to 1/10 of the contract consideration;
- (iii) a reasonable indemnity in the event the execution of the the works is made more difficult than expected due to geological or hydrological or similar causes.

A contractor may also try to include in the contract an automatic termination clause for the occurrence of some material breaches that may reveal a high risk of insolvency of the employer (e.g. termination of the contract for failure of the employer to pay one or more installments of the contract consideration and/or for loss of the employer's securities guaranteeing the contract, if any).

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?*

Yes, there is a standard rule providing that in case of bankruptcy of the employer, contracts are automatically terminated, unless the trustee decides to continue the contract upon prior authorization by the creditors (article 81, § 1). Parties cannot deviate from this rule in their contracts.

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

See sub a) above. The trustee, upon authorization by the creditors, may decide not to terminate the contract. This might be the case when it is deemed by the trustee that the completion of the works under the contract, as provisional operation, by the bankrupt company may be of advantage for the bankruptcy estate.

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

The liquidator takes over, unless the judge authorizes the provisional operation of the bankrupt company.

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

a) *In case of termination of the contract?*

The contractor will be paid by the bankruptcy for the works accepted and/or for the installments due and payable at the date of declaration of bankruptcy, subject to the proceedings and to the rule of equal treatment of creditors⁴. No indemnity nor damages nor reimbursement may be claimed for the costs borne and/or the works not yet accepted at the date of the declaration of bankruptcy.

b) *In case the contract is carried forward?*

The trustee succeeds in the contract and is liable for all payments due to the contractor according to the consideration originally agreed upon in the contract (*i.e.* in this case the *par condicio creditorum* does not apply to the contractor). This is because the contract is deemed to be of interest for the bankruptcy estate and the creditors have authorized the carrying forward of the contract.

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?*

The parts of the building that have already been finished are owned by the employer, if the ground on which the works are realized belongs to the employer. In such case, the contractor cannot get a freehold of the construction site and continue the project with a different employer.

Only in the rare case the contractor should own the ground on which the construction is built, the contractor may acquire the parts of the building that have already been finished and may continue the project with a different 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?*

The contractor may include in the contract a condition subsequent for the occurrence of the insolvency of the employer.

⁴ The contractor might enjoy a right of priority payment against unsecured creditors only in the event it was granted a pledge or mortgage or lien on some of the employer's assets.

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?*

The lease is not affected by the foreclosure of a mortgage over the leased property if the following conditions are satisfied:

- the lease was entered into, with certified date, prior to the seizure;
- the lease was registered (for lease with a term exceeding 9 years) or, for not registered lease, the lease had commenced, at least, 9 years before the seizure;
- the tenant was in hold of the property before the seizure in the event there is no lease agreement or the lease agreement has no certified date.

Regardless of the above, the landlord may terminate the lease in the event the amount of the rent is poor (1/3 less than the fair rent or the measure of rent resulting from prior leases).

In case the lease is of indefinite term, or has no term, the landlord is bound for one year to the lease, and may withdraw from it by giving prior notice to the tenant.

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.*

See above.

No right of first refusal for acquisition of the leased property is granted to the tenant.

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?*

In case of insolvency of the tenant, the trustee may at any time withdraw from the lease, paying to the landlord an indemnity for the anticipated termination of the lease.

Insolvency clauses in lease may not validly be enforced in courts, since lease agreements have a mandatory statutory term⁵. Furthermore, a general rule of the Italian

⁵ According to Italian Law no. 392/1978 leases for commercial, industrial, artisanal or touristic purposes have a minimum duration of 6 years and leases of hotels have a minimum duration of 9 years. Upon expiry leases are automatically renewed for 6 or 9 years (respectively) unless the

bankruptcy act provides that insolvency clauses subjecting the termination of an agreement to the bankruptcy of one of the parties are not effective.

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?

The landlord usually demands a deposit amount, to be returned at the end of the lease (increased by the yearly interest on the deposited amount). The tenant's insolvency does not affect the right of the landlord to retain said deposit amount.

The landlord may also request a bank or insurance guarantee to secure the payment of the rents. In such case the tenant's insolvency would not affect the right of the landlord to execute the guarantees, unless the guarantee does not cover the event of bankruptcy of the tenant.

tenant or the landlord refuses the renewal (restrictions apply in relation to the ground for refusal to renew by the landlord).