

# **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 Spain**

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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 employer<sup>1</sup> check the financial standing of the contractor<sup>2</sup>? Is credit/financial information publicly available in your jurisdiction?

In today's challenging economy, an employer starting a new project, or continuing an existing project, should give increased consideration to the contractor it hires to perform the work. Obviously, hiring a financially distressed contractor puts the owner at increased risk of not completing the project on time or on budget if the contractor goes out of business. As a preventive step an employer can seek help to avoid hiring a financially distressed contractor therefore minimizing the impact should the contractor becomes financially distressed during the project. The financial statements will help identify whether the contractor's short term financial position puts them at risk of cash shortfalls and possibly going out of business in the future.

According to Spanish legislation, it is mandatory in Spain to prepare financial statements. Annual accounts comprise of: balance sheet, income statement, the statement of changes in equity, cash flow statement and notes to the annual accounts. Annual accounts are prepared every twelve months. Within one month following approval of the annual accounts, certification of the agreements adopted by the shareholders at their annual general meeting to approve the annual accounts and the distribution of profit/application of loss is filed with the Mercantile Registry, along with a copy of each of the accounts, the directors' reports and the auditors' report (if the company is subject to audit). One the first working day of each month, the Mercantile Registrars provide the Central Registry with a list of the companies that complied with the requirement to file their annual accounts during the prior month. The *Official Gazette of the Mercantile Registry* publishes an announcement detailing the companies which have complied with this requirement. All the aforementioned financial documentation is available to view, as all documentation files are publicly available in Spain.

However there is other information that may not be apparent in the financial statements. For example: the contractor's ability to obtain further financing if needed, when the contractor's current loans are due, whether the contractor has significant past-due obligations, whether the contractor has aging accounts receivable, history of claims against the owner, previous bankruptcy filing, etc. It is very important to evaluate this kind of credit information but unfortunately it is

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

<sup>2</sup> The person, company or organization hired to execute the construction works.

not publicly available in Spain. In conclusion, analyzing the credit/financial health of a contractor in these difficult economic times before a contract can help prevent a potential impact in case of financial difficulties.

**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 general terms, the Spanish jurisdiction has standard conditions for the construction contracts some of which are included in order to protect the employer in case of contractor's insolvency but they offer limited protection for the employer. In fact it is possible to include provisions under which the employer can monitor and manage any adverse changes in the contractor's financial condition. Examples of contractual protection that allow the employer to monitor the contractor's finances include:

- Require the contractor to provide updated financial statements on a periodic basis for owner review;
- Allow the employer to institute different payment or management processes if the updated financial statements indicate an unacceptable deterioration in the contractor's financial condition including direct or joint payment to subcontractors;
- Allow the employer the right to inspect and audit contractor records during the job. In addition to contractual rights, the owner can also avail itself of publicly available information during the project to check the contractor's financial status. These sources are basically the same as the ones that should be checked before hiring a contractor such as credit bureaus and court records.

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

The securities that the employer will normally require from the contractor are:

(i) Bank guarantee of between 5% and 20% of the amount of the work or a withholding of 5% of the amount of work certificates. The bank guarantee or the withholding are usually in force one year from receipt of the work by the employer.

(ii) Insurance for construction (ensuring damage during execution of work) is also required by law.

**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 contractor's insolvency, the only alternative the employer has is to request the termination of the contract in the insolvency proceedings due to the breach of contract. After the termination of the contract, the employer may continue the completion of the project with another contractor.

**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?**

In general terms, according to Spanish law and the principle "*superficies solo cedit*", the owner of the land becomes the owner of everything built on it. Regarding the machinery and tools for the execution of the work, in principle, they are owned by the contractor, although the land is property of the employer. With regards to material stockpiles for the work (cement, bricks, etc) this need to be referred to the conditions detail in the contract.

**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?**

The kind of clauses according to a case of employer's insolvency or loan default of the employer is not typical in construction contracts in Spain. In fact, it seems illogical that a financial institution accepts a clause such as this, it would be very damaging for the financier to continue to finance a work or project of an insolvent company.

**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 warranty usually requested by the contractor from the employer in the construction contracts is either a bank guarantee or an advance of the total price both being between 5% to 20% of the total price.

**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?**

Another clause which is often included in a construction contract to protect the contractor is the possibility for the contractor to retain the construction (the possession not the ownership) until the contractor receives the payment of the amounts owed by the promoter.

**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?**

In the Spanish jurisdiction there are no standard rules for termination of a contract in case of insolvency of the employer. In fact, according to the Spanish Act on Insolvency, clauses that establish the power to rescind or terminate the contract due to the sole cause of declaration opening insolvency proceedings of either of the parties shall be deemed non-existent.

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

The declaration opening the insolvency proceedings, alone, shall not affect the validity of contracts with reciprocal obligations pending fulfillment. Notwithstanding the insolvency administration (in case of voluntary insolvency) or the insolvent debtor (in case of compulsory insolvency) may request rescission of the contract if they deem it convenient to the interests of insolvency proceedings. The Court Clerk shall summon the insolvency administration and all other parties involved to a hearing before the Court. If an agreement is reached with regard to rescission and its effects, shall hand down an order declaring the contract rescinded pursuant to the provisions agreed. Otherwise, the dispute shall be substantiated as an insolvency procedural plea and the Court shall decide on the termination.

In any case we have to say that the declaration opening insolvency proceedings shall not affect the power to terminate contracts due to

subsequent branch by any of the parties. The termination action shall be exercised before the insolvency Court and be substantiated as an insolvency procedural plea. Although there may be a cause for termination, the Court considering the interests of the insolvency proceedings, may resolve fulfillment of the contract.

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

It depends, in the event of voluntary insolvency, the debtor shall conserve the powers of management and disposal of his estate. The exercise of which shall be subject to intervention by the insolvency administrators via their authorization or approval. In case of compulsory insolvency, exercise by the debtor of the powers of management and disposal of his assets shall be suspended, being substituted therein by the insolvency administrators.

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

**a) In case of termination of the contract? b) In case the contract is carried forward?**

In case of termination of the contract or in case the contract is carried forward it shall be considered a claim against the estate or ordinary claim.

i) The claim after the insolvency proceedings has been declared open shall be considered claim against the estate. Before proceeding to pay the insolvency claim, the insolvency administration shall deduct the properties, goods and right required from the estate to pay claims against the estate.

ii) The claim prior to the insolvency proceedings has been declared open shall be considered ordinary claim. Payment of the ordinary claims shall be carried out once the claims against the estate and preferential claims are settled.

**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?**

According to Spanish legislation the landowner is always owner of the parts of the building that have already been finished. In addition, we have to say that there are no rules under Spanish law to allow the contractor to obtain the property of the parts of the building that have already been completed. What may occur is a

transfer of possession to the contractor but it is an instrumental possession for the execution of the work but never a transfer of property.

**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?**

There is no kind of provision that a contractor should or can include in the contracts with his subcontractors in order to protect himself in case of the employer's insolvency.

**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?**

Like other types of property, real estate that is used as rental property can be sold, or may be affected by foreclosure proceedings. Sales and foreclosures are major events for the owner of rental property, but tenants or renters of the property are affected as well.

Regarding the foreclosure of a mortgage or other in rem guarantee we have to distinguish two possible situations:

(i) If the lease is prior to January 1, 1995, it is therefore governed by the Urban Leases Act 1964 (LAU), and the contract was drawn before the creation of the mortgage, nothing will be affected by the foreclosure of a mortgage. The same would apply if the contract is subsequent to the mortgage loan, unless the same is fraudulent for the rights of the buyer.

(ii) If drawn after January 1, 1995, it is therefore governed by the Urban Leases Act 1994 (LAU) according to the Article 13.1, in case of foreclosure of a mortgage the leased property shall remain for a maximum period of 5 years, even if the contract is not entered in the Registry of the Property.

Therefore depending on when the contract was signed the new landlord may or may not terminate the lease according to the aforementioned 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.**

According to Spanish legislation, the protection for the tenant in this case consists in guaranteeing the continuity of the lease agreement.

**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 landlord is not entitled to terminate the lease according to the Spanish Act on Insolvency. Declaring insolvency proceedings, alone, shall not affect the validity of contracts with reciprocal obligations pending fulfillment. Therefore when the insolvency proceedings opens, one of the parties has entirely fulfilled his obligations, full or partial fulfillment of the reciprocal ones by the other side is pending, the debtor's credit or debt shall be included, as appropriate in the aggregate assets or liabilities of the insolvency proceedings. In any case, the declaration opening the insolvency proceedings shall not affect the power to terminate contracts due to subsequent breach by any of the parties.

**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 ask for a security deposit at the time the lease is signed and at the end of the tenancy landlord must return a tenant's security deposit or give a written explanation as to why the deposit (or any part of the deposit) will not be returned. So the claim after the insolvency proceedings has been declared open shall be considered claim against the state it will be paid at its maturity depending on the liquidity of the company. On the contrary, claim prior to the insolvency proceedings has been declared open shall be considered ordinary claim and the payment of the ordinary claims shall be carried out once the claims against the estate and preferential claims are settled.