

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

## **Real Estate and Insolvency Commissions**

National report, Sweden

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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?

Credit/financial information are publicly available in Sweden through private companies that are under supervision of the Swedish Data Inspection Board, a public authority. They provide permits to companies that work with credit information. 21 companies are licensed (2014-02-23). They ensure that those that have obtained a license then comply with the Swedish Credit Information Act, which may be described as a form of consumer protection law and does not, in first hand, protect companies. All Swedish companies are tracked and monitored by the credit information companies and every company receives a rating. The rating system is different from each credit information company. Newly registered companies does normally not receive a rating until financial information has been handed in to the tax authorities at the end of the first financial year of the company. As a client to a credit information company you are able to receive online information about the rating of a company within seconds. The cost for this is between five and fifteen euros depending on which credit information company you use. According to the Credit Information Act, for companies, there is no registration that someone has asked for your rating. The credit information companies gather all kinds of information regarding companies, such as financial information, judgments, bankruptcies among the directors other positions in other companies and if someone has handed in an application for payment to the Swedish Enforcement Authority. These companies rating systems are different in sensibility but are free to use any circumstances they want to create a rating.

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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.

The ratings are also commonly used in public procurement as a qualification criterion. However, case law has developed a strong protection for companies competing for public contracts and provides a right to show a rating with other means than a certificate from a credit information company.

Free of charge, an employer (or any legal or physical person) may receive information, within one or two days, about whether a company has paid its taxes and duties related to their employees- through a standard form called SKV 4820. Free of charge, anyone may also call the Swedish Enforcement Authority to check whether an application for payment has been handed in and if a company is suffering under measures from the Enforcement Authority.

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 Sweden, the standard conditions for construction contracts are found in a set of standard agreements that have been negotiated by representatives of the different parties on the market, such as public and private employers and associations of different kind of contractors organized in a body called the "Construction Contracts Committee" that has been in function for over sixty years. The standard agreements are revised and updated about every tenth year and are used for approximately 95 % of all construction contracts within a business-to-business contractual relation.

Hence, at present, the great majority of contracts in Sweden are based either on AB 04 (General Conditions of Contract for Building, Civil Engineering and Installation Work) or ABT 06 (General Conditions of Contract for Building, Civil Engineering and Installation Work performed on a package deal basis). Supporting these two documents are commentaries and forms of agreement which have been worked out jointly by the parties. The Construction Contracts Committee has had a decisive influence on the production of all these documents.

In these standard agreements the regulation on securities is as follows. If, according to the contract documents, a party has a liability to provide a security for his obligations, such security shall be provided to the other party within two weeks from the concluding of the agreement. Unless otherwise prescribed in the contract documents, the contractors security shall equal to a sum of 10 % of the contract price during the time for completion and 5 % for time thereafter for two years after approval of the total works or, if defects are confirmed at inspection within this period until the defect has been rectified or the contractors obligation has been otherwise discharged. The security shall be returned immediately after the party has discharged his obligations under the agreement.

If the security deteriorates so it no longer has the intended value, the party shall, upon request from the other party, provide supplementary security without delay.

It shall also be mentioned that the standard agreements has clauses on termination of the contract if the contractor becomes bankrupt or is otherwise found to be insolvent to such a degree that he cannot be expected to discharge his duties and adequate security for the correct fulfillment of the contractors obligations to the employer is not provided immediately in request. The employer is also entitled to terminate the agreement if the

contractor fails to provide the stipulated security in the contract or to provide supplementary security. In these cases, the employer is entitled to compensation for his loss.

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

On demand-bank guarantees, Insurance for the fulfilment of the contract works or (rarer) a guarantee from the mother company of the contractor for the fulfilment of the contract.

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

He may terminate the contract and claim compensation for his loss from the guarantor. He may, in order to complete the contract works, enter in to contract with the bankruptcy estate for the fulfillment of the contract works. He may also use another contractor if he so wishes.

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?

Except for tools and equipment for the construction works, that are the property of the bankruptcy estate, a transfer of title is almost useless according to case-law. Regarding materials that are inserted into a property the following apply. From the standard agreements used in Swedish construction law, it is not clear when the ownership of the objects which the contractor provides is transitioning from contractor to the employer. Is it an object that is inserted in the employers building, the ownership issue is are not treated in the standard agreement but the rules in chapter 2 of The Land Code. Under many agreements works are performed on a property belonging to the Purchaser. Insofar materials etc. is incorporated in the building or facility or placed in the ground where the works are performed, it will normally become a part of the property, which is owned by the employer. The ownership is thus transferred from the contractor to the employer according to the different parts is transitioning to become accessories to the property (inserted in the property). The consequence of this "passing of title" is that the contractor cannot remove objects that have been inserted in the property, whether he has been paid or not. The contractor/bankruptcy estate can only remove property that have not been built into/inserted the fixed property or otherwise assumed the character of "real property". It does not in this case matter whether the supplier would have made a reservation of title (retention of title). Such reservation ceases namely cease to apply when the object is inserted on the property according to Swedish case-law.

It may in this context be briefly mentioned that the exception is in the event that the property is approved for industrial activities. In these situations, the property owner in the land register of declaring the property introduced into the property for use in its main

business should not be considered as belonging to the property. Property is in this case considered chattels. With industrial activity means activity that is focused on the production of goods all the way down to the machinery. A declaration to the Land Registry is thus the property owner's protection against the contractor or the contractor's creditors limited the extent retention of title clause is valid.

Concerning materials delivered to the job site and not been incorporated in to the Purchaser related property the following may be mentioned. The question is what happens if the contractor delivers materials to the employer's place of work, the site, and this has not been inserted into the property because the contractor becomes bankrupt. Who will have the ownership, the contractor's bankruptcy estate or the employer? The decisive question is whether the contractor has been able to freely dispose of the material or if he cut off actual physical control over the material at the time of the bankruptcy. The issue has been examined in a case of the Supreme Court (NJA 1945 p 400). In this case the contractor was declared bankrupt in the midst of an ongoing contract. At the time of the bankruptcy there was material left at working site, which certainly not in this case belonged to the employer. In a separate document was stipulated that the ownership of all material would be transferred to the employer when being unloaded on the site. The question arose whether the material supplied was considered to belong to the employer or the bankruptcy estate. The court concluded that even if the material would have been on the employer's site, material could not have been passed in the employer's possession prior to the bankruptcy. The material was therefore considered to belong to the bankruptcy estate. When the judgment talks about that the property had not been released in the employer's possession, it probably in this context means that the actual (physical) access to material was not exclusively transferred to the employer. Hence the contractor used the material in the current work, had it not therefore exclusively passed to the employer. The same conclusion was reached by the Supreme Court in another case, which concluded that the circumstances that contractor's work performed on employer's site when the workplace was fenced, protected and guarded, did not mean that the material would be deemed to have been submitted in the employer's possession (NJA 1941 p 687). The general rule is thus the need for a so-called tradition (passing) of property for the protection of property rights arising. This refers to the fact that a possession change occurs or a severing of disposition of the material occurs.

Normally argued that if for example it is evidence of the insolvency of the employer or that defaults occur, the contractor should bring the material home or lock it in to mark ownership. The contractor should also not perform the final installation of valuable material in order to prevent that this qualifies as the employer's property.

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. I have never even heard of it.

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?

This is extremely rare in business-to-business contracts but may occur in consumer-business contracts. From time to time securities are asked for from the contractor when the employer is a foreign company (when the contractor is of a certain size) or when the employer is known to be difficult, but this is rare. They are however not mandatory.

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?

Down-payment clauses are very common in Sweden. The construction contract does normally contain a plan for the payment, agreed by the parties, where the contractor becomes allowed to invoice when certain conditions are fulfilled, such as when the roof is on place or when the foundation is ready. If there is no plan for the payment agreed the principle is the "completion principle" according to the standard agreements. This means that the employer has a duty to make partial payments of the contract price against an invoice for the contract works completed. Of the amounts invoiced, the employer may retain 10 % of the value of the contract works completed as a security for the future rectification of defects, such sum shall not, however, exceed 5 % of the contract price.

Advance payments are rare but if they are agreed upon, the standard agreements stipulates that the advance payments shall be successively balanced, unless otherwise provided for in the contract, by the making of a special percentage deduction from each partial payment, the percentage rate being equivalent to the ratio of the advance payment to the contract price.

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?

Swedish law does not have standard rules or case-law on what happens with your agreement in general when your counter-party enters in bankruptcy. In some specific cases it provided for in the legislation, but no such *lex specialis* exist for construction contracts. The general rule is then to terminate the contract with the counter-party that entered in to bankruptcy, in order to avoid that an agreement is momentarily entered into with the bankruptcy estate. Hence, in the standard agreements on construction the contractor is given the right to terminate the contract if the employer fails to fulfil, in due time, his liability to pay or otherwise to discharge his obligations and this is not rectified without delay after reminder, provided that such failure is of substantial importance and if the employer becomes bankrupt or is otherwise found to be insolvent to such a degree that he cannot be expected to discharge his duties and adequate security for the correct fulfillment of the employers obligations to the contractor is not

provided immediately upon request. If such a request has been made, the contractor is entitled to suspend the works. If the works are resumed, the contractor is entitled to compensation for the costs incurred by the reason for suspension. The contractor is in these cases, if a termination is done, also entitled to compensation for loss.

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

The parties. However, a termination may be challenged and overridden in court, something that does not normally happen in the cases of insolvency.

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

The guardian of the estate is in charge, if a specific contract is entered into between the contractor and the bankruptcy estate. This of course if the construction that has been erected so far is not assigned to a third party.

- 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 a bankruptcy takes place, the contractor and his claim is to be found among the unprivileged creditors.

- b) In case the contract is carried forward?

See answer on a) regarding the claims to what was performed prior to the bankruptcy.

- 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?

See answer on 1.1.2 for the first question. There are no such rules as mentioned in the second question.

- 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?

If possible, ask for security, down-payments or advance payment. The legal shield is weak, not to say non-existent, in Swedish law regarding this matter.

## **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?

No. The bankruptcy of the landlord or the take-over of a creditor, like a bank, does never entitle a new landlord to terminate lease agreements as long as they are in writing and the tenant has gained access to the premises, that is that the lease period has begun. This according to mandatory rules in the lease section of the Swedish Land Code.

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 my answer above. The tenant is fully protected against a new owner as long as the lease agreements are in writing and the tenant has gained access to the premises, that is that the lease period has begun.

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?

If the tenant goes bankrupt, the bankruptcy estate of the tenant is entitled to terminate the lease. For commercial leases the landlord has a right to terminate the lease if no security is provided from the bankruptcy within one month from the day the bankruptcy was declared, a security for the performance of the agreement that may reasonably be satisfying to the landlord, or if the bankruptcy estate within the same time declares its willingness to take over to the tenant's obligations under the lease, or if not, when the tenancy may be transferred, the transfer is in accordance with the agreement. If a landlord calls a bankruptcy estate to provide the lease object for the landlord's disposal and the bankruptcy estate within one month doesn't comply, the landlord may charge the bankruptcy estate for the agreed rent from the day bankruptcy was declared until the premises are at the landlord's disposal.

Insolvency clauses are rare, due to the fact that the above mentioned clauses are mandatory.

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?

Bank guarantees, other kind of guarantees (like directors and owner of the tenant personally guaranteeing the rent) and – more rarely – a depository of, for instance, three months rent.