

# **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 Switzerland**

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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?

Before contracting with a Swiss contractor the employer may check the commercial register. The Swiss commercial register is publicly available and the use is for free<sup>3</sup>. All Swiss companies can be found in the commercial register. The commercial register does not contain financial information about the contractor. However, it could be interesting to know for example that the contractor has been existing since many years and has a share capital exceeding the minimum legal requirements or that the contractor was created only some months ago and has the minimum share capital.

Furthermore, there is an official register indicating past and ongoing enforcement against persons and companies in Switzerland. One can check the register to see if there are pending enforcement proceedings or if creditors were not fully satisfied when enforcing their claims against the potential future contractor.

The respective register is not public. One has to show prima facie a legitimate interest to consult the register (article 8a paragraph 1 of the Swiss Debt Enforcement and Bankruptcy Law, referred to as "DEBL" in the following<sup>4</sup>). However, it is not difficult to show such legitimate interest. According to article 8a paragraph 2 DEBL a legitimate

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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.

<sup>3</sup> The Swiss commercial register can be found on the following website: <http://zefix.admin.ch/> - subcategory "Central Business Names Index".

<sup>4</sup> There is no English version of the DEBL in the internet. The German version of the DEBL can be found under <http://www.admin.ch/opc/de/classified-compilation/18890002/index.html>.

interest can especially be assumed when a request for an extract is directly linked to the conclusion of a contract. Therefore, it is for example sufficient to send the draft of the construction contract, the contractor's offer or even just an e-mail indicating a future contractual relationship to the competent enforcement office. The request has to be sent to the enforcement office at the contractor's domicile.

If the extract indicates enforcements against the contractor this does not necessarily mean that the counterparty has no credit-worthiness (in Switzerland enforcement proceedings can be launched without possessing an enforcement title). However, if there was an entry the employer should discuss this topic with the contractor in order to clarify the reason for such entry.

On the other hand the employer can neither be sure about the credit-worthiness of contractor if the register does not indicate enforcements against him.

As in other countries there are private credit agencies in Switzerland that can provide you with financial information about your future contractor (e. g. the company Creditreform<sup>5</sup>). One has to pay for the services of the credit agencies. The information that is provided by the credit agencies may help you to learn more about your potential contractor. However, it is not guaranteed that the provided financial evaluation is correct and one may find oneself with a contractor being in a worse financial situation than it was assumed before.

- 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 only 17 articles in the Swiss Code of Obligations (referred to as "CO" in the following)<sup>6</sup> concerning contracts for works and services (including construction contracts). It turned out that those 17 articles did not sufficiently cover all the aspects of a construction contract. Therefore, specific rules for construction contracts were developed by the Association of Swiss Engineers and Architects ("*Schweizerischer Ingenieur- und Architektenverein [SIA]*" in German).

The codification that was developed by the aforementioned association is called SIA Norm 118 General Conditions for Construction Works (referred to as "*SIA-Norm 118*" in the following)<sup>7</sup>.

The SIA-Norm 118 can only be applied if the parties to a construction contract agree on the application of this codification in their contract. It is quite common to include the SIA-Norm 118 to construction contracts in Switzerland often amending the wording of the codification by special contractual stipulations.

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<sup>5</sup> <https://secure.creditreform.ch/index.php?id=1&L=1>.

<sup>6</sup> A (non-official) English version of the CO can be found on the following website: <http://www.admin.ch/ch/e/rs/c220.html>.

<sup>7</sup> The SIA-Norm 118 (and others) can be purchased on the homepage of the Swiss Association of Engineers and Architects <http://www.sia.ch/>.

There are no special stipulations in the SIA-Norm 118 with regard to insolvency of the contractor. However, there are stipulations concerning securities (see answer to question 1.1.3 below).

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

#### a) General remarks

It is always difficult to identify typical securities in contracts. A very good, cheap and fair way to secure the interests of an employer are payment schedules corresponding to the value of the work that was actually rendered. From the employer's point of view advance payments have to be avoided if possible.

#### b) Securing advance payments

In some cases the contractors may not be willing to start working without such advance payments. This is understandable if the contractor himself has to pay considerable amounts of money in order to start the construction (e. g. if he has to purchase expensive materials in advance). In such case the employer has to insist on contractual stipulations securing his advance payments. There are various possibilities for such securities. The most common ones are contracts of surety (article 492 ss CO) and abstract guarantees, both generally issued by banks or insurances. The main difference between contracts of surety and abstract guarantees is the link of this security to the contractual relationship between the employer and the contractor: contracts of surety are accessory to the claims in the relation of the employer to the contractor, abstract bank or insurances guarantees do not depend on the existence of such claims. In both cases the wording of these securities has to be checked properly, especially including the formal requirement for drawing such security in relation to the person having issued this security.

#### c) Securing the warranties of quality and fitness

If the parties do not agree on a payment schedule and the SIA-Norm 118 is part of the contract the employer has the right to retain 5%-10% of the value of the work that was rendered (article 150 paragraph 1 SIA-Norm 118<sup>8</sup>). The employer may retain this amount until acceptance. Once the employer has accepted the work, he has to pay the retained amount after receipt of the final invoice and the security set forth in article 181 SIA-Norm 118 (article 152 paragraph 1 SIA-Norm 118). The aforementioned security according to article 181 SIA-Norm 118 is a contract of joint and several surety between a bank or an insurance company and the employer. The amount to be secured depends of the amount to be paid to the contractor (cf. the detailed stipulations in article 181 paragraph 2 SIA-Norm 118).

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<sup>8</sup> According to article 150 paragraph 1 SIA-Norm 118 the percentage of the payment that can be retained depend on the value of the work that was rendered. In general 10% can be retained. If the value exceeds CHF 500'000 only 5% can be retained with a minimum retained amount of CHF 50'000.00. If there is no specific agreement the maximum amount to be retained is CHF 2'000'000.00.

In case that the contractor becomes insolvent the securities issued according to article 181 SIA-Norm 118 secure the claims that the employer would have had against the contractor with regard to the warranties of quality and fitness.

- 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 the answer to question 1.1.3 above it was explained what kind of monetary protection the employer has (or should at least insist to have when negotiating the construction contract). However, there also are non monetary aspects to be taken into consideration in order to protect an employer against insolvency of the contractor. One major aspect concerns special know-how, drawings, schemes, maps, etc. that are necessary to finalize the construction. Therefore, general contractors often insist to already receive all necessary information from their subcontractors in the early stages of a project and payments to the sub-contractor are conditioned upon receipt of such information. It is rather uncommon that private employers insist on such legal stipulations even if it would be advisable.

See answer to 1.2.3. below that also applies in case of contractor's insolvency.

- 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?

According to article 714 of the Swiss Civil Code (referred to as "CC" in the following) the transfer of chattel ownership requires transfer of possession to the acquirer<sup>9</sup>. The requirements for a transfer of possession are set forth in articles 919 ss CC. In principle one has to gain effective control over an object to possess it (article 919 paragraph 1 CC). Possession is transferred by the delivery of the object itself or of the means by which the recipient may gain effective control of it (article 922 paragraph 1 CC). However, transfer of possession is also possible without physical transfer of the object. According to article 924 paragraph 1 CC possession of an object may be acquired without physical delivery if a third party or the transferor himself retains possession of it in terms of a special legal relationship. Notwithstanding this possibility of transfer of possession without physical transfer of the object it is uncommon to agree on such special legal relationship and a transfer of title to the employer. Therefore, the employer has to use other means to protect himself against a bankruptcy of the contractor.

- 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, such clauses are rather uncommon.

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<sup>9</sup> A (non-official) English version of the CC can be found on the following website: <http://www.admin.ch/ch/e/rs/c210.html>.

## 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?

There are no specific stipulations in the CO or the SIA-Norm 118 with regard to securities to be granted by the employer. The parties often agree that the employer has to effect an advance payment to the contractor (which should be sufficiently secured, see answer to question 1.1.3 above).

In case of private persons building their private home, contractors often insist on a contract of surety with the bank that is financing the construction. The employer has to pay his bank for such contract of surety. Therefore, employers try to avoid such obligation. A possibility to avoid such costs is a mere information of the financing bank that there are sufficient financial means to accomplish the building project. This is not a "hard security" for the contractor but helps him at least to learn about the financial ability of the employer. Perhaps contractors in Switzerland tend to start construction without a security as the contractor has a right to establish a statutory charge on immovable property securing the claims of tradesmen and building contractors who have supplied labour and materials, or labour alone, for construction or other works, for demolition work, scaffolding work or for securing the construction pit or similar on the property whether the debtor is the owner of the property, tradesman or building contractor, tenant or any other person with rights to the property according to article 837 paragraph 1 (3) CC (cf. answer to question 1.2.5 below).

### 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?

See answer to question 1.2.1 above.

### 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, there are no specific rules with regard to the termination of construction contracts in case of insolvency of the employer. However, there are rules with regard to the influence of insolvency on contracts in general and rules with regard to the termination of an employment contract.

The influence of insolvency on contracts is set forth in article 211 paragraphs 1 and 2 DEBL. Art. 211 paragraphs 1 and 2 DEBL have the following wording:

*"<sup>1</sup> Claims which are not for a sum of money are converted into a monetary claim of corresponding value.*

<sup>2</sup> *However, the bankruptcy administration is entitled in the debtor's stead to fulfil synallagmatic contracts which had not or had only partially been fulfilled at the time of the opening of the bankruptcy. The other party to the contract may demand that security be furnished."*

Therefore, the construction contract does not end by law<sup>10</sup>. In fact, the bankruptcy administration is allowed to decide whether a contract is fulfilled or not. The contractor, however, may ask for a security (article 211 paragraph 2 DEBL). Article 211 paragraph 2 phrase 2 DEBL is in interaction with article 83 CO. Article 83 CO has the following wording:

<sup>1</sup> *Where one party to a bilateral contract has become insolvent, in particular by virtue of bankruptcy proceedings or execution without satisfaction, and this deterioration in its financial position jeopardises the claim of the other party, the latter may withhold performance until security has been provided for the consideration.*

<sup>2</sup> *He may withdraw from the contract if, on request, no such security is provided within a reasonable time.*

Therefore the contractor has no claim with regard to a security. However, the contractor may withhold performance until such security is provided. If such security is not provided the contractor can withdraw from the contract. On the other hand the contractor cannot withdraw from the contract if the required security is provided. However - due to the fact that the bankruptcy administration insisted on the fulfilment of the contract - the contractor acquires privileged claims against the insolvency mass according to article 262 paragraph 2 DEBL in addition to the aforementioned security. Therefore, the contractor is in a better position as the common debtors that only receive a certain share of the proceeds.

It has to be added that article 211 DEBL is only applicable if the contract was not yet entirely fulfilled by the contractor. In the latter case the contractor is in the same situation as the other debtors and only receives a share of the proceeds.

The Swiss Federal court has not decided yet if the parties can deviate from the rules of article 211 paragraph 2 DEBL. According to the major voices in the legal doctrine such deviates are possible in principle<sup>11</sup>. Therefore, the parties could for example agree on a contractor's right to terminate the contract in case of the employer's bankruptcy. However, it is disputed if the parties can agree on the financial consequences of a contractor's withdrawal from the contract based on the employer's bankruptcy. Swiss bankruptcy law tries to achieve an equal treatment of the creditors (cf. article 219 DEBL). It is undisputed that the insolvent party cannot agree with the solvent party on the solvent party's share of the proceeds. Financial agreements that favour a creditor in case of the debtor's bankruptcy (e. g. penalties in case of the termination of the contract based on the employer's bankruptcy) would circumvent the

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<sup>10</sup> *Schwob*, in: Basler Kommentar, Art. 211 SchKG N 7.

<sup>11</sup> *Stahelin*, AJP 4/2004, page 363, 367; *Schwob*, in: Basler Kommentar, Art. 211 SchKG N 13.

legislator's goal of equal treatment of the creditors. Therefore, it is more convincing to deny the possibility of agreeing on contractual stipulations that would trigger a financial advantage of the contractor in case of the employer's bankruptcy<sup>12</sup>.

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

The contractor may withdraw from the contract according to article 83 paragraph 2 CO if he is not provided with sufficient security (cf. answer to question 1.2.3 lit. (a) above).

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

The bankruptcy administration takes over (cf. answer to question 1.2.3 lit. (a) above).

#### 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 that the contractor terminates the contract according to article 83 paragraph 2 CO the contractor may refuse the promised consideration and demand the return of any performance already made (analogue application of article 109 paragraph 1 CO). The "*return of any performance already made*" must be effected in form of a payment if – as in case of a construction contract – a compensation in kind is not possible.

However, it has to be pointed out that the contractor is in the same position as the other creditors of the debtor. Therefore, the contractor only receives a respective share of the proceeds according to article 219 DEBL.

b) In case the contract is carried forward?

In case that the bankruptcy administration wants to carry forward the contract and furnished a security the contract does not end. The contractor has a privileged remuneration claim according to article 262 DEBL. This claim is covered by the security that was handed over by the bankruptcy administration.

#### 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 article 671 paragraph 1 CC in case that a person uses materials of his or her own on land belonging to another, such materials become an integral part of the parcel of land. This applies to all buildings and building parts that are permanently in-

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<sup>12</sup> *Staehelin*, AJP 4/2004, page 363, 374 s.



stalled and cannot be removed easily. The landowner owns these parts as soon as they are permanently installed.

The contractor and owner of the material cannot demand the material to be removed and returned to him because he knew that the land was not his own. If there is no contract between the landowner and the owner of the materials the landowner must provide appropriate compensation for the cost of the materials (article 672 paragraph 1 CC). In case there is such contract, the contractual agreements apply. Only in exceptional cases, where the value of the building plainly exceeds the value of the land, the party acting in good faith may even request that ownership of both building and land be assigned to the owner of the materials in exchange for appropriate compensation (article 673 CC).

According to Swiss law there is no possibility for the contractor to get a freehold of the construction site and continue the project with a different employer. However, tradesmen and building contractors have the right to establish a statutory charge on immovable property for certain claims. According to article 837 paragraph 1 (3) CC this right applies to the claims of tradesmen and building contractors who have supplied labour and materials, or labour alone, for construction or other works, for demolition work, scaffolding work or for securing the construction pit or similar on a immovable property, whether the debtor is the owner of that property, tradesman or building contractor, tenant or any other person with rights to the property. This statutory charge cannot be waived in advance (article 837 paragraph 3 CC). If more than one statutory building contractor's charge is recorded in the land register, such charges confer an equal entitlement to satisfaction from the mortgaged property even if the entries were made on different dates (article 840 CC).

The contractor's charge may be recorded in the land register as of the date of the undertaking to perform work but the application for such entry must be made within four months after completion of the work of the applicant (article 839 paragraph 1 and 2 CC). To meet this deadline the contractor has to submit to the court a request for a provisional entry of his charge in the land register. If the contractor satisfies the court of his entitlement, the court proves the provisional entry and sets a time limit within which the contractor must bring an action to assert his rights in an ordinary court proceeding (article 961 CC). The charge is entered definitively only if the claim has been acknowledged by the owner or confirmed in a court judgment. It may not be requested if the owner (or a third person) provides the claimant with adequate security (article 839 paragraph 3 CC).

The aforementioned statutory charge is a strong tool for contractors. On the other hand the land owners fear the statutory charge. As it cannot be waived, land owners depend on other contractual safeguards such as a confirmation of any performing sub-contractor that all their claims are settled before the landowner effects payment to the general contractor.

- 1.2.6 What kind of provisions should/can a contractor include in the contracts with his sub-contractors to protect himself in case of the employer's insolvency?

The contractor's focus concerning the potential bankruptcy of the employer is on the contractual agreement with the employer. In this contract the contractor must make sure that the negative consequences of an employer's bankruptcy for him are as small as possible. He will check the financial credibility of the employer, insist on a reasonable payment schedule and ask the employer to furnish sufficient securities (see answer to question 1.1.1. above). And last but not least the contractor has the right to establish a statutory charge on immovable property according to article 837 CC (see answer to question 1.2.5 above).

Therefore in most of the contracts with the subcontractors there are no special stipulations with regard to an insolvency of the employer. However it is possible to add such clauses to the contract with the subcontractor. E. g. the contractor could agree on a right to terminate the contract with the subcontractor in case of the employer's bankruptcy including a reduced remuneration of the subcontractor.

## 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 a new landlord terminate the lease?

Cf. answer to question 2.2 below.

- 2.2 Does your jurisdiction afford any protection for a 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?

- a) Basic principle: passing of the lease to the new owner, right to terminate the contract

If the landlord transfers title of the leased property or the property is dispossessed in debt collection or bankruptcy proceedings the lease passes to the acquirer together with the ownership of the property (article 261 paragraph 1 CO).

The new owner may terminate the lease as of the next legally admissible termination date if he claims an urgent need of the premises for himself, his close relatives or in-laws (article 261 paragraph 2 (a) CO), even if the contract has a fixed duration.

However, the tenant is not without protection. If the new owner terminated the contract sooner than is permitted under the contract, the former landlord would be liable to the tenant for all resultant losses (article 261 paragraph 3 CO).

b) Entry of the lease in the land register (and effect)

The parties to a lease may agree to have the lease entered under priority notice in the land register. The effect of such entry is that every future owner must allow the property to be used in accordance with the lease (article 261b CO).

c) Double offer in case of realisation of property

If the property has been charged with a registered lease without the consent of the mortgage creditor who takes precedence and if this property goes to auction in a debt collection or bankruptcy proceeding, the mortgage creditor may request that the property is offered both with and without the lease (double offer). If the offer for the property with the charge of the lease does not suffice to cover the mortgage creditor and if better coverage is obtained without the charge, the creditor may request that the charge be removed from the land register (article 142 paragraph 1 and 3 DEBL. The new owner may then terminate the lease contract as of the next legally admissible termination date even if he cannot claim an urgent need for himself, close relatives or in-laws. According to the jurisdiction of the Swiss Federal Court the same applies to non-registered lease contracts (BGE 125 III 123 ss<sup>13</sup>).

In any case the tenant may request an extension of the lease according to the general provisions of the CO.

- 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?

Where the tenant becomes bankrupt after taking possession of the property, the landlord may call for security for future rent payments. He must grant the tenant and the bankruptcy administrators an appropriate time limit to furnish the security. In general two to three weeks are considered to be appropriate.

Where no such security is furnished to the landlord he has the right by law to terminate the contract with immediate effect (article 266h CO). No special contract clause is needed and no extension can be granted in this case (article 272a paragraph 2 (c) CO).

- 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 under the lease?

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<sup>13</sup> The German name of the Swiss Federal Court is "*Bundesgericht*". In German the leading decisions are called "*Bundesgerichtsentscheide*" or "*BGE*". The BGE can be found on the following website: <http://www.bger.ch/index/jurisdiction/jurisdiction-inherit-template/jurisdiction-recht/jurisdiction-recht-leitentscheide1954.htm>. Besides the BGE there are the other decisions of the Swiss Federal Court. Such other decisions can be found on the following website <http://www.bger.ch/index/jurisdiction/jurisdiction-inherit-template/jurisdiction-recht/jurisdiction-recht-leitentscheide1954.htm> using the reference number or the date of the decision.

a) Security in the form of cash

Usually security in the form of cash is agreed on in the lease contracts. In residential leases, the landlord is not entitled to ask for more than three months' rent by way of security (article 257e paragraph 2 CO). In commercial premises the security is not limited and may reach considerable amounts.

The landlord must deposit the security in a bank savings or deposit account *in the tenant's name* (article 257e paragraph 2 CO). The bank may release such security only with the consent of both parties or in compliance with a final payment order or final decision of the court. On expiry of one year following the end of the lease, the tenant may request that the security be returned to him by the bank if no claim has been brought against him by the landlord.

In case of insolvency of the tenant the security that is deposited according to article 257e paragraph 2 CO is treated like a lien:<sup>14</sup> The landlord's claims against the tenant are satisfied directly out of the proceeds from the realisation of these securities (article 219 paragraph 1 DEBL).

b) Other securities

Other securities in form of insurance agreement or surety are possible.<sup>15</sup>

c) Landlord's special lien (right of retention, only for commercial premises)

As security for rent for the past year and the current six-month period, a landlord of commercial premises has a special lien on chattels located on the leased premises and either used as fixtures or required for the use of the premises (article 268 paragraph 1 CO). The landlord's special lien also extends to property brought onto the premises by a sub-tenant to the extent that he has not paid his rent (article 268 paragraph 2 CO). Goods not subject to attachment by creditors of the tenant are not subject to the lien (article 268 paragraph 1 CO).

The rights of third parties to objects which the landlord knew or should have known do not belong to the tenant and to stolen, lost, missing or otherwise mislaid objects take precedence over the landlord's special lien (article 268a paragraph 1 CO). Where the landlord learns only during the lease that objects brought onto the premises by the tenant are not the latter's property, his lien on them is extinguished unless he terminates the lease as of the next admissible termination date (article 268a paragraph 2 CO).

Where the tenant wishes to vacate the premises or intends to remove the objects located thereon, the landlord may, with the assistance of the competent authority, retain such objects as are required to secure his claim (article 268b paragraph 1 CO). Items removed secretly or by force may, with police assistance, be brought back onto the premises within ten days of their removal (article 268b paragraph 2 CO; article 284 DEBL).

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<sup>14</sup> SVIT Kommentar, Art. 257e N 17; BGE 51 III 77.

<sup>15</sup> SVIT Kommentar, Art. 257e N 12.

The landlord may, even if no enforcement proceedings have been instituted, request the help of the enforcement office to provisionally protect his right of retention. If time is of essence even police or municipal authority assistance may be requested. The enforcement office draws up an inventory of the chattels and sets the landlord a deadline to institute enforcement proceedings (article 283 DEBL).

In case of bankruptcy of the tenant, the landlord may claim his lien for rent for the past year (if not paid) and the current six-month period. These claims are satisfied directly out of the proceeds from the realisation of the inventoried objects (article 219 paragraph 1 DEBL).