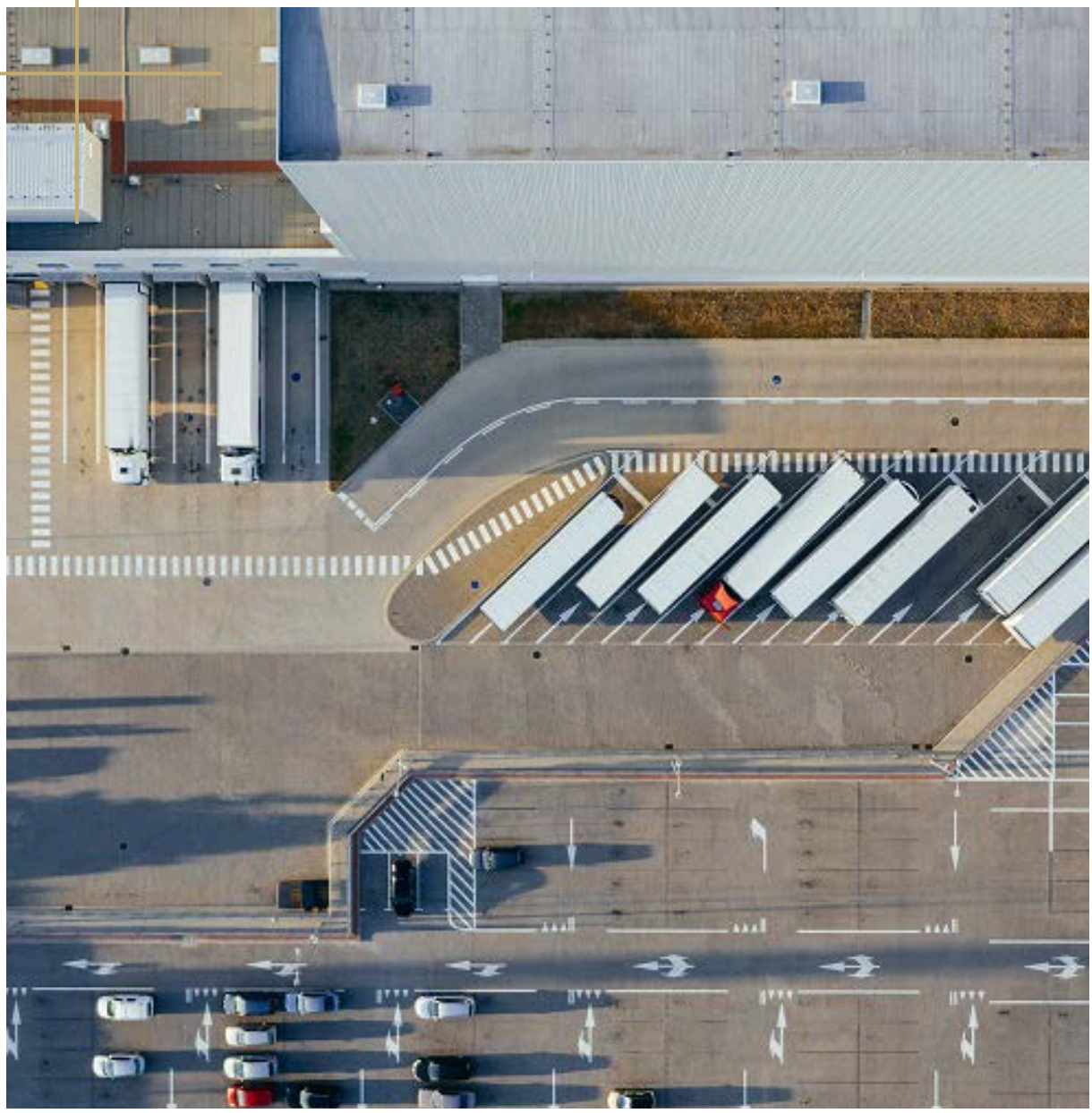


ARGON LEGAL

WAREHOUSES
ARTICLES FOR
“EUROLOGISTICS” MAGAZINE

We invite you to read our articles published in Eurologistics – a quarterly magazine dedicated to warehouses.

The warehouse market is booming, so we share our knowledge drawn from practice, which may prove useful in the daily struggles of managers in logistics parks.

Fires in warehouses

The destruction of a warehouse by fire has a number of consequences that most owners and managers of this type of facility have never thought about. Is it possible to prepare for them to minimize their negative effects? For some of them, certainly.

One of the most popular opinions in the commercial leasing market in recent years has been that, while the market for retail facilities has been short of breath and started a fierce battle for keeping customers with the growing e-commerce industry, the market for warehouses has heated up. Of course, behind this formulation is the huge popularity of this type of facility among tenants and the growing number of new logistics parks. However, what if a warehouse facility really does heat up, i.e. a fire breaks out or even destroys all or part of it? The recent past has shown that, despite the use of a number of fire protection systems in warehouses, fires in this type of facility do occur, and they are not isolated incidents.

Our practice and experience in recent years have led to the conclusion that, while a fire itself cannot be predicted, prior reflection on the broader issues of fire safety of a facility and potential post-fire scenarios can make a significant contribution to minimizing damage and restoring a warehouse to full functionality in the shortest possible time.

Fire outbreak – from ignition to ruins

The outbreak of a fire itself is usually completely outside the decision-making process of the building owner and manager. The notification of the emergency services is also completely automatic, due to modern fire protection systems. But what happens after a fire has broken out, what are the possible consequences of a fire, and what can the owner and manager expect from a fire?

A key stage that will fundamentally affect the further fate of the entire building and the factual and legal situation of its owner is the firefighting operation carried out by the fire brigade. There are no exceptions in this respect – the relevant services are responsible for its execution and one must submit to their instructions. On the other hand, active cooperation during the extinguishing action on the part of the owner and the warehouse management is expected by all means, and its absence may have negative consequences. We should remember that, depending on the size of the fire, the size of the facility, the specificity of the items stored by the tenants, the rescue services will need access to plans of the facility, current information, and possibly also active participation of representatives of the owner or manager, e.g. in terms of assistance in emptying some of the premises, carrying out certain demolition works or even providing access to social rooms for people taking part in the firefighting operation.

The above actions are extremely important for two reasons. Their proper execution obviously contributes to the quickest possible extinguishing of the fire and completion of the firefighting

action, thus minimizing the damage. In addition, proper co-operation with the emergency services distances the representatives of the building owner or manager from the prospect of criminal liability, and it should be remembered that the causes of the fire will be investigated by the fire brigade and, in the case of some fires, also by law enforcement authorities.

The completion of the firefighting operation, in the case of more serious fires, almost immediately involves the intervention of the building supervisory authorities, who will take the building out of use in whole or in part. This moment can be considered the beginning of the building owner's journey to restore the building to full functionality.

The characters in the drama – the leading roles are already cast

With a high degree of probability, it can be indicated that the number of entities with whom the facility owner and manager will cooperate during the restoration of the warehouse to full functionality is known in advance. They are: fire brigade, building supervisory authorities, tenants, insurers, law enforcement authorities, demolition and construction contractors.

It should be borne in mind that, in principle, each of the above entities will present different interests, which will often be mutually exclusive. Conflicts that are bound to arise include, on the one hand, the insurer's and tenants' desire to restore the facility to full use as quickly as possible in order to limit damage while the facility is still unsafe and, on the other hand, the need for the fire brigade and building supervision inspector to ensure that the facility is safe for use. In addition, the entirety of these activities will be watched by the law enforcement authorities, who will seek to establish the cause of the fire.

Ultimately, it will be up to the owner to decide on the implementation of measures to restore the facility to full use, and it will have to balance the interests of the various entities and decide on the prioritization of measures to achieve the desired results.

What actions should be taken by the owner and manager of the facility?

Proper supervision of the technical condition of the facility is a basic requirement expected of the owner and manager of the facility. This includes fire protection systems in particular, but also the control of tenant activity on the premises, i.e. verifying that the tenants' use of the premises does not adversely affect the safety of the building.

In this respect, it is important not only to comply with the fire safety standards themselves and to carry out the required inspections, but also to carefully collect and store all documentation relating to fire safety. In the event of a fire outbreak, both the fire brigade and law enforcement authorities will demand access to all of the documentation in question, so it is good that it is diligently maintained.

As for the actions to be taken by the owner and manager of the facility once the fire has broken out, been extinguished and the facility has started to be restored to its functional state, then although these will mainly focus on factual actions – verifying the damage after the fire, carrying

out the relevant inspections and sometimes demolishing and rebuilding the facility– the whole thing requires due consideration from a legal point of view. In particular, let us remember that taking a warehouse out of use and the period of restoring it to full functionality takes time and in itself generates a claim by various entities. It is therefore important for the facility owner to pay attention to these claims and think of them as potential court disputes.

For example there should be highlighted the required cooperation with insurers, who will largely pay claims from various insurance policies. Also the facility owner's policy. In addition, informing tenants of the current state of affairs and looking after their interests as well, indirectly contributes to reducing the damage on the part of the owner of the warehouse.

In the above regard, good practices can be:

1. responding to correspondence from those affected by the fire on an ongoing basis;
2. carrying out any activities on the burned area after arrangements have been made with the building supervisory authority and the prosecutor's office;
3. providing your own insurer with any information that may be relevant from the perspective of funds due under the insurance policy;
4. confirming actions that sought to minimize the damage, for example, by keeping arrangements in writing or through email correspondence.

In the whole matter of the unfavorable situation that is associated with the fire in the warehouse, small claims are sometimes neglected. In the meantime, any claim may ultimately find its finale in court, and practice shows that court proceedings are getting longer and more complicated. It is therefore worth taking steps to avoid litigation and, where this is not possible, to build up own claim accordingly, also by proving that the dispute occurred through no fault of our own.

Eurologistics, 9 August 2022

Expansion of the logistics park

Commercial real estate has always been a great bargain for investors, but recently they have been moving away from investing in the geese that lay golden eggs, which shopping centers and office buildings were usually perceived to be, and investing their assets in warehouse properties. There are certainly many reasons for such a situation, but the events of the last several months cannot be left without comment – the COVID-19 epidemic not only deprived shopping centers of part of the revenue from lease agreements, but also the uncertainty as to the further fate of the epidemic and the financial condition of tenants, reduced the guarantee of return on investment. What hit the shopping centers, drove the warehouse market – e-commerce and demand for space (Small Business Units are particularly attractive in this context), high rate of return and lower investment costs compared to e.g. shopping centers. – all this effectively attracts Polish and global capital. This article focuses on the popular trend in the market of expanding warehouse parks.

Permits

Expansion can consist of adding new warehouses as well as extending existing buildings. The regulations do not provide a clear answer to the question of what an expansion of a building structure actually is. However, referring to the case law, we will learn that the expansion is an enlargement, extension of a structure, already built-up area, addition of new elements. Such a broad interpretation of the regulations makes it virtually certain that any attempt to expand a warehouse will require a building permit, just like constructing a building from scratch.

As part of a planned investment, the first thing to check is whether a local spatial development plan (LSDP) has been adopted for the area where the property is located and whether it allows for the scope of works planned by us. If so, the matter is quite simple – after fulfilling the statutory conditions, on the basis of the LSDP the investor applies for a building permit. This situation is most often encountered in the case of urban warehouses, although it should be borne in mind that only about 30% of Poland's area has been covered by a local spatial development plan.

Things get more complicated if the property is not included in the LSDP (which is the case in most non-urban areas). In such a case, you must first apply for a zoning decision, and only on its basis apply for a building permit. This process will be more time-consuming than the process of obtaining a building permit based on the LSDP described in the previous paragraph, however, even in this case the investment can be successfully implemented. It is worth mentioning that not only the owner of the land, but also an entity interested in its purchase may apply for the issuance of a zoning decision – in this way it is easy to assess whether a potential investment can take place and whether the land is worth buying. This is important when an investor is interested in expanding the park into adjacent parcels.

In the context of permits, it is worth bearing in mind the form in which the investor acquires the property. If the investor purchased the real estate through an asset deal (land purchase transaction) – he does not benefit from the so-called universal succession, so he must ensure that the existing permits concerning the real estate are transferred to him (e.g. zoning decision). It is different in case of acquisition through a share deal, i.e. purchase of a company owning a real estate – here the investor becomes a party to all previous decisions issued in favour of the previous owner (e.g. purchase of a real estate with an already issued zoning decision shortens the investment time as the investor can immediately apply for a building permit).

General contractor and construction contract

After obtaining the necessary permits, the next step to start the investment is to select a general contractor and conclude a construction contract with him. Careful selection of a general contractor and a good construction contract can save an investor from a number of problems, including the biggest one – the risk of the contractor leaving the construction site. Above all, you should make sure that the general contractor is a financially stable entity and provides adequate security for the performance of the contract. An entity providing warranty of proper performance of the investment is one thing. You should also take care of the content of the contract between the parties – it is well known that the contract is written for bad times, not for good.

Among the means of securing the general contractor's performance are primarily bank guarantees. The higher the security amount, the better for the investor, of course. A bank guarantee is the safest security measure; do not choose to enter into a contract with an entity that insists on providing only an insurance guarantee. Enforcement of a bank guarantee is independent of contractual provisions (the bank cannot evade payment by invoking the contract), and of the contractor's situation (e.g. bankruptcy), and thus gives the investor a great sense of security and enforceability of the amounts due to him, e.g. under contractual penalties.

It is also worth regulating the issue of settlements in such a way as to make payments for specific, completed stages of the work. Thanks to this solution, the investor reduces the danger of spending funds allocated for work that will not actually be performed.

In addition, in order to protect own interests, it would be advisable to provide for grounds for termination in the contract that would allow the contractor to be quickly removed from the construction site in the event of problems, including, in particular, financial problems. Bankruptcy law prohibits the severance of contracts in the event of the declaration of bankruptcy or the filing of a bankruptcy petition, so ongoing monitoring of construction progress, as well as attention to claims management issues, is important.

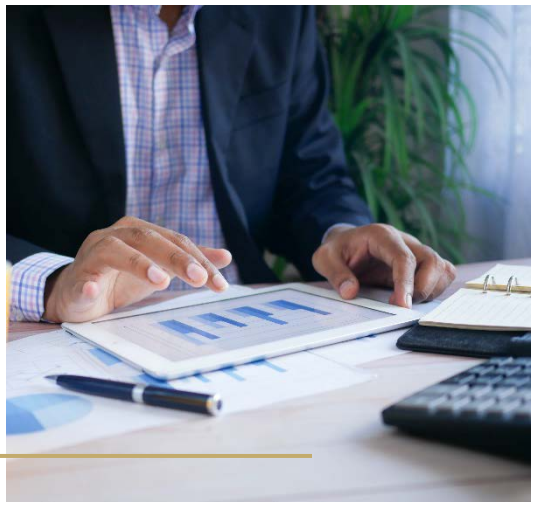
What about existing tenants?

Imagine a situation in which you are a tenant of several thousand square meters of a warehouse. The building next door has begun the expansion process, and the landlord has

begun construction of a new warehouse on the adjacent plot. Noise, difficult access to the warehouse, power outages and contamination of the plot around our building are everyday occurrences. Sounds like an upcoming tenant claim…?

Prior to any construction that may adversely affect the use of the leased property by existing tenants of buildings around the development, their leases would need to be audited. Tenants, in addition to claims under mandatory law, such as termination for defects that endanger life or health, are usually entitled to contractual claims for limited or impeded use of the premises, such as rent reduction, contractual penalties, or in the worst case, the right to terminate the contract.

Already at the stage of investment planning, it is worth to manage this risk, to include the potential value of such claims in the investment costs. It may also be a good idea to enter into additional agreements or annexes to contracts with tenants, even before construction begins, to limit potential claims and reduce risk on the part of the landlord.



However, the expansion of the logistic park itself may also bring benefits to the existing tenants – in connection with the increase in gross lettable area (GLA), their share in common costs, usually calculated according to the proportion of the subject of the lease in relation to the entire GLA, will decrease, and therefore the annual service charge may decrease.

Investment boom

The last several months have seen a specific boom in the warehouse investment market. Currently in Poland there is about 22 million square meters of warehouse space, but this space still does not meet the needs of the market. With the current demand for storage space, it is certain that many property owners will choose to expand their existing buildings or add more. There are various risks associated with an investment of this scale – some of which, with the help of good advisors, can be mitigated already at the preparatory stage.

Eurologistics, 11 January 2022

Service charges in logistics parks

It might seem that **most of the costs included in the service charge are already a market standard. However, practice shows that some of its elements can still arouse a lot of emotion and be a subject of lengthy negotiations.** This is because not always the simplest solution from the tenant's perspective, i.e. removal of some costs from the service charges catalogue, will mean a real benefit for the tenant. On the contrary, reducing such costs may result in lowering the standard of services provided in the future. The catalogue of costs and their amount is influenced by a number of variables. Before selecting a real estate or renegotiating a lease agreement, it is worth to get acquainted with the specificity of these factors, so that the agreement worked out is tailored to the specific needs of the business we run.

In the lease agreements currently operating in the real estate market, including warehouse leases, most of the costs associated with the current operation of the real estate are transferred to the tenants. This is due to the fact that "triple net" leases, otherwise known as net – net – net (NNN) leases, are now a standard. This is one of three ways of determining how costs are shared between tenants and landlords. A "triple net" agreement means that the rent in the lease is specified as a net value, i.e. without taking into account additional costs. In other words, the tenant is required to pay in addition to the base rent:

- real estate taxes,
- property insurance and
- costs of repair and maintenance of the property.

All these costs, in addition to the rent, make up the so-called service charge (also referred to, depending on the agreement, as operating costs or common costs).

Some tenants consistently defend themselves against the inclusion of certain costs by landlords in the service charges catalogue. To this end, they use various measures aimed at reducing these charges, which in their opinion are unnecessary.

One of the demands most frequently raised in practice by tenants is the restriction of the catalogue of service charges to a closed list, which would remain unchanged throughout the term of the lease. In practice, this means there is no possibility of adjusting the catalogue of costs to changing legal regulations, the situation in the market or growing expectations of tenants.

In the opinion of many tenants, an open-ended catalogue of service charges gives the landlord the opportunity to charge tenants any unreasonable costs. However, it is worth emphasising that service charges are not the cost component on which landlords earn. The remuneration of the landlord who incurred the cost of construction or purchase of the property is the base

rent. Other payments related to the maintenance of the real estate are costs that the tenant would have borne in any case if it had built or bought the building itself.

While closing the catalogue of costs, advocated by some tenants, will be difficult to agree (e.g. due to the expectations of investors or banks financing the project), the use of a catalogue of exclusions may turn out to be a compromise solution for both parties. On the one hand, it leaves the landlord flexibility and does not expose it to costs that were not included in the catalogue of service charges agreed with the tenant and that may arise in the future. On the other hand, it allows tenants to exclude specific costs that they are concerned about. These are often costs whose exclusion from the catalogue of service charges will not be controversial for the landlord. In the case of warehouse space, these may include, for example

- costs incurred by the landlord exclusively on behalf of a particular tenant;
- costs of litigation with specific tenants;
- CAPEX costs, i.e. costs associated with capital expenditure on the property;
- income taxes or
- costs of negotiating leases with other tenants.

As mentioned at the outset, a number of elements influence the catalogue and amount of service charges. Not all of them will be negotiable or possible to exclude, as mentioned above. Some of the costs result from the nature or standard of warehouse facilities. Therefore, when tenants are looking for savings in service charges, it is worth paying particular attention to certain factors already at the property selection stage, as they may have a significant impact on the amount and the way the charges are shaped in the future.

Age of the warehouse

The age of the warehouse in which the tenant intends to lease space is an important factor that may affect the operating costs incurred by the tenant. It should be expected that in the case of new facilities, they will not require major renovation work. Also, the question of possible extension or modernisation plans in the case of new facilities, even if to some extent they were to constitute an element of service charges, seems to be hypothetical. In the case of new buildings, the costs of maintaining the property will probably come down to small, ongoing expenses, in respect of which there should be no doubt that these are so-called OPEX costs (operating expenditures). They can include, for example, maintenance of equipment, current repairs, maintenance of roads, yards or green areas around the warehouse.

In the case of older properties, higher expenditures may be necessary. In the case of certain expenditures, the question may arise as to whether these are still OPEX costs, i.e. standard maintenance fees, or rather CAPEX (capital expenditures), i.e. investment costs. CAPEX costs may include e.g. replacement of roof sheathing in a building or purchase of new installation elements. Unfortunately, distinguishing between these two types of costs is often not as easy as it may seem. Therefore, already at the stage of negotiations, it is worth to specify which particular costs will be excluded from the service fee.

Additional services offered to tenants

Another factor influencing service charges may be additional services offered to tenants. The highest class warehouses are equipped with a number of solutions convenient for tenants, starting from such solutions as car parks for cars and trucks, maneuvering areas, 24-hour security or monitoring, to the so-called environmentally friendly solutions, such as energy-efficient lighting. In the case of warehouses in the portfolio of foreign funds, energy-efficient solutions are already a standard. In the past they were not very popular, because they were connected with additional expenses. With the passing of time, it has turned out that they can represent real savings for both tenants and landlords. Thus, the requirements connected with the so-called "green certificates", although they may constitute an additional element of service charges, do not necessarily have to mean their increase; on the contrary, in the perspective of a long-term lease, they may constitute savings.

Specific cost categories

In addition to the more general factors indicated above, which a tenant may take into account already at the stage of choosing a property, the individual elements of the costs covered by them may also have a real impact on the amount of service charges.

When renting warehouse space located in urban areas, it should be taken into account that a relatively large part of service charges will be the perpetual usufruct fee. This is a fee paid by the perpetual usufructuary on an annual basis and calculated on the basis of the value of the real property, which may vary over time. This fee, which is important from the perspective of the tenants, may be updated through written notice of termination of the existing fee amount, e.g. as a result of recognition by the state authorities of the increase in the value of the property. Therefore, tenants must take into account the fact that in the case of updating the fee, the amount of the service charge will also increase.

Another important element of the service charges worth noting, specific to multi-building warehouse complexes, is the division of building costs and the costs of the entire complex. The tenant's share in the service charges may include both a share in the building (costs are then allocated to its tenants in proportion to the area of premises) and a share in the entire property (costs are usually allocated to individual buildings, and then – within them – to individual tenants of premises located in them). From a tenant's perspective, it is important to allocate these costs in such a way as to avoid double charging of the same costs to tenants.

Another element of the service charges that may raise disputes and affect its amount is the possibility of including fines and penalties imposed on the landlord in the service charges. Many tenants question the validity of including such a cost in the service charges, treating it as the landlord's problem. However, if the property is managed more aggressively and the landlord actively seeks savings in property maintenance costs, the landlord may be more exposed to potential penalties. The inability to include such penalties and fines in the service charges may lead to a more passive management model in which the landlord, fearing that its actions will be penalised, will be reluctant to seek savings, the consequences of which in the form of a higher service charges will be borne by the tenants.

Experience shows that despite the sometimes different concepts of assigning given costs as service charges by the parties to a lease agreement, charging tenants with unjustified costs is rare today, if it happens at all. The very high competition in the warehouse market and the business approach of landlords who do not generate income from service charges have resulted in the elimination of situations that occurred in the market several years ago and which some tenants still fear.

Eurologistics, 16 November 2021

Red lights in leases – what contractual provisions should warehouse tenants watch out for?

The old saying of the commercial leasing industry is: an ***agreement is written for bad times, not good times.*** As long as the parties are in agreement and the cooperation is undisturbed, both parties usually do not refer to the content of the agreement on a daily basis. A feverish study of its provisions begins at the moment of unexpected expenses on the part of the tenant, questioning of the landlord's actions or financial troubles.

Already at the stage of concluding the agreement, the tenant should pay particular attention to several key issues. Below we present a brief description of selected issues.

Service charge – a bottomless pit?

Seemingly standard, unsuspicious contractual provisions regarding the service charge may become a real financial pain for the tenant. In addition to studying the content of the agreement, it is necessary to refer to the schedule specifying the list of items to which the tenants contribute. Controversial is certainly not participation in the costs of clearing snow from the complex, replacement of lighting, maintenance of common areas, but what about the legal fund, maintenance of the manager's office, or creating a reserve for unplanned expenses of the landlord? Or what about "capex" (capital expenditure), which is not for ongoing maintenance, but for improving the facility or its surroundings?

You've made your bed, now lie in it. If at the stage of negotiating the terms of the agreement we do not take care to have a good understanding of what costs are included in the service charge, we may be in for a surprise during the annual settlement. Pay particular attention to the fact that the low monthly advance payment for common costs offered by the landlord, not always reflecting the real monthly costs, will simply result in a high additional payment after the settlement period.

Another issue is the division of costs – appropriate for multi-building warehouse complexes – into categories: pertaining to a given building (distributed to its tenants in proportion to the area of premises) and common for the entire complex (usually distributed to individual buildings and then – within their framework – to individual tenants of premises located in them). A well-planned distribution of the latter costs should prevent their "duplication" to the tenants of different buildings.

Finally, it is worth checking whether the land on which the warehouse complex is located is the property of the landlord or whether the landlord is merely the usufructuary. If the warehouse is based on perpetual usufruct, the cost of the annual fee that the landlord is obliged to pay for it will certainly form part of the common charges. Why is it so important? Well, the amount of

the fee can be updated, which means that it will increase, and therefore the tenant's service charge will also increase.

Performance bond – why so much and so expensive?

It is market standard for the landlord to demand instruments securing the proper performance of the lease agreement. Starting with a cash deposit, a wide range of demands by the landlord may also include the provision of a bank guarantee, a declaration on submission to enforcement under a notarial deed for the handover of the premises or the payment of certain amounts, or – less and less frequently – a bill of exchange.

In principle, these provisions have become standard in the market, but what can be done to reduce the severity of the security for the tenant and its costliness?

The standard provision for the amount of the security is that it should correspond to a certain number of times of the rent and service charges (usually three times). Given the annual indexation of the rent and the advance payments for service charges, this can result in the need to repeatedly apply to the bank for an increase in the bank guarantee, which is not a cost-free operation. In order to reduce these costs, it is worth agreeing with the landlord on the possibility of using a mixed form of security and supplementing the deposit (in cash) to the existing guarantee (without increasing it). Another way is to provide for a guarantee amount that is slightly higher than the typical three times the rent, in order to avoid having to increase it after a slight increase in rent/service charges.

It is also worth negotiating with the landlord the tenant's freedom to exchange the guarantee for a deposit (and vice versa).

Care must also be taken with regard to the period during which the landlord can make use of the security. The landlord will strive for a period that extends beyond the term of the lease as long as possible. It will be in the tenant's interest to ensure that the term does not extend too far (2-3 months are in most cases sufficient to settle all costs that may have to be paid by the tenant).

In case of submission to enforcement by notarial deed, it is advisable to cooperate with a notary who knows the commercial leasing sector and verify in advance the cost of drawing up the deed – rates vary among notaries – it is worth checking them in several notary offices (especially in view of the practice of some notaries to make the fee for the deed securing the return of the premises dependent on the value of the property).

Termination of agreement – should the tenant live in fear of eviction?

Tenants are often afraid of termination of the lease for a trivial reason – understandably. Taking into account the cost of investment in moving, equipment, people working in the warehouse, the lease itself, as well as the contractual penalties usually stipulated in the lease in case of

early termination, it is simply not worthwhile for the tenant to expose itself to termination by the landlord.

On the other hand, landlords insist on retaining the option to terminate in many cases. The following code grounds for termination are not controversial: delay in rent payment, using the subject of the lease in a manner contrary to the lease agreement (e.g. for production rather than storage purposes), or contractual provision that the tenant's failure to provide the required contractual security entitles the landlord to terminate the agreement. Other grounds, however, can be more controversial – for example, those that relate to housekeeping matters, such as the use of shared ramps, blocking of driveways, and compliance with fire regulations. In such cases, two positions clash: that of the tenant claiming "this is a reason too trivial to result in such a severe consequence as termination", and that of the landlord claiming: "I have to manage the entire logistics park and if the action of any tenant makes life difficult for neighbours (ramp, blocked driveway) or puts them at risk (fire regulations), then I must have effective means of intervention". In such cases, a possible compromise is to retain the "housekeeping" grounds for termination of the agreement, but to supplement them with a regulation that termination is not possible without a prior request to the tenant to remedy the breaches (with a minimum deadline).

How long do I have to wait for the premises?

Model lease agreements prepared by the landlord usually provide that, in a situation where the landlord delays the handover of the premises (e.g. in the event of a delay in the construction of the complex), the tenant is to wait patiently for a signal from the landlord that it is ready for handover.

On the part of the tenant, the question arises: what to do in such a situation, when the possibility of using the premises is postponed for an unspecified period of time and it is necessary to take the steps to start the business (hiring staff, transporting machinery, etc.)? In this case, it is a good idea to set a deadline after which the tenant can withdraw from the lease and look for other solutions. It may be expected that the landlord will insist on a distant date, but even such a date is better than none at all, as it gives the parties the opportunity to settle the situation in the event of unforeseen situations during the construction of the warehouse.

When regulating withdrawal, it is important for the effectiveness of this right to precisely indicate the deadline for withdrawal – e.g. "by 12 May 2025" or "within 30 days from the date of delivery of the premises as indicated in clause XYZ of the agreement".

Minefield to be defused

The model lease agreement is intended to safeguard the interests of the landlord (and its financing bank). Sometimes it becomes a minefield for the tenant. We have presented above only a few issues that may cause considerable trouble to the tenant, therefore it may be important to use experienced advisors (brokers, lawyers). The mature real estate market in

Poland makes it possible to find help to reduce risks and guide the tenant through the transaction without explosive surprises.

Eurologistics, 1 October 2021

General bankrupt on the construction site

How do you protect yourself from warehouse contractor bankruptcy?

Building a warehouse is a demanding undertaking, especially for an investor who is not a warehouse developer and does not have the expertise to handle complex construction projects. And most importantly – who has normal operations on its mind (because it cannot be suspended until construction is complete…).

Necessary steps in the construction process include:

- selection of the general contractor;
- negotiations of the construction contact;
- monitoring the construction process;
- acceptance of the warehouse and putting it into operation.

The whole thing is a complex undertaking, the success of which depends on many factors. General contractor bankruptcy can turn out to be a stick put in the spokes of the construction process (or even a log, given the potential scale of the problems). This article provides a list of recommendations for the investors the implementation of which can reduce the risk of problems should this situation arise.

Choose your general contractor well

The investor should look for a contractor who not only has the necessary competences, but is also financially stable enough (and will present a strong enough collateral) to give comfort that in case of any crisis on the construction site there will be a real chance for the investor to satisfy its claims, and especially to complete the commenced work.

It is worth considering different means of verifying the contractors. In addition to the invaluable recommendation, gossip and “community news”, it is worth digging into the harder financial information available, for example, here:

- debtors registers and commercial databases (e.g. Bisnode database);
- Altman index (Z-score) helping to estimate the risk of the future bankruptcy;
- financial statements, which have been accessible through publicly available electronic systems for some time.

When evaluating a contractor, it is also worth pausing to consider its organizational structure. Will the construction be carried out by a special purpose vehicle set up as part of the group of the general contractor, or are all its constructions “in one bag” – carried out by the same company? The disadvantage of the first solution is that in certain situations it is much easier to “make the SPV declared bankrupt” – without much damage to the group. Whereas the

disadvantage of the latter is that an investor carrying out even the simplest construction may find out that the contractor is going bankrupt because of investment problems at the other end of Poland.

Finally, it is worth noting that the stability and solvency of the contractor established at the outset (when evaluating the offer) is not guaranteed forever – there are known cases of even large contractors who, over the years, have fallen into financial trouble or even bankruptcy. Therefore, the to-do list must also include the need for ongoing monitoring of the situation (see section 3 below).

Negotiate the contract carefully

Another important risk mitigation measure is the appropriate wording of the construction contract. The content of such a contract and the possibilities of negotiating it in an optimal form is a topic so vast that a whole series of articles could be devoted to it. Here, let us just flag some of the most important issues from the perspective of the general contractor bankruptcy risk.

1. **It is worth regulating the issue of settlements in such a way as to make payments for specific, completed stages of the work.**

   Thanks to this solution, the investor reduces the danger of spending funds allocated for work that will not actually be performed (the chance that the trustee will successfully complete the construction should be considered very small).

2. **A condition of payment should be providing statements of subcontractors confirming that they received their remuneration.**

   Construction works regulations provide for joint and several liability of the investor for the remuneration of subcontractors. The purpose of this regulation is to prevent a situation in which the investor – despite having paid the general contractor – will have to pay the subcontractors again, and will have to apply to the bankruptcy estate for reimbursement, which in most bankruptcies means that the investor will never see the money (or a significant part of it).

3. **Among the means of securing the general contractor's performance are primarily bank guarantees. For large, not symbolic, amounts.**

   A bank guarantee is the safest security measure. Not an insurance guarantee (which can be difficult to enforce); not a surety (which requires a separate lawsuit in the event of a dispute); not even a deposit / retained amount (which trustees often try to force to be returned in the event of bankruptcy). Enforcement of a bank guarantee is independent of contractual provisions (the bank cannot evade payment by invoking the contract), and of the contractor's situation (including its bankruptcy).

The above points include a "minimum program" of contractual provisions that reduce the risk of contractor bankruptcy. The purpose of including them in the contract is to prevent a bad scenario in which the investor pays for work that has not been performed, then pays the subcontractors (harmed by the general contractor) again, only to end up paying a third time for the removal of defects discovered after the acceptance.

Monitor the situation of the contractor and on site

The scouts' greeting "be prepared!" also applies to construction sites. The investor can breathe easier only after the final acceptance (or actually after the expiry of warranty periods, although the scale of potential problems after the acceptance will certainly be smaller). Beforehand, exercise extreme caution and keep monitoring the progress of work on the site. Any delays, conflicts with subcontractors, perceived shortfalls in construction material orders, and limited site activity are all significant warning signs that should be watched closely.

Important warning signs of potential bankruptcy also include "management evacuation". If, for unknown reasons, long-time managers disappear from a contractor's management board and new people appear (especially young ones without experience and professional history), it may mean that strawmen appeared on our construction site… It is important to pay attention to this because bankruptcy is always a risk for directors – in case of late filing for bankruptcy they risk criminal and civil liability (they may be liable with their own assets for the debts of the bankrupt contractor); they also may have professional problems due to possible ban on holding positions in management boards. Therefore, it is not uncommon for a manager who foresees the possibility of company bankruptcy to step down from the management board out of caution. It is therefore worth monitoring such situations, which in the era of electronic KRS (*National Court Register*) is a relatively simple task.

Another tip is ongoing attention paid to claims management issues. The suggestion to implement claims management procedures on an ongoing and organized basis is universal advice – on any construction site, it can save a lot of trouble and just as much cost (not to mention increase the chances of avoiding a burdensome lawsuit). In the context of a potential general contractor bankruptcy, it is all about the ongoing collection of materials that will assist in the discussion (or dispute) with the trustee as regards the completed stages of work (and their defect-free nature). An example of a situation we want to prevent is when the trustee demands payment for work that was not performed by the bankrupt, but by a substitute contractor to whom the investor had already paid for the work (and probably more than according to market valuations, because the investor had to appoint the substitute contractor on an emergency basis, as it was forced to do by the bankruptcy of the original contractor).

Prepare plan B

As we begin construction, we hope for a smooth completion. However, it is worth preparing an alternative plan of action in advance that takes into account the risk of general contractor bankruptcy.

Such a plan B should address the issues discussed above. However, it is worth supplementing it with the points below:

- **providing in the construction contract for grounds for termination, which will make it possible** – to put it bluntly (though brutally) – to get rid of the contractor in the

event of its financial problems (this is not a simple matter and requires the use of legal and sometimes economic skills, because bankruptcy regulations prohibit the termination of contracts on the condition of declaring bankruptcy or filing a petition for its declaration);

- **ensuring the possibility of a smooth transition from the general contracting system to the so-called "construction management"**, i.e. direct management of the scopes of work of individual subcontractors (the idea is to easily "redirect" the construction process in such a way that the subcontractors – who perform individual scopes of work anyway – after the general contractor's bankruptcy continue their work, being responsible for their implementation directly to the investor, often assisted by a construction manager, i.e. a coordinator of the contractors' work);

- **preparing for problems with the trustee**, especially in terms of its attempts to recover the deposit (retained amount) and withdraw from the contract (at the time least convenient for the investor).

To conclude

Contractor bankruptcy during construction is sure to cause headaches for the investor. On the other hand, it is not the end of the world either, and taking the above tips into consideration may allow you to complete your warehouse fairly painlessly. That is why it is worth implementing these tips, especially since the current momentum in the logistics market means that the largest and most stable warehouse contractors may be busy months ahead. As a result, even those investors who are normally willing to pay more for their services may be forced to seek out less experienced contractors with weaker financial standing.

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ARGON LEGAL Adam Miłosz i Sławomir Lisiecki sp. k.
ul. Puławska 39 lok. 30 | 02-508 Warszawa
22 211 22 60 | office@argon.legal | www.argon.legal