VEFA: the limitations of the completion guarantee legislation by Vanessa LOMORO

When an economic sector is doing well, there are often few questions about the exact scope and limits of the protective norms surrounding it.

When the trend is reversed and difficulties arise, the limitations of the legislation are usually revealed to their full extent.

Following this natural trend, recent bankruptcies of real estate development companies have highlighted a series of complex but fundamental issues surrounding completion and/or repayment guarantees issued in connection with off-plan property sales (*ventes en l'état futur d'achèvement* or "**VEFA**").

Table of contents

I. VEFA and completion guarantee basics

Article 1601-3 of the Civil Code defines a VEFA contract as follows:

> *"Off-plan sales is a contract by which the seller transfers immediately to the purchaser his rights on the ground as well as, as the case may be, the property of the existing construction. The future works become the property of the purchaser as they are executed; the purchaser is required to pay the purchase price as the work progresses.*
>
> *The seller retains the powers of project owner until acceptance of the work*."

Article 1601-5, para. 2 point f) of the Civil Code provides for the obligation at the time of the conclusion of such a contract, which must imperatively be signed before a notary, to give to the purchaser of the building to be built a guarantee known as "completion".

The Civil Code is quite terse as to the content of such a guarantee and limits itself to stating that it must guarantee the "*total completion of the building under the terms of the contract*", or otherwise the "*repayment of payments made in case of termination of the contract for incompletion, under the conditions and using the modalities to be set by Grand-Ducal Regulation*".[1]

To that the Civil Code adds that:

> " *When a completion guarantee has been stipulated, it is transformed into a repayment guarantee when it is established that the construction cannot be physically or legally completed* ".

The 24 February 1977 Grand-Ducal Regulation, executing Article 1601-5 of the Civil Code, as amended by the 3 October 1978 Grand-Ducal Regulation, completing Article 1 (the "**GDR 1977**"), actually provides little clarification despite the high stakes of such guarantees.

However, the 1977 GDR specifies that the completion guarantee must take the form of either:

- the obtaining of credit by which the person who granted it undertakes to advance to the seller or to pay on his behalf the sums necessary for the completion of the building, this agreement having to stipulate for the benefit of the purchaser or sub-purchaser the right to demand the execution thereof; or
- a guarantee agreement under the terms of which the guarantor undertakes to pay to the purchaser, jointly and severally with the seller, the sums necessary for the completion of the building.

As concerns the repayment guarantee, Article 3 of the 1977 GDR specifies that it must take "the form of a guarantee agreement under the terms of which the guarantor undertakes towards the purchaser, jointly and severally with the seller, to reimburse the payments made by the purchaser in the event of amicable or judicial termination of the sale due to a lack of completion".

[1] Note: This guarantee cannot be required for:
1) construction carried out directly by the State, municipalities, public establishments and companies in which the communities hold a majority participating interest; and
2) the construction of a building with multiple apartments acquired by a sole owner.

It adds that the seller and the guarantor have the option, during the execution of the contract of sale, of substituting the completion guarantee for the repayment guarantee or vice versa, provided that this option was provided for in the contract of sale.

In conclusion, although the current legislation on completion guarantees may at first sight seem sufficiently clear because of its succinct nature, a confrontation with the practical reality reveals numerous questions which remain unanswered to date.

II. Examples of problems linked to implementing payment guarantees

In the event of the implementation of a completion guarantee, the guarantor will pay or make available to the VEFA purchasers the sums necessary to carry out the work remaining to be done in view of the completion of the acquired building under the terms of the VEFA contract.

However, it should not be forgotten that in consideration for these payments by the guarantor, the purchasers who have called upon the completion guarantee will remain correspondingly obliged to pay for the remaining stages of the work, as provided for in the notarized deed.

Often it will be agreed that once the guarantor is involved, all remaining payments will have to be made to him.

Thus, if the notarial deed provides that the amount to be paid for the completion of the "interior carpentry" work is based on EUR 30,000, the guarantor will pay or make available to the purchasers the sums necessary for the completion of the carpentry work in accordance with the specifications, but the purchasers must, in principle, in return pay to the guarantor the amount of EUR 30,000 set out in the deed.

So what are the difficulties that may arise in practice?

A. Completion compliant with a VEFA contract

The legislation is clear in that it provides that the object of the guarantee is the completion of the building in accordance with the stipulations of the VEFA contract, or of its annexes.

In this context, the guarantor generally guarantees the completion of a building on the basis of the characteristics determined and known at the time of the execution of the notarial deed.

The guarantor does not in principle guarantee the various supplements ordered by the purchasers from the developer during the execution of the VEFA contract and which were not known and quantified at the time of the signing of the deed, or at the time the guarantee was issued.

In the Grand Duchy of Luxembourg, most completion guarantees are issued on the basis of surety agreements concluded between the guarantor and the developer. It should be remembered that a guarantee cannot be extended beyond the limits within which it was contracted.

Purchasers would in any case be well advised to check before signing a VEFA deed what is the extent of the guarantee that the promoter proposes to give them, i.e. the extent of the guarantee, or the conditions and limits of the credit granted if this is the form of guarantee chosen.

It should be noted that *a fortiori* and also in principle, excluded from the guarantee are the modifying and/or additional works ordered directly from the subcontractors of the developer, or from third-party companies.

In other words, the guarantor will only pay for the work remaining to be done in accordance with the specifications foreseen by the notarial deed and its schedules.

The problem highlighted here should usually remain marginal in the context of modification/additional work ordered directly from the developer, whereas it is formally forbidden for the developer to request payment for work in advance under a VEFA contract if it has not yet been carried out.[2]

Therefore, in theory, if the purchasers have ordered from the developer and paid it for modifications and/or supplements, these should already have been executed and therefore not be impacted by a subsequent default of the developer.

However, two cases require special attention.

1. Advance payment for modifications and/or supplements

If a purchaser has ordered and then paid in advance for modifications and/or supplements relating to work not carried out on the day of the developer's default, the guarantor will in principle not be obliged in accordance with the generally stipulated guarantee conditions to pay for the carrying out/completion of this work.

In this case, the purchaser could find himself having to pay again for the works in question to the company in charge of their realization if he wishes to see them carried out in spite of everything, or else having to give them up them in spite of their being paid for in advance.

In order to avoid this situation, real estate agents, notaries and lawyers (if a lawyer is consulted) should formally draw the attention of purchasers to the prohibition on promoters requiring advance payments, and the risks attached to such payments. Unfortunately, this prohibition and the penal sanctions attached to it are often misunderstood or simply ignored in practice.

2. Work to be redone

In the event that additional work has already been carried out and paid for, but needs to be destroyed and redone due to defects or faulty workmanship, the guarantor will, in accordance

[2] *See* Article 1601-9 of the Civil Code civil and Article XVII of the Law of 28 December 1976 on the sale of buildings to be constructed and the obligation to guarantee for construction defects. Based on our analysis, alterations and/or additional work ordered from the developer fall within the scope of these provisions.

with the generally stipulated guarantee conditions, only pay for the completion of work corresponding to the basic services provided for in the specifications.

Thus, if for example a high-end parquet floor was installed as supplements ordered after the conclusion of a VEFA contract, if it had to be removed and replaced upon completion of the building (e.g., in case of flooding during construction), the guarantor will generally only pay for the supply and installation of a floor corresponding to the standards of the specifications.

Again, the role of real estate agents, notaries and lawyers (if consulted) should be to draw the attention of the purchasers to the possible limits of a guarantee in this matter if modifications and supplements can be ordered.

B. General issues related to advance payment for work not completed

If a purchaser has paid in advance all or part of the work provided for in the specifications but not carried out on the day of the developer's default, the payment thus made in violation of the provisions of article 1601-9 of the Civil Code could be considered as an undue payment that does not discharge the purchaser.

In this case, the guarantor could be entitled to demand that the purchaser pay the remaining instalments even if the latter has already made an undue payment to the promoter.

The role of the real estate agents, notaries and, if applicable, the lawyers consulted is once again of capital importance with regard to the information given to the purchasers.

Although the illegal situation of advance payments should remain a textbook case, it must unfortunately be noted that the practice on the market is often to require advances from uninformed purchasers, and that this is still endorsed by some notaries who provide for advance payments in their deeds in violation of the law.

C. Issues related to the inability of certain purchasers to pay remaining tranches

As discussed in the preceding paragraphs, undue payments by purchasers may expose them to having to "re-pay" for certain work.

However, the sums in question are generally far from negligible.

Moreover, in case of default of the developer, the completion deadlines are often considerably extended for various reasons. This will also lead most purchasers to incur considerable additional expenses in order to house themselves while waiting for the completion and acceptance of the purchased property.

Also, purchasers will often incur legal fees.

All these circumstances will necessarily lead to a more difficult financial situation.

It is therefore not uncommon that some purchasers end up exhausting both their credit and their equity before their building can be completed and that they find themselves unable to ensure the payment of the remaining installments.

In such a case, the guarantor should therefore be able to apply the exception of non-performance and suspend the performance of its own obligations as long as the purchasers do not honour theirs.

The situation can be even more complex in the case of a multi-family building where the progress on the day of recourse to the guarantee does not allow for the suspension of work on certain lots only.

For example, if a building sold in VEFA is completed only up to the level of the slab on the second floor at the time of recourse to the completion guarantee, but that several purchasers do not pay to the guarantor the amount of the instalments corresponding to the other slabs, it is the entire project which could be blocked, even compromised.

In addition, it is not excluded that one or the other bank having financed the acquisition of a lot and not obtaining from its clients in difficulty the repayment of the monthly credit instalments, enforces the mortgage that it holds on the lot, which can further complicate matters.

III. Issues related to the implementation of repayment guarantees

If the completion guarantee is converted into a repayment guarantee, other complex issues arise.

A. The need to terminate a VEFA contract

In the first place, before any reimbursement can be contemplated, it would be appropriate for the purchasers to cancel the VEFA contract in accordance with Article 3 of the 1977 GDR.

In principle, this termination will take place before a notary, but if one of the parties to the deed refuses the voluntary termination, it will be necessary to obtain such termination by legal means.

Thus, the time required to obtain reimbursement can vary greatly, depending on circumstances often beyond the control of the guarantor.

Moreover, the attention of purchasers should be drawn to the fact that in case of cancellation of the VEFA contract, notary fees as well as registration fees, if any, may have to be paid. Insofar as in case of default of the promoter, it will generally have financial difficulties - if it is not already bankrupt -, it cannot be excluded that it is the purchasers who have to bear or at least advance such expenses.

As cases of recourse to repayment guarantees have remained rare to date, these issues are still relatively unknown in practice and their resolution is uncertain for the moment.

However, it is not the guarantor's responsibility to take charge of any expenses or to advance payment of any expenses in this context.

B. Exclusion of land shares from the majority of guarantees

It seems that the drafter of the provisions relating to completion or repayment guarantees did not have in mind the possibility or in any case the consequences of a possible structure in which the seller of the share of the land and the seller of the buildings would be two separate entities.

However, it is clear that most VEFA contracts are concluded by purchasers with two separate sellers.

However, the only sellers who take out completion guarantees, which can be transformed into repayment guarantees, are in principle the companies selling the buildings.

The guarantors generally have no contractual relationship with the seller of the land shares/land, which do not issue a specific guarantee.

Thus, the certificates given to the purchasers at the time of the conclusion of VEFA notarial cover in principle only the risks related to the construction, and in no case the land.

In other words, after termination of a VEFA contract, the guarantor reimburses the purchaser for the amounts duly paid by the latter to the developer for the construction provided for in the specifications, while the reimbursement of the price of the land must be claimed from the entity that sold it.

However, there is no certainty for the purchaser to recover the full price if the seller of the land does not have the necessary funds, or if it does not manage to resell the land it recovers at the price at which it was sold to the purchasers.

C. Exclusion of repayment from potential overpayments

The terms of payment guarantees generally provide that only amounts paid by the purchasers in accordance with and within the limits of Article 1601-9 of the Civil Code will be refunded.

Consequently, if purchasers have paid for work in advance, which is prohibited by law, the amounts corresponding to stages of work not actually carried out will not in principle be reimbursed by the guarantor.

D. Exclusion of repayment from supplements

As seen above, a guarantee given to the purchasers covers in principle only the basic works provided for in the specifications and known at the time of the conclusion of the VEFA contract.

Consequently, in the event of default by the developer and recourse to the repayment guarantee, the guarantor will not reimburse the purchasers for any amounts paid by them for modifications or supplements ordered afterwards.

Conclusion

In the absence of at least some established case law, uncertainties reign, and it will certainly be years before the courts decide on these essential questions.

Therefore, unless the current legislation is amended to provide clarification, there will probably be many disputes. While the outcome of such litigation is uncertain, even if decisions are very favorable to purchasers, they will often take years to be rendered and become enforceable. These delays will obviously have negative consequences for purchasers, if not for the market in general, whenever the market conditions are not the best and a loss of confidence is felt.

Note: The purpose of this article is not to give legal advice or to take a general position, but only to highlight certain questions and practical difficulties. Each situation must be analyzed on a case-by-case basis according to the applicable contractual provisions.

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