FIDIC CONTRACTS AND HUNGARIAN LAW

IMPORTANT ASPECTS OF USING FIDIC CONTRACTS IN HUNGARY

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1. FIDIC CONTRACTS AND HUNGARIAN LAW

Hungarian law is part of the European-continental legal system. It most closely resembles German law in particular and is in the form of itemised legal norms. Developed on the basis of Roman legal tradition, these norms are incorporated into codes and promulgated legislation. FIDIC contracts however, fundamentally bear the hallmarks of, and presuppose the customs of Anglo-Saxon contracts. In light of this, whenever comparing Hungarian law to FIDIC contracts and attempting to align them in practice, we are faced with the problems that occur when there are conflicts between Anglo-Saxon and Hungarian law. Hungarian private law including the provisions of the civil code dealing with contract for works is dispositive so the use of the FIDIC forms is generally viable without major adjustments in the particular conditions. However, it is a specific feature of Hungarian construction law that it contains a great many mandatory norms from which the parties must not deviate. Divergent provisions in construction contracts may be declared null and void despite complying with the terms and conditions of FIDIC contracts, because mandatory Hungarian legal provisions prevail, even when Hungarian law is not chosen as the governing law by the parties. Problems in connection with the above occur primarily in legal disputes between the parties and during testing by Hungarian construction supervisors. In this short study, we provide a brief overview of specific, frequently asked questions, based on the Red Book and the Yellow Book, that arise when drawing up a FIDIC contract in Hungary. The study will further examine instances when the terms and conditions of FIDIC contracts need to be aligned with the provisions of Hungarian law.

For these purposes we focus on the provisions of Hungarian law which are to be applied when choosing Hungarian law as the governing law or when applying the terms and conditions of FIDIC contracts (irrespective of Hungarian law) in certain cases.

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2. CHOICE OF LAW AND THE ISSUE OF JURISDICTION

It follows from the above that the terms and conditions of FIDIC contracts cannot be regarded as supranational generally binding norms in Hungary. So, whenever applying the terms and conditions of FIDIC contracts, it is always necessary to choose the applicable substantive law and to specify the jurisdiction. If there is no choice of law, the rules of international private law will decide which country's law will have to be applied. In Hungary, these rules are outlined in Law Decree No 13 of 1979 and Regulation (EC) No 593/2008 of the European Parliament and of the Council ("Rome I") with regard to the Member States of the European Union. Pursuant to Rome I, if there is no choice of law, then the law of the country where the contractor has their registered office must be applied.

However, the choice of law must not lead to deviation from the non-dispositive type of norms, mandatorily applicable in the country of construction. In Hungarian law, for example, Government Decree 191/2009 (IX 15) Korm on works in the construction sector includes detailed rules in connection with the content of the construction contract. Mention must be made of the Construction Act (Act LXXVIII of 1997) which contains a number of mandatory provisions. Government Decree 181/2003 (XI 5) Korm could also be mentioned as another example which stipulates a mandatory guarantee period of three years with regard to newly built homes and dwellings. Contractual provisions deviating from the decree to the detriment of the employer are null and void. As the decree only applies to newly built homes and dwellings, it is not significant in terms of engineering works where FIDIC forms are used. The "Defects Notification Period" is usually agreed under sub-clause 11.1 of the Red Book and Yellow Book via the "Appendix to Tender" so it is important this agreement respects the governing law to avoid being declared null and void.

In order to avoid difficulties of interpretation and the need to apply the law of several countries in the case of legal disputes, it is advisable to choose Hungarian substantive law and to stipulate the jurisdiction of a Hungarian Arbitration Court in the case of construction work planned to be carried out in Hungary. These Arbitration Courts follow their own procedural rules.

Hungarian construction law was amended significantly in 2013 with the aim of strengthening the legal position of contractors and their sub-contractors. The most important changes concern the settlement of legal disputes and the establishment of a new, special professional body. The contractor is entitled to request the review of this professional body and there is a dedicated and streamlined review process (see section 4 below for more details). In Hungarian legal practice, the parties usually stipulate the jurisdiction of the Arbitration Court attached to the Hungarian Chamber of Commerce and Industry. Its registered office is in Budapest. It is also possible to appoint foreign judges to particular arbitration court proceedings.

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The advantages of arbitration to both parties are as follows:

- time savings because it is a first and only instance review body; and
- appointing the appropriate people by the parties helps to ensure that the tribunal possesses the necessary professional knowledge.

3. CHOICE OF LANGUAGE

The official original language of FIDIC contractual clauses is English. Official translations have been made into several languages, primarily of the Red Book. In view of the fact that Hungarian law is also part of European-continental law, if a Hungarian language FIDIC contract is drawn up, we are likely to encounter terminological problems similar to those experienced by other, European continental laws when specific legal terms are aligned with Anglo-Saxon legal terms. Pursuant to contractual and judicial practice developed in Hungary, whenever there are differences in terms of substance and meaning between the two individual language versions, the language version designated by the parties in the contract as authoritative should be used as the basis for interpretation[4]. Failing that, the authorities or the courts decide (with regard to all the circumstances of the case) what contractual obligations were intended to be established by the parties.

4. SETTLING LEGAL DISPUTES IN THE CONSTRUCTION SECTOR IN HUNGARY

Two special Hungarian dispute resolution bodies need to be mentioned concerning the settlement of disputes in connection with construction contracts entered into on the basis of FIDIC terms and conditions of contracts. The power and procedures of these bodies to decide legal issues overshadow the triple hierarchy of FIDIC dispute resolution (Dispute Adjudication Board – Amicable Settlement – Arbitration) in Hungary. Legislation enacted into force on 1 July 2013 (Act XXXIV of 2013 on the Expert Body for Performance Certification, hereinafter: the "Act") set up the Expert Body for Performance Certification ("EBPC") and regulated its functions and powers. The reason for enacting new legislation and establishing this body was in reaction to legal disputes having increased greatly in connection with the performance of construction contracts in recent years. Disputes were mainly between the employer and contractor but, to a lesser extent, between the contractor and their subcontractors. Generally, these legal disputes took years to decide before a binding judgment was eventually handed down by the courts. The scope of the

[4] See e.g., s. 1.4 of the Red Book.

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legislation covers all construction projects in Hungary. The Act states that contractual clauses that exclude or restrict the powers or procedures of the EBPC or which attach any negative, legal, consequence to initiating EBPC procedures are null and void. Therefore, if the construction project is implemented in the territory of Hungary, we are faced with a mandatory provision of Hungarian law that cannot be bypassed even if choosing the law of another country. However, the EBPC does not have jurisdiction over all legal disputes in the construction sector. Its jurisdiction only applies:

(a) to those cases in connection with the performance of construction contracts when no performance certificate is issued;
(b) where the issuance of a performance certificate is disputed;
(c) payment is not made despite being due; as well as
(d) to those cases when the ancillary obligations to guarantee the contract (bank guarantee, lien, surety) and their enforcement are disputed by the parties.

It is to be emphasised that the ex officio procedure of the EBPC is not mandatory and can be initiated upon request of one of the parties. The Act grants priority and summary procedure to the parties involved in court litigation where they have attempted to use the EBPC. Presumably, this will motivate the parties concerned to avail themselves to the possibility granted by the new Act instead of opting for the much longer "normal" court procedure. The EBPC comprises of independent court experts and must deliver its expert opinion in 30 days from the date of receipt of the application. The party that disagrees with the expert opinion can start litigation within 60 days from the date of its receipt and the court is obliged to handle all such cases with priority in a summary procedure. The amended Code of Civil Procedure provides a number of guarantee provisions and preferential treatment to the party which sustained injury according to the expert opinion (for example, judicial protective measures and prior enforceability).

This procedure is particularly advantageous to the contractor if the employer disputes performance or certain aspects of performance stated in the contract. Provided that EBPC review is allowed, the contractor will probably decide against using arbitration.

The other special bodies created to decide legal disputes are the conciliation boards attached to the regional Chambers of Industry and Trade. This institution enforces consumer protection regulation in Hungary and its functions are accessible to the consumer. The definition of "consumer" was broadened considerably as a consequence of an amendment to the Consumer Protection Act (2013) which came into effect in July 2013. The new definition covers not only natural persons acting to promote objectives outside the scope of their independent professions and activities but, among other things, micro, small and medium-sized enterprises in the European sense. The conciliation board can give a binding decision with regard to the

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enterprise which is subject to the complaint but *only* if it made a statement of submission before the adoption of the decision. It is further possible – even in this case – for the entity subject to the complaint to start litigation (i.e. appeal) against the conciliation body's decision within 15 days of the decision. Where the terms and conditions of the FIDIC contract are used in Hungary, the contract must contain the rules for deciding legal disputes in accordance with the relevant contract templates. Failing that – and if the competent court and the applicable law are not specified – the registered office of the Hungarian company subject to litigation in Hungary or the site of the construction project in Hungary may lay the foundation for determining the jurisdiction of the Hungarian court (see also Chapter 20 of the FIDIC Red and Yellow Books).

The functions of the EBPC overlaps those of a Dispute Adjudication Board ("DAB") under FIDIC, if initiated by a party. Given the advantages of the EBPC mentioned above, the parties are likely to choose it over the DAB. The EBPC still remains somewhat of an "unknown" in Hungary because Act XXXIV of 2013 providing for the rules of EBPC procedure only came into effect on 1 July 2013. It is important to note that Act XXXIV of 2013 states that contractual clauses that exclude or restrict the applicability of the procedure of EBPC are null and void.

5. THE MOST IMPORTANT CONTRACT PARTICIPANTS AND THEIR TASKS

Hungarian law includes a number of binding provisions for the employer, contractor and designer as the most important participants of a construction project. These provisions cannot be disregarded when applying Hungarian law (Construction Act, section 43(1)) – even if FIDIC contract terms and conditions are used. In general, there is no problem in implementing particular FIDIC sub-clauses in relation to the following provisions of Hungarian law. In Hungary, the employer:

- must provide full funding for the construction project (sub-clause 2.4);
- must provide a valid construction permit in the same manner as the Red and the Yellow Books (sub-clause 1.9 and 1.13);
- must ensure compliance with the provisions of the design documentation and the construction permit (sub-clause 17.3(g));
- is responsible for handing over the construction site to the contractor (sub-clause 2.1);
- is responsible for reviewing the execution of the construction activities (chapter 3); and
- is responsible for activating the electronic construction log.

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The designer is responsible for the suitability of the technical content of the drawings and specifications made by it (so that their content is in line with actual status), the selection of the sector-specific designers and coordinating conciliation among them and the quality of the architectural work (Construction Act, section 33(1)). According to the rules governing warranties for the transfer of title specified in Act IV of 1959 on the Hungarian Civil Code (hereinafter: the Hungarian Civil Code), the designer warrants that no third person has any right to hinder or restrict the implementation of the drawings and specifications. The contractor is responsible for their own competency, for the legitimate conduct of the construction project, for maintaining the construction log and for compliance with the content of the construction designs. The contractor is responsible for all legal consequences arising from its failure to indicate deficiencies in the drawings or specifications of which they were aware before entering into the construction contract (Construction Act, section 40(1); also see clauses 2.2–2.4, 3.1 and 4.1 of the FIDIC Red and Yellow Books).

6. CONTRACTUAL GUARANTEES IN FIDIC CONTRACTS AND HUNGARIAN LAW

There is a two-fold system of contractual guarantees: (1) additional sanctions are prescribed in the case of contract violation (e.g. a penalty); and (2) the sanctions facilitate the satisfaction of claims (e.g. bank guarantees, surety).

In practice, the mechanism most frequently used to ensure performance by the contractor is the penalty regulated by the Hungarian Civil Code. According to Hungarian law, a penalty can be stipulated in writing for contract violation such as delay, faulty performance or actionable non-performance of the contract. Under Hungarian law, a penalty has the character of flat-rate compensation. Thus, in each specific case, it has to be determined whether an actionable contract violation has taken place. The actual extent of damage sustained is not examined and Hungarian courts may reduce the rate of the penalty stipulated if it is considered excessive. In accordance with the governing practice of the Hungarian courts, a penalty considered acceptable is currently 10% of the amount of the contract. The Hungarian Civil Procedure Act came into force on 1 January 1953. The acceptable penalty rate is 10% and is based on the general practice of Hungarian courts since 1953. Under Hungarian law, damages in excess of the penalty can also be enforced. However, in this case, the quantum of damages must be confirmed by itemisation and total to a specific amount.

In a certain sense, the guarantee undertaken by the contractor in the contract (prescribed under separate law in certain cases) or the mandatory guarantee already referred to can be regarded as contractual collateral.

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It is a mandatory provision of Hungarian law that the employer must have the funds for the performance of the construction contract at the time of the execution of the construction contract and it must pay what is due to the contractor upon contractual performance by the contractor. In the practice, if the employer does not have these funds, the contractor is not obliged to start building operations. Nevertheless, if the employer decides to start building operations at their own risk, the contractor can commence as well even if the financial funds are not available. A primary lien, bank guarantee or surety may be used as guarantees instead. Although not a typical form of contractual collateral, special mention must be made of Article 17(2) of Government Decree 191/2009 (IV 15) Korm. According to this provision, a collateral manager must be involved in the implementation of construction projects that either reach or exceed the "Community Value Limit" specified by the Public Procurement Act.

In accordance with the rules of Hungarian law, the collateral manager is an independent person overseeing the funding of building construction. The parties must place the financial funds of building construction into the bank account of the collateral manager. In accordance with Hungarian Law, the value limit of the building investments must exceed five million euros for the collateral manager to be required. If a building investment exceeds this limit, assignment of the collateral manager is obligatory. In such cases, the employer is obliged to provide the collateral manager with adequate financial assets in the form of:

- security issued by the Hungarian State or a Member State of the European Union;
- security with profit and capital guarantee;
- part of the budget of the Hungarian State;
- loan;
- bank guarantee; or
- subsidy contract signed by the Hungarian State or a Member State of the European Union.

The contractor is not obliged to start construction if the employer does not provide security according to the above provisions. In this case, the contractor may also terminate the contract referring to clause 16.2(d) of the FIDIC contracts and the mentioned provisions of Hungarian law.

Employers from the public and the private sector are subject to the same provisions.

When using FIDIC contracts, the parties have no fundamental obligation to assume an ancillary obligation if performance falls through. A separate agreement has to be reached in every case about the collateral. Examples of collateral are included in Annexes A to G attached to the *Guidance for the Preparation of Particular Conditions*. Interpretation of the collateral actually specified depends to a great extent on the provisions of the law chosen. In this respect, attention is again directed to the fact that if there is a legal

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dispute about a bank guarantee, lien and surety used as collateral, the EBPC has deemed competence in Hungarian construction projects if contacted by any of the parties.

We wish to mention that the choice of law may have significance from a special Hungarian perspective if Hungarian law and Hungarian courts are chosen. Although the terms and conditions of the FIDIC contracts include that commitments predominantly of a bank guarantee character must be assessed according to the governing law of the contract, the bank guarantee may be considered on the basis of a law other than the law governing the other provisions of the contract. If the parties do not avail themselves of the possibility of the choice of law, bank guarantees are consistently regarded as independent commitments in Hungarian judicial practice and not as "ancillary obligations" (see also clauses 2.2–2.4, 4.2 and 14.2 of the FIDIC Red and Yellow Books).

7. VARIATIONS WHEN APPLYING FIDIC CONTRACTS IN HUNGARY

Hungarian legal regulations consistently differentiate between "extra work" and "additional work". "Extra work" definitions are essentially identical to those contained in the Hungarian Civil Code and in Government Decree 191/2009 (IV I5) Korm ("the Decree"). These are of decisive importance for regulating construction activities. This Decree is, in fact, an administrative decree because the regulations under administrative law are binding to all legal entities. If these rules were prescribed by the Hungarian Civil Code, the parties could deviate from these rules by contract. It follows that, according to Hungarian law, extra work means an item "verifiably included in the construction documentation that serves as a basis for contracting which, however, is not taken into consideration in the contractual price". The Hungarian Civil Code obliges the contractor to perform extra work, without which, the facility would not otherwise function properly. In case of a fixed price contract, the contractor cannot demand any extra payment for extra work, but can do so if payment is by measure and value. According to the definition in the Decree, "additional work" means "items of work ordered separately that are not included in the construction documentation that serves as a basis for contracting". The Decree obliges the parties concluding a contract for construction activities to regulate the method of settling payment for additional work in the contract that may become necessary at a later date. As a general rule, in the case of additional work, the parties are free to agree under Hungarian law whether the employer orders the additional work. However, the Decree includes a mandatory provision that the contractor must perform additional work required because of "technical necessity or for proper and safe use". If we review the terms and conditions of FIDIC contracts in connection with performance modification, we will see

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that they (in practical terms) depend on conciliation between the Parties and their representatives. The engineer has a leading role in determining to what extent they deviate from the original contract or the drawings and specifications and how related financial issues are settled. Naturally, this kind of conciliation exists in Hungarian practice also but, as discussed above, Hungarian law sets greater limits on the room for manoeuvring for the Parties relative to the terms and conditions set out in FIDIC contracts. This is despite the fact that the provisions of the Decree are mandatory and any deviations from them deemed null and void where Hungarian law is the governing law. Under FIDIC forms in Chapter 12 (Red Book) and Chapter 13 of the FIDIC Red and Yellow Books the extra or additional works must be subject to the variation procedure both in cases of a lump sum or re-measured contract price.

8. PERFORMANCE BY THE PARTIES AND TAKING OVER

Under Hungarian law, taking over and the preparations for it are regulated very similarly to the terms and conditions of the FIDIC contract. It is necessary to highlight that these are mandatory provisions of Hungarian law which prevail in any case when Hungarian law is applicable – even if the parties agree differently in their contract. The conditions of FIDIC contracts exclusively apply to cases where Hungarian Law does not have different regulations from FIDIC contract terms. We emphasise that under Hungarian law, taking over is always preceded by a joint site inspection. At the inspection, the technical manager of the contractor hands over the taking over certificate to the employer (or their technical inspector or the technical manager of the general contractor) which includes the activities to be carried out by the contractor. One of the binding rules of Hungarian Law is the Performance Certificate that must be issued in electronic form. On the basis of the taking over certificate and the related inspection, the employer (or their technical inspector or the responsible technical inspector of the general contractor) issues a Performance Certificate for the construction activities to be done. This includes their extent, quantity and quality and an estimate of the amount due to the contractor. This is followed by the "technical taking over" procedure initiated by the employer. The construction supervisory authority and others must be notified of this. A protocol is drawn up about the technical taking over procedure which lists – among other things – the quantitative and qualitative defects and deficiencies identified during the taking over, budgeted amounts concerning defective items of work, the employer's decision about taking over or rejecting the construction, whether they require the defects be repaired and if a discount is required. We note that according to the Hungarian Civil Code, taking over cannot be denied due to insignificant defects and deficiencies of service. Services performed in connection with other defects

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and deficiencies (i.e. repair and replacement) do not hinder "proper use". According to the provisions of Hungarian law, performance has to be inspected within the framework of a follow-up supervisory procedure one year from the date of the taking over procedure (see also clauses 4.1, 8.2, 8.4 and 10 of the FIDIC Red and Yellow Books).

9. FORCE MAJEURE AND DEFECTIVE PERFORMANCE

FIDIC contracts provide a detailed definition of the force majeure concept and its consequences (Article 19). Despite being familiar with the legal principle of force majeure, Hungarian law does not go into any detail and provides no definition. Under Hungarian law the term "unavoidable external cause" comes closest to the concept of "force majeure" in FIDIC contracts. In fact, FIDIC contracts play a supplementary role in this case: as the Hungarian Civil Code does not give a definition of vis major, the regulations of FIDIC contracts can be applied as subsidiary rules.

It follows from the above that detailed provisions of FIDIC contracts concerning force majeure are in harmony with Hungarian law and set out the details of force majeure with respect to the given contract.

In cases of contract violation by the contractor, clause 11 of the FIDIC conditions ("Defects Liability") contains detailed rules which include, among others, what is regarded as defective performance, what constitutes the notification obligation of the contractor and what is the scope of responsibility. These rules can be applied under Hungarian law. At the same time, certain mandatory provisions of Hungarian law should be taken into consideration, although similar provisions can also be found in the terms and conditions of FIDIC contracts. According to Hungarian law, contractual provisions are null and void if they wilfully exclude or restrict liability for defective performance caused by gross negligence, criminality, or where harm was done to life, body or health.

In connection with defective performance, the concepts of warranty and guarantee need to be discussed as these terms are clearly separated in Hungarian law and in judicial practice – particularly in relation to liability for latent defects. In the case of guarantee obligations, the contractor can only be exempted from them if it can prove that the defect arose after the performance of the contract. In the case of warranty, the employer must prove that the latent defect existed at the time of taking over. A government decree mandatorily calls for three-year guarantee obligations by the contractor in the case of dwelling construction. Guarantee obligations in the case of commercial premises can be stipulated under contractual provisions as should the duration of the guarantee obligation. In the case of a warranty, the claim can be enforced within six months of performance. If, however, the employer was unable to enforce its claim within this period due to an excusable reason, three years are available in the case of construction

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contracts. The guarantee obligation period may range from five to 10 years in the case of building components for which a mandatory period of suitability is specified by legislation. When enforcing warranty rights, the employer may demand repair and replacement in the first place or, if it is not possible, a reduction of the fee or even cancellation of the contract if there is a major defect. These rights demonstrate striking similarity to the terms and conditions of FIDIC contracts. Generally speaking, the parties may deviate from most of the provisions of Hungarian law applicable to warranty in their contract. This possibility does not exist if the person on the employer's side is a consumer. Under the Hungarian Civil Code, a consumer is defined as a person who enters into a contract dealing with matters which are outside the scope of the person's economic or professional activities (see also clauses 11 and 19 of the Red and Yellow Books).

10. TERMINATION OF THE CONTRACT WHEN APPLYING THE TERMS AND CONDITIONS OF THE FIDIC CONTRACT AND HUNGARIAN LAW

According to the Hungarian Civil Code, the employer may cancel the contract at any time if it is a works contract (i.e. unilateral right to ex tunc cancellation). The employer must, however, compensate the contractor for the entire loss sustained. The employer may also cancel the contract if the contractor performs defective work (to a major extent) and does not agree to repairs or replacement. According to Hungarian law, the parties have the possibility to terminate the contract jointly. If the employer cancels the contract, it ceases with ex tunc effect. If it is terminated jointly, it ceases with ex nunc effect. In the former case, services already delivered should be refunded and the parties must settle with one another. In the latter case, the value of services performed before termination must be paid. We can refer to unilateral cancellation with ex nunc effect as termination. In principle, under Hungarian law, we can refer to the cancellation of construction contracts with ex nunc effect if the contract is cancelled jointly by the parties (right to joint ex nunc cancellation), while termination as the right to unilateral cancellation with ex nunc effect occurs as an exception only subject to certain conditions in Hungarian law. So, for example, Article 18(6) of Government Decree 191/2009 (IX 15) Korm, grants the right to termination to the general contractor if the employer uses a collateral manager and if the employer fails to provide coverage for the contractor's next performance by the time suspension of construction expires.

Clause 15 of the FIDIC conditions regulates the conditions according to which the employer may terminate the contract unilaterally with ex nunc effect. The text differentiates between the right to termination based on special reasons (clauses 15.1 to 15.4) and the "free" right to termination.

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According to the terminology of the FIDIC contracts, "termination" refers to ex nunc termination. In certain circumstances the employer has the possibility (such as in the case of severe deficiencies) to demand restoration of the initial status (which is also referred to as "termination").

The employer may terminate the contract on the basis of clause 15.5 at its own discretion without giving any reason. This right is subject to restriction and can be exercised in specific circumstances only. In this case, the contractor must finish work in accordance with clause 16.3 and hand over the construction site in a satisfactory condition. The employer may resort to "extraordinary termination" if, for example, the contractor fails to supply the performance bond specified in the contract.

According to clause 16, the contractor may also terminate the contract and stop construction work if either the designer or the employer violates the contract. According to clause 16.2, severe contract violation on the employer's side may give rise to termination by the contractor. In the case of legitimate termination by the contractor, they are entitled to stop work immediately, except for those works required to protect life, body and property.

It should be mentioned that the right to termination by the employer for convenience (i.e. right to unilateral cancellation with ex nunc effect) is unknown in Hungary. The parties may stipulate this by applying the terms and conditions of the FIDIC contract, but even in these cases it is advisable to take into account the requirements of contract termination under Hungarian law (see also clauses 15 and 16 of the FIDIC Red and Yellow Books).

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