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## **ECONOMIC CRISIS THE LIMITS OF THE FLEXIBILITY OF CONTRACT LAW IN HUNGARY**

### **Abstract**

*We analyse the influence and the ineffectivity of the economic crisis/business risk in the course of the dynamics of contract (from the contracting negotiations until the termination of contract) on the basis of the Hungarian Civil Code in force, and from the aspect of those contractual relations that cannot be found in the Hungarian Civil Code and finally, we look outside the current European regulations.*

### **Keywords**

*economic crisis and business risks in Hungarian legal cases – modification of contract by court – European overview*

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## I. INTRODUCTION

With the conclusion of a contract of civil law, the parties may take some reasonably unforeseeable economic risks that might disrupt the synallagmatic character of the contract; therefore, a disproportionate, unviable extra burden may appear in the contractual relations on the side of some parties. A sudden increase in inflation or prices, the intense reduction of the purchasing power of wages, the radical changes in the relations between supply and demand, the collapse of the product market, the insolvency of the economic actors (especially in the case of a contractual party), the negative changes of the market and financial relations and the production and liquidity problems of the economic sector will result in this incalculable risk. In the case of maintaining the original contractual content, an economic crisis affecting the whole economy and society of one or more countries may cause any or all the parties to bear inequitable and intolerable risks.

In the following pages, we intend to analyse those reasons in the Hungarian judicial practice that are based on the Hungarian Civil Code and referred to by the parties in order to get rid of the contractual obligation in the name of economic/business risk. Then we examine the importance of economic/business risk in those contractual relations that cannot be found in the Hungarian Civil Code, and finally, we make a conclusion with respect to the current European regulations.

## II. THE LEGAL REASONS FOR OBTAINING ECONOMIC/BUSINESS RISK ACCORDING TO THE HUNGARIAN CIVIL CODE<sup>1</sup>

In accordance with the Civil Code<sup>2</sup> in the course of exercising civil rights and fulfilling obligations, all parties shall act in the manner required by good faith and fairness, and they shall be obliged to cooperate with one another, and unless the Civil Code prescribes stricter requirements, it shall be necessary to proceed in civil relations in a manner that can generally be expected in the particular situation. No person shall be entitled to refer

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<sup>1</sup> The old Hungarian Civil Code (Act IV of 1959), which is in force until 15.03.2014.

<sup>2</sup> Section 4 (1), (4).

to his own actionable conduct in order to obtain advantages. Whosoever has not proceeded in a manner that can generally be expected in the particular situation shall be entitled to refer to the other party's actionable conduct. In case of the framework contract about the sales of natural gas, because of the Russian-Ukrainian dispute on natural gas at the beginning of 2006, the gas service was hampered, and therefore, for supplying heat, the plaintiff produced the necessary quantity by oil heating, while the defendant could not receive any subsidy for gas prices during the period of suspension; the legal action taken by the defendant was based on Section 4 of the Hungarian Civil Code. There is no subsidy referring to that amount of gas which was not consumed, however, the defendant had the possibility to enforce his economic interests in connection with the potential business risk emerging by changing to oil heating: the plaintiff is not responsible for the missing of this opportunity by the defendant. The court held that the party neither violated the principle of good faith and integrity nor realized unfair conduct on the market by not warning his partner of the possible economic consequences and business risks of facts known by both parties<sup>3</sup>.

In order to pass on or share the business risk, the parties intended to use the legal term of implied conduct<sup>4</sup>: in the analysed suit<sup>5</sup>, in the second half of 1989 the parties had negotiations about concluding an agreement in principle about a partnership of which the aim was to set up a joint venture, but at the time of the conclusion of the contract, the Soviet market collapsed and the parties tried to shift the losses on to each other.

The party losing the investment wished to get compensation for the outstanding profit based on the above mentioned rule of "implied conduct". The court held that the company itself had to cover the costs relating to the ordinary business risk that could emerge at the time of preparing the contract (e.g. in case of an investment that cannot be realized because of the bankruptcy of the product market of a country).

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<sup>3</sup> BDT 2008. 1900 [Casebook of the Courts].

<sup>4</sup> The court may award damages payable in full or in part by a party whose willful conduct has explicitly induced another, bona fide, person to act in a manner that has brought harm to this person through no fault of his own.

<sup>5</sup> BH 1996.586 [Court Order].

In another judgment<sup>6</sup> the court held that in general it had no legal basis upon which to refer to the rule of “implied conduct” so as to pass on the business risk.

In many litigations<sup>7</sup> the same mistaken assumption (Civil Code § 210 (3))<sup>8</sup> was the legal base for those contractual conditions to be voidable that became disadvantaged because of the business failure due to the negative economic circumstances; notwithstanding this the court declared several times that – in theory – the expectations and ideas falling under the business risk cannot mean that the contract can be voidable based on vitiated consent<sup>9</sup>. For example if the parties estimated the future increase of the prices of the contractual object and it proved to be less than it was in the reality, it cannot be regarded as same mistaken assumption<sup>10</sup>.

In the following case the plaintiffs considered the contract for purchase of business shares to be voidable on grounds of deceit<sup>11</sup>. Before concluding the contract the defendants informed them in writing about the financial situation of the limited liability company<sup>12</sup>. The plaintiffs omitted to check whether the future expectations of the defendants, and the estimated economic results were realistic or whether the value of the business share reflected their expectations or not. The conclusion of the contract for the purchase of the business shares happened in November, 1994, while the so called “Bokros-package” came into force from December, 1994. This economic event, which was unforeseeable by the, limited liability company and the defendants, meant the changes of the economic milieu and relations, therefore, the arbitration held that the risks emerging in the operation of the association after the conclusion of the transaction and influencing the financial situation of the association in a negative way, must be accepted by the buyer of the business share.

On the basis of Article 241 of the Civil Code, the court may modify the contract under three conjunctive conditions: the aim of the agreement

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<sup>6</sup> BH 1994.179 [Court Order].

<sup>7</sup> 2003/1 [Arbitration Decision].

<sup>8</sup> If the parties had the same mistaken assumption at the time the contract was concluded, either of them may contest the contract.

<sup>9</sup> BH 1998.272 [Arbitration Decision].

<sup>10</sup> BH 1983.205 [Court Order].

<sup>11</sup> 1997/6.

<sup>12</sup> ltd: company with limited liability of members.

must be a persistent legal relation, and after concluding the contract the contractual relation must change, therefore, the contract interferes with an important and justified interest of one of the parties<sup>13</sup>. In judicial practice it occurred several times that the alteration of the contract by the court based on the economic crisis could not be applied in default of one of the conjunctive conditions:

- the circumstance itself that some contractual provisions can be mistaken due to the unexpected changes of the market and financial relations, cannot be used as a legal base for the modification of the contract by the court, as an extra condition, the important and justified offense of interests of the party is required<sup>14</sup>,
- in case of a legal action that aims to modify a persistent legal relation, it is not enough to refer to general circumstances (e.g. to changes in the price level) that emerged after the conclusion of the contract, but its influence on the contract has to be specified too<sup>15</sup>. In connection with modification of the contract by the court, not only section § 241 of the Civil Code was analyzed, but the conditions were interpreted too<sup>16</sup>. If the parties considered the future insecurity of the level of production and the way in which the profit turned out to be a mutual risk at the time of the conclusion of the contract, the parties had to take into account these types of changes in the circumstances; in this case the modification of the contract based on important and justified injury of interests cannot be claimed. Neither can the alteration of the contract by the court be suggested with reference to the § 241 of the Civil Code, if it is about the widespread consequences of the basic social-economic changes<sup>17</sup>. The inflation

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<sup>13</sup> *A Ptk. magyarázata [The Comment of the Hungarian Civil Code]*, Budapest: Közlönykiadó 2007, p. 319; G. Gellért (ed.), *A Polgári Törvénykönyv magyarázata [The Comment of the Civil Code]*, Budapest: CompLex 2007, p. 905; F. Petrik (ed.), *Kommentár a gyakorlat számára [Comment for the Practice]*, Budapest: hvgorac 2008, p. 423.

<sup>14</sup> BDT 2007. 1707 [Casebook of the Courts].

<sup>15</sup> BH 1977.118 [Court Order].

<sup>16</sup> BH 1984.489 [Court Order].

<sup>17</sup> BH 1992.123 [Court Order]; Gellért (ed.), *supra* note 13, p. 323; T. Nochta, *A gazdasági válság mint szerződési kockázat [Economic crisis as contractual risk]*, [in:] T. Nótári (ed.), *Ünnepi*

and the changes of the relations of supply and demand belong to the economic risk, which shall not entitle any party to suggest a modification and these do not lead to automatic modification of the contract<sup>18</sup>. The ordinary changes of the market cannot be cited as a legal basis for the alteration of a unique contract by the court: by concluding a contract both parties take a business risk, the alteration of the contract by the court cannot be considered as a possibility to eliminate or redistribute the business risk taken by the parties<sup>19</sup>. In conclusion, the Civil Code does not entitle the courts to alter unique contracts in case of changes that affect the whole economy or the subjects of agreements that belong to different contractual types<sup>20</sup>: changes in the economic milieu, or the collapse of the market in certain products can be considered as a significant change in the circumstances of the conclusion of the contract that cannot be expected at the time of the conclusion of the contract and the risks of which have to be borne mutually by the parties<sup>21</sup>.

The obligated party has tried to refer to economic impossibility<sup>22</sup> in order to get rid of the contractual relations that became disproportionate because of the negative economic and market circumstances. The court held that the economic impossibility was not absurd. However, in the case of bank loan contracts, the economic changes or changes affecting the market during the period of repayment can be considered as business risk that cannot be ignored by the borrower (debtor) at moment of concluding a long-term loan contract. Therefore, he must take this risk<sup>23</sup>. In another suit the court held that the modification of the contract by the court cannot be suggested based on economic impossibility, since

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*tanulmányok Sárközy Tamás 70. Születésnapjára [Celebratory volume for the birthday of Prof. Tamás Sárközy]*, Szeged: Publisher Lectum 2010, p. 211.

<sup>18</sup> BH 1996.145 [Court Order]; BH 1993.670 [Court Order]; Gellért (ed.), supra note 13, p. 325; Nohta, supra note 17, p. 211.

<sup>19</sup> 2003/1 [Arbitration Decision]; BH 1988.80 [Court Order]; BH 1988.80 [Court Order]; BH 1985.470 [Court Order].

<sup>20</sup> The Comment of CompLex Legal Database in connection with § 241 of the Civil Code.

<sup>21</sup> BDT 200.277 [Casebook of the Courts].

<sup>22</sup> Code Civil § 312 (1): If performance has become impossible for a reason that cannot be attributed to either of the parties, the contract shall be extinguished.

<sup>23</sup> FIT 4.Pf.21.148/2009/4 [Decision of the High Court of Appeal of Budapest].

according to the § 241 of the Civil Code, the judicial modification and the declaration of the impossibility shall be regarded as two different provisions of the judgment that exclude each other mutually<sup>24</sup>.

We can also mention examples when the obligated party gave notice of termination<sup>25</sup> (unilateral termination) in order to repudiate the contract which meant an extra burden for him. The court held that<sup>26</sup> the defendant (debtor) breached the contract by terminating it since he could not refer to the unfavorable tendencies, the existence of which he knew when he concluded the contract, as a reason of the notice of termination. When judging the financial situation, the loss of revenue, the negative changes of the market, and liquidity problems cannot be accepted: the real reason of the termination must be considered by the facts revealed later.

The above mentioned analysis following the dynamics of the contract demonstrates well that the Hungarian courts regard an economic-financial crisis as a contractual risk and they use the principle *pacta sunt servanda* instead of a broader sense of the *clausula rebus sic stantibus*. Similarly to the domestic courts, the European Court of Justice – the judicial practice of which affects the domestic judicial practice of the Member States<sup>27</sup> – also considers the business-financial crisis to be a contractual risk and the different actors in the economy shall take the risks in connection with their activity. For in every contractual relation there is a risk that one of the parties may not fulfil the agreement in an adequate way or becomes insolvent: in such a case the parties must reduce the risk suitably in the contract itself<sup>28</sup>.

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<sup>24</sup> BDT 2000.277 [Casebook of the Courts].

<sup>25</sup> The defendant terminated a contract of loan concluded with a credit institution based on the § 525 (1).

<sup>26</sup> BH 2005. 63 [Court Order].

<sup>27</sup> K. Gombos, *Bírói jogvédelem az Európai Unióban [Judicial Legal Protection in the European Union]*, Budapest: CompLex 2009, p. 27.

<sup>28</sup> Case C-47/07 *Masder Ltd. (UK) v. the European Communities Committee*.

### III. THE IMPORTANCE OF THE ECONOMIC/BUSINESS RISK IN CASE OF CONTRACTS NOT INCLUDED IN THE HUNGARIAN CIVIL CODE<sup>29</sup>

In the following, we analyze atypical and business association contracts from the aspect of whether the business/financial crisis can be considered to belong to the contractual risk.

In the case of some atypical contracts<sup>30</sup> we can deduce that the economic/business risk is part of the contractual risk:

- in the case of a distance contract, the consumer is not entitled to the right of withdrawal (if not agreed otherwise) in connection with the changes of prices or charges depending on a fluctuation that cannot be controlled by the salesman in the financial market<sup>31</sup>,
- the independent commercial agent must act in accordance with the principle of due diligence expected in a given situation in order to perform the independent commercial agency contract: this refers to the careful selection of the third party as well. The agent must examine the solvency of the client, but he does not have to bear the liability for the creditability of the client (if the third party does not perform, the agent shall not be entitled to get commission)<sup>32</sup>,
- in the case of consort contracts (agreements with the purpose of taking part in a consumer-group), to meet debt obligations are not impossible only because of the difficult financial situation of the consumer<sup>33</sup>,
- in connection with real factoring, debts shall be realized in the name and at the risk of the factor (if the factor cannot receive the debt from the debtor later on, he must take the risk), and the invoice seller is not liable for the solvency of the debtor

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<sup>29</sup> These contracts may be atypical, or mixed, or innominated agreements.

<sup>30</sup> Contracts which are regulated out of the Hungarian Civil Code by act, by international conventions or by government decrees and which are implemented from the Anglo-Saxon legal system.

<sup>31</sup> T. Papp, *Atipikus szerződések [Atypical Contracts]*, Szeged: Publisher Lectum 2009, p. 45.

<sup>32</sup> *Ibidem*, p. 73.

<sup>33</sup> FIT-H-PJ-2009-117 [Decision of the High Court of Appeal of Budapest].

(in case of the unreal factoring, the factor does not bear the *del credere* risk)<sup>34</sup>.

In the case of a concession contract, the economic/business risk may already have been taken into consideration during the announcement of the tender (it can take its place among the “other, necessary information according to the tenderer”), however, if the tender does not mention this, then, based on section (1) of § 19 of the Concession Act<sup>35</sup>, the rules of alteration of the contract according to the Civil Code shall be applied<sup>36</sup>.

There are some atypical contracts where the economic-financial changes that emerged after the conclusion of the contract may result in the termination of the contract:

- in case of timeshare contracts, if the property affected by the consumer’s right to use is before or under construction and from the information of the company or by inspecting the property it becomes obvious that the property will be suitable for occupation only with a significant delay that results in the loss of interest on the part of the consumer or it will not be suitable for occupation after 3 years after the conclusion of the contract, the consumer can rescind<sup>37</sup> (subjective right to rescind that sanctions the breach of the contract irrespectively of the reason),
- termination without successor due to the insolvency of any party may result in the termination of the license contract<sup>38</sup>,
- in case of the delayed, incomplete, or non payment of the leasing fee (even the financial-economic changes in the position of the lessee can result in this), the lessor is entitled to terminate the contract immediately<sup>39</sup>.

The contract on business associations, due to the special nature of this legal relation, is an organizational (it creates a legal entity) and co-operational (it organizes economy), *sui generis* agreement<sup>40</sup>.

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<sup>34</sup> BH 2005.72 [Court Order].

<sup>35</sup> Act XVI of 1991 about concession.

<sup>36</sup> Papp, *supra* note 31, p. 130.

<sup>37</sup> *Ibidem*, pp. 91-92.

<sup>38</sup> *Ibidem*, p. 140.

<sup>39</sup> *Ibidem*, p. 165, p. 172.

<sup>40</sup> C. Farkas, P. Jenovai, T. Nótári, T. Papp (ed.), *Társasági jog [Company Law]*, Szeged: Publisher Lectum 2009, p. 52.

The general economic function of the business association is realized by the contract, in other words, the organization of the resources for a common goal<sup>41</sup>. The subjects of the contract form a special community of same interests (cooperation for the profit in a system of relations covered by a matrix of interests of many factors) that takes the risk for aiming the goal: liability for the result, for the risk of the jointly done management (liability for risk)<sup>42</sup>. From the aspect of the contract of company law, the appearance and handling of the economic-financial crisis is a phenomenon that belongs to the operation of the business associations. Besides, taking risk in an obviously not reasonable and unjustified way can lead to sanctions (e.g. the liability of the executive officer for the damage caused for the company): if the executive officer invests in buying or extracting diamonds in distant African countries hit by civil war in a way that cannot be controlled and by violating the rules of company law and also with capital that originates from also called “pyramid scheme”, from the money of more than twenty thousand retail investors, then it must be considered as a seriously unreasonable usage which is obviously opposed to the interests of the company<sup>43</sup>.

#### IV. EUROPEAN OVERVIEW IN RESPECT OF THE ECONOMIC/BUSINESS RISK

In connection with handling the imbalance which has arisen by the occurrence of some events that were unforeseeable at the time of the conclusion of the contract, the domestic rules of private law of the European countries and the codes (or the draft codes) aiming to integrate the European private law show us different pictures.

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<sup>41</sup> A. Kisfaludi, *Társasági jog [Company Law]*, Budapest: CompLex 2007, p. 42.

<sup>42</sup> Z. Novotni, *A kodifikált társasági jog, mint a magyar polgári jog megújulásának eszköze [The Codified Company Law as the Instrument of Renewal of the Hungarian Civil Law]*, *Jogtudományi Közlöny [Bulletin of Law Science]* 1989, Issue 2, pp. 65-73; A. Kisfaludi, *Társasági jogviták választottbíróóság előtt [Disputes of Company Law at Arbitration]*, [in:] T. Papp (ed.), *Acta Conventus de Iure Civili X., University of Szeged Faculty of Law Department of Civil Law and Civil Procedural Law*, Szeged: Publisher Lectum 2009, p. 119; Farkas, Jenovai, Nótári, Papp (ed.), *supra* note 40, pp. 38-39.

<sup>43</sup> BDT 2004. 959. II [Casebook of the Courts].

The French regulation<sup>44</sup> persists in the principle *pacta sunt servanda*, based on the belief that a judge cannot measure the effect of his judgments on the national economies, therefore, he is not entitled to alter the contract (“modifying the contract entails the risk of threatening the performance of the obligation committed by the other party in connection with another contract, hence, through an unstoppable and unforeseeable chain reaction it results in a general lack of balance”)<sup>45</sup>.

According to the Dutch, Italian and Serbian rules<sup>46</sup>, there is a difference between the ordinary contractual risk, arising after making an agreement and originating from the character of the contract, and those changes of circumstances that are irrespective of the nature of the agreement. As for the latter, the person under an unfair obligation in the Netherlands may ask the court for the modification or termination of the contract, while in Italy and Serbia the party for whom the completion of the contract is more burdensome, can only suggest that the court terminate the contract.

In virtue of the Greek civil law regulation<sup>47</sup> and the draft of the common reference framework<sup>48</sup> (in this case only under conditions) – the same solution is implemented in the Rumanian civil law<sup>49</sup> – the modification or termination of the contract because of extraordinary changes in the circumstances that affect the contract are allowed irrespectively of the relation of the risk factors to the contract.

The German Civil Code<sup>50</sup> provides the possibility of modifying a contract if – after its conclusion – an unforeseen change occurs according to which the contract would have not been concluded or it would have been concluded with different content and one of the parties cannot be expected to maintain this agreement in the same way. If the modification of the contract is not possible or it cannot be reasonably

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<sup>44</sup> BDT 2004.959. II [Casebook of the Courts].

<sup>45</sup> Article 1148, Article 1134 of the Code Civil.

<sup>46</sup> T. Kadner-Graziano, J. Bóka, *Összehasonlító szerződési jog [Comparative Contract Law]*, Budapest: CompLex 2010, p. 435.

<sup>47</sup> § 388, Kadner-Graziano, Bóka, *supra* note 46, p. 428.

<sup>48</sup> *Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference*, Munich: Sellier 2008, III-1. 110.

<sup>49</sup> Article 1.271 of the Codul civil; E. Veress, *Új román Polgári Törvénykönyv, szerződések és a gazdasági válság [The New Rumanian Civil Code, Contracts and the Economic Crisis]*, Cluj Napoca: Korunk (Our time) 2012.

<sup>50</sup> Bürgerliches Gesetzbuch § 313 Störung der Geschäftsgrundlage.

expected from the party, the one in a disadvantaged situation may rescind (or in case of permanent obligation he may cancel it).

In connection with the unforeseen events happening after the conclusion, English law introduced the legal terms “frustration” and “hardship”. In order to solve the economic-financial crisis, the following preferences have been defined: principally, the parties should create adequate provisions in their own contract (hardship clauses), in absence of these, there is a possibility of modifying or terminating the contract by the court (intervene clause)<sup>51</sup>.

The Project of Contractual Civil Code of Gandolfi<sup>52</sup>, the Principles of European Contract Law<sup>53</sup>, and the Principles of International Commercial Contract<sup>54</sup> urge the parties to negotiate again in connection with the contract in the case of the occurrence of events that cannot be foreseen at the time of the conclusion of the contract and can cause contractual imbalance. If the parties cannot make an agreement in a reasonable time<sup>55</sup>, they can ask the court for alteration or termination.

According to the first attempt of the Hungarian Civil Code<sup>56</sup> which did not come into force, the Technical Proposal<sup>57</sup> and the new Hungarian Civil Code<sup>58</sup> for the judicial modification of a contract, the above mentioned regulations require the possibility of any changes in the circumstances not to have been foreseen. This change in the circumstances is not due to the parties and it cannot belong to the ordinary business risks of the parties<sup>59</sup>. Analyzing the last condition, there is a possibility

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<sup>51</sup> E. McKendrick, *Contract Law*, London: McMillan Law Masters 1997, pp. 255-256, pp. 266-271, pp. 282-284; Kadner-Graziano, Bóka, supra note 46, pp. 438-439.

<sup>52</sup> Articles 97, 157 of the European Contract Code 2001 (Academy of European Private Lawyers).

<sup>53</sup> Principles of European Contract Law 1995-2002 § 6:111.

<sup>54</sup> Principles of International Commercial Contract (UNIDROIT Convention, Rome, 2004) §§ 6.2.1., 6.2.2., 6.2.3.

<sup>55</sup> 3 or 6 months according to the Civil Code of Gandolfi.

<sup>56</sup> Act CXX. of 2009, § 5:168 (1), the Hungarian Constitutional Court abolished it.

<sup>57</sup> § 5:175 (1).

<sup>58</sup> Act V of 2013 (will enter into force on 15.03.2014) § 6:192.

<sup>59</sup> L. Vékás (ed.), *Szakértői Javaslát az új Polgári Törvénykönyv tervezetéhez* [Technical Proposal to the Draft of the New Civil Code], Budapest: CompLex 2008, p. 845: “The Proposal based on the requirements of the professional economic actors makes it clear that everybody should measure the business risks in connection with the conclusion of the contract on his own and there is no possibility of reducing it in a judicial way”.

of avoiding considering the economic crisis and its effects as “ordinary business risk”, but it is necessary to change the current judicial practice.

We agree with Tibor Nochta<sup>60</sup> on the fact that the extra risks emerging after the conclusion of a contract need to be divided equitably and in our opinion, the Civil Code of Gandolfi, the Principles of the European Contract Law, and the Principles of International Commercial Contracts provide the best instrument to realize it.

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<sup>60</sup> Nochta, *supra* note 17, p. 216.

