



# The Possibility and Significance of Legal Guarantees in the Case of Construction Contracts

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**Abstract.** This paper gives a deeper insight into the possible contract guarantees and safeguards from the aspect of the interests and positions of both the contractor and the customer appearing in the opposite poles of the construction contract.

The customers appear to be stronger, thus – even with the lack of legal guarantees – they are able to force guarantees mitigating the risks in the contract. Apart from the guarantees listed in the Civil Code, the customers also contributed to the practical spread of the so-called performance bonds. Performance bonds are a part of the agreed contractual fee withheld for the period of warranty after performance or for a period specified in the contract, with the intention of covering the expenses resulting from imperfections and flaws. The paper deals with a range of issues related to the question of the practical use of performance bonds.

The contractors, on the other hand, are more vulnerable: for this reason, they have been provided with the protection of statutory lien by the legislator to the extent of the contractual fee. The legal examples regarding the practical application of statutory lien are also presented in detail.

**Keywords:** construction contract, statutory lien, contractual fee, withholding contractual fee, warranty, contract guarantees, liquidation

## 1. Introduction

Within the framework of the construction contract, a contractor has two major obligations: performing design work by which the design documentation is completed and handing the resulting design documentation over to the customer.<sup>1</sup> The customer's main obligation is to accept delivery and pay the contracted fees. The design activities in the areas listed above are not only under the provisions of the Civil Code, the regulations are included in Act LXXVIII of 1997 on the Formation and Protection of the Built Environment, Government Decree No 191/2009 (IX. 15) on the building construction activities.

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<sup>1</sup> Civil Code, Section 6:252.

The two parties of the construction contract, the liabilities of the customer and the contractor are similar to a magnet, they have opposite poles, thus attracting each other: the responsibility of the contractor is performing and transferring the work to the customer, while the customer's right is to demand the work specified in the contract with the responsibility of paying the contractual fee at the same time. Because of the opposite poles, it is in the customer's interest that the contractor perform in time, in accordance with the terms of the contract as well as the legal regulations, that is, the performance must be without any defects, thus lowering the chance and the disadvantages of a possible breach of contract. The construction contractor's interest is to receive the contractual fee from the customer, together with the fees of other possibly occurring works (additional work, extra work, technically necessary work).

## **Guarantees Aimed at Protecting Customers**

Based on the Civil Code, the above-mentioned interests of the customer can be safeguarded by the guarantees determined in the general provisions of contracts, which can be either imposing stipulated payments for non-performance or enforcing such collateral agreements as suretyship,<sup>2</sup> and guarantee contracts.<sup>3</sup> The Civil Code, however, does not provide specific legal guarantees to the customer. Given that, according to the provisions of Government Decree No 191/2009, the general contractor is allowed to take a subcontractor, and thus not only the actual builder is considered to be a customer hereafter but also the general contractor entering a contractual relationship with the subcontractor since in this respect the general contractor actually becomes the subcontractor's customer.

Of the guarantees listed above, the guarantee contract is the only one that is capable of compensating for one of the most significant risks of construction contracts after the technical handover and the payment of the contractual fee, namely for the expenses resulting from imperfections and faults occurring within the warranty or guarantee period. The imperfections and faults of the buildings and structures usually come to surface mostly during their use and are revealed over time even after several years: the lack of roof insulation and roofing failures, minimal water retention due to water insulation faults, the installation of inappropriate materials, sinking of foundation, the appearance of wall cracks or the spread of mould due

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2 Section 6:416 [Contracts of suretyship]

(1) Under a contract of suretyship, the surety undertakes the obligation of performance to the creditor in the event of non-performance by the principal debtor.

3 Section 6:431 [Guarantee contracts]

(1) The guarantee contract, and the statement of guarantee, means a guarantor's commitment under which payment is to be made to the creditor subject to the conditions laid down in the statement.

to thermal bridges. Depending on the volume of the building, the correction of imperfections could mount up to millions, not to mention the damage claims that may arise. On the other hand, the financial risk lies in the possibility that during the time after the handover, the financial conditions of the construction contractor in breach of contract may deteriorate, resulting in becoming insolvent, being terminated without a successor or, in the worst case, even being liquidated. For all these reasons, the customer may be left with the costs and damages all alone. In Hungary, the number of both involuntary and voluntary liquidation procedures is one of the highest in the construction sector.

Because of the high fee paid to the guarantor (which is usually a credit institution), maintaining the guarantee contract for years can be a serious burden on the construction contractor, but it can also happen that the construction contractor does not have the financial condition needed for providing guarantee. As a consequence, another solution has reached maturity in the Hungarian practice, which is mentioned as ‘performance bond’ in most cases. In fact, it is the retention of a certain part of the contractual fee determined by the contract for a specified amount of time.

Depending on the total amount of the contractual fee, the rate of the so-called ‘performance bond’ is usually between 5% and 10% (the higher the contractual fee, the lower the retention percentage), which is not paid to the contractor upon fulfilment by the customer, but it is retained from the overall contractual fee. The duration of retention ranges between 1 and 3 years in practice in the event that the construction contractor does not fulfil his obligations resulting from the warranty or guarantee contract during the retention period. In this case, the customer can cover the costs of the revealed imperfections and faults by using the retained amount.<sup>4</sup>

<sup>4</sup> *Section 6:159*

*[Warranty rights]*

(1) On the basis of a contract in which the parties owe mutual services to one another, the obligor shall be liable to provide warranty for lack of conformity.

*Section 6:163*

*[Expiry of a right to warranty]*

(1) The obligee’s right to warranty shall lapse after one year from the delivery date.

*Section 6:171*

*[Commercial guarantee]*

(1) Any person who guarantees performance of a contract or is required by law to provide guarantee shall assume liability for lack of conformity during the guarantee period under the conditions set out in the guarantee statement or in the relevant legislation. The guarantor shall be released from liability if he is able to prove that the cause of the defect occurred after performance.

In Hungary, for housing construction, there is a mandatory guarantee provided by law, which was regulated by a separate Government Decree No 181/2003 (XI. 5).

The regulation extends the guarantee to the building structures of a newly built dwelling and residential building, the construction and installation of housing and building equipment, and the areas and parts of residential buildings serving the dwellings.

At the same time, in spite of the amount withheld, the customer's warranty and guarantee claims can be validated, the construction contractor is obliged to cover the incurring expenses and perform the necessary work, and therefore it is not the customer's obligation to cover the incurring costs by using the retained amount. The unused part (or the whole) of the retained amount must be paid to the construction contractor by the customer after the end of the retention period specified in the contract.

The practice described above was also adopted and implemented in Act CVIII of 2011 on Public Procurement, allowing to withhold a certain part of the contractual fee for guarantee purposes. The reasons behind it have already been mentioned and their significance is even higher in the practice of public procurements as the largest investments are mainly financed by public money, the selection of construction contractors takes place in the process of public procurement, because of the magnitude, here is the highest risk of non-compliance with warranty obligations, and, finally, this is the least expensive option for the contractor in contrast to other types of guarantee.

Under Article 126 (1), the contracting authority is entitled to stipulate contractual guarantee with the successful tenderer. In paragraphs (2) and (3), the rate of the stipulated guarantee is also determined; according to paragraph (3), the amount of the retention for guarantee and warranty claims related to defective performance may not exceed five percent of the amount of the contract, the net of VAT.

Paragraph (7) deals with the issue of the 'performance bond': as regards the guarantee for the validation of warranty and guarantee claims, the contracting authority (the customer) may allow in the contract to assure the guarantee or a set part thereof through deduction from the amount of consideration due to the tenderer (construction contractor) for the (partial) performance instead of crediting it to the contracting authority's account.

Based on the Act on Public Procurement, the partial withholding of the contractual fee is for securing guarantee and warranty claim; its maximum rate cannot exceed 5 percent of the contractual fee exclusive of VAT. This legal regulation necessarily determines the actual practice, which means that the determined withholding rate is taken into consideration even in the case of design contracts outside the range of public procurement. It has to be noted that there has not been any legal dispute published before where the subject of the case was the amount withheld from the contractual fee.

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Beyond the mandatory guarantee, the contractor is entitled to assume voluntarily guarantee in the contract. Under the terms of the guarantee statement, the contractor is required to take responsibility for any defects. The guarantee is stricter than the warranty to the extent that the burden of proof lies with the person liable, it is exempted from the guarantee if s/he proves that the defect occurred after the performance. The guarantee claim can be enforced within the warranty period. The guarantee period laid down in the Decree ranges from 3 to 10 years.

## Judicial Judgements on ‘Performance Bonds’

The ‘performance bond,’ which is withholding a part of the contractual fee specified in the related clause of the contractual agreement, raises some problems in judicial practice when the construction contractor goes under liquidation. In this case, the liquidators launch a lawsuit on behalf of the debtor in order to obtain the withheld amount of the contractual fee, claiming that the withheld part qualifies as collateral regulated in the Civil Code, the claimants can satisfy their claim within three months after the commencement of the liquidation proceedings, and then the collateral has to be given to and the accounts have to be settled with the liquidator.<sup>5</sup>

The courts have therefore had to make a decision primarily on the issue whether the part of the contractual fee retained by the customer as a safeguard stipulated in the contract for performing the contractor’s guarantee and warranty obligations qualifies as a collateral or not.

Based on the same state of affairs, conflicting court rulings were born: one of the appellate courts found that the clause on ‘performance bond’ in the contract did not qualify as collateral,<sup>6</sup> while another court of appeal was of the view in its verdict that the stipulation in the construction contract complied with the rules regarding the content of a collateral, so the retained amount of the contractual fee has to be given to the liquidator after three months if the customer does not have any guarantee or warranty claims to be satisfied from the retained amount.<sup>7</sup>

The Civil Code coming into force in the meantime rearranged the rules of the collateral security; they were integrated into the regulations on liens, mortgages, and other pledges according to which collateral security may be arranged on money and securities in the form of possessory lien.<sup>8</sup> In order to establish a possessory lien, a pledge agreement is needed together with transferring the possession of the pledged property to the lien holder.<sup>9</sup> The pledge agreement

5 Act XLIX of 1991 on Bankruptcy Proceedings and Liquidation Proceedings.  
Section 38

(5) If the debtor provides financial collateral under a financial collateral arrangement to secure a claim before the time of the opening of liquidation proceedings, the collateral taker shall be able to realize this financial collateral directly, irrespective of whether liquidation is opened or not, and shall refund any excess collateral to and settle accounts with the liquidator. If the collateral taker fails to exercise his right to direct satisfaction within three months following the publication of the opening of liquidation, he may seek satisfaction as lien holder in accordance with the regulations set out in Section 49/D.

6 Judgement by the Court of Appeal of Győr (2008).

7 Judgement by the Court of Appeal of Szeged (2009).

8 Section 5:95

*[Arrangement of collateral security]*

(1) Collateral security may be arranged:

a) on money and securities in the form of possessory lien;

9 Section 5:88

becomes effective when the pledged property and the secured claim are properly defined,<sup>10</sup> referring to the amount of the claim as well.<sup>11</sup>

In our point of view, the withheld amount of a contractual fee does not meet the legal criteria for being qualified as collateral security.

First of all, the parties' will is clearly not directed at establishing collateral security because they are aware of its legal aspects of bankruptcy with regard to which the withheld amount would not fulfil the purpose of which it is actually stipulated. As it was stated above, the imperfections and faults of the buildings and structures usually come to surface over time, mostly after the fulfilment of the construction contract; so, it may happen that, when the liquidation proceedings are initiated against the contractor, there are not any guarantee or warranty claims against faulty performance. They only occur much later, when the customer is unable to take part in the liquidation proceedings as a creditor (as a claimant), or when the contractor is terminated without a legal successor. The collateral security would mean a safeguard for guarantee or warranty claims arising before the liquidation proceedings or within the first three months of its duration, although its probability is very low.

Secondly, in terms of the withheld amount, no transfer of property takes place, the contractor does not give a certain part of the actually paid contractual fee back to the customer but an amount which was not and is not in his possession; in fact, it can also happen that the amount is not even in the customer's possession at the time of signing the contract. Its best example is when the contractor pays a certain part of the contractual fee to its subcontractor as a subcontractual fee, from which the contractor will also withhold a defined part as a 'performance bond'. So, the contractor (as a customer in this relation) will possess the withheld part of the amount after receiving the contractual fee from the original customer.

Thirdly, it can be stipulated only in the contract which claims that the customer should be safeguarded by retaining a certain part of the contractual fee, but neither the amount nor its expected rate can be determined in advance since it is uncertain whether, and if so, what kind of guarantee or warranty claims will arise in the future.

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[Establishment of a lien]

A lien shall be considered established upon entering into a pledge agreement, and in that context it is necessary:

b) to transfer the possession of the pledged property to the lien holder (possessory lien).

10 *Section 5:89*

(3) The pledge agreement shall be considered effective if the pledged property and the secured claim are defined properly.

11 *Section 5:89*

(5) A claim secured by a pledge shall be determined in a way by which it may be identified, with an indication of the – one or more – underlying relationship and showing the amount, or in any other way suitable for the identification of the secured claim. The description may also pertain to certain claims which do not yet exist.

It should be noted that the challenges of economic life and the responses of the relevant judicial practice develop existing legal practice, which sometimes leads to ingenious solutions. Probably, partly due to the court rulings cited above, an improved version of the stipulation on ‘performance bond’ has appeared in construction contracts, according to which the withheld part of the contractual fee as a safeguard for guarantee and warranty claims for an unspecified period will permanently be in the possession of the customer if bankruptcy, liquidation, or other proceedings aimed at terminating the company without a legal successor are initiated against the contractor during the period of retention. A court ruling has already been published on this legal matter. The plaintiff of the lawsuit was a liquidator who sought the release of the withheld part of the contractual fee as a collateral from the customer, the defendant, also claiming that the content of the contractual stipulation was contrary to good morals. Both the appeal court and the Curia (the Supreme Court of Hungary) concluded that, under the stipulation of the contract, at the start of the liquidation proceedings, the withheld amount as a redemption for the warranty and guarantee obligations finally became the property of the customer, so it cannot be claimed as a collateral.<sup>12</sup> The courts did not find the reference to the conflict of good morals established either, as the Civil Code does not rule out the possibility of redeeming the obligations originating from faulty or defective performance by the contractor in this way. The defendant (the customer) did not gain any unilateral benefit from the contract because obtaining the withheld part of the contractual fee meant that the contractor’s obligations caused by defective or faulty performance also ceased at the same time.

## The Legal Guarantees of the Contractual Fee

Since the contractor is in a more vulnerable position than the customer because of the constant competition among businesses, the contractor is rarely able to ‘squeeze’ the guarantee of paying the contractual fee; therefore, the situation had to be resolved by the legislator. For this reason, a *pledge*, or to be more precise, a *statutory lien* is provided for the contractor by the Civil Code.

The failure of paying contractual fees can be traced back to a number of reasons in the case of construction contracts: it may happen that the customer does not intend to pay at the time of signing the contract or runs out of money during the investment. It may also happen that the customer continually comes up with suggestions for construction changes, demands additional work,<sup>13</sup> but

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12 The Curia of Hungary Pfv. V. 20.973/2013.

13 It is governed by paragraph (2) of Section 6:244 of the Civil Code: The contractor shall perform works ordered subsequently, prompted, in particular, by changes in the plans or designs, if carrying out such works is unlikely to impose unreasonable burden upon the contractor (extra work).

unforeseeable and technically necessary work<sup>14</sup> may also arise that is not covered by the contractual fee previously stipulated in the contract, and there is not enough money for covering the additional expenses of the construction. It also happens quite frequently that the main contractors (the contractors directly employed by the customer) during the tendering procedures calculate lower expenses than the actual cost of construction in order to win the bid; thus, the low contractual fee is enough to cover the expenses of the main contractor but is not enough to cover the subcontractors' fee. Partly thanks to the economic crisis, the non-payment of contractual fees, especially that of subcontractual fees, has become widespread in Hungarian construction sector for the last 10 years, so much that this issue has been dealt with at a governmental level.

The practice reflected the fact that in the case of construction contracts the legal statutory lien guaranteeing the contractor's fee claim was not satisfactory. As a solution to this, in 2007, the Civil Code was amended and *legal mortgage* was added to the rules of the construction contract as a subtype of supply contracts, guaranteeing the contractor's fee claim. According to the amendment, in the case of a construction contract, the contractor was entitled to legal mortgage up to the amount of the fee claim on the property owned by the customer where works settled in the contract had to be performed. It was established by the fact of signing the contract and the contractor's request to have an entry in the Land Register.<sup>15</sup>

According to the explanation attached to the amendment, 'the establishment of legal mortgage is made possible for the contractor of the construction contract so as to allow the law to provide a really effective method for satisfying the contractor's claims under the contract'. Until then, the rules of the Civil Code provided legal mortgage only in the case of personal property, which did not give sufficient coverage for the fee claim of a contractor performing works of significant value. The explanation also noted that it was justified to formulate legal mortgage as a mandatory provision so that it could not be ruled out in the contract, which would be contrary to the purpose of making this rule and it would be dependent on the power relations between the contracting parties.

Shortly after the amendment entered into force, a constitutional complaint was submitted against it. The petitioner claimed that the provision amended in the Civil Code violated the right to property because it restricted its content. According to the petitioner, the restriction of rights manifested in not stating it necessary to get the property owner's consent in order to establish legal mortgage as a burden on the property.

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14 Additional or technically necessary work is included indirectly in paragraph (1) of Section 6:245 in the Civil Code: the customer shall reimburse the contractor's expenses incurred in connection with carrying out additional works, which could not have been foreseen at the time of conclusion of the contract (technically necessary work).

15 Civil Code, Section 402, paragraph (2).

The Constitutional Court, therefore, examined this legal institution to determine whether it might result in an unconstitutional restriction on the right to property. The Constitutional Court, referring to some of its previous decisions, concluded that the legal requirements of mortgage with a security purpose as a type of restriction on property ownership did not violate the right to property in itself. It also referred to the fact that a similar legal institution is known by the German Civil Code (Bürgerliches Gesetzbuch – BGB § 648) and the French Civil Code (Art. 2103, 4°) as well. These two examples are somewhat better since the legislators developed more detailed rules (mortgage can be registered only on the value of actually performed work, which is also confirmed by an expert).

The Constitutional Court also examined whether the restriction of the new legal solution on the right to property could be considered as of public interest and proportionate.

After investigating the aspect of public interest, the Constitutional Court concluded that the restriction directly served the individual interests of certain contractors, but it also resulted in increasing the willingness of customers to pay for the services settled in the contract and the elimination of circular debt among businesses,<sup>16</sup> eventually serving the overall interests of the national economy. In this regard, the restriction on ownership was justified by the purpose of public interest.

However, the restriction on property ownership for public interest is only constitutional if the importance of the desired goal and the violation of a constitutional right in order to achieve that goal are in proportion with each other. According to the Constitutional Court, the new legal provision does not contain any restrictive conditions either in the nature of constructions or in respect of their value. As a result, the balance is broken down between the parties, putting some contractors (performing less significant work compared to the value of the property) into a highly advantageous position. Based on the text of the Act, it seems as if every contractor, as opposed to every customer, was the weaker

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16 In the case of complex construction works, for the sake of easier demand enforceability, and in order to avoid the burdensome task of organizing work, or, in the case of public procurement, due to the prohibition of subdivision of work, the customer does not make individual construction contracts for specified parts of jobs but makes a contract with one contractor (general contractor), who takes this burden from the customer by choosing the appropriate subcontractors for a given work, entering into contracts with them, co-ordinating and supervising their activities, and, last but not least, taking responsibility for all of them toward the customer. As a consequence, so-called contractor chains may develop, meaning that the general or main contractor makes contracts with other subcontractors for a specified part of work, who make further works contracts with other subcontractors for performing less important skilled jobs. Thus, a series of contractor chains is created, which forms the basis of the so-called circular debt or when the customer does not pay the main contractor, which is why the main contractor is not able to pay the subcontractors, or the customer pays the contractual fee but the payment gets stuck somewhere in the chain, sometimes right at the main contractor. This process goes hand in hand with the destruction of subcontractors, the termination of businesses accompanied by rising unemployment, unfortunately even occurring in the volume of billions.

party in every case, therefore requiring stronger guarantees and protection. By registering legal mortgage on a property of high value, the contractor might obtain a disproportionate collateral in the contract against the customer even for a small-scale work (e.g. minor home improvement, cable works). Thus, even properties of high value can be sold up because of a relatively low-value legal mortgage. The law does not take into consideration the possible causes of non-payment by the customer: they can be legitimate reasons or serious breaches of contract.

Using these arguments, the Constitutional Court found that the lack of differentiation led to a disproportionate restriction on the right to property, hence the amendment was annulled.

The new Civil Code did not smuggle back the institution of legal mortgage as a guarantee for the contractor, but it still maintains the *statutory lien* as guarantee for the contractor in the general rules of construction contracts.

According to Section 6:246 of the Civil Code, *the contractor shall be entitled to statutory lien up to the contract price and expenses on the property of which the customer gains possession in consequence of the works contract.*

It might be the case that some of the customer's assets get into the possession of the contractor such as things to be repaired or material provided for construction. This makes it possible for the contractor to obtain collateral security in the event of not paying the contractor's fee, in the form of legal mortgage to the extent of the fee claim. *The statutory lien covers only those assets that are originally owned by the customer and are possessed by the contractor as a result of the works contract.*

The statutory lien applies only to the assets being in the possession of the contractor and it cannot extend to those assets that are already returned to the customer, they cannot be reclaimed.

In the same way, it does not apply to assets that are built into the property of the customer (e.g. built-in kitchen appliances bought by the customer that are built into the kitchen with a suitable furniture). On the one hand, this is because they are no longer in the contractor's possession, while, on the other hand, those assets became a constituent part of the main thing.

The statutory lien does not apply to buildings, only legal mortgage can be established on them with the condition of an entry into the Land Register; the possession of a building does not constitute a right to establish legal mortgage on it.

In the Hungarian judicial practice, the contractor's statutory lien on the assets getting into his possession as a result of the works contract also exists (e.g. a suit left at the dry-cleaner's, a pair of shoes left at the shoemaker's, or a car repaired by the mechanic, etc.) if their value exceeds the amount of the contractual fee.

The statutory lien does not extend only to the things determined in the contract but also to the tools, equipment, and materials provided by the customer.

It also has to be mentioned that the statutory lien on the assets getting into the possession of the contractor as a result of a specific contract does not apply

in connection with a different legal status or in the case of another contract (e.g. deposit or a different works contract).

## **Conclusions**

It can be seen that both parties in the construction contract are exposed to the risks of non-contractual performance. The position of the customers – in the absence of competition – is better; the more preferable it is, the larger orders or jobs they can offer. Thus, if necessary, the customers can force to include such collateral securities into the contract, which reduces their risk. At the same time, the contractors are more vulnerable, on the one hand – there is a fierce competition and the lack of resources are quite frequent –, while, on the other hand, the contractor advances the work or even the material from which the performance of the contract is materialized. Non-payment of the contractual fee might lead to a total shift in the balance of the contract as well. For this reason, the legislator intervened and secured statutory lien for the contractor to the extent of the contractual fee. Seeing that the phenomenon of circular debt – in spite of all attempts – continues to exist with regard to construction contracts, it is regrettable that the legislator has not made an attempt to codify the institution of legal mortgage, securing the contractual fee again in a more thoughtful and more detailed way.

Finally, it has to be noted that the already referred German Civil Code, exceeding the guarantee of legal mortgage, provides the opportunity for the contractor to ask additional guarantees from the customer for the sake of paying the contractual fee, as a result of an amendment, for example, in the form of surety (BGB § 648A).