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Can We Get out of a Contract Gone Bad?
– in Hungary –

Pacta sunt servanda: contracts must be performed. This is the most fundamental tenet of the law of obligations. In this two-part series, we examine Hungarian and international law in terms of the opportunities they offer for getting released from a contract that has become financially untenable due to a change in the circumstances. This, the first article discusses Hungarian laws and regulations.

The article examines three sets of cases. The first is the modification of contract terms by courts, the second is impossibility of performance for economic causes and finally, we will discuss contractual liability for damages.

Judicial modification of contracts

[1] The modification of contract terms by courts is a solution in Hungarian law that can only be used under exceptional circumstances. Its purpose is to keep the relevant contract in place while repairing the balance of value that has become compromised. It is a less drastic solution than impossibility but Hungarian courts have consistently applied a strict approach to it and rarely rule in favour of it. A contract can be modified by court if it applies to a long-term legal relationship and the performance of an obligation under its original terms would harm one of the parties' material interests due to a change in the overall circumstances, as long as the change could not be foreseen when the contract

was signed, was not caused by the party that requests the modification and does not qualify as a normal business risk.

[2] A legal relationship is considered to be long-term if the parties are obliged to provide persistent or recurring services, for example if the parties conclude a framework agreement. A construction contract can also meet the longevity criterion, if it takes longer to complete, the performance can be broken up into several phases, and the contract determines the contractual behaviour of the parties for a longer term. It is important to note, however, that in claiming extra work and extra expenses, a special option is available in the case of construction contracts.

[3] The absence of a party's contribution to the change in a given circumstance is an objective condition. No matter what was reason for the party to cause the change (and regardless of whether its responsible or not), a judicial modification cannot be made.

[4] A modification can only be made on the basis of an unforeseeable circumstance that arose after the conclusion of the contract and goes beyond what could be considered as a normal business risk. In terms of foreseeability, the question is whether companies on the same market acting reasonably could have in a similar situation foreseen the change in the circumstances with sufficient foresight, while the category of normal business risks includes everything that the parties should reasonably reckon with. Inflation and fluctuations in demand and supply are generally considered by courts to fall into this category. A judgment which held that a contract could be modified on the basis of high inflation, and a significant increase in wages and raw materials prices has not gained wider currency. However, another judgment held that the change in the circumstances of the market was within the boundaries of normal business risk, whereas the collapse of the market had to be treated as a circumstance that the parties could not have reasonably expected to change so significantly. Therefore, according to this judgment it is possible that a circumstance that is otherwise within the bounds of normal business risk (such as inflation, supply and demand, or wages) changes so drastically that the parties could no longer be reasonably expected to have foreseen it. However, judgments making that finding are rare and judicial practice appears to be less permissive at present. This strict approach of the courts is amply illustrated by the fact that an economic crisis is no longer typically considered to be a cause for judicial contract modification, and the focus is more on legislative changes when it comes to mitigating its effects.

[5] Finally, the harm must reach a level that, if known by the relevant party at the time of contracting, it would not have concluded the contract or would have done so with different terms.

Impossibility of performance for economic reasons

[6] A contract terminates if its performance is rendered impossible. The disputes concerning this issue tend to focus on whether the performance is really impossible and, on the facts and circumstances that render performance impossible. The parties must prove that the cause for the impossibility was beyond

their control, the circumstances of the impossibility could not be foreseen on the contract date and they could not be reasonably expected to avoid the circumstances or avert the damage. The situation where these conditions apply to both parties is known as objective impossibility and the services provided before the termination of the contract must be compensated. If the other party did not perform a service already paid, the money must be refunded. If performance has become impossible for a reason attributable to one of the parties, the other will be relieved from the performance and may demand damages for loss caused by the non-performance. Finally, if the performance has become impossible for a reason attributable to both parties, the contract will be terminated and the parties may demand damages from one another in the proportion of their responsibility.

[7] Special rules apply to the objective impossibility of construction contracts. Such contracts impose an obligation on the contractor to produce a result, and therefore the contractor bears the objective risk associated with not producing the result. However, the unchecked application of this doctrine would impose a disproportionately heavy burden on contractors. Consequently, the contract fee will be payable to a contractor in the light of which party was liable for the cause of the impossibility. If both parties are or none of them is liable for that cause, a pro-rated part of the fee will be payable to the contractor in consideration for the work performed and the expenses incurred. If the developer is liable for the cause of the impossibility, the contractor will be entitled to remuneration, but the developer may deduct the amount that the contractor saved in expenses and the amount that the contractor earned or could, without great difficulty, have earned elsewhere in the time gained. If the cause for the impossibility was in the interest of the contractor, he cannot claim any compensation.

[8] There are special requirements not only for the contractor, but for the developer too in the case of a construction contract. In a scenario where a developer cannot hand over the construction site to the contractor in a condition suitable for work and it will not be able to do so at any later point in time, it will be held liable for the impossibility of contract, even though the developer is not responsible for this circumstance.

[9] The cause for the impossibility can be legal, physical or economic. An easily understandable example for physical impossibility is when the subject matter of the contract is destroyed. Legal impossibility is when performance is rendered impossible by legislative changes, such as the introduction of economic sanctions or export embargoes. The most ambiguous case of impossibility is that of economic impossibility. Courts tend to rule that this applies only in exceptional cases, where there was an unforeseeable change in the circumstances after the conclusion of the contract that would require one of the parties to endure extreme hardship or to make disproportionately great sacrifices in order to perform its obligations.

[10] The other key issue is the extent to which the cause for the impossibility was foreseeable. Courts use normal business risk as the standard to judge this issue: What is it that the parties should reasonably have reckoned with? A key attribute of economic impossibility is that the underlying change must be so serious and important as to exceed the extent of economic and market changes

that can be foreseen with due care and must clearly surpass the rate of normal business risks. Normal business risks can include (even drastic) changes in economic circumstances, as long as they are the result of market processes. Therefore, price fluctuations and changes in market conditions will not render the performance of a contract impossible. However, a court ruled that the exit from foreign investors from Hungary was an unforeseeable event. It held that the parties did not have to reckon with that level of risk when they built the industrial estate regulated in the contract, even though the foreign investors were key in the operation of the estate.

[11] Therefore, when it comes to economic impossibility, in order for the *pacta sunt servanda* doctrine to be overridden, an event must occur that is beyond the parties' control and imposes such disproportionate hardship on a party that it can no longer be reasonably expected to perform its obligations.

Exemption from liability for damages

[12] If a party cannot obtain a release from its obligations, it will necessarily be in breach of contract. The party can only try to alleviate the consequences of its breach by seeking exemption from liability. The party in breach of the contract will be exempted from the liability to pay compensation for the related damage if it can prove that the breach was a result of circumstances that were beyond its control and that could not be foreseen at the time when the contract was signed, and it could not be reasonably expected to avoid the circumstance or to avert the damage or loss.

[13] The circumstances that are beyond a party's control cannot be listed exhaustively, but typical examples include traditional vis maior events such as war, revolution, closure of shipping routes, a pandemic in certain circumstances, and natural disasters. Similarly, certain government measures, such as export and import restrictions, embargoes and foreign exchange limitations also qualify as circumstances that cannot be controlled by the parties to a contract. Finally, a party can in exceptional cases be exempted from the liability for damages due to radical changes in the market (drastic price increases, hyperinflation or a financial collapse).

[14] Courts treat a circumstance as being beyond the control of a party if the party does not have the power to influence it. It is important note, however, that being in control is an objective standard, and what is known as "internal vis maior" will not exempt the party from the liability for a breach of contract. For example, events associated with the party's operations, its organisation of the process of performing the contract, the conduct of its employees or problems in its supply chain must be treated as circumstances within its control. A party may be exempted from liability for a breach of contract on the basis of objectivised factors, and this basically involves the transfer of risks. It is a clear legislative objective that the liability should be stricter than fault-based liability for damages in tort. The fact that the party in breach of a contract is not in the position to have influence over a circumstance will not in itself mean that such circumstance should be considered as being beyond its control.

[15] The second condition is that the circumstance should not be foreseeable on the date of the contract. Foreseeability must be examined objectively.

Consequently, the party in breach of a contract will not be exempted from liability if a reasonable person in the same position could or should have anticipated the relevant circumstance. There is a point in time in the case of most vis maior events from which the parties should reckoned with the possibility that the relevant circumstance might occur.

[16] The third condition that must be met in order to be exempted from liability is that there should be no reasonable expectation for the party in breach to avoid or avert the circumstance. The assessment of unavoidability is based on the date of the contract. Unavoidability sets the limits of the efforts that the party can be reasonably expected to exert in order to perform the contract. This condition is typically met when the party in question was not in the position to influence the event that caused the damage. In terms of repairing the damage, the party should act as it can be reasonably expected in the given situation. The reasonable expectation is the that party should proactively take all measures that it has a realistic chance to take in order to prevent or repair the damage. If this limitation was not in place, a party in breach of a contract could be exempted from liability for damages only in the most narrow cases of vis maior. It is an often cited example in legal literature that if railway traffic was limited to tunnels or walled-in tracks, damage caused by trains could be avoidable, but the absurdity and economic unviability of such a setup is easy to see.

Summary

[17] *Pacta sunt servanda: contracts must be performed – even if the performance becomes difficult or disadvantageous for a party over the life of the contract.* A party can only be released from the obligation to perform a contract and be exempted from the related liability if certain specific and strict conditions are met. This may include judicial contract modification and economic impossibility of performance.

[18] In the second part of our series, we will discuss international practices and show how continental and common law systems approach the issue of changes in economic circumstances.

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