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CONSTRUCTION PAPERS

When can contractors claim additional and downtime costs?

Enforcing claims for unanticipated costs that are not included in flat-rate fees can often create headaches for contractors. In this, the third article of our four-part series, we discuss the nature of costs that are incurred by contractors outside flat-rate fees, and how these can be recovered. We also describe the various types of fees and cost reimbursements that may exist for contractors in this category. Finally, we examine the conditions under which the unforeseeable costs of additional work resulting from the prolongation of a project for reasons beyond the contractor's control can be recovered.

What is and what is not included in flat-rate fees?

[1] **General rule: flat-rate fees include all fees and (additional) costs:** The general rule holds that the contractor is liable for performing the agreed works within the time limit and budget it calculated, and it must bear the related risks. Therefore, with the exceptions described below, a contractor may not demand additional fees or cost reimbursements for its performance of the works in accordance with the technical specifications stated in the contract. **As a rule of thumb, flat-rate fees not only include anticipated, but also unforeseeable cost increases.**

[2] **Key cases where fees and cost reimbursements can be due over flat-rate fees**: fees for (and costs of) extra work, [Civil Code, Section 6:245(1)], unforeseeable costs of additional work [Civil Code, Section 6:245(1)], damage, loss and additional costs resulting from disruptions [Civil Code, Section 6:150(1)].

What kind of fees and cost reimbursements can apply in excess of flat-rate fees?

[3] **Distinction between extra work and additional work:** Extra work means work resulting from modifications of the technical specifications (typically, of plans and designs) that the contractor could not be expected to anticipate when the contract was signed, and therefore such work could not have been included in its fee calculations – hence it is entitled to additional fees. In contrast, additional work includes activities that were always going to be necessary to perform the contract in line with the original technical specifications (i.e. activities that are not related to any modification) but that, for some reason (such as later developments) represent higher costs than what the contractor calculated with. The contractor is responsible for preparing an accurate budget and it bears the risk of cost increases, and therefore the general rule holds that it is not entitled to any fees or cost reimbursements on account of extra work. The contractor can only recover extra work-related costs if such costs were unforeseeable when the contract was signed.

Summary table (* *flat-rate contracts*)	**Additional work**	**Extra work**
Technical specifications	Modified.	Not modified.
Fee	Cannot be claimed.	Can be claimed.
Cost reimbursement	Only costs that were unforeseeable on the date of the contract can be claimed.	Can be claimed.

[4] **Unforeseeable costs of additional work**: the contractor must bear the costs associated with additional work, i.e. work that are within the scope of the technical specifications or are necessary to complete the construction project or to guarantee fitness for purpose, even if it failed to include such costs in its calculation of the flat-rate fee. However, in order to ensure a fair and equitable allocation of risks while in keeping with the above principles regarding restrictions on contractual commitments and cost payments, certain special exceptions have been introduced. The limits on a contractor's risk has been established on the basis of the foreseeability standard. In the light of the relevant judicial practice and legal literature, the main categories of the recoverable costs of additional work are as follows:

- Costs associated with *additional work that must be completed out of a technical necessity* are a risk-sharing issue: work items that are unforeseeable and therefore cannot be planned for or included in the budget should be paid by the contractor in the light of the nature of flat-rate fees and the contractor's obligation to produce a result. The costs of works that are not included in the plans but are technically necessary can be exceptionally recoverable if, in the light of the circumstances of the case, and the nature, volume and cost of suck works, the contractor could not have anticipated the need for such works in its calculation of the fee even with due care *(e.g., obstacles hidden underneath the wok site*).
- *Soil risks:* Judicial practice has held that soil properties that are not apparent (different from what could be reasonably assumed) can serve as grounds for the contractor to claim additional costs. In a widely cited case, the contractor successfully claimed additional costs by arguing that the developer had issued an

erroneous soil mechanics opinion, stating that the contractor would have to remove 200 cubic metres of loose soil. Once work started, however, the contractor found that 3,000 cubic metres of soil had to be removed in order to guarantee that the building could be built safely.[1] In another case, the court held that the contractor could not be reasonably expected to reckon with the possibility of ammunition and other explosive ordnance being buried in the ground. The court found that the circumstances discovered in the excavation of the work site constituted an extraordinary situation and served as grounds for the contractor to charge additional costs.[2] Various items hidden underground are considered in the relevant legal literature as risks that, in the right circumstances, can entitle a contractor to make a claim for additional costs.[3]

[5] **Conditions for recovering the costs of additional work:** Hungarian and international cases suggest that the following conditions should be met:

- *Cause beyond the contractor's control:* If a contractor influenced or, with due care, could have influenced the circumstances that later caused disruptions in its performance, it may not claim additional costs on their basis.
- *Foreseeability:* A contractor may not rely on circumstances that it could have foreseen with due care and it may not seek the recovery of costs that contractors acting reasonably and prudently generally reckon with.
- *Avoidance and mitigation of costs:* A contractor is expected to perform a contract in accordance with its original terms (in the agreed quality, within the agreed deadline and in line with all other agreed terms) even it has to reorganise its work processes and use additional resources due to unforeseeable circumstances. Consequently, the additional costs incurred with such reorganisation and additional resources will have to be borne by the contractor. However, the contractor cannot be expected to bear a disproportionately large part of unforeseeable costs.
- *Material changes (in costs) that go beyond normal business risks:* A contractor may not pass on general risks that are typically accepted and known in the given industry and may not recharge the costs related to such risks. Contractors may only seek the recovery of costs associated with disruptions that go beyond normal business risks and disrupt the entirety of the project.
- *Information or "warranties' provided by the developer:* It has an fundamental impact on the treatment of additional costs if the contractor calculated with certain factors on the basis of circumstances that existed on the contract date or on the basis of information provided be the developer, and such circumstances and information later turn out to be untrue. In the first case, the rules described above apply. In the second case, however, the question that should be analysed is whether it is information that the contractor should have checked or it is a quasi "warranty" on the developer's part, and the contractor could not be expected to factored in any other information.

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[1] Bartal, Géza: A vállalkozási típusú szerződések In: WELLMANN, György (ed.): Az új Ptk. magyarázata VI/VI, second revised edition, Budapest, 2014, p. 94

[2] BH1998 124

[3] See: BARTA, ibid p. 21: "Unforeseeable additional work is additional work that is necessary to make the structure fit for purpose, but the value of which could not be calculated by the contractor in advance before the contract was signed, because the work itself was not foreseeable (e.g. underground contamination, explosive ordnances, caves or springs, corrosion in the case of covered structures, or harmful substances, etc)."

[6] **Losses due to inflation:** As noted above, the general rule holds that the contractor must bear additional costs. As opposed to a service provider acting on the basis of a process-based service contract, a building contractor cannot obtain exemption for its delays and cannot recover its unexpected costs even if it acted with reasonable due care and the works still could not be completed within the original budget. A contractor can only recover its unexpected additional costs and be excused for a breach of contract in a limited set of exceptional cases:

If a contractor wants to be released from the obligation to perform a contract with its original terms, it can have two objectives: a) the restoration of the balance of value under the contract, and b) obtaining exemption for the non-performance of the contract. There is an obvious difference between these two options: in case a), the contractor continues to perform, albeit with modified terms, e.g. for the payment of its additional costs; in case b), there is no performance and the contractor tries to mitigate the consequences of its breach. In addition to these practical differences, the two cases are also different in terms of the available legal options.

- *Restoration of the balance of value with contract modification:* this is possible in two ways. Firstly through judicial modification, and secondly by demanding the reimbursement of additional costs. Both can only be used in exceptional cases, where the balance of values under the contract have been materially upset due to circumstances that were unforeseeable on the date of the contract, that are beyond both the parties' control and that cannot be reasonably seen as being within the realm normal business risks, with a harmful effect on the contractor's vital interests.
- Managing a breach of contract: If the performance of a contract would place undue hardship on the contractor due to circumstances that were unforeseeable on the contract date and are beyond the contractor' control, and the balance of value cannot be restored, the only options that remain are the termination of the contract (on the grounds of impossibility) or exemption from the liability for damages. The cases where either of these options is available are very rare.

[7] **General principles with regard to price inflation:** The question of which option (judicial contract modification / claiming additional costs / impossibility / exemption from liability for damages) should be used must be examined on a case-by-case basis. In any event, if a contractor can prove the existence of the following factors, it can improve the chances of successfully using any of the options:

- **Unforeseeable circumstance:** The primary case where a party can be released from its original obligations under a contract is if there is a circumstance that could not be foreseen on the contract date and is beyond the parties' control. An event is considered unforeseeable if a similar company with similar experience and in a similar situation, proceeding with due care, could not have anticipated it even as a worst case scenario. It is important to note, however, that if a contract is modified, the general rule states (and must be applied e.g. in the absence of a reservation of rights clause with sufficiently specific language) that the date of the modification will qualify as the reference date for the purposes of foreseeability. For example, if the Ukraine war was not foreseeable when the contract was concluded but had already broken out when it was modified, the possibility of enforcing a claim might be lost. Consequently, parties should always proceed carefully in the modification of contracts.

- **Uncontrollable (vis maior) circumstances:** An event qualifies a uncontrollable if **similar companies were also not, and could not have been, in the position** to control or influence the event itself or its consequences. The events in this category are typically vis maior events, such as epidemics, wars, embargoes, border closures and the collapse of entire supply chains. It is important to note, however, that citing a vis maior event in general (e.g. the coronavirus) is not enough; the specific aspects of it that have a direct impact on the contract must be identified and demonstrated (e.g. that a factory halted production due a quarantine, and therefore materials had to be purchased elsewhere at a higher price).
- **Price increases beyond normal business risk:** A circumstance goes beyond normal business risk if, as its result, performance of the contract places hardship on a party to a materially greater degree than the level of risk that usually applies to the relevant type of contract. For example, this is the case where costs increase at a much greater rate than could be reasonably anticipated in the light of the general levels of past market volatility. The reference point for the comparison of costs is the date of the contract. The amount that can be claimed as unforeseeable additional cost is the balance of the amount agreed in the contract as increased by the rate of general market volatility and the amount that was actually incurred, since any cost increases must be borne by the contractor up to the level of general business risk. In the calculation of a cost increase, the decision on the question of a) how the amount of costs used in calculations on the contract date can be proved and b) which period should be used for the determination of general market volatility must be made on a case-by-case basis. The first can be easier if there is a priced bill of quantities. If it is not available, the general level of costs on the date of the contract can be a starting point. The additional costs actually incurred is also a key question, and invoices related to the project might be needed to prove this amount. This can be more problematic if a contractor buys materials on a continuous basis rather than specifically for a given project. In such cases, the solution can be if the total cost is averaged out among all ongoing projects.
- **Direct *causal relationship*:** Whether the attempt to enforce a claim is successful will be fundamentally determined by the degree to which the additional cost **can be defined as a direct and unavoidable result of the vis maior event**. In addition to determining the specific effect of the vis maior event on the project, it must also be demonstrated that its negative consequences were unavoidable. The more specific and clear the negative impact of the vis maior event on the project is, the better the contractor's chance of successfully relying on it to enforce its claim will be. For example, statements with figures that demonstrate the negative impact on the project might be appreciated a lot more (both by the developer and the courts) than general references to major energy price hikes due to an epidemic or a war. Such negative impacts can include the need to reorganise and reschedule certain works or to replace a supplier for an unforeseeable reason (curfew applicable on the worksite or supply disruption due to a war). Generally, it can be a useful approach to present the cost increase as a result of the disruptions created by the vis maior event in the completion of the project. In other words, it is advisable to present the cost increase as a specific consequence of the events that disrupted work on the given project (e.g. through problems in the supply chain) rather than in separation (e.g. with invoices).

Recommendations

Specific definition of costs and risk allocations in the contracting phase

[8] **Prevention of disputes about extra work with clear and detailed technical specifications:** Exact and detailed technical specifications offer the most efficient way to avoid the risks associated with extra work and additional work. It is a widespread practice to address this issue in contracts with detailed rules regarding these matters, but this usually results in the overcomplication of the definitions, and therefore in even more uncertainties. The Civil Code provides a clear enough distinction with the definitions of extra and additional work, and courts can apply these definitions consistently. Therefore, when it comes to a lawsuit, the dilemma usually does not lie in the differentiation of these two concepts but in answering the question of whether a particular work item was part of the technical specifications or not. **Consequently, the primary focus should always be on an accurate definition of the technical specifications.** For a more detailed discussion of this matter, please read the first article in our series.

[9] **Agreeing on items that can and cannot be included in price calculations:** Another similar problem can be the existence of factors that are not part of the technical specifications and the contractor is unable to assess them properly and include them in its budget. When this is the case, **it is advisable to agree on pricing principles and assumptions that will be applied if an assessment cannot be made**, and to state the price and cost reimbursement adjustments that should be used if the actual situation materially differs from such principles and assumptions.
Subsoil risks are the best example for these kinds of situations. The contractor is rarely in the position to assess these when it submits it bis, and therefore its budget will be based on estimates, assumptions or information provided by the developer. In order to avoid later misunderstandings, this should be expressly stated in the contract, specifically noting that the contractor's calculations are based on information provided by the developer, and that the contractor was not requested nor had the opportunity to review such information, and therefore it treated the information as facts that did not require verification (quasi "developer's warranties").

[10] **Defining a minimum downtime fee (penalty):** In the light of how onerous the administrative tasks concerning the recovery of costs associated with time extensions can be and how difficult it is to prove the actual amount of such costs, it is a good idea to specifically state in the contract what cost reimbursements (liquidated damages / penalty) the contractor will be entitled to if the time required for the completion of the project is prolonged by the developer.

[11] **Escalation clauses:** Escalation clauses, which are typically used in English speaking countries but are sometimes also used in Hungary, can offer an adequate solution for the management of the impact of major price increases or inflationary processes. Escalation clauses can apply to all possible costs generally but can also target certain specific costs. Depending on how the parties set it up, an escalation clause can address the management of unexpected cost increases on the basis of the parties' agreement once the price increase occurred, or automatically with the use of an

algorithm. For example, a model escalation clause that is widely used internationally is included the FIDIC Yellow Book.

Enforcing claims based on extra work

[12] **Claims for extra work fees:** Developers often give informal (even verbal) instructions to contractors to carry out work beyond the agreed technical specifications. The fact that a developer does not make a formal order for extra work may be explained by strategic considerations but can also be the result of a simple misunderstanding. **Whatever the reason, if a contractor concludes that the developer wants it to perform work that is not included in the originally agreed technical specifications, letting the developer know this is definitely a good idea** – preferably noting that the contractor treats this is an order for extra work and will charge extra fees for it. If possible, the first notice should state at least a ballpark figure for the fees (and cost reimbursements) that the extra work will entail.

[13] **General advice on claiming fees and cost reimbursements for extra work:** As with any claims that concern more money as a result of more work performed, the first step that a contractor should focus on in connection with claims for fees and cost reimbursements with regard to extra work is to provide detailed and prompt information to the developer.
The contractor should let the developer know what circumstances (disruptions / unexpected events / orders for extra work) resulted in the claims for the extra money, how the contractor intends to respond to these circumstances, and what impact they will have on the project, the deadlines and the costs (payable by the developer). It might be a good idea to seek the developer's involvement in the planning of the response and to allow it to ask questions and make suggestions. This way the contractor will be aware of potential complaints and can even prevent them altogether.

Claiming extra fees and cost reimbursements due to the prolongation of the project

[14] **The meaning of prolongation cost:** Prolongation cost is cost that is incurred by the contractor solely because the completion of the project takes longer than originally expected due to a disruption caused by the developer or by a vis maior event. The enforcement of a claim for this cost may by partially excluded if the contractor's delay has contributed to the prolongation.

[15] **Options to claim prolongation costs:** Under Hungarian law, prolongation costs can claimed on two grounds: as the cost of additional work in the case of a vis maior disruption [Civil Code, Section 6:245(1)], or as damages for a breach of contract in the case of a disruption caused by the developer (Section 6:142).

[16] **Types of prolongation costs:** The prolongation of a project has an impact on the contractor's direct and indirect costs:
- Direct costs are those that can be directly and solely attributed to extended duration of the project. These are known as "bricks and mortar costs" and include direct variable costs (such as lease fees for equipment), and are mostly related

to the need for additional works and additional materials. These costs will inevitably (and often proportionally) increase with the prolongation of the project.

- Indirect costs cannot be directly and solely attributed to the prolongation, but are nevertheless closely related to it. Such costs include overhead costs that directly serve the purposes of the completion of the project. General costs associated with the contractor's operation and management, i.e. head office overheads, also belong to this category. If the completion of a project is delayed, these overhead costs globally increase, and the contractor can seek the recovery of a part of these costs.

[17] **Different calculation methods:** The distinction between direct and indirect costs is also important because the contractor will have to employ different strategies in order to recoup each. Proving the valid existence of direct costs is easier, because it is generally sufficient to demonstrate that price increases happened and that inflation would not have affected the project if the project duration had not been extended.
On the other hand, enforcing a claim for indirect costs is always more difficult and sometimes just simply not possible. In this case, demonstrating inflation and the prolongation of the project is not enough – further calculations will be needed to prove that additional costs were incurred and how these should be allocated.

[18] **Additional overheads versus lost opportunity cost:**
In cases where the actual costs can be demonstrated (e.g., if it can be proved which specific costs of additional materials or management costs would not have been incurred if construction had not been delayed), it is sufficient to list the relevant invoices and accounting documents. For example, if a project manager is only employed for the purposes of a specific project until its completion, the contractor will have to pay the manager's salary for duration of the delay. ("Additional overheads")
However, if the costs cannot be so clearly demonstrated – for example because the contractor would like to claim costs for the additional workload of its permanent staff – a reverse logic must be applied. In the case of such costs, the contractor will not have to show the costs that would not have been incurred (since the costs associated with a permanent employee will be incurred regardless of any delay in a given project), but demonstrate which fixed costs it could have recovered in another project had its resources not been tied up in the delayed project. ("Lost opportunity cost")

[19] **Issues regarding the demonstration of actual costs:** Although demonstrating actual costs is somewhat easier than lost opportunity cost, the related administrative tasks can nonetheless be burdensome. For example, it is not always possible to show which materials were purchased for the purposes of a specific project, and how earlier and how cheaper the contractor could have purchased them were it not for the delay. If these factors cannot be shown, various public databases and market information, primarily the Hungarian Statistical Office's construction price index should be used as the starting point. On the basis of this data, mathematical formulas should be used to demonstrate that, as a result of the delay, costs were higher than what was originally anticipated and agreed in the contract. Therefore, the balance between the original costs (which were rendered obsolete by the delay) and the increased costs have to be paid by the contractor, and it is entitled to recover it from the developer. There are several models that can be used to calculate this balance:

- price changes pertaining to the projected mean time to completion,
- balance of price changes on the basis of the contractual assumption of risks,
- additional costs resulting from change in the price of work items,
- statement of additional costs resulting from price changes.

[20] **Demonstration of non-recovered costs:** The central costs of company management is a typical example for costs belonging to this category. A contractors can seek to recover non-recovered costs in the form of a claim for damages on the grounds of a breach of contract. In order to do that successfully, the contractor will have to prove the existence of all three of the following conditions:

- *Lost income*: income that the contractor could not realise during the extended time of the project. The amount of expected but not realised income can be demonstrated on the basis of historical data, such as the figures stated in the audited annual report for the previous three years.
- *Tied-up resources*: the contractor could not realise the income because its resources were tied up in the delayed project. The contractor will have to show that other, objective factors did not contribute to the loss of income, i.e. that probably there were other projects that the contractor could have taken on if its resources had not been tied up (e.g. with the number of tender invitations and contract award procedures).
- *Cost allocation*: as these are primarily overhead costs that cannot be directly allocated to specific projects, some form of mathematical operation is needed in order to quantify that part of lost central income which can be allocated to the delayed project. Cost allocation can be determined with the following formulas, which are widely used internationally:

Hudson formula:

$$\frac{\text{Head office overheads + profit}}{100} * \frac{\text{contract fee * period of delay}}{\text{contract term}}$$

Head office overheads + profit: the percentage represented by head office overheads and profits in the bid.
The Hudson formula has been criticised because the calculation is based on a number that already includes head office overheads and profits, and therefore the result can be inaccurate.

Emden formula:

$$\frac{\text{Head office overheads + profit}}{100} * \frac{\text{contract fee * period of delay}}{\text{contract term}}$$

Head office overheads + profit: percentage of head office overheads and profits (actual).
As with the Hudson formula, the Emden formula is also criticised for its assumption that the average weekly turnover projected at the start of the project will remain constant during the delay, which raises the issue of potential double recovery.

Eichleay formula:
Step 1: determination of head office overheads that can be allocated to the contract as follows: final contract fee (without the claim for head office overheads) divided by the total income realised over the contract term, multiplied by head office overheads incurred during the actual period of performance.
Step 2: dividing the figure produced in step 1 by the number of days of the actual period of performance in order to determine the daily amount.
Step 3: multiplying the figure produced in step 2 by the number of days of the delay that serves as the basis for the compensation.
The benefit of the Eichleay formula is that it calculates the average weekly turnover on the basis of the final bill for the relevant works and the actual time required for the works (rather than projected time), as the head office overheads allocated to the contract and profit recovery will not be duplicated in the sum produced by the formula. Additionally, the formula is based on the assumption that head office overheads are spread out evenly over the entire term of the contract.

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Authors: Bence Rajkai and Anna Nánási

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Our mailing address:
CERHA HEMPEL Dezső & Partners
1011 Budapest
Fő utca 14-18.
Hungary

E-mail:
bence.rajkai@cerhahempel.hu
anna.nanasi@cerhahempel.hu