SECURING PERFORMANCE AND PAYMENT IN CONSTRUCTION PROJECTS:

A COMPARISON OF INDUSTRY PRACTICES IN HUNGARY AND IN THE U.S.

by Domokos Kocsis

LL.M. SHORT THESIS
COURSE: Comparative Secured Transaction Law
PROFESSOR: Professor Tibor Tajti
Central European University
1051 Budapest, Nádor utca 9.
Hungary

ABSTRACT

In this research paper I will concentrate on the various legal methods and practices used in the United States and in the Hungarian construction industry by its participants with the purpose of securing and defending themselves. I will focus on two key aspect, which are vital in every construction project: due performance and due payment. Hence, I will make a thorough legal analysis of the published template construction and security agreements, which are proposed by the appropriate private US contractor associations or by the governmental bodies in respect of Hungary. Furthermore, I will also examine the peculiarities of these recommended legal devices, and – with the assistance of court cases – clarify those statutory rules that have an impact on the progress of construction projects in respect of the two aforementioned aspects. Finally, I will propose an optimal synthesis of the legal devices used in each jurisdictions.

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INTRODUCTION

In the construction business, the issues of getting and furnishing security are one of the most important aspects, which the relevant parties must consider. These issues might be game changers, considering the fact that the main purpose of securities is to act as a defense against calamities and serve as a protection. In construction projects – originating from the very nature of the construction activities – delays, improper performance and other problems might frequently appear. In the US alone, contractors have a failure rate of 26%.[1] The main reasons are drastic financial or economic changes, unforeseen changes in respects of jobs, or a key employee's illness or death. However, other factors also play an important role, which might be accounting or management issues, unrealistic expansion into a new type of activity or into a new geographical area or performance issues.[2]

The question of the types of the securities used in construction projects is also relevant since a default or a delay in a construction does not only affect the contractor, its subcontractors or the owner itself, but the lender or other financing party as well. It should be also considered that if the construction project is a major one, then such default or delay may have a huge impact not only for just one creditor, but it might affect a considerable part of the whole financing industry, considering the possibility of a syndicated credit agreement.

With my paper, I intend to examine and outline the methods that are used by the actors in the construction industry in order to hedge or limit their liability and to ensure the smooth completion

[1] Why Do Contractors Fail. Surety Information Office. http://c.ymcdn.com/sites/www.surety.org/resource/resmgr/LearnAboutSurety/Why_Do_Contractors_Fail.pdf. Last accessed on March 04, 2017.
[2] Ibid.

of their projects. However, considering the nature and the vastness of the topic, I will narrow down the scope of my research to the questions of:

1) how the owners ensure that faulty or delayed performance, or the required repairs/corrections inevitably occurring after the construction's completion are duly performed and remedied by the contractors; and

2) how the construction industry ensure that the contractors are being paid and how they prevent gridlocks, e.g. the situation where the main contractor fails to duly pay its subcontractors, although it received due payment from the owners.

In order to answer the above questions properly, I will first point out some peculiarities of both jurisdiction regarding the construction industry, since I believe this information are vital for duly understanding the emerged issues and the given answers. Secondly, I will examine the most important template agreements used by the construction industry in each respective jurisdiction. These are published either by professional associations, or – in case of Hungary – by the government and the chamber of commerce. Usually such template agreements contain a balanced allocation of risks to the project participants, considering their ability to control such perils.[3] Among others, these risks might be related to completion, permitting problems, price, operation or resources, etc.[4] The reason behind this balance is that the ultimate purpose is to successfully finish the construction without any additional dispute or litigation. This is the most effective way to reach this goal and it is the interest of all participating parties.[5] Thirdly, I will deal with the most

[3] Klee, Lukas. International construction contract law. Chichester, West Sussex: John Wiley & Sons, 2015. p. 16.
[4] Wood, Philip. Project finance, securitizations, subordinated debt. London: Sweet & Maxwell, 2007. pp. 6-7.
[5] Ibid.

vital statutory provisions set out by the US and Hungarian legislations, and in order to highlight some interesting litigated issues, I will take a look at certain court judgments.

Nevertheless, no thesis is free of limitations, and mine is no exception from that rule: while there is an abundance of US template construction agreements and US cases, in Hungary the available court cases are limited in their numbers. I believe this might be the reason of the sheer size of the Hungarian economy and the relatively smaller number of construction projects. Furthermore, another limitation of this paper is that it does not cover all of the accessible cases published about the above questions, since it would require a significantly lengthier research, which – I think – might be the topic of a S.J.D. research. Moreover, in respect of the United States, I will only cover the federal level in respect of statutory law applicable for public construction projects. However, considering the fact that the actual construction projects are governed by state law, the analyzed court cases will be inevitably dealing with state law.

As it is shown within the following chapters, the two jurisdictions adopted different approaches to address the same problems. Thus, I believe that this paper might be an engaging reading for those interested in these questions. Moreover, I am of the opinion that – since both the US and the Hungarian legislature and the construction industry adequately solved the emerged issues to some degree – this thesis might be also interesting for those jurisdictions, which still struggle with the aforementioned problems.

CHAPTER I

Securities Typically Used by the US and Hungarian Construction Industry

1. The Specialties of the Construction Industry in the United States

The construction industry in the United States relies heavily on the concept of surety bonds,[6] which might be used for almost every aspect of a construction project against risks: for the bidding process, for the construction, for maintenance and for securing payments for the subcontractors. A surety bond is essentially a guarantee, in which the surety of the bond undertakes to perform an obligation (usually in the form of payment) for the beneficiary, if the contractor (in US legal terminology the "*principal*") fails to duly perform its obligation towards the beneficiary (which is usually the owner of the project or the owner of the construction agreement). Generally, both the surety and the contractor are jointly and severally liable towards the owner. Under common law this means that the owner may have the possibility to sue in its discretion either the contractor or the surety for the full amount. Of course, it has the possibility to sue both of them jointly or each of them separately at the same time. Each of such bonds has an amount stated therein, which indicates the upper level or the liability undertaken by the surety (with US legal terminology the "*penal sum*" or the "*penalty amount*").[7]

If the owner successfully claimed the amount from the surety, then theoretically the surety may claim the same amount from the contractor,[8] thus this a major difference between suretyship and

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[6] Dan Donohue and George Thomas. "Construction Surety Bonds In Plain English." Construction Surety Bonds in Plain English. 1996. http://www.attny.com/gci32djd.html. Last accessed on March 04, 2017.
[7] Ibid.
[8] "What is JOINT AND SEVERAL?" The Law Dictionary. http://thelawdictionary.org/joint-and-several/. Last accessed on March 23, 2017.

insurance. Although suretyship and insurance has common characteristics (e.g. both risk transfers and they provide for financial loss), but they are significantly different both in economic and in legal sense. Apart from the aforementioned, other major differences include that the risk remains with the contractor, and that it is not spread among the participants.[9]

The US courts established in a series of cases that although surety bonds and insurance are similar, but not the same, and the issuer of such bond is obliged to act in good faith towards both parties. For illustration, I refer to a case judged by the Supreme Court of Arizona.[10] According to the facts, the owner contracted a construction company for building a house. The contractor furnished a performance guaranty, but subsequently he was in default and the owner initiated lawsuit against the surety, claiming that the surety refused to pay and to investigate the notice. Within the lawsuit, the Arizona Supreme Court declared that "*our statues make clear our legislature's intent to include sureties within the coverage of insurance statutes*", and that "*a contractor's default has the potential for creating great financial and personal hardship to a homeowner. Surety insurance is obtained with the hope of avoiding such hardship*".[11] But even more importantly, it concluded that "*a surety has a duty to act in good faith in responding to its obligee's claims that the principal has defaulted*".[12] The same relationship between the insurance and the surety bonds was also highlighted by a Californian court, stating that "*we recognize liability insurance is not identical in every respect with suretyship. But we are not concerned with the differences between suretyship*

[9] "About Surety - The Surety & Fidelity Association of America (SFAA)." The Surety & Fidelity Association of America (SFAA). http://www.surety.org/?page=AboutSurety. Last accessed on March 07, 2017.
[10] Dodge v Fidelity and Deposit Company of Mariland, 161 Ariz. 344; 778 P.2d 1240 (Supreme Court of Arizona, 1989).
[11] Ibid.
[12] Ibid.

and liability insurance. We are concerned with whether the Legislature included suretyship among the classes of businesses it intended to regulate under the Insurance Code. It clearly did so."[13]

Surety bonds are not a novelty in the US market, and on the basis of the available cases and literature, it can be assessed that they were commonly used even in the 1920-30's.[14] Surety bonds in the US exist in various types and with purposes.[15] Although there is no strict *numerus clausus* for them, the main types include a) bid bonds, b) performance bonds, c) maintenance bonds and d) payment bonds. Within chapter II will deal with bond types which secure performance (which are the bid, the performance and the maintenance bonds), while the payment bonds are analyzed in Chapter III.

In theory and in the legal sense, any person is entitled to issue surety bonds for construction projects. However, in practice, the situation is different. Further differentiating is also required whether the construction is a public or a private one. There are also over 50,000 of different surety bonds in the US, and each bond has a separate designated amount.[16] The risk is determined in a case-by-case basis (considering the unique requirement of the project, the contractor, its operation history and background, etc.), and the surety bond premium is usually in the range of 1-15% of the bond amount.

Currently there are two major associations, which publish template agreements for private construction projects. These are the American Institute of Architects (AIA) and the Associated

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[13] General Ins. Co. v. Mammoth Vista Owners Ass'n, 174 Cal.App.3d 810, 824, 220 Cal.Rptr. 291, 298 (Court of Appeal of California, Third Appellate District, 1985).
[14] Saddler, Walter Clifford. Legal aspects of construction. 1959. p. 196.
[15] "The Importance of Surety Bonds in Construction." 2012. http://c.ymcdn.com/sites/www.surety.org/resource/resmgr/LearnAboutSurety/Importance_Of_Surety_Bonds_I.pdf. Last accessed on March 8, 2017.
[16] "Find a Surety Bond in Your State." SuretyBonds.com. https://www.suretybonds.com/states.html. Last accessed on March 23, 2017.

General Contractors of America (AGC) publish popular contracts.[17] Although other template agreements might exist, but with reference to the limitations set out in the introductory part of my thesis, I will analyze the template contracts published by these two institutions.

The AIA is a community of over 90,000 members with a national headquarter in Washington, DC and over 250 chapters worldwide[18]. As an association for architects, it empowers architects and design professionals, and provide resources and help for its members to work smarter and better.[19] Its webpage contains a significant number of different construction agreements designed for various purposes.[20] In the following Chapter II-III, I will analyze out of this big collection only the contract which i) sets out the general terms and conditions, ii) is intended to use for large projects and iii) is designed to provide rules specifically for bonds.

The other association, the AGC is the leading association for the construction industry, and it "*represents more than 26,000 firms, including over 6,500 of America's leading general contractors, and over 9,000 specialty-contracting firms*. *More than 10,500 service providers and suppliers are also associated*".[21] The association's legal database contains an abundance number of different agreements for various purposes.[22] Out of them, in the subsequent chapters I will analyze i) the Agreement no. 200 with the title 'Standard Agreement and General Conditions Between Owner an Contractor', ii) the Agreement no. 260 on performance bonds and iii) the Agreement no. 263 on warranty bonds.

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[17] Dan Donohue and George Thomas. "Construction Surety Bonds In Plain English." Construction Surety Bonds in Plain English. http://www.attny.com/gci32djd.html. Last accessed on March 06, 2017.
[18] "About the AIA." AIA. https://www.aia.org/pages/3711-about-the-aia. Last accessed on March 07, 2017.
[19] Ibid.
[20] The database is located at https://www.aiacontracts.org, and the agreement samples are accessible free of charge.
[21] "About Us." About Us | Associated General Contractors. https://www.agc.org/about-us. Last accessed on March 07, 2017.
[22] "Contract Catalog." Consensus Docs. http://consensusdocs.org/Catalog/generalcontracting. Last accessed on March 07, 2017. Note that upon registration, the number of freely accessible template agreements is 3 pieces.

In respect of statutory provisions, the private construction projects are not bound by statutory limitations. However, in case of publicly financed construction projects there are some limitations exist set out in federal level.[23] Although its counterparts (which might considerably differ from the federal act) can also be found in the legislation of each and every state for state governmental construction projects,[24] but as mentioned in the introductory part, due to the limitation of scope, this paper will not include them. Nevertheless, I mention that in certain cases similarity between the federal regulation and the state regulation can be so significant, that courts deciding in accordance with state regulation might find cases about federal provisions persuasive in some context, although within this practice interpretation is not binding.[25]

2. Peculiarities of the Hungarian Construction Industry

Regarding the available template agreements for construction projects, there is a major difference between the US and Hungary (similarly to other Eastern European countries as well). As it was discussed above, various professional associations exist in the US, which – for a long time – provide and publish risk-balanced template agreements for the participants of the industry. Although such associations exist in Hungary, but they lack the knowledge and expertise which their US counterparts possess. This led to the problem that what agreement types should be used

[23] US Code. "40 U.S.C. § 3131.
[24] "Prompt Pay Acts Set Payment Guidelines for Construction Work." Baker Donelson. https://www.bakerdonelson.com/Prompt-Pay-Acts-Set-Payment-Guidelines-for-Construction-Work-01-17-2007. Last accessed on March 23, 2017.
[25] Edward V. Crites and Joseph C. Blanner, "Payment Bonds for Public Works Contractors". Journal of the Missouri Bar. 70 J. Mo. B. 18 (January/February 2014).

in various construction projects financed by foreign institutions (e.g. World Bank or EU) or by foreign investors.[26]

Furthermore, another important aspect is that similarly to the US, in the Western European countries numerous well-established local templates exist.[27] However, Hungary lacked this kind of uniform contract or standard, which resulted in the practice that in the beginning of the 1990s the FIDIC standard form was introduced into Hungary (as well as other CEE countries) – although such standardized template agreements were often modified to the disadvantage of the contractors, thus disrupting the delicately drafted risk balance.[28] Moreover, another aspect to consider is the fact that the FIDIC agreement is an English language agreement and is usually not well suited for smaller projects due to its complexity and the required significant legal assistance.[29]

Recently, the Hungarian government realized this problem and pursued an initiative to remedy the situation by introducing a standardized Hungarian language construction template agreement.[30] According to the wording of the governmental decree, [31] the Government requested the Hungarian Chamber of Commerce and Industry (hereinafter the "*MKIK*") to draft and publish template agreements for general construction projects as well as for engaging subcontractors. These templates which might provide a more balanced and unified concept in order to provide and to secure the interests of both the owner and the contractor.

[26] Klee, Lukas. International construction contract law. Chichester, West Sussex: John Wiley & Sons, 2015. p. 386.
[27] For example, Austria – ÖNORM B 2110, Germany - VOB/B, France and Belgium – CCAG, Netherlands – UAV 1989 and 2012.
[28] Klee, Lukas. International construction contract law. Chichester, West Sussex: John Wiley & Sons, 2015. pp. 387-393.
[29] Ibid.
[30] Governmental Decree 1593/2012. (XII. 17.) on the Acts Preventing the Emergence of Gridlocks.
[31] Article 1 of the Gov. Decree 1593/2012 (XII. 17.).

In my opinion, the intention behind these initiatives was to create a relatively simply useable template agreement, which may be recommended for projects involving domestic (and not relatively sophisticated) parties. Currently, two official template exist: the first is managed by the government,[32] and the second by the MKIK.[33] In the following chapters, I will analyze them regarding that what kind of securities they offer for the industry participants for securing performance. The MKIK published four different version of agreements: for general construction and for special construction projects, and also for flat rate payment and for accounting based on items. However, due to the scope of this paper, I will analyze only those versions which handles flat rate payment for general constriction works, but it should be mentioned that the difference between the agreements using flat rate payment scheme and the accounting based payment scheme are different only on the accounting methods, thus they should have the same security instruments.[34]

The above theory (i.e. that these template agreements are targeting the smaller and not so sophisticated parties) was supported by the explanatory articles published by the MKIK.[35] In them, it is stated that these agreements were drafted in order to assist the micro and small enterprises (generally under 50 employees) and sole proprietors, and to give them a guidance during their contracting activities as general contractors or special contractors. Moreover, another purpose was that the contracts should fit the needs of the private individual owners (and who are customers in a legal sense)[36] Based on the above the MKIK wished to include a simple and short wording,

[32] "Szerződéskötés minták." E-építés portál. https://www.e-epites.hu/iratmintak. Last accessed on March 23, 2017.
[33] "Építőipari Vállalkozók Etikai Kódexe, valamint Építési szerződésminták." MKIK. http://www.mkik.hu/hu/magyar-kereskedelmi-es-iparkamara/epitoipari-vallalkozok-etikai-kodexe-valamint-epitesi-szerzodesmintak-9636. Last accessed on March 23, 2017.
[34] "Magyarázatok." Építési Szerződésminták, MKIK. http://www.mkik.hu/hu/letoltes/73454/559db. Last accessed on March 23, 2017.
[35] Ibid.
[36] Ibid.

consequently they exclude those legal devices which are usually found in contracts between bigger entities and higher contractual amount (such as parent company guarantee, notarial deed, or provisions on insurances), but would be unrealistic for small enterprises.[37] However, the explanations points out that the agreements should be duly amended on the basis of the actual case's circumstances, and legal advice might be also required. Moreover, the template agreements – at some places – contain alternative wording, and the parties are required to amend the templates based on their business negotiations. The explanatory documentation also put emphasis on the fact that the templates are not suitable for special purpose projects assisted by governmental subventions or using facility agreements from banks for sponsoring the projects. In such cases, the templates should be amended in accordance with the applicable requirements.[38]

Furthermore, the explanation point to the fact that if the agreement was concluded before a notary or it was transformed into a notarial deed after its conclusion, then the option of direct enforcement unfolds. This means that no litigation is required prior to enforcement, which might mean saving on costs, time and legal procedure. However, the template agreements do not contain such provisions.[39] I believe this might be because that notarial procedure can be costly, since they are determined based on percentage of the disputes amount – and private individual owners are especially cost aversive.

Another major factor influencing the construction industry is the issue of statutory provisions and limitation, considering that Hungary is a civil law country. Contrary to the US, where contractual freedom rules and the government has influence only over public projects , the Hungarian parliament and government has a major influence on every aspect of life, and the construction

[37] Ibid.
[38] Ibid.
[39] Ibid.

industry is not an exception. Their regulation affects both the public and private projects. In the following chapters, I will analyze that how, in which respect and to what limit have these issues an impact on the construction industry.

CHAPTER II

Different Solutions for Ensuring Performance

1. The US Approach

1.1 The Recommended Solutions of the Template Agreements

a) the AIA Template Contract

The contract with the title of 'A201-2007 General Conditions of the Contract for Constructions' – dubbed as keystone – sets forth the rights, responsibilities and relationships of the owner, contractor and architect, and governs the general conditions of the construction projects.[40] Although the agreement is lengthy, but it is surprisingly laconic in respect of bonds.[41] Nevertheless, the wording stipulates that the owner should have the right to require the contractor to furnish bonds, which requirement is set out either in the bidding requirements or in the contract documents on the date of the execution of the contract. Furthermore, this standard agreement also handles the issue when – because of a change of the owner's construction directive – the costs of premium for bonds increase in accordance with the extra work.[42]

As for a more specific (although general purpose) agreement, the AIA agreement titled "A101-2007 Standard Form of Agreement Between Owner and Contractor where the basis of payment is a Stipulated Sum" handles the relation between the owner and the contractor, and is intended for the use where the payment price is fixed. According to its description, it is suitable for large or

[40] Aiacontracts.org. https://www.aiacontracts.org/contract-documents/22076-general-conditions-of-the-contract-for-construction. Last accessed on March 06, 2017.
[41] Article 11.4 of Document A201.
[42] Article 7.3.7 of Document A201.

complex projects, and is designed for the use of the A201.[43] Nevertheless, apart from a reference to the provisions set out by the general agreement, the contract does not have any specific provisions regarding bonds.[44]

The AIA document no. A312[45] contains the template provisions for both the payment and performance bonds (the performance bond provisions are analyzed in Chapter III). The standard agreement meticulously stipulates the procedure, which might led to the termination of the construction contract and the performance of the surety. Among others, it sets out that before the owner intends to declare a contractor's default, it should notify the surety (and the parties may arrange joint negotiations on the default matter) and the owner should transfer to the surety all of the outstanding amount of the total construction price.[46] Subsequently, the surety should promptly decide one of the following options:

- "*arrange for the contractor, with the consent of the owner, to perform and complete the construction;*
- *undertake to perform and complete the construction itself (with agents or independent contractors);*
- *obtain bids or negotiated proposals from contractors acceptable for the owner for performance of the construction;*
- *make payment to the owner in accordance with its liability or deny payment and its liability*". [47]

[43] Aiacontracts.org. https://www.aiacontracts.org/contract-documents/21387-owner-contractor-agreement-stipulated-sum. Last accessed on March 06, 2017.
[44] Article 10 of Document A201.
45 Aiacontracts.org. https://www.aiacontracts.org/contract-documents/22106-performance-bond-and-payment-bond. Last accessed on March 07, 2017.
[46] Article 3 of Document A312 (performance bond).
[47] Article 5 of Document A312 (performance bond).

In case the surety fails to do so seven days after receipt of an additional written notice, the surety should be deemed in default and the owner is entitled to enforce any remedy available for it.[48] Regarding the formal requirements, it is to be signed only by the contractor and the surety, and in relation to the penal amount and any other information, the template is really flexible since all the parties need to do is just insert the numbers.

b) The AGC Template Contract

Agreement no. 200 (on the Standard Agreement and General Conditions Between Owner and Contractor) is drafted in a way that most of the time the parties needs only to tick in options, and this is also true in respect of the template of bonds.[49] According to the provisions, if bonds are needed then both performance and payment bonds are required, and both bonds should have the penal sum 100% of the construction project's price. It also prescribes that the contractor should endeavor to keep its surety advised of changes potentially affecting the contract time and contract price, though contractor should require that its surety might waive any requirements to be notified of any alteration or extension of time.[50]

In respect of performance bonds, the proposed wording is set out in the AGC document no. 260. Similarly to the AIA performance bond document, it is to be signed by the surety and the contractor. However, a major difference between the two is that it prescribes only a short and simple procedure. It provides that upon making demand on the bond, the owner should make the total amount – payable by the owner to the contractor less amounts properly paid by the owner to the contractor – available to the surety for completion of the work.[51] Afterwards, the surety's

[48] Article 6 of Document A312 (performance bond).
[49] Article 10.6 of Agreement no. 200.
[50] Ibid.
[51] Article 1 of the Agreement no. 260.

choices are the same as under the AIA performance bond agreement. However, I consider this document more owner friendly, and acts much faster if the contractor defaults the agreement.

1.2 Detailed Analysis of the Various Types of Bonds Used in the US

As mentioned above, many different types of typical and non-typical bond exist, and most widespread bond types for securing performance will be analyzed below. Nevertheless, I will put special focus on the performance bond, since in my opinion it is the most important among them in respect of construction projects.

a) Bid Bonds

"*A bid bond is a form of guarantee by a bank or insurance company for a potential customer against a tenderer's failure to sign a contract in accordance with the terms of the tender*".[52] Thus, the purpose of the bid bonds are to frighten away those bidders, who might not take the tender seriously and to grant security for the owner in case the winner – for some reasons – are unable to sign the contract. Although bonds are commonly used for this purpose, but other forms, like money orders or letter of credits are also used.[53]

The penalty amount is usually ranged between ten to twenty percent of the value of the bid,[54] and is payable by the surety towards to owner if the contractor fails to sign the construction agreement which it previously won. Often, the amount up to which the surety and the contractor is liable, is

[52] "Glossary of Terms." ACT | Glossary of Terms. https://web.archive.org/web/20090226130402/http://www.treasurers.org/glossary/B. Last accessed on March 06, 2017.
[53] Sweet, Justin, and Jonathan J. Sweet. Sweet on Construction Industry Contracts: Major AIA Documents. New York: Wiley, 1996. p. 205.
[54] "What Happens if the Construction Bond Obligation is Not Met?" Rodriguez, Juan. https://www.thebalance.com/what-is-a-bid-bond-844376. Last accessed on March 06, 2017.

the price difference between the best and the second best bid.[55] Although this type of "bid spread" is the most common, but other types also exist,[56] while some are forfeiture in nature. It means that the entire penal sum should be forfeited if the contractor fails to conclude the agreement. However, this type is not frequently used considering the fact that disputes often arise regarding the calculation of the actual damages.[57]

For private projects, the penalty amounts of the bid bonds are usually ranged between 5-10% of the bid amount, however, higher might still exist, but they seldom reach 50% of the construction price.[58] On the other hand, for public projects, the officials acting in accordance with the Miller Act may prescribe the use of such security device, and its amount should be totaling 20% of the bid amount.[59] From the economic side, contractors prefer the use of bid bonds since it is a cheaper way to provide insurance for tenders than held bank cash or credit way. Moreover, owners and general contractors also require bid bonds because they held to determine whether the bidding contractor or supplier is qualified enough to undertake the project.

Some authors argue that the given the nature of the bid bonds, the surety performs a very thorough inspection of the bidder, thus "*even an unsophisticated project owner can probably stumble through the bid process and end up with a qualified contractor simply by requesting bid bonds*".[60] However, the author claims that the bid bond does not ensures alone a risk-free construction, it only strengthen the chance of choosing a more qualified contractor.[61]

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[55] Russel, Jeffrey S. Surety bonds for construction contracts. Reston, VA: ASCE Press, C2000. p. 37.
[56] Ibid.
[57] Ibid.
[58] Ibid.
[59] Ibid.
[60] David J. Barru. „How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds With Bank Guarantees and Standby Letters Of Credit.", George Washington University, George Washington International Law Review, 37 Geo. Wash. Int'l L. Rev. 51 (2005).
[61] Idib.

In respect of court cases, a Pennsylvanian court analyzed whether a bid bond might be stretched in to a performance and payment bond.[62] According to the facts, the contractor failed to provide a performance and payment bond, it furnished only a bid bond. Although the owner permitted to continuance of the work, but later the contractor declared bankruptcy and ceased the construction. The owner tried to claim remedy on the basis of the bid bond, but the court ruled that they are separate types of devices and they offer protection against different risks.[63]

b) Performance Bonds

Performance bond (or contract bond) "*is a guarantee that a construction project will be completed in accordance with federal and state regulations as well as the terms laid out in a construction contract*".[64] If the contractor fails to perform the contract, the owner may declare it as a default and draw down the surety's obligation.[65] The majority of the construction project owners prescribes the use of both performance and payment bonds (which are discussed in Chapter III), each with the penal sum of 100% of the construction fee; however, even this dual approach might be insufficient in case the contractor defaults. [66] It is also important to point out, that although the owners might require performance and payment bonds, but the costs of such bonds are to be included into the total costs of the construction.[67] Thus, the security of the bonds furnished by the contractor is to be paid eventually by the owners.

[62] Chas. H. Tompkins co. v Lumbermens Mutual Casualty co., 732 F. Supp. 1368 (United States District Court for the Eastern District of Virginia, Alexandria Division, 1990).
[63] Ibid.
[64] "What Are Surety Bonds?" Bryant Surety Bonds. https://www.bryantsuretybonds.com/what-is-a-surety-bond. Last accessed on March 06, 2017.
[65] Russel, Jeffrey S. Surety bonds for construction contracts. Reston, VA: ASCE Press, C2000. p. 39.
[66] Ibid.
[67] Sabo, Werner. Legal guide to AIA documents. Austin: Wolters Kluwer Law & Business, 2008. p. 321.

Regarding the procedure, a performance bond should usually be handed over to the owner even before the commencement of the construction itself, considering the fact that after the start of the construction, sureties are reluctant to undertake such obligation.[68] The bond is valid until the end of the indicated time, and the surety is relieved from the obligations only when the contractor's work is done and the contract is complied with.[69]

The performance bonds have some peculiarities, which has an influence on the validity and effectiveness of the construction contract. In a case before a Florida court,[70] the contractor won the tender for a construction project. However, subsequently the owner requested the contractor to provide a performance and payment bond, which the contractor failed to do so, and the owner notified the contractor that it did not wish to sign the construction agreement. The contractor initiated lawsuit, and the court established that the owner defaulted the construction agreement with its conduct.

During the actual usage of the performance bonds, several question emerged in various US states. One question revolves around the fact that what might happen if the owner sues the contractor, but the court rules that the initiated litigation was unlawful and the contractor defended its case. In such instance, can attorney fees be calculated against the performance bond if the owner wins the case? And also, can the unlawfully sued contractor require payment from the surety for attorney's fee? Generally, unless provided by statute of contract, the parties cannot recover attorney's fees.[71] However, in some cases, the courts adopted a different approach. The Supreme Court of California ruled in favor of this approach in Mepco Services Inc. v. Saddleback Valley Unified School

[68] Russel, Jeffrey S. Surety bonds for construction contracts. Reston, VA: ASCE Press, C2000. p. 39.
[69] Sadler, Walter Clifford. The specifications and law on engineering works. New York: J. Wiley, 1957. p. 160.
[70] Terra Group, Inc. v Sandefur Management, Inc., 527 So. 2d 849 (Court of Appeal of Florida, Fifth District, 1988).
[71] Sweet, Justin, and Jonathan J. Sweet. Sweet on Construction Industry Contracts: Major AIA Documents. New York: Wiley, 1996. p. 322.

District,[72] where it established that "*since Mepco was successful in defending against the accusation, and since the school district would have been entitled to attorney's fees and costs if the verdict had been in its favor, reciprocity compelled the same result for Mepco when it prevailed*".[73] The counsel of Mepco of this case also mention in his published article, that "*the ruling in Mepco is significant because it provides contractors with the ability to recover attorney's fees through the provisions in performance bond authorizing recovery. Mepco effectively purchased the right to recover its attorney's fees when it obtained the bond that it was statutorily required to provide for the project. Under Mepco, when there is a performance bond, contractors have an alternative means of collecting attorney's fees, because these bonds ordinarily contain such a provision*."[74]

Another disputed issue was that how should it be qualified if the contractor fails to deliver the agreed performance bond, and the owner sues for damages due to its absence – although no premium has been originally paid for it. In the Metropolitan Government v Cigna case[75] the Tennessee court ruled that "*a mere breach of the contract does not entitle the injured party to damages, the injured party must have suffered actual damages because of the breach. In Metropolitan, Cigna fully performed all of its duties under the contract except executing a performance bond. Metro would have been in the same position if Cigna had executed the performance bond at the commencement of the deal*."[76]

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[72] Mepco Services Inc. v. Saddleback Valley Unified School District 189 Cal. App. 4th 1027; 117 Cal. Rptr. 3d 494; 2010 Cal. App. LEXIS 1874. (Court of Appeal of California, Fourth Appellate District, Division One, 2010).
[73] Andrew Carlton, "Practice Tips: The Tools Available To Contractors For Recovery of Attorney's Fees." Los Angeles County Bar Association Los Angeles Lawyer, 34 Los Angeles Lawyer 16 (January 2012).
[74] Ibid.
[75] Metropolitan Government of Nashville and Davidson County v. Cigna Healthcare of Tennessee, Inc., 195 S.W.3d 28 (Court Of Appeals of Tennessee, at Nashville, 2005).
[76] Brett T. Smith, "Case Commentary: Equitable Relief Remains Unavailable for Contracts Implied in Fact." The Clayton Centre for Entrepreneurial Law, University of Tennessee College of Law, Transactions: The Tennessee Journal of Business Law, 8 Transactions 210 (Fall 2006).

Nevertheless, since the suretyship is a contractual relationship between the parties, the surety has the chance to defend himself against payment requests. However, sureties are usually not completely informed regarding the actual construction's actual situation, and they rely on the information received by the parties, most notably the owner.[77] Although the surety often tries to clarify the situation with the contractor, but it is not an always easy and successful task.[78] It might happen that the owner unlawfully requests payment, but it might also happen that the insolvent contractor claims that the owner performed a payment default and this is the reason of the contractor's insolvency. Nevertheless, the most commonly used defenses by the sureties includes reference to that the surety's risk has been materially increased, the use of subrogation (e.g. the surety steps in to complete the project), citing uncompleted condition precedents or a prior material breach, claiming a fraud has been committed or relying on the statute of limitation.[79] I believe the last exception is an interesting issue. Although the underlying rules differ from state to state, but it might be worth noting that the Supreme Court of Georgia held in the United States Fidelity & Guaranty Company v. Rome Concrete Pipe Company case[80] that for a private project, the statute of limitation is 20 years, while for a public project it is merely one year after the completion of the construction project.[81]

In respect of the surety's obligation, the question arises that what is the situation if the surety deliberately acts in bad faith. In such situation, can the parties rely only on contractual breaches, or also tort damages might also be claimed. Similarly to the issue of statute of limitation, the

[77] Cheryl S. Kniffen, "A Georgia Practitioner's Guide to Construction Performance Bond Claims", Walter F. George School of Law, Mercer University, Mercer Law Review, 60 Mercer L. Rev. 509, (Winter 2009).
[78] Ibid.
[79] Ibid.
[80] United States Fidelity & Guaranty Company v. Rome Concrete Pipe Company, Inc. 256 Ga. 661; 353 S.E.2d 15. (Supreme Court of Georgia, 1987).
[81] Cheryl S. Kniffen, "A Georgia Practitioner's Guide to Construction Performance Bond Claims", Walter F. George School of Law, Mercer University, Mercer Law Review, 60 Mercer L. Rev. 509, (Winter 2009).

statutory and common law differs in each state, but it can be established that even in very similar factual situations the different state courts might follow completely opposite approaches. In a case before the Colorado Supreme Court,[82] the ruling stated that "*Colorado common law recognises a cause of action in tort for a commercial surety's failure to act in good faith when processing claims made by an oblige pursuant to the terms of a performance bond*."[83] However, the California Supreme Court ruled contrary in a similar case,[84] establishing that "*recovery for a surety's breach of the implied covenant of good faith and fair dealing is properly limited to those damages within the contemplation of the parties at the time the performance bond is given or at least reasonably foreseeable by them at the time*"[85]. Although different approaches exist, but some authors argue that "*under normal circumstances, liability for such a breach of covenant of good faith and fair dealing implicit in every contract would be limited to traditional contract remedies. Perhaps predictably, however, in states that recognize an insurance exception[86] to this general rule, project owners have also sought, and often successfully recovered tort damages*."[87]

In another court case the issue whether granted advance payment can be recovered on the basis of performance bond was analyzed by the court.[88] According to the facts, a contractor offered advance payment for its subcontractor who furnished a performance bond. Subsequently the subcontractor defaulted, and the contractor tried to recover using the performance bond, but the surety denied

[82] Transamerica Premier Insurance Company V. Brighton School District 27J; 940 P.2d 348; 1997 Colo. (Supreme Court of Colorado, 1997).
[83] Ibid.
[84] Cates Construction, Inc., et al. v. Talbot Partners et al., 21 Cal. 4th 28; 980 P.2d 407; 86 Cal. Rptr. 2d 855; 1999 Cal. (Supreme Court of California, 1999).
[85] Ibid.
[86] The author refers to that exception – which exist only in some states – that it is possible to claim tort damages in insurance agreements if the agreement is breached by the insurer in good faith.
[87] Aron J. Frakes, "Surety Bad Faith: Tort Recovery For Breach of a Construction Performance Bond." University of Illinois Law Review, 2002 U. Ill. L. Rev. Online 497. (2002).
[88] Southwood Builders, Inc. v. Peerless Insurance Company; 235 Va. 164; 366 S.E.2d 104 (Supreme Court of Virginia, 1988).

this request. Upon examination, the court established that "*the advance money is a material deviation from the original contract that established sufficient prejudice to the surety to release the surety from its obligations under the performance bond*".[89]

c) Maintenance or Warranty Bonds

Maintenance bonds "*are purchased by a contractor that protects a completed construction project's owner for a specified time period against defects and faults in materials, workmanship and design that could arise later if the project was done incorrectly*".[90] Although maintenance bonds are not very often used– it is estimated that they give only 5% of the total bonding amounts –, but they are getting increasingly popular in public and co-generation projects.[91] Moreover, maintenance bonds are commonly used together with performance and payment bonds, and usually as a bond, which is separated from the two aforesaid bonds.[92]

Regarding the economy behind the maintenance bonds, the market practice also shows that the amount of the maintenance bond is often ranged between 5%-15% of the total construction fee, but in some rare instances, it might reach up to 100%.[93] This significant difference might occur where the construction project is more complex, like in a case where the contractor is required to design, build, operate and maintain the construction, since the underlying agreement is a design and construction joint agreement.[94]

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89 Ibid.
90 Staff, Investopedia. "Maintenance Bond." Investopedia. April 26, 2010. http://www.investopedia.com/terms/m/maintenance-bond.asp. Last accessed on March 06, 2017.
91 Russel, Jeffrey S. Surety bonds for construction contracts. Reston, VA: ASCE Press, C2000. p. 45.
92 Ibid.
93 Ibid.
94 Russel, Jeffrey S. Surety bonds for construction contracts. Reston, VA: ASCE Press, C2000. p. 47.

Furthermore, another pitfall for contractors are those contracts which put responsibilities on them in respect of warranties and guarantees, which are originally undertook by the product manufacturers. If the construction contract specifies that the owner is responsible for administering such defects, then this possess no risk for the contractor. On the other hand, if the contractor should perform all administration work in respect of replacement and the required labor (and also run the risk that the defect liability might be denied by the manufacturer), then the risk is something which should be taken into consideration[95]. Thus, this have impact on both the maintenance bond coverage ratio and also on the price for which the surety issues the bond.

However, court cases also illustrates that disputes regarding maintenance bonds exist. According to a Hawaii court case,[96] the contractor furnished a maintenance bond, which to provide protection against workmanship and material defaults. After the handover of the construction, the painting was starting to defect, but the surety rejected to pay. The parties went to arbitration, where the arbitrators established that the contractor is not in breach. The Supreme court of Hawaii accepted the legal position of the surety, and established that although the surety is not permitted to delay payment, but "*it is not unreasonable for the surety to determine whether it is legally bound to pay such claims before it expends the time and expense to investigate their factual validity*".[97]

[95] Ibid.
[96] Board of Directors of the Association of Apartment Owners of the Discovery Bay Condominium v United Pacific Insurance Company; 77 Haw. 358; 884 P.2d 1134 (Supreme Court of Hawaii, 1994).
[97] Ibid.

1.3 Specific Statutory Provisions for Bonds Used in Public Construction Projects

In respect of the public construction projects, the most important statutory regulation is the Miller Act,[98] which prescribes that "*before any contract of more than $100,000 is awarded for the construction, alteration, or repair of any public building or public work of the Federal Government, a person must furnish to the Government*"[99] with performance bond and payment bond. However, the provisions do not permit "*the authority of the contracting officer to require a performance bond or other security in addition to those*"[100]. Nevertheless, it should be noted that the contracting officer's activities do have significance, and it has authority in a considerable degree. In a case,[101] the court established that the contracting officer implicitly authorized the contractor to submit different surety bonds for different phases of the same work (due to pricing issues), thus creating a difference between the security provided for the subcontractors.

In respect of executive agencies, another set of US statutory rules are also applicable for them, which aims to acquire goods or services. These rules are known as the Federal Acquisition Regulation (hereinafter the "*FAR*"). In contrary to the provisions of the Miller Act, the FAR[102] set out other threshold values, and *"requires performance and payment bonds for any construction contract exceeding $150,000*." However, for projects between $35,000 and $150,000, the contracting officer should select two or more payments protections, which types are duly listed in the FAR. Such options include an irrevocable letter of credit, a payment bond, a tripartite escrow

98 Now part of the US Code. "40 U.S.C. § 3131.
99 Ibid.
100 Ibid.
101 United States ex. rel. Sheet Metal Eng'g, Inc. v Job Shops Co., NO. 4:05-cv-00080-RAW (Lead), NO. 4:05-cv-183-RAW, NO. 4:05-cv-503. (United States District Court for the Southern District of Iowa, Central Division, 2006).
102 FAR Part 28 on Bonds and Insurance.

agreement,[103] a certificate of deposit[104] or other types of securities listed specified further (which are US bonds and checks, bank drafts, money orders or currency).

The FAR also sets out that that contracts over the threshold of $150,000 should have a performance bonds with the penal amount of 100% of the original contract price. Moreover, in case the contract fee becomes higher, then the penal amount should grow accordingly – unless the contracting officer determines that a lesser amount is adequate for the government's protection. In addition to that, the FAR also contains requirements that certain contractual clauses should be included in the construction agreements.[105] However, it should be noted that the FAR does not contain provisions regarding performance bonds for contracts between $35,000 and $150,000; as well as for contracts under this value.

Regarding the persons who are entitled to act as surety, the Bureau of the Fiscal Services maintains a list of all the approved and certified companies, and also uses circulars to update the list, which – apart from the name and business address of such reinsurer companies – also contains that in which states are they allowed to operate.[106]

[103] According to FAR 28.102-1 (b) (1) (iii), tripartite escrow agreement means that "the prime contractor establishes an escrow account in a federally insured financial institution and enters into a tripartite escrow agreement with the financial institution, as escrow agent, and all of the suppliers of labor and material. The escrow agreement should establish the terms of payment under the contract and of resolution of disputes among the parties. The Government makes payments to the contractor's escrow account, and the escrow agent distributes the payments in accordance with the agreement, or triggers the disputes resolution procedures if required."

[104] According to FAR 28.102-1 (b) (1) (iv), certificates of deposit means that "the contractor deposits certificates of deposit from a federally insured financial institution with the contracting officer, in an acceptable form, executable by the contracting officer."

[105] FAR 28.102-3.

[106] "Department of the Treasury's Listing of Certified Companies." Surety Bonds - Certified Companies, Department of Treasury. https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570_a-z.htm. Last accessed on March 06, 2017.

2. The Hungarian Practices to Secure Performance

2.1 Analysis of the Hungarian Template Agreements

The template agreement published by the governmental site is somewhat outdated because – among other reasons – the old Hungarian Civil Code[107] regulates it, which is ineffective since 2014. Nevertheless, considering the fact that an official website maintained by one of the Hungarian Ministries still publishes it online,[108] I believe its analysis is worthwhile, and the 7-page long agreement itself may contain useful information regarding the proposed securities. Below I quote the relevant clauses from the agreement, which are applicable for securing the contractor's performance:

- "*The Contractor shall secure the performance and the warranty with a bank guarantee (liability insurance), which shall be provided within ___ months after the handover of the construction area*".[109]

- "*In case of non-contractual performance, the Contractor is obliged to perform penalty payments and is also liable for damages*".[110]

- "*The Owner is entitled to withhold ___% of the total contractual fee until the end of the warrantee period in order to secure the warranty performance*".[111]

Although the above provisions are not thoroughly detailed, but it can be established that the proposed securities for securing performances are 1) bank guarantee for securing performance and

[107] Act V of 2013 on the Hungarian Civil Code.
[108] "E-építés portál." E-építés portál. http://www.e-epites.hu/. The website is maintained by the Lechner Knowledge Center on behalf of the Miniszterelnökség (in English: *the Ministry attached to the Prime Minister*). Last accessed on March 25, 2017.
[109] Gov. Template Agreement Clause 22.
[110] Gov. Template Agreement Clause 24.
[111] Gov. Template Agreement Clause 26.

warranty, 2) penalty payments and 3) retention of contractual fee (or in other words, retention money).

In respect of the other standardized template agreement published by the MKIK, it is significantly more detailed, more sophisticated and drafted in a much organized way. Basically its Vth Chapter lists all the security devices, available for securing performance by the contractor. The proposed legal instruments are the following:

- "*In case of a delayed performance, the contractor is obliged to perform penalty payment, which shall be equal to the weekly amount of ___% of the construction fee, up to the maximum amount of ___%".*[112]

- *"In case of a faulty performance, the contractor is obliged to perform penalty payment for the duration until the fault is remedied, in the amount as it is set out for the penalty payment applicable for delayed performance".*[113]

- *"If the construction is frustrated, then the contractor is obliged to pay penalty payment in the amount of ...% of the total construction fee*".[114]

- "*The Owner is entitled to set off penalty payments against the duly payable construction fee*".[115]

- "*As a security for warranty performance, the Owner is entitled to withhold ___% of the total payable amount for the duration of the warranty period, without any interest*."[116]

[112] MKIK Template Agreement Chapter V clause 1.
[113] MKIK Template Agreement Chapter V clause 2.
[114] MKIK Template Agreement Chapter V clause 3.
[115] MKIK Template Agreement Chapter V clause 4.
[116] MKIK Template Agreement Chapter V clause 8.

- "*The Contractor is entitled to redeem the above withheld money with a bank guarantee issued by a 1st class Hungarian Bank with the same amount as the withheld money. The duration of the bank guarantee shall be 60 days longer than the warranty period*."[117]

As it is discussed above, the more detailed MKIK template agreement suggests using 1) various penalty payments and 2) retention of money, which can be redeemed with an adequate 3) bank guarantee. Somewhat not surprisingly, the suggested security instruments are similar (penalty payment, retention of money) in both template agreements. However – interestingly – the MKIK agreement completely leaves out completely the performance guarantee, which is a major part in the governmental template agreement.

2.2 Statutory Provisions of the Securities Proposed by the Template Agreements

Considering the fact that Hungary is a civil law country, in this sub-chapter I will analyze the statutory provisions that – as background provisions – regulate and govern the relevant securities. Although the governmental template agreement is based under the old civil code, but due to its ineffective nature I will analyze only the provisions of the currently effective Hungarian Civil Code.

1) Bank Guarantee

Pursuant to the Civil Code, "*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, and they should be executed in writing*".[118] A major

[117] MKIK Template Agreement Chapter V clause 8.
[118] Clause 6:431 (1) of the Hungarian Civil Code.

difference between the US type surety and the Hungarian bank guarantee is that in Hungary, the obligation of the guarantor (which is set out in the statement of guarantee) is independent of the obligation for which he has promised to answer, and the guarantor may not enforce the same objection that can be made by the obligor against the beneficiary.[119] However, similarities exist, namely that in both jurisdiction both the suretyship and the guarantee agreement are attached to the persons of the beneficiary, and the contractual relationship can be transferred only with the consent of the parties.[120]

Some authors claim that the use of bank guarantee in practice is a good solution for securing performance. They might even argue that it should be consider whether to make mandatory the use of bank guarantee in construction projects above a certain threshold.[121] Other authors also argues that the bank guarantee seems the most commonly used security in major construction projects within the last decades.[122]

In respect of the procedural rules of the drawdown of the guarantee, the Civil Code sets out that "*the guarantor should be liable to make payment under the guarantee if the beneficiary requested payment in writing, strictly abiding by the requirements specified in the statement of the guarantee*".[123] Upon the receipt of the payment request notice, the guarantor should either perform to the beneficiary and simultaneously notify the obligor, or refuse performance and should notify the beneficiary indicating the reasons.[124] Regarding the drawdown, the question emerges whether it is possible for the beneficiary to request the guarantor to disburse payment in favor of a third

[119] Clause 6:432 of the Hungarian Civil Code.
[120] Clause 6:433 of the Hungarian Civil Code.
[121] Márton, Mária. "A körbetartozások jogi dimenzióiról." Kodifikációs tanulmányok a polgári jog és a polgári eljárásjog témakörében (in English: 'On the Legal Dimension of Public Procurement'. Codification Studies in the Field of Civil Law and Civil Procedural Law) (2011), pp. 179-87.
[122] Klee, Lukas. International construction contract law. Chichester, West Sussex: John Wiley & Sons, 2015. p. 372.
[123] Clause 6:435 of the Hungarian Civil Code.
[124] Clause 6:435 of the Hungarian Civil Code.

party. According to Hungarian scholarly articles,[125] it is possible, similarly to the international standards of UNCITRAL, ICC Uniform Customs and Practice for Documentary Credits and the Uniform Rules for Contracts Guarantees and Demand Guarantees. It is also worth mentioning that the Supreme Court of Hungary has also knowledge about these international standards: in one court decision, the Supreme Court referred to the ICC Demand Guarantees clauses.[126]

Hungarian court cases examine the questions of drawdown in details. One court ruling states "*in case of a bank guarantee the guarantor is entitled to define the conditions of the drawdown*".[127] Others also point out that "*the guarantee is a separate obligation from the underlying agreement, and it is independent in its nature*"[128], and that "*the obligor's protect cannot serve as a ground to deny payment to the beneficiary if the drawdown conditions are met*".[129]

The courts also analyzed whether the guarantor has the possibility, or if it is obliged to examine the factual basis of drawdowns. According to the facts, the general contractor signed a construction agreement and provided a 'due performance bank guarantee' for the owner. Subsequently, the building was damages, and the owner requested its correction, and later it requested payment from the issuer of the guarantee, which it denied claiming that the correction was already performed at the time. The parties initiated litigation, and the court established that "*the guarantee's issuer may examine with due diligence whether the drawdown request conditions are formally met, but it is not obliged to examine the factual background*".[130] Further, the court also ruled that "*the*

[125] Vékás, Lajos, Dr., and Péter Gárdos, Dr., eds. Kommentár a Polgári Törvénykönyvről szóló 2013. évi V. törvényhez. Wolters Kluwers, 2014.
[126] K-H-PJ-2013-405.
[127] BH2012. 266.
[128] BH2012. 70.
[129] BH2003. 473.
[130] BH2009. 251.

drawdown payment can only be rejected if the beneficiary made the drawdown request in a fraudulent way."[131]

In addition to the above, the bank guarantees are also used for other purposes, apart from securing performance. American authors claim bank guarantees are used as a counterparts for bid bonds, serving a pre-qualification for selecting contractors.[132] However, contrary to bid bonds where the issuer inspects the technical capabilities of the contractor, in such instance the bank checks only whether the contractor has adequate assets available to issue such bank guarantee.[133]

2) Penalty Payments

Pursuant to the Civil Code, "*penalty payment means that the obligor may pledge to pay a certain sum of money in case he fails to perform the contract for reasons attributable to him, however, the obligor should be relieved from the obligation of payment of contractual penalty if his non-performance is excused*".[134] Other important aspects of the penalty payment is that it should be concluded in writing[135] and that the beneficiary is entitled to lay claim for the penalty payment irrespective of any loss from the obligor's non-performance.[136] As seen in the template agreements, penalty payment might be stipulated for delayed or faulty performance or even for the lack of performance.

However, regarding the extent of full performance, the question arises based on real life experiences that what about those minor defects, which are not prohibiting the use effective use of

131 Ibid.
132 David J. Barru. „How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds With Bank Guarantees and Standby Letters Of Credit.", George Washington University, George Washington International Law Review, 37 Geo. Wash. Int'l L. Rev. 51 (2005).
133 Ibid.
134 Clause 6:186 (1) of the Hungarian Civil Code.
135 Clause 6:186 (2) of the Hungarian Civil Code.
136 Clause 6:186 (3) of the Hungarian Civil Code.

the construction by the owner, but still they are considered as defects. This issue emerged before a Hungarian court in a very recent case,[137] where it ruled that if, during the handover procedure, the owner does not determine a defect, which could prohibit the handover, then the handover cannot be rejected, and no penalty payment for delayed performance can be claimed, even if it was duly stipulated in the construction agreement.

Another question revolved around that how should it be qualified if the contractor undertook an unreally short construction time sanctioned by penalty payment, and it failed to deliver it. Within the case, the contractor claimed that the external market circumstances and the market competition forced him to do so. However, the court qualified this as negligence, and established that "*it should not be a ground for excusing the penalty payment*".[138]

In another case, the court analyzed the issue whether in construction project having multiple subsequent phases, are delay penalty payments cumulative for each of the phases, or in case of a delay of an earlier phase, it does not have an effect for the later phases, and thus it does not constitute a ground for delay payment obligation. The court answered this question by stating that "*if the parties wishes to sanction delays not just in respect of the phases, but for the construction project as a whole, then they should stipulate it separately in a written construction agreement*".[139] Thus, effectively it means a delay in a phase do not have an effect on the delays in later phases.

A different case[140] revolves around the construction of a sewage system, where the parties stipulated delay penalty payment. However, at the deadline the construction was completed only partially, thus the question emerged whether the penalty payment should be paid after the whole,

[137] BDT2017.3635.
[138] BDT2010.2198.
[139] BH2010. 276.
[140] BDT2006. 1416.

or only the incomplete part? The court answered this issue by establishing that the delay penalty payment should not be calculated and paid after those parts, which are already finished, considering the fact that they are not in delay.[141]

In practice, the question also emerged whether the stipulated penalty payment could be reduced in a public procurement procedure, and whether the contractor might be exempted from the payment if it proves that its subcontractor caused the delay. The court ruled on the latter that "*the delay can be exempted only if the contractor proves that the delay is also not attributable to the subcontractor*".[142] In respect of reducing the penalty payment, the court did not established a strict test or conditions. Instead, it stated that such practice could only be an exceptional method, taking into account the objective and subjective aspects.[143] However, for public procurement procedure the test is even stricter, considering the fact that the originally prescribed delay penalty payment might played a significant role upon the determination of the contractual fee and the other market actors' participants in the tender.[144]

3) Retention of Contractual Fee and Security Deposit

The retention of the contractual fee for security purposes is not a specified or regulated security, and it is not set out in the Civil Code is a separate legal institution. However, in accordance with the practice of the courts and the relevant court rulings,[145] the parties are free to stipulate any kind of security they might seem fit; and the Hungarian courts ruled in a number of cases that the withheld amount acts and should be considered as security deposit.[146]

141 Ibid.
142 BDT2011. 2487.
143 Ibid.
144 Ibid.
145 BH2003. 288.
146 LB-H-GJ-2009-116.

The security deposit, on the other hand, is a unique Hungarian legal institution used for securing performance. It might be established over money, securities or payment account balances and funds available through deposit account contracts.[147] In addition to that, in case of money and non-dematerialized securities it should be established as a possessory lien, while over other kinds of valuables (dematerialized securities or payment accounts) it should be established by transforming from the actual possession of the obligor to the beneficiary of the security deposit. Other important aspects of the security deposit is that direct enforcement (i.e. no separate court or other procedure is required) is possible, and the lack of mandatory filing, which properties makes the security deposit a versatile and easy-to-use legal instrument. It should also be noted that security deposit has a priority over other various liens,[148] thus this feature makes it even more useful.

Regarding the court practice, the Hungarian higher courts examined that how should the security deposit be qualified during a bankruptcy procedure. In a recent case,[149] the court established that if the owner is going under bankruptcy procedure, then the contractual fee (which was withheld for security reasons) possessed by the owner should not be qualified as the owner's assets. Thus, it is not part of the amount which are to be distributed to creditors.

Nevertheless to the above, it might worth also mentioning that practice after the fall or communism also proposed the use of other securities furnishing performance. Apart from the above mentioned penalty payment, these also included down payment and lump-sum damages.[150] In my opinion these might be also used, although they offer a lower protection in a legal sense.

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147 Clause 5:95 (1) of the Hungarian Civil Code.
148 Pursuant to clause 5:123 of the Civil Code, it the same subject is encumbered with both security deposit and lien, then the security deposit should have first priority.
149 BH2015. 229.
150 Oppenheim, Klára, Jenny Power, Éva Fried-Kallós, Ulrike Rein, Ádám Máttyus, Ilona Bánhegyi, Lásló Lehmann, Ákos Mester, Gyula Hock, and Judit Nádor. Hungarian business law. The Hague: Kluwer Law International, 1998. p. 50.

CHAPTER III

Approaches for Securing Payments

1. Legal Devices in the US for Securing Payments

1.1 The Proposed Wordings of the Template Agreements

a) AIA Template Contract

The AIA Document A201 (General Conditions of the Contract for Constructions) – similarly to the wording on the requirements of the performance bonds – stipulates only that "*the owner should have the right to require the contractor to furnish bonds covering faithful payment of obligations, as set out either in the bidding requirements or in the applicable construction contract*".[151] Thus, as it may be seen, the exact provisions are left for the parties to implement if they wish to do so. However, more often than not, owners of the construction projects are require the use of payment bonds, both in public and private constructions.[152]

The provisions of the AIA Document A312 Payment Bond are similar to the Performance Bond provisions analyzed in Chapter II above. Among others, the wording prescribes that "*the contractor and the surety jointly and severally binds itself and assigns to the owner to pay for labor, materials and equipment furnished for use in the performance of the construction contract*".[153] Moreover, it states that "*if the contractor promptly makes payment of all sums due to*

[151] Article 11.4 of the A201 document.
[152] Russel, Jeffrey S. Surety bonds for construction contracts. Reston, VA: ASCE Press, C2000. p. 41.
[153] AIA Document A312 Performance Bond, article 1.

the claimants and indemnifies and hold the owner harmless, then the surety and the contractor should have no obligation under the bond".[154]

From the aspect of the owner and the claimants, the payment procedure regarding the bond is the following:

(i) If the owner is approached by the claimants, then the owner should notify the surety and the contractor about of claims, demands, liens or suits against the owner.[155] Upon the notice of the owner, the surety should promptly and at the surety's expense should defend, indemnify and hold harmless the owner against a duly tendered claim, demand lien or suit.[156]

(ii) The claimants may also approach the surety directly. Claimants who are employed or have direct contract with the contractor may send the claim directly to the surety's address,[157] while those who do not have a direct contract should also send the claim directly to the surety and also should send a notice to the contractor. They should state 1) the claimed amount (with substantial accuracy) and 2) the name of the party to whom the material were, or equipment was, furnished or supplied or for whom the labor was done or performed, within 90 days after having last performed labor or last furnished materials or equipment in respect of the claim.[158] Upon the fulfillment of the above conditions by the claimants, the surety should promptly take the following actions:[159]

[154] AIA Document A312 Performance Bond, article 2.
[155] AIA Document A312 Performance Bond, article 3.
[156] AIA Document A312 Performance Bond, article 4.
[157] AIA Document A312 Performance Bond, article 5.1.
[158] AIA Document A312 Performance Bond, article 5.2.
[159] AIA Document A312 Performance Bond, article 7.

- within 60 days after the receipt of the claimant's notice, it should send an answer (with a copy to the owner) to the claimant stating the disputed and undisputed amounts,[160] and

- pay or arrange for payment of the undisputed amount.[161]

Regarding the contractor's liability, the provisions of the bond prescribe that any amount owned by the owner to the contractor under the construction agreement should be used for the performance of the construction agreement and to satisfy claims under any construction performance bond.[162] Moreover, by signing the bond the parties agree that the amount earned by the contractor are dedicated to satisfy the obligation of the contractor and the surety.[163]

b) The AGC Template Contract

Similarly to the aforementioned AIA template construction agreement, the AGC document no. 200 (on the Standard Agreement and General Conditions between Owner and Contractor) also contains identical provisions in respect of the requirements of the performance and payments bonds. It prescribes that the parties have the option to require a payment bond, which "*should be issued by a surety admitted in the state in which the project is located*".[164] Moreover, "*the penal sum of the bond should be 100% of the contract price*".[165]

The proposed wording of the payment bond is set out as document no. 261. Parallel to AGC's proposed performance bond, it is also a declaration to be signed by the contractor and the surety. Moreover, compared to the AIA payment bond, the payment procedure is more simple. The

[160] AIA Document A312 Performance Bond, article 7.1.
[161] AIA Document A312 Performance Bond, article 7.2.
[162] AIA Document A312 Performance Bond, article 9.
[163] Ibid.
[164] AGC Document no. 200, article 10.6.
[165] Ibid.

declaration states that each and every claimant – who has not been paid in full before the expiration of the period of ninety days after the claimant provided or performed the last of the work or labor, or furnished the last of the materials for which said claim is made – may have the right of action in accordance with the bond.[166] Nevertheless, the bond also contains a limitation of action on behalf of the surety, according to which no action or payment should be performed unless the claimant, who has no direct agreement with the contractor, gives a written notice to the contractor, the owner and to the surety within ninety days after the claimant provided or performed the last of the work or labor, or furnished the last of the materials for which the claim is made.[167] Moreover, such notice should contain the claimed amount with substantial accuracy, and also those party's name, for who the work has been performed.[168] As for a claimant who has a direct contract with the contractor, the above limitation is not applicable.[169] However, there is a contractual limitation of one year starting after the last perform of labor or furnish of material or equipment for the construction project, after which all claims should be deemed expired.[170]

1.2 Statutory Provisions in Respect of the Payment Bonds

"*A payment bond (sometimes referred to as a labor and material bond[171]) is given by the contractor to guarantee payment to laborers, material suppliers and subcontractors for the labor or service that is incorporated in the project that they perform and the material that they furnish in*

166 AGC Document no. 261, article 2.
167 AGC Document no. 261, article 3.a.
168 Ibid.
169 AGC Document no. 261, article 4.
170 AGC Document no. 261, article 3.b.
171 Hoffman, Scott L. The law and business of international project finance. Cambridge: Cambridge University Press, 2008. p. 177.

performing the construction contract."[172] Thus, contrary to the Hungarian legal system as will be described below, the purpose of the payment bond is not to secure payment from the side of the owner, but to secure the contractor's payment towards its subcontractors in order to avoid the application of the mechanic's lien, which may block the whole construction project and consequently creating unavoidable financial losses for the owner.[173] Other authors also share this view, claiming that "*when an owner does not want construction liens to be recorded against a particular property, it may require that the general contractor post an unconditional (traditional) private payment bond prior to the construction. Such a bond stands as substitute security for the payment of lienors*."[174]

A closely related legal device to the payment bond is the mechanic's lien. According to the Black's Law Dictionary, it is "*A statutory lien that secures payment for labor or materials supplied in improving, repairing, or maintaining real or personal property, such as a building, an automobile, or the like. — Also termed lien of the mechanic; artisan's lien; chattel lien (for personal property); construction lien (for labor); garageman's lien (for repaired vehicles); laborer's lien (for labor); materialman's lien (for materials)*".[175] Although mechanic's lien is regulated by the various state legislation (and they differ in their details),[176] it can be said in general that this is an effective protection for laborers and those material suppliers, whose material has been already built into the construction. Considering the fact that built-in materials and performed work cannot be undone

[172] Russel, Jeffrey S. Surety bonds for construction contracts. Reston, VA: ASCE Press, C2000. p. 41.
[173] Ibid.
[174] Daniel R. Vega. ""Here Comes The Money": A Subcontractor's and Material Supplier's Guide to Perfecting Construction Lien and Bond Rights Under Florida Law". Florida Bar, The Florida Bar Journal. 76 Fla. Bar J. 22 (October 2002).
[175] Black's Law Dictionary. 10th ed. 2014.
[176] Russel, Jeffrey S. *Surety bonds for construction contracts*. Reston, VA: ASCE Press, C2000. p. 41.

(or only with significant financial losses), this legal device is the only valid and effective protection for workers.[177]

However, mechanic's lien can be used only in private construction projects, but not in public ones. According to the ancient common law notion of sovereign immunity, the United States is protected from uncontested suit,[178] and consequently the mechanic's lien is inapplicable in public projects. Thus, in order to avoid a potential public outrage in case of a subcontractor is not duly paid by the general contractor, the federal (and also state and local municipalities) bodies usually order construction projects to require the use of payment bond – even for those projects, for which their use is not prescribed by statutory law.[179]

The requirement of furnishing payment bonds are enforced by the federal organs. In a case[180] a surety, which issued a performance and payment bond to the contractor, went bankrupt after the commencement of the construction project. Although the contractor tried to remedy the situation by requesting a reinsurance agreement from a third party, but the new document covered only the performance bond, thus the government terminated the construction agreement. In litigation, the court declared that in accordance with the provisions of the Miller Act and the FAR, payment bond should be furnished by the contractor. In its absence, the government lawfully terminated the agreement.[181]

Another aspect which might be considered is that subcontractors and material suppliers are more likely to grant a longer extended credit period for general contractors, who have such payment

[177] Ibid.
[178] Gray v. Bell, 712 F.2d 490, 507 (United States Court of Appeals for the District of Columbia Circuit, 1983.
[179] Russel, Jeffrey S. *Surety bonds for construction contracts*. Reston, VA: ASCE Press, C2000. p. 42.
[180] Airport Industrial Park, Inc. d/b/a P.E.C. Contracting Engineers v the Unites States, 59 Fed. Cl. 332 (United States Court of Federal Claims, 2004).
[181] Ibid.

bonds.[182] Thus, obtaining a payment bond might be also important factor for the general contractor, since this may grant him better leverage in negotiations and also strengthening trust among its partners.

In respect of the content of payment bonds, apart from the obvious information on the relevant parties and the amount of the payment terms, it is also advisable – as it was described previously – that the payment bond should include deadlines that until what date can the unpaid party request payment, sue or initiate litigation. In respect of public project, US law stipulates[183] that if a supplier of furnished labor or material is not duly paid in full before the expiration of ninety days after the day on which the last of the labor was done or performed by him or material was furnished or supplied by him, he should have the right to sue on such payment bond for the amount, or the balance thereof, unpaid at the time of institution of such suit and to prosecute said action to final execution and judgment for the sim or sums justly due him. However, for those who do not have a direct relationship to the general contractor but only with the subcontractor, they should give a written notice to the contractor with the terms set out in the statute or they risk losing the protection provided by the payment bonds.[184] Consequently, this wording means that federal payment bonds protect only the first level of subcontractors, but not the second level, unless they give notice. Nevertheless, the protection stops at this level and does not cover the third level of subcontractors (i.e. sub-subcontractor) – but in this case the general contractor may be obliged to pay for such unpaid suppliers or laborers, even though the subcontractor has been already fully paid.[185] Some scholars[186] argue that the logic behind these provisions is to constrict general contractors to require

[182] Ibid.
[183] 40 U.S.C. 270b.
[184] 40 U.S.C. 270b.
[185] Russel, Jeffrey S. *Surety bonds for construction contracts*. Reston, VA: ASCE Press, C2000. p. 43.
[186] Ibid.

payment bonds from their sub-contractors. In addition to that, it might be improper to require the general contractor to bear the full risk, even for those bus-contractors he might not be even aware of.

However, the above limitation of eligibility might be disregarded for provisions set out in state law. An illustration for this is an Indiana case,[187] where the second-level subcontractors (natural person laborers) were not paid out due to the default of the first-level subcontractor. They requested payment from the surety, but were rejected. In the subsequent litigation, the court stated that although the payment bond stipulates limitation of eligibility, but it is contrary to Indiana statute, which is "*liberally construed regarding the classes of laborers, materialmen and suppliers covered*".[188]

As for formal requirements, payments bonds should be duly signed and dated (and the underlying agreement should predate the bond itself), and also a power of attorney should be also attached to it. Nevertheless, the precise details should be taken care, since they are prescribed by the statues of the state where the construction is located.[189]

In practice, the question emerged whether – due to contractual provisions – can the surety request reimbursement from third parties after it performed payment towards the subcontractors. In a case in Oklahoma,[190] the surety performed payment for the subcontractors and laborers of the contractor, who failed to perform due payment to them, although it was paid by the owner. The surety initiated litigation against the owner, seeking reimbursement. However, the court clearly

[187] Fid. & Deposit Co. v. Sheet Metal Workers' Int'l Ass'n Local Union No. 20, 7 N.E.3d 1024 (Court of Appeals of Indiana, 2014).
[188] Ibid.
[189] Russel, Jeffrey S. *Surety bonds for construction contracts*. Reston, VA: ASCE Press, C2000. p. 43.
[190] American Casualty Company v Town of Shattuck, Oklahoma, 228 F. Supp. 834 (United States District Court for the Western District of Oklahoma, 1964).

stated that it might seek reimbursement against the contractor, but it "*has no claim for reimbursement against other persons, though they may have benefited by this Act*" (with reference to an Oklahoma Statute).[191]

Other issues were also emerged in respect of payment bonds. In a court case in New York,[192] the question was that if the original contractor, who furnished a payment bond, is forced to withdrawn from the construction and the surety takes over the construction performance, then does the original payment bond is in effect for the new subcontractors? The court answered this question by analyzing the text of the bond, which stated, "*only those with a direct contract with the principal is covered*".[193] Thus, although the takeover agreement provided coverage for the new subcontractor, but due to the wording of the bond, the subcontractor cannot be reimbursed from the original payment bond. Nevertheless, the court also noted that this does not mean that the subcontractor "*cannot seek redress through other means*".[194]

2. Solutions for Securing Payments in Hungary

Since the fall of communism, the Hungarian construction industry was plagued by gridlocks, i.e. the situation when one party duly issued an invoice but its consideration is not paid or transferred by the other party due to lacks of funds, and thus the other parties are also not paid out by the party which issued the invoice.[195] The most important reasons, why the construction industry is

[191] Ibid.
[192] Milcon Construction Corporation v The Travelers Indemnity Company, 2009 N.Y. Misc. LEXIS 4770; 2009 NY Slip Op 30718(U) (Supreme Court Of New York, New York County, 2009).
[193] Ibid.
[194] Ibid.
[195] "Pénzügyi fogalomtár - pénzügyi fogalmak magyarázata." http://www.bankihitel.hu/?us=fogalomtar&id=252. Last accessed on March 21, 2017.

especially plagued by the gridlock, is that the performance and the payment are not simultaneous, the contractor is required to perform advance payment, and that the constructed building consist the property of the owner.[196] In fact, the phenomenon become so widespread that it was a heavily debated issue not just among the construction and legal experts, but also in the press and media. The typical model was the following: the owner or the general contractor – in order to maximize profit or due to a miscalculated budget – did not wish to pay to its subcontractor, thus it claimed that due to quality problems no payment is due. When the subcontractor initiated lawsuit against the general contractor, it lasted for years, and at the time of a final and binding court verdict, the general construction is already in bankruptcy. Consequently, the subcontractor would never get its money for the duly performed work.[197] In addition to that, usually there is a significant and inherent difference between the owners' or general contractors' and the subcontractors' situation: the former usually had a significantly higher budget or better financial sources and also better access to professional legal assistance, while the latter are plagued by underfinancing during the litigation, thus they might be liquidated before the end of the successful court procedure.[198]

However, the situation might become more complex and difficult to overlook in case of multi-levels of subcontractor. According to an actual case decided by the Hungarian court,[199] the general contractor duly paid out the 'level I subcontractor'. However, if failed to pay out its own subcontractor, the 'level II subcontractor', although the work has been duly performed. Level II

[196] Bodnár, Zsolt. „Az építtetői fedezetkezelés intézménye és működése a gyakorlatban". Közbeszerzés. (in English: 'Construction Collateral Management and its activities in Practice'. Public Procurement.) 5. évf. 2. sz. (2010). pp. 2-9.
[197] Borbás, Barna. "Mire jók a lánctartozás ellen bevetett új eszközök?" Heti Válasz. http://valasz.hu/uzlet/fegyver-a-korbetartozasok-ellen-65576. Last accessed on March 21, 2017.
[198] "Öngyilkosság vagy önbíráskodás az építőiparban?" Építinfo. http://www.epitinfo.hu/index.php/articles/23/49310/ongyilkossag-vagy-onbiraskodas-az-epitoiparban. Last accessed on March 21, 2017.
[199] BDT2008.1906.

subcontractor initiated lawsuit against the general contractor, but the court ruled that the level II subcontractor do not have legal claims with the legal title of unjust enrichment or damages against the general contractor, thus it is not allowed to request any payment. It can only have claims against its contractual partner, the level I subcontractor.

This phenomenon is adverse not only because the subcontractors were not paid, but also because it contributed to the weakness of the whole construction industry, and thus indirectly affected the society as a whole. Only in 2011, the approximate total value of gridlock in the construction industry was reaching the level of HUF 400 billion.[200] Every government after the democratic change battled this phenomenon with more or less success. Among various approaches (e.g. tax inspections, amendment of the bankruptcy act, tightening the rules on public procurement),[201] the introduction of two major legal institutions worth mentioning: (i) the collateral management for construction, and (ii) the Expert Organization for Completion Certificate.

Nevertheless, apart from the aforementioned institutions which will be thoroughly analyzed in section 2.2 below, the template agreements also introduced contractual protections for the parties.

2.1 The Recommended Legal Instruments of the Hungarian Template Agreements

The wording of the governmental template construction agreement proposes several legal devices, which are supposed to secure and enhance payment. Among others is that the owner should make a statement, according to which it confirms that the amounts required for the performance of the

[200] Márton, Mária. "A körbetartozások jogi dimenzióiról." Kodifikációs tanulmányok a polgári jog és a polgári eljárásjog témakörében. (in English: 'On the Legal Dimension of Public Procurement'. Codification Studies in the Field of Civil Law and Civil Procedural Law) (2011) pp. 179-87.
[201] Ibid.

works are available for the contractor in the form of a deposited money in a bank account, credit or bank guarantee.[202] Although I consider this as a soft commitment, but this has the benefit that in case the owner fails to do so (or fail to provide proof for the available funds) then the contractor may freely, unilaterally and extraordinarily terminate the construction agreement.[203]

Furthermore, the agreement proposes the provision that the owner should acknowledge that in case the owner fails to perform due payment for the contractor, then the contractor is entitled to establish lien over the real estate on which the construction project is located.[204] However, the problem with this provision is that the applicable Hungarian Civil Code clause[205] enabling this possibility has been deleted by the Constitution Court of Hungary,[206] but the template agreement is still accessible with this improper wording. Nevertheless, the Constitutional Court justified its ruling by claiming that although the Parliament inserted this legal provision into the Civil Code in order to remedy the effects of gridlock situations in Hungary - thus implicitly accepting that the provision stating that the contractor is entitled to have a lien over the owner's possession in case if fails to perform its payments[207] - by enabling to establish this lien without a separate, explicit agreement. Although similar legal institutions are also existing in other European jurisdictions like in France or in Germany, but – contrary to the Hungarian solution – rules on guarantee also exist. Consequently, the Constitutional Court established that the inserted provisions are too broad and too vague, and provides disproportionate benefits for the contractors: they would be entitled having a lien over real estates without any consideration for the proportionately of the claimed amount or the existing

[202] Gov. Template Agreement Clause 1/f.
[203] Gov. Template Agreement Clause 23.
[204] Gov. Template Agreement Clause 25.
[205] Clause 402 (2)-(3) of the old Hungarian Civil Code, invalid since March 31, 2010.
[206] Constitutional Court resolution 35/2010 (III.31.).
[207] Clause 397. (2) of the old Hungarian Civil Code, Act IV of 1959 on the Hungarian Civil Code.

value of the real estate.[208] Nevertheless, it might be worth noting that during its short effectiveness, this clause was duly implemented by court in different court cases.[209]

The other template construction agreement published by the MKIK offers a wider range of protection. Similarly to the governmental agreement's wording, this also contains the declaration of the owner in respect of the available funds[210] – however, it lacks the explicit provision on the extraordinary unilateral termination, but implicit rules still permits it as a serious breach of contract.[211]Nevertheless, the agreement advices the use of more significant protections as well. It stipulates that in respect of the delivered products and materials furnished by the contractor, the ownership is transferred only upon the transfer of possession and the full payment of the contractual price.[212] In my opinion, this kind of retention of title[213] is an effective way to offer protection for those suppliers who deliver more significant products, which might exist separately and do not mix with other furnished materials. An example of this could be the delivery of air conditioning devices, or the installments of lifts.

However, I believe that the above is not a suitable protection for laborers or subcontractors delivering smaller and less valuable/separable devices. For this purpose, the template agreement offers a wide range of solution, from which the parties might freely select which one they wish to apply.[214] The options are the following:

a) prepayment and lien encumbering the contractor's materials

[208] Constitutional Court resolution 35/2010 (III.31.).
[209] KGD2011.19.
[210] MKIK Template Agreement Chapter I clause 6.
[211] MKIK Template Agreement Chapter VI clause 2.
[212] MKIK Template Agreement Chapter II clause 5.
[213] Clause 6:247 (5) of the Hungarian Civil Code.
[214] MKIK Template Agreement Chapter III.

According to the proposed wording, "*the owner transfers a defined percentage of the construction fee to the contractor with the condition that the contractor takes possession of the construction site, and it is registered in the electronic construction log*".[215] The exact number of percentage should be inserted by the parties.[216] However, the owner is entitled for a lien over the assets of the contractor, which should be registered in the official register of liens,[217] but this lien ceases to exist when the amount of prepayment is set-off against the instalments of the construction fee.[218]

b) earnest money

In accordance to the wording, the parties stipulate that "*an earnest money should be paid to the contractor until a date in the percentage of the construction fee determined by the parties*".[219] If the contractor performs its obligations, then it should be set-off against the payable construction fee. In other aspects, it follows the provisions of the Hungarian Civil Code[220] that if the agreements is terminated due to the fault of the owner, then it loses the earnest money, while if it is terminated due to the contractor, then it should transfer the double of the received earnest money.[221] Moreover, it should not be considered as a ground for an exclusion from liability.[222]

c) securing the construction price with the use of escrow provided by attorneys

Pursuant to the proposed wording, the parties may agree that the whole construction fee should be put into an escrow account managed by an attorney, in accordance with a separate escrow agreement which should be attached to the construction agreement (although no template is

215 MKIK Template Agreement Chapter III/A clause 1.
216 Ibid.
217 MKIK Template Agreement Chapter III/A clause 2.
218 MKIK Template Agreement Chapter III/A clause 4.
219 MKIK Template Agreement Chapter III/B clause 1.
220 Clause 6:185 of the Hungarian Civil Code.
221 MKIK Template Agreement Chapter III/B clause 3.
222 MKIK Template Agreement Chapter III/B clause 4.

provided).[223] The assets might be released from the escrow only upon the receipt of the contractor's invoice, which should be preliminary accepted by the owner.[224] The template also proposes that in case of a dispute between the owner and the contractor, then it should be decided exclusively by the Expert Organization for Completion Certificate (which institution will be analyzed below).[225] However, if either party is unsatisfied with this decision, then it can start court procedure in accordance with the statutory provisions.[226]

This escrow approach is promoted in an article by some authors,[227] arguing that this might result in a special risk community, where all parties are urged to duly finalize the construction, and the work performing party would not suffer losses (or just to a minimal extent).

d) securing the construction price with the use of bank guarantees

In case of this option, the parties might agree that the owner should hand over an irrevocable, unconditional bank guarantee to the contractor, which should be equal to the full construction price and should be issued by a Hungarian bank.[228] The guarantee should be handed over within 5 days after the conclusion of the construction agreement, and if the owner fails to do so, then the contractor is entitled to unilaterally withdraw from the contract.[229] Regarding the procedure, the template provision stipulate that the contractor is entitled to draw down the guarantee if the owner

[223] MKIK Template Agreement Chapter III/C clause 1.
[224] MKIK Template Agreement Chapter III/C clause 2.
[225] MKIK Template Agreement Chapter III/C clause 3.
[226] MKIK Template Agreement Chapter III/C clause 4.
[227] Márton, Mária. "A körbetartozások jogi dimenzióiról." Kodifikációs tanulmányok a polgári jog és a polgári eljárásjog témakörében (in English: 'On the Legal Dimension of Public Procurement'. Codification Studies in the Field of Civil Law and Civil Procedural Law) (2011), p. 179-87.
[228] MKIK Template Agreement Chapter III/D clause 1.
[229] Ibid.

fails to perform payment in due time, and also for damages if the owner terminates or withdraw.[230] Moreover, the parties should also determine the long stop date of such bank guarantee.[231]

2.2 The Hungarian Statutory Provisions on Securing Payments

As it was described above, the template construction agreements offer the contractual solutions of 1) lien over the owner's assets, 2) bank guarantee, 3) retention of title, 4) prepayment, 5) earnest money and 6) using escrow agreement; however, all of the above were already analyzed previously in this paper, or the proposed contractual wording borrows - - in full compliance - the text of the Hungarian Civil Code's provisions. Therefore, I leave aside their repeated analysis. However, I will point out some problems which were analyzed by the Hungarian higher courts.

Nonetheless to the above, I will analyze two important and unique legal institutions, which was recently[232] introduced into Hungary by the legislation.

(i) The Collateral Management for Construction

One way the government tried to remedy the situation of gridlocks was by introducing the collateral management for construction.[233] According to the relevant act,[234] it means that the required assets for the construction project should be kept secured and used only for the purpose of the construction.[235] Consequently, it means that a third actor comes between the owner and the contractor, who manages the payments and handles the construction's amount. An interesting side

[230] MKIK Template Agreement Chapter III/D clause 2.
[231] MKIK Template Agreement Chapter III/D clause 3.
[232] The collateral management was introduced in 2009, while the Expert Organization for Completion Certificate was introduced in 2013.
[233] in Hungarian: építtetői fedezetkezelő.
[234] Act LXXVIII of 1997 on the Formation and Protection of Build Environment (hereinafter "Étv.").
[235] Clause 39/B of Étv.

note is that this role has not been taken by commercial banks, but by the Hungarian State Treasury as well.[236]

According to the regulation, collateral management is required for private construction projects where the construction value equals or higher than the threshold for the community (i.e. EU) public procurement construction projects.[237] Although the threshold changes yearly and may also fluctuates due to the EUR/HUF ratio, but in 2017 it is around HUF 1.6 billion.[238] However, collateral management for construction projects was required for public procurement procedures only for a short duration in 2010, and pursuant to the currently effective provisions, it is not required at all. Nevertheless, the Hungarian State Treasury still performs similar forms of collateral managerial duties for projects which are financed by the central government, although under a different name.[239]

The act also specifies the procedure which must be followed by the respective parties. The collateral manager concludes a written agreement with the owner[240] and opens an escrow account for it, and grants him information regarding this account. The owner is obliged to transfer to this account or otherwise hand over to the collateral manager the amount which is required for the construction.[241] Moreover, the applicable governmental decree specifies that what kind of sources should this amount consist of, which - apart from money - might be among others bank credit, EU or Hungarian tender support, governmental support or bonds of the EU member states.[242] In case

[236] "Építtetői fedezetkezelés." Magyar Államkincstár. http://www.allamkincstar.gov.hu/hu/nem-lakossagi-ugyfelek/epittetoi_fedezetkezeles. Last accessed on March 24, 2017.
[237] Clause 17 of Gov. Decree 191/2009 (IX. 15.).
[238] "Közbeszerzési értékhatárok 2017." Közbeszerzés. Accessed March 23, 2017. http://www.e-kozbesz.hu/ertekhatar_2017.
[239] Clause 17/B Gov. Decree 191/2009 (IX. 15.).
[240] Clause 17 (6) Gov. Decree 191/2009 (IX. 15.).
[241] Clause 18 Gov. Decree 191/2009 (IX. 15.).
[242] Clause 18 (4) Gov. Decree 191/2009 (IX. 15.).

the owner fails to provide the required and adequate assets, then the collateral manager should register a mortgage over the owner's plot, where the construction is being performed. In this case, the beneficiary should be the contractor. However, if the owner manages to produce the required assets, then the collateral manager is obliged to request the deletion of the mortgage by the land registry office.[243]

In addition to that, the collateral manager should electronically register the subcontractors used for the projects. This is important, since the collateral manager is entitled to release amount from the escrow account only based on invoices, and in the amount which are accepted with certificates of completions. However, such amounts are not transferred to the general contractor in order to let him divide it among its subcontractors, but the subcontractors should be directly paid out. The general contractor is entitled to receive payment only all the subcontractors are duly paid.[244]

According to the act, the collateral manager is obliged to withhold payment in certain situations. These includes the case where the subcontractor has further subcontractors, and the subcontractor is not entitled to receive payment until all its subcontractors are duly paid. Another instance for withholding money is when the subcontractor disputes the certificate of completion. However, the subcontractor has the obligation to initiate litigation or any other formal legal dispute resolution procedure within a reasonably short.[245] The regulation also handles the situation when a liquidation or bankruptcy procedure is initiated against the general contractor, and for such case it orders that the withholding of money may be lifted.[246]

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243 "Áprilistól a magánberuházásoknál is fedezetkezelő az építőiparban." HKIK. http://www.hkik.hu/hu/heves-megyei-kereskedelmi-es-iparkamara/cikkek/aprilistol-a-maganberuhazasoknal-is-fedezetkezelo-az-epitoiparban-45818. Last accessed on March 23, 2017.
244 "Építtetői fedezetkezelő." TERC - Az építőipar szellemi centruma. http://www.terc.hu/tudastar/epittetoi-fedezetkezelo. Last accessed on March 23, 2017.
245 Ibid.
246 Ibid.

Thus, as a summary of the legal instrument of construction collateral management, it might be established that it targets construction projects with higher value. I am of the opinion that the reason behind is that these involve a wider group of contractors and subcontractors, and the value at stake is also more significant. Another reason is that at this level usually legal assistance exists for the contracting parties, for both sides, thus the likelihood is bigger for a potential lawsuit. Moreover, since a fee should be paid after the construction collateral managerial duties,[247] the participants (and especially the owner) has adequate financial strength to pay for such services.

Despite the highly technical and detailed wording of the regulation on the construction collateral management, some disputed points remain. Among them, one of the open question is that how should the value of the construction project be calculated. The problem revolves around the fact that the Gov. Decree 245/2006. (XII. 5.) on Construction Penalties (hereinafter "*Épbír*") does not regulate certain monumental buildings or buildings with heritage protection – however, the Gov. Decree on the collateral management prescribes that the construction value should be calculated in accordance with the schedule of Épbír. Nevertheless, the solution for this problem is that the value of those constructions, which are not regulated by the Épbír, should be determined in accordance with the construction agreement, meanwhile for the other construction projects the value should be determined with the assistance of the aforementioned schedule.[248]

A related problem is that according to the relevant provisions, the value of such buildings should be calculated jointly, which are built by the same contractor in the same or joint plot with having the same or similar function, and which has the construction project starting date within 2 years.

[247] Ibid.
[248] "Építtetői dilemma." KCG Partners. http://www.kcgpartners.com/wp-content/uploads/2016/05/%C3%89p%C3%ADttet%C5%91i-dilemma-T%C3%A9nyleg-kell-e-fedezetkezel%C5%91.pdf. Last accessed on March 23, 2017.

However, the interpretation of this definition is unclear, since neither the term "same or joint plot" nor the "same or similar function" is promptly defined. For this problem, a practitioner refers to the situation of a factory expansion with also environmental investments, and the question whether the environmental investment building should be also calculated or not.[249]

A further dilemma revolves around the requirement that the construction project should start within two years. In respect of this notion, two interpretations are possible, with the one claiming that only the value of those constructions should be taken account, which are started within two years after the start of the given construction. However, the author leans towards the other interpretation, according to which the two years' provision should also be taken into account retrospectively.[250]

The regulation is also unclear on the issue on how to calculate the value of the constriction projects, when they revolve around the expansion of a multistorey building: whether the value of the whole building should be taken as basis for calculation, or only the difference between the old and the newly constructed building. However, according to the actual practice of the relevant authorities, the latter interpretation prevails. Problems also arise for properly calculating the value of atypical buildings and constructions (like silos or special container).[251]

Other authors point to the practical problems, which the owner might face. In case the whole project is financed by the owner's already acquired assets, then it is a clear case. However, if the construction is partly financed by tenders, then the situation is more complex. Tenders pay out in the form of payment directly to the supplier, or with after financing, and in both cases certain prescriptions exist in respect of invoices, to which the owner as tender participant should comply,

249 Ibid.
250 Ibid.
251 Ibid.

and this might be especially problematic for project sponsored by the EU.[252] The author argues that considering that there are certain uncertainties regarding the procedural background of such tender financed project, the consequence could be delays and potential fines for the collateral manager.[253]

(ii) The Expert Organization for Completion Certificate

In a recent initiative,[254] the government proposed to establish the Expert Organization for Completion Certificate (hereinafter the "*TSZSZ*").[255] According to the act, the TSZSZ is an independent organization attached to the MKIK, whose chairman and members are elected with the consent of the minister responsible for construction matters.[256]

Regarding its procedure, the TSZSZ is entitled to decide on cases in relation to design and construction disputes,[257] which might be initiated either by the owner, the architect, the contractor or the subcontractor. An important pre-requirement of the procedure is that a written contract should exist between the parties.[258] It is also important to note that the TSZSZ is entitled to decide on the merits of disputes with retrospective effect.

The aim of the TSZSZ's procedure to make a relative quick judgment on the merit of the construction dispute by speeding up the whole procedure. Thus, the deadline for preparing an expert opinion by the TSZSZ is 30 days, which can be prolonged with the maximum of another

252 Előházi, Zsófia. "Építtetői fedezetkezelés: problémakezelés vagy problémahalmozás?" Közjogi Szemle in English: 'Construction Collateral Management: Managing or Creating Problems?'. Public Law Review (Autumn 2010), pp. 52-54.
253 Ibid.
254 Act XXXIV of 2013 on the Organization Responsible for the Disputes about the Design and Construction of Buildings, and on the Amendment of Certain Acts Regarding the Prevention of Delayed Payments and Gridlocks.
255 In Hungarian: Teljesítésigazolási Szakértői Szerv.
256 Clause 3 of the Act XXXIV of 2013.
257 Clause 1 of the Act XXXIV of 2013.
258 "Teljesítésigazolási Szakértői Szerv." MKIK. http://www.mkik.hu/hu/tszsz. Last accessed on March 22, 2017.

30 days.[259] Thus, the maximum procedural length is 60 days. A fee should be paid for the procedure, but it is determined as 1% of the disputed amount,[260] which is low compared to normal court procedure where the fee is 6%.[261]

However, the expert opinion of the TSZSZ is not enough for direct enforcement, and the plaintiff should initiate another civil procedure for such purpose. Nevertheless, the civil procedural law has been adequately amended to facilitate lawsuits based on the TSZSZ.[262] Regardless of the disputed amounts, they should be considered as special trials,[263] which means that after the receipt of the expert opinion the lawsuit should be initiated within 60 days. Moreover, the court is obliged to specify date of the first court hearing, which should not be later than 60 days after it received the claim, and any subsequent court hearing cannot be later than 60 days.[264] Another peculiarity of such lawsuit is that – upon request – the court may order the preliminary seizing of the disputed amount for security reasons, and the award is enforceable regardless of any subsequent appeal.[265]

Upon the introduction of the TSZSZ, its reception was mixed. Some legal practitioners[266] praised this instrument by summarizing that if the subcontractor is not paid out for its duly performed work, then he may approach the TSZSZ; and if after the issuance of the certificate the subcontractor is still not paid out, then a quick enforcement is possible in a short civil litigation. However, others claimed that it is feared that these strict deadlines would not be implemented due to capacity problems of courthouses. In addition, the verdict of the TSZSZ might only be helpful

[259] Clause 6 (4) of the Act XXXIV of 2013.
[260] "Teljesítésigazolási Szakértői Szerv." MKIK. http://www.mkik.hu/hu/tszsz. Last accessed on March 22, 2017.
[261] Clause 38 of the Act XCIII of 1990 on the Fees and Duties.
[262] Clauses between 386/0 and 386/U of the Act III of 1952 on the Civil Procedural Code.
[263] Clause 386/O of the Civil Procedural Code.
[264] Clause 386/C of the Civil Procedural Code.
[265] Clause 386/T of the Civil Procedural Code.
[266] "Lánctartozások alkonya?" Piac és Profit. http://www.piacesprofit.hu/kkv_cegblog/lanctartozasok-alkonya/. Last accessed on March 23, 2017.

if the general contractor still has adequate sources and not in bankruptcy or under liquidation procedure.[267]

[267] "RTL II: Felszámolnák a lánctartozást." RTL Híradó. June 13, 2013. http://rtl.hu/rtlklub/hirek/belfold/videok/366279. Last accessed on March 23, 2017.

CONCLUSION

Construction is a risky business in both in the US and in Hungary: delays, non-payments, defaults are happening in both jurisdiction. Although the problems are the same or very similar in their nature, but the two countries adopted different approaches to tackle such issues. In the US a market-based solution exist, while in Hungary the government directly interfered by statutes to try to solve or at least limit the emerged problems since the fall of communism. This difference is clearly indicated that in the US, practically only surety bonds are used to secure various kinds of risks and obligations, ranging from bidding through performance and payment to maintenance and warranty issues. It might be argued that their Hungarian counterparts are the bank guarantees, but these are not so widespread or commonly used like the surety bonds in the US. In addition to that, an interesting difference might be also spotted that in the US, the payment bonds are used exclusively to secure the payment of the contractor towards the sub-contractors, while in Hungary bank guarantees securing payments are used for securing the payment of the owner towards the contractor.

What is also worth noting is that in both jurisdictions construction template agreements exist. In the US, the acknowledged and embedded construction expert associations prepare them for decades. But what is more important is that such template contracts are universally known and accepted within the construction industry, which is proven by the fact that apart from the scholarly analysis, materials also exist about them which are prepared by practicing legal or construction experts. In addition to that, there are many specially adapted templates for a number of different construction situation and construction projects.

On the other hand, in Hungary, such templates were prepared only recently, and they are drafted either directly by the government or by the semi-governmental Hungarian Chamber of Commerce, upon the request of the government. It can be also established that the Hungarian ones are only targeting the micro and small enterprises, and the smaller construction projects. Furthermore, they are prepared as an emergency response in order to solve the ever-growing problems of gridlocks, which were and are infecting the whole construction business.

Needless to say, that the organically developed practices furnished by the US construction industry are duly tested and proven solutions. They apply a relatively simple and efficient legal device: the surety bond and its many incarnations used for different purposes. In addition to that, well-balanced template agreements are available for the industry players to use them in all levels. If we compare this considerably organized situation to the Hungarian one – where only a handful of template agreements exist targeting only the small players, and the templates are proposing the use different legal devices and solution, while some of them are even ineffective – it is easy to conclude that it would be advisable for the Hungarian industry to thoroughly study and completely adapt the US practices. Of course, it is true, and it would be recommendable. In fact, the Hungarian industry does so with the wide usage of the bank guarantee, which is practically a similar legal instrument to the surety bonds, since both use a third party to vouch for the contractor and pay upon the contractor's default.

Nevertheless, although many can be learned from the US, but among the ad-hoc solutions offered by the Hungarian legislation, I believe that the notion of a separate expert body established for quickly deciding construction project disputes (in Hungary the TSZSZ) could be an idea to consider even for the US construction industry. Although presumably many private organizations exist in the US (similarly to Hungary) which offers such alternative dispute resolution, but the

Hungarian one has the advantage that its practice and activities are duly integrated into the existing system of litigation. Consequently, it is not an alternative dispute resolution method, and the parties should not agree about it preliminary, but they have the possibility of the direct enforcement. In addition to that, although it was just recently introduced, even the counter arguments were focused only on such issues that the problem would be the lack of available staff and personnel, which might hinder the effective use. Needless to say, that it is not something which could not be remedied if needed. And on the basis of the reviewed US case law, it is clear for me that the US is also facing the problem of long, multi-level litigation procedures, which is adverse for the whole economy.

Summarizing the above, in my opinion an ideal system of legal devices used for securing performance and payment within private construction projects would consist of various forms of surety bonds or bank guarantees. I also recommend using a smaller variety of securities, since in this way it would be more understandable for every member of the construction industry, and would cause less confusion and the legal results could be more predictable. Finally, I would favor the introduction of an official, independent body in order to solve the disputes in a quick an efficient way.

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