



CERHA HEMPEL CEE NEWSLETTER *Hungary*

Legal risks of buying a new-build property

From a legal perspective, buying a new-build property can sometimes be much riskier than buying a “second-hand” property. It is advisable from the outset to prepare for circumstances such as delays in the property's construction, the developer's defective performance, or bankruptcy or liquidation proceedings being initiated against the developer. Moreover, in our experience, buyers are often asked to pay substantial sums of money at an early stage of the construction, with no real guarantee that compensation will be paid in the event that the risks mentioned above materialise. It is therefore crucial from the buyer's perspective to negotiate appropriate legal terms at the start of the transaction.

In the following we address three issues that might be relevant for buyers: (i) developer's extensive right of withdrawal, (ii) impossibility defence, and (iii) developer's insolvency.

Developer's extensive right of withdrawal and impossibility defence

It is understandable and commercially reasonable for developers to grant themselves a right to withdraw from a contract in the event of the buyer's failure to pay the purchase price. Unavoidable external circumstances can also render the completion of a project impossible. However, the right of withdrawal and force majeure claims are often misused.

Such a case may arise where the developer has the right of withdrawal in cases that are under the developer's total control (e.g. if the developer does not reach shell and core completion by a certain time, it is entitled to withdraw from the contract).

Developers also argue sometimes that the completion of their project has been rendered impossible due to force majeure (such as labour

shortages or increases in the price of construction materials).

However, the real reason for the above circumstances might be purely financial. It is advantageous for developers to finance their projects with the advances paid by the buyers, rather than taking out high-interest loans. It is particularly advantageous to use buyer financing for a project if property prices are expected to rise because if the developer exercises its right of withdrawal or claims that the completion of the project has become impossible, it can later resell the property at a significantly higher price on the market.

To avoid the aforementioned risks, we strongly recommend that buyers insist on a clear definition of the developer's right of withdrawal in contracts (pre-contracts, or sale and purchase agreements) and on the limitation of the scope of force majeure cases. Please note that according to the relevant case law, changes in economic circumstances and in market conditions qualify as business risks, and therefore even major changes in prices and market conditions do not render the performance of a contract impossible.

Developer's insolvency

If a developer becomes insolvent and goes into liquidation, the buyers' chances of regaining the money paid by them in advance are often slim. In such cases, buyers of new-build residential properties are in a better position if they are private persons because under the Hungarian Bankruptcy Act, they have a right of first refusal in the liquidation sale if they already paid all or part of the purchase price but did not acquire ownership of the property before the beginning of the liquidation procedure. In this case, private buyers, while exercising their right of first refusal, will also be entitled to set off the amount they paid in advance against the price offered in the liquidation sale.

However, these provisions cannot always provide real protection. First of all, years can pass by before the developer's liquidation starts, and as a



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result, the value of the property at the time of the liquidation sale may be significantly higher than the purchase price originally agreed between private buyers and the developer. If private buyers choose to exercise their right of first refusal in the liquidation sale in such a case, they will have to pay the difference between the two prices.

In addition, secured creditors are also entitled to buy the real property in the liquidation sale and pay the purchase price by means of a set-off up to the amount of the mortgage. In a new-build residential property, all apartments are encumbered with the mortgage securing the entire loan amount that was granted by the creditor to finance the whole building, i.e. the amount of the mortgage encumbering a single apartment is not adjusted to the value of the apartment. Therefore, creditors are able to offer prices in the liquidation sale that are far beyond the appraised value set by the liquidator. This strategy can force private buyers to accept higher prices because otherwise they would lose the entire payment they have made to the developer – often from a loan that they would have to continue to repay anyway. As a result, they can often end up paying twice as much as the originally agreed price. This strategy benefits creditors because they can increase their own recovery in the liquidation proceedings, since if the liquidation price is close to the original purchase price or the appraised liquidation value and the original buyers exercise their right of first

refusal and right of set-off, creditors will receive next to nothing from the proceeds of the mortgaged property. Though this strategy can raise concerns about misusing the rights of secured creditors, such a scenario undoubtedly creates a conflict between two rightful interests: that of the secured creditors and that of private buyers (who often struggle to keep their life savings).

Besides obvious measures such as doing due diligence on the reliability of developers, the best one can do to avoid such situations is not to agree on pre-contracts that require the payment of significant amounts to the developer without any security but to insist on contracts which grant an ownership share of the property as soon as relevant amounts are paid to the developer.

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