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Hungary: Enforcing Arbitration Agreements by Applying Foreign Law

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Conflict of laws issues can have a pivotal effect on the effectiveness of arbitration when state courts are asked to enforce arbitration agreements. Has the approach of Hungarian courts crystalized in the last few years in this respect? Can the contemporary Hungarian judicial practice and the new domestic legislation be characterized as arbitration friendly? This post provides the answers to these questions.

The Importance of Law Governing the Arbitration Agreement

The law applicable to arbitration agreement is an evergreen topic of international arbitration, primarily because of its decisive impact on the effectiveness of arbitration agreement. Not only is an arbitration agreement the principal gateway to arbitration, but its existence and validity may also come up in various phases of arbitral proceedings. These matters, of course, are almost always decided against the backdrop of the applicable law to arbitration agreement.

However, the dual nature of arbitration agreements – namely their debated classification as substantive or procedural contracts – complicates the search for the proper law of arbitration agreement.

Since the issue of governing law emerges mostly in front of state courts, which decide on their own jurisdiction when enforcing arbitration agreements, the old principle of *"forum regit processum"* calls for the application of the *lex fori* to this issue.

At the same time, the classification of arbitration agreements as substantive contracts and the principle of separability supports the application of other law, as *lex causae*, to assess the existence and validity of arbitration clauses.

When it comes to legal sources, except for Article VI (2) of the European Arbitration Convention, the leading international legal instruments of contemporary arbitration (like the New York Convention or the UNCITRAL Model Law) remain silent on conflict of laws issues in relation to arbitration clauses. It is also relatively rare that national laws expressly regulate the law governing the arbitration agreement.

In Hungary, the issue of applicable law to arbitration agreements has not been regulated until

recently. Although this situation has changed with the adoption of the new Private International Law Code ("PIL"), effective from 2018, there is no yet case law under the new regime.

For this reason, before summarizing the provisions of the new law, we examine the Hungarian case law. Specifically, we analyse two appellate court decisions and trace the evolution of the domestic approach in relation to the law governing the arbitration agreement in the pre-award phase.

Traditional Approach – *Lex Fori*

Since the law governing the arbitration agreement had not been regulated previously in Hungary, state courts traditionally applied the *lex fori* approach to arbitration agreements.

A good example of this approach is the judgment of the Appellate Court of Budapest from 2011,[1)] rendered in a dispute involving a share purchase agreement in relation to the business shares of a Hungarian limited liability company (target company).

The contract had been entered into in Budapest by a Cyprian company as the seller and a Swiss company as the buyer, and it contained an arbitration clause in favour of the Arbitration Court of the Russian Chamber of Commerce and Industry.

The seller sued the buyer in front of the Hungarian courts, challenging the existence of both the share purchase agreement and the arbitration clause by arguing that the contract was concluded on its behalf by a false representative, who acted based on a power of attorney executed in Cyprus five years before the sales transaction.

The buyer disputed the jurisdiction of Hungarian courts based on the arbitration clause. However, in the opinion of the Hungarian courts, the power of attorney issued in Cyprus and the share purchase contract concluded 5 years later in Budapest had to be examined as one transaction. According to the courts, this transaction had the closest connection with Hungary, so they applied the Hungarian law in the case.

Since the sale of the target company did not fall into the subject matter scope of the power of attorney, the Hungarian courts ruled that the false representative could not enter into a binding arbitration agreement on behalf of the seller.

The above decision can be criticized mainly for ignoring the principle of separability of the arbitration agreement, which prevented the court to examine the issue of representation, and the existence of the arbitration clause in light of any other law than the *lex fori*.

A More Sophisticated View – *Lex Causae*

In a (more) recent case from 2020, the Appellate Court of Gy?r has taken a more sophisticated approach.[2)] This case involved a legal dispute between an Austrian seller and a Hungarian buyer in relation to a supply contract for gas engines. It also involved a subsequent service contract concluded between the same parties through representatives to repair one of the engines broken down in the post-warranty period.

The seller's general terms and conditions ("GTC") stipulated Austrian law as the governing law of the contract, and an ICC arbitration clause with a seat of arbitration in Innsbruck (Austria).

The buyer sued the seller for damage, arising out of the unsuccessful repair and subsequent forced sale of the engine, while the seller raised an e*xceptio arbitri*, relying on the arbitration clause in the GTC.

While the GTC had been duly incorporated in the supply contract, the buyer argued that, despite the seller sending the GTC to him together with the service contract, he had not expressly accepted it. The buyer went on to argue that, given the damage claim had arisen from the service contract, the Hungarian courts had jurisdiction.

The court of first instance, taking the traditional *lex fori* approach, applied Hungarian law to the arbitration agreement, according to which in the absence of express acceptance of a "surprise clause" in the GTC, like the arbitration agreement, the latter does not become part of the parties' agreement. Consequently, the first instance court ruled that no valid arbitration agreement had been entered into by the parties.

However, the Appellate Court of Gy?r, acting as court of second instance, modified the first instance decision and applied Austrian law to the arbitration clause, according to which in case the parties do business in the same sector, or they have a continuous business relation, the provisions of the GTC become part of the contract if one of the parties intends to use it, and the other party is aware of this fact.

Based on the above, the second instance court ruled that the GTC and the arbitration clause had become part of the service contract by tacit acceptance of the buyer, and therefore, it terminated the litigation in that part that fell under the arbitration agreement.

Analysis and the New Hungarian PIL

The two above decisions showcase a paradigm shift in the approach of Hungarian courts in finding and applying the proper law of the arbitration agreement.

In the first case the courts took the traditional *lex fori* approach, and they applied domestic law to the contract and to the arbitration agreement, despite the apparent international dimensions of the case.

The second judgment indicates a departure from the strict *lex fori* approach towards the examination of the proper law of the arbitration agreement, which, as a so-called *lex causae*, can be distinct from the law of the state court, or from the law of the main contract, as well.

When it comes to the linking factor, the appellate court in the second case tacitly applied the *lex loci arbitri* principle, according to which, in the absence of choice of law by the parties, the arbitration agreement shall be governed by the law of the seat of the arbitration, reflecting the majority view of scholars.[3)]

Even if the new Hungarian PIL was not yet applicable in the second case – because the facts arose before 2018 – it seems that the second instance court was inspired by this new piece of domestic

legislation.

This new law introduced arbitration-friendly provisions regarding the law applicable to the arbitration agreement with effect from 1st January 2018.

According to Section 52 of the Hungarian PIL, in the absence of law chosen by the parties, the substantive validity of the arbitration agreement shall be governed by the law governing the main contract, or by the law of the seat of arbitration, provided that the latter is in closer connection with the contract than the former.

When it comes to formal validity, the PIL sets forth a provision, based on which the arbitration agreement shall be valid, if it complies with any of the abovementioned laws or with the *lex fori*.

The above provisions clarify that instead of *lex fori*, the existence and substantive validity of an arbitration agreement can be evaluated based on separate law as *lex causae*, reflecting the principle of separability on the conflict of laws level.

In addition, the provisions in respect of formal validity can be interpreted as statutory expressions of the so-called *validation principle*.[4)]

Hopefully, when applying the provisions of the PIL in the future, Hungarian state courts will follow the pro-arbitration approach taken by the Appellate Court in the second case, and they will give effect to international arbitration agreements under the new arbitration-friendly domestic conflict-of-laws rules.

References

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