CZECH PLEDGE OF BUSINESS: AN ASSESSMENT OF AN ALTERNATIVE BUSINESS DEBT FINANCING TOOL SIMILAR TO THE AMERICAN FLOATING LIEN CONCEPT

by Anna Hergottova

LL.M. SHORT THESIS

COURSE: COMPARATIVE SECURED TRANSACTIONS

PROFESSOR: Tibor Tajti, S.J.D.

Central European University
1051 Budapest, Nador utca 9
Hungary

Abstract

Legislation in the field of secured lending has significant impact on availability and terms of credit. There is a huge difference between the comprehensive legislation in the field of secured credit in the United States on one hand and the scattered norms related to the same topic (although unrecognized as a separate field of law) in the Czech Republic. In the United States, the positive impacts of credit on market economy have been realized more than half a century ago which lead to the enactment of the comprehensive Uniform Commercial Code "Secured Transactions" Article 9.

Since the enactment of UCC Article 9, the United States asset-based financing has grown to a completely new level. On the other hand, there is shortage of credit and very little asset-based financing in the countries of Central and Eastern Europe. The Czech Republic is among the countries of the CEE region which has recently modernized its legislation in order to enhance credit opportunities in the business sector. The Czech pledge of business, enacted by the Act No. 317/2001 Coll., on Amendment to the Civil Code, is a positive development, but there are various conceptual deficiencies of the current legislation, especially when compared against UCC Article 9.

The floating lien of is one of the key concepts of UCC Article 9 which enabled creation of a broad security interest in the mostly business debtor's present and future property. Similarly to the floating lien, the Czech pledge of business has also been intended to enhance asset-based long-term business debt financing.

However, the American floating lien is supported by the complex secured transactions solutions found in Article 9 making the floating lien a reliable and preferred type of business debt financing in the United States. Contrary to that, there are only a few scattered and conceptually weak provisions relating to the Czech pledge of business, which gives rise to specific concerns over its implementation and enforcement practice.

TABLE OF CONTENT

I Introduction

Historically, England has been the first country to introduce the *floating charge*: a long-term debt financing device enabling the debtors to utilize both their present and future property as security and enabling the debtors to continue operating their business[1]. For the purposes of long-term business debt financing, it is economically reasonable for both sides of a secured transaction to enable the debtor to be able to use both the business debtor's current *and* future property for security purposes.

In the United States, the same purpose as the English floating charge is served by the *floating lien* concept: a security interest[2] can extend to after-acquired property, proceeds and future advances, allowing the general secured creditor to create a broad security interest in the business assets which are mostly of transitory nature. In a civilian legal system, the *qui non habet, ille non dat* doctrine[3] and the doctrine of *legal certainty* stepped in and it has long been rejected that charge over both present and future property should be enacted among the statutory security devices.

The creditor can decide to grant credit on *secured* or *unsecured* basis. The choice made by a *rational creditor* is; however, to provide for 'security' which can take the form of either *personal* or *in rem* security.[4] In civil law countries, there are various restrictions that apply to the collateral that can be charged and there are also restrictions on the debtor's ability

---

[1] In *Holroyd v. Marshall* (1862), it was held that equity would recognize a charge over the after-acquired property as effective to create a security interest which would attach automatically upon acquisition. The recognition of what became to be known as the floating charge came eight years later with the holding in *Re Panama* (1870). The debtor charged its 'undertaking and all sums of money arising therefrom', and the court construed such stipulation as the undertaking being not merely the income from the business but also its present and future property. Roy Goode, *Commercial Law (*Penguin, 2nd Ed. 1995), p. 731-735.

[2] *‚Security interest'* is used to refer to a right given to one party in the asset of another to secure payment or performance of an obligation.

[3] *Qui non habet, ille non dat* stands for "a man cannot give what he does not have". In the context of the secured transactions, it extends to giving security in something which you *currently* do not have at all - the future, *after*-acquired property.

[4] Personal security is created when the debtor or a third person guarantees the repayment of a debt so that the creditor has a claim against such a person which can be enforced through litigation. On the other hand, *in rem* security means taking security in specific parts of the debtor's property (such as real estate mortgage) which attaches to the charged collateral and creates a security interest in that specific collateral which is valid against third persons and subsequent creditors. For this particular reason, the *in rem* security is regarded to be stronger than personal security. Phillip R. Wood, *Comparative Law of Security and Guarantees* (Sweet and Maxwell Ltd., 1995), p. 272.

to possess and manage the charged collateral. On the other hand, in common law countries – and namely in the United States, the trend is opposite: to enable charge over any item of value which the creditor finds suitable for security purposes. Modern business financing needs are further best served by such security which can be created *without taking possession*, i.e. the *non-possessory* security devices.

In order to address the problem of shortage of credit observed in the countries of Central and Eastern European (CEE) region, EBRD launched a project aimed at modernization of CEE collateral laws. The Czech Republic is one of the countries which - to some extent - modernized its legislation, in order to facilitate credit. The Czech progress in the field of secured transactions has been assessed by the EBRD as one of the "major reform countries", which denotes that significant progress has been made; however, there are also significant shortcomings in the law itself and/or the *implementation* of the collateral law.[5]

Until 2000, creating a pledge[6] which stands for the most common security device in the Czech Republic was only possible by taking possession[7]. The Civil Code contains a sub-division on 'Securing of contractual obligations' with provisions on contractual penalty, guarantee, security transfer, assignment, plea of debtor, surety, salary deduction agreement, and Section 552 of the Civil Code provides that "a claim can also be secured by a *pledge*. Pledge is regulated in the *in rem rights*[8] subdivision of the Code."

In 2001, the Czech legislators reflected on the need to introduce an alternative *in rem business debt financing tool* taking into account the modern business needs and enacted

[5] EBRD, Enforcing Secured transactions in Central and Eastern Europe, 2004, http://www.ebrd.com/pubs/legal/lit041c.pdf.

[6] The pledge or Latin *pignus* known since the Roman times is traditionally created by handing the pledged collateral over to the creditor. It is historically the most common *possessory* security device, which is; however, completely inaccurate for the modern business needs. While it is true that the creditor has the control over the collateral, it also 'deprives' the debtor of the possession of his property and therefore, it complicates debtor's ability to repay the debt because he clearly cannot use the asset which is not in his possession for business purposes. Roy Goode, *Legal Problems of Credit and Security,* 2nd ed. (London: Sweet & Maxwell, 1988), p. 563.

[7] The Act No. 367/2000 amending the Civil Code enabled creating a pledge without taking possession.

[8] The *in rem* rights, Czech "věcné práva". These are regulated in Part II of the Civil Code. Sections 123-180 deal with ownership, joint ownership, *pledge* and right of retention.

pledge of business in the Civil Code 'pledge' provisions.[9] Notwithstanding the archaic term *'pledge'*, the 'pledge of business' as it has been implemented in the Czech Civil Code breaks through the *qui non habet, ille non dat* doctrine because it enables the debtor to pledge the *business as a 'going concern'*.[10] This means that the pledge does not attach merely to the business property 'as it stands' at the time of concluding the pledge agreement. Similarly to the American floating lien concept, it also attaches to the after-acquired property and proceeds of a business. Furthermore, it is construed as a *non-possessory* security device - the debtor (i.e. pledgor) can continue the business independently and uninterrupted.[11]

Both the American floating lien concept and the Czech pledge of business have been intended as long-term business debt financing tools. The UCC *Secured Transactions* legislation increased the level of legal predictability and reduced legal risks involved in granting of credit, which made particularly the floating lien a popular long-term business debt financing device. Adversely to that, 'secured transactions'[12] as a separate field of law is unknown to most civil law countries and the Czech legal system is no exception to the rule. The Czech pledge of business was enacted by simply adding the word *business* to the list of collaterals that can be pledged.

Firstly, I shall describe the floating lien concept of UCC Article 9. Since the floating lien concept is embedded within the comprehensive legislation dealing with various aspects of secured credit, I shall focus on the *policy choices* made by the drafters of UCC Secured Transactions Article 9 which influence the floating lien concept in practice. The solutions of UCC Article 9 - mainly priority rules, public notice, efficient enforcement mechanisms, and

[9] Section 153(1) of the Act No. 40/1964 Coll., the Civil Code as amended provides that "the pledged collateral may take form of a tangible or immovable asset, *business or any other group of assets*, claim and other property right, if its nature so allows, a flat, a share in a company, a negotiable instrument or intellectual property rights."

[10] Tomáš Richter, „Zástavní právo k podniku z pohledu teorie a praxe dluhového financování", *Právní rozhledy* 3 (2004): p.88.

[11] Both amendments of the pledge provisions (2000, 2001) have supposedly been prompted by the business circles and the banking sector which found the possessory pledge impracticable. Radmila Kulková, „K zástavnímu právu po novelách občanského zákoníku"*, Právní rozhledy* Vol. 7(2002), p. 319-320.

[12] ‚Secured Transactions', which is also a short title of Article 9, are used to refer to the transactions which involve the granting of a security interest.

complex coverage of the previously fragmentized secured credit field could in many ways inspire other jurisdictions lacking similarly comprehensive legislation.

Following description of the floating lien and its supporting policies, I shall assess the Czech pledge of business bearing striking similarity to the American floating lien – so far as the *legislative intent* is concerned. The complex solutions adopted by the drafters of UCC Article 9 shall serve as a model against which various significant aspects of the floating lien equivalent in Czech legislation – pledge of business, will be compared. The comparison between the UCC Secured Transactions Article and rules found (or missing) in the Czech law shall allow me to identify the drawbacks of the pledge of business in the current Czech legal practice.

In the final part, I shall conclude on the successful use of the floating lien concept in the United States which led to the development of an ever growing asset-based lending field. Further, I will state my conclusions about the consequences of the deficiencies of the current Czech pledge of business legislation for a secured creditor (i.e. pledgee) willing to rely on the pledge of business provisions. I will particularly express concerns over the lack of efficient enforcement mechanisms for a pledgee of business who is seeking satisfaction of the secured debt *outside bankruptcy.*

Also, it remains to be assessed whether such a complex legal issue as long-term debt financing can function effectively provided the various scattered provisions relating to the Czech pledge of business. If anything, UCC Article 9 is inspirational for its complexity and credit market enhancing policy choices.

II United States secured transactions law: implementation of complex solutions

The floating lien is a concept within the Unites States' Uniform Commercial Code Secured Transactions Article 9. It enables creation of a broad security interest in after-acquired property, proceeds and future advances, supported primarily by the rules on priority, public notice and enforcement found within Article 9. To regulate the complex secured credit relationships is not an easy matter and the solutions adapted by the drafters of Article 9 are in many ways groundbreaking. Firstly, it is uniform legislation for all secured transactions. Uniform legislation was inevitable due to concerns regarding the market developments in the 1940's and 1950's: lending agencies were lowering their standards when extending credit as a reaction to a wider credit demand[13].

With new categories of borrowers willing to borrow and creditors willing to lend, new types of securities were being invented in order to make use of new types of personal property (such as accounts receivables, inventory and raw materials).[14] UCC Article 9 was seen as a tool, which would set rules in the growing credit industry. Its uniform legislation was intended to provide the basis on which the credit economy can grow. In order to provide for modern legislation, a few concepts of the previous law had to be abandoned.

Significantly, for the purposes of this paper, *the floating lien concept* (i.e. lien on a shifting stock of goods) would be deemed to be void as against public policy if under chattel mortgage law[15]. Another rule of law abandoned by the UCC Article 9 is the "*Benedict v. Ratner* rule*",* asking for an exercise of dominion over cash flowing from security regarding receivables or inventory (i.e. which is rapidly turned into cash)[16].

Grant Gilmore, one of the drafters of UCC Article 9, expressed the belief that the positive developments in the field of secured transactions are the result bringing a set of rules

[13] It was no longer true that only those with real estate or expensive equipment would be the only subjects eligible to obtain credit. Credit was more and more used by small and medium sized businesses and customers buying durable goods. *Homer Kripke* and *Grant Gilmore* were among the most influential drafters of UCC Article 9. See e.g. Kripke, Homer, "Modernization of commercial security under Uniform Commercial Code", *Law and Contemporary Problems*, Vol. 16, No.2 Commercial Code: Part 2. (Spring 1951): 183-184; Grant Gilmore, "The Secured Transactions Article of the Commercial Code", *Law and Contemporary Problems*, Vol. 16, No.1, (Winter 1951): p.28-29.
[14]Grant Gilmore, *Id.*, p. 29.
[15] Grant Gilmore, *Security Interests in Personal PropertyVol.1* (Boston: Little, Brown and Company, 1965): p. 354.
[16] *Id, p. 355.*

to a field which in the pre-Code era was characterized by varying, unclear rules.[17] Both sides of a secured transaction, i.e. secured lenders *and* borrowers have been provided with a feeling of security, which led to the development of trust in then entirely novel methods of financing. Another common argument for the growth of asset-based financing is the *institutionalization* of secured credit: UCC Article 9 contained significant policy choices, among those the enactment of *floating lien concept* and the recognition of *purchase money security* interest*.*

Both the floating lien concept and purchase money security (which are inter-related concepts within the structure of UCC Article 9) reflected the will of the drafters to make the secured credit legislation support positive developments in the growing credit market.[18] However, the sophistication of Article 9 stems from the integration of various policy choices made by the drafters of UCC Article 9. In order to understand how efficiently the floating lien concept works, I shall also explain the supporting concepts within Article 9: the priority rules, the public notice, the purchase money security and the efficient enforcement mechanism.

II.1 Floating lien concept

II.2.1 General remarks

The floating lien is one of the key concepts within UCC Article 9. The floating lien enables creditors to create security interest in (1) after-acquired property, (2) proceeds and (3) future advances. Therefore, a security agreement enables a secured creditor to create a security interest not merely in the debtor's present, but also future property and such security can extend to security for debts to be incurred by the debtor in the future. [19]

[17]Grant Gilmore, The Good Faith Purchase Idea and the UCC: Confessions of a Rependant Draftsman, 15 *GA L. Review*, 626 (1981): p.620.
[18] See e.g. Robert E. Scott, "The Politics of Article 9", *Virginia Law Review*, Vol. 80, No. 8 (Nov. 1994), pp. 1787-1790.
[19] Although similar to the floating lien, the *floating charge* had already been recognized in other common law jurisdictions – England and Canada, at the time of the enactment of UCC Article 9, the floating lien concept became the most controversial aspect of the whole secured transactions law on its enactment. Grant Gilmore, *Supra* 15, p. 359.

Floating lien was primarily intended to enhance *long-term business debt financing*. In other words, the business practice shows that any business debtor is likely to have a general (or exclusive) creditor - the floating lien enables this type of creditor to create a broad security interest in the business debtor's assets, including property acquired in the future. However, the idea that the secured creditor should be able to create such a broad encumbrance on the debtor's property was first viewed as somewhat revolutionary.[20]

The revolutionary aspect of the floating lien concept lies in overcoming of the then rules of law, which were making security most of all in the after-acquired property difficult to enforce. Notwithstanding the fact that such security agreements had already been part of the American business practice[21], the courts continued to apply the rule of *Benedict v. Ratner*[22], asking the creditors (i.e. assignee of the debtor's accounts) to exercise daily watch over the debtor's business, which increased the monitoring costs of creditors.

Moreover, similarly to the civil law *qui non habet, ille non dat* doctrine,[23] common law also knew the theory according to which it is a legal and practical impossibility to make a valid assignment of present *and* future accounts. Opponents of the floating lien concept further argued that a floating lien will diminish chances of subsequent creditors to create security efficiently (since the borrower's property will already be encumbered) and that the "necessitous borrower" should be protected from hastily granting security interest in all the property he is to acquire in the future[24].

[20] According to *Gilmore*, the most famous drafter of UCC Article 9, the floating lien concept has been perceived as the *most revolutionary* aspect of UCC Secured Transactions provisions. Prior to its adoption, UCC Article 9 as a whole was even being referred to as the "floating lien statute". Grant Gilmore, *Id.*, p. 359.

[21] A functional equivalent of the floating lien concept had already been in practice among businesses, but the complications posed by application of various pre-UCC devices made such security privilege of those that could afford the most expensive lawyers and the whole issue of creating security in present and future borrower's property became "cumbersome, expensive and tricky". See Gilmore, *Id*., p. 360-361.

[22] 286 U.S., 353 (1925).

[23] *See Supra* 3.

[24] Grant Gilmore, *Supra* 15, p. 360. As noted by the New York Court of Appeals in *Zartman v. First National Bank(1907),* "a court of equity will not enforce a contract to give a mortgage upon a subject to come into existence in the future, if the result would deprive the general creditors of their only chance to collect the debts".

Applying the traditional doctrines and surrendering to the opponent's arguments could invariably complicate the enforceability of floating lien security agreements. So why was the floating lien concept needed and how did the drafters justify the controversial departure from the then doctrinal rules?

Most of businesses' principal assets are usually formed by items of transitory nature. While it is true that the overall value of transitory assets may remain relatively unchanged, the particular items are constantly changing. Nevertheless, they do usually form a substantial part of a business.[25] Therefore, the intent of the drafters was on one hand to enable the business debtors use this huge security potential of transitory collateral and on the other, to allow the general secured creditor create a broad security interest in such assets.

II.2.2. The floating lien concept: security in after-acquired property, proceeds and future advances

The floating lien concept enables creditors to take security in a *pool of assets*. A security agreement making use of the floating lien provisions of UCC Article 9 will therefore contain a clause, with a wording such as "the collateral of this agreement is inventory, including all merchandise, raw materials, goods in process, finished goods and other tangible personal property now *owned* or hereinafter acquired by the Debtor…, and all accounts, chattel paper and general intangibles with respect thereto and proceeds thereof"[26].

It is clear from its wording that the creditor is creating a *broad security interest* in both the present and future assets of the debtor (i.e. in a pool of assets rather than in particular assets). The floating lien represents the flexibility of secured finance and was primarily

[25] Nimmer R. T., Nimmer, R. T., Hillinger, I. M., *Commercial Transactions: Secured Financing Cases, Materials, Problems 2nd ed.* (New York: Lexis, 1999), p.525.
[26] Frankel, L.H., Frankel, L. H., McDonnell, J. B., Nimmer, R. T., *Commercial Transactions: Secured Financing*, (Virginia: The Mitchie Co., 1982), p. 274.

invented for those utilizing transitory items, such as inventory and accounts for security purposes.

An after-acquired property clause maintains such effects that when the present assets are being traded for future ones, the security will attach to the after-acquired assets *automatically* upon their acquisition by the debtor. The lien created by such agreement is then ‘floating’ over the constantly changing mass of assets.[27]

Under UCC Article 9, the *debtor is free to manage* the encumbered property. Therefore, various restrictions imposed on the debtor’s management powers will depend on specific covenants in a particular security agreement. The secured creditor provide for different types of restrictions depending on the type of collateral, type of business and transaction secured by the lien. The secured creditor can for instance include a provision in the security agreement obliging the debtor to ask for permission before he disposes of equipment or before he transfers the readily movable assets to another jurisdiction. The secured creditor may also include debtor’s warranty that insurance on various encumbered assets will be maintained.

Such provisions may not have the *in rem* power of the lien itself, but a failure to comply with the terms of the security agreement can trigger debtor’s default – upon the occurrence of which the secured creditor becomes a real master of the situation and can accelerate the loan (if such arrangement is part of the agreement) and/or reach satisfaction of the secured debt by any other remedies provided for by security agreement or by UCC Article 9.

An important aspect of the floating lien is the liberal approach to description requirements of the collateral in a security agreement. UCC Article 9 requires that in a valid security agreement the collateral securing the transaction must be *sufficiently defined*. The collateral’s definition is sufficient if it *reasonably identifies* what is described. Revised Article

[27]Nimmer, R.T., , *Supra* 25, p.525-526.

9 clarifies that except certain consumer transactions, a description is sufficient by description of a category, e.g. debtor's "current equipment"[28], or "all farm machinery currently owned"[29]. However, it is also made expressly clear by Revised Article 9 that description of the collateral such as "all debtor's assets" or "all debtor's personal property" is not sufficient as the collateral description[30]. The current requirement of *reasonable identification* seems to be liberal enough to support the flexibility of secured transactions which was intended by the drafters when enacting the floating lien concept.

Unlike the English floating charge, the floating lien is a *concept* embodied within provisions of the UCC Article 9 which deals separately with (a) after-acquired property, (b) proceeds and (c) future advances. What is covered by these provisions?

(a) After-acquired property

UCC Article 9 validates broad security agreements which cover not only what the debtor currently owns, but extent to the property acquired by the debtor in the future. [31] As noted above, such arrangements will be predominant in commercial relationships, where it is property of transitory nature such as inventory and accounts rather than a single piece of equipment which is used as security. The limit set by the drafters as to *what future property* can be used as collateral is the consumer goods acquired by the debtor.

Importantly, Article 9 includes stringent priority rules designed to protect the creditor making use of the after-acquired property provisions – these will be dealt with separately.

[28]Richard Duncan, William H. Lyons, and Catherine Lee Wilson, *The Law and Practice of Secured Transactions: Working with Article 9*, (N.Y.: Law Journal Press, 2006), p. 2.20-2.23.

[29] *Midkiff Implement Co. v. Worrall*, 116 Ill. App. 3d 546, 451 N.E.2d 623.

[30] Richard Duncan, *Supra 28*, p. 2-18.

[31] The drafters made an important policy choice when enacting the after-acquired property provisions: "The widespread 19th Century prejudice against the floating charge was based on a feeling…that a commercial borrower should not be allowed to encumber all his assets present *and* future, and that for the protection of not only the borrower but of his creditors a cushion of free assets should be preserved….In pre-Code law there was a multiplication of security devices designed to avoid the policy…This Article, in expressly validating the floating charge, merely recognizes an existing state of things." Section 9-204(1), Comment 2.

(b)Proceeds

Proceeds are defined as whatever is received upon the sale, exchange, collection or other disposition of the collateral or proceeds and they attach by operation of law – no special security agreement is therefore needed for a creditor to gain security interest in the proceeds of the collateral.[32]

UCC Article 9 deals unanimously with both cash and non-cash proceeds. The cash proceeds are money, checks and deposit accounts. The non-cash proceeds consist primarily of accounts, instruments, goods, documents and general intangibles.[33] Therefore, in a commercial transaction secured by inventory and accounts, the creditor's security interest will not only extend to the debtor's future property, but also to the *identifiable proceeds* from sale, exchange, etc. of such future property.

The word *identifiable* is not defined within the UCC. A separate body of case law developed which deals with the issue what constitutes identifiable proceeds. Although Prof. Gilmore (one of the drafters of UCC Article 9) objected that the creditor's security interest shall not extend to such proceeds which have been commingled in the debtor's general accounts, most courts dealing with identifiable proceeds issues applied the common law principles of tracing in order to effectively trace the proceeds of the secured property.[34]

(c) Future advances

Future advances are functionally a mirror-reflection of the after-acquired property clause. While the after-acquired property clause enables the creditor to *presently* create a security interest in *future property*, the future advances clause enables the creditor to extend credit *in the future* using the same *present property* (i.e. property existing and defined at the time of entering the security agreement). Therefore, a security agreement may cover property

[32] Section 9-306(2) UCC.
[33] Clark Barkley, *Law of Secured Transactions under the Uniform Commercial Code*, (New York: WGL, 1993), p. 10-4.
[34] Richard Duncan, *Supra* 28, p. 2-62.

acquired by the debtor in the future and it may likewise secure debt incurred by the debtor after the security agreement has been executed[35].

Significance of the Code's future advances provision is in the simplification of revolving credit: the lender involved in revolving credit commercial relationship can include a future advances clause and doesn't have to enter new security agreements with the same debtor. Just how much flexibility is the creditor allowed with respect to the type of obligation that can be secured by the same security agreement (and the same collateral) depends on a court's interpretation of the Uniform Commercial Code[36].

The floating lien concept is one of the key concepts within UCC "Secured Transactions" Article 9, which provides for complex solutions in the field of secured creditor-debtor relationships outside bankruptcy. In the next section, I shall define the main characteristics of UCC Article 9 and its most significant underlying policy-choices.

II.2 Complexity of the UCC Article 9 solution: unitary approach

UCC Article 9 represents unitary approach to all secured transactions - unlike in the pre-Code era, when the area of secured transactions was fragmentized. The pre-Code era law on various types of security was characteristic with different statutes in various states dealing with particular types of transactions, such as a Chattel Mortgage act, a Conditional sale act, a Factor's Liens Act, a Field Warehousing Act.[37] These statutes were intended to regulate the emerging types of secured transactions.[38]

[35] William Davenport & Daniel R. Murray, *Secured Transactions*, (Philadelphia: ALI ABA, 1979), p. 102.
[36] Case law has dealt with the so-called "dragnet clause" (i.e. a security agreement when the collateral is to secure *all obligations* from Debtor to Secured Party *whenever they arise*, *of whatever kind and nature)* and some courts have upheld such dragnet clause (E.g. *The Kimbell Foods, Inc. v. Republic Nat'l Bank,* 401F. Supp 316, 18 UCC Rep. 507, (Tex. 1975); while other courts invalidated such a clause (E. g. In Re Johnson, 31 UCC Rep. 291, 9 BR 713 (Bankr. MD Tenn, 1981). Clark Barkley, *Supra* 35, p. 10-15.
[37] Gilmore, Grant, *Supra* 13, p. 31.
[38] The federal structure of the United States raised another concern: particularized state legislation may be particularly problematic when its purpose is to regulate the use of *movable* assets as security (i.e. assets which unlike real estate can be moved from one state to another

The unitary approach of UCC Article 9 means that it is applicable to any transaction, regardless of its form, which is intended to create a security interest.[39] The important denominator of an assessment whether a particular transaction qualifies as a secured transaction under UCC Article 9 is the *intent* of the parties. In order to cover different types of existing security devices, the drafters invented a new universal vocabulary, which became an area of contention among the legal scholars.[40] However, the unitary treatment of secured transactions is not limitless: UCC Article 9 only deals with personal (movable) property, not the real property[41] and there are also several types of transactions (which are not the typically commercial transactions) that are exempt from its application.[42]

Secured transactions legislation efficiently tackles the ostensible ownership problem. Creation of a valid security interest which is also effective towards third parties has been made contingent upon compliance with certain public notice requirements. In the next subsection, I will explain *why* public notice is considered to be one of the central aspects of an *efficient and reliable* secured transactions legislation and *what are the specific requirements* relating to public notice giving where personal (i.e. movable) property is involved.

[39] UCC Article 9 deals with *secured transactions* – transactions intended to create a security interest. The parties to such a transaction are the *debtor* and the *secured party*. The latter is the person who holds a security interest[39] – be it a seller who retains a security interest in the sold goods or a lender taking security interest in debtor's immediate property. The former is the person who owes payment or other performance of the obligation secured. *Collateral* is the (movable) property which is subject to the security interest.

[40] The terminology of UCC Article 9 is universal enough to cover the intended broad spectrum of secured transactions. Beutel, F. K., "The Proposed Uniform(?) Commercial Code Should Not Be Adopted", *The Yale Law Journal*, Vol. 61, No.3 (March 1952), p. 334-342; Gilmore, G., "The UCC: A Reply to Professor Beutel", *The Yale Law Journal*, Vol. 61, No. 3 (March 1952), p. 367-368.

[41] The *realty* is a common law counterpart of the civil law *immovables*. The UCC Article 9 does cover security interest so-called fixtures, which is a category 'between movable and real property'.

[42] These include landlord's lien, transfer of a claim for wages, salary or other compensation of an employee, an equipment trust covering railway rolling stock, transfer of an interest in or claim any policy of insurance, any right of set-off, or any right represented by a judgment (other than a judgment on a right to payment which was collateral). The reason for exemption of these types of transactions from the general application of UCC Article 9 is in the inherent public interest underlying such transactions. Therefore, it seems to be a generally accepted opinion that these transactions are and should be subject to special legislation. Henson, R. D., *Secured Transactions under the Uniform Commercial Code*, (St. Paul, Minn.: West Publishing Co.,1978), p. 20-29.

II.2.1 Perfection and public notice

While the floating lien represents the need for flexibility in the field of credit, there are other aspects, such as priority and public notice, which provide static rules and have brought legal certainty in the growing credit field. The *efficient public notice system* has the primary purpose of protection of the third parties. Once the possession is separate from ownership of collateral, the law has to deal with the *ostensible ownership dilemma* – dilemma that the debtor (or potential debtor) might seem wealthier than he really is since he remains in possession of the collateral already used to secure a debt.

In order to tackle the ostensible ownership problem, a party who is to acquire or to retain a *non-possessory* interest (i.e. who acquires security interest without taking possession) in a property must make it possible for the third parties to find out about the existence of such a non-possessory interest. Therefore, drafters of UCC Article 9 made the creation of a valid security interest contingent upon public notice giving.[43]

The most prevalent form of perfection under Article 9 is *filing*. Notwithstanding that the public notice giving had had almost a hundred-years-long history in the pre-Code era, it was Article 9 which significantly provided for uniform filing requirements for all types of secured transactions overcoming distinctions among the different filing requirements secured transactions.[44] Perfection by filing requires that the secured party files a completed financing statement in the appropriate UCC filing office. The *financing statement* itself is construed as a form containing the names of the secured party and the debtor, the address of the secured

[43] *Effective* creation of a security interest is the one effective towards subsequent creditors and grants the secured creditor priority in case of competing security interests. UCC Article 9 recognizes two stages of creating a security interest: (1) attachment and (2) perfection. Attachment of a security interest occurs when three conditions are met: the debtor has to have rights in the collateral, there has to be a valid security agreement, and secured party has to give some value in return for the security interest. On the attachment stage, the security agreement is only valid *inter partes*. In order for the security interest to be effective *erga omnes* (and fully enforceable), it needs to be perfected. (UCC Section 9-204(1)).

[44] In the pre-Code era, each statute (e.g. a chattel mortgage act, factor's lien act etc.) imposed different filing requirements and these would vary from state to state; creditor who was considering extension of loan would have to search through different records in different offices and sometimes even in different states in order to make sure that debtor's property is not encumbered. Lakin & Berger, *A Guide to Secured Transactions*, (Illinois: Callaghan, 1970), p. 136-137.

party, mailing address of the debtor and a statement describing the collateral of a secured transaction.[45]

The other two perfection methods are by *taking possession* and by *control*. And both of them reflect practical concerns where filing is less efficient than the two other methods mentioned. *Taking possession* is the traditional form of demonstrating interest in the property, *pledge* being the globally accepted security device already in the Roman law. The Code does not explain what is meant by taking possession of the collateral, but it is interpreted to mean that the pledged collateral shall be transferred from the debtor to the secured party unless the collateral is already in the debtor's possession.[46]

Perfection by control is the method relating to investment property[47] when the requirement for control is fulfilled by one of the following: (1) delivery and endorsements to the secured party, (2) an agreement between the issuer of the securities and the secured party that the issuer will follow instructions from the secured party; the same with a broker, bank or other intermediary holding a securities account, (3) registering of the securities in the name of the secured party.[48]

To conclude, the requirement of public notice is connected with the perfection of security interest and the time of perfection is crucial for priority position of a creditor. Therefore, there is enough motivation for the secured creditor to comply with the notification

[45] Section 9-402(1) UCC. Revised UCC Article 9 (1999) has changed the requirement for debtor's signature: it is no longer necessary for the debtor to sign the financing statement, it is sufficient if the debtor authorizes the secured party to file the statement and this can be done *electronically*. As for *where* (in which office) to file, Revised Article 9 altered choice of law rules determining the appropriate filing office. In most cases, it is no longer the location of the property, but the location of the debtor[45] which is decisive for proper filing. The Code previously required that the filing should take place according to the place of the good (except for the mobile goods) and according to the debtor's chief executive office when the collateral consisted of accounts and general intangibles. The revised requirements are simpler for the secured party to follow without incurring excessive *monitoring costs*. Corinne Cooper, *The New Article 9 (2nd Ed.)*, (N.Y.: ABA, 2000), p. 27-28.

[46] Revised UCC Article 9 has modified the method of perfection where a third person, i.e. bailee, is involved: it requires that the bailee receives notice to the effect that it shall hold the property for the secured party and the bailee cumulatively acknowledges the receipt of the notice and that "he is holding the collateral for the secured party's benefit. Corinne Cooper, *Supra* 45, p. 30.

[47] Investment property is defined in UCC Article 8.

[48] Revised UCC Article 9 enabled perfection by control also in deposit accounts, and letter -of -credit rights. In deposit accounts, control is manifested by changing the deposit account in the secured party's name or by an agreement between the bank and the secured party that the bank will only comply with the instructions of the secured party. In case of letter of credit, the secured party obtains control by assignment of proceeds by the issuer or the beneficiary under the letter of credit. Corinne Cooper*, Supra* 45, p.31.

requirements. Why the priority position itself is crucially important for enforcement of secured creditors' rights will be explained in the next subsection.

II.2.2 Priority rules: reflections of public policy considerations

Priority rules decide which one of the competing creditors has priority when debtor's funds are insufficient to satisfy all his debts. UCC Article 9 provides detailed priority rules which reflect public policy considerations: commercial certainty, efficiency, fairness, and most significantly, incentive for growth and flow of commerce.[49] UCC Article 9 main priority rule is the *first-in-time rule*. Since it is the *moment of public notification* which is decisive for perfection and therefore also decides the priority of a creditor, it is possible to reach priority over an earlier created encumbrance. This is very different from the previous priority rules, when the court would try to find out whether the subsequent creditor knew about the previous encumbrance (i.e. the good faith of the subsequent creditor is not decisive)[50].

Article 9 creates a stable system with certain general priority rules and also exemptions from those rules. The conceptually most important exemptions are the *general priority of the floating lien creditor* against subsequent creditors of the debtor and the related *super-priority of the purchase money security interest.*

[49] The *commercial certainty* principle has been applied in recognition of the fact that business people need to be able to predict strength of their interest in collateral against other creditors – both of the antecedent and/or subsequent creditors. UCC Article 9's detailed list of objectively cognizable priority rules leaves little space for uncertainty in this respect and so does the filing-system. The *efficiency* criterion was consulted in order to ensure that creditors have means to predict risks and plan the forthcoming transactions accordingly. The *fairness* principle transpires in Article 9 giving chance to the creditors to use their diligence. They can check the public records in order to find out facts about debtor's property. The *economic growth* and *flow of commerce* is encouraged by making sure that there are exceptions to the general secured transactions rules in order to facilitate rather than complicate business. Richard Duncan, *Supra* 28, p.4-4 – 4-7.

[50] The first-in-time rule is *cost-minimizing*: the secured creditor needs to acquire the security interest in the collateral *and* provide public notice to gain priority. The idea is to "freeze" the debtor's *creditworthiness* – once the security interest is registered, it eliminates debtor's chances to use the same collateral as security for future loans since the registers are public and easy to access. Apart from the first-in-time rule, the secured creditor should have priority against an unsecured creditor and depending on perfection, also over a judicial lien creditor. Robert E. Scott, *Supra* 18, p. 1799-1802.

II.2.3 Exemptions from the priority rules: floating lien, purchase money security and other exemptions

(a) Floating lien: a conceptual exemption from the general priority rules

Floating lien is given special position in the priority system when the secured creditor who registered his security interest in the debtor's current and future assets will gain *priority against subsequent creditors* even before the particular assets are acquired. The justification for the special protection granted to the general financing creditor is based on the efficiency criteria: since the floating lien attaches mostly to the transitory items (such as inventory), it would collide with the very purpose of a simple and efficient public notice system to allow for a competition between the general financing creditor and subsequent creditors regarding every single asset acquired by the debtor. Such arrangement would be unnecessarily cumbersome for the general financing creditor and would in turn have disastrous effects on the price of the credit (i.e. the interest the debtor would have to pay)[51]. The departure from the first-in-time priority rule has arguably also had positive effects on the behavior of the general financing creditors.

The general (or exclusive) secured creditor who creates a floating lien has an imminent interest in the debtor's business performing well after the extension of credit. Therefore, it is likely that the secured creditor will provide for contractual provisions in the security agreement that will allow him to monitor and participate in management of the debtor's business. Why would that be a justification of the floating lien priority?

The responsibility and monitoring of the general secured creditor is a positive signal to the other creditors. Notwithstanding the significance of the insider-problems which also occur in the field of secured transactions, a *reliable* general secured creditor may be a positive signal

[51]*See* Stephen McIntosh, "Priority Contests under Article 9 of the Uniform Commercial Code: A Purposive Interpretation of a Statutory Puzzle", *Virginia Law Review*, Vol. 72, No.6 (Sept. 1986), pp. 1155-1182.

to other creditors. Policing of the debtor's business by the general secured creditor has been argued to reduce the prospects of debtor's misbehavior.[52]

The priority of the general secured creditor against subsequent creditors is balanced with another exemption from the priority rules: *purchase money security interest*, which serves mainly to avoid the negative impacts that the broad security created by a floating lien might have on the debtor's chances to access *alternative sources of credit*.

(b) Purchase money security interest (PMSI): super-priority

The purchase money security interest arises when the seller of the collateral takes or retains security interest in the property he is selling to secure all or part of its price or when there is a third party who obtains such PMSI for advancing funds or incurring obligation which enables the debtor to finance the purchase of a collateral (e.g. a bank financing the debtor's new equipment).[53]

The PMSI was intended to avoid monopolization of secured credit and is an exception from the race-for-priority rule: once there is a floating lien created on debtor's property, debtor's alternative chances to buy anything on credit in the future would be diminished if the law did not provide for this significant exception to the general priority rules. The enactment of PMSI was necessary to effectuate a difference between the "long-term creditors" (or general secured creditors) taking advantage of the floating lien clause and "random" lenders enabling the debtor to acquire assets subsequently: since the floating lien creditor's interest in the after-acquired property of the debtor attaches automatically and gains priority, exceptions reflecting practical concerns of both lenders and debtors had to be made.

The debtor who gave a floating lien interest to a long-term creditor would hardly be able to acquire any after-acquired property on credit because the subsequent creditor's interest

[52]*See* Ronald J. Mann, "Explaining the Pattern of Secured Credit", *Harvard Law Review*, Vol. 110, No. 3 (Jan. 1997), pp. 649-650.
[53] Cohen A. B., *Guide to Secured Lending Transactions*, (Boston: Warren, Gorham & Lamont, Inc., 1988), p. 5-5.

would automatically be subordinated to the long-term creditor's interest in the after-acquired property. Therefore, Article 9 contains rules enacting "super-priority" of the various PMSI types enabling acquisition of new property free of prior liens. Long-term creditor's interest in the after-acquired property of the debtor does not suffer any damage as well: since the debtor has a chance to acquire future property (such as new equipment for his factory), the debtor's pool of assets is growing and the chances to repay the debt should be therefore increasing.

(c) Other priority rules: buyers of goods, security interests in fixtures, commingled goods and other special security interests

UCC Article 9 provides that security interest *continues* in collateral (which is sold, given or disposed of in any other way) unless either the secured party authorized the debtor's disposition of the collateral[54] or some *other circumstance* exists as provided in Article 9 in which case the security interest is extinguished on acquisition by a subsequent owner.[55] Article 9 provides a variety of cases when the 'other circumstances' exist.

Buyer in ordinary course of business[56] takes free of security interest if the seller is in the business of selling goods of that kind[57] (i.e. the buyer does not need to be in the business of buying). The buyer must be in good faith[58] and without the knowledge that such sale is in violation of the ownership rights or security interest of a third party. UCC Article 9's 'buyer in ordinary course of business' protection does not apply to farm products, which provoked a

[54] The secured party can expressly authorize or prohibit subsequent sale of the collateral in a security agreement. There is controversy as to whether the secured party's security interest is only extinguished when the secured party expressly authorizes the disposition *free and clear* of its security interest. Revised Article 9 aims to solve it and states that a security interest *'survives' unless the secured creditor expressly authorizes the sale free of security interest.* Richard Duncan, *Supra* 28.

[55] Section 9-306 (2) UCC.

[56] 'Buying in ordinary course of business' does not include transfer by way of security or in partial or total satisfaction of a money debt. Section 1-201 (9). Other facts which may cause the buyer not to qualify for the ordinary course of business protection include: sale as a sham transaction intended for purpose other than the exchange of goods for money, inadequate sale price, close connection between the seller and the buyer. Duncan, *Supra* 28,. p. 4-12.

[57] Section 9-307 (1) UCC.

[58] Section 9-201 (9) UCC defines good faith as "honesty in fact in the conduct of the transaction concerned".

lot of criticism and subsequently, the federal Food Security Act of 1985 has stepped in to make it possible also for buyers of the farm products to buy free of prior security interests.[59]

With regards to *consumer goods*, the buyer takes free of security interest even though it is perfected if he buys without knowledge of the security interest, for value and for his own personal, family or household purposes unless prior to the purchase the secured party has filed a financing statement covering such goods.[60]

UCC Article 9 contains further specific priority rules regarding *concessions*, *commingled* and *processed goods*, *federal tax liens* etc. These can be found in various provisions of Sections 9-301 through to 9-318 UCC.

To conclude, priority rules embedded in Article 9 create a system, the purpose of which is the legal certainty of secured creditors: they can estimate their priority position with regards to the debtor's assets offered as collateral even before entering a secured transaction. Article 9's main priority rule is the first-in-time rule and there are also exemptions from the main rule reflecting serious policy choices. Most importantly, the floating lien and purchase money security interest reflect the intent of the drafters to enhance the efficiency of the whole priority system.

The most important exemption from the first-in-time rule is the super-priority given to the purchase money security interest[61]. *The floating lien priority enabled the general (or exclusive) creditor to acquire priority in debtor's property even before its acquisition.* Therefore, it was critical to provide for a mechanism which would balance the interests of the general creditor and other (subsequent) creditors, allowing the debtor to seek alternative funds. The super-priority protects the suppliers of inventory as well as financiers of equipment and those supplying consumer goods and other assets against the holder of the floating lien

[59] Bonnen, J. T., Schweikhardt D. B., "The Future of U. S. Agricultural Policy: Reflections on the Disappearance of the Farm Problem", *Review of Agricultural Economics*, Vol. 20, No.1 (1998). p. 4-12.
[60] Section 9-307 (2) UCC.
[61] Barkley Clark, *Supra* 33, p. 3-136.5.

which would otherwise have priority. As a result, the debtor has the access to alternative funds and is not left "at the mercy" of the general creditor and the credit market is not monopolized by the general, long-term creditors.

Purchase money security is perceived as a conceptual and inevitable supplement of the floating lien, but it is *as such* unknown in other jurisdictions. However, in the Czech Republic, there is no super-priority granted to the category of creditors selling or financing particular assets, and therefore we may ask whether the general secured creditor has such an exclusive position that he "takes all".

The floating lien is supported by a very strong concept of remedies in the event of debtor's default. UCC Article 9 gives the secured creditor both a chance to pursue satisfaction of the debt secured by collateral using the statutory self-help remedies, swift judicial remedies or pursue satisfaction according to the contractual terms (the secured creditor has a great contractual freedom to stipulate various provisions setting up procedures to be applied in the event of default).

II.3 Remedies in the event of default

Default is a crucial term for the enforcement of the secured party's interests. The secured creditor can legally enforce his interest only in case the debtor is in default with the obligations under the security agreement[62]. UCC Article 9 does not define the term itself, but contains rules on what the rights and obligations of both parties of the secured transaction are once a default occurs. The intention of the drafters of UCC Article 9 was to leave the law silent on what constitutes default in order to let *the parties* to the secured transaction *decide*

[62] UCC Article 9 Section 9-601 (1) (a) provides that "after default, a secured party has the rights provided in this part (UCC Article 9 Part 6: Default and Enforcement) and, except as otherwise provided in Section 9-602, those provided by agreement of the parties." Therefore, parties have contractual freedom to agree on the terms of the security agreement which define the debtor's *default*. The freedom is not limitless and Section 9-602 (*Waiver and variance of rights and duties*) contains a list of invalid contractual provisions which would give rights to the obligor and impose duties on the secured party, such as waiver of the secured party's rights under Section 9-607 (c) on collection and enforcement.

what in their contract-specific situations *constitutes a default*[63]. Since the occurrence of default has significant legal consequences, the parties of a security agreement – and particularly the secured party shall provide for very clear terms of the agreement defining the term.

Most security agreements will provide warranties and representations by the debtor, the breach of which will constitute default.[64] What are the likely default provisions in case of a security agreement creating a *floating lien* on the debtor's property?

The security agreement creating a floating lien on the debtor's property will typically provide for some or all of the following default provisions: (1) a covenant to provide additional collateral as security upon demand of the lender, (2) a representation that the debtor's receivables are not subject to any prior encumbrance, (3) a representation that the debtor's receivables are not subject of right to set-off or any other similar defense, (4) a covenant that the debtor will not interfere with the secured party in the collection of the receivables. In case of breach of any of the obligations defined in the security agreement, default occurs and the secured creditor has the right to use any of the remedies defined in the contract or in UCC Article 9.[65]

Another significant feature of a security agreement is that it will define the secured *creditor's rights upon occurrence of a default.* The secured creditor creating a floating lien might want to include (and then invoke upon default) an *acceleration clause.* Acceleration of the underlying loan is only possible when the security agreement expressly provides for such option.[66]

[63] Nimmer R. T., *Supra* 25, p.423.
[64] *Id.*, p. §5.01 [2].
[65] *Id.,* p. § 5.01 [2].
[66] The security agreement may provide either that *acceleration occurs automatically* in specified situations (e.g. the debtor fails to make installments) or it can provide more generally that the creditor has the *option to accelerate* the debt upon a default. The latter is the more common type of an acceleration clause since it gives the secured creditor power to decide what is strategically better. UCC Article 9 does not require that the secured creditor has to notify the debtor of the intent to accelerate. Duncan, R., *Supra* 28.

Providing detailed default provisions in a security agreement is typical in the American legal practice. It is also the statutory enforcement rules with supporting efficient court system that are to a great extent significant for the realization of the secured creditors' enforcement rights upon default.

II.3.1 UCC Article 9 remedies in the event of default

UCC Article 9 gives the secured party *unprecedented variety of remedies to legally enforce* interests in the collateral upon a debtor's default. A secured creditor can choose to pursue any of the remedies expressly provided in the security agreement and in addition, the secured creditor can choose to enforce his interests by any of the statutory devices provided by UCC Article 9.

The secured creditor can decide for any of the following: repossession of the collateral, strict foreclosure, judicial procedure against the debtor to obtain a judgment and subsequent execution against debtor's property, and enforcement of any guarantees.[67] Importantly, none of the remedies is exclusive. Therefore, the secured creditor can pursue satisfaction of the debt by any and possibly more of the contractual provisions and statutory remedies *at the same time or subsequently*. Decisions on the right timing and choice of remedies give the secured creditor strategic advantage.[68]

[67] The coercive creditor remedies are, apart from the floating lien, one of the most ground-breaking aspects of UCC Article 9. Unlike in other jurisdictions, the secured creditor is given the authority to go and seize the collateral and dispose of it in a commercially reasonable manner. The opponents of such statutory authorization of self-help argued that the mere enactment of such remedies makes the debtor vulnerable and is evil per se. The defendants have claimed that the enactment of coercive remedies is not significant in providing the force, but strategy.

[68]The choice of a particular remedy (or remedies) depends merely on the secured creditor's assessment of the debtor's repayment abilities. In case the creditor is a wealthy firm and its default is a likely result of an administrative mistake, the secured party will probably not take any action apart from a notification of the firm's representatives. If the debtor suffers some kind of temporary financial insufficiency, the secured party is likely to prefer to agree with the debtor on modification of the terms of the repayment schedule so that both parties are better off. However, when there is a defaults and it is known to the secured creditor that the debtor is in real financial trouble, the secured creditor will probably try to repossess the collateral or proceed against debtor's other property. Mann R. J., "Strategy and Force in the Liquidation of Secured Debt", *Mich. Law Review*, Vol. 96, No.2 (1997, p.160-162.

It follows that the secured party should in its own interest *monitor debtor's ability* to repay the debt in order to make the most of the enforcement possibilities enacted by UCC Article 9. Apart from the obvious possibility of the secured creditor to - upon debtor's default - *legally* liquidate the collateral and collect the debt owed, the enactment of various enforcement remedies has a *strategic impact* on debtor's behavior: the mere possibility of forced liquidation may positively influence the debtor's decision-making and avert him from excessive risks.[69]

I am inclined to agree with Ronald J. Mann, who suggested that it is mainly the strategy, not the force which matters here: forced liquidation is in practice negligible when compared to the strategic importance of coercive remedies on both sides of secured transactions.[70] Although since the enactment of UCC Article 9, there have been various changes in the enforcement practice of various States, the restrictions were mostly limited to the *consumer* credit field. For the purposes of business debt financing, the American legal practice seems to have fully accepted the idea that the coercive creditor remedies have primarily positive, *strategic significance.*

Both the secured creditor and the debtor who are entering the contractual relationship participate in an *equal bargaining opportunity* and both parties can *mutually benefit* from knowing that the secured creditor has the legal devices to collect the debt upon the debtor's default.

I shall briefly describe repossession, disposition and strict foreclosure rules applying in the American secured transactions practice. As noted above, these are statutory enforcement remedies which apply uniformly to all secured transactions, floating lien including.

[69] *Id.*, p. 159-243.
[70] *Id.,* p. 159-244.

II.3.2. Repossession of the collateral

After debtor's default, the secured party can take possession of the collateral and dispose of the collateral on debtor's premises.[71] It can do so without judicial assistance if it can repossess *without breach of peace*.[72] Limitation of self-help repossession to that which is conducted without breach of peace is a pragmatic decision of the legislators to prevent violent behavior of the secured creditors upon repossession. Breach of peace occurs when the secured party uses force or threats to achieve repossession.[73]

In case the self-help repossession is not possible without breach of peace, there is still the possibility of the secured party achieving the same (although at a considerably higher cost) by judicial process, utilizing replevin or similar actions.[74]

It needs to be added that for the purposes of business debt financing, the general secured creditor creating a floating lien is likely to be very careful to *include provisions* in the contract allowing him not only to monitor the debtor's activities, but also to gain physical *access to the debtor's premises*. Such arrangements are completely in compliance with the law and the secured creditor has high chances of using self-help *without breach of peace*.

II.3.3 Disposition of the collateral

The secured party that repossesses the collateral, has *two options:* (1) it can either dispose of the collateral in a commercially reasonable manner[75] or (2) accept the collateral as

[71] Section 9-609 (a) (1)(2) UCC.
[72] As far as the question of *constitutionality* of self-help repossession is concerned, the courts have been considering whether such repossession is a violation of the 14th amendment to the Constitution according to which a state may not deprive a person of property without due process of law. The due process criteria requires that the debtor be heard and prior notice of repossession should be given unless serious circumstances exist which justify action without such prior notice and hearing. The common position of the courts regarding this issue is that where the state is involved, the due process criteria need to be met and where entirely private repossession (without involvement of the state clerks and the like) takes place, Article 9 self-help repossession provision's use is constitutional within the 'without breach of peace' standard.
[73] See e.g. *Morris v. First National Bank & Trust Co*., 21 Ohio St. 2d 25, 254 N.E.2d 683 (1970), *General Finance Corp. v. Smith*, 505 So.2d 1045 (Ala. 1987).
[74] Article 9 does not specify the procedure applicable in such a case. Therefore, state procedure for recovering possession should govern. Duncan, R., *Supra 28.*
[75] Section 9-607 (c) UCC stipulates that in case of any sale of goods, Article 2 of the UCC applies

discharge of the debtor's obligations.[76] Apart from the requirement to dispose of the collateral in a commercially reasonable manner, the secured party is required to notify the debtor about the intended disposition and the debtor has the right of redemption of the collateral under certain circumstances.

In case the secured party decides to sell the collateral, it has to provide for reasonable notification of the debtor and other known secured parties having interest in the collateral so that they may exercise their right of redemption.[77] The secured party selling the collateral can either opt for a public or private sale.[78]

Disposition of the collateral in a commercially reasonable manner requires that the secured party disposes of the collateral in the usual manner at the current price on any recognized market or otherwise in conformity with reasonable commercial practices among dealers of such type of collateral.[79] With regards to a *sale* of the collateral, commercial reasonability is interpreted in the case law as the requirement that the secured party makes any necessary steps to achieve a fair price when selling the collateral.[80]

II.3.4 Strict foreclosure

Strict foreclosure is the preferred solution only in such circumstances when conducting a sale is not economically feasible: the collateral might have lost most of its value and incurring further sale expenses is not economic for either the secured party or the debtor. Strict foreclosure means that the secured party effectively accepts the collateral in full or

[76] Section 9-610 UCC.

[77] The debtor is entitled to redeem the repossessed collateral at any time before the secured party has disposed of the collateral. In order to redeem, the debtor has to fulfill all existing obligations secured by the collateral and any expenses incurred by the secured party in holding the collateral, retaking it or arranging for its sale. See Section 9-506 UCC.

[78] UCC does not define a ‚public' and ‚private' sale. However, for a sale to be in the public category, the relevant public must be invited to attend and public must have the opportunity to bid competitively for the collateral. Whichever option the secured party chooses, the sale –as any disposition of the collateral by the secured party must be conducted in a commercially reasonably manner.

[79] Section 9-627 (b) UCC.

[80] E.g. In *Franklin State Bank v. Parker* (136 NJ Super, 476, 346 A2d 632) the court held that the secured party did not act in a commercially reasonable manner when it did not replace the repossessed vehicle's carburetor and therefore significantly reducing the possibility to get a fair value for the vehicle.

partial[81] satisfaction of the debt. The debtor must agree to such acceptance – it is sufficient if the debtor does not object upon receiving notice of intended foreclosure.

UCC Article 9 does not allow strict foreclosure in case of a purchase money security interest in consumer goods provided that the debtor has paid at least 60 percent of the total price and any other interest in consumer goods and the debtor has paid 60 percent of the loan.[82] The policy consideration behind this rule is the equitable interest of the debtor which should be protected. In case the secured party repossesses the collateral, it has to dispose of it within 90 days - otherwise the debtor can recover the repossessed collateral from the secured party.[83]

The general secured creditor is very likely to rely on the contractual provisions relating to default. Since the creditor extending loan is taking a huge risk, it is necessary that he includes provisions granting him monitoring rights and very often certain management powers upon the debtor's default with the underlying debt. However, if the contractual provisions prove not to work, the general secured creditor may also rely on a supporting efficient court enforcement.

II.3.5 Judicial enforcement

The secured creditor who cannot repossess without breach of peace can proceed through the judicial process. Apart from the common *post-judgment remedies*, the creditor may initiate the action *of replevin*[84] or seek an *injunction* against the debtor, which are extraordinary measures and their need has to be substantiated by the enforcing secured creditor.

[81] Strict foreclosure in *partial* satisfaction of the debt arises in the following cases: the debtor is in default and the collateral's value has fallen significantly. Therefore, the secured party and debtor may agree that the secured party will foreclose on the collateral in partial satisfaction of the debt, but will remain a creditor for the remaining part of the debt. Duncan, R., *Supra* 28

[82] Section 9-505 (1) UCC.

[83] Section 9-507 (1) UCC.

[84] Replevin is an action seeking authoritative decision that the secured party has a greater right in the collateral than the debtor – in case the secured creditor is successful, the court will adjudge the property to secured party's ownership. Cohen A. B., *Supra* 45

In case the secured party is worried about the debtor moving or disposing of the collateral, the secured party can seek an *ex parte order* on grounds of which the collateral can be seized by a sheriff.[85]

To an outside observer, it may come as a surprise that although the enforcement rules of UCC Article 9 allow the secured creditor to make use of coercive remedies, only a very small number of American secured creditors decide to proceed that way. As Ronald J. Mann demonstrated in his empirical study, the liquidation of collateral is marginal even in cases of distressed debt[86]. The puzzle raised by this notion has been explained by two arguments: (1) both sides of transaction gain more by refinancing arrangements and (2) there is a well-functioning credit market which allows the debtor to find secondary sources so that the debtor's business may survive even if in distress[87].

Contrary to the complex enforcement solutions adopted by the American jurisprudence, creditors' rights' enforcement is probably the weakest point of the Czech secured lending field. In the next chapter of my thesis, I shall describe the Czech pledge of business bearing close resemblance to the American floating lien concept: both have been intended to enhance long-term business debt financing.

While the *floating lien* is supported by other *systematic solutions* found within UCC Article 9, the pledge of business is only supported by various scattered provisions related either to priority, publicity and enforcement. The problem of practical utility of the *pledge of business* as a means of business debt financing is right there: in the *non-systematic provisions*

[85] However, *prejudgment seizure* of the collateral has raised issues with respect to the due process requirements: while in *Fuentes v. Shevin*, the Supreme Court held replevin laws of Florida and Pennsylvania unconstitutional because a prior notification of the debtor and a chance to hearing requirements were not met; in *Mitchell v. W. T. Grant Co*., the Supreme Court authorized the use of replevin statute when certain requirements are met, such as that there have to be strong factual allegations that the debtor will try to dispose of the collateral or otherwise obstruct the justice and that the plaintiff posts a bond in order to indemnify the debtor for potential damage.
[86] See Ronald J. Mann, *Supra* 68, pp. 159-244.
[87] *Id.*

of the Civil Code and Civil Procedure Act relating to the pledge of business, often leading to *ambiguous interpretation*, as I shall demonstrate in the following part of my thesis.

III. Czech Republic: Assessment of the pledge of business as a long-term business debt financing tool

III.1 General remarks

The previous chapter of my thesis dealt with the United States secured transactions law, focusing on the *floating lien* concept. The comprehensive and detailed legislation of UCC Article 9 has been inspirational for many legal scholars and institutions, including the EBRD[88]. It needs to be noted that the *economic justification* for the *secured credit* being so much favored by the US legislation over the *unsecured credit* is still being debated[89]. However, regardless of the fairness or bigotry of the secured transactions legislation, UCC Article 9 is enhancing legal stability in the sphere of secured transactions, which seems to be crucial for this particular sphere of legal relationships.

Since it has been noted that borrowers in the countries of the Central and Eastern Europe region face *shortage of readily available credit* - the European Bank for Reconstruction and Development (EBRD) launched its Secured Transactions project (1992)[90] in response to the problem. The project is aimed at modernization of the secured transactions laws in the Central and Eastern European countries in order to facilitate available credit and

[88] UCC Article 9 inspired EBRD in its *Secured Transactions* project. See *Ten Years of Secured Transactions Reform*, Law in Transition, Autumn 2000. http://www.ebrd.com/pubs/legal/lit002.htm. *See* also Bonnell, J.M., „Do We Need a Global Commercial Code?,“ *Dickinson Law Review* (2001) 87-100.
[89] See e.g. Schupack, Paul M., "Solving the Puzzle of Secured Transactions", *Rutgers Law Review*, 41 (1989).
[90] EBRD, *Ten Years of Secured Transactions Reform*, Law in Transition, Autumn 2000. http://www.ebrd.com/pubs/legal/lit002.htm.

improve credit terms. The key word in the secured transactions reform is the *collateral*[91]: designating the objects which are capable of being offered as security[92] for credit.

Traditionally, the more familiar type of collateral used to create security in the Central and Eastern European region (CEE) is the immovable – real property. The 'natural' perception of real property as suitable for security purposes is based on the real property's characteristics. Most importantly, it is immovable and therefore considered permanent. When we focus on movable assets, the issue becomes somewhat more problematic.[93]

The EBRD secured transactions project is aimed at extending the types of collateral that can be used as security and at the introduction of *non-possessory* security types which suit the contemporary business needs much more effectively than the *possessory* types of security[94].

The Czech Republic is one of the countries of the CEE region which has seen the introduction of some new collateral legislation. Firstly, the Czech legislators enabled creation of a charge by other means than taking possession – by registration in the pledge registry. However, the pledge registry is construed as a non-public registry and therefore not providing enough third parties protection.

In 2001, the Czech Civil Code was amended in order to introduce 'pledge of business', which was intended to provide an alternative business debt financing tool similar to floating charge.[95] The discussions surrounding the enactment mostly covered the following issues: (1) what norms need to be amended in order to introduce the new security device and (2) what are

[91] The term *collateral* may both denote any item of value which is subject to the security interest of the secured creditor and the connotation *collateral law* refers to the whole area of secured transactions law.
[92] The term *security* is used within this paper interchangeably with the term *security device* to denote any legal device which is used to secure creditor's obligations. *Security interest* is a property interest in a *collateral* which is used in a transaction to secure an obligation.
[93] Contrary to the real property characteristics, the *personal - movable*[93] *property*'s use as security has been traditionally viewed as too risky – unlike a parcel of land, it can easily be taken away by another person or simply 'vanish' away.
[94] EBRD, *Supra* 2
[95] Although pledge of business has already been known and proposals implementing it were drafted in Czechoslovakia in 1930's Tomáš Dvořák, "Dispozice s podnikem", *Právní rozhledy.* Vol. 3 (2003).

the risks undertaken by the creditors who decide to make use of the pledge of business provision.

In this chapter, I shall focus on the enactment and implementation of the Czech pledge of business which is an alternative long-term debt financing tool bearing functional resemblance to the American floating lien concept. Both have been intended to enable a business to give security in the 'business as a going concern'. The '*going concern'* aspect makes both the floating lien concept and the pledge of business a flexible and attractive tool of debt financing. The reason for that is clear: the security given will not only attach to the property 'as it is' at the time of creation of security, but it also attaches to the after-acquired property and proceeds.

My aim is *to compare* the recently enacted Czech pledge of business and the American floating lien concept embedded in UCC Article 9. Whereas the secured transactions field has only lately gained the attention of legal scholars in the CEE region, the United States saw introduction and successful implementation of comprehensive legislation in the field decades ago. The United States currently stands as one of the world's most developed credit economies and its legislation has also served as a model for the EBRD secured transactions project.[96]

Although the Czech law does not deal with "secured transactions" as a separate field of law, there are various Civil Code provisions dealing with 'securing of contractual obligations' which are the basis for the pledge of business provision.

III.2 Securing of contractual obligations in the Czech law

In the early 1990's, the Czech legal environment experienced a new phenomenon: there were creditors lending beginning businesses the needed money; however, the legal system did not provide for the necessary protection of such creditors. Since then, the Czech

[96] See EBRD. *Ten Years of Secured Transactions Reform, Supra note 2.*

legislation in the field has to some extent been developed and some changes in execution mechanisms were put in place. [97]

The legislative intent behind the pledge of business was providing for a legal frame in which the creditors – banks being considered the primary source of credit[98], could safely extend credit taking security in business rather than the traditional real estate pledge because most of the small and medium-size businesses hold most value in items of transitory nature – such as cars, computers, technologies etc.

The general provisions on *Securing of Contractual Obligations* can be found in the Act No. 40/1964, the Civil Code, in the *General Provisions* part of *Contractual Relationships* (Chapter VII of the Code). The relevant provisions of Securing of Contractual Obligations provide that the contractual obligations can be secured by the following: contractual penalty, guarantee, wage deduction agreements, *contractual pledge*, transfer of right, and assignment of claim.

The Civil Code provisions on contractual relationships and securing of contractual obligations specifically were enacted in the Czech law by the Act No. 509/1991 Coll., *on Amendment to the Civil Code* – there were no such provisions in the Civil Code in the socialist era. However, legal concepts such as the *pledge* had had a long legislative history in the pre-socialist Czechoslovakia.

The previous chapter dealt with the Uniform Commercial Code's "Secured Transactions" Article 9. Its drafters had the intention to cover the whole area of secured finance in order to overcome particularized statutes on various types of transactions and

[97] The puzzle in the early 1990s was that suddenly many people wanted to borrow in order to invest in growing business opportunities, but lenders who lent the money to such borrowers could not provide for effective security for their loans and subsequently, their claims arising from the loans when these were in default, were practically unenforceable in the then legislative and judicial frame. *See* Jan Kocina, "Zástavní právo v ČR po poslední novelizaci", *Bulletin advokacie* 5 (2002): p.20-33.

[98] It comes as no surprise that banks have been the main group interest representatives behind legislative intent to extend the possibilities of secured creditors and enforcement rights. As argued in the original legislative proposal implementing the pledge of business and related procedural enforcement modernization, it is primarily the banks that are extending credit to the small and medium-size businesses.

doctrinal rules which were outdated for the needs of the growing credit market. The underlying idea was to facilitate credit and provide for legal stability in the growing credit industry since the drafters accepted the idea that more available credit *as such* is good for the economy[99].

In comparison, the Czech legislation covers "Securing of Contractual Obligations" in the general "Contractual Chapter"[100] of the Czech Civil Code. It has never been alleged that there would be any special intent to facilitate credit market by these provisions. It simply is a subchapter of the Civil Code, and the same way it covers the creation and dissolution of contractual obligations, it also contains provisions on securing of obligations. The traditional method of securing of obligations is by a pledge. In the next section of my thesis, I shall focus on the creation of pledge - and on the creation of the pledge of business in particular.

III.3 Pledge

The *pledge* is considered to be the traditional and most common legislatively regulated type of securing of contractual obligations in the Czech law,[101] which is predominantly influenced by the German civil law stream. Pledge was the most common method of securing of contractual obligations also in the pre-World War II era.[102] The current provisions on pledge can be found in the *Real rights*[103] chapter of the Civil Code, which is very significant: because the pledge creates a real right: the transfer of the pledged collateral's ownership does not affect the interest created which can be enforced even against a subsequent owner of such collateral.

[99] One of the drafters, Homer Kripke expressed his belief that the legal structure of secured credit developed to make possible mass production and the distribution of goods, which has increased the human welfare". See *Homer Kripke*, "Law & Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact", *University of Pennsylvania Law Review*, Vol.133, No.5, (June 1985), pp. 929-985

[100] I. e. the chapter of the Civil Code on *Contractual Obligations* (Chapter VII of the Civil Code).

[101] Švestka, J., a kol., *Občanské právo hmotné*, Vol. 1, (Prague: Codex, 1999), p. 286.

[102] *See* Jan Kapras*, K dějinám českého zástavního práva* (Prague, 1923).

[103] Chapter III of the *Civil Code* contains of 3 parts: *ownership, joint ownership* and *real rigths in alien property* (Latin ‚iura in re aliena').

Real rights (ius in rem) – unlike merely contractual obligations create an interest in the property itself. Pledge created *before* the re-enactment of the pledge in the Civil Code has been held to create merely contractual obligations, i.e. the subsequent owner of pledged collateral was not considered to become obligated by the pledge on acquisition. Therefore, the creditor taking security in pledge would be trapped in the same situation as an unsecured creditor when enforcing his rights, which proves the point that it is the legislation that matters when it comes to the secured credit.[104]

Although known for centuries, the pledge concept was abolished (together with other personal property institutes such as the lease) in the socialist era and was reintroduced in the Czech law by the Act No. 509/1991 Coll., on Amendment to the Civil Code[105]. The Civil Code stipulates that "pledge secures a creditor's claim; in the event that the underlying debt is not satisfied, the pledgee can obtain compensation from the proceeds of the liquidated collateral"[106]. The Act No. 367/2000 Coll. and the Act No. 317/2001 Coll. further modified the Civil Code pledge provisions, among other changes introducing the pledge of business.

The legal requirements for creating a pledge are: a *valid claim* securing of which is sought by creating the pledge, a *valid cause* – i.e. usually the pledge contract, and a *valid method* of creating a pledge[107]. The *valid claim* requirement means that the creditor's claim which is secured by the pledge must be a legally recognized claim which is either existing or arising in the future – in the latter case the contract has to sufficiently individualize the future claim so that it could not be exchanged for a different claim.[108] The *valid cause* requirement means that there has to be either a valid pledge contract between the creditor and the debtor or

[104] According to the Czech Supreme Court decision in 2000, such creditor would only be able to assert the existence of a debt against the original borrower without the possibility to invoke any interest in the particular pledged collateral. See the Czech Supreme Court decision No. R 64/2000.
[105] In 1948, the new constitution (so called "May 9 Constitution") "called for socialism in all areas of life. The socialist Civil Code (1950) drafted according to the socialist dogmas abolished individual property rights and enacted new collective rights system". Snemovní tisk, http://www.psp.cz/cgi-bin/eng/eknih/1990fs/tisky/t0685_08.htm.
[106] Section 152 of the Civil Code.
[107] Jiří Švestka, a kol., *Občanské právo hmotné*, Vol. 1, (Prague: Codex, 1999), p. 286.
[108] Tomáš Dvořák, *Supra* 95, p. 119-130.

another valid cause for creation of a pledge, e.g. the decision of a court in the inheritance proceedings[109]. A valid pledge contract has to be executed in the form of a notary deed[110] and it has to identify the claim it secures, the pledged collateral and the parties of the contract[111]. The *valid method* of creation of a pledge is either handing over the pledged collateral to the pledge or any other legal method of creating a pledge – i.e. various registration procedures for different types of collateral in the relevant registries.[112]

There are restrictions as to what the pledge contract *may not* stipulate: (1) that the pledgor cannot acquire the pledged collateral back once the underlying claim vanishes, (2) that the pledgor cannot encumber the pledged real estate in the future, (3) that the pledgee cannot seek compensation after the debtor is in default with payment of the debt, (3) that the pledgee can seek compensation in a manner not regulated in the law, and (4) that the pledged collateral becomes the pledgee's property upon default. Such contractual provisions are totally invalid[113] and unenforceable – they may also cause invalidity of the whole pledge contract when they affect the validity contract *as such*[114].

With regards to the *collateral* that can be pledged, section 153(1) of the Act No. 40/1964 Coll., the Civil Code as amended provides that "the pledged collateral may take form of a tangible or immovable asset, *business* or any other group of assets, claim and other property right, if its nature so allows, a flat, a share in a company, a negotiable instrument or intellectual property rights". The *pledge of business* has only been included in the list in 2001,

[109] According to Section 153(1) of the Civil Code, pledge can be created by a pledge contract, by a decision of a court in judicial proceedings, decision of an agency in an administrative proceeding or it can also be created by a statute (the statutory pledge). However, the *contractual pledge* is by far the most common cause for pledge creation. Jehlička, Oldřich et al., *Občanský zákoník, Komentář*, (Praha: C.H. Beck, 2006), p. 256.

[110] The penalty for a pledge contract which is not executed in a notary form is the total invalidity of such a contract (Section 40 of the Civil Code).

[111] Section 156(2) of the Civil Code.

[112] The real estate mortgage (which is functionally a real estate *pledge*) is created by the registration in a cadastral registry. The pledge of a movable property requires taking possession of the pledged collateral by the creditor, registration in a notary registry, or taking possession by a third person (i.e. a trustee if the pledge contract so requires). *See* Section 157,158 of the Civil Code.

[113] Section 169 of the Civil Code.

[114] Section 41 (*partial invalidity*) provides: "If the reason of invalidity only affects a part of a legal act, only that particular part shall be invalid, unless the nature of a legal act, its content or its circumstances make it impossible to separate such an invalid part from the rest of the contract."

and it was intended to provide an alternative long-term business debt financing tool primarily for small-sized and medium-sized businesses.

Similarly to the floating lien concept, pledge of business was intended to provide a long-term business debt financing tool enabling the secured creditor to create a broad security interest in the debtor's business property. In the previous part of my thesis, I have described the American floating lien concept embedded in UCC Article 9.

The pledge, although a somewhat archaic term, could well serve modern secured credit needs provided that: (1) it is possible to create a *non-possessory* pledge, (2) the legislation is clear on the rights and obligations of the parties and (3) there is an efficient enforcement mechanism in place which can be utilized upon debtor's default. We shall see in the following subsections whether these conditions are met in the Czech law.

III.4 The pledge of business: Introduction of an alternative business debt financing tool

III.4.1 What is *business*?

The Act No. 367/2000 Coll., *on Amendment to the Civil Code* extended the list of collaterals that can be pledged to include "collection of assets". Since it raised controversies whether such "collection of assets" also included *business*, the later Act No. 317/2001 Coll. expressly added the word *business* in the list of collaterals that can be pledged.

Importantly, pledge of business as a *'going concern'* is similar to the floating lien in the respect that it was meant to entail primarily the after-acquired assets and intangible assets which would be difficult to encumber using the traditional pledge. The business assets are bound to change on a day-to-day (or even hourly) basis and the pledge attaches to the business identified in the contract *as such*. The clear understanding that the pledge of business includes the after-acquired property of the business debtor stems from the Civil Code provision which stipulates that the pledge encumbers the accessory assets, *accruals* and also not separated products of a pledge.[115]

Business is defined in Section 5 (1) of the Act No. 513/1991 Coll., Commercial Code: "Business is a collection of tangible, personal and intangible assets. Business comprises of all things, rights, and other valuables, which belong to the business and are used for the business purposes or which are intended to serve business purposes." There is; however, a controversy among the Czech legal scholars whether the *business* as an object of contractual relationships includes also the liabilities of a business or whether the legal definition in the relevant provision of Section 5 limits itself merely to the actives of the business[116].

In the legal provisions dealing with the *transfer of business*[117], it is stated that the transfer of business must include both its *actives* and *passives.* The Czech legal theory is split on the issue whether also in the case of pledge of business the pledgee would take interest in the business as a collection of both actives *and* passives or merely business as a collection of assets. As a result, the insufficient legal definition of the business weakens the legal certainty for subjects involved in the pledge contract since they cannot be certain how the controversy would be resolved by a court applying the relevant provision in a particular case.[118]

III.4.2 *Who decides for the business* to enter a pledge contract?

From the perspective of a debtor (i.e. potential pledgor), pledge of business increases the chances to obtain a long-term credit on better terms. However, it is also a *serious business decision*. It is clear who makes decisions in a sole proprietorship, but as soon as the business is a corporate legal entity, the owner and management structures are more complex and it was

[115] Section 153(2) of the Civil Code.
[116] See e.g. Radmila Kulková, *Supra* 11, p. 319.
[117] Section 477 of the Act No.513/1991 Coll., Commercial Code.
[118] Tomáš Richter, *Supra* 10*,* p.88.

debated among the Czech legal scholars what procedure and whose consent is needed in order to encumber the business[119].

The two main positions to the argument were that either the board of directors or the general meeting should have the decisive vote[120]. Again, the uncertainty produced by such controversies undermined the legal certainty of the prospective business lenders and borrowers. Needless to say, controversies surrounding even creation of the pledge of business did not enhance the trust of the business circles to take advantage of the new long-term business debt financing tool.

The disputes were resolved by the Act No. 56/2006 Coll.[121], on amendment to various acts, incl. Commercial Code. The relevant provision of Section 67a expressly stipulates that in order to enter a valid transfer, lease or pledge of business contract, it is necessary to obtain the consent of the majority of shareholders (i.e. applicable to the LLC and general and limited partnership) or the consent of the general meeting (i.e. applicable to joint stock company) is needed.

III.4.3 Valid creation of a pledge of business

The Czech *pledge of business* was enacted by the Act No. 317/2001 Coll., on Amendment to the Civil Code[122], which simply added the word 'business' to the list of collaterals that can be pledged. *Business* as a typical object of commercial relationships is defined in the Commercial Code[123] and Commercial Code also contains provisions on transfer

[119] See e.g. Dvořák, Tomáš, *Supra* 95*,* p. 119-130. The main controversy evolved around the "old" version of section 67a of the Commercial Code, which provided that in order to dispose of, lease or encumber the business or its part, requirements analogous to the ones in merger and acquisitions provisions should be fulfilled. This section was later repealed and the new provision seems sufficiently clear on the subject: the consent of a majority of shareholders (i.e. in a partnership and LLC) and the consent of the general meeting (I.e. in a joint stock company) is needed.
[120] *Id*. The board of directors' decision-making power was argued on grounds of commercial flexibility and the supporters of the decision-making power for the general meeting argued it is necessary to protect the rights of the shareholders.
[121] Effective as of March 8, 2006.
[122] The Act No.367/2000 Coll. on Amendment to the Civil Code added "group of assets" to the list of collaterals that can be pledged. Since it raised controversies whether that includes business, the Act No. 317/2001 expressly added the word *business* into the list of collaterals that can be pledged. The Act came to effect as of January 1, 2002.
[123] The Act No.514/1991, *Commercial Code.*

of business.[124] It was argued that the reason for placing the pledge of business provision in the Civil, rather than Commercial Code was necessary in order to maintain the Civil Code as the primary source of regulations in the field of real rights.[125]

Pledge of business is created once there is a valid pledge contract which sufficiently defines *which business* is being pledged and furthermore, the contract has to be *notarized* and *registered* in the Pledge Registry[126]. The registration in the pledge registry has constitutive effects and is therefore decisive for determination of the time of pledge of business creation[127]. However, business is a *group of assets* and some of those have to be registered in specialized registries. Pledge of business does not suspend creditor's obligation to register these particular assets as required by special acts.

The special registration requirements include the following: (1) in case of a real property which is part of a business, the pledge is created upon its registration in the cadastral registry, (2) ships need to be registered in a special naval registry, (3) pledge of civil aircraft also needs to be registered in a special aircraft registry, (4) a participation/share in a business has to be registered in the Commercial Registry, (5) trademarks and patents need to be registered in the trademark and patent registry, and (6) the pledge of listed securities is created upon its registration by the Czech National Bank.[128]

In order to register pledge of these particular assets, *it is not necessary to expressly refer to them* in the pledge contract. However, if the secured creditor does not register these assets even though they are functionally parts of the business, the pledge of business remains effective, *but not with regards to these particular assets*. In practice, it means that the secured creditor will not be able to invoke his rights in those particular assets against subsequent

[124] Sections 477-488a of *Commercial Code.*
[125] *See* Radmila Kulková, *Supra* 11, p. 319-325.
[126] Section 35b of the Act No.358/1992 Coll., the Notary Act (as amended) provides that "Pledge Registry is a non-public registry, in an electric form, which is managed by the Notary Chamber of the Czech Republic."
[127] Section 158(1) of Commercial Code.
[128] *See* Section 42 of the *Act on Securities*. The registration of the listed securities was formerly executed by the Czech Securities Commission which seized to exist in April 2006 and its functions were taken over by the Czech National Bank.

purchasers. Moreover, the creditor can lose priority in case there is a competing charge and the secured creditor is not the first to register[129].

UCC Article 9 recognizes two stages of creation of a security interest: the *attachment* and the *perfection*. In order for the security interest to attach, there has to be a *valid security agreement*. In order to perfect, either: filing, taking possession or control (in case of investment property) is required. *Filing* the financing statement may resemble registration of a pledge at the Pledge Registry in the Czech law; however, it is much cheaper and more convenient for an American secured creditor to file a financing statement than it is for the Czech pledgee to register the pledge of business in the Pledge Registry.

It seems that the procedure of creating a broad valid security interest in after-acquired property, proceeds and/or future advances is much less cumbersome in the United States: it is possible to file even electronically and the fee amount is very reasonable. On the other hand, the Czech pledgee of business has to comply with cumbersome formal requirements and with the involvement of public notaries, the whole registration procedure is bound to be more expensive and lengthier when compared to the swift electronic or in person filing of the simple form financing statement[130].

As far as the "special assets" forming part of a pledged business are concerned, it is also the case in the United States that certain types of assets (motor vehicles, ships, aircraft) are subject to special registration – i. e it is also not possible to perfect a security interest in such "special assets" by fulfilling the general filing requirements.

We may conclude that although the procedure of the creation of a valid security interest in the debtor's business is much less complicated in the United States, there are no significant shortcomings in the Czech legislation regarding this issue, apart from the

[129] The pledge of business is effective since the registration in the Pledge Registry, but with regards to the „special assets" - they need to be registered subsequently and there is a possibility that some of those special assets could be encumbered in the meantime. Tomáš Dvořák, *Supra* 95, p. 129.
[130] For a sample financing statement and pledge of business contract, see Appendices x.

ambiguity regarding the creation date of the special assets mentioned above and the fact that the valid creation of an enforceable security interest is not contingent upon public notice providing as is the case in the American jurisdiction.

III.4.4 Who has the management power once the pledge is created?

The main function of a pledge is to create security for a creditor and in case the debtor does not perform the underlying obligation, the creditor shall be able to obtain compensation from the proceeds of the liquidated collateral. The pledgee (i.e. the secured party) has the right of objection against any act of the debtor which could be detrimental to the pledged collateral or jeopardize his potential ability to seek compensation in the future. On the other hand, the pledgor has the obligation to refrain from any act which would harm the rights of the secured creditor[131].

The law does not provide for a specific standard of care that the pledgee who remains in possession of the pledged collateral is obliged to apply when disposing of business. It is clear though that once the pledge of business is created, the pledgor *remains the owner* of the pledged business and even in case the pledgor transfers the business to another subject, the real right created by the pledge of business will also be effective towards subsequent owners of the business until the underlying obligation is fulfilled or until it is extinguished in another legal way[132].

According to the legal theory, since the pledged business remains in the ownership of the pledgor, he has the obligation to manage and keep the overall value of the business approximately the same as it was at the time of creation of the pledge.[133] Furthermore, since section 163(1) of the Civil Code provides that "the pledgee is obliged to refrain from any act

[131] Section 163(1) of the Civil Code.
[132] Section 163(1) of the Civil Code provides: "The pledge is effective towards subsequent owners of the pledged collateral… The same applies to every subsequent assignee of the pledgee's rights." (I.e. the right of the pledge attaches to the collateral and is effective even when assigned to another as against any subsequent owner of the collateral.)
[133] Tomáš Dvořák, *Supra* 95, p. 119-130.

which would harm the rights of the secured creditor", it can be construed a contrario as an obligation to continue using the collateral in a manner that does not cause any detriment to the secured creditor's interests. It follows that in such case the courts can decide to apply commercial care standard, which would be preferable for the secured creditor: the pledgor who remains in possession of the business has to act in a commercially reasonable way: in case of sale of products, he should only accept the highest price possible etc. Otherwise, the pledgee could under statutory requirements initiate acceleration of the debt.

In order to avoid acceleration of the underlying debt and to escape the very last possibility – liquidation of the pledged business, the pledgor should exercise great care not to act or omit to act the consequence of which would be depreciation of the value of a business. In case the depreciation in value is substantial, the pledgee can ask for additional security on the underlying claim – if that happens, the pledgor has the obligation to give such additional security without delay. If the pledgor fails to make arrangements satisfying the pledgee's request for additional security, the pledgee has the *ex lege* right to *accelerate* the unsecured part of the debt[134].

The American floating lien concept is supported by other important aspects of the secured transactions legislation. One of them is the *publicity* of the secured transactions. Since the aim of the drafters was to facilitate non-possessory security, they had to deal with the ostensible ownership dilemma. The solution adapted by Article 9 in order to solve the ostensible ownership dilemma is an efficient public notice system. It remains to be seen how – and if – the Czech law dealt with the ostensible ownership dilemma once it allowed for the creation of non-possessory pledge. There are serious concerns suggesting that the ostensible ownership dilemma is *not dealt with effectively* in the Czech legislation.

[134] Section 163(2) of the Civil Code.

III.5 Ostensible ownership dilemma: does the Czech law deal with it effectively?

The Act No. 327/2000 enabled creation of a *non-possessory* pledge. Enabling valid and enforceable non-possessory pledge has been certainly an improvement in the Czech secured transactions area. Nevertheless, 'divorcing' possession from ownership can have the negative impact of vague and uncertain legal position of the third parties who may be misled into trusting that the property is unencumbered.

As a general rule, a non-possessory pledge is created by its registration in the pledge registry. In case of pledge of business, it is also *the only valid method* of creation of a pledge: after the pledge contract is executed in the form of a notary deed, it has to be registered with the Pledge Registry which has constitutive effects. However, it remains to be a legal controversy whether such registration of a pledge of business entails also the assets which are subject to special registration requirements.[135]

There are at least two possibilities of solving the puzzle: (1) some legal scholars claim that since business is a collection of assets and pledge of business is created by its registration in the Pledge Registry and such registration is valid for the whole collection of assets (i.e. the "special" assets including)[136], (2) the others interpret the law differently and claim that the registration of pledge of business in the Pledge Registry is not effective on the assets which are subject to the special requirements[137]. I am inclined to think that the latter interpretation is correct, which has some important implications:

[135] Business is a *collection of assets*; however, some of them (e.g. real estate, aircraft, etc.) are subject to registration in special registries.
[136] See e.g. Petr Baudyš, "Zástavní právo k podniku", *Právní rozhledy* (2003), p. 293. For more recent views, see e.g. Gabriel Achour and Alois Šatava, Nabývaní nemovitostí od obchodních společností, article no. 29444, http://www.epravo.cz/v01/?s1=3&s2=0&s3=0&s4=0&s5=0&m=1&typ=clanky&recid_cl=29444.
[137] See e.g. Tomáš Richter, *Supra 10,* p.89 and Tomáš Dvořák, *Supra* 95*,* p. 319. The latter stream argue that since the "business" provision of the Commercial Code provides that the "business is a collection of assets, and law on collective assets shall apply to it, which does not affect the applicability of special laws on real estate, intellectual property, motor vehicles etc. if these assets are part of the business"(Section 5(2)) of the Commercial

There might be considerable time differences between the registration of the pledge of business as a whole and the registration of various special assets. Moreover, any such special assets acquired in the future are also subject to the special requirements and creditors are expected to use theirs monitoring skills to register such assets as soon as possible since there might be a time gap and there is no provision in the Code granting the creditor priority in such cases. The controversy relating to registration requirements of pledge of business as a collection of assets is; however not the only problematic issue relating to the Pledge Registry.

Pursuant to the relevant provision of the Notary Act, "Pledge Registry is a non-public registry, in electronic form, which is managed by the Notary Chamber of the Czech Republic."[138] The Notary Act further provides that only those who can prove their *legal interest* in the pledged collateral can access the pledge files. Since the law does not define what constitutes a legal interest, it is up to the decision of a notary whether he will or will not allow access to the pledge registry. Therefore, in case a third party, e.g. a prospective creditor should find about encumbrances on a business or its various assets, he will have to follow a cumbersome procedure documenting his legal interest in such an inquiry and in the end, the notary can refuse the access to the file since it is completely in the notary's discretion[139].

The construction of the Pledge Registry as a *non-public registry* is deemed to be the least perfect feature of the *non-possessory* pledge concept in the Czech Republic.[140] Notwithstanding the fact that the primary legislative proposal counted upon the Registry being a public registry since the publicity of the entries was in line with the incentive of legal

Code). When applied to the registration rules, such provision, they argue, cannot be interpreted otherwise than to say that registration of the pledge of business as a whole does not have the effect of creating a pledge also on the assets which are subject to special registration rules.

138 *See* Section 35b of the Act No.358/1992 Coll., the Notary Act.

139 Apparently, the discretion of the notaries to grant or deny access to pledge registry is viewed as a risk for prospective buyers of the business property. According to Gabriel Achour and Alois Šatava , the only really safe access to the information is given to the pledgee and pledgor. Therefore, a prospective buyer (the same relates to prospective creditor) should ask the seller (!) to produce a statement from the registry with the relevant information. See Gabriel Achour and Alois Šatava, Nabývaní nemovitostí od obchodních společností, article no. 29444, http://www.epravo.cz/v01/?s1=3&s2=0&s3=0&s4=0&s5=0&m=1&typ=clanky&recid_cl=29444. Needless to say, such state of affairs is completely against the need for efficient protection of the third parties' interests.

140 See e.g. Gabriel Achour, *Supra* 139

certainty and protection of third parties, the final version of the Act implementing the Pledge Registry enacted it as a *non-public* registry[141].

An *efficient public notice system* increases the level of legal certainty and provides for stability in the credit market. The *Secured Transactions Article 9* institutionalized public notice: public notice giving is required for a security interest to become perfected, i.e. enforceable against third parties and for the secured creditor to gain priority position against subsequent creditors. The drafters of UCC Article 9 intended the public notice system as one of the Article's fundamental elements serving most of all the protection of third parties. Nowadays, the potential creditor can conduct a very simple electronic search and find out whether the potential debtor's property or a business has already been encumbered[142].

On the other hand, the *Czech legislator* implemented the *Pledge Registry as a non-public registry*, allowing complete *discretion of the relevant notary* to grant or refuse to grant the relevant information on whether a particular business has been pledged. Bearing in mind that the pledge of business can only be found out from this particular registry, such state of affairs certainly does not maintain protection of the third parties nor does it enhance legal certainty in the credit market.

The efficient public notice system of UCC Article 9 is connected with another 'building block' of the secured transactions legislation – priority rules. Detailed priority rules decide which creditor has priority when the debtor's property is not sufficient to satisfy all claims upon default. In the American secured transactions legislation, priority is based on a simple, cost-minimizing "first-in-time" rule and importantly, perfection of a security interest

[141] According to Tomáš Richter, the later changes in the legislative proposal have not been justified by any objective criteria. *See* Tomáš Richter, *Supra* 10: p.91. Furthermore, judicial and administrative bodies which decide about creating a pledge have 30 days to register such pledge in the Pledge Registry. The registration of such a pledge; however, has only declaratory effects – therefore, third parties unaware of such proceedings would not be able to find out about such encumbrances in the 30 days period.

[142] For example, in Georgia, the secured party can conduct electronic search of the *UCC index* for a marginal fee of $9.95 USD for a monthly access to the personal property records or for a fee of $5.00 single access. The amount for certified searches is $10.00 USD/debtor. *See Georgia Superior Court's Clerk Cooperative Activity*, http://www.gsccca.org/Account/default.asp

was made contingent upon public notice provision: with some exceptions, the one who is the first to file is the one who is first in time. One of conceptual exemptions from the first-in-time rule is the priority of the general secured creditor who creates a floating lien on debtor's property.

Floating lien was given special position in the priority system when the general secured creditor creating a *broad security interest* in the debtor's current *and* future property has priority over subsequent creditors. If not for such exception, the efficiency of the public notice and priority system *as such* would be jeopardized. To subject the general secured creditor to the first-in-time rule with regards to every single asset acquired by the debtor would be too cumbersome and counterproductive for the system as a whole. On the other hand, broad security interest of the general secured creditor would be too much of an advantage for the general secured creditor if not for another exception to the first –in-time rule: the purchase money security interest.

Purchase money security interest (PMSI) is the interest created by a seller or a financier of a particular asset acquired by the debtor. It has so-called super-priority over other creditors, including the general secured creditor. PMSI serves primarily to balance the interests of the secured creditors entering the credit market and to avoid its monopolization by the floating lien holders. In the next subsection, I shall assess whether there is similar priority system in the Czech legislation and most importantly, whether the general secured creditor (i.e. pledgee of business) is given priority over subsequent creditors and whether the Czech law knows a concept similar to the purchase money security interest.

III.6 Priority rules

The general (exclusive) creditor who is creating security using floating-charge-like security tool such as the Czech pledge of business is taking on a commitment the standing of which should be protected by the law. In the American legal practice, the general secured creditor creating a floating lien on the debtor's property has a strong priority position with regards to the encumbered after-acquired property – such secured creditor has priority in particular in the after-acquired property even before such property is acquired.

In order to avoid monopolization of the credit market by the general secured creditors, the priority of the floating lien holder is supplemented by the purchase money security concept. The purchase money security should secure that the debtor is eligible to seek alternative sources of credit even after conclusion of a security agreement creating a floating lien on debtor's property. I shall try to assess what priority position is given to the pledgee of business in the Czech law and whether there is a concept similar to the purchase money security.

The Czech Civil Code does not stipulate detailed priority rules apart from the following general principles: (1) in case there is more than one pledge on the same collateral, priority is determined according to the date they came into existence: the pledge validly created *earlier on* prevails over the subsequently created pledge[143] and (2) the holder of a retention right has priority against any other creditor, the pledgee including.[144] Could such broad and all-encompassing priority rules be sufficient in the secured finance practice?

The chance that there would be another pledge of business on the already pledged business is quite limited although not impossible. However, the more intriguing aspect is whether there are any priority rules relating to the possible conflicts that may arise between

[143] Section 165(1)(2) of the Civil Code.
[144] Section 179 of the Civil Code. The retention right is defined in section 175(1) of the Civil Code as the right of a person "who is in possession of a (movable) thing owned by another to retain such a thing in order to secure his obligation against the person who would otherwise have the right to take the thing." In practice, it is most often the right of a person who is carrying some type of maintenance/work on a thing and has the claim to get paid for the service done.

the pledgee of business (as a collection of assets)[145] and pledgees or subsequent purchasers of various assets belonging to the business. In the Civil Code, there are *no specific priority rules* that would solve the issue; in case such circumstances arise, the creditor can merely "rely" on the court applying analogous legal provisions the outcome of which is difficult to predict - it is likely to vary from case to case.

Applying the *general rule* that priority is given to the earlier pledge, it depends on whether the pledge of business was validly created in all assets (also in those with special registration requirements) – and whether it was the first pledge created. In such case, the pledgee of business shall have *priority in all assets belonging to the business*. However, as noted earlier, there can be time gap between registration of various assets and it might happen that another creditor would be the first to register a pledge to a particular asset subject to special registration – such creditor would have priority since he was the first to create the pledge. Apart from this one general rule on priority, there are some *conflicting priority rules in the Act on Civil Procedure.*

The current procedural law allows that the unsecured or secured creditors other than pledgee can initiate execution against the business or its various parts and therefore deprive the pledgee of the control over the liquidation process[146]. The Act on Civil Procedure allows an execution against the debtor, which is initiated by a *secured or unsecured* creditor and the pledgee of collateral against which the execution is sought is left in a passive role throughout the proceeding[147].

In such proceedings, the pledgee has only the procedural right to submit his claim and he remains the first to be satisfied from the proceeds of the pledged collateral; however, he is

[145] For definitions of business and its controversies, see part *3.3.3. Creation of pledge of business*.
[146] Tomáš Richter, *Supra* 10, p.95.
[147] The court does not even have to notify the pledgee about the proceeding, the only exception being the execution against a real estate. See the relevant provisions of the Act on Civil Procedure (Sections 323-332 and 336c (1) (a) of the Act).

deprived of a chance to decide when and how he wants to have the collateral liquidated[148]. Furthermore, the Act on Civil Procedure does provide for priority of claims secured by retention – and that applies also against a pledgee. Similar and maybe even more significant issue arises with regards to the pledged business receivables since they form a huge portion of the pledged business revenue.

Any unsecured or secured creditor other than pledgee may initiate execution against receivables of the business and when successful, the pledgee's claim will automatically be subordinated to the claim of such creditor. According to the Act on Civil Procedure, in case the execution is initiated against the receivables of a debtor, the law treats differently the cash claims against a financial institution and any other claims. With regards to the claims against a financial institution, the pledgee is given priority before other secured creditors; however, with regards to all other account receivables, the pledgee is not only left in a passive position, but he is also not given priority (!) against any other secured creditor. It is only the creditor whose claim is secured by an assignment of receivables that is given priority when the proceeds of receivables are being distributed among the competing creditors.[149]

UCC Article 9 contains detailed priority rules reflecting important policy choices: commercial certainty, efficiency, fairness, and incentive for the growth of commerce. Article 9 used to be referred to as the "race statute" since the general rule for priority is the "first-in-time" rule: a later created security interest can gain priority position over a prior encumbrance provided that the later creditor is the first to perfect. The reason behind the simple rule is the certainty of the secured creditors and potential secured creditors: the first-in-time rule is simple to adopt and it is also easy to find out a secured creditor's priority position (in the

[148] The Civil Procedure Act rules affecting the priority position of the pledgee are being criticized by the legal scholars as unsatisfactory and contrary to the essence of the real rights, i.e. the pledgee who has this real security interest in collateral shall be given priority also in the execution procedure against the debtor when it is regarding the pledged collateral. The procedural rules should ideally provide that the pledgee's consent is needed once such execution against the pledged collateral is sought. *See* Tomáš Richter, *Supra* 10, p. 94.
[149] *See* Tomáš Richter, *Id.*

common cases). There are; however, significant exemptions from the first-in-time rule – the floating lien being the most significant exemption, employing the efficiency criteria.

The long-term (or exclusive) secured creditor who holds the floating lien has priority according to the date of creation of the floating lien which extends also to the assets yet to be acquired by the debtor in the future. Therefore, should we conclude that other parties do not ever reach priority over such an exclusive creditor? Drafters of UCC Article 9 came up with a solution reflecting the incentive for growth of commerce criteria and in order to escape monopolization of the secured credit, they invented purchase money priority – allowing the debtor to seek alternative sources financing acquisition of new assets.

UCC Article 9 further contains rules on the continuation (or discontinuation) of a security interest on acquisition of the encumbered collateral by a third party – rules on buyers of goods, rules on security interests in fixtures, commingled and processed goods etc. The exhaustive priority scheme of UCC Article 9 lowers the risk of those taking part in secured transactions since it is "black on white" what their position in the chain of creditors is going to be should the debtor fail to have sufficient funds to honor his contractual obligations.

In comparison, the Czech Civil Code contains one single rule which is significant for the priority position of a pledgee of business: in case of more than one pledge, the pledge earlier created should have priority over the later pledge. Since the probability of two subsequent pledges on the same business is very low, there is only the relevant possibility that the assets which form parts of the pledged business and which are subject to special registration requirements can also be subject to priority competition between various creditors.

However, the priority position of the pledgee of business (which is the functional equivalent of the long-term, exclusive creditor – floating lien holder under UCC Article 9) is more significantly undermined by the current Civil Procedure Act. According to its rules, any secured or unsecured creditor may initiate execution against business or its parts. The pledgee is granted priority under the redistribution plan, but he is deprived of the strategic advantage which he perhaps should have – recognizing the fact that a pledge of business is likely to secure a long- term debt of the pledgor, similarly to the American floating lien holder.

Since apart from the one above mentioned general priority rule (first to create the pledge has priority), there are no further *material* priority rules in the Czech law, the secured or unsecured creditors do not know their priority in the chain of creditors until the redistribution plan is approved by the court – due to the fact that there are various classes of claims that first have to be submitted but then they can also be rejected within the proceedings.

Lack of clear priority rules certainly does not have positive effects on the level of legal certainty of business people who might participate in the credit market. Furthermore, unlike the American legal practice, the Czech law does not know any concept similar to the purchase money security.

Notwithstanding the obvious difficulties the pledgee of business may face when enforcing his rights against the pledgor, once the legislation allows creation of a security tool equivalent to the floating charge, the issue arises how to prevent the monopolization of secured credit market. If the floating lien concept functions well, the general secured creditor is given special priority position reflecting the exclusivity of such credit arrangement. However, in order to avoid the debtor being "at mercy" of such exclusive creditor, the legislation should then also deal with the issue whether to allow the debtor access to alternative funds – for that reason, UCC Article 9 purchase money security supplements the floating lien.

However, it is the weak enforcement rules which is currently the most pressing issue regarding the pledge of business practice in the Czech legislation. I have previously described the efficient enforcement mechanism found in UCC Article 9. It remains to be assessed what remedies are provided in the Czech law for the pledgee to enforce his rights upon debtor's default and what are the drawbacks when compared to the American secured transactions legislation.

III.7 Enforcement of pledgee of business' rights in the Czech courts

Debtor's default occurs when the secured (or underlying) obligation is not fulfilled on time or when the obligation is only fulfilled partially. The pledgee is entitled to demand satisfaction of the debt from the proceeds of the liquidation of the pledged collateral[150]. Default may; however, also appear when the security provided by the debtor is no longer sufficient: it may be the case that business depreciates in value significantly and the debtor is unable to provide for an alternative security.

From the secured party's perspective, once the pledged collateral loses value, the debt is no longer secured and the Civil Code gives such secured party the same remedies as when the debtor is in default on payment of the underlying debt. The secured party can only use such remedies which are allowed, i.e. enacted in the Civil Code or special acts[151]. In theory, pledgee should be able to reach satisfaction from the liquidation of the collateral at his convenience – the soonest possible.

The liquidation of a *business* is *per se* more complicated than the liquidation of any other pledged collateral – for example a valuable painting. The basic characteristic of a business is that it consists of a *collection of assets* and those assets are mostly of transitory nature. The mere fact that it is a collection of assets rather than a particular item of value which is going to be liquidated invariably leads to practical issues such as whether the business is supposed to be liquidated *as such* or whether *its particular assets* are going to be sold separately. Furthermore, the transitory nature of business assets suggests that it is

[150] Section 165(1) of the Civil Code.
[151] Section 169(c) of the Civil Code.

important for the secured creditor to be able to decide on strategy when aiming to liquidate the pledged business.

As a general rule, the secured party can either choose *judicial sale* of the pledged collateral or a *sale at a public auction*. The Civil Code expressly restricts the creditor from seeking foreclosure on the pledged collateral[152] - therefore, if parties to a secured transaction included a provision that the pledgee can seek satisfaction of the debt by keeping the collateral as his own, courts will refuse to enforce such contractual provision as illegal and the pledgee will be asked to proceed by one of the legal remedies.

Both the judicial sale of the collateral and sale of the collateral at a public auction can only be initiated by the pledgee (i.e. the secured party). In case the main obligation is secured by *more than one* pledge, the secured party may initiate liquidation of one or all of the pledged collaterals. Does the law define the rights and obligations of the parties in a situation when the debtor defaults and the secured creditor (i.e. the pledgee) wanted to seek compensation of the debt?

The Civil Code stipulates that if the debtor defaults with the payment of the underlying debt, the pledgee is entitled to satisfy the debt owed from the proceeds from the liquidation of the pledged collateral. The same applies if the underlying obligation was only partially fulfilled.[153] The Civil Code further provides that in case there is more than one pledge encumbering the same collateral, the pledge created on an earlier date has priority over a later created pledge[154]. Following provision stipulates that the pledgee can initiate a *judicial sale of the collateral* or at a *public auction*.[155] There are no further provisions in the Civil Code which would define the rights and obligations of the pledgor and pledgee on occurrence of a default.

[152] The so-called *antichretic* pledge is prohibited by Section 169(e) of the Civil Code.
[153] *See* Section 165(1) of the Civil Code.
[154] *See* Section 165(2) of the Civil Code.
[155] See Section 165a (1) of the Civil Code.

Quite contrary to UCC Article 9 which stipulates *what the secured creditor can do* (what remedies to employ) once a default occurs, the Czech Civil Code refers to the general civil procedure – i.e. that the pledgee can initiate a judicial sale or a sale at an auction. Furthermore, the Civil Code *expressly prohibits contradictory contractual provisions* in a pledge contract which would allow the secured creditor (i.e. pledgee) to seek satisfaction of the debt from the sale of the collateral in any other method than that stipulated in the law.[156] As mentioned above, the Civil Code also *expressly prohibits foreclosure* or even sale of collateral to the pledgee in satisfaction of the underlying debt.[157] It follows that the Civil Code in these two sentences prohibits all the coercive secured creditor's remedies found in UCC Article 9 as *illegal.*

What seems to transpire through these procedural rules is the evident lack of trust in the secured creditor's actions upon default. It does not seem logical that on one hand the pledgee of business is to become a general (or exclusive) creditor, taking a huge amount of risk and on the other, such creditor is not in position to decide for appropriate action which should be taken upon debtor's default.

The reference should be made here to the English law, which allows the charge holder who created a floating charge on the debtor's business to include a provision in the security agreement that gives the charge holder the right to appoint a receiver upon debtor's default. The advantage of such solution to the secured creditor seems obvious: he has the real incentive - and better means perhaps - to appoint a qualified and experienced person whose main interest would be to take all steps necessary to preserve as much value as possible in the defaulted debtor's business. The power to appoint a receiver who takes over the management

[156] See Section 169 (c) of the Civil Code.
[157] Section 169 (e) of the Civil Code provides that the "pledge contract may not include provision which would entitle the pledgee to foreclose on the collateral upon default or entitle the pledgee to keep the collateral for a certain price upon the occurrence of a default".

upon debtor's default would put the secured creditor in control of the situation upon default.[158]

Completely contrary to UCC Article 9 policy of the secured party gaining much control over debtor's business upon default, the Civil Code provision limiting pledgee's enforcement remedies to the judicial sale or sale at public auction has the actual effect of the pledgee *losing control* over the enforcement upon debtor's default. Moreover, both these procedures (i.e. judicial sale and public auction) are *destructive* towards the will and possibility of the pledgee to seek restructuring rather than destroying the secured credit relationship.

In the next subsections I shall assess what are the procedural rules for a pledgee seeking satisfaction of the underlying debt from the proceeds of the pledged collateral. The pledgee can only seek satisfaction of the debt by judicial sale or a sale at a public auction. I shall try to assess whether the rules for both procedures enhance efficient enforcement of the pledgee of business' rights.

III.7.1 Judicial sale of the pledged collateral

On debtor's default, the secured party may choose to initiate judicial *sale of a part* or *of the whole pledged business*. The judicial sale is regulated in the Act No. 99/1963, *Civil Procedure Act* which divides the sale process into two stages: the *discovery* and the *execution* stage.

The discovery stage ends in a *judgment of sale* of the pledged collateral. The discovery procedure can only be initiated by a pledgee's petition to the court. The petition has to be supplemented by documents substantiating a *valid claim* against the pledgor (e.g. credit

[158] The Czech Civil Code; however, does not allow the parties to stipulate around the methods prescribed by the Civil Procedure Act. Unlike the EBRD Model Law on Secured Transactions[158], which exhaustively describes the possibility of the chargeholder to appoint a qualified administrator (a lawyer or an accountant), the Czech Civil Code restricts the pledgee of business to seek enforcement via judicial procedure. Had the pledgee the right to include a provision in the pledge contract stipulating another procedure that would apply upon the debtor's default, the pledgee's position upon debtor's default would be much better than it currently is.

contract), *validly created pledge*, and it must sufficiently *identify the pledgor*. The judge may or may not hold a hearing, depending on the "strength" of the pledgee's petition.[159]

In case all the legal requirements are fulfilled, the judge will deliver judgment of sale of the pledged collateral. The decision of the court is *ex lege* binding on any subsequent owners of the pledged collateral, which ensures that the pledgor cannot *efficiently* obstruct the secured party's satisfaction from the sale by transferring the pledged business onto third parties. As soon as the decision of the court is final, the pledgee can file a petition for execution of the judgment.

The *execution procedure* of sale of a business is in some detail regulated in the Civil Procedure Act[160]. In the court's judgment of sale of business, the court nominates a *trustee.* The nomination of a trustee is perceived as one of the positive aspects of a judicial sale of a business since the trustee's role is -among other duties- to monitor debtor's activities. The trustee is chosen from the list of bankruptcy trustees;[161] although it is also possible to nominate an unlisted person if there are serious reasons for such decision of the court.[162] The law only requires that the court should consider whether a particular nominee has the skills needed for this position.[163] However, the pledgee (i.e. the secured creditor) has no vital influence on *who* is chosen. Although a proposal of a specific person from or outside the list is possible, the decision on actual nomination is in complete discretion of the court.

The trustee's primary duty is to find out the total net assets of the business. In order to fulfill that duty, the trustee is given corresponding rights to monitor the business and the right of access to information about accounts etc. The daily running of the business is left to the

[159] The hearing is not required when the petition is sufficiently supplemented by notarized or officially authenticated documents (i.e. authenticated by state agencies), the defendant has given up his right to a hearing or the defendant agrees with the petition.
[160] *See* Sections 338f-338yq of the Civil Procedure Act.
[161] The list of bankruptcy trustees is maintained by the district courts.
[162] „Serious reason" criteria can be fulfilled by unique knowledge of an unlisted trustee who is the only person to efficiently fulfill the role of a trustee of a special type of business etc.
[163] Section 338i (2) stipulates rather vaguely that the court shall "…take into consideration the skills needed for proper management. Person who is listed in the Bankruptcy Trustee List cannot decline the nomination unless serious reasons for that exist."

debtor. The debtor; however, cannot sell or encumber the business or any from the collection of assets forming it[164]. The evaluation of the value of the pledged business is not an uncomplicated matter.

There are concerns whether the current Civil Procedure Act sufficiently stipulates the role of the trustee and his rights and obligation towards the parties concerned: the pledgor, pledgee and the potential buyer. Putting a value on a business is always tricky. However, the situation is even more complicated by the fact that similarly to the provisions on the transfer of a business, the provisions of the Civil Procedure Act stipulate that upon the sale of a business, obligations of the sold business which are not satisfied within the redistribution plan are to be transferred on the buyer of the business.[165] Logically, we need to ask who is going to buy the business which is on sale for a debtor's default under such legislation.

The Civil Procedure Act does not stipulate either obligation or right of the trustee to render useful information (or in other words, to enable the third parties interested in buying the business) to the third parties – potential buyers. The Civil Procedure Act merely stipulates the related rights and duties between the pledgor and the trustee. The potential buyers are in fact unable to verify the information leading to price evaluation. Needless to say, such lack of information is invariably going to have disastrous (diminishing) effect on the bids entered by potential buyers.

Once the trustee is finished with the duties which resemble of an audit, he produces a *report* for the court. On grounds of the report, the court delivers an *auction advertisement* with the price estimated according to the trustee's report. The auction shall take place at one of the preferred location (such as the location of the business head office and similar) within

[164] *See* Section 338h (1) of the Civil Procedure Act.

[165] The sale of a business which includes the transfer of obligations on a successful bidder is not the only worrying issue. As noted by *Richter*, the current Civil Procedure Act completely ignores the informational problems facing the potential buyers. A potential buyer of a business sold within the judicial procedure normally has the same incentives as a buyer of a business outside judicial procedure. Because business as such is a complicated entity when it comes to price evaluation, it is the common practice currently to conduct a due diligence before the buyer offers a price which reflects the market value of a business, especially when there are concerns about the "real" value of a business. Tomáš Richter, *Supra* 10

30 days from the auction advertisement date. The auction is conducted by a judge and the business is sold to the participant in the auction with the highest bid[166]. The law stipulates which claims get priority once the auctioned price is collected.

According to the Civil Procedure Act, the proceeds of the judicial sale of a business shall be distributed among competing claimants as follow: expenses of the auction, trustee's expenses, *value of the obligations taken over by the purchaser*, claims of the pledgee and other secured creditors and finally tax and social security claims followed by all other classes of claims[167]. It follows from the above said that since also the obligations are transferred on the buyer, the potential bidder should have the right to know *what obligations in what amount* are transferred on him if his bid is the successful one.

However, the Civil Procedure Act does not stipulate that the *claims against the sold business* are extinguished upon its sale. It only stipulates that the claims against the sold business which were submitted and confirmed by the trustee within the judicial sale procedure are extinguished upon claimants' satisfaction from the redistribution plan. Therefore, the successful bidder takes the risk that there may be creditors with claims who will wait for the sale to be over and then seek satisfaction of the claims from the successful bidder (!).[168]

Furthermore, it is not at all clear why the value of the obligations taken over by the purchaser should be given priority because the trustee's report (which serves as the basis for the bids entered) should stipulate business evaluation where the obligations should already be taken into account[169]. Notwithstanding the huge inconsistencies in the procedural rules on evaluation of the business, a pledgee of business should know what his position and his chances of satisfaction from the judicial sale are.

[166] The Civil Procedure Act stipulates that in case a right of issue to the pledged business exists, the holder of such right still has to make a bid, and he is given priority only when his bid is equally high as the highest bid. (Section 338w, x of the Act)
[167] *See* Section 338 ze (1) of the Civil Procedure Act.
[168] *See* Tomáš Richter, "Zástavní právo k podniku z pohledu teorie a praxe dluhového financování", *Právní rozhledy* 4 (2004), p. 132-135.
[169] Section 338n (2) stipulates that the trustee is to produce a report on grounds of which the court decides on the *net assets* of the liquidated business.

It seems possible that the pledgee of business who would initiate the judicial sale could quite possibly walk away with zero or very little gain from its proceeds. In the end, if the claims of other (even unsecured) creditors are submitted and approved by the trustee, they will in practice have priority (!) over the pledgee who initiated the judicial sale because the pledgee is only satisfied *after the obligations taken over by the purchaser.*

The last (but not least) problematic issue to be raised is that the *obligations taken over by the purchaser* (which have priority against the pledgee of business) are not clearly defined. The relevant provision *lets the court decide* that the buyer of the liquidated business has the right to be reimbursed within the redistribution plan (a) for monetary claims taken over by the buyer if the total value of such obligations does not amount to the total redistribution amount (the buyer is to be reimbursed for the difference between the two sums) *or* (b) all claims which are to be satisfied from the redistribution plan if the redistribution plan cannot suffice to satisfy the claims (the buyer is to be reimbursed for the difference between the two sums).[170]

To conclude on the efficiency of a judicial sale, both the pledgee and the potential buyers of the auctioned business are taking risk when taking part in a judicial sale of business. The ambiguous provisions of the Civil Procedure Act do not provide either of them with legal certainty. Firstly, the buyer - bidder is taking a real risk here because he does not really know *what exactly* he is buying (i.e. what obligations are included in the price and what happens to those outside the proceedings). Secondly, the secured creditor can be worried that nothing will be left for satisfaction of the underlying debt once the obligations (i.e. claims against the business and obligations taken over by the buyer) in the first group of the redistribution plan are satisfied.

[170] The relevant provisions are to provide for a certain discount from the sale price for the successful bidder who otherwise would give a higher price than the value he is getting. However, such legislative intention is disturbed by the fact that these two alternative provisions give rise to ambiguous interpretation and by the fact that the law does not stipulate what happens with the claims against the business once the sale is effective. Is the successful bidder to be obliged for those? The law does not give an express answer to such an issue.

III.7.2. Involvement of professional executors

The secured creditor (i.e. pledgee of a business) can also initiate judicial sale of collateral according to the Act No. 120/2001 Coll., on Court Executors and Execution Activity. This law was passed in order to increase the chances of creditors for *efficient enforcement* of their rights. It was initiated by the legislators intending to create a new class of impartial and independent professionals who would be authorized by the state to conduct the execution procedure and who could also speed up the execution procedure since the courts are considered to be overloaded with petitions. The main incentive for more efficient enforcement mechanism came from the banks – unsurprisingly, they are the main interest group among secured creditors in the Czech Republic.[171]

The secured creditor needs to decide for what is considered an *alternative* execution procedure at the very moment of filing a petition for judicial sale of the pledged collateral.[172] Once the court delivers a judgment of sale, instead of naming the trustee, it nominates the executor who then conducts the whole execution procedure[173].

However, executors can only conduct their duties according to the same provisions as the trustee[174] described in the previous subsection. Therefore, even though the legislative intent was to enhance creditors' enforcement rights, the ambiguous legislation does not provide a stable and reliable environment for the secured creditors to fully enjoy this advancement.

[171] Although the exact statistics are missing, the claims of the banks against debtors secured mostly by real estate mortgage were estimated at 150-200 billion Czk at the time when the law was passed. See e. g. "Dúvodová zpráva k zákonu č. 120/2001Sb", http://www.uradexekutora.cz/e/texty/d_119-2001sb.php, and „Stenozáznam Senátu ČR, 30. června 200",
http://www.senat.cz/xqw/xervlet/pssenat/hlasovani?action=steno&O=2&IS=1945&T=286.

[172] There are also considerable differences in fee requirements: while the creditor who wants the whole procedure conducted by the court has to pay 3,000 CZK for the petition, creditor asking for execution by an executor does not have to pay any fee (costs should be covered from the proceeds of the sale.) at initiation.

[173] According to Sections 70-71 of the Act No. 120/2001, the executor is obliged to proceed in compliance with the procedure rules of the Civil Procedure Act.

[174] See "Dúvodová zpráva k zákonu č. 120/2001Sb", http://www.uradexekutora.cz/e/texty/d_120-2001sb.php.

Further advancements of secured creditors' enforcement rights were intended by the Act No.26/2000 Coll., on Public Auctions – allowing for public auction of the pledged business upon debtor's default.

III.7.3 Public auction

The secured creditor can instead of judicial procedure choose to have the pledged business sold at an involuntary public auction according to the Act No.26/2000 Coll., on Public Auctions. This act raised controversies regarding the question whether it is in compliance with the rule of law principle since it was made possible to sell the collateral without involvement of courts: it was not necessary to obtain a judicial execution order which can be replaced with affidavit of the secured creditor. However, this provision of the Act has been repealed[175] and to initiate a public auction according to this Act, the secured creditor has to obtain an enforceable judgment, arbitration award, an enforceable execution order or an enforceable notary order[176].

The Act on Public Auctions was mainly intended to make the enforcement system more efficient. The legislator reasoned that the proposed act is motivated by the intent to help in particular the banks *in the real property mortgage business* because it should have helped to increase their legal certainty when extending credit. However, pledge of business was added to the original proposal's list of instances which can lead to a public auction – without any further adjustments to that particular case. Regardless of the good intentions of the legislators, it needs to be asked whether it is a good idea to buy a business at an involuntary auction. Again, the information deficit and lack of comprehensive rules regarding transfer of

[175] The relevant provision allowing the secured party to seek public auction without any involvement of the courts (Section 36(2)) was deemed unconstitutional by the Constitutional Court of the Czech Republic in March 2005 (Decision No. 181/2005). The Constitutional Court held that execution against the pledged collateral by public auction on grounds merely of an affidavit of the pledgee in front of a public notary is against constitutional principles of equality and legal certainty. Since there is no controlling authority involved in the process, Section 36(2) was also deemed to be against the rights to a fair trial and third party protection. http://portal.gov.cz/wps/portal/_s.155/701/.cmd/ad/.c/313/.ce/10821/.p/8411/_s.155/701?PC_8411_l=181/2005&PC_8411_ps=10&PC_8411_text=Ob%C4%8Dansk%C3%BD%20z%C3%A1kon%C3%ADk.

[176] *See* Section 36(1) of the Act No. 26/2000 Coll., on Public Auctions.

obligations of such an auctioned business step in to prevent the risk-averse businessmen to ever participate in such procedure[177].

Another argument for passing the Act was to stimulate the extinction of secondary over-indebtedness of businesses and generally stimulate the credit market. The legislators reasoned that the Act is in the interest of the debtors as well since sale conducted at a public auction is expected to get a better price than that conducted judicially[178]. However, despite the main intent –to stimulate the credit market and help creditors to efficiently enforce their rights against defaulting debtors, the law incorporates (perhaps contrary to the main legislative intent) very strong debtor protection which might prove counter-productive[179].

Efficient enforcement is a strong incentive for development of a strong credit market. UCC Article 9 contains rules on enforcement which have sparked controversies in the American legal practice. The *coercive remedies* (also referred to as *self-help remedies*), under UCC Article 9 enable the secured creditor to repossess, dispose of and sell the collateral upon debtor's default on the underlying debt. The without the breach of peace standard is setting limits on the coercion which the secured creditor is allowed to exercise or not.

In case the coercive remedies avail of no success, the secured creditor can always seek enforcement through *judicial procedure*, also allowing for extraordinary measures, in case an instant protection of the secured creditor is needed – such as the *replevin* and *attachment*. Such extraordinary measures allow the secured creditor seize the collateral even before the judicial procedure is over. Does the Czech law provide the secured creditor with similarly efficient remedies upon debtor's default?

[177] Tomáš Richter, *Supra* 168, p. 135-136.
[178] *See* Dúvodová zpráva k zákonu č. 120/2001 Sb. http://www.uradexekutora.cz/e/texty/d_120-2001sb.php.
[179] The pledgor can object to the public auction even before the auction itself: the Act gives the pledgor a 30-day period (since the delivery of the auction advertisement) within which it is possible to petition a court to seek a judgment on *inadmissibility* of the sale. Such petition postpones the planned auction until the relevant court decides which can take a long period of time. Furthermore, the Act stipulates that the pledgor, the pledgee or any participant at the public auction can object to its validity within 3 months since the date when the auction took place.

First of all, the coercive remedies are *not uncontroversial* even in the United States. Therefore, let us conclude on the issue of the use of coercive remedies in the Czech legal practice that the legal tradition and business environment probably would not favor enactment of self-help since the Czech legal tradition is more *protectionist* about the alleged individual interests than the American legal practice. Therefore, enactment of coercive creditor's remedies would most probably be viewed as unduly harsh on the debtor and there would not be enough trust in the secured creditors to give them such a "strong armor" when fighting a commercial cause – i.e. enforcement of their rights against the defaulting debtor.

However, secured creditors – especially the long-term creditors should be given some real incentive to enter credit arrangements, in the form of efficient enforcement mechanisms. As demonstrated in the previous section of my paper, both judicial remedies available for a pledgee of business upon a debtor's default are far from efficient. There are considerable shortcomings in the Civil Procedure Act undermining the *judicial sale*: buyer's incentives are completely ignored and since the purpose of the sale remains to achieve the maximum bid, it is questionable whether a rational buyer would take part (and offer a good price) under the present circumstances. Even more doubts spring from the ambiguous provisions of the same act stipulating *whether* and *what obligations are transferred* upon the successful bidder in the judicial sale of a business.

The other judicial remedy available for a creditor is the *involuntary public auction* the rules on which - similarly to the judicial sale, ignore the incentives for a potential buyer. Moreover, business – unlike a valuable painting is not the preferred auction object since putting a value on a business is usually a process, and quite a complicated one, too.

IV Conclusion

Credit market is directly influenced by the legislation in the field of secured lending. It has been argued that the Uniform Commercial Code "Secured Transactions" Article 9 has become the driving force behind the positive market developments in the United States. Since the enactment of UCC Article 9, there has been a continuous growth in the number and size of firms willing to enter the credit market. Lending was no longer stigmatized as a poor man's way of obtaining the money, but rather as a tool to finance the current business and consumer needs as well as to finance plans to expand.

One of the key concepts of the American comprehensive secured transactions legislation is the floating lien, which allows creditors create a broad security interest in present and future property of mostly business debtors. The secured creditor creating a floating lien becomes general (or exclusive) secured creditor and is given special position in the priority system: the floating lien holder is exempt from the first-in-time rule and gains priority in after-acquired property even before it is acquired. The reason for that is the concession to the efficiency criterion and recognition of the fact that any business debtor is very likely to have a general creditor and such creditor – when granted according contractual freedom, can even have positive impact on the business debtor's behavior.

The general secured creditor creating a floating lien has an imminent interest to conduct policing of the debtor's business and is claimed to reduce the prospects of the debtor's misbehavior as such. A reliable general secured creditor can therefore also be an indication of a reliable debtor. However, the floating lien would not be complete and perceived as 'fair' towards the other secured creditors if not for the supplementing concept of purchase money security.

Purchase money security diminishes the exclusivity of the general secured creditor in the sense that while the general secured creditor is granted general priority, the purchase money lenders are given super-priority in the particular collateral they are selling or financing on credit terms.

The main idea behind such super-priority is quite logical: once there is a general creditor creating a floating lien - and due to public notice, this is a known fact - the debtor would hardly gain access to any alternative funds following creation of the floating lien. The other potential secured creditors would hardly be willing to extend any credit to the debtor to purchase for example equipment on installment credit terms had they known that it is not them, but the general secured creditor who has priority even before such equipment is acquired by the debtor.

The issue of alternative sources of credit seems to be the next step from an efficient security in the form of a floating lien or its equivalent. The Czech conceptual equivalent to the American floating lien is the pledge of business. The pledge of business was enacted primarily to enhance long-term business debt financing as an alternative method of financing, intended to utilize the security potential of transitory collateral owned by the businesses. However, when compared to the American floating lien, it becomes obvious that the concept is missing out on some crucial supplementing solutions which are adapted in UCC Article 9 practice.

The legislative intent to introduce alternative long-term debt financing tool is undermined primarily by the following: to begin with, the pledge registry is non-public and therefore, the law fails to provide for effective protection of the third parties once the possession has been separated from ownership. Secondly, the definition of 'pledge of business' found in the Civil Code compared to the definition of 'business' in the Commercial Code give rise to controversial interpretation of the actual encumbrance. And thirdly, the pledgee of business is given priority in the assets belonging to the business, but cannot efficiently utilize such priority since the enforcement mechanisms which can be utilized upon debtor's default are very limited and generally perceived as weak.

The Civil Code provides that the pledgee of business may only seek enforcement of the satisfaction of the underlying debt proceeding through the remedies found in the Civil Procedure Act, i.e. the judicial sale and public auction of business. Both methods are completely unfavorable for the purposes of long-term business debt financing since the pledgee is deprived of control in a situation where he took a risk and extended typically a considerable amount of credit secured by the business. Clearly, the pledgee of business has a natural incentive to aim to keep the business going well and to preserve its value even upon the debtor's default.

The solutions found in the American floating lien, but also in the English floating charge practice are simple: trust the general secured creditor enough to *put him in control*, rather than *subject him to control* of courts upon debtor's default. The American general secured creditor can rely on any of the statutory remedies or contractual 'default' provisions. UCC Article 9 allows the use of self-help upon debtor's default and is said to have a relevant strategic rather than real coercive influence in the creditor-debtor relationship. The mere knowledge of the possibility of employing the legal coercive remedies has the strategic importance of both the secured creditor and the debtor reaching mutually favorable solutions when bargaining price and terms of secured credit.

The English floating charge holder also has the contractual freedom and is very likely to provide for such 'default' provisions which will allow him to appoint a receiver who might take over the business should the default occur. Both solutions are flexible and currently impossible to legally create and enforce in the Czech legal practice since the law does not support, but clearly restricts the pledgee of business' possibilities upon default. Not only does the law provide that it is only possible to seek enforcement using judicial sale and public auctions provisions, but it also expressly prohibits contractual provisions which would bestow on the pledgee of business rights to proceed differently upon the occurrence of debtor's default.

To conclude, the chances of a debtor in the Czech legal practice to gain access to readily available credit on competitive terms are much less than in a system supported by detailed secured transactions legislation. My impression is that the reason for that might be in the legal uncertainty stemming from the lack of clear rules relating to the pledge of business implementation and lack of favorable rules on enforcement of the pledgee's rights. The significance of such legislative deficiencies is strategic: both the potential general secured creditor (in other words, pledgee of business) and the debtor (i.e. pledgor of business) are missing out on the *strategic advantage* they would have in the American legal practice. They cannot rely on comprehensive legislation in the field and therefore cannot utilize *strategy* in terms of mutually beneficial solutions in the long-term business debt financing.

While both the American general secured creditor creating a floating lien and the Czech pledgee of business participate in *long-term* business debt financing relationship, the conditions and control they exercise are very different.

In order to enhance the credit market, the Czech law will have to deal with its equivalent of the American floating lien – pledge of business, on a conceptual level. Since the legislative intent is to create an incentive for bigger and more competitive credit market, which is now almost exclusively run by the banks, the law has to create legal environment in recognition of the secured creditor's (i.e. pledgee's) interests. That would entail at least the minimum amount of legal certainty relating to the *position* of pledgee of business towards other creditors and on enforcement of his rights, *public* pledge registry and *more contractual freedom* to employ individual pledge contract terms relating to the powers of the pledgee of business upon debtor's default.

BIBLIOGRAPHY

Books & Articles

English language

Bailey, J. Henry, III, *Secured Transactions in a Nutshell* (Westlaw 1976)

Baird, G. Douglas, "Security Interests Reconsidered", 80 *VA. L. REV*. 2249 (1994)

Barkley, Clark, *Law of Secured Transactions under the Uniform Commercial Code*, (New York: WGL, 1993)

Barkley Clark & Jonathan M. Landers, "Sniadach, Fuentes and beyond: The Creditor Meets the Constitution", *Virg. Law Review*, Vol. 59 (Mar.1973)

Bertrams, R. I. V. F., *Bank Guarantees in International Trade* (Kluwer Law and Taxation Publishers, Deventer 1992)

Beutel, F. K., "The Proposed Uniform(?) Commercial Code Should Not Be Adopted", *Yale Law Journal*, Vol. 61, No.3 (March 1952)

Black – Liels, Susan, "The Unsecured Creditor's Bargain: A Reply", 80 *VA*. L. *REV*. 1989 (1994)

Bonnell, J.M., „Do We Need a Global Commercial Code?," *Dickinson Law Review* (2001)

Bonnen, J. T., Schweikhardt D. B., "The Future of U. S. Agricultural Policy: Reflections on the Disappearance of the Farm Problem", *Review of Agricultural Economics*, Vol. 20, No.1 (1998)

Bridge, Michael G., "How far is Article 9 Exportable? The English Experience", 27 *CAN. BUS. L.J.* 196 (1996)

Bridge, Michael, *Personal Property Law* (Blackstone Press, London 2nd ed. 1996)

Carlson, Gray David, "On the Efficiency of Secured Lending", 80 *VA. L. REV*. 2179 (1994)

Clark, Barkley, *The Law of Secured Transactions under the UCC* (Warren, Gorham & Lamont, Boston 1995)

Cohen A. B., *Guide to Secured Lending Transactions*, Warren, Gorham & Lamont, Inc., Boston, 1988

Coogan, Peter F.; Hogan, Michael J. & Vagts, Detlev, *Secured Transactions under the UCC* (West 1984)

Cooper, Corinne, *The New Article 9 (2nd Ed.*), (N.Y.: ABA, 2000)

Corneill, A. Stephens, "Creditor's Remedies and Debtor's Relief", 2 *GA. Practice* 625 (1989)

Cranston, Ross (ed.), *Commercial Law* (Dartmouth, Aldershot, UK, 1991)

Cuming, R.C.C., "Second Generation Personal Property Security Legislation in Canada", (1981-81), 46 *SASK. L. REV*. 1 (1982)

Davenport, William & Daniel R. Murray, Secured Transactions, (Philadelphia: ALI ABA, 1979

Duncan, Richard, William H. Lyons, and Catherine Lee Wilson, *The Law and Practice of Secured Transactions: Working with Article 9*, (N.Y.: Law Journal Press, 2006)

EBRD, *Model Law on Secured Transactions* (London, 1994)

Ferran Eilis, *Floating Charges – The Nature of the Security*, Cambridge L.J. 152 (1991)

Ferran Eilis, *Company Law and Corporate Finance* (Oxford University Press, 1999)

Frankel, L.H., Frankel, L. H., McDonnell, J. B., Nimmer, R. T., *Commercial Transactions: Secured Financing*, (Virginia: The Mitchie Co., 1982)

Gilmore, Grant, *Security Interests in Personal Property* (Little, Brown and Company, Boston, 1965)

Gilmore Grant, "The Secured Transactions Article of the Commercial Code", *Law and Contemporary Problems*, Vol. 16, No.1, (Winter 1951)

Gilmore, G., *The UCC: A Reply to Professor Beutel*, The Yale Law Journal, Vol. 61, No. 3 (March 1952),

Gilmore Grant, "The Good Faith Purchase Idea and the UCC: Confessions of a Rependant Draftsman", 15 *GA L. Review*, 626 (1981)

Goode, R.M., *Legal Problems of Credit and Security* (2nd ed., Sweet & Maxwell, London, 1988)

Goode, Roy, *Commercial Law* (Penguin, London, 2nd ed. 1995)

Hendrik, Jan Rover & Simpson, John L.,, *General Principles of A Modern Secured Transactions Law* (EBRD, London, June 1997)

Henson, R. D., *Secured Transactions under the Uniform Commercial Code*, (St. Paul, Minn.: West Publishing Co.,1978

Heydt Karl – Eduard, Keller Stanley, *International Securities Law Handbook* (Graham & Trotman, London, 1995)

Heywood, Fleisig, *The Power of Collateral in Viewpoint* (the World Bank, April 1995)

Hodsworth, W.S., *The History of the Treatment of Choses in Action by the Common Law*, 33 Harrold L. REV. 967 (1920)

ICC Publication No. 467, *Retention of Title – A Practical Guide to 19 Legislations* (ICC Publishing, Paris)

Kripke, Homer, "Modernization of commercial security under Uniform Commercial Code", *Law and Contemporary Problems*, Vol. 16, No.2 Commercial Code: Part 2. (Spring 1951)

Kronman, A., Jackson, T., "Secured Financing and Priorities Among Creditors", Vol. 88, *Yale Law Journal* (May 1979)

Lakin & Berger, *A Guide to Secured Transactions*, (Illinois: Callaghan, 1970)

Leebron, W. David, *Claims for Harmonization: A Theoretical Framework*, 27 CAN. BUS. L.J. 63 (1996)

Lynn, M. LoPucki, "The Unsecured Creditor's Bargain", 80 Va L. Rev. 1887 (1994)

MacDonald, Roderick, A., *Exploiting the Pledge as a Security Device*, 15 Revue de Droit de Universite de Sherbrooke 554 (1985)

Macleod, Henry Dunning, *Principles of Economical Philosophy*, Longmans, Green, Reader & Dyer, London, 1881.

Mann, F.A., *The Legal Aspect of Money* (Clarendon Press, Oxford 1982)

Mann, R. J., “Explaining the Pattern of Secured Credit”, *Harvard Law Review*, Vol. 110, No. 3 (Jan. 1997)

Mann, R. J., “Strategy and Force in the Liquidation of Secured Debt”, Mich. Law Review, Vol. 96, No.2 (1997

McIntosh, Stephen “Priority Contests under Article 9 of the Uniform Commercial Code: A Purposive Interpretation of a Statutory Puzzle”, *Virginia Law Review*, Vol. 72, No.6 (Sept. 1986)

McLaren, Richard H. & de Jon, Katherine, *Secured Transactions in Personal Property in Canada* (Carswell, Toronto 1979)

Mitchell, C. Thomas, *The Negative Pledge Clause and the Classification of Financing Devices – A question of Perspective*, 60 AM. BANKR. L. J. 154 (1986)

Nimmer R. T., Nimmer, R. T., Hillinger, I. M., *Commercial Transactions: Secured Financing Cases, Materials, Problems* (2nd ed.), Lexis, New York, 1999

Norton J. J. & Spellman P. R., *Asset Securitization* (Basil Blackwell Ltd., 1991)

Oditah, Fidelis, *Legal Aspects of Receivables Financing* (Sweet & Maxwell, London 1991)

Schupack, Paul M., “Solving the Puzzle of Secured Transactions”, *Rutgers Law Review*, 41 (1989).

Scott, Robert, E., “The Politics of Article 9”, Virginia Law Review, Vol. 80, No. 8 (Nov. 1994)

Scott, Robert, E., “Rethinking the Regulation of Coercive Creditor Remedies”, *Columbia Law Review*, Vol. 89, No.4 (May, 1989)

Sealy, L.S. & Hooley, R.J.Z., *Text and Materials in Commercial Law* (Butterworth, London 1994)

Simpson, John L., Rover, M.Jan-Hendrik, *An Introduction to the European Bank’s Model Law on Secured Transactions* (EBRD, 1994)

Tajti, Tibor, *Comparative Secured Transactions* (Akademiai Kiado, Budapest, 2002)

Weil, H. Peter, *Asset-based lending – An Introductory Guide to Secured Financing* (New York City, Practicing Law Institute 1989)

White & Summers, *The Uniform Commercial Code* (West, 4th Edition, 1995)

Wood, R. Philip, *Comparative Law of Security and Guarantees* (Sweet and Maxwell Ltd., 1995)

Wood, R. Philip, *Comparative Financial Law*, (Sweet and Maxwell, London, 1995)

Zweigert, Konrad & Kotz, Hein, *Introduction to Comparative Law* (Clarendon, 3rd edition, 1993)

Czech language

Baudyš, Petr "Zástavní právo k podniku", *Právní rozhledy* (2003), p. 293.

Bureš Jaroslav a kol., *Občanský soudní řád*, 7.vydání, (C.H.Beck, Praha, 2006)

Černá**,** Stanislava, *Obchodní právo III. Akciová společnost*, (ASPI, Praha, 2006)

Dědič, J., Čech Petr, *Obchodní právo po vstupu České republiky do EU*, (Polygon 3.vyd., Praha, 2005)

Dědič, J., *Komentář k Obchodnímu Zákoníku*, (Polygon, Praha, 2002)

Deutsch, Erich, *Právo a podnikání z pohledu jednoho případu vzniklého v konkursním řízení*, Právo a podnikání, 3/2005

Deutsch, Erich, „Přehled a rozbor konkursú a likvidací z pohledu jejich členění a dopadú podle oborové klasifikace ekonomické činnosti za sledované období let 2000 až 2005", *Právo a podnikání*, 9/2006

Dvořák, Tomáš, „Dispozice s podnikem", *Právní rozhledy*, 3/2003

Eliáš Karel a kol., *Právnické osoby jako podnikatelé*, (C.H.Beck, Praha, 2006)

Eliáš, K., *Sbírka příkladů z obchodního práva, skripta*., (C.H. Beck, 2.vyd., Praha, 2002)

Jehlička a kol., *Občanský zákoník, Komentář*, (C.H.Beck, Praha, 2006)

Kopáč L., *Obchodní kontrakty, I. a Ii. Díl,* (Prospektrum Praha, 1992)

Kulková, Radmila, „K zástavnímu právu po novelách občanského zákoníku“, *Právní rozhledy*, Vol. 7/2002

Pelikánová, Irena, Obchodní právo, I. díl, (ASPI, Praha, 2005)

Pelikánová, Irena, Černá, Stanislava a kol., *Obchodní právo II. Společnosti obchodního práva a družstva*, (ASPI, Praha, 2006)

Pelikánová, Irena, Úvod do srovnávacího práva obchodního, (C.H.Beck, Praha, 2000)

Plíva, Stanislav, *Obchodní závazkové vztahy*, (ASPI, Praha, 2006)

Richter, Tomáš, *Zástavní právo k podniku z pohledu teorie a praxe dluhového financování*, Právní rozhledy, 3/2004, 4/2004

Štenglová, Plíva, Tomsa a kol., *Obchodní zákoník, Komentář*, (C. H. Beck, 8.vyd., Praha, 2003.

Winterová, Alena, *Civilní právo procesní*, (Linde, 4. vyd., Praha, 2003)

Online sources

Portál veřejné správy, http://portal.gov.cz/wps/portal/_

Úřad exekutora, http://www.uradexekutora.cz/e/texty/d_120-2001sb.php.

Senát ČR, http://www.senat.cz

Poslanecká sněmovna ČR, http://www.psp.cz

Portál občanského práva, http://obcanske.juristic.cz

VŠEM, http://www.vsem.cz

Portál e- právo, http://www.epravo.cz

EBRD, http://www.ebrd.com

Cases

United Kingdom

Holroyd v. Marshall (1862) 10 HL Cas 191

Re Panama (1870) 5 Ch App 318

Re Victoria Steamboats Ltd (1897) 1 Ch 326

Re Yorkshire Woolcombers Association (1903) 2 Ch 284

National Westminster bank plc v Spectrum Plus Limited and others (2005) HL 41

The United States

In re Resource Technology Corp., 2005 WL 2588860

In re Twins, Inc., 318 B.R. 90 Bankr. D.S.C. 2004

In re Thiara, B.A.P. 9th Cir. 2002

In re Houlihan's Rest, 286 B.R. 137, 2002

In re Smith's Home Furnishings, Inc., 2001 WL 1045600

Franklin State Bank v. Parker (136 NJ Super, 476, 346 A2d 632)

Waisner v. Jones, 107 N.M. 260, 755 P2.d 598

Motor Credit Co. v. Hunt, 141 Ga. App. 612, 234 S.E.2d 112 (1977).

Fuentes v. Shevin (407 U.S. 67, 92 S. Ct. 1983)

Bosse v. Crowell, Collier & MacMillan, 565 F.2d 602 (9th Cir. 1977).

Gibson v. Dixon, 579 F.2d 1071 (7th Cir. 1978).

Morris v. First National Bank & Trust Co., 21 Ohio St. 2d 25, 254 N.E.2d 683 (1970), General Finance Corp. v. Smith, 505 So.2d 1045 (Ala. 1987).

Czech Republic

Decision of the *Supreme Court* of the Czech Republic of February 28, 2006, sp. zn. 29 Odo 824/2003 (pledge, bankruptcy)

Decision of the *Supreme Court* of the Czech Republic of November 15, 2006 sp. zn. 21 Cdo 2672/2004 (pledge, creation and disposition of the collateral)

Decision of the *Supreme Court* of the Czech Republic of February 22, 2006, sp. zn. 29 Odo 728/2003 (pledge, assignment of claim, void contract)

Decision of the *Supreme Court* of the Czech Republic of September 29, sp. zn. 29 Odo 1103/2004 (pledge, sale of business)

Decision on the *Supreme Court* of the Czech Republic of October 10, 2005, sp. zn. 35 Odo 653/2004 (pledge, sale of business)