CERTAIN FEATURES OF SECURING PAYMENTS BY HUNGARIAN BANKS

by Zsófia Oláh

Budapest, Hungary
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Central European University
Legal Department
International Business Law
Secured Transactions
Supervisor: Professor Tibor Tajti

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1. INTRODUCTION

Developed secured transactions law is an important prerequisite to Hungary's successful transformation into a viable market economy. As it would be impossible to exhaust the whole topic of Hungarian secured transactions law in a few pages, the present paper limits itself to the analysis of the features and problems of those security devices used by Hungarian banks[1] which generated the most debates and which will possibly be subject to significant amendments after the entering into force of the new Hungarian Civil Code.[2]

These security devices are fiduciary assignment and purchase option used for security purposes analyzed in Chapter 2 and charge analyzed in Chapter 3.

Uniquely among post-socialist countries, the charge rules of the Ptk[3] were revised in two reform acts (Act XXVI of 1996 on the Amendment of Certain Provisions of the Civil Code of the Hungarian Republic and Act CXXXVII of 2000 on the Amendment of the Law Regulating Charges) (hereinafter referred to as 1st and 2nd Reform Act) after the change of the regime, based on the EBRD Model Law on Secured Transactions.

Though the Reform Acts established the basis for a developed charge law, they, on the other hand, did not introduce a unified, non-*numerus clausus in rem* security interest system concerning personal property as that of Article 9 of the Uniform Commercial Code (hereinafter referred to as UCC). This failure is probably due to the system-oriented thinking of the drafters of the Hungarian charge law reform and their fear that the functional approach

[1] Similarly to Germany, Hungary is a bank-based credit economy, where the primary credit providers are banks and where the non-bank financial sector (insurance companies, pension funds, capital market, etc.) is relatively small and inefficient. For the further analysis of this topic *See* the IMF country report "Hungary: Financial System Stability Assessment Update" (IMF Country Report No 05/212, June 2005).

[2] In the Government Decree No. 1050/1998. (IV. 24.), the Government has ordered the commencement of codification works regarding the comprehensive reform of the Act IV of 1959 on the Civil Code of the Republic of Hungary (hereinafter referred to as Ptk or Civil Code) and the establishment of the Codification Committee in charge of supervising the codification activity. The last draft of the Chapter on Law of Things is dated 26 May 2006, and that of Obligations is dated 31 July 2006.

[3] *See* § 251 – 271/A of the Ptk.

of the UCC would not fit into the Hungarian Civil Code which follows a completely different approach.

The present thesis attempts to show that it is the lack of an effective, unified and predictable security system that leads to the use of legally problematic and ambiguous solutions in the financing practice of banks. The re-codification of the Ptk is a unique occasion to analyze and revise the current charge regulation and with regard to the wide use of atypical fiduciary securities (as an alternative to the often inefficient charge), to reconsider the introduction of a unified security interest system regarding personal property.

2. FIDUCIARY ASSIGNMENT AND PURCHASE OPTION[4]

2.1 ABOUT FIDUCIARY SECURITY TRANSACTIONS IN GENERAL

The group of fiduciary security agreements[5] includes fiduciary transfer of ownership, fiduciary assignment, purchase option used for security purposes and retention of title.

The primary distinguishing characteristic of fiduciary security agreements is that the ownership, the purchase option or the assignee's (the creditor's) position serves security purposes.[6] The creditor in the fiduciary transactions has more *in rem* rights towards third parties than he has *in personam* towards the debtor according to the security agreement.[7] It is also important to mention already here that the main concern related to fiduciary transactions is that in case of personal property the creditor's ownership right is – in the lack of obligatory registration – hidden from third party creditors.

Based on the above mentioned civil law institutions (fiduciary transfer/assignment, purchase option and retention of title) a number of financial security practices have been developed in the financial market: (e.g. financial leasing, repurchase agreements, factoring).[8]

The primary economic aim of using fiduciary securities in Hungary is the strengthening and better supporting of the creditor's position and safety compared to that available by the use of charge as security.

[4] The terms 'fiduciary assignment', 'security assignment', 'use of receivables/assignment by way of security' are used as synonyms in the present chapter of this paper.
[5] Fiduciary transactions have two main forms: fiduciary security transactions and trust management transactions. The examination of the latter would, of course, exceed the scope of the present paper.
[6] *See* Gárdos, István - Gárdos, Péter; *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article) POLGÁRI JOGI KODIFIKÁCIÓ (No. 1-2, 2004) at 33
[7] *See* Csizmazia, Norbert; *Tulajdon mint biztosíték?* (Property as security?) POLGÁRI JOGI KODIFIKÁCIÓ (No. 1-2, 2004) at 3-22
[8] *See* Gárdos, István - Gárdos, Péter, *supra* note at 34

Concerning the scope of application of fiduciary transactions István Gárdos and Péter Gárdos distinguish the following segments of the market in their above-cited article[9]:

1.) Fiduciary securities are widely used **in the national and international financial markets between authorized financial institutions**. The collaterals applied on this market are typically financial assets (shares, bonds, etc.). The use of fiduciary arrangements on the financial market "strengthens the safety of the whole market and significantly lowers the costs of credit"[10], because the special features of this market require that creditors applying fiduciary securities can dispose of the collaterals as their own assets. This would be problematic by the application of the current Hungarian charge rules since the original charge is terminated by the use of the secured asset and the surrogatum is not the subject of the original charge which may cause problems regarding the priority of the charge.[11]

Financial collateral agreements used in the financial market are regulated by Directive 2002/47/EC. Hungary implemented the Directive by adopting the Act XXVII. of 2004.[12]

2.) Especially fiduciary assignment is also applied by the banks financing corporations in the business market (**corporate – asset and working capital finance – market**). As István Gárdos and Péter Gárdos argue the contractual relationship between the financing bank and the debtor corporation is balanced concerning this type of security agreements, whereas the protection of third party creditors is problematic especially in case of the insolvency of the debtor.

[9] *See* Gárdos, István - Gárdos, Péter, *supra* note at 34
[10] *See* Gárdos, István - Gárdos, Péter, *supra* note at 34 *(„..a piac egészének biztonságát erősíti és a forrásszerzés költségeit csökkenti.")*
[11] *See* Anka, Tibor – Gárdos, István – Nemes András, *A zálogjog kézikönyve* (Handbook on charge), (Budapest, 2003) at 352-353
[12] The Directive *"seeks to protect the validity of financial collateral arrangements which are based upon the transfer of the full ownership of the financial collateral, such as by eliminating the so called re-characterization of such financial collateral arrangements as security interests"*.
http://eur-lex.europa.eu/LexUriServ/site/en/oj/2002/l_168/l_16820020627en00430050.pdf (22 March 2007)
For further details on the subject *see* Gárdos, Benke, Mosonyi Tomori Ügyvédi Iroda, Pénzügyi biztosítékok (Financial collaterals) (2002) http://www.gfmt.hu/hu/kiadvany_11.html (22 March 2007)

3.) Due to the unequal bargaining position of small clients compared to the credit institutions, not even the contractual relationship is balanced between the parties regarding the **retail financing practice** of Hungarian banks. "On this segment of the market the use of charge combined with purchase option is widely used in cases of real estate financing."[13]

4.) Lastly, the **unregulated, non-institutional segment of the market** has to be mentioned when talking about the scope of application of fiduciary securities. This segment– including illegal lending and usury – is highly problematic as "even customary contractual defenses usually applied by contracts between sophisticated parties of more equal bargaining position are not available to the debtors"[14].

The present chapter of this thesis limits itself to the detailed analysis of the most significant fiduciary transactions generally used by Hungarian banks which also cause the most debates in legal literature: fiduciary assignment[15] and purchase option. With regard to its special features, purchase option is going to be analyzed in a separate subchapter at the end of the present chapter.

The use of fiduciary transfer especially in case of real property has practical limits, such as the double payment of tax and duties, the extra expenses regarding the formal requirements and in case of banks restrictions on their acquisition of real estate regulated by § 84 of Act CXII of 1996 on credit institutions.[16] Although the main purpose of this chapter is to analyze fiduciary assignment and purchase option, in order to give a general overview of fiduciary securities it

[13] *See* Gárdos, István – Gárdos, Péter, *supra* note at 34. *("E piaci szegmensben, az ingatlan (lakás-) finanszírozás terén elterjedt a zálogjog mellett a vételi jog alkalmazása.")* Subchapter 2.5 of this paper addresses the topic of purchase option in more details.

[14] *See Id* at 34. *("Ebben a körben az adósnak még azok a kötelmi jogosítványok sem állnak rendelkezésére, amelyeket kiegyensúlyozottabb helyzetben és szofisztikált szereplők között a szerződés általában biztosít.")*

[15] Fiduciary transfer of ownership and fiduciary assignment are very similar legal institutions, ownership being transferred for security purpose in the fist case and receivables assigned for the same purpose in the latter. The things mentioned in connection with security assignment generally apply also to fiduciary transfer of ownership.

[16] *See* Lajer, Zsolt – Leszkoven, László, *A bizalmi (fiduciárius) biztosítékokról* (On fiduciary securities), POLGÁRI JOGI KODIFIKÁCIÓ (No. 1-2, 2004) at 23

is inevitable to also devote some words on certain aspects which only concern fiduciary transfer of ownership (e.g. in connection with security purpose as valid title).

The detailed analysis of financial securities would extend the scope of the present paper. A short description of securities as collaterals is contained in Subchapter 3.2.6.

Even if retention of title has a lot of fiduciary elements, it does not belong to the scope of this paper as it is not used by Hungarian banks as collateral.[17]

2.2 GENERAL FEATURES OF FIDUCIARY ASSIGNMENT

There are two possible ways of using receivables as collaterals. The first is by creating charge on the receivable[18], the second is the fiduciary assignment of the receivable.[19] The latter – being an atypical agreement - is not regulated by the Ptk, thus the general rules on assignment apply to it.

By virtue of fiduciary assignment the debtor assigns his account receivable against a third party (his account debtor) to the creditor in order to secure his repayment of the credit. The creditor (assignee) is entitled to satisfy his claim by collecting the assigned debt upon the default of the assignor.

Due to the security character of the transaction the rights of the creditor concerning the assigned receivables are contractually limited, most importantly he is obliged to reassign the receivables to the debtor (assignor) upon the repayment of the credit (unless the parties agreed that the repayment of the loan is the condition subsequent of the assignment).[20]

[17] It is generally used by suppliers and natural persons when they sell real estate.
[18] According to § 267 – 269 of the Ptk.
[19] *See* Leszkoven, László *A fiduciárius engedményezés jogi természetéről* (On the legal nature of fiduciary assignment), GAZDASÁG ÉS JOG (No. 3, 2002) at 13
[20] In the first case (provision regarding reassignment) the assignor (debtor) has an *in personam* expectancy, whereas in the latter case (repayment as condition subsequent) an *in rem* expectancy (estate in expectancy).

There are several different types of fiduciary assignment that have evolved in the financing practice of banks: notification/non-notification based financing, one-shot type or bulk assignments, etc.

The specialties of the fiduciary assignment in general are as follows:[21]:

- **Abstract transaction:** It is non-accessory, independent from the secured claim. Contrary to charge the subject of the security may – theoretically – be assigned without the assignment of the principal (secured) claim.

- **Assignment as collateral:** The assigned receivables do not replace the debt but only secure their payment.

- **No registration:** Contrary to charge, fiduciary assignment is not subject to mandatory registration requirements. (As pointed out latter on below this does not comply with the publicity principle concerning proprietary rights.)

- **Non-notification until default event:** The credit institutions usually dispense with the notification of the account debtor as long as the assignor complies with his obligations arising from the credit agreement. In case of the assignor's default the bank notifies the debtor of the assignment and calls him upon performing to it.

- **Control:** Until the above notification the bank (the assignee) can 'police' the assignor's business activity by requiring from the assignor to collect the receivables on an account managed by the creditor bank.

- **Continuation of the business:** Until any default event and the notification of the account debtor as a consequence thereof, the assignor is entitled to continue his

[21] Based on the features collected by Lajer, Zsolt, *Jövőbeni követelések engedményezése mint hitelbiztosíték* (Assignment of future claims as collateral), MAGYAR JOG, (No. 1, 1997), at 21

business in the ordinary course of business and as a part thereof to collect the receivables. These collected receivables do not necessarily form part of the repayment of the loan until default.[22]

- **Reassignment:** Due to the fiduciary nature of assignment, the bank obliges itself in the credit agreement to reassign the receivables to the assignee in case of the repayment of the loan.[23] By virtue of the abstract nature of the assignment transaction the creditor (assignee) can act as a fully entitled obligee of the claim. But in case the it violates the security agreement e.g. by notifying the account debtor and collecting the debt despite the fulfillment of the repayment terms by the assignor, the assignor can sue the assignee for damages.[24]

- **Partial reassignment:** Should the value of the assigned receivables not only temporarily and to a significant extent exceed the secured claim, the assignee is obliged to reassign the surplus to the assignor.

- **Obligation to account for surplus:** If the assignee bank satisfies its claim through the collection of the assigned receivables, it is obliged to account to the assignor debtor for the surplus.

- **Framework assignment agreement (constant flow of receivables):** The parties to the loan agreement usually conclude a framework assignment agreement whereby the debtor obliges himself to constantly assign receivables of a sufficient value to the bank by providing it with a detailed list of the actually assigned receivables from time to time.

[22] The assignor is, of course, entitled to apply the collected receivables for the repayment on his own decision.
[23] Another possibility is that the repayment of the loan is the condition subsequent of the assignment. In this case the assigned receivable(s) automatically revert to the assignor upon repayment of the loan.
[24] SZLADITS, KÁROLY, A MAGYAR MAGÁNJOG VÁZLATA I. [The Outline of Hungarian Civil Law I.] (Budapest, 1937) at 241

2.3 THE ADVANTAGES OF FIDUCIARY ASSIGNMENT[25]

The main reason for the widespread use of fiduciary assignment is the need for strengthening the creditors' position and avoiding the lot-criticized priority rules of the Insolvency Code concerning charge. Unless otherwise provided by the parties, the assignment agreement is completed upon conclusion and thus the assigned claim does not form part of the debtor's estate. As a result, the assignment cannot be terminated by the bankruptcy trustee.

As analyzed in Chapter 3, in case of non-possessory charges, registration is required in order to ensure publicity and to avoid the ostensible ownership problem. Whereas the *in rem* effect of fiduciary assignment does not call for either registration or special formal requirements in Hungarian law.

While charge is a limited, accessory-type *in rem* right - enabling enforcement subject to strict mandatory rules and only in case of the default of the debtor, not allowing the creditor to obtain ownership/full disposition of the security and ceasing automatically upon repayment of the credit – security assignment is abstract and non-accessory enabling the creditor to remain the 'owner' of the collateral until it is reassigned to the debtor.

Unlike charge, fiduciary assignment is not subject to any mandatory court or non-court enforcement rules. The critics of fiduciary assignment – as specified below – argue that the absence of these mandatory enforcement rules results in the lack of "fair procedure" taking into account both the debtor's, the creditor's and third party creditors' interests.[26]

The primary aim of creditors when securing their claims is to gain priority against unsecured creditors and to be capable of enforcing the secured claim even if the debtor becomes insolvent. There is a major difference between charge and security assignment in insolvency

[25] *See* Gárdos, István - Gárdos, Péter, *supra* note at 34-35
[26] *See* Gárdos, István - Gárdos, Péter; *supra* note at 35

proceedings. Whereas in case of charge the property forms part of the bankruptcy estate and the claim secured by charge can only be satisfied in the bankruptcy proceedings, the creditor secured by the assignment has absolute priority because the assigned receivables do not pool in the bankruptcy estate.

2.4 FIDUCIARY ASSIGNMENT (FIDUCIARY SECURITIES) AND THE NEW HUNGARIAN CIVIL CODE

2.4.1 LEGAL LITERATURE

As mentioned above, the 1st and 2nd Reform Acts have failed to establish a non-*clausus numerus in rem* security interest system. Fiduciary securities - although a lot used in practice by banks and other economic participants – do not belong to the limited number of security devices acknowledged by the Ptk.

As argued later below, receivables financing (assignment of receivables by way of security) in Hungary is – among other security devices – a good example for the too much importance given to traditional elements of civil law and too little attention given to modern achievements in the field.

The possible functions and faith of fiduciary assignment and fiduciary securities in general have generated a lot of debates during the preparatory works of the new Civil Code Concept among the members of the codification team responsible for the drafting of a new Hungarian secured transactions system.

This subchapter is devoted to the short presentation of the arguments for and against fiduciary securities. The subchapter summarizes the primary questions raised and the possible solutions suggested during the preparatory codification works and the main reform elements of the draft regarding fiduciary securities.

The most important questions regarding fiduciary securities also emphasized by the authors of the relevant legal literature are as follows:

- Is *causa fiduciae* a valid title regarding fiduciary transfer of ownership?
- Are fiduciary transactions a means for evading statutory regulations?
- Are fiduciary transactions fake arrangements, can they be re-characterized?
- How should the new Hungarian Civil Code tackle fiduciary security arrangements?

Two conflicting opinions (for and against the validity and application of fiduciary arrangements) have developed in the legal literature of the recent few years the main arguments of which are going to be summarized in the following paragraphs.[27]

2.4.1.1 Security purpose as valid title concerning the fiduciary transfer of ownership

"Title is the indirect aim of creating an obligation. There is no obligation without title, and the contract itself usually gives expression to its legal title."[28] Legal title expresses the special economic or legal purpose because of which the parties enter into an obligation.

[27] **Arguing against the validity and application of fiduciary securities:**
- Gárdos, István - Gárdos, Péter; *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article) POLGÁRI JOGI KODIFIKÁCIÓ (No. 1-2, 2004) at 33-47;
- Gárdos, István – Gárdos, Péter, *Az engedményezés és a vételi jog biztosítéki célú alkalmazása* (The use of assignment and purchase option as collateral), GAZDASÁG ÉS JOG (No. 4, 2004) at 14-19;
- Gárdos, István – Gárdos, Péter, *Ismét a fiduciárius biztosítékokról* (Again on fiduciary securities), GAZDASÁG ÉS JOG (No. 3, 2005) at 13-18;

Arguing for the validity and application of fiduciary securities:
- Lajer, Zsolt – Leszkoven, László, *A bizalmi (fiduciárius) biztosítékokról* (On the fiduciary securities), POLGÁRI JOGI KODIFIKÁCIÓ (No. 1-2, 2004) at 23-33
- Leszkoven, László *A fiduciárius engedményezés jogi természetéről* (On the legal nature of fiduciary assignment), GAZDASÁG ÉS JOG (No. 3, 2002) at 13-17
- Lajer, Zsolt, *Jövőbeni követelések engedményezése mint hitelbiztosíték* (Assignment of future claims as collateral) MAGYAR JOG, (No. 1, 1997), 19-25

[28] *See* SZLADITS, KÁROLY, A KÖTELEM JOGALKATA ÉS KELETKEZÉSE (The legal nature and formation of obligation), in MAGYAR MAGÁNJOG III. KÖTET (Hungarian Private Law III.) (Grill Kiadó, Budapest, 1941) at 41

The question arose among authors whether *causa fiduciae* can be a valid title for the transfer of ownership (besides the more typical titles: e.g. *causa solvendi, causa aquirendi and causa donati)*. According to Subsection 2 of § 117 of the Ptk transfer or other legal title is a prerequisite for the transfer of ownership. Lajer and Leszkoven argue that there is no *clausus numerus* list on the possible legal titles for the transfer of ownership, thus *causa fiduciae* can be valid and acceptable.[29]

István Gárdos and Péter Gárdos, on the other hand, came to the conclusion that "due to the similar nature of abstract transactions and *fiducia,* the title-requirement of the transfer of property excludes the permissibility of fiduciary transfers in Hungarian law unless the legislator positively regulates and acknowledges such transfer".[30] According to their view in legal systems where the transfer of ownership is not an abstract title– such as in Hungary – the validity of the transfer can be doubted in the absence of a legal title or in case it is contractually limited by the parties[31].

2.4.1.2 The abstract nature of assignment

As pointed out by Leszkoven, contrary to the need for a valid title in case of the transfer of ownership[32], assignment – being of abstract legal nature – does not *prima facie* require a valid legal title in order to become a completed, 'perfect' legal transaction. It is in itself able to

[29] *See* Lajer, Zsolt – Leszkoven László, *supra* note at 26

[30] *See* Gárdos, István - Gárdos, Péter; *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article) *supra* note at 40

[31] In their opinion in case of fiduciary transfer of ownership the 'formal' ownership belongs to the creditor (assignee) as he has the power to exercise all rights belonging to ownership, whereas the 'material' ownership belongs to the assignor (debtor) because the creditor is contractually limited regarding the exercise of these rights.
See the detailed analysis of the issue in Gárdos, István - Gárdos, Péter; *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article) *supra* note at 35-40

[32] Subsection 2 of § 117 of the Ptk

realize the change in the position of the obligee without being dependant on the validity of the legal title.[33]

The significance of this abstract nature of assignment regarding the permissibility of fiduciary assignment in Hungarian law – according to Leszkoven – is that it ensures a bigger level of independency from the legally relevant purpose of the parties.[34]

The aim of assignment is that the assignee becomes the obligee in the original legal relationship between the assignor and the account debtor. The assignment is completed upon the consensus of the parties. No further legal act – neither the notification of the account debtor, nor the enforcement of the claim - is required on the side of the assignee in order to acquire the claim.[35] These observations are going to be significant concerning the analysis of the ambiguous Hungarian court practice in Subchapter 2.4.2 below.

With regard to the above, one of the main differences between charge created on an account receivable and its assignment is that in the first case the obligee of the original claim does not change, whereas in the latter case the creditor becomes the obligee of the original claim. The creditor in case of fiduciary assignment acquires an unlimited right on the assigned claim as regards third parties (even if his rights are contractually limited towards the assignor). In case of a default event he can act on his own in order to collect the debt and satisfy his claim from the assigned receivable, with the only restriction that he is obliged to account for the surplus.

[33] *See* Leszkoven, *supra* note at 14

[34] Leszkoven also argues that the contemporary Hungarian jurisprudence is not concerned with the abstract or causal nature of assignment. Regarding earlier 20th century Hungarian legal literature Szladits, Villányi and Nizsalovszky emphasized the abstract, whereas Világhy the casual nature of assignment, (*See* Leszoven, *supra* note at 14)

[35] *See* Leszkoven, *supra* note at 14-15

2.4.1.3 Do fiduciary securities form a means of circumventing statutory rules?

All authors agree that in the absence of a prohibition of fiduciary transactions in the Ptk, they cannot constitute a direct breach of law. The question is whether the creation of ownership or assignment for security purposes is invalid by virtue of the intention of evading mandatory rules applicable to charge.[36]

It goes without saying that the widespread use of atypical fiduciary security agreements by economic participants is attributable to the dissatisfaction with certain rules applicable to charge. The two pairs of co-authors (Gárdos – Gárdos and Lajer – Leszkoven) cited above disagree whether the intention of the parties to use fiduciary securities instead of charge is legitimate.

István Gárdos and Péter Gárdos arguing against the validity of fiduciary securities emphasize that the limitations contained in the mandatory charge rules serve the aim of establishing a balance between the interests and position of the secured creditor, the debtor and interested third parties (other creditors).[37] In their view charge is the exclusive *in rem* security under Hungarian law and in case other *in rem* securities were possible, the relevant acts (Ptk, Insolvency Act and Execution Act [38]) would use a general term instead of 'charge' which

[36] According to Subsection 2 of § 200 of the Ptk contracts in violation of legal regulations and contracts concluded by evading a legal regulation shall be null and void, unless the legal regulation stipulates another legal consequence. A contract shall also be null and void if it is manifestly in contradiction to good morals.

[37] *See* Gárdos, István – Gárdos, Péter, *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article), *supra* note at 40-41. The authors summarize the most important mandatory charge rules that serve the above purpose as follows: „1. Non-possessory charge is created by registration.
2. The chargor is entitled to use the charged property until the chargeholder enforces his rights.
3. The chargeholder is not entitled to dispose of the charged property until his rights to enforce are triggered, in addition it is regulated in detail when a third party buyer can acquire ownership subject to the security right and when it is possible to acquire ownership free of charge.
4. Satisfaction (whether with the involvement of the court or without it) is a regulated procedure, in which it is secured to that the charged property will be sold at the highest possible price in the given circumstances, and that the creditor will account to the debtor for the result of the sale.
5. Prohibition of *lex commissoria* i.e. that the creditor cannot acquire ownership in case of the debtor's default.
6. The charged property remains in the ownership of the chargor, therefore in case of the debtor's insolvency it will be part of the insolvency asset."

[38] Act XLIX of 1991 on Reorganization Procedure and Insolvency and Act LIII of 1994 on Judicial Execution

would be applicable to all similar securities as it can be seen with regard to the functional approach of Article 9 of the UCC.[39]

With regard to the above, they have come to the conclusion that fiduciary securities are invalid as parties are not free to create new forms of proprietary securities which enable the circumvention of mandatory rules e.g. publicity and fair procedure regarding the satisfaction of the claim.

Zsolt Lajer and László Leszkoven, on the other hand, argue that that there is no legal provision in force under Hungarian law that prescribes the exclusivity of charge as *in rem* security.[40]

They also argue that publicity does not require unconditional enforcement regarding securities as neither e.g. *sui generis* charges securing bank credits that existed in socialistic times nor present rules related to charges on rights and claims prescribe registration.[41]

The author of this thesis disagrees with the above view concerning publicity. Recent and present legal deficiencies cannot legitimate the lack of publicity of securities which is the most efficient (if not the only) way of ensuring the avoidance of the ostensible ownership problem and it is the basic principle of *in rem* rights.

2.4.1.4 Are fiduciary securities fake?

According to István Gárdos and Péter Gárdos fiduciary transactions are similar to simulated contracts as the legal appearance does not conform to reality. The debtor continues to use the secured collateral (the asset or the assigned receivable) in his ordinary course of business and

[39] *See* Gárdos, István – Gárdos, Péter, *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article) *supra* note at 38
[40] *See* Lajer, Zsolt – Leszkoven Laszló, *supra* note at 26
[41] *See* § 267-268 of the Ptk.

the third party creditors – in the lack of publicity – do not know that the real owner is already the creditor. The intention behind these transactions is that they whish to hide the actual situation from third parties and they whish to avoid the application of compulsory charge rules.[42] This is a clear example of the false wealth problem.

According to Zsolt Lajer and László Leszkoven the fact that a transaction serves security purposes in terms of its economic functions, does not render it a fake contract.

Before turning to the analysis of the possible solutions for regulation of fiduciary securities, a short description of the Hungarian court practice of the last sixteen years concerning the enforceability of fiduciary securities is important to get a general overview of these legal institutions.

2.4.2 COURT PRACTICE

Judicial attitude towards fiduciary assignment has significantly changed since the beginning of the '90s. It is not a surprise that legal disputes usually concerned the faith of fiduciary assignment in bankruptcy proceedings. The question generally was whether the assigned receivables form part of the bankruptcy estate.

In two decisions of the early '90s[43] the Supreme Court of the Hungarian Republic (hereinafter referred to as Supreme Court) did not pay much attention to the security nature of the assignment used by the parties and held as follows:

In case the debtor assigns his claim before the commencement of the insolvency proceedings, the bankruptcy trustee is not entitled to terminate the already perfect assignment agreement.[44]

[42] *See* Gárdos, István – Gárdos, Péter, *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article), *supra* note at 41-42

[43] *See* BH1993.114 and BH1993.446

The assignment agreement is perfect upon its conclusion, the bankruptcy trustee is thus not entitled to terminate such an agreement concluded before the publication of the bankruptcy proceedings.[45]

The Supreme Court based its decisions on the provisions of the Ptk applicable to assignment (§328 and 329)[46] and – apart from the above-quoted arguments concerning the validity of the fiduciary assignment - it emphasized that as a result of the assignment the creditor has become the obligee of the legal relationship between the debtor and his account debtor and thus he is entitled to the claim.[47] No consent of the account debtor is required for the validity of the assignment, he only needs to be notified according to Subsection 3 of § 328 of the Ptk.

By virtue of the above court decisions of the early '90s, fiduciary assignment became a very popular security device used by banks.[48]

Later on in the previous decade the Supreme Court – presumably trying to preclude the dissipation of the bankruptcy estate by using assignment by way of security – came to a much debated decision by holding that

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[44] *See* BH1993.114 *„Ha az adós követelését - még a felszámolási eljárás megindítása előtt joghatályosan engedményezi, a felszámoló szervezet az engedményezésre vonatkozó, teljesedésbe ment megállapodást nem mondhatja fel."*

[45] *See* BH1993.446 *„Az engedményezésre vonatkozó szerződés a megkötésével egyidejűleg teljesedésbe megy, ezért a felszámolási eljárás közzététele előtt kötött ilyen szerződésnek a felszámoló részéről történő felmondása kizárt."*

[46] § 328 (1) An obligee shall be entitled to transfer his claim to another person by contract (assignment).

(2) Claims that are bound to the person of the obligee and claims whose assignment is not permitted by legal regulation shall not be assigned.

(3) The obligor shall be notified of assignments; the obligor is entitled to perform to the assignor before notification.

(4) If the obligor is notified by the assignor, the obligor shall be allowed to perform only to the new obligee (assignee) after notification; in the case of notification by the assignee, the obligor shall be entitled to demand certification of the assignment. In the absence thereof, he shall be entitled to perform to the person who acted as assignee solely at his own risk.

§ 329 (1) An assignee shall subrogate the original obligee through the assignment, and the rights proceeding from the charge and suretyship that secure the claim shall also pass to him.

(2) Notification of the obligor regarding assignment suspends the period of limitation.

(3) An obligor shall be entitled to enforce the objections and offset the counterclaims against the assignee that arise with regard to the assignee on the legal grounds prevailing at the time of notification.

[47] *See* BH1993.114 § 329 (1) An assignee shall subrogate the original obligee through the assignment, and the rights proceeding from the charge and suretyship that secure the claim shall also pass to him.

[48] *See* Gárdos, István – Gárdos, Péter, *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article) *supra* note at 43

A claim not existing at the time of conclusion of the assignment agreement cannot validly be assigned. Notwithstanding such a contract the claim continues to belong to the bankruptcy estate of the company.[49]

In the above case the debtor assigned to the creditor his purchase price claim arising from the future sale of his seed stock as a partial security of the credit granted by the creditor. The Court argued that as the indication of the account debtor and the amount of the claim are essential elements of the assignment agreement and these cannot be indicated in case of a future claim, future accounts cannot be assigned.

The above decision is clearly contrary, firstly, to the general perception that things not existing at the time of the conclusion of a sale and purchase agreement can be subject to sale[50] and, secondly, to the general rule that a contract is created if its essential elements can be indicated through interpretation[51].

Apart from the above-mentioned legal reasons the acknowledgement of the assignment of future claims also has economic grounds. Due to the constantly increasing pre-financing need of companies in the modern credit economy, the banks endeavor to secure the repayment of the credit by making the debtor assign his account receivables arising from his pre-financed supply contracts.[52]

Apart from the above case concerning the assignment of future claims, two landmark cases of 2001 and 2002 have significantly changed the Supreme Court's previously sympathetic approach towards fiduciary assignment.[53]

[49] *See* BH1996.380 *„Az engedményezési szerződés megkötésének időpontjában még létre sem jött követelés - érvényesen - nem engedményezhető; az ilyen szerződés ellenére ezért a követelés összege továbbra is az adós gazdálkodó szervezet felszámolási eljárás körébe tartozó vagyonának a része."*
[50] *See* KISFALUDI, ANDRÁS, AZ ADÁSVÉTELI SZERZŐDÉS (The sale and purchase agreement) (KJK-Kerszöv Kiadó, Budapest, ed. 2003) at 72
[51] *See* Lajer, Zsolt, *supra* note at 20
[52] *Id.* at 20
[53] *See* EBH2001.439 (BH2001.489) and BH2002.364

In the first case the creditor bank and the factoring company debtor entered into a framework assignment agreement whereby the factoring company assigned to his creditor bank the future claims arising from the factoring contracts precisely indicated in the annexes attached to the security agreement. The assignment of each claim took place in a way that the factoring company indicated the transfer of the relevant claim on the copy of the invoice and the bank accepted it by permitting the use of a certain amount of the current account credit line.

According to the usual scenario the debtor went bankrupt and the bankruptcy trustee terminated the assignment contracts and notified the account debtors that they shall not pay to the creditor bank but to the account of the factoring company in liquidation. The creditor, of course, filed an objection against the above act of the bankruptcy trustee and the Supreme Court eventually held as follows:

> Fiduciary assignment shares the faith of the other securities in insolvency proceedings, thus if the creditor did not collect and enforce his claim based on assignment from the account debtor until the starting date of the insolvency proceedings, he is not entitled to dispose of such a claim any more. The security provided by the debtor for a certain purpose hence belongs to the bankruptcy estate.[54]

Although the Supreme Court emphasized the validity of fiduciary assignment and stated that no legal provision precludes the use of assignment by way of security, it did not accept the most significant effect of assignment that the claim becomes the property of the creditor upon the conclusion of the assignment agreement and it is extracted from the debtor's estate. "In effect the court re-characterized the assignment as charge over claim. (…) It seems that the court tries to avoid the unjust result that in case of the debtor's insolvency the assigned claims will not be part of the insolvency asset."[55]

[54] *See* EBH2001.439 *„Felszámolási eljárásban a biztosíték célú engedmény osztozik a többi biztosíték jogi sorsában, így ha a hitelező az engedményen alapuló követelést a felszámolás kezdő időpontjáig nem szedte be a kötelezettől, azzal már nem rendelkezhet. Az adós által meghatározott célból nyújtott biztosíték a felszámolás körébe tartozó vagyon része lesz."*

[55] *See* Gárdos, István – Gárdos, Péter, *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article), *supra*

In the view of István Gárdos and Péter Gárdos the intention to keep the assigned claim in the bankruptcy estate is just, but the reasoning of the court that, on the one hand, it accepts the validity of fiduciary assignment and, on the other hand, it in fact re-characterizes it as a charge over a claim by stating that the claims not yet enforced belong to the bankruptcy estate, is incorrect. Re-characterization is correct if the court establishes that an agreement is simulating. Otherwise the reason for re-characterization is missing.[56]

In the second case the Supreme Court held that

By virtue of the assignment agreement the assignee is entitled to directly satisfy his claim against the assignor from the assigned claim by collecting the debt from the assigned debtor until the starting date of the insolvency proceedings.[57]

The result of the last two court decisions – apart from being dogmatically incorrect, as pointed out above – are also unjust from the point of view of the creditors secured by fiduciary assignment. Their claim becomes unsecured as of the starting date of the insolvency proceedings, without having a privileged position in the priority order, at least.

After having seen the different opinions concerning fiduciary assignment and fiduciary securities in general in the legal literature and the ambiguous and inconsistent relevant court practice the next subchapter is devoted to the suggestions concerning the regulation of fiduciary securities in the new Civil Code.

note at 43 *("Ez azt jelenti, hogy az engedményezést valójában átminősítette biztosítékká. … úgy tűnik, hogy a bíróság el kívánja kerülni azt a harmadik személyek szempontjából igazságtalan eredményt, hogy az engedményező felszámolása esetén az engedményezett követelés kikerüljön a felszámolás alá vont vagyonból.")*

[56] *Id.* at 43

[57] *See* BH2002.364 *„Az engedményest az engedményező ellen indult felszámolási eljárás kezdő időpontjáig illeti meg a biztosítéki célú engedményezési szerződés alapján az a jog, hogy az engedményezett követelésből az engedményezővel szemben követelését közvetlenül kielégítse, az adóstól a tartozást beszedje."*

2.4.3 POLICY CONSIDERATIONS AND POSSIBLE SOLUTIONS FOR REGULATION IN THE NEW CIVIL CODE

István Gárdos and Péter Gárdos came to the conclusion that there is no policy reason for supporting fiduciary securities and they strongly emphasize the exclusivity of charge as *in rem* security. They argue that the creditors' aim – being dissatisfied with the current mandatory charge rules - to strengthen their position is not a valid reason for codifying fiduciary securities in the new Civil Code, as creditors' primary aim is to evade obligatory charge rules. They rather argue for the amendment of the charge rules, if the legislator accepts the criticism formulated in practice concerning certain rules related to the creation and enforcement of charge. They themselves acknowledge the necessity of the revision of the current charge rules. [58]

Although mentioning the possibility of the introduction of a unified concept of security interest similarly to the functional approach of the UCC, they reject this alternative by arguing that "it is needless to codify more institutions for the same purpose, which in substance are not different from each other"[59].

In contrast to the above-mentioned opinion, Zsolt Lajer and László Leszkoven argue that there is no reason for contesting the validity of fiduciary securities. They suggest the short regulation of fiduciary securities in the new Civil Code in order to avoid legal uncertainties. They also support the establishment of a priority order in the insolvency proceedings – under the reforming of insolvency law – which would tackle the different type of securities (consensual liens) equally.[60]

[58] *See* Gárdos, István – Gárdos, Péter, *Van-e a fiduciárius biztosítékoknak helyük a magyar jogban? Vitacikk*, (Do fiduciary (title transfer) security arrangements fit into the Hungarian legal system? Debate article), *supra* note at 45-46
[59] *Id.* at 46
[60] *See* Lajer, Zsolt – Leszkoven, László, *supra* note at 31

Leszkoven also suggests in his separate article on fiduciary assignment that either it be regulated in the amended Insolvency Act that the assigned claim shall revert to the assignor debtor at the starting date of the insolvency proceedings in order to protect the interests of third party creditors, or the collection of the debt be regulated in a different way (e.g. joint entitlement of the creditor and the debtor).

He also emphasizes the significance of regulating fiduciary assignment as a privileged claim in insolvency proceedings similar to the position of charge and security deposit.[61]

To some up, the author of this thesis shares the view of Norbert Csizmazia expressed in the conclusion of his article already cited above. As Csizmazia argues, the primary question regarding fiduciary securities is not whether the new Civil Code provides creditors with a security device stronger than charge, but whether – by regulating a new security device – it abandons important rules guaranteeing the balance between creditors, debtors and third party creditors.[62]

He also emphasizes the inevitable revision of the present charge rules. In the course of their development, charge-related rules have become subject to restrictions contrary to their security nature.[63]

Csizmazia argues not only for a unified security registration system guaranteeing publicity of all non-possessory securities, but also favors the general functional approach represented by Article 9 of the UCC, which concentrates on the economic purpose of the transactions.[64]

[61] *See* Leszoven, *supra* note at 17
[62] *See* Csizmazia, *supra* note at 15
[63] E.g. in case of the insolvency of the debtor the charged asset forms part of the bankruptcy estate, satisfaction is only possible in the insolvency proceeding, separate satisfaction right of enterprise charge in the insolvency proceeding restricted to 50 % of the purchase price, etc. *See* in more details in Chapter 4 of the present thesis.
[64] *See* Csizmazia, *supra* note at 16. He also refers to the proprietary workshop led by Ulrich Drobnig of the *Study Group on a European Civil Code* which also applies the functional approach regarding security interests. http://www.sgecc.net/media/downloads/proprietary_securitiesjune_2005.pdf 25 March 2007

2.5 PURCHASE OPTION

As mentioned already in the previous subchapters – apart from fiduciary assignment – purchase option is the other form of fiduciary transactions which is the most widely used in practice (especially by banks related to real estate financing) and related to which the most court decisions have been published. The general remarks related to fiduciary transactions, of course, also apply to purchase option.

Although court practice in this field is rather settled and unambiguous as pointed out later on below in this subchapter, there are still problematic elements of this legal institution.

The Ptk regulates purchase option as one of the special types of sale.[65] Creditors' purpose when using purchase option as a security device is not to acquire ownership over the secured asset but to use it as collateral for securing the repayment of the credit.

According to the typical contractual provisions, the creditor is entitled to buy the asset encumbered with his purchase option with a unilateral declaration at a purchase price either stipulated in the security agreement or calculated at the time of the enforcement of the purchase option right. The creditor – partially or wholly - pays the purchase price by setting off his claim against the owner (debtor).[66]

[65] § 375 of the Ptk: (1) If an owner grants a right of purchase (option) to another person, the beneficiary shall be entitled to buy the thing with a unilateral statement. Agreements on options to purchase shall be put in writing with the thing and the purchase price specifically indicated.

(2) An option to purchase stipulated for an indefinite period of time shall expire after six months; any agreement to the contrary shall be null and void.

(3) Unless otherwise provided by law, the court may relieve an owner of his obligation deriving from the option to purchase if the owner is able to prove that, after granting the option, his circumstances have altered significantly, as a consequence of which performance of his obligation cannot be reasonably expected.

(4) Concerning other issues, the regulations governing the rights of repurchase shall apply to the rights of option to purchase.

[66] *See* Lajer, Zsolt – Leszkoven, László, *supra* note at 29

2.5.1 COURT PRACTICE

The Supreme Court's approach towards purchase option used by the way of security has always been consistently favorable. It has acknowledged its validity and determined the conditions of its application and also its relationship with mortgage in several decisions.

In its decision No. BH1998.350 the Supreme Court held that the prohibition of *lex commissoria* regulated by the Ptk[67] "only concerns agreements according to which the chargee acquires ownership over the charged asset in case of the default of the debtor (chargor). The regulation only renders such an agreement null and void, and only in case such an agreement is concluded before the commencement of the right of satisfaction. Such agreements are prohibited because they would lead to the abuse of the disadvantageous position of the debtor, as creditors would be entitled to acquire ownership over the charged asset in return for their outstanding claim without taking into account the installments already paid by the debtor, without an obligation to account to the debtor and without the determination of the valid market value of the asset."[68]

In the view of the court the prohibition of *lex commissoria* does not affect the right of the debtor to grant a purchase option to or for the benefit of his creditor on the asset (real estate) already encumbered by mortgage. It also emphasized that the agreement granting purchase option has to be in writing and has to indicate the encumbered asset and the purchase price. Further provisions ensuring the protection of the debtor's interests specified by the court are the right to challenge the validity of the contract in case of highly unreasonable

[67] *See* Subsection 1 of § 263

[68] *See* BH1998.350 *„…csak az arra vonatkozó megállapodást tiltja, mely szerint a zálogjog jogosultja a kötelezettség teljesítésének elmulasztása esetén megszerzi a zálogtárgy tulajdonjogát. A jogszabály kizárólag az ilyen megállapodáshoz fűzi a semmisség jogkövetkezményét, és azt is csak akkor, ha a megállapodás megkötésére a kielégítési jog megnyílta előtt került sor. A jogszabályban írt tartalmú megállapodás nyilvánvalóan azért tilos, mert a hitelező az addig esetleg törlesztett részleteket figyelmen kívül hagyva, elszámolási kötelezettség nélkül, a zálogtárgy valóságos értékének meghatározása nélkül szerezhetné meg a fennálló követelése fejében a zálogtárgy tulajdonjogát, amely a kötelezett hátrányos helyzetének kihasználására vezethet."*

disproportionality[69] and the right to discharge of the performance of the contract in case of frustration[70] (*clausula rebus sic stantibus*).

To sum up, the court held that the contract granting purchase option for security purposes is valid in case it is concluded in writing, the real estate(s) encumbered, the purchase price and the lapse of the purchase option are precisely stipulated.[71]

The above arguments in favor of purchase option used as collateral are repeated in the court decisions No. BH1999.415 and No. BH1999.452. In the latter case - where not the debtor but a third person encumbered his asset by a purchase option - the Supreme Court also held that the owner of the asset not personally obliged against the creditor is entitled to grant purchase option to the creditor in order to secure the repayment of the credit by the debtor.[72]

With regard to the above cited court decisions, the conclusion can be drawn that the Supreme Court did not consider the use of purchase option by the way of collateral as legally problematic. Risks and problems with this legal institution may arise if the creditor – with the intention of profiteering – evades his obligation to account to the debtor.

In its decision No. BH2001.584 the Supreme Court held that "the contract is not invalid if – although it does not contain a purchase price in conformity with the real intention of the parties - the purchase price can be determined according to the intention of the parties."[73] In the case in question, however, none of the parties could determine what purchase price they actually agreed on and the purchase price stipulated by the agreement was fictive. The

[69] *See* Subsection 2 of § 201 of the Ptk If at the time of the conclusion of the contract the difference between the value of a service and the consideration due, without either party having the intention of bestowing a gift, is grossly unfair the injured party shall be allowed to challenge the validity of the contract.
[70] *See* Subsection 3 of § 375 of the Ptk Unless otherwise provided by law, the court may relieve an owner of his obligation deriving from the purchase option if the owner is able to prove that, after granting the option, his circumstances have altered significantly, as a consequence of which performance of his obligation cannot be reasonably expected.
[71] *See* BH1998.350
[72] *See* BH1999.452
[73] *See* BH2001.584 *„A szerződést nem teszi érvénytelenné, ha az írásba foglalt szerződés nem a felek valóságos akaratának megfelelő vételárat tartalmazza, de a felek akaratának megfelelő vételár megállapítható."*

purchase option granted by the plaintiff on his real estates to the defendant lessor secured the repayment of the debt of a third party lessee (debtor). "The amount of the purchase price was indeterminate and depended on the debt accumulated by the lessee until the termination of the lease agreement, which debt could range from HUF 500.000 up to HUF 24.000.000."[74]

The Supreme Court held that – in lack of a determined purchase price – the contract granting a purchase option by way of security was simulated and it concealed the intention of creating mortgage on the real estates of the plaintiffs. The court thus re-characterized the contract.

It can be concluded from the decisions that the Supreme Court acknowledges the validity of the use of purchase option as collateral if it is in conformity with the conditions cited above. In case the lack of such a condition causes the invalidity of the agreement, the Supreme Court corrects the discrepancy by re-characterizing the contract as a charge agreement.

2.5.2 LEGAL LITERATUE

Zsolt Lajer and Laszló Leszkoven share the view of the Supreme Court expressed in the above-cited decisions on the validity of purchase option used by the way of security.[75] Leszkoven argues in favor of the validity of this type of secured transactions also in a separate article.[76]

[74] *See* BH2001.584 *„…a vételár bizonytalan volt, attól függött, hogy a lízingbevevőnek mennyi tartozása halmozódott fel a lízingszerződés felmondásáig, amely tartozás 500 000 Ft-tól egészen 24 millió forintig is terjedhetett."*
[75] *See* Lajer – Leszkoven, *supra* note 29
[76] *See* Leszkoven, László: *A biztosítéki célú vételi jog néhány kérdéséről* (On certain questions regarding purchase option used by the way of security), GAZDASÁG ÉS JOG (No. 12, 2004) at 16-21

István Gárdos and Péter Gárdos – apart from their paper on fiduciary securities in general – devoted a separate article to the analysis of purchase option, disputing the arguments in favor of the validity of this legal institution as an answer to Leszkoven's above article.[77]

In their article, they partially repeat the general arguments enumerated against fiduciary securities (already detailed above in subchapter 2.4) and they also analyze the specific problems concerning purchase option. Regarding the general counter-arguments they emphasize that the use of ownership and that of different legal institutions related to it (e.g. retention of title, assignment and purchase option) by the way of security is problematic with regard to the specific guarantees included in charge rules, namely, the balance established between the interests of the debtor, creditor and third party creditors.[78]

Although they agree with Leszkoven that there is no explicit legal provision stipulating that charge is the exclusive *in rem* security and thus the creation of other atypical *in rem* securities (e.g. fiduciary securities) is prohibited, they come to a different conclusion based on this lack of prohibition. While Leszkoven argues that the aim of creating securities can be reached either by charge or by other proprietary securities, István Gárdos and Péter Gárdos point out that the lack of settling the relationship of charge towards other securities is a serious legislative deficiency leading to legal uncertainty. They argue that the new Civil Code has two alternatives: it either explicitly prohibits the use of *in rem* securities other than charge (as did the new Dutch Civil Code) or it extends the most important mandatory requirements related to charge (creation, publicity, obligation to account to the debtor for surplus, fair procedure concerning enforcement, etc.) also to fiduciary securities (based on

[77] Gárdos, István – Gárdos, Péter, *Ismét a fiduciárius biztosítékokról* (Again on fiduciary securites), GAZDASÁG ÉS JOG, (No. 3, 2005), at 13-18
[78] *Id.* at 13

the functional approach of the UCC[79]). They argue in favor of a new secured transactions system, which ensures that creditors can compete with each other according to unified rules and which does not allow the competition of different legal institutions. Concerning the functional regulation of secured transactions they mention that it would be hard to fit it into the Hungarian Civil Code generally following a completely different approach.[80]

The specific problems raised by István Gárdos and Péter Gárdos concerning the use of purchase option by the way of security can be summarized as follows:[81]

1.) The prohibition of *lex commissoria* (guaranteeing that the charge cannot be title for acquiring ownership over the encumbered asset) does not prevail in case of purchase option, thus it is not ensured that the creditor does not enrich at the detriment of the debtor.

2.) Purchase option used by the way of security cannot be treated purely on the basis of the rules concerning general option transactions. The argument expressed by Leszkoven and the Supreme Court in the above decisions that proportionality[82] between obligation and counter-obligation shall exist at the time of the conclusion of the sale and purchase agreement (upon the default of the debtor when the creditor enforces his right of option) is incorrect. The legality of the option transaction has to be assessed on the basis of the option contract and not the sale and purchase contract. Option is a speculative transaction – widely used on the financial market - where the primary obligation is the granting of the option right and the counter-obligation is the payment of an option fee.[83] The right of option itself is a property right, which can be negotiated on the market. The speculative nature is not compatible with

[79] *See* UCC § 9-102 (1) Except as otherwise provided in Section 9-104 one excluded transactions, this Article applies (a) to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts; and also (b) to any sale of accounts or chattel paper.
[80] *See* Gárdos – Gárdos, *supra* note at 14
[81] *Id.* at 15-18
[82] Proportionality actually means the lack of unreasonable dispropotionality.
[83] The person entitled to use his option right is speculating on the decrease of the purchase price compared to that stipulated in the option agreement.

securities. Secured transactions should generally be subject to the requirement of disposing of the collateral under market conditions and accounting to the debtor for the surplus.

3.) Even if it is contractually regulated that the parties shall conclude the sale and purchase agreement at the market value existing upon the conclusion of the contract and determined by an independent expert or that the creditor is obliged to dispose of the collateral and account to the debtor, these are no validity requirements of the option transaction.

4.) Even if the purchase option is registered in the land registry in case of real estates, the registration is not in conformity with the actual situation as it does not indicate the security nature of the right of option. The main difference between the general (commercial) and the security-type right of option is that while in the first case the obligee is free to decide when to enforce his right, in the latter case the enforcement is dependent on the default of the debtor. The position of the debtor thus seems to be worse.

5.) Concerning the faith of the right of option in the insolvency proceedings, the authors do not see a difference compared to fiduciary assignment and argue that the purchase option used by the way of security is neither protected against a possible judicial re-characterization. They also argue against the circumvention of mandatory charge rules in insolvency proceedings by creating atypical securities and hence extracting the collateral from the bankruptcy estate.

3. CHARGE RULES

Charge in general and among its forms mortgage and security deposit are the primary securities Hungarian banks rely on. Whenever there is a valuable chargeable asset, all other securities (e.g. personal securities) are only supplementary. While there has been a strong tendency of using fiduciary securities for reasons already detailed above in Chapter 2, charge law is still the most reliable *in rem* security in Hungary, with a mostly consistent regulation not subject to legal uncertainties and not threatened by judicial re-characterization. As argued later below, this, of course, does not necessarily mean that charge law is not in an urgent need of revision. In order to keep the discussion of this very complex field of law within manageable bounds, this Chapter of the thesis – after a short description of the present charge system – is going to focus on the amendments proposed in the process of the re-codification of the new Civil Code. The possible areas of revision are mainly described on the basis of the Dispute Paper written by István Gárdos in this topic.[84]

The charge rules of the Ptk[85] were revised - in the most comprehensive way among the post-socialist countries - in two reform acts (1st and 2nd Reform Act) after the change of the regime, based on the EBRD Model Law on Secured Transactions. In addition – as already mentioned above in Subchapter 2.1 - there has also been an important amendment concerning financial collaterals based on the EC Directive 2002/47 implemented by Act XXVII of 2004.

As already pointed out in Chapter 2, a complex revision of the charge rules is inevitable in the process of drafting the new Hungarian Civil Code. It is a possible occasion to review the

[84] *See* Gárdos, István, *A zálogjog felülvizsgálata a polgári jogi kodifikáció keretében* (Dispute Paper for the revision of the rules on charges within the framework of the re-codofocation of the Civil Code), POLGÁRI JOGI KODIFIKÁCIÓ, (NO. 4, 2004) at 3-17 also published online in English: http://www.gfmt.hu/en/index.html, (28 March 2007)

[85] *See* § 251 – 271/A of the Ptk.

present rules, establish their main strengths and weaknesses and to introduce maybe even fundamental changes where needed.

3.1. THE PRESENT SYSTEM ESTABLISHED BY THE REFORM ACTS

As the most significant novelty in charge law, the 1st Reform Act introduced non-possessory charge on personal property and enterprise charge. Its aim was to extend the applicability of charge to a wide range of assets and to increase the creditworthiness of enterprises by making it possible for them to keep the encumbered assets in their possession and enabling them to continue to use the assets in their ordinary course of business.[86]

Despite the very important above innovation, the 1st Reform Act could not come up to the expectations raised by it and the use of non-possessory charge on personal property and that of enterprise charge did not become very popular in the everyday financing practice. The reason for this is a conceptual mistake. The 1st Reform Act introduced a unified charge regulation making no differentiation among the physical and legal features of the charged assets (real and personal property).[87]

The 2nd Reform Act, on one hand, preserved the novelty introduced by the 1st reform Act that the parties are free to decide whether they create a possessory or non-possessory charge on personal property, and on the other hand, established some rules that emphasize the differences between mortgage and non-possessory charge on personal property.

Real property may be encumbered as security only in the form of a mortgage. A mortgage shall be considered valid only if contracted in writing and recorded in the real estate

[86] Prior to the 1st Reform Act personal property could only be subject to pledge.
[87] *See* Gárdos, István, *Az ingó jelzálogjog és a vagyont terhelő zálogjog a Ptk-módosítás után* (The non-possessory charge on personal property and the enterprise charge after the amendment of the Ptk) http://www.gfmt.hu/hu/index.html, 29 March 2007

register.[88] For the creation of a non-possessory charge on other things, the charge contract shall, unless otherwise provided by legal regulation, be documented in front of a notary public, and the charge shall be recorded in the register maintained by the Hungarian Chamber of Notaries Public (Charge Register).[89] If a charge is put on several properties or if the charged property cannot be uniquely determined, the charged property or the group of properties may be described by type and quantity or by elaborate description.[90]

The present system of charges can be summarized as follows. All of the below species of charge can be created in accessory or independent form:

"1. mortgage (registered charge on land and other real property)

2. charge on registered assets (registered charge on certain specific movable assets)[91];

3. non-possessory charge (registered charge on non-registered movables);

4. charge on rights and claims;

5. enterprise charge;

6. possessory charge; and

7. financial collaterals.

The two main characteristics of charge are its accessory nature and *in rem* effect. The accessory nature is not true for independent charge, and the *in rem* effect in strict sense applies only to charges on registered goods.(…..) The new institutions can only function properly, if the differentiation started by the reforms is carried along. This can only be

[88] *See* Subsection 1 of § 262 of the Ptk
[89] On the detailed rules of the Charge Registry S*ee* Decree no. 11/2001 (IX.1.) of the Ministry of Justice.
[90] *See* Subsection 2 of § 262 of the Ptk
[91] Ships, aircrafts, patents

achieved, if the characteristics of the new species are examined thoroughly, the necessary consequences are drawn and thus legislation clearly reflects the common elements and also the distinguishing features of each species."[92]

Based on the above, István Gárdos wrote his proposal for the re-codification of charge rules with special regard to non-possessory charge, the Charge Registry, charge on rights and claims and enterprise charge.[93]

3.2 THE AMENDMENTS NEEDED IN THE NEW CIVIL CODE

3.2.1 NON-POSSESSORY CHARGE ON NON-REGISTERED PERSONAL PROPERTY

The specific identification of non-registered personal property is usually impossible (e.g. stock, inventory, goods in a warehouse). The subject of non-possessory charge in this case is a constantly changing pool of assets (*universitas rerum*) that can only be described generally both in the charge agreement and thus also in the Charge Registry. As already mentioned above, the present Ptk regulation on charges contains two exceptions from the principle of specific determination. General description of the charged asset is possible either if the charge covers more than one asset or if specific determination is impossible.[94] As the characteristics of non-registered personal property usually do not enable unique description, the new Civil Code should accordingly be adjusted to this reality.

The fact that specificity - the primary principle of property law – cannot prevail in case of non-possessory charge on non-registered assets, has several consequences This type of charge is also a proprietary security with priority in enforcement but its *in rem* effect is limited "so that the rights of a *bona fidea* purchaser of the charged asset may be stronger than

[92] *See* http://www.gfmt.hu/en/index.html, (28 March 2007)
[93] The analysis of the amendments needed regarding charge rules is based on the paper *See* Gárdos, *supra* note at http://www.gfmt.hu/en/index.html, (28 March 2007)
[94] *See* Subsection 2 of § 262 of the Ptk

that of the chargeholder."[95] According to the present regulation the non-possessory charge registered in the Charge Registry terminates if

1. the charged asset is sold in trade activity,

2. the charged asset is sold in the ordinary course of business, or

3. the transferred charged asset belongs to the regular things of everyday life

In each of the above cases the transfer has to be effectuated by way of a sale and purchase agreement, the buyer has to be in good faith and acquire the asset for consideration.[96]

As Gárdos argues, there is no reason for excluding onerous contracts other than sale and purchase agreements from the above protection and hence the provision should cover all type of transfers for consideration where the purchaser is in good faith.

The features of non-registered personal property and the needs of the business participants require that the non-registered charged assets can be sold free from the charge and replaced by new assets. As – except for the enterprise charge - there is no direct authorization in the present Ptk to create such charge on changing pool of assets, Gárdos emphasizes that explicit provisions to this effect shall be introduced in the new Civil Code.[97]

The use of the charged asset has a different meaning concerning real property and personal property. In the latter case it usually means the consumption, processing or transfer. If the legislative aim is to extend non-possessory charge to personal property, the regulation has to recognize the special features of these assets and acknowledge that consumption, processing and transfer are normal ways of using personal property, they help to preserve the business

[95] *Id.* at http://www.gfmt.hu/en/index.html, (28 March 2007)
[96] *See* Subsection 6 of § 262 of the Ptk
[97] *Id.* at http://www.gfmt.hu/en/index.html, (28 March 2007). *„Charge on changing pool of assets can presently be created as a contractual combination of generally defined charge and charge over future assets."*

activity of the debtor and thus enable the repayment of the credit. Apart from acknowledging the above forms of usage of the charged asset, the new Civil Code - similarly to Article 9 of the UCC - also has to clarify that the type of usage is only acceptable if it is in conformity with the nature of the asset and the ordinary business activity of the debtor.

To sum up, Gárdos argues that "based on the aforementioned characteristics, non-possessory charge should be regulated separately from mortgage and non-possessory charge on registered goods as separate specie, in order to clearly show its characteristics."[98]

3.2.2 THE CHARGE REGISTRY

The Hungarian Charge Registry – contrary to the Land Registry being a *real folium* based on the real estates – is a *personal folium* based on the debtors (chargors). According to the present rules the Charge Registry is authentic concerning the charge agreement creating the non-possessory charge or the enterprise charge[99] and it is also constitutive concerning the creation of the charge.[100] With regard to the special characteristics of personal property mentioned above, it should be realized that the Charge Registry cannot ensure the same protection and authenticity as the Land Registry regarding the existence of the charged asset, its owner, etc. "Prior to the creation of the charge, the Charge Registry – as opposed to the Land Registry – contains no information regarding the existence and the owner of the charged asset. (…) There is no and there can be no guarantee that the change in the state, place or owner of the charged asset is reflected in the Registry. In case of multiple sale of the charged asset it is, therefore possible that the acquirer has no information about a charge created under the name of the previous owner, thus the owner cannot avoid uncertain

[98] *Id.* at http://www.gfmt.hu/en/index.html, (28 March 2007)
[99] *See* Subsection 1 of §47 of Ptké (Law Decree no 11 of 1960)
[100] *See* Subsection (2) of § 262 of the Ptk

situations, he may acquire the ownership of a charged asset irrespective that he acted in good faith and checked the Registry."[101]

Therefore, as pointed out by Gárdos, there seems to be no reason why the Concept Paper of the new Civil Code[102] suggested that the authenticity of the Registry be enhanced. Even the present rule regarding authenticity is useless because the existence of the charge agreement is a prerequisite to the registration. So, the new Civil Code should rather regulate that the Registry is not authentic but – similarly to the public notice giving system of the U.S. – is only a starting point for further investigation. In the absence of registration there is no charge with *in rem* effect, of course, but "the registration cannot guarantee the creation of the charge or the existence of any amendments thereof"[103].

There is no point in giving the Registry constitutive effect, either. The *in personam* effect of charge should also be recognized in the new Civil Code by regulating – again similarly to the U. S. solution – that the charge is created between the parties with an *in personam* effect upon the conclusion of the agreement, whereas it only has *in rem* effect upon and from the date of registration.

In order to create a registration system similar to that created by Article 9 of the UCC already mentioned several times above in Chapter 2 and 3, the scope of registration should be extended to all the secured transactions concerning personal property. The present Charge Registry is only the registry of movable charged assets. It should be extended to charge on rights and claims, leasing, factoring, etc.[104]

[101] *Id.* at http://www.gfmt.hu/en/index.html, (28 March 2007)
[102] Concept Paper and Regulatory Framework of the new Civil Code, MAGYAR KÖZLÖNY (OFFICIAL GAZETTE) 23 February 2003, at 53
[103] *See*, Gárdos, *supra* note at http://www.gfmt.hu/en/index.html, (28 March 2007)
[104] *Id.* at http://www.gfmt.hu/en/index.html, (28 March 2007)

If the authenticity and the constitutive effect of the Registry were put aside in the new Civil Code, the procedure of registration should also be made simpler and less expensive. Thus, it should be reconsidered whether a notarial deed is really required as the form of the charge agreement for the creation of non-possessory charge as regulated by the present charge rules.[105] In order to make the whole registration procedure a fast and well-functioning system, the solution of the UCC could possibly be examined, where only basic data is required and this can usually be given via Internet.

Concerning charge on registered movables, Gárdos emphasizes that charge on these type of assets should generally be subject to registration in these separate asset-based registries. This is already the case regarding aircrafts and ships, but it should also be extended to e.g. cars.

3.2.3 CHARGE ON RIGHTS AND CLAIMS

The current Civil Code regulates charge on rights and claims separately from charges on tangibles.[106] By this regulation the legislator acknowledged that limited *in rem* right (charge)

[105] *See* Subsection 2 of § 262 of the Ptk.

106 See § 267-268

§ 267 (1) A charge can be put on a right or claim by contract. It may include future rights and claims that may be created in favor of the obligor. The rights and claims encumbered may be specified by elaborate description. If the right or claim is substantiated by some official record and the pertinent legal regulation prescribes having the charge entered in such record as a prerequisite, the charge shall be construed effective when recorded. Charge can also be put on a specific part of a divisible claim.

(2) For enforcing the charge, the obligor of the right or claim shall be notified when the charge is created. The chargeholder shall be entitled to demand that the obligor surrenders the documents necessary to enforce the charge.

(3) In respect of a charge on a claim or right, the obligor, with a force extending to the charge, shall, with the consent of the chargeholder, be entitled to make a legal statement to terminate or adversely alter the chargeholder's grounds for satisfaction. This provision shall be applied to a charge on a claim prevailing on the basis of a bank account contract, regarding the right of disposition of the account holder, if it is expressly stipulated by the parties in the charge contract.

§ 268 (1) If a claim encumbered by a charge becomes due before the charge is to be satisfied from the pledged property, the obligor of the claim shall only be able to pay the chargeholder and claimant together, unless otherwise stipulated in the charge contract; money claims, however, shall be placed in court deposit in favor of both the chargeholder and the claimant if so requested by either one of them. If a claim encumbered by a charge is for the delivery of a thing and if, by agreement of the parties, the chargeholder is entitled to possession of the pledged property, the obligor of the claim may pay just the chargeholder.

(2) If a claim encumbered by a charge becomes due after the charge is to be satisfied from the charged property and if it was not sold in the course of enforcing the charge, the obligor of the claim can pay just the chargeholder, unless otherwise stipulated in the charge contract.

can be created on assets which are not considered to be things according to the Ptk.[107] This was an important novelty of the 1st reform Act and an adoption to important and legitimate business needs as rights and claims are valuable assets of the property of many economic participants.[108]

Regarding the rules on charge on rights and claims the following amendments are suggested by Gárdos:[109]

1.) According to the present rules of the Ptk charge may be created on any transferable right or claim. Gárdos suggests that it be clarified in the new Civil Code which rights and claims are transferable and how they can be transferred.

2.) He also urges that the differences between claims having relative and rights having absolute structure should be recognized in the new Civil Code.

3.) According to the present rules of the Ptk for the creation of charge on rights or claims usually only a written charge agreement is needed. The principle of publicity of *in rem* rights thus generally does not prevail in this case. Registration of the created charge is only needed

(3) If a pledged property is to be delivered into the hands of the chargeholder, the provisions on security deposits shall apply in respect of money claims, while the provisions on possessory charges shall apply to other things.
(4) If the maturity of a claim encumbered by a charge or the exercise of a right depends on the legal statement of the claimant or on a condition to be performed by him, the chargeholder shall be entitled, after the claim is due, to make the legal statement or perform the condition required for maturity.
(5) If the pledged property is a right or claim, within the meaning of the common rules on charge, the owner of the pledged property shall be understood as the beneficiary of the right or claim, and the ownership right to the pledged property shall be understood as the right or the claim.

107 See Subsection 1 of § 94 of the Ptk: There may be ownership of all things which are capable of appropriation.

[108]In case of intangible assets possession is impossible and by virtue of this special rules have to be applied to them. Gárdos, however, believes that "it is possible and worthwhile to create "possessory" and "non-possessory" versions of charge on rights and claims". He argues that in case of non-possessory charge on rights and claims registration would be a prerequisite to creation and "the chargor would remain the creditor of the claim or beneficiary of the rights vis-à-vis third parties" Ensuring publicity, this solution would, on one hand, contribute to the uniformity of the regulation and, on the other hand, also protect the interests of third parties.
Gárdos also suggests that the regulation of a "possessory" charge on rights and claims be considered in the new Civil Code. In this case the notification of the obligor and the handing over of the documentation would take place upon the creation of the charge (which is obviously not possible in case of charge on future claims). Registration would not be a prerequisite as by the fulfillment of the above conditions, the creditor would have a strong position for enforcing his claim and the chargor would not be able to dispose of the charged asset any more. *See*, Gárdos, *supra* note at http://www.gfmt.hu/en/index.html, (28 March 2007)

if the existence of the right or claim is certified by an authentic registry (e.g. patents). In order to avoid the false wealth problem, registration is required also in case of charge on rights and claims if the parties intend to give their agreement an *in rem* effect.

4.) In the view of Gárdos, the parties to the charge agreement should remain free to stipulate when they notify the obligor and when they hand over the documentation related to the charged right or claim.[110] Until the notification of the obligor the creditor, of course, runs a certain risk which can be compensated by the continuous control of the debtor. The legislator should regulate that "any liability or obligation may only be imposed on the obligor after being notified of the creation of the charge, therefore, the risks arising from the lack of notification are of the chargeholder."[111] The rules determining that the position of the obligor cannot be more burdensome as a result of the assignment should also prevail in case of charge on intangibles.[112]

5.) The fact that charge on shares of limited liability companies is not subject to registration, is a significant deficiency of the present system. This is not understandable as limited liability companies and the shares in them are registered in the Company Registry. So, only the scope of the latter should be amended and extended to charges created over shares in limited liability companies.

6.) In the present system notification of the obligor is needed for the enforcement (and as mentioned above, not for the creation) of the charge. Gárdos argues that the notification requirement should also be omitted in this regard in the new Civil Code as enforcement either takes place by way of contacting the obligor and collecting the claim, when notification is evident, or by way of assigning the claim where notification is not needed.

[110] Immediate notification of the obligor and transfer of the documents might have advantages in one case (e.g. charge over one specific claim) but disadvantages in another (e.g. a pool of claims).
[111] *See*, Gárdos, *supra* note at http://www.gfmt.hu/en/index.html, (28 March 2007)
[112] *See* Subsection 3 and 4 of § 328 of the Ptk.

3.2.4. ENTERPRISE CHARGE[113]

Due to the amendment of the rules on non-possessory charge brought about by the 2nd Reform Act, the creation of charge over an *universitas rerum*, a constantly changing pool of assets became possible.[114] As a consequence of this change, the only distinguishing feature of enterprise charge remained that it can be created over an economic unit that is able to operate as a going concern. This is, however, a very important characteristic. It enables the creation of charge by upholding the activity of the chargor without significant disruption.

As in case of the English floating charge, the chargeholder is entitled to seek satisfaction on the basis of the rank achieved by the date of registration. According to the enforcement rules of the Ptk the chargeholder may seek satisfaction by selling the enterprise as a going concern or he shall be entitled to convert the charge on the property to a charge on specified property items with a written statement addressed to the obligor (similarly to the English

113 See § 266 of the Ptk (1) The creation of a charge on the financial assets of a legal entity or an unincorporated business association, whether on the whole or on a strategic business unit (asset) - without having to specify the things, rights and claims comprising it (property) - shall be made in a charge contract and documented in front of a notary public, and the charge shall be registered in the charge register. Such charge shall apply to any and all property acquired by the obligor after the contract has entered into effect, commencing with the date on which the obligor acquires the right of disposition; it shall, however, cease when the property in question is no longer in the obligor's possession.
(2) Once the claim is due, the holder of a charge on financial assets shall be entitled to seek satisfaction from the assets of the obligor, given that the assets are maintained intact, or he shall be entitled to convert the charge on the property to a charge on specified property items with a written statement addressed to the obligor. This statement shall not replace any further conditions made necessary under the charge contract for creating the charges to be established by it.
(3) The holder of a charge on financial assets or a charge created through a conversion statement shall be entitled to seek satisfaction on the basis of the rank achieved by the date of registration. However, the chargeholder shall not be entitled to cite this provision with regard to any person who has, on any property item that is construed part of the entire assets,
a) acquired a charge before it became part of such assets,
b) acquired a charge registered in records other than the charge register,
c) acquired, in good faith, a possessory charge in commercial trade or a charge on a claim or right.
(4) In the event of any depreciation in the assets on which the charge was put to an extent jeopardizing satisfaction, the chargeholder shall be entitled to make the conversion statement before the claim is due.
(5) In the event of any depreciation in the assets on which the charge was put to an extent jeopardizing satisfaction, the obligor must notify the chargeholder. Parties may include a clause in the charge contract in which they stipulate the extent of depreciation that is considered to jeopardize satisfaction. Parties may also agree to stipulate the chargeholder's right to inspect the manner in which the obligor cares for the pledged property.
(6) In respect of other issues, the provisions on mortgages shall be applied regarding charges on financial assets.
114 See Subchapter 3.2.1 above.

crystallization). According to Gárdos this transformation of the enterprise charge into classical charge should not be obligatory in any case and should not be a precondition to enforcement, but only an alternative right of the chargeholder.[115]

Enterprise charge is widely used by Hungarian banks usually as a supplementary security, but "the rules that would enable the sale of the enterprise as a going concern are missing in enforcement and insolvency procedure alike. (…) One may also come to the conclusion that (…) it would be worth to regulate the sale of enterprises as a going concern in general."[116] Gárdos also argues that the sale of the enterprise as a going concern should be the preferable way of enforcement of the enterprise charge.

Gárdos – as an answer to the concerns in legal literature that the classical *in rem* nature of charge does not exist in case of enterprise charge – emphasizes that similarly to non-possessory charge on movables, the contractual, *in personam* nature of charge prevails in case of enterprise charge.

3.2.5 ENFORCEMENT OF CHARGE

3.2.5.1 Execution procedure

As a general rule, enforcement of charge in Hungarian law is based on court decision and is realized in a judicial execution procedure.[117] In order to make charge a strong and effective security device, the Reform Acts established the possibility of out-of-court enforcement as follows:

[115] *See*, Gárdos, *supra* note at http://www.gfmt.hu/en/index.html, (28 March 2007)
[116] *Id.* at http://www.gfmt.hu/en/index.html, 28 March 2007. Gárdos also argues that the realization a s a going concern can only be achieved if at least some of the obligations (e.g. labour contracts, volume of orders, financial obligations) are attached to the charged property (economic unit). He points out that such a solution may allow „transfer" of obligations from the chargor to the purchaser of the enterprise.
[117] *See* Subsection 1 of § 255.

1.) The parties can agree in writing to sell the charged asset together before the claim to which it pertains falls due by establishing the lowest sale price or a formula for calculating the sale price, and a deadline for the sale of the asset commencing on the due date of the claim. If the charged asset cannot be sold before the deadline and/or under the conditions set forth in the agreement, the agreement for joint sale shall become inoperative.

2.) If the charged asset has an official market price or if the chargeholder is engaged in a commercial activity of providing loans against security (in terms of claims secured by charge, including all credit institutions), the parties can - before the claim becomes due - agree, under the terms and conditions prescribed above in Point 1.) to permit the chargeholder to sell the charged asset himself without judicial execution.

3.) If the provisions set forth in the above Point 1.) and 2.) cannot be applied or if the parties decide not apply them, the parties can agree, under the terms and conditions prescribed above to permit the chargeholder to appoint a person who is commercially or ex officio engaged in providing loans against security or organizing auctions to sell the thing.118

Despite the above regulation on out-of-court enforcement, on one hand, creditors legitimately criticize the effectiveness of the enforcement of charge and, on the other hand, the abuse of debtors and predatory lending has become a fairly common topic in the media. Gárdos summarized the complex problem as follows:

> I believe both statements contain elements of the truth. Banks are operating in an unpredictable economic and legal environment: it is difficult to estimate the creditworthiness of debtors, the situations are rapidly changing; the effective and lawful system of enforcement has not been created; therefore – with some exaggeration – one might also say that banks are often forced to use solutions that are on the verge of illegality in order to enforce their claims. Under such circumstances it is not surprising that corrupt practices occur, especially in the field of retail banking services; sometimes for the personal benefit of the involved employees. (…) The paradox situation is that it would be perfect to have quick and effective enforcement without court procedure, preferably with the cooperation of the

[118] *See* § 257 of the Ptk.

chargor, but this can only be achieved if alternatively an efficient court system is available, thus the chargor knows that he cannot escape. (…) If these conditions were given, the operation of banks would be more flexible both at granting credit and during maturity. Significant interests legitimize the need for an effective and legal way of enforcement. This would require significant development both in the regulatory framework and the institutional system.[119]

The above rule on the joint sale of the charged asset as a form of enforcement only makes sense if the chargeholder can dispose of the charged asset alone if the chargor does not cooperate. The chargor has to be entitled to participate in the enforcement to a certain extent as it is needed to protect his legitimate interests, but this can be guaranteed by the general enforcement rules. Even the sale by the chargeholder can be blocked by the debtor, if he does not transfer the possession over the sold asset.

3.2.5.2 Insolvency procedure

The real value and effectiveness of charge can be tested by the way of analyzing the insolvency rules of a given jurisdiction. Insolvency regulation generally determines the amount of credit available and the conditions for borrowing in a certain economy.

The English and Dutch insolvency law, for instance, follow a separatist model where the charged asset does not belong to the bankruptcy estate, the creditors do not participate in the insolvency procedure and can enforce their claims irrespectively of the commencement of the bankruptcy procedure.

The situation is significantly different in Hungary where the chargeholders' rights have a lot been restricted. The chargeholders – although generally separately - can only satisfy their claims in the insolvency procedure (the charged assets form part of the bankruptcy estate). It is a great step forward that as of January 1st, 2007 – except for enterprise charge - the separate satisfaction of the chargeholders' claims in the insolvency procedure amounts to 100

[119] *See*, Gárdos, *supra* note at http://www.gfmt.hu/en/index.html, (28 March 2007)

% of the purchase price deriving from the sale of the charged asset, if the charge was created prior to the commencement of the bankruptcy procedure.[120] Before this date the separate satisfaction in the insolvency procedure was restricted to 50 % of the purchase price. With regard to the policy considerations that the 100 % separate satisfaction of enterprise charge would put other creditors at a disadvantage, the legislator has decided to maintain the 50 % restriction in case of enterprise charge.[121]

The above amendment of the Hungarian Insolvency Act effective as of the beginning of this year is a very significant evolution as it recognizes that *in rem* rights of creditors cannot be infringed by bankruptcy procedures. The amendments increase the readiness of banks to grant credit by requiring fewer securities because they can be sure that the value of the charged asset will secure the repayment of the loan, even in bankruptcy procedure. Thus, the new regulation might also preclude over-securing, predatory lending practices and the use of ambiguous fiduciary securities in the future.

It had a lot been criticized before the above amendments that the Hungarian Insolvency Act determined a broad concept of liquidation fees[122] and regarding the 50 % of the purchase

120 See Subsection 1 of § 49/D of the Insolvency Act (1) Where a charge was filed prior to the opening of liquidation proceedings, the liquidator shall be allowed to deduct from the proceeds from the sale of the property charged as security only the costs of safeguarding - including maintenance - and costs of the sale of the charged property, and the liquidator's fee specified in specific other legislation, and shall use the remainder to satisfy the claims for which such property was pledged - immediately upon completion of the transaction - in the sequence specified under Subsection (1) of Section 256 of the Civil Code if there is more than one charge.
(5) As for the satisfaction of the unsettled part of the claims defined in Subsections (1)-(2) and for the distribution of the sum remaining after satisfaction of the claims for which such property was charged, the regulations on satisfying debts from assets subject to liquidation (Sections 57-58) shall be applied.
121 See Subsection 2 of § 49/D of the Insolvency Act (2) In the case enterprise charge (Civil Code, Section 266), by way of derogation from Subsection (1), fifty per cent of the proceeds from the sale of a property charged as security, less the costs of sale, shall be used exclusively to satisfy the claims for which such property was charged to the amount covered by the charge - in the sequence specified under Subsection (1) of Section 256 of the Civil Code if there is more than one charge - provided that the charge was established prior to the time of the opening of liquidation proceedings.
122 See Subsection (2) of § 57 of the Insolvency Act Liquidation fees are as follows:
a) wages and other personnel costs payable by the debtor (…)
b) costs in connection with the rational termination of the debtor's business operations incurred following the time of the opening of liquidation proceedings, furthermore, the costs in connection with the protection of his assets, (…)
c) verified costs in connection with the sale of the assets and the enforcement of claims;

price of the charged assets these fees had priority over the chargeholders' claims. Due to the amendments in case of the sale of the charged assets, only the costs of the maintenance and the sale of the charged assets can be deducted before the satisfaction of the chargeholders' claims.[123]

It is also important to mention that in connection with security deposit (financial collaterals) the Insolvency Act provides that if the debtor provides financial collateral under a financial collateral arrangement to secure a claim before the time of the opening of the liquidation procedure, the collateral taker shall be able to realize this financial collateral according to Section 271 of the Civil Code irrespective of whether liquidation is opened or not, and shall refund any excess collateral to and settle accounts with the liquidator. If the collateral taker fails to exercise his right conferred under Section 271 of the Civil Code within three months following publication of the opening of liquidation, he may seek satisfaction according to the regulations on liens.[124]

Thus, in case of financial collaterals the encumbered assets are handled separately from the bankruptcy estate in line with EC Directive 47/2002.

3.2.6 SECURITIES AS COLLATERALS

Though widely used by credit institutions, the detailed analysis of the topic of securities as collaterals would significantly extend the scope of the present paper and could be the subject

d) assistance received from the wage guarantee segment of the Labor Market Fund, charged to the debtor;
e) court costs payable by the economic operator under liquidation;
f) costs in connection with the arrangement, placement and safeguarding of the debtor's documents;
g) liquidator's fee [Subsection (4) of Section 60] - if not claimed on the basis of Subsection (1) of Section 49/D - which contains expenditures incurred in connection with any civil relationship entered into by means other than what is contained in Subsection (10) of Section 27/A.

123 See Subsection 1 and 2 of § 49/D of the Insolvency Act above.

124 See Subsection 5 of § 38 of the Insolvency Act

of another thesis. The present Subchapter thus is going to focus only on the main features of the prospective amendments in the new Civil Code.[125]

According to the proposals regarding the regulation of securities in the new Civil Code, the ownership, transfer and encumbrance of securities should be regulated on the basis of differentiation between direct and indirect holding system instead of the present rules based on the differentiation between certified and uncertified securities. The indirect holding system and the rights and obligations of the account holder, the securities intermediary, the issuer and third parties should be regulated on the grounds of Article 8 of the Uniform Commercial Code and the Draft convention on substantive rules regarding securities held with an intermediary.[126]

The principles of the regulation to be introduced by the new Civil Code collected by Csizmazia in his above-cited article can be summarized as follows:

1.) Similarly to the regulation of UCC Article 8 on security entitlement, the account holder and the securities intermediary should not have classical ownership over specified securities but an interest consisting of a bunch of *in rem* and *in personam* rights in securities belonging to the same securities series.

2.) The account holders (investors) should have co-ownership over the fungible securities belonging to the same securities series held with an intermediary.

3.) The acquisition and transfer of securities should take place by way of debiting and crediting the securities accounts. Related to this the new Civil Code should also regulate immobilized securities (global securities) in which case there are a few certificated securities

[125] The short analysis is based on the article of Csizmazia, Norbert, *A tőkepiaci értékpapírok "tulajdona, átruházása és megterhelése* ("Ownership", transfer and encumbrance of securities), POLGÁRI JOGI KODIFIKÁCIÓ, (No. 5-6, 2004) at 34-43

[126] *See* http://www.unidroit.org/english/publications/proceedings/2004/study/78/s-78-13-e.pdf (30 March 2007)

of cumulative denomination, but the securities are held on securities accounts and exist in the form of book entries.

4.) The account holders (investors) could only enforce their claims against their direct securities intermediary.

5.) The creditors of the account holders (investors) could also enforce their claims only against the direct securities intermediary of the account holders.

6.) The securities intermediary should without delay and precisely fulfill the orders of his investors and should dispose of the securities only in accordance with these orders. He should at all times have securities on his account enough for the satisfaction of the claims his investors have against him. "Losses in a collective holding of a particular class of securities are to be borne jointly and on pro rata basis by the co-owners of the collective holding on the basis of the credit balance existing at the time the loss occurred."[127]

7.) Similarly to UCC § 8-303, the regulation on protected purchasers should be introduced.[128]

8.) The ways of encumbering securities should be clarified in the new Civil Code (non-possessory charge and security deposit, or also pledge). Csizmazia suggests that the introduction of the differentiation of Article 8 of the UCC between possession/delivery in case of certificated and control in case of uncertificated securities be considered.[129]

[127] *See* Clearstream Luxemburg, General terms and conditions, Subsection 2 of Section 50. http://www.clearstream.com/ci/dispatch/en/binary/ci_content_pool/60_publications/20000_customer_information/5000_general_terms_conditions/terms_and_conditions_CBL_en.pdf (31 March 2007)

128 See UCC § 8-303 "**Protected purchaser**" means a purchaser of a certificated or uncertificated security, or of an interest therein, who:
(1) gives value;
(2) does not have notice of any adverse claim to the security; and
(3) obtains control of the certificated or uncertificated security.
(b) In addition to acquiring the rights of a purchaser, a protected purchaser also acquires its interest in the security free of any adverse claim.

129 See UCC § 8-511 (b) A claim of a creditor of a securities intermediary who has a security interest in a financial asset held by a securities intermediary has priority over claims of the securities intermediary's

9.) The institution of broker's lien should be regulated. If the securities intermediary gives credit to the account holder, he should have an *ex lege* security interest in the securities of the account holder anticipating the interest of any other creditor.

10.) In case of the bankruptcy of the securities intermediary, the securities held for the benefit of the account holders should not belong to the bankruptcy estate as regulated by the Capital Markets Act.[130]

entitlement holders who have security entitlements with respect to that financial asset if the creditor has control over the financial asset.

[130] Act CXX of 2001 on Capital Markets.

4. CONCLUSION

Chapter 2 of this thesis has demonstrated that Hungarian banks – in the struggle to overcome the deficiencies of the current charge law - have evolved the use of fiduciary transactions, especially fiduciary assignment and purchase option. Though they can strengthen their position by the use of these atypical security devices, it can also be seen that because of the legally uncertain, ambiguous and problematic nature of these devices they also risk the re-characterization of fiduciary transactions to charge agreements.

There are supporters and opponents of fiduciary securities in the Hungarian legal literature but it can be summarized that in order to put an end to the contradictions, the new Civil Code has two possibilities. It can either prohibit the use of fiduciary securities and make charge the exclusive *in rem* security, or it can choose to follow a more functional approach and establish a unified system of securities regarding personal property similar to that of the UCC. In the latter case the law would apply the same mandatory requirements to all transactions which have a security function. The author of this thesis argued in favor of the latter solution due to the fact that the unified security interest system is efficiently functioning in developed market economies (U.S., Canada, New-Zealand, etc.) and in these jurisdictions it successfully precluded the circumvention of mandatory rules concerning securities which ensure the balance between the interests of creditors and debtors. This approach is also represented by the Study Group on a European Civil Code which focuses on the economic purposes of transactions.[131]

The thesis has hopefully also proven that the Hungarian charge regulation – although being an impressive pattern especially in Central-Eastern Europe – is in urgent need of further amendments. The positive process initiated by the Reform Acts has to be carried on and its

[131]Csizmazia, Norbert; *Tulajdon mint biztosíték?* (Property as security?) POLGÁRI JOGI KODIFIKÁCIÓ (No. 1-2, 2004) at 16

most important, general features – the rules concerning the creation, registration, rights and obligation of the parties and enforcement - could also serve as the basis for the establishment of a unified system of securities.

Not only banks but all participants of the economy need a predictable and effective system of securities with special regard to there enforcement. Everyone would benefit of such a system. It would increase the credit-giving inclination of banks and their operation would be more flexible concerning the security requirements. It would also enhance the position of debtors who would have a better and easier access to credit and who would probably have to face less over-securing and predatory lending bank practices.

The secured transactions regulation of the new Civil Code should not be a servile imitation of foreign systems. But the experiences of developed economies should be taken into consideration in the re-codification process.

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