



**PROTECTION OF CREDITORS BY THE ENGLISH
FIXED AND FLOATING CHARGE
AS COMPARED TO THE CZECH ENCUMBERING
CHARGE OVER BUSINESS**

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ABSTRACT

Just as external financing is crucial to the operation of any business, so is securing crucial to any creditor willing to provide the business with a financial facility whose primary interest is to be protected against the non-performance of his debtor. The present paper is devoted to a comparative study of the level of **protection of creditors** by the Czech encumbering charge over business and the English fixed and floating charge.

The aim of the thesis is to **analyze and compare** the English fixed and floating charge to the Czech encumbering charge over business with regard to the level of protection of creditors granted by the two distinct legal systems through legislation and case law. Special attention is given to the **critical assessment** of the Czech legal environment with specific suggestions for legislative amendments pursuant to the English concept of the floating charge. Through a comparative analysis of the main advantages and disadvantages of the two security devices from the point of view of a secured creditor, the thesis answers the question whether the Czech encumbering charge over business in its current form serves the best interests of the creditors and advocates the introduction of a new statutory framework.

In conclusion, the thesis demonstrates that due to several **principal weaknesses** of the Czech law on the encumbering charge over business, and unlike the English charge, this security device is not yet in a condition to become widely used in commercial reality, unless radical reform of the valid law takes place.

TABLE OF CONTENTS

INTRODUCTION.....	1
CHAPTER 1 - CHARGES AS MEANS OF TAKING SECURITY	4
1.1 Commercial use of charges.	4
1.2 Distinguishing charges from other security devices.....	8
1.2.1 In rem security devices.	8
1.2.2 In personam security devices.....	12
1.2.3 Creditors' position enhancing devices.	14
1.3 The use of charges in combination with other security devices and covenants when taking security over various forms of property.	17
CHAPTER 2 - COMPARISON OF THE ENGLISH FIXED AND FLOATING CHARGE WITH THE CZECH ENCUMBERING CHARGE OVER BUSINESS.....	21
2.1 Defining the English fixed and floating charge and the Czech encumbering charge over business.	21
2.2 Distinguishing the English fixed and floating charge from the Czech encumbering charge over business.	28
2.2.1 Creation.	28
2.2.2 Registration.	32
2.2.3 Priorities.	34
2.3 The chargee's rights under the English fixed and floating charge and the Czech encumbering charge over business.	37
2.4 Principal weaknesses of the Czech encumbering charge over business.	40
CHAPTER 3 - ENFORCEMENT OF THE CHARGEES' RIGHTS	46
3.1 Enforcement of the English fixed and floating charge and the Czech encumbering charge over business.	46
3.2 Protection of the chargee in insolvency proceedings.	50
CONCLUSION	57
BIBLIOGRAPHY	62

INTRODUCTION

In commercial reality of market economy **the risk of default** of the party to a transaction is always present. Various **security devices** have been used to reduce the risk at least to the acceptable level. “Real security is a right in another’s asset to secure performance of an obligation. The creditor acquires real rights over one or more of the debtor’s assets in order to secure the payment of the debt.”¹ “The security used most widely to secure advances to the company is the charge.”²

In the English law, charge (fixed and floating) as a security device evolved only in equity and is therefore sometimes called the equitable charge. “An **equitable charge** does not involve the transfer either of possession or of ownership but constitutes the right of the creditor, created either by trust or by contract, to have the designated asset of the debtor appropriated to the discharge of the indebtedness. Since a charge is a mere encumbrance and does not involve any conveyance or assignment at law, it can exist only in equity or by statute.”³

On the other hand, the Czech law stems from the principles of **Roman law**, which

in its long history, was inconstant in its ideas about security rights. In its later period, at least, it abandoned *fiducia cum creditore*⁴ and developed a generous system of hypothecary rights. Express hypothecs⁵ could be over universalities, covering not only specific assets, but also ‘other assets which the debtor has now and which he may in the future acquire’. This *hypotheca generalis* was, we are told, in daily (*cottidie*) use. In addition, there were several tacit (implied-in-law) hypothecs. In the absence of a registration system, it is difficult to believe that the law could have functioned satisfactorily. Much of this tradition of general

¹ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 583.

² E.P. Ellinger et al., *Ellinger’s Modern Banking Law* (London: Sweet & Maxwell, 2006), 781.

³ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 587.

⁴ As one of the real securities used in the Roman law, it was a contract adjoined to the contract for transfer of property, whereby the debtor transferred ownership to the property to the creditor on condition that the creditor would transfer it back once the underlying debt was paid.

⁵ Type of security in which neither ownership nor possession was transferred to the creditor, who could take possession of the property subject to hypothec once the underlying debt was not paid.

hypothecs, express and tacit, survived, or was revived, in parts of Europe after the end of the Empire.⁶

Charges in the Czech law are based on the Roman law tradition. The charge is an accessory security device for securing the performance of an underlying obligation. “The function of the charge is **securing and compensation**. The compensation function is used only in the case that the debtor is in arrears with the performance of his underlying obligation to his creditor.”⁷ Due to the strong influence of the Roman law tradition the concept of the floating charge has never evolved in the Czech law.

The present thesis focuses on the **protection of creditors** by the Czech encumbering charge over business in comparison to the level of protection of creditors provided by the English fixed and floating charge. The aim of the thesis is to **analyze and compare** the English fixed and floating charge to the Czech encumbering charge over business with regard to the protection of creditors and to assess critically the level of protection of creditors provided by the Czech encumbering charge over business. The comparison aims at explaining the essential features of the English fixed and floating charge and the Czech encumbering charge over business as well as the chargee’s rights granted by each of these security devices. Pursuant to the comparison of the features of both security devices the **principal weaknesses** of the Czech encumbering charge over business are then identified and analyzed in detail.

The analysis of any security device is not complete without at least a brief discussion of the enforcement of the security device and the protection of the creditor’s rights granted by the charge in the **insolvency proceedings**, which are essential from the creditor’s point of view.

⁶ George L. Gretton, “Reception Without Integration? Floating Charges and Mixed Systems,” *Tulane Law Review* 78 (2003): 311.

⁷ Jiří Švestka et al., *Občanský zákoník: komentář* [Civil Code: Commentary] (Prague: C.H. Beck, 2006), 644.

The discussion is again comparative with regard to the protection granted by the English fixed and floating charge and the Czech encumbering charge over business.

The thesis is concluded by the main **comparative advantages and disadvantages** of the English fixed and floating charge and the Czech encumbering charge over business for the protection of creditors with the aim to identify whether the Czech encumbering charge over business is in its current form a suitable security device for the creditors and whether the introduction of a concept similar to the English floating charge which would replace the current Czech encumbering charge over the business would be an improvement in relation to the protection of creditors. **Suggestions *de lege ferenda*** on the improvement of the Czech encumbering charge over business also form part of the conclusion.

CHAPTER 1

CHARGES AS MEANS OF TAKING SECURITY

1.1 *Commercial use of charges.*

Commercial transactions are always associated with a certain degree of risk. A significant part of the **transaction risk** is the risk of the party entitled to receive performance that the other party or parties fail to perform their obligation and that as a consequence the entitled party will have to bear the commercial loss. To avoid that, the party entitled to receive performance (the creditor) seeks to protect itself against such non-performance of the other party (the debtor) by employing various means of security, i.e. **security devices**.⁸

“The legal techniques for taking security in commercial transactions fall broadly into four categories. The first category is security by means of **taking title** in some property. This group of techniques includes the trust, transfer of title provisions and retention of title provisions⁹. In each of its situation the legal technique identifies a proprietary right of some sort in some assets to which the rightholder can have recourse if its counterparty fails to perform its obligations under the contract.”¹⁰

⁸ For the purposes of this paper, the terms *security* and *security device* are used interchangeably to denote any legal device used by the creditor to secure the performance of the debtor’s obligation and thus protect himself against the transaction risks.

⁹ Including common law *mortgages*, which involve the transfer of ownership, as opposed to mortgages under the civilian tradition, where the mortgagee acquires only a so-called *jus in res aliena* (lat. “a right in another’s thing”) and the ownership of the encumbered property remains with the mortgagor.

¹⁰ Alastair Hudson, “Collateralisation in Derivatives Transactions,” Professor Alastair Hudson, <http://www.alastairhudson.com/financelaw/Collateralisation.pdf> (accessed February 2010): 2.

“The second category is comprised of a weaker form of security by means simply of **contract**.”¹¹ It is considered to be weaker “in that the rightholder does not have any identified asset to which it can have recourse on the default of its counterparty; rather, it is reliant on both the counterparty’s ability and willingness to pay, either of which may have been the cause of the original failure to perform under the contract. Within this category are events of default, guarantees to make payments, some collateralisation obligations to transfer value to a collateral fund, and some liens.”¹²

“The third category is comprised of **quasi-proprietary rights**: that is a group of rights which purport to grant title in assets but which are nevertheless dependent on some contractual rights crystallizing so as to transform that right into a proprietary right.”¹³

“The fourth category comprises doctrines such as **pledge and lien** which grant only rights of possession, not ownership of property but with the ability to petition the court for permission to sell the property so as to recover money owed to the creditor.”¹⁴

Charge as a means of security falls into the third category, because it purports to grant title in assets but its enforcement depends on default in underlying obligation. “A charge is a security whereby real or personal property is appropriated for the discharge of a debt or other obligation, but which does not pass either an absolute or a special property in the subject in the security to the creditor, nor any right to possession.”¹⁵ “Basically, a charge gives the creditor the right to apply to court to realize the security upon the debtor’s default and to

¹¹ Alastair Hudson, “Collateralisation in Derivatives Transactions,” Professor Alastair Hudson, <http://www.alastairhudson.com/financelaw/Collateralisation.pdf> (accessed February 2010): 2.

¹² Ibid.

¹³ Ibid., 3.

¹⁴ Ibid.

¹⁵ Falcon Chambers, *Fisher and Lightwood’s Law of Mortgage* (London: LexisNexis Butterworths, 2005), 25.

recover his debt from the proceeds in priority to other claims. Conceptually, therefore, a charge may be identified with a hypothecation¹⁶.”¹⁷

From this definition the functioning of charges in commercial transactions is quite clear. First of all, there has to exist **an underlying obligation**, which arises in most commercial situations from a contract, nevertheless it is not limited solely to contractual obligations. Such an obligation may arise also either from breach of the contract (obligation to pay damages) or from invalidity of the contract (obligation to return unjust enrichment). Charges as security may be used to secure performance in a variety of contracts, but they are most commonly used in **financing transactions**, i.e. to secure the obligation to repay money lent to the debtor by a financing institution (mostly banks or leasing companies). “Companies depend upon loan finance as one of their major sources of capital. However, banks and other financial institutions involved in the business of lending money to companies generally ensure that their exposure to the risk of non-repayment is minimised by taking security over the debtor company’s property. One particularly important type of security which is available when money is lent to a company is the floating charge.”¹⁸

Charges may also be used to secure obligations from other types of contract, e.g. contracts for supply of goods and services, but they are used only rarely in this way, because there are other means of security which are more efficient in such commercial situations. These other means of security suitable for different commercial transactions will be briefly discussed in chapter 1.2.

¹⁶ *Hypothecation of goods* is a type of security whereby the debtor agrees to hold the purchased goods in trust for the creditor without the creditor obtaining either possession or legal title to them and is said to confer only an equitable charge or interest in the goods. It is used mostly when the parties wish to avoid the creation of either the pledge or chattel mortgage.

¹⁷ E.P. Ellinger et al., *Ellinger’s Modern Banking Law* (London: Sweet & Maxwell, 2006), 781.

¹⁸ Eilís Ferran, “Floating Charges – The Nature of the Security,” *Cambridge Law Journal* 47, no. 2 (1988): 213.

Once the underlying obligation arises a charge may be created to secure the performance of the obligation. The charge is created by **a contract** between the creditor and the debtor pursuant to which the debtor appropriates some of its property to be used for the discharge of the underlying obligation should it be not performed duly and timely by the debtor or in the event that some other provision of the underlying contract is breached by the debtor. Property appropriated for the discharge of the underlying obligation does not have to belong to the debtor itself, but may belong to another person, who creates the charge over such property expressly to secure the debtor's obligation towards the creditor. An example of such a situation in commercial transactions is the security provided by a company to secure the obligation of another company – usually a member of the same holding, i.e. a charge created by the parent company over its property to secure the obligation of its subsidiary.

After the creation of the charge **two situations** may occur. Either the underlying obligation is performed and as a consequence of the performance the charge ceases to exist, or the underlying obligation is not performed and as a consequence of such default the rights of the rightholder arise. Therefore, as a consequence of the default the rightholder has a right to apply to the court to seize the property and to sell it so that the rightholder can recover the amount due or to appoint a receiver.

The use and functioning of charges in commercial transaction is in principle similar under different legal systems. As an example we can compare the functioning of the encumbering charge under the Czech law, which is similar to the English model described above. Under

the Czech law, one of the conditions for the creation of a charge¹⁹ is also the existence of an underlying obligation, without which the charge cannot be created. Similarly, the charge is created also by a contract, by which specific property is appropriated for the discharge of the underlying obligation. If the underlying obligation is not performed the rightholder has the right to enforce the charge. Enforcement of the charge means that the rightholder has a right to apply to court for judicial sale of the charged property or sell the property in public auction.

As was already mentioned, almost all commercial transactions in which a charge is used represent either various forms of **loans** provided by banks to their clients or various forms of **leasing** provided by leasing companies. Under the English law,

the charge is not commonly used by banks for the financing of individual traders or of unincorporated business firms. The two main reasons for this are to be found in the Bills of Sale Acts. First, a charge, like hypothecation, falls within the definition of section 4 of the Bills of Sale Act 1878 and, accordingly, requires registration as a bill of sale. Being in the nature of a security, it also has to be in the form prescribed by section 9 of the 1882 Act. These factors render it an unattractive security. Secondly, a bill of sale is ineffective to cover property acquired by the debtor after its execution as it must specifically list the property covered. A charge granted by an individual or by an unincorporated business firm is, therefore, unsuitable for financing the acquisition of plant that may have to be changed from time to time, or of stock in trade.²⁰

1.2 *Distinguishing charges from other security devices.*

1.2.1 **In rem security devices.**

In rem security devices (or real securities) grant to the creditor a **proprietary right** in some ascertained property or appropriate certain property for the discharge of an underlying

¹⁹ For the purposes of this paper and when speaking about the Czech legal environment, the terms *encumbering charge* and *charge* are used interchangeably to denote the uniform security device taken over various kinds of property (business being one of them) pursuant to the Czech Civil Code.

²⁰ E.P. Ellinger et al., *Ellinger's Modern Banking Law* (London: Sweet & Maxwell, 2006), 782.

obligation. Real securities comprise of mortgages, charge, pledges, liens, retention of title clauses and trusts.

As to the distinction between **mortgages and charges**, the following words of A. Hudson summarize the key distinctive features of the two security devices the most concisely:

Mortgages and charges are subtly distinct concepts. A mortgage grants a mortgagee a proprietary right in property as security for a loan so that the mortgagee may enforce its security by means of sale, repossession, foreclosure or appointment of a receiver, always provided that the mortgagor is entitled to recover unencumbered title of the mortgaged property once the loan has been repaid; whereas a charge, which may be fixed or floating, provides a chargee with a contingent right to seize property in the event that the chargor fails to perform its obligations in relation to an underlying contract, and then to seek an order of the court to permit sale. ... The distinction between the two concepts, strictly, is as follows. A mortgage grants the mortgagee a proprietary right in the mortgaged property, whereas a charge creates no right in property but rather creates only a right to apply for a judicially-ordered sale of property if an underlying contractual obligation is not performed.²¹

The mortgage has to be always subject to the **equity of redemption**, which means that the mortgagor has to recover unencumbered title as soon as the underlying obligation is performed. If the mortgage states that it is irredeemable, the mortgage is void.²²

“The earliest form of security was the **pledge**, in which the creditor took possession of the debtor’s asset as security until payment of the debt. The common law understandably attached great significance to **possession**, for this was the principal *indicium* of ownership, and to allow the debtor to grant security over his assets while remaining in possession was the surest way to facilitate a fraud on his other creditor, who might be led to lend money on the strength of the debtor’s apparent continued ownership of the assets in question.”²³ “To this day the pledge remains the most powerful form of security interest known to English law, for though the pledgee’s interest is a limited one, his possession gives him a legal title to that interest, with an implied power of sale in the event of default; and the very fact of possession

²¹ Alastair Hudson, *The Law of Finance* (London: Sweet & Maxwell, 2009), 562.

²² *Samuel v Jarrah Timber and Wood Paving Corp Ltd* [1904] AC 323.

²³ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 584.

suffices both to evidence the transaction and to put third parties on notice of the pledgee's rights without any need for registration.”²⁴ The main difference between the charge and the pledge is that the pledge grants to the pledgee the right of possession, but not the right to deal with the property, whereas the charge only appropriates certain property for the discharge of the underlying obligation. Another advantage of the pledge is the scope of remedies available to the pledge, because these depend on the pledge agreement. Most commonly, the pledge agreement grants to the pledgee the right to sell the pledged property, but it may also entitle the pledgee to take full title in the pledged property.

“**Lien** may be defined in general terms as **a passive right** to retain a chattel (in certain cases, documentary intangibles and papers) conferred by law. The party entitled to assert the lien may be called the lienee and the party surrendering the possession, which gives rise to the lien, the lienor. Lien is therefore not consensual, is not conferred by the lienor and is confined to cases where the right has historically been established.”²⁵ “Liens may be divided into general and special (or particular) liens. The former is the rarer case. It is to be found, for example, in the case of solicitors (bankers, accountants and stockbrokers too) who have a lien over their clients’ papers for all sums owing for professional services rendered.”²⁶ The lien differs from the charge in two ways. Firstly, it is not consensual and, therefore, it does not appropriate by agreement certain property for the discharge of the underlying obligation. Secondly, it grants only the right of retention and if the lienee wants to sell the property he has to apply to court to order the sale. The lienee does not have any contingent rights granted by agreement like the chargee or the pledgee.

²⁴ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 585.

²⁵ Michael Bridge, *Personal Property Law* (London: Blackstone Press, 1996), 142.

²⁶ *Ibid.*, 143.

Besides 'lien' within the meaning described in the preceding paragraph;

the expression 'lien' is applied in a secondary sense to a security right which arises by operation of law but in favour of a creditor who has no possession of the property secured. This is known as an '**equitable lien**'. It arises by operation of the rules of equity based on a certain relationship between the parties. The most common example is the equitable lien of an unpaid vendor, which arises where a vendor of land or other property remains unpaid in whole or in part notwithstanding execution of a conveyance, and even where it recites that the purchase price has been paid. Except in relation to the non-consensual manner of its creation which causes its classification as a lien, an equitable is otherwise identical to an equitable charge or hypothecation.²⁷

Under the retention of title clause, known as **Romalpa clause**²⁸, the rightholder retains the title in property until some condition is fulfilled. In practice, the retention of title is used in trade agreements and the condition is usually the payment of price for the goods supplied by the seller to the buyer. Using the retention of title by the seller, the buyer is not able to pass good title to the purchase goods to any third party and the seller may always use the process of **tracing**²⁹ to either recover the goods themselves or the proceeds of their sale. Even if the buyer becomes insolvent the goods do not form part of the bankrupt's estate.

An example of trusts used as a security device is the **Quistclose trust**. In the leading case of *Barclays Bank Ltd v Quistclose Investments Ltd*³⁰ Quistclose Investments Ltd lent money to Rolls Razor Ltd for the purposes of payment of dividends and the money was deposited in a separate bank account. After Rolls Razor Ltd went into insolvency, Barclays Bank used the money to repay an overdraft of Rolls Razor Ltd. The issue to be resolved by the court was whether the bank had been entitled to use the money for the repayment of the overdraft. The House of Lords held that the money was held by the bank on a resulting trust for Quistclose,

²⁷ William James Gough, *Company Charges* (London: Butterworths, 1996), 500.

²⁸ *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd* [1976] 1 WLR 676.

²⁹ As explained in *Foskett v McKeown* [2001] 1 AC 102, tracing is neither a claim nor a remedy, but "merely a process by which a claimant demonstrates what has happened to his property, identifies its proceeds and the persons who have handled or received them, and justifies his claim that the proceeds can properly be regarded as representing his property".

³⁰ [1970] AC 567.

hence the name for this type of a resulting trust. Another explanation of the Quistclose trust was given by Lord Millett in *Twinsectra Limited v Yardley and Others*³¹, when his Lordship explained the Quistclose trust as akin to the retention of title clause. “It is suggested that Lord Millett’s expression ‘the money remains the property of the lender’ should be interpreted to mean that it is merely all of the **equitable interests** in the money which remains vested in the lender, and that the borrower is vested either with the legal title in that money so as to be entitled to use it for the purpose identified in the loan contract as a trustee, or else with a power to advance that money for the contractually-specified purpose.”³²

1.2.2 In personam security devices.

In personam security devices (or personal securities) grant the creditor only **a right to demand performance** from either a natural or legal person. The main difference between the charge and *in personam* security devices is that there is no specific property appropriated for the discharge of an underlying obligation, but rather the creditor has a right to demand performance from a specific person and if that person does not comply, then the creditor may enforce its right through court proceedings. Personal securities encompass guarantees and indemnities.

“A **guarantee** is an undertaking to answer for another’s default. It is thus both a secondary and an accessory engagement. It is secondary in that the guarantor can be sued only after default by the principal debtor; and it is accessory in that, in principle, the guarantor’s

³¹ [2002] 2 AC 164.

³² Alastair Hudson, *Equity and Trusts* (Oxon: Routledge-Cavendish, 2007), 944.

obligation is coterminous with the obligation of the principal debtor and is enforceable only where and to the extent that the principal contract is enforceable.”³³ Typically, it

is an undertaking to meet the money liability of the principal debtor arising from his default, whether the default itself relates to the payment of money or the performance of some other obligation, for example, to execute building works. But there is nothing to prevent a guarantor from assuming a secondary liability for performance of the principal debtor’s non-money obligations, and it is not uncommon for **suretyship bonds**³⁴ given in connection with construction contracts to empower the issuer of the bond to take over the contract upon default by the contractor, as an alternative to payment of damages.³⁵

While charges and other *in rem* securities are usually used to secure monetary obligations, guarantees may also be used as a performance security. In practice, even the suretyship bonds are drafted in a way to compensate the creditor for damages suffered and not giving him a right to take over the contract or to perform the underlying non-monetary obligation instead of the defaulted debtor.

A special kind of guarantee which is the most appreciated by the creditors in commercial transactions is the **bank guarantee**. The reason is twofold. First of all, bank is usually a solvent financial institution which reduces the risk of the creditor to a very low level, because default of a bank is far less likely than default of a guarantor which is not the bank or state body. Second of all, bank guarantees are in practice issued as first demand bank guarantees, which are autonomous and separate from the underlying obligation, so that if the demand is made in accordance with the terms of the guarantee the bank is obliged to pay without recourse to the terms of the underlying obligation. Principles of **autonomy and separation** make the first demand guarantees more similar to the letters of credit than to guarantees themselves. The first demand bank guarantees are also termed as the equivalent of cash in

³³ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 799.

³⁴ *Suretyship bond* is a special type of guarantee used in the construction industry. It is a three-party contract whereby the surety guarantees the performance of the general contractor’s (the principal) obligations to build a project to the owner (the beneficiary).

³⁵ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 799.

hand³⁶, because the bank is obliged to pay without regard to the terms of the underlying obligation, with the exception of clear evidence of fraud and the bank's knowledge of it.³⁷

“By contrast, an **indemnity** is a promise to make good any loss which the creditor suffers under a transaction whether or not the primary debtor would have been liable to make payment. In this latter instance, it is a creditor loss which is being compensated in general terms and not the primary debtor's failure to perform some obligation which it was at law or in equity obliged to perform.”³⁸ The main difference between a guarantee and indemnity is that while the guarantee is secondary and accessory to the primary debtor's obligation, the indemnity is separate and autonomous on such primary liability.

1.2.3 Creditors' position enhancing devices.

Creditors' position enhancing devices do not give the creditor recourse to certain property which could be used for discharging the underlying obligation or to another person obliged to discharge the underlying obligation *in lieu* of the debtor. Credit enhancing devices only improve the position of the creditor in the transaction and consist of covenants, letters of comfort and letters of credit.

Covenants are contractual clauses drafted for the protection of interest of the creditors and are most commonly used by banks and other money lenders. “This is the way for the creditors to get some form of control of the debtor's business. The degree of supervision and

³⁶ *Intraco Ltd v Notis Shipping Corporation* (“*The Bhoja Trader*”) [1981] 2 Lloyd's Rep 256.

³⁷ *Kvaerner John Brown Ltd v Midland Bank Plc* [1998] CLC 446.

³⁸ Alastair Hudson, “Collateralisation in Derivatives Transactions,” Professor Alastair Hudson, <http://www.alastairhudson.com/financelaw/Collateralisation.pdf> (accessed February 2010): 47.

interference depends on the circumstances from case to case.”³⁹ Covenants are used in various forms. For example, negative covenants restrict the dealing with certain kinds of assets or restrict the entry into certain kind of transaction, whereas financial covenants prescribe certain financial results which have to be reached or kept by the business. The advantage of covenants is that they do not require consideration for their enforcement. They are often used together with charges to improve the charges’ position. The use of covenants together with charges will be discussed in chapter 1.3.

The most significant covenant combined with the charges is the negative pledge clause. As anticipated by R. Goode,

the typical **negative pledge clause** in a domestic financing transaction is that which is to be found in the standard form of floating charge, by which the debtor company undertakes that it will not, without the prior written consent of the debenture holder, grant any subsequent security ranking in priority to or *pari passu* with the floating charge. Such a stipulation may also be contained in a fixed charge, though it is not strictly necessary for priority purposes, since a fixed charge has priority over subsequent interests except a bona fide purchaser for value of the legal title without notice.⁴⁰

Letter of comfort is a letter usually given by a parent company to a bank or other financing institution, which finances or intends to finance a subsidiary of that parent company. “In most cases a comfort letter is intended to create only moral and not legal obligations of the parent company. In those cases it is couched in general terms, for example, that the directors of the parent company are aware of the loan facility sought by the subsidiary. In other cases the parent, by the comfort letter, accepts a legal obligation, though not of a financial nature, for example, it undertakes not to sell and otherwise dispose of the shares in the subsidiary as long as the loan is outstanding.”⁴¹

³⁹ Tibor Tajti, *Comparative Secured Transactions Law* (Budapest: Akadémiai Kiadó, 2002), 107.

⁴⁰ Roy Goode, *Legal Problems of Credit and Security* (London: Sweet & Maxwell, 2003), 50.

⁴¹ Leo D’Arcy et al., *Schmitthoff’s Export Trade: The Law and Practice of International Trade* (London: Sweet & Maxwell, 2000), 58.

In more strict letters of comfort the parent company undertakes an obligation to ensure that the subsidiary is able to meet its obligations under the terms of the contract concluded with a financial institution. At this point it is necessary to distinguish letters of comfort from guarantees. The main difference is that in the letter of comfort the parent company never accepts the undertaking to repay a financial obligation in the event that it is not paid by the subsidiary, but merely to apply such policy to the subsidiary so as to ensure that it could meet its financial obligation, which does not give the parent company any legal liability to repay the liabilities of the subsidiary.⁴² A letter of comfort helps to improve the creditor's position only if it is given by a parent company which is both solvent and has a good reputation in the business environment as the company is expected to keep not only its legal, but also moral obligations.

Letter of credit is a device used mostly in international trade. "Through letter of credit the buyer pays its debt to the seller arising under the contract. This letter contains a promise by the issuing bank to pay the seller once the seller complies with the stated delivery requirements in respect of the goods or documents representing the goods. It is an enforceable promise that may not be withdrawn when it takes the form of irrevocable letter of credit."⁴³

Letter of credit improves the position of the creditor who after the opening of the letter of credit has almost certainty that he receives the payment he is entitled to, provided he complies with the terms of the letter of credit. The compliance in vast majority of cases means that he will be able to present to the bank documents which are required by the terms

⁴² *Kleinwort Benson Ltd v Malaysia Mining Corporation Berhad* [1989] 1 WLR 379.

⁴³ Michael Bridge, *The International Sale of Goods* (New York: Oxford University Press, 1999), 244.

of the letter. It is necessary to mention that the compliance is strict, and the strictness was defined by Lord Sumner in the following words:

“There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines.”⁴⁴

Therefore, it is important for the seller to carefully define the scope and content of the documents which he will be required to present to the bank, because if he is not able to comply with the terms of the letter of credit, the letter expires without the seller receiving his payment.

1.3 The use of charges in combination with other security devices and covenants when taking security over various forms of property.

In commercial reality charges are often combined with other security devices, so that the creditor can achieve the desired level of protection against the default of its debtor. The combination of charges with other security devices is more common in complex commercial transactions like structured financing where the level of risk for the creditor is usually very high. In simple commercial transactions the combination of charges with other security devices is used usually only if the creditor is not sure that the market price of the charged property will fully cover the sum of money to which the creditor is entitled. In such a case the creditor usually asks the debtor for additional security either real or personal.

In my opinion, the best way to discuss the combination of charges with other security devices is on an **illustrative example**. A very good example of complex commercial transaction is a **financing facility** provided by the bank to its client. Due to the sum of money involved, the

⁴⁴ *Equitable Trust Co of New York v Dawson Partners Limited Ltd* [1927] 27 Lloyd's Rep 49.

level of risk is usually high and thus, the bank seeks to lower the risk by employing various security devices.

First of all, the bank wants to make sure that the money will be used for the **contractually agreed purpose**. It is for exactly this reason that the bank may want to use a **Quistclose trust**⁴⁵ arrangement, so that when the money provided to the debtor under the financing facility agreement will be used for different purpose than the agreed one it will then be held for the bank (as beneficiary) on a resulting trust, i.e. the equitable interest in money passes back to the bank and enables the bank to employ tracing to recover its money.

As the next step in lowering the transaction risk the bank wants to take security to ensure that it could **recover the money** lent to the debtor in the event of the debtor's default. The bank can use a variety of security devices for this purpose depending on the kinds of assets available as security and the availability of solvent natural or legal persons, who could provide the bank with guarantees.

When **real property** is available the bank will usually take a **mortgage** over that property, which gives the bank a variety of different remedies, i.e. sale, repossession, foreclosure or appointment of a receiver. Creating a mortgage over real property is very important in a situation when the real property generates income in the form of rent, because the bank may use the power of repossession⁴⁶ and start to use the benefits for the repayment of the debt.

Although mortgage may be taken also over **chattels**, it is usually the **charge**, which is used for this purpose. If the chattels have the character of fixed assets which are not used in the

⁴⁵ See p. 11.

⁴⁶ *Four Maids Ltd v Dudley Marshall Ltd* [1957] Ch 317.

ordinary course of business then the fixed charge is used.⁴⁷ On the other hand, if the chattels have the character of assets which are used in the ordinary course of business then the floating charge is used, because it enables the debtor to deal with the charged assets as if they were unencumbered. Floating charge is also taken over book debts, because proceeds from such book debts are used by the debtor to finance the expenses of the business and this fact does not allow the fixed charge to be used for this purpose.⁴⁸ Typically, the charge will be combined with a negative pledge clause, which precludes the debtor from granting subsequent charges ranking in priority or *pari passu* to the charged property without the prior consent of the bank.

If the property has such a character that the bank wants to have it in **possession**, e.g. bearer securities, bills of exchange, promissory notes or documents representing goods such as bills of lading, then the **pledge** is used. However, the pledge must relate to property which is identifiable and therefore cannot be created, for example, by transferring a bill of lading relating to an undivided share in a consignment of goods.⁴⁹ The pledge enables the creditor to take possession of the property although not the right to deal with the property as if it was his own until after the default of the debtor, at which time the bank may sell the assets although by virtue of the pledgor's title, not with the title of its own.⁵⁰

In addition to the aforesaid, the bank can also require additional **financial covenants** to be included in the transaction documentation which will entitle the bank to make the facility immediately due once any of the covenants is broken ('acceleration clause'). The bank may

⁴⁷ *Re Bond Worth* [1980] 1 Ch 228.

⁴⁸ *National Westminster Bank plc v Spectrum Plus Ltd* [2005] UKHL 41 (hereinafter as "***Re Spectrum Plus***").

⁴⁹ Michael Elland-Goldsmith, "Real Security over Personal Property in English Law," *International Business Law Journal*, no. 2 (1995): 147.

⁵⁰ *The Odessa* [1916] 1 AC 145.

also require a **letter of comfort** from the parent company to have moral assurance that the business of the debtor will be prudently managed and that the debtor will be always both adequately solvent to meet its debts and reasonably managed in a way to meet its other obligations.

An example of combination of various security devices, although not a very good one, is set out in paragraph 2(b) of the ISDA Credit Support Deed, which provides that:

Each party as the Chargor, as security for the performance of the Obligations: (i) mortgages, charges and pledges and agrees to mortgage, charge and pledge, with full title guarantee, in favour of the Secured Party by way of first fixed legal mortgage all Posted Collateral (other than Posted Collateral in the form of cash), (ii) to the fullest extent permitted by law, charges and agrees to charge, with full title guarantee, in favour of the Secured Party by way of first fixed charge all Posted Collateral in the form of cash; and (iii) assigns and agrees to assign, with full title guarantee, the Assigned Rights to the Secured Party absolutely.⁵¹

“The principal point to make on the basis of paragraph 2(b) is this: it is impossible to know from this provision what the nature of the secured party’s right is. In subparagraph (i) the provision that the relevant party “mortgages, charges and pledges” is simply doctrinally impossible. ... Clearly, a person has one or other of these rights but it is not possible to have all three simultaneously.”⁵² It is clear from this example that such a combination of security devices is not possible and that those who could become party to the ISDA Credit Support Deed should redraft it in a way which would specify which security device is used for which kind of property.

⁵¹ International Swaps and Derivatives Association, Inc., *ISDA Credit Support Deed* (1995): 2(b).

⁵² Alastair Hudson, “Collateralisation in Derivatives Transactions,” Professor Alastair Hudson, <http://www.alastairhudson.com/financelaw/Collateralisation.pdf> (accessed February 2010): 74.

CHAPTER 2

COMPARISON OF THE ENGLISH FIXED AND FLOATING CHARGE WITH THE CZECH ENCUMBERING CHARGE OVER BUSINESS

2.1 Defining the English fixed and floating charge and the Czech encumbering charge over business.

Charge under the English law is an **equitable security device**. “A charge is a security whereby real or personal property is appropriated for the discharge of a debt or other obligation, but which does not pass either an absolute or a special property in the subject of the security to the creditor, nor any right to possession. In the event of non-payment of the debt, the creditor’s right of realisation is by judicial process.”⁵³

From the aforesaid definition it is clear that the charge does not grant to the rightholder any proprietary right, but **only appropriates** certain property for the discharge of the underlying obligation. Although this opinion prevails both in literature and practice, there are some cases, in which it was suggested that the rights granted by the charge have some proprietary aspect. It is important to mention especially two cases, because they are the decisions of the House of Lords. In *Re BCCI*⁵⁴ it was held that charge creates a security interest without any transfer of title or possession to the beneficiary. Moreover, in *Re Spectrum Plus*⁵⁵ it was held by Lord Walker that under a fixed charge the assets charged as security are permanently appropriated to the payment of the sum charged, in such a way as to give the chargee a

⁵³ Falcon Chambers, *Fisher and Lightwood’s Law of Mortgage* (London: LexisNexis Butterworths, 2005), 25.

⁵⁴ *Re BCCI (No. 8)* [1998] AC 214.

⁵⁵ *Supra* fn. 48.

proprietary interest in the assets. From both of these decisions it is clear that the consideration of at least the fixed charge has developed significantly in favour of the creation of a proprietary right. On the other hand, this **quasi-proprietary right** cannot be thought to be similar to a proprietary right created by the mortgage which enables the mortgagee to take possession of the mortgaged property as soon as ‘the ink on the contract is dry’.⁵⁶

In case of a fixed charge there is one aspect which precludes the right created by the fixed charge as being the proprietary right and that is the **contingency of the fixed charge**. “A fixed charge grants contingent proprietary rights over the charged property, the contingency being that the chargor must have defaulted in some defined obligation.”⁵⁷ “A fixed charge is said to fasten on the assets which are the subject matter of the security; thus in a leading case of *Illingworth v Houldsworth*⁵⁸ Lord Macnaghten described a fixed charge as ‘one that without more fastens on ascertained and definite property or property capable of being ascertained or defined’.”⁵⁹ “A fixed charge is similar to a mortgage in that the holder immediately obtains rights in relation to secured property and can restrict the chargor company from disposing of it or destroying it.”⁶⁰

On the other hand, the floating charge is based on a different concept. By contrast with a fixed charge, in which the rights attach to identified property, **a floating charge has a defined value which takes effect over a range of property** but not over any specific property until a certain point in time at which it crystallises.

⁵⁶ *Four Maids Ltd v Dudley Marshall Ltd* [1957] Ch 317.

⁵⁷ Alastair Hudson, *Equity and Trusts* (Oxon: Routledge-Cavendish, 2007), 958.

⁵⁸ [1904] AC 355.

⁵⁹ Eilís Ferran, *Principles of Corporate Finance Law* (New York: Oxford University Press, 2008), 367.

⁶⁰ *Ibid.*

Defining features of the floating charge were summarised in the leading case *Re Yorkshire Woolcombers Association*⁶¹ where it was held that floating charge is a charge on a class of assets of a company present and future, which is changing from time to time in the ordinary course of business and the company may carry on its business in the ordinary way so far as it concerns the particular class of assets as a going concern.

Thus, floating charge is “ambulatory and **shifting** in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.”⁶² Thus, the floating charge enables the chargor to deal with the property as if it was unencumbered. This right is the key distinction between the fixed charge and the floating charge.⁶³ “If the chargee has no control over the proceeds, for example, because the chargor has a contractual right to draw on and use the proceeds, it is difficult to see how the charge can be anything but a floating security.”⁶⁴ This approach is also supported by the case law. “In *New Bullas*⁶⁵ the Court of Appeal, reversing Knox J., decided that the debenture took effect according to its expressed intention. The parties were at liberty to make whatever bargain they chose, provided that it was not unlawful. Freedom of contract must prevail. The Privy Council described this approach as fundamentally mistaken⁶⁶:

“The question is not merely one of construction. In deciding whether a charge is a fixed charge or a floating charge, the court is engaged in a two-stage process. At the first stage it must construe the instrument of charge and seek to gather the intentions of the parties from the language they have used. But the object at this stage of the process is not to discover whether the parties intended to create a fixed or a floating charge. It is to ascertain the nature of the rights and obligations which the parties intended to grant each other in respect of the charged assets. Once these have been ascertained, the court can then embark on the second

⁶¹ [1903] 2 Ch 284.

⁶² *Illingworth v Houldsworth* [1904] AC 355 at 358.

⁶³ *Re Spectrum Plus*, supra fn. 48.

⁶⁴ Fidelis Oditah, “Fixed Charges and Recycling of Proceeds of Receivables,” *Law Quarterly Review*, no. 120 (2004): 537.

⁶⁵ *New Bullas Trading Ltd* [1993] BCLC 1389.

⁶⁶ *In Agnew v. Commissioner of Inland Revenue (Re Brumark)* [2001] 3 WLR 454.

stage of the process, which is categorisation. This is a matter of law. It does not depend on the intention of the parties. If their intention, properly gathered from the instrument, is to grant the company rights in respect of the charged assets which are inconsistent with the nature of a fixed charge, then the charge cannot be a fixed charge however they may have chosen to describe it.”⁶⁷

It becomes clear from the aforesaid that equitable company charges are similar to equitable mortgages. The distinction between the charges and equitable mortgages was analysed in *Swiss Bank Corp v Lloyds Bank Ltd*⁶⁸ where it was held:

“An equitable charge may, it is said, take the form either of an equitable mortgage or of an equitable charge not by way of mortgage. An equitable mortgage is created when the legal owner of the property constituting the security enters into some instrument or does some act which, though insufficient to confer a legal estate or title in the subject matter upon the mortgagee, nevertheless demonstrates a binding intention to create a security in favour of the mortgagee, or in other words evidences a contract to do so ... An equitable charge which is not an equitable mortgage is said to be created when property is expressly or constructively made liable, or specially appropriated, to the discharge of a debt or some other obligation, and confers on the chargee a right of realisation by judicial process, that is to say, by the appointment of a receiver or an order for sale.”⁶⁹

The **encumbering charge under the Czech law** forms part of the substantive civil law area. The current law on the encumbering charge was introduced into the civil law by the Act No. 591/1991 Sb. and as of the introduction the concept was subject to numerous changes, from which the most changes introducing the concept of encumbering charge over business were the two Acts No. 367/2000 Sb. and No. 317/2001 Sb. Both Acts amended the Act No. 40/1964 Sb., Civil Code (hereinafter as the “**Civil Code**”). Unfortunately, due to changes of the legal system during the transformation of the Czech Republic’s economy from state dominated to free market after the year 1989, the law on the encumbering charge is fragmentary, which brings a lot of difficulties. However, this can be said as well about other civilian legal systems. “The civil law systems tend to share basic conceptions of property law and obligations law. Because rights in security are obligations underpinned by a device of

⁶⁷ Robert Walker, “Fixed and Floating Charges – The Debate Continues,” *Insolvency Lawyer*, no. 3 (2002): 78.

⁶⁸ [1982] AC 584.

⁶⁹ *Ibid.*, per Buckley LJ.

property law, is almost inevitable that much of the grammar of rights in security is shared through the civil law. And yet, at the same time, the law of rights in security is, in the world of the civilian and mixed systems, fragmented. The fragmentation, disunity, and diversity are greater than anything one can find in, say, the law of obligations.”⁷⁰

As to the development of the statutory regulation of the Czech encumbering charge,

prior to the amendment of the Civil Code, the encumbering charge was included in a number of statutes. The Civil Code of 1964 allowed the creation of a charge only by operation of law. The Act No. 103/1990 Sb. (amendment of the then valid Economic Code) temporarily regulated the encumbering charge at least for the purposes of relations between business persons. However, according to the Supreme Court of the Czech Republic, such a charge did not have a real character at law (decision sp. zn. Odon 14/95). In international business, the regulation of charge as contained in the Act No. 101/1963 Sb., International Business Code was being used. Current regulation represents a unified regulation for all legal relations and is contained in Sections 151a – 151m of the Civil Code.⁷¹

Currently, the general law on the encumbering charge is governed by Sections 152 - 174 of the Civil Code. The **general law on the encumbering charge** gives the definition of the charge, general rules which govern the creation of the charge, rights and obligations of both the chargor and the chargee as well as the rules on termination of the charge. Furthermore, it sets out the general rules for the encumbering charge over immovables as well as movables and book debts. Charges over other forms of property such as business share, securities and industrial property are governed by special statutes which are in the position of *lex specialis* to the Civil Code. This concept is clear from Section 154 of the Civil Code, which sets out that the rules contained in the Civil Code apply also to charges over business shares, securities and industrial property, unless special statutes governing charges over this property do not state otherwise. These special statutes include the following:

⁷⁰ George L. Gretton, “Reception Without Integration? Floating Charges and Mixed Systems,” *Tulane Law Review* 78 (2003): 309.

⁷¹ Josef Fiala et al., *Občanské právo hmotné* [Substantive Civil Law] (Brno: MU in Brno and DOPLNĚK, 1998), 158. Pursuant to numerous later amendments of the Civil Code the numbering of the sections regulating the encumbering charge in the Civil Code was changed as further mentioned below.

- (1) Act No. 513/1991 Sb., Commercial Code.
- (2) Act No. 591/1992 Sb., on Securities.
- (3) statutes regulating rights to industrial property, i.e. Act No. 137/1995 Sb., on Trademarks and Act No. 207/2000 Sb., on the Protection of Industrial Designs.

With regard to the aforesaid, it is needless to say that the encumbering charge over business itself is **not governed by any special statute**, therefore only the general rules contained in the Civil Code are applicable. This means that every rule on the charge over business has to be derived from the general rules. By applying those rules we can define the charge over business as a security device which “secures the underlying obligation against being not performed timely so that in the event of such non-performance the underlying obligation is satisfied from the proceeds of sale of the property subject to charge.”⁷² This definition appears to be quite clear; the chargee appropriates certain property for the discharge of an underlying obligation of his debtor, provided that the underlying obligation is not timely performed. Two essential principles are to be derived from the definition. First, it is the **accessoriness principle**, which means that the charge may be validly created only if the underlying obligation itself is valid. The second is the **principle of subsidiarity** which means that the charge may be enforced only if the underlying obligation is not timely performed or the underlying obligation does not cease to exist for other reasons prescribed by law. In the event that the underlying obligation ceases to exist the enforcement of the charge is not possible.⁷³ As to the charge over business the property appropriated for the discharge of the underlying obligation (the business) is a so-called ‘**global asset**’. This is expressly permitted by Section 153(1) of the Civil Code, which defines the kinds of property which may be subject to the charge and includes, among others, also business.⁷⁴ Unfortunately, this is the

⁷² Civil Code, s. 152.

⁷³ Decision of the Supreme Court of the Czech Republic sp. zn. 21 Cdo1467/2004 (December 2, 2004).

⁷⁴ Literally, Section 153(1) reads as follows: “Property subject to charge may include a movable or immovable asset, business or other global asset, a collection of assets, a receivable or other proprietary right, if its

one and only section in the Civil Code where the charge over business is expressly mentioned.

We can conclude that **the Czech charge over business does not form a distinct security device**, but it is only a charge whose subject is the business as a special kind of property over which the charge is taken and thus, according to the Civil Code, the charge over business does not differ from charges over any other kinds of property. This is where all the problems with the charge over business start to unfold, because, in practice, charge over business does indeed differ from charges over other kinds of property to a significant extent.

To fully understand the practical differences, it is necessary to analyse the definition of the term **‘business’**. For the Czech law the term business is defined in the Act No. 513/1991 Sb., Commercial Code (hereinafter as the **“Commercial Code”**), as “a group of tangible, personal and intangible values used for business purposes.”⁷⁵ Next section is only slightly more specific saying that business comprises of property, rights and other property values owned by the business, which are used or should be used with regard to its character for the business purposes.⁷⁶ To sum up:

What makes the business a business as such are three principal defining features. Firstly, it is an organisation. It flows from the character of the business that it must be an organised grouping of tangible, intangible and personal values, because otherwise it could not well serve the business purposes. Secondly, it is inherent that the business activities of the business cannot be illegal (brothel with minors or distribution of heroine are not considered to be a ‘business’ within the meaning of Section 5). That follows from the fact that such ‘businesses’ cannot be sold, because they relate to *res extra commercium*⁷⁷. On the contrary, another defining feature of a business is its tradability. Finally, it is inherent that business is

character so allows, a flat or non-residential premise in ownership under a special statute, a business share, a security or an object of industrial property”.

⁷⁵ Commercial Code, s. 5.

⁷⁶ Ibid., s. 6.

⁷⁷ Lat. “things outside commerce”, i.e. things excluded from the possibility of individual ownership and not susceptible to commercial transactions.

characterised by its business purpose. That means that business is necessarily accompanied by the opportunity for sale of its products.⁷⁸

Under this definition, the charge over business is not created over all property, rights and other property values owned by the business, but only over those which are used or should be used for business purposes. In practice, if the scope of the business should be exactly determined, all property belonging to the business should be examined to find out whether it is used or should be used for business purposes. The situation is further complicated by Section 5(2) of the Commercial Code which sets out that business is a ‘global asset’ and that all statutes regulating property (such as real estate, chattels, intangible property) apply also to business.

Consequently, law does not consider business as one piece of property, but a pool of different property, rights and values, which are all governed by special statutory rules. This approach is totally distractible for the charge over business, because it is considered to be a charge over separate ascertained different kinds of property, rights and values comprising the business. Practical problems caused by this approach are discussed further in chapter 2.4.

2.2 *Distinguishing the English fixed and floating charge from the Czech encumbering charge over business.*

2.2.1 Creation.

From the definition of both security devices it is apparent that although they evolved in different legal systems, there are certain similarities between the two concepts. It must be

⁷⁸ Karel Eliáš, *Obchodní zákoník* [Commercial Code] (Prague: Linde Praha a.s., 1998), 56.

taken into account that in comparison to the Czech encumbering charge over business, the English charge exists in two forms as either fixed or floating. The Czech charge over business has certain similarities with both forms of the English charge. It appropriates certain property for the discharge of an underlying obligation in a similar way as the fixed charge, meaning that the charge fastens on the property, which is consequently permanently appropriated for the discharge of the underlying obligation. From the point of view of legal practice it would be more desirable for the charge over business to be more similar to the floating charge due to the specific character of business as a ‘global asset’ which changes from time to time but, unfortunately, this is not the case. In fact, with regard to at least one aspect the charge over business is similar to the floating charge. The chargor is entitled to deal with the property, but while in the case of floating charge as if the property was unencumbered, in the case of charge over business the charge fastens on the property which is subject to the transaction and is enforceable against the subsequent owner of the charged property.⁷⁹

The creation of the English charge, either fixed or floating is **consensual**, i.e. executed by a contract, to which the principles of the contract law apply. “In the generality of cases, a simple oral contract is all that is required though, in practice, there will be writing in considerable and expensive detail. For security interests relating to land the writing requirement is mandatory under the Law of Property (Miscellaneous Provisions) Act 1989 and, before that, the Statute of Frauds.”⁸⁰ “The parties to a charge contract usually specify expressly whether the charge is to operate as a fixed charge or a floating charge, either generally or in relation to particular charges assets or classes of charges assets.”⁸¹ “Apart

⁷⁹ Civil Code, s. 164.

⁸⁰ Gerard McCormack, “Convergence, Path-Dependency and Credit Securities: The Case against Europe-Wide Harmonisation,” *Global Jurist* 10, no. 2 (2010): 15, <http://www.bepress.com/gj/vol10/iss2/art2> (accessed March 2010).

⁸¹ William James Gough, *Company Charges* (London: Butterworths, 1996), 109.

from legal impossibility or inconsistency in the intention of the parties to the charge contract, there are no considerations of public policy preventing the parties from making whatever contract they choose. It is possible to create a fixed equitable charge over future as well as present assets within any particular class, instead of a floating charge.”⁸²

In general, the creation of the English charge requires **two essential conditions** to be fulfilled. The first is the existence of an underlying obligation; the second is the existence of some ascertained or ascertainable property. The advantage of the English charge is the fact that it might be taken over future property. “Charges on after-acquired assets were formally approved by the House of Lords in *Holroyd v Marshall* [1862] 10 HLC 191.”⁸³ For the purposes of securing future advances,

the parties can agree to assign by way of charge assets that have not yet come into existence. In equity the effect of making such an agreement is that when an asset answering the description in the agreement does come into existence, the assignor automatically and immediately becomes a trustee and the assignee the beneficiary, as beneficial owner to the extent of the charge, of the asset. Future assets when received become impressed with the charge and a trust in favour of the chargee. A person may create an effective equitable charge over assets by declaring that he holds them in trust for a creditor by way of security for the payment of a specified debt.⁸⁴

The creation of the encumbering charge under the Czech law is based on the same principle. It is also consensual and it is created by an agreement under similar conditions as in English law. Nevertheless, as opposed to the English law, **a written contract** is required for a valid creation of an encumbering charge pursuant to the Civil Code.⁸⁵ Furthermore, it also anticipates the existence of an underlying obligation to be secured and some ascertained or ascertainable property, in our case, the existence of business within the meaning of Section 5 of the Commercial Code. Unfortunately, the law is silent on the issue whether the charge may

⁸² William James Gough, *Company Charges* (London: Butterworths, 1996), 111.

⁸³ K.J. Naser, “The Juridical Basis of the Floating Charge,” *Company Lawyer* 15, no. 1 (1994): 11.

⁸⁴ William James Gough, *Company Charges* (London: Butterworths, 1996), 82.

⁸⁵ Civil Code, s. 156, which mentions also the court decision approving an agreement on settlement of the estate of a deceased person as another ground for the creation of an encumbering charge.

be created over future property. This causes indispensable difficulties, because the substance of the business changes from time to time and, therefore, the question of the future property is essential but, regrettably, the answer to that question is not entirely clear. In the case of the charge over business the answer seems to be in the application of Section 153(1) of the Civil Code which lists the business as a kind of property which may be subject to the charge.⁸⁶ From the aforementioned it can be concluded that any future property acquired by the business is subject to the charge, provided the charge is properly registered.

A specific feature of the floating charge which is unknown to the Czech law is the **crystallization**. Crystallization of the floating charge means “the transformation of the floating charge into the fixed charge”⁸⁷, depends on the terms of the charge agreement and might be either express or implied.

Express crystallisation depends on the exact wording of the charge contract and is usually in the form of an automatic or semi-automatic crystallisation clause. “The first type of clause places the occurrence of crystallisation outside the control of the holder of the charge and, unless the clause is narrowly and carefully drafted, may result in situations where the charge crystallizes even though the charge holder is content for it to continue to exist in uncrystallised form.”⁸⁸ “The second form of automatic crystallisation clause avoids the issue of unwanted crystallization by keeping the trigger for crystallization within the control of the holder of the charge by stipulating for crystallisation on service of notice.”⁸⁹ This second form is also known as the semi-automatic crystallisation clause.

⁸⁶ Supra fn. 74.

⁸⁷ *Georger Barker (Transport) Ltd v Eynon* [1974] 1 WLR 462.

⁸⁸ Eilís Ferran, *Principles of Corporate Finance Law* (New York: Oxford University Press, 2008), 390.

⁸⁹ Ibid.

Implied crystallisation is caused by a certain event, which is by the operation of law deemed to be part of the charge contract between the chargor and the chargee even if it is not expressly mentioned in the contract. Put into other words:

The law implies terms of crystallisation into debentures which provide that the charge will crystallise:

- (i) on the appointment of a receiver;
- (ii) on the commencement of a liquidation;
- (iii) on the company ceasing its business - it should be noted that in the case of *In Re Woodroffes Ltd* [1985] 3 WLR 547 Nourse J was of the view that there was no distinction in the authorities between this and 'ceasing to be a going concern', which had been advocated as a separate occasion. It is appropriate and necessary for the charge to crystallise in the above-mentioned circumstances.⁹⁰

In *Re Brightlife Limited*⁹¹ Hoffmann J upheld the crystallisation in the business activities of the charge such as the giving of notice by the debenture holder.⁹²

2.2.2 Registration.

In the English law the registration of charges is regulated by Section 860(7) of the Companies Act 2006 which provides for a list of charges **registrable with the Companies House**, which includes the following:

- (a) a charge on land or any interest in land, other than a charge for any rent or other periodical sum issuing out of land,
- (b) a charge created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale,
- (c) a charge for the purposes of securing any issue of debentures,
- (d) a charge on uncalled share capital of the company,
- (e) a charge on calls made but not paid,
- (f) a charge on book debts of the company,
- (g) a floating charge on the company's property or undertaking,
- (h) a charge on a ship or aircraft, or any share in a ship,

⁹⁰ Clive Hugh Jones, "Crystallisation of Floating Charges," *Journal of International Banking Law* 4, no. 1 (1989): 34.

⁹¹ [1986] 2 BCC 99.

⁹² Clive Hugh Jones, "Crystallisation of Floating Charges," *Journal of International Banking Law* 4, no. 1 (1989): 34.

- (i) a charge on goodwill or on any intellectual property.⁹³

A company that creates a charge or acquires property subject to a charge registrable under the Companies Act must deliver to the registrar the prescribed particulars of the charge, together with the instrument (if any) by which the charge is created or evidenced within 21 days beginning with the day after the day on which the charge is created or the acquisition is completed.⁹⁴

The result of the abovementioned statutory rules in case of subsequently created charges with regard to their registration is the following:

Where particulars of a charge (charge A) are delivered for registration outside the 21-day period from the date of the charge's creation and a second charge (charge B) is created before actual registration of charge A, charge B takes priority over charge A, irrespective of whether charge B was created within or without the period of 21 days from the date of creation of charge A. In the Companies Act 1989 the issue was specifically addressed in s. 95.⁹⁵

Land securities are subject to a completely different regime. Depending on whether the land is registered or not they are registrable

either in the Land Charges Register in the case of unregistered land or in the Land Registry in the case of registered land. It should be noted that although all land securities are registrable in the Companies Register, a narrower category of land securities are also registrable in the Land Charges Registry. As regards unregistered land, only legal mortgages not protected by deposit of deeds and certain equitable mortgages need to be registered in the Land Charges Register. Moreover, there is a special provision rendering registration of a floating charge with the Companies Register equivalent to registration in the Land Charges Register.⁹⁶

The Czech law has a more complicated system of registration of charges due to the **fragmentary legal regulation** of the charges. As a consequence, charges over different kinds of property have to be registered in different registers, the list of which is provided in chapter 2.4 below. Due to the lack of special statutory provisions concerning the registration of the

⁹³ Companies Act, 2006, c. 46, pt. 25, s. 860(7).

⁹⁴ Ibid., ss. 860, 862, 870.

⁹⁵ Gerard McCormack, "Priority of Charges and Registration," *Journal of Business Law* (November 1994): 589.

⁹⁶ E.P. Ellinger et al., *Ellinger's Modern Banking Law* (London: Sweet & Maxwell, 2006), 786.

charge over business the charge must be registered in all applicable registers according to the assets of the charged business. The registration problem is one of the major weaknesses of the Czech charge over business and is discussed in detail also in chapter 2.4

2.2.3 Priorities.

The strength of the charge as a security device is also considered with regard to its relation to other security interests created over the same property. It is essential to mention that under the English law as well as under the Czech law the property may be subject to more than one security interest and, therefore, secure more underlying obligations. This situation is solved by the so-called **priority rules**.

Under the English law the general rule governing the priority among multiple security interest is the well-known equity rule, which sets out that if there are equal equities **the first in time shall prevail**. By application of this rule it is clear that the security interest which was created, i.e. registered if registrable, first takes priority over the security interest created later in time. However, in the case of charges there are numerous exceptions to this rule. First, there is a question of registrable but unregistered charges. According to Section 874(1) of the Companies Act a registrable but unregistered charge is void as against the liquidator, administrator and any creditor of the company.⁹⁷ Accordingly,

such a charge will lose its priority to a subsequent chargee and will be completely ineffective in liquidation and administration. As nothing is said about 'notice', it seems clear that a subsequent chargee obtains priority even if he knew of the prior, unregistered charge. But what is the position of two unregistered charges: do they retain their chronological priority or is the first charge void against the second creditors/chargee? And what of a purchaser (is he a 'creditor'?) of the charges property? These questions remain unanswered.⁹⁸

⁹⁷ Companies Act, 2006, c. 46, pt. 25, s. 874(1).

⁹⁸ E.P. Ellinger et al., *Ellinger's Modern Banking Law* (London: Sweet & Maxwell, 2006), 788.

Furthermore, the **special rules apply to the floating charge** can be summarised as follows:

Since a floating charge leaves the company free to deal with its assets in the ordinary course of business, a subsequent disposition by the company will in principle take effect free from the charge, while the grant of a subsequent fixed charge or mortgage will take priority over the floating charge. The ability to grant a fixed charge ranking in priority to the floating charge arises by implication from the nature of the floating charge, in the absence of a term of the charge to the contrary, and does not require to be provided expressly in the charge. By contrast, the grant of a subsequent floating charge ranking in priority to the first floating charge is *prima facie* against the intention of the earlier charge and, even if the later charge is the first to crystallize, it is ineffective *vis-à-vis* the holder of the earlier charge except in so far as thereby authorized.⁹⁹

On the other hand, in *Griffiths v Yorkshire Bank plc*¹⁰⁰ it was held that it is possible to grant priority to the second floating charge as against a prior floating charge. This is an exceptional decision which is considered to be in contradiction with other decisions such as *Re Benjamin Cope & Sons Ltd*¹⁰¹ and *Smith v English and Scottish Mercantile Investment Trust Ltd*¹⁰². In both cases it was held that a second floating charge is subsequent in priority, despite absence of notice of the prior floating charge.

It should be considered that the priorities cover not only the plurality of security interests, but also the priority of a **bona fide purchaser** of legal title without notice of the existence of the charge. Therefore, if the bona fide purchaser acquires legal title to the charged property such purchaser will acquire legal title to the property unencumbered by the charge. This priority rule is overridden by the registration of the charge, because the purchaser is deemed to have notice of all matters of registration disclosed in the Companies Register.¹⁰³

To mention the recent developments - for the past decades, English law on personal property security has been subject to extensive criticism crying out for a reform along the lines of

⁹⁹ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 686.

¹⁰⁰ [1994] 1 WLR 1427.

¹⁰¹ [1914] 1 Ch 800.

¹⁰² [1896] WN 86.

¹⁰³ *G. And T. Earle Ltd v Hemsworth Rural District Council* [1928] 44 TLR 605.

Article 9 of the United States Uniform Commercial Code.¹⁰⁴ After numerous revisions, the Law Commission's final report is based on the "retention of the fixed/floating charge distinction though priority between competing charges, whether fixed or floating, will be by date of filing, unless otherwise agreed between the parties involved... in order to make it unnecessary for a chargee to rely on a negative pledge clause in order to prevent subsequent charges gaining priority."¹⁰⁵

According to Section 165(2) of the Civil Code, "when the same property is encumbered with more charges, then the underlying obligations shall be satisfied one after another according to the time of creation of the charges". It may be thought that the Czech law is based on the same principle of priorities of competing security interests, but the following fact must be taken into account. If the encumbering charge is subject to registration and the registration is constitutive for the creation of the charge¹⁰⁶, priority is determined according to the time of registration of the charge, not its creation by the charge agreement. For example, if two charges over business are created, the charge which was registered first receives priority. This makes the time period between the creation of the charge and its registration risky for the chargee who is motivated to register the charge as soon as possible after the conclusion of the charge agreement.

¹⁰⁴ Gerard McCormack, "Convergence, Path-Dependency and Credit Securities: The Case against Europe-Wide Harmonisation," *Global Jurist* 10, no. 2 (2010), Article 2: 13, <http://www.bepress.com/gj/vol10/iss2/art2> (accessed March 2010).

¹⁰⁵ *Ibid.*, 27.

¹⁰⁶ *Supra* fn. 118.

2.3 *The chargee's rights under the English fixed and floating charge and the Czech encumbering charge over business.*

The chargee's rights under the English charge concept differ significantly according to the type of charge. A fixed charge is similar to a mortgage in that the holder immediately obtains rights in relation to the secured property and can restrict the chargor company from disposing of it or destroying it. The chargee may obtain an **injunction** to restrain unauthorised disposals, so that if the property which is subject to an enforceable fixed charge is wrongfully disposed of by the chargor, the person acquiring the property will take it subject to the charge, unless he can claim to be a bona fide purchaser of legal title to the property who is without notice of the existence of the fixed charge. The same rule is described by R. Goode saying that "a fixed charge is one which attaches as soon as the charge has been created or the debtor has acquired rights in the asset to be charged, whichever is the later. The effect of this is that the debtor cannot dispose of the asset free from the charge without the chargee's consent except by satisfying the indebtedness secured by the charge."¹⁰⁷

On the other hand, the chargee's rights under the floating charge vary according to the condition of the floating charge. Prior to crystallisation of the floating charge the chargor is free to deal with the charged assets in the ordinary course of business due to the principle of a so-called '**implied licence**', which the case law regarded as

extending to any dealing or transaction within the powers of the company. Any such dealing or transaction was, for the purposes of an implied licence, within the ordinary course of business. The only limitation on dealing was that the chargor remained a going concern at the time of the dealing. This original approach was recently re-affirmed in *Fire Nymph Products Ltd v Heating Centre Pty Ltd (in liquidation)*¹⁰⁸ where the court treated the expression 'dealing in the ordinary course of business' as meaning in this context the same as 'dealing with a view to carrying on business as a going concern'.¹⁰⁹

¹⁰⁷ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 587.

¹⁰⁸ [1992] 7 ACSR 365.

¹⁰⁹ William James Gough, *Company Charges* (London: Butterworths, 1996), 188.

In practice, dealing with the charged assets is limited by the charge agreement. Restrictions on dealing are binding between the chargor and the chargee increasing the chargee's certainty that the assets covered by the floating charge will not suffer a loss from certain risky dealings. The **dealing restrictions** are not binding on subsequent purchaser or encumbrancer, unless he has notice of them. After crystallisation, the floating charge is transformed into a fixed charge and the chargee of the floating charge has the same rights as the chargee of the fixed charge. Upon crystallisation of the floating charge the right of the chargor to deal with the property as if unencumbered ceases to exist.

Under the Czech law there is only one statutory right concerning the dealing restriction. Section 163(1) of the Civil Code imposes an obligation on the chargor to “**refrain from all dealings which would cause a decline in the value** of the charged property”, in our case the business. “It is not possible to overlook that some disposals of the chargor with the charged property can significantly weaken the perspective of effective sale of charged property, e.g. long-term lease of a real estate.”¹¹⁰ “A wilful intervention by the chargor can be opposed through a court action with the demand that the court prohibits the chargor such a conduct, i.e. imposes an obligation to refrain from such conduct (Section 80(b) of the Civil Procedure Code¹¹¹).”¹¹² The cited rule on dealing restriction is only a general rule applicable to all charges and that causes a variety of problems in practice for the charge over business. Taking into account that the value of the business changes from time to time and that the managing of business encompasses a certain level of risk, which is not always under the control of the chargor, it is questionable whether the chargee is able to prove to the court that the specific transaction falls under the scope of the dealing restriction rules.

¹¹⁰ Jiří Švestka et al., *Občanský zákoník: komentář* [Civil Code: Commentary] (Prague: C.H.Beck, 2006), 674.

¹¹¹ Act No. 99/1963 Sb., Civil Procedure Code (hereinafter as the “**Civil Procedure Code**”).

¹¹² Jiří Švestka et al., *Občanský zákoník: komentář* [Civil Code: Commentary] (Prague: C.H.Beck, 2006), 674.

In addition, Section 163(2) of the Civil Code grants the chargee “the right to demand **additional security** from the chargor, when the charged property decreases in value in such a proportion, that the underlying obligation becomes partially unsecured”. Breach of this obligation by the chargor makes the unsecured part of the underlying obligation immediately due. In the case of the charge over business this rule motivates the chargor to manage the business properly, because any decline in the value of the business under the value of the underlying obligation inevitably leads to the unsecured part of the obligation becoming due by the operation of law. In practice, the value of the business is determined from its financial statements and the charge agreement usually contains the obligation of the chargor to present at least quarterly the financial statements of the charged business to the chargee.

There is no corresponding rule to the rule to require additional security in the English law. On the other hand, freedom of contract applicable also to charge agreements enables parties to draft such a rule as a part of the charge agreement. Whether the chargee is successful with the inclusion of such clause into the charge agreement depends on the bargaining power of both parties.

The most important rule conferred upon the chargee by the Civil Code is the **right of sale** governed by Section 165. The right of sale means that the chargee is entitled to the proceeds from the sale of the charged property, if the underlying obligation is not performed timely or, once it became due, it is performed only partially and not in full.¹¹³ The right to the proceeds from the sold charged property arises on the day when the chargee is entitled to demand repayment of the underlying obligation from the sale of the charged property; such time

¹¹³ Civil Code, s. 165(1).

arises, if the underlying obligation is not performed by the debtor.¹¹⁴ The right of sale is the only remedy the chargee has under the Civil Code and as such, it is always exercised through court proceedings either by public auction or judicial sale.

According to both A. Hudson and M. Bridge, besides an *in personam* action in debt, the *in rem* remedies of an English chargee in case of the debtor's default are only **sale and appointment of a receiver**, since foreclosure and possession are available solely to a mortgagor.¹¹⁵ On the other hand, W. J. Gough mentions also foreclosure as one of the possible post-crystallisation remedies while, at the same time, noting that in *Re Otway Coal Co Ltd*¹¹⁶ O'Bryan J said that foreclosure was not available under a floating charge as inappropriate.¹¹⁷

The available remedies for both the English and the Czech chargee are further discussed in chapter 3.1.

2.4 Principal weaknesses of the Czech encumbering charge over business.

The **principal weaknesses** of the Czech encumbering charge over business are caused by the **lack of specific statutory provisions** which would take into account the special legal requirements to regulate charge over pool of assets of different nature, as it was already explained in chapter 2.1. Section 153 of the Civil Code sets out clearly that also business may be subject to a charge but, on the other hand, both statutory provisions governing the

¹¹⁴ Decision of the Supreme Court of the Czech Republic sp. zn. 21 Cdo 616/2005 (February 2, 2006).

¹¹⁵ See Alastair Hudson, *The Law of Finance* (London: Sweet & Maxwell, 2009), 573, and Michael Bridge, *Personal Property Law* (London: Blackstone Press, 1996), 156-157.

¹¹⁶ [1953] VLR 557.

¹¹⁷ William James Gough, *Company Charges* (London: Butterworths, 1996), 129.

encumbering charge in general and also statutory provisions governing charge over single items of property apply to charge over business. This is due to the unfortunate wording of Section 5(2) of the Commercial Code, which sets forth that provisions of all statutes regulating property apply if that property is part of the business. These provisions which consider the business not truly as a ‘global asset’, but as a **pool of different kinds of property** causes the first principal weakness of the charge over business, which is known as the registration problem.

The **registration problem** is based on the fact that charges over different kinds of property are registered in different registers. Due to the fact that the creation of a charge over business means that every single item of the property comprising the business is encumbered and, therefore, according to the abovementioned Section 5(2) special statutory rules concerning the registration of the charge over different kind of property apply and have to be complied with. Consequently, the encumbering charge over business is not registered in a single uniform register but the number of registers where the charge has to be registered is determined by the different kinds of property comprising the business. This leads to an absurd situation, when the chargee has to at the time of creation of the charge register the encumbering charge over business in the following registers, provided that the business has the property in question listed as an asset belonging to the business subject to the charge:

- 1) **Cadastral of Real Estate** of the Czech Republic maintained by the cadastral offices for the registration of charges over real property subject to registration in the Cadastre as well as flats and non-residential premises qualified as units.
- 2) **Register of Charged Property** maintained by the Notarial Chamber of the Czech Republic, for the registration of charges over real property not subject to registration in the Cadastre as well as over chattels which are to be encumbered by a charge pursuant to a contract without the chargee or other third party taking possession, as well as charges over these individual assets created by a decision of a court or administrative authority.
- 3) **Register of Dematerialized and Immobilized Securities** for the registration of charges over securities and their chargees by the Prague Securities Centre.
- 4) **Shipping Register** of the Czech Republic maintained by the shipping offices, for the registration of charges over vessels.

- 5) **Trademarks Register** maintained by the Industrial Property Office, for the registration of charges over trademarks.
- 6) **Aviation Register** of the Czech Republic maintained by the Civil Aviation Office, for the registration of charges over aircrafts, aircraft components and spare parts to an aircraft and its components.
- 7) **Naval Register** of the Czech Republic maintained by the Navy Office, for the registration of charges over sea vessels.
- 8) **Road Vehicles Register** of the Czech Republic maintained by the municipal offices of municipalities with extended competence, for the registration of charges over road motor vehicles and connected vehicles.
- 9) **Commercial Register** maintained by the court appointed in a special statute, for the registration of charges over business shares.
- 10) **Industrial Designs Register** maintained by the Industrial Property Office, for the registration of charges over patents.¹¹⁸

Without proper registration, charge over such property is not validly created with the exception of registration in Shipping Register and the Road Vehicles Register. “In this respect the Shipping Register and the Road Vehicles Register differ, because the registration of the encumbering charge has only declaratory, and not constitutive, effects¹¹⁹; this of course does not influence the obligation of registration itself.”¹²⁰

Even the initial registration of charge in the appropriate registers does not solve the registration problem, because in compliance with Section 153(2) of the Civil Code all property acquired by the business is subject to the charge over business and same registration regime applies to such property. In practice, it is impossible for the chargor to register the charge over newly acquired property and for the chargee to control whether the chargor really made the registration. The conclusion that after the initial registration of the charge over various kinds of property comprising the business at the time of its creation the charge is

¹¹⁸ Petr Baudyš, “Zástavní právo k podniku” [Encumbering charge over business], *Právní rozhledy* 11, no. 6 (2003): 292.

¹¹⁹ The *declaratory effects* of registration mean that the legal situation to be registered has already arisen and thus, the registration itself only declares its existence, whereas the *constitutive effects* of registration directly give rise to the registered legal situation, i.e. the registration itself is necessary to create, change or terminate the relevant legal situation.

¹²⁰ Tomáš Dvořák, “Ještě k zástavnímu právu k podniku” [More on encumbering charge over business], *Právní rozhledy* 11, no. 10 (2003): 521.

imposed automatically, i.e. without additional registration obligation, does not have any support in law or in the ruling of the Supreme Court of the Czech Republic.

Second weakness of the Czech encumbering charge over business is the **disposal of assets** belonging to business over which the charge was imposed. Any business can be commercially successful only if it is able to dispose of, i.e. to sell, its products without any encumbrance fastening on them. As it was explained in chapter 2.2, the owner of the charged property may freely dispose of it, but the charge fastens on it even after the legal title is transferred to another person and the charge can be enforced against the new owner of the encumbered property. Enforceability of the charge against the transferee makes the charged property commercially useless, since the transferee is only interested in acquiring an unencumbered legal title in the purchased assets. This is the reason why it must be analysed whether the business over which the charge was created is able to sell its products unencumbered. It is clear that all assets comprising the business are subject to the charge, provided that the charge over business is properly registered. Unclear is the situation with the disposal of charged assets, mainly with the sale of products manufactured by charged business to its customers.

The law and judiciary are silent on this specific situation, therefore, it is necessary to analyse the provisions concerning the **termination of the charge**. According to Section 170(1) of the Civil Code the charge is terminated by the “termination of the underlying obligation, termination of the security, chargee’s waiver of the charge by a unilateral written act, expiry of the time period for which the charge was created, payment of the market price of the security by the chargor or debtor to the chargee, written agreement entered into between the chargee and the debtor or the chargor and in specific events set forth by special statutes”.

With regard to all of these drawbacks, T. Richter concludes that “should the encumbering charge over business be a true alternative to other means of taking security over obligations of domestic corporate debtors, it is necessary to implement an express (and commercially reasonable) regulation of its extent, and all this with regard to both the legal certainty of the parties to a secured loan transaction as well as legal certainty of third parties entering into legal relations with the chargor.”¹²¹

The situation is more complicated with those products of the business the charge over which is subject to registration. **If the charge is properly registered it is legally impossible to transfer the property unencumbered**, i.e. to sell manufactured product to the buyer without them being encumbered by the charge. For the buyers it means a nuisance to inquire in the appropriate register whether the property is charged and if it is, then to receive a release of the charge from the chargee prior to the completion of the transaction. In practice, such dealing causes many problems. Most importantly, it requires the buyer to spend some time enquiring whether the property is charged and then negotiating the release of the charge with the chargee which is usually a financing institution. In this situation most of the buyers simply buy a similar product from one of the business’ competitors.

Even more complicated is the disposal of assets not manufactured by the business. In this case it is clear and beyond doubt that the assets are subject to the charge if properly registered and that the buyer has to negotiate the release of the charge which brings all of the aforesaid problems. In practice, the need to release the charge makes commercial sale of any surplus

¹²¹ Tomáš Richter, “Zástavní právo k podniku z pohledu teorie a praxe dluhového financování” [Encumbering charge over business from the point of view of the theory and practice of debt financing], UK FSV – IES Working Paper No. 33 (2003): 17, <http://ies.fsv.cuni.cz/default/file/download/id/670> (accessed February 2010).

material machinery or other assets very slow and complicated, because the chargees are usually only willing to release the charge under the condition that the money received by the business will be used for partial repayment of the underlying obligation.

Third principal weakness is the **enforcement of the charge** over business which is explained in details in the following chapter.

CHAPTER 3

ENFORCEMENT OF THE CHARGEES' RIGHTS

3.1 Enforcement of the English fixed and floating charge and the Czech encumbering charge over business.

In the English law the chargee has **two principal remedies** available to him in the event that the underlying obligation is not performed. The first remedy is the power of sale; the second is the power to appoint a receiver.

“The **power of sale** is regulated by the Law on Property Act 1925. The power of sale under s. 101 LPA 1925 applies to charges and liens because s. 103 LPA 1935 extends the definition of the term “mortgage” so that it “includes any charge or lien on any property for securing money or money’s worth”.¹²² This provision is applicable only to **charges created by way of deed**. This is a very advantageous position for the chargee, because the chargee may decide when the sale takes place¹²³ and does not occupy the position of a trustee in the manner in which the sale is conducted¹²⁴. Secondly, the chargee in this case also controls the terms of the sale.¹²⁵ There is also “a judicial power of sale in relation to **charges not created by way of deed**. The judicial power relates to charges falling outside the statutory power under s.101 LPA 1925. Thus a chargee has a right to apply to the court to seek a right to seize the charged property and to sell it so as to realise the amount owed to her.”¹²⁶

¹²² Alastair Hudson, *The Law of Finance* (London: Sweet & Maxwell, 2009), 568.

¹²³ *China & South Sea Bank Ltd v Tan Soon Gin* [1990] 1 AC 536.

¹²⁴ *Cuckmere Brick Co. Ltd v. Mutual Finance Ltd* [1971] 1 Ch 949.

¹²⁵ *Cheltenham & Gloucester plc v Krausz* [1997] 1 WLR 1558.

¹²⁶ Alastair Hudson, *The Law of Finance* (London: Sweet & Maxwell, 2009), 569.

The second remedy is the **appointment of an administrative receiver**. The administrative receiver is appointed either by the court or by the chargee under express or implied power in the charge contract. On the appointment of a receiver the directors are not discharged from their offices, but their power is reduced to the extent that the receiver can discharge its powers.¹²⁷

The administrative receiver is considered to be **the agent** of the company with far-reaching powers and as such, he has

complete control over the assets subject to the charge under which he was appointed. In addition, he can apply to court for an order empowering him to dispose of the property subject to a prior charge. In the exercise of his powers a receiver is under a duty to the debtor company to take reasonable care to obtain the best price reasonably possible at the time of sale; this duty is also owed to a guarantor of the company's debts. However, as the receiver in exercising his power of sale is in a position analogous to that of the mortgagee, he is not obliged to postpone sale in order to obtain a better price or to adopt a piecemeal method of sale. The basis of the receiver's duty set out above was initially considered to involve the extension of the common law of negligence to supplement equity, but the courts now treat it as something which flows from the nature in equity of the relationship between the mortgagee and mortgagor.¹²⁸

In the Czech law, according to Section 165a of the Civil Code, the charged property, in our case the business, can be sold “pursuant to a petition of the secured creditor either in public auction or by judicial sale”. Both possibilities of the enforcement of the charge over business suffer from insufficient legislation which makes the enforcement of the charge over business practically impossible.

The Act No. 26/2000 Sb., on Public Auctions (hereinafter as the “**Public Auctions Act**”) mentions in its Section 36 that business may be sold in public auction. In the event of the

¹²⁷ *Re Emmadart Ltd* [1979] 1 All ER 599.

¹²⁸ Paul L. Davies, *Gower's Principles of Modern Company Law* (London: Sweet & Maxwell, 1997), 845.

enforcement of the charge it would be in a **compulsory public auction**, because it is initiated by the petition of the chargee. Unfortunately,

other provisions of the Public Auctions Act, except for s.36, are silent as to the issue of the compulsory public auction of business. Space for guessing about what is on sale and what is transferred to the buyer if it is not only assets but also liabilities of the business remains by this kind of sale of the charged business seemingly wide. With regard to the fact that the Public Auctions Act does neither provide any solution to these questions nor does it refer to the provisions governing voluntary public auctions or to appropriate use of the provisions of the Civil Procedure Code, it is possible to say practically whatever about these matters.¹²⁹

Furthermore, in the case of sale of business in public auction there is no possibility for the chargee to nominate the administrator with the power to supervise the management of the business in order to prevent the decline in the value of the business. Therefore, the chargee finds himself in a passive role without even the slightest possibility to prevent the chargor from any mismanagement of the business after the petition for the sale in public auction is submitted with the court. Due to the lack of statutory regulations on the process of sale of business in the compulsory public auction this remedy is totally impracticable for the chargee.

Judicial sale is governed by the Civil Procedure Code, which contains at least some provisions on the sale of business, but for practical commercial life it is not a much more useful remedy than the sale in public auction. The only advantage of the judicial sale is that the court, upon petition for judicial sale, nominates the administrator with the power to supervise the management of the business, which at least prevents the chargor from deteriorating the value of the business. Unfortunately, this is the only advantage the judicial sale has. The main problem with the judicial sale of the charged business is very similar to the main problem of the sale in public auction. It is the uncertainty about what liabilities of

¹²⁹ Petr Baudyš, “Rozsah zástavního práva k podniku” [Extent of the encumbering charge over business], *Právní rozhledy* 12, no. 8 (2004): 301.

the business pass to the buyer together with the business. “From the distribution of the proceeds of the sale of charged business not only the receivables of the chargee, but also other receivables of other creditors can be satisfied. The creditors may submit only adjudicated receivables or receivables secured by charge, lien and by securing transfer of title.”¹³⁰

The **receivables must be submitted** to the court (by a so-called ‘application’) no later than five days before the sale is executed. Due to the fact that according to Section 338zk of the Civil Procedure Code “all liabilities of the business not satisfied from the distribution of proceeds pass to the buyer together with the business”, the prospective buyer is uncertain until the fifth day prior to the sale about the extent of the liabilities passing with the business, which makes it impossible for the prospective buyers to make a reliable estimate of value of the business. The judicial sale itself is realized by **auction** held by a judge and the prospective buyer who offers the highest bid becomes the owner of the business provided he pays the offered price in the period given by the judge which cannot be longer than two months.¹³¹

Nevertheless, “without regard to the regime of the sale, the key issue for the commercial usability of the encumbering charge over business is that the buyer knows that he buys the business without debts. If it is not so, then it is not possible to expect a meaningful return from the sale of the charged business and that harms, above all, the domestic debtors in their ability to decrease the costs of financing by the use of charge over business.”¹³²

¹³⁰ Jaroslav Bureš et al., *Občanský soudní řád: komentář, II.díl* [Civil Procedure Code: Commentary, Part II] (Prague: C.H. Beck, 2006), 1713.

¹³¹ Civil Procedure Code, s. 338z(2).

¹³² Tomáš Richter, “Zástavní právo k podniku z pohledu teorie a praxe dluhového financování” [Encumbering charge over business from the point of view of the theory and practice of debt financing], UK FSV – IES

From the present discussion, it is clear that both remedies available under the Czech law are unsuitable for the sale of a ‘global asset’ such as the business. Because commercial use of each security device depends on the ability of the rightholder to satisfy his claims from the security after the underlying obligation is not performed it can be said that the unsuitable legal regime for the enforcement of the charge over business in the Czech law limits the use of the charge over business as a security device to a significant extent.

3.2 Protection of the chargee in insolvency proceedings.

In the English insolvency law the chargee occupies the position of a **secured creditor**, which forms the base for the protection of the chargee’s rights in insolvency proceeding. “The assets of an insolvent debtor available for distribution to its creditors are necessarily diminished to the extent of legal and equitable interests held by third parties in those assets. Unsecured creditors rank in priority after any legal or equitable property interest, whether absolute or by way of security, conferred on a third party.”¹³³ The protection of the chargee’s rights in insolvency proceedings also depends on the type of insolvency proceeding. There are three regimes of insolvency proceedings under the English Insolvency Act 1986 - winding up, administrative receivership and administration.

The first insolvency regime is **winding up** which is in principle a liquidation of the company, which at the end of the process ceases to exist as a legal entity. Winding up may be either voluntary, i.e. initiated by decision of the company members, or compulsory, i.e. initiated by

Working Paper No. 33 (2003): 31, <http://ies.fsv.cuni.cz/default/file/download/id/670> (accessed February 2010).

¹³³ William James Gough, *Company Charges* (London: Butterworths, 1996), 949.

the petition of the creditors. The appointed liquidator sells the assets of the company and pays off its debts to the creditors; at the end, the surplus of the process is transferred to the company members. “In principle a secured creditor is not a contender in the priority stakes. Assuming his security to be valid against the liquidator and creditors, he is entitled to have recourse to it before anyone. Even the costs of the liquidation cannot be taken out of an asset given as security before the secured creditor has realized what is necessary to pay his debt.”¹³⁴

The second insolvency regime is the **administrative receivership**, in which the receiver is appointed to manage the business, sell the assets or the whole business and to distribute the proceeds to the creditors. “The peculiar feature of administrative receivership is that it is an enforcement remedy for a debenture holder rather than a true collective insolvency proceeding.”¹³⁵

The protection of the chargee in administrative receivership is based on the following two principles:

First, administrator proposals to the creditor may not involve downgrading the rights of secured or preferential creditors, without their consent or use of a scheme of arrangement or a company voluntary arrangement (which contain mechanisms for the protection of minorities). Thus, although the secured creditor is put into a collective insolvency procedure, it is given specific protection that the administrator may not propose action which “affects the right of a secured creditor to enforce his security”. Second, and more general, protection against unfair prejudice is extended to actions of the administrator, so that any member or creditor of the company can apply to the court for relief on the grounds that the administrator is acting, has acted or proposes to act in a way which “unfairly harms” the interests of the applicant.¹³⁶

Furthermore, and to make the picture complete,

by statute the receiver is required to see that the preferential creditors are paid ahead of the holders of a floating charge and to file accounts and present a report to creditors. Apart from

¹³⁴ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 837.

¹³⁵ *Ibid.*, 845.

¹³⁶ Paul L. Davies, *Gower's Principles of Modern Company Law* (London: Sweet & Maxwell, 1997), 853.

this and the fact that on winding up the receiver's agency powers come to an end, he is largely unaffected by the liquidation process. His primary duty is to the debenture holder who appointed him and his primary function is to ensure that, through the disposal of assets or of the business as a going concern, he raises such money as he can to pay off the amount due to the debenture holder.¹³⁷

Administration as the third insolvency regime is a process in which the aim is focused not on the liquidation of the company but on the restructuring of the company or on the higher proceeds received by the creditors than they would receive in the process of winding up or on sale of the assets and distribution of the proceeds to the preferential and secured creditors. The administrator presents its proposal to the creditors who may either approve or reject it, but they are not entitled to make any modifications. Similarly to the receiver, the administrator may manage the business and sell its assets. The administration restricts the right to enforce the security and, therefore, the chargee is not entitled to enforce the charge but depends on the administrator's proposal approved by the general body of creditors.

In certain circumstances the security interest is not provided with protection in the insolvency proceedings. "There are eight statutory grounds on which **a security interest given by a company can be attacked**, namely that it:

- (1) contravenes the principle of *pari passu* distribution, as where it is expressed to come into existence only on the advent of winding-up;
- (2) was not registered as required by statute;
- (3) is a transaction at undervalue;
- (4) is a preference of a creditor or surety;
- (5) secures an extortionate credit bargain;
- (6) is a floating charge given by an insolvent company otherwise than for new value and the company goes into winding up or administration within the statutory period;
- (7) was given after the commencement of a winding up by the court and has not been sanctioned by the court;
- (8) is a transaction made to defraud creditors."¹³⁸

¹³⁷ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 845.

¹³⁸ Roy Goode, *Legal Problems of Credit and Security* (London: Sweet & Maxwell, 2003), 197.

The protection of the chargee of a floating charge is weaker than the chargee of a fixed charge. When the company comes into liquidation, administration or receivership, part of the assets over which the floating charge floats has to be compulsorily available to the unsecured creditors. “According to Section 176A of the Insolvency Act 1986, the prescribed proportion is nil for net property not exceeding £10,000 in value, and for property exceeding £10,000 50% of the first £10,000 plus 20% of the excess over £10,000 up to a maximum of prescribed part £600,000.”¹³⁹

In addition, the liquidator or administrator of the company may avoid the floating charge created within 12 months prior to insolvency, or 24 months if the chargee is connected with the company, because such person is able to identified the risk of bankruptcy sooner than other creditors and may try to improve its position in insolvency proceeding¹⁴⁰, if it can be proved by the chargee that the company was solvent at the time of creation of the charge. “The rationale of section 245 seems to be to avoid the temptation of existing unsecured creditors of a company in difficulties obtaining floating charges which would then attach to subsequently acquired property at others’ expense.”¹⁴¹ Furthermore, preferential creditors¹⁴² are preferred against the chargee entitled from the floating charge.

From the preceding discussion, it is clear that the chargee’s rights are well protected by the English insolvency law. On the other hand, a floating charge receives weaker protection in comparison to the fixed charge.

¹³⁹ Roy Goode, *Commercial Law* (London: Penguin Books, 2004), 838, fn 73.

¹⁴⁰ Insolvency Act, 1986, c. 45, pt. VI, s. 245(3).

¹⁴¹ E.P. Ellinger et al., *Ellinger’s Modern Banking Law* (London: Sweet & Maxwell, 2006), 790.

¹⁴² Nowadays, *preferential creditors* only include employees with regard to four month wages and pension contributions and have priority over both ordinary unsecured creditors and floating charge creditors.

In the Czech law, the protection of the chargee in insolvency proceedings is governed by the Act No. 182/2006 Sb. on Insolvency and Methods of its Solution (hereinafter the “**Insolvency Act**”). The Insolvency Act provides the chargee with a rather strong protection of his rights. The chargee in the insolvency proceeding occupies the position of a secured creditor, which is similar to the position of the secured creditor in English law, under the following conditions:

If the creditor should be considered a secured creditor and have the rights of a secured creditor the creditor has to mention in the application that he enforces its right from the security and has to describe the type of security and the time of its creation; if the creditor does not do so, it is considered that the right to payment of the proceeds from the security of the applied receivable was not enforced.¹⁴³

The rights of the secured creditor vary according to the method of solution of the debtor company’s insolvency, which may be either bankruptcy or reorganization.¹⁴⁴

The purpose of **bankruptcy** is “the sale of all of the bankrupt’s assets and distribution of the proceeds to all of the applied creditors.”¹⁴⁵ The chargee is entitled to all proceeds derived from the sale of the charged property after the deduction of expenses of the sale and the remuneration of the bankruptcy administrator, which is also deducted from the proceeds of the sale.¹⁴⁶ There are no preferential creditors which would rank in priority to the chargee. The chargee as a secured creditor is entitled to instruct the bankruptcy administrator in all aspects concerning the management and sale of the charged property. The bankruptcy administrator is bound by such instructions and may divert from them only if he can sell the charged property for a higher price. By sale of the charged property in the insolvency

¹⁴³ Lubomír Lánský and Anna Bartůňková, “Postavení zajištěných věřitelů podle nového insolvenčního zákona” [Position of the secured creditors under the new Insolvency Act], EPRAVO.cz, a.s. (22 February 2008), <http://www.epravo.cz/top/clanky/postaveni-zajistenych-veritelu-podle-noveho-insolvenčního-zakona-53343.html> (accessed March 2010).

¹⁴⁴ Another method of solution of insolvency anticipated by the Czech Insolvency Act is the so-called *discharge from debts*. However, since according to s. 389 it is only available to natural (non-business) persons, it does not relate to the charge over business and, therefore, it is not analysed in this paper.

¹⁴⁵ Insolvency Act, s. 244.

¹⁴⁶ Ibid., s. 167(1).

proceeding the charge terminates and the secured creditor is entitled to the proceeds from the sale. If more charges were created over the property the same priority rules as described in chapter 2.2 apply.

In **reorganization**, whose purpose is aimed at maintaining the debtor's business as a going concern while, simultaneously, repaying at least partially the creditors' receivables¹⁴⁷, each secured creditor has a specific position. According to Section 337(2) of the Insolvency Act, for the purpose of the reorganization each secured creditor is considered as an independent group of creditors. Because the reorganization plan has to be approved by all groups of creditors, each secured creditor has to give his consent with the reorganization plan and, therefore, each secured creditor may block the reorganization plan, unless the court approves it without such consent of the secured creditor.¹⁴⁸ The reason for the power of the court to approve the reorganization plan regardless of the lack of consent of each group of creditors is to prevent a sole secured creditor from blocking the reorganization of the insolvent debtor against the will of the majority of other groups of creditors.

Much like in the English insolvency law also in the Czech insolvency law there are certain **vulnerable transactions** which allow the bankruptcy administrator to avoid charges created as part of those transactions. Such vulnerable transactions include all transactions at undervalue, transactions bringing an advantage to one of the creditors over the other creditors, and transactions which decrease the level of repayment of the creditors' receivables.

¹⁴⁷ Insolvency Act, s. 316(1).

¹⁴⁸ Ibid., s. 348(2).

In conclusion, the Insolvency Act brought into the Czech legislation a very high standard of protection of the chargee's rights which is similar to the level of protection the chargees enjoy under the English legislation.

CONCLUSION

From the comparison of the main features of the English charge and the Czech encumbering charge over business it seems that the English charge is a much more advantageous security device than the Czech encumbering charge over business. One of the reasons for this can be found in the **historical background**. The Czech encumbering charge over business evolved from the Roman law tradition of *in rem* securities fastening on ascertained property and enforceable against any subsequent holder or owner of the property. To the contrary, the English charge evolved as an equitable concept which allowed the charge to become a flexible security device.

The most important point is the development of the **fixed and floating charge as distinct charge concepts**. While the fixed charge fastens on the property and restricts the dealing of the owner with that property, the floating charge does not attach to certain property but in a defined value floats over a pool of property which enables the owner of the property to deal with that property until a so-called **crystallisation event**. Upon crystallisation, the floating charge is transformed into an ordinary fixed charge which fastens on the property comprising the pool of the property over which the charge was created.

Although the concept of the floating charge is in principle an advantageous one, there are certain disadvantages that must be taken into consideration. First of all, the pool of property over which the charge floats changes from time to time and, therefore, once it is badly managed, there can be insufficient property at the time of crystallisation of the charge for the discharge of the underlying obligation. The solution to this disadvantage lies in the **combined use of the fixed and floating charge**, as it frequently happens in practice. A fixed charge is

granted over current assets with which the owner does not need to deal in the ordinary course of business, whereas, simultaneously, a floating charge is granted over those current assets with which the owner wishes to deal in the ordinary course of business. Another disadvantage of the floating charge is the fact that, in practice, it is sometimes **difficult to identify** the assets which were part of the pool of property at the time of the charge's crystallisation. Even though the fixed charge has none of these disadvantages it, on the other hand, prevents the owner from dealing with the charged property which makes it a useless security device for certain types of assets with which the owner needs to deal in the ordinary course of business. A good example of such an asset is a product manufactured by the business which can be sold to the customer only if unencumbered.

Taking into account all of the advantages and disadvantages I conclude that the English charge, in its fixed and floating form, is a **commercially useful security device** mainly for securing financing provided by banks and other financial institutions to companies, because the charge may be taken over fixed and current assets as well as over future property. The position of the chargee may be strengthened also by the combination of the charge with restrictive covenants like the negative pledge clause in the charge agreement.

On the other hand, the Czech encumbering charge over business remains within the boundaries of the traditional Roman law security concept. The business, although being a **complex and specific global asset**, is considered by the Czech law to be a pool of different kinds of property, but not as a single global asset. Therefore, the creation of the charge over business virtually means the creation of charge over various kinds of property comprising the business, not the creation of charge over business as a single unit.

This approach of the law evolved into the **registration problem**, which means that the charge over business is not registered in a single register, but different kinds of property comprising the business are registered in **different registers**. If the registration of the charge over all kinds of property in different registers is not completed, then the charge over business is not enforceable, because due to incomplete registration the chargee does not hold the charge over business at law. Furthermore, charge over future property acquired by the business is also subject to registration which creates practical problem for the chargee of periodical registration of the charge over future-acquired property. In addition, the priority between competing charges over business is determined according to registration and not actual conclusion of the charge agreement.

The result of this legal concept of the encumbering charge over business is that, in practice, the charge over business is not a popular security device. In commercial reality of the Czech Republic a chargee who wishes to use an encumbering charge takes **individual charges** over selected property of the debtor. Thus, instead of taking the ‘uniform’ charge over business, the creditor takes separately charges such as the charge over land and buildings, charge over selected equipment, charge over selected stock of manufactured products, charge over book debts, etc. This approach provides the creditor as the chargee with sufficient legal certainty that he has a valid security and will be able to enforce it.

Due to the fact that the charge over business **fastens on every asset** comprising the business and is enforceable against any subsequent holder of such asset, it is impossible for the business to sell or otherwise dispose of any of its charged assets as unencumbered. This is a particularly sensitive issue in relation to products manufactured by the charged business, because they are also subject to the charge and if the charge is registered it is legally

impossible to dispose of such products unencumbered even in the ordinary course of business without the charge being released by the chargee.

The third major problem of the Czech encumbering charge over business is the **enforcement** of the charge, because valid legislation on the enforcement of the charge over business makes the sale of charged business in practice almost impossible. This is precisely due to the fact that the current legislation does not grant the prospective buyers any rights to obtain sufficient information necessary to determine the value of the business. Secondly, legislation is also unclear about which liabilities pass on with the business to the buyer and which liabilities are to be paid from the proceeds of the sold business. Under these conditions it is very difficult to attract prospective buyers and all of that increases the likelihood that the enforcement will not be successful. In practice, the solution of the situation for the chargee who is not able to enforce the charge lies in the insolvency proceedings. If the business is insolvent at the time of enforcement of charge, the chargee may submit to the court an insolvency petition and once insolvency is declared the administrator sells the business. Subsequently, the chargee receives all of the proceeds from the sale of the charged business after deduction of administrative costs. This **indirect enforcement through insolvency proceedings** forms the easiest way how to receive proceeds from the charged business, because the buyers acquires the property from the insolvency proceedings without any encumbrances or liabilities. That naturally attracts a lot of prospective buyers and increases the likelihood of the sale.

It can be concluded that while the English charge provides the creditor with sufficient certainty, the Czech encumbering charge over business is, in its current state, a legally uncertain and risky security device which should be avoided by any creditor who wishes to

have a legally certain and enforceable security device. Should the encumbering charge over business play at least the slightest role as a security device, radical reform of law must take place. In my opinion, *de lege ferenda* it is necessary to introduce **a special statute** on charges over business, which would be based on the floating charge principle. Hence, the encumbering charge over business would not fasten on all assets comprising the business at the time of its creation but would float over the business and would enable the business to deal with its assets in the ordinary course of business as if unencumbered. Following the default of the debtor on performance of the underlying obligation the charge over business would fasten on all assets comprising the business. This solution would enable the business to carry on its activities even after the creation of the charge without uncertainty about whether the business sells its products unencumbered. For practical as well as commercial purposes, the registration of the charge should be in **one publicly accessible register** so that everybody could inquire about the existence of a charge over the business. Simultaneously, **new rules on the enforcement** of the charge over business should be introduced to grant the prospective buyer a right to obtain information about the business for the purposes of determining the value of the business and also to establish clear rules concerning the passing of liabilities of the business to the buyer.

Unless a complete reform of the law on the encumbering charge over business is introduced to the Czech law, I would personally recommend the creditors to avoid using the encumbering charge over business as a security device due to the numerous difficulties analysed throughout this paper.

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