

# New Hungarian Bankruptcy Law Protects Secured Loans

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**Editor's Note:** *It seems like yesterday that the European Bank for Reconstruction and Development (EBRD) began its good work in supporting the emerging private sector in the transition economies of Eastern Europe, including Hungary, whose recent amendments to its Bankruptcy Act are featured in this European Update. The EBRD's most recent overview records that Hungary is now one of the "most advanced countries across the new EC member states, with almost 80 percent of economic activity in private hands, a large degree of price liberalisation, an open foreign trade regime and liberal foreign investment conditions." This is remarkable progress, but remember that you must still deal with 27 different EC insolvency regimes. You could be forgiven (by anyone but an unhappy client) for not knowing that Hungary has a floating charge, that creature beloved of U.K. lawyers but (you might assume) unheard of outside the Commonwealth. But Hungary does have this device, and thus stands as a reminder of the danger in any assumption that Europe remotely resembles a unitary state.*

*This will be my last Editor's Note. A young and very energetic Freshfields partner, Adam Gallagher, will take over beginning with the next issue. It has been a huge privilege to introduce the European Update since its inception a couple of years ago, and I look forward to continuing my involvement in the important work as the new co-chair of ABI's International Committee. As of September, I may be found at University College London, where I shall be the Dean of the Faculty of Laws (sandy.shandro@ucl.ac.uk). I wish you all a slight upturn in the kind of work we love, and continued success to the ABI and its high-quality Journal.*

## About the Author

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An amendment to the Hungarian Bankruptcy Act<sup>1</sup> came into effect on Jan. 1, 2007, entitling secured creditors (other than floating charge-holders) to a privileged position in the event of the debtor's insolvency. In recent years, creditors have been faced with uncertainty about the most effective manner in which to take security under Hungarian law. This lack of clarity has led to creditors adopting a range of methods in an attempt to overcome what has been seen as a rather unsatisfactory regime. Such methods have included the invention of new "atypical" forms of security—or quasi security—that do not involve taking a mortgage, charge, pledge

the event of failure by the debtor to fulfil its obligations, the lienholder is granted a right to acquire ownership of the pledged property. In seeking to evade a regulation of the HCC, concern has also been expressed that such agreements might be null and void under §200(2) or that they should be re-construed as a contract for mortgage, lien or pledge.

The judiciary has been slow to offer much assistance, although, over time, the use of option arrangements and assignments of future claims as security has been accepted.<sup>2</sup> Recently, however, the Supreme Court declared that a debtor's right to repurchase land is, as a matter of substance, a mortgage, and following such reconstruction of the contract, rejected enforceability of a repurchase right as effective security. The Supreme Court established that the owner of the right to repurchase should have been registered at the land registry as mortgagor and, not being so, did not have the right to exercise his option.<sup>3</sup>

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or lien. The most common form of atypical security has been the use of sale and repurchase arrangements and assignments by way of security.



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Freedom of contract, a principle encapsulated in §200(1) of the Hungarian Civil Code (the HCC), points strongly in favor of the validity of these solutions as a means to provide effective security. Express support for some of the constructions may even be found in provisions of the HCC, such as the right to repurchase contained in §374 of the HCC.

However, the use of atypical security is not universally accepted and has been the subject of much doubt both in academic circles and among practitioners. Some see these developments as seeking to evade §252(2) of the HCC, which prohibits certain lien arrangements entered into before a debt is due—in particular, those agreements that purport to provide that, in

The enforceability of atypical security arrangements is a key concern under Hungarian private law. To invalidate such arrangements would operate as a considerable and, perhaps, unnecessary limit on parties' freedom to contract on such terms as they see fit. Conversely, allowing them would seem to be incompatible with the policy underlying security regulation, namely registration.<sup>4</sup>

## The Changes

The driving factor behind the changes was to provide secured creditors (other than floating charge-holders) with the most favorable position possible in the event of the debtor's insolvency in order to make it less attractive for creditors to enter into atypical security arrangements. Prior to Jan. 1, 2007, secured creditors had a right to 50 percent of the proceeds of sale of the secured assets, less the costs of sale, where the debtor went into liquidation, provided that the security had been taken

<sup>1</sup> Section 5 of Act VI of 2006 amending Act XLIX of 1991 on Bankruptcy Proceedings, Liquidation Proceedings and Members' Voluntary Dissolution.

<sup>2</sup> BH 1999. 452. Legf. Bir. Pfv. III. 22.796/1997. Supreme Court and EBH 2001. 439. Legf. Bir. Gfv. X. 31. 608/1999. Supreme Court, respectively.

<sup>3</sup> BH 2006. 118. Legf. Bir. Pfv. IX. 21.703/2005. Supreme Court.

<sup>4</sup> See the prohibition in §252 subparagraph (2) of the HCC mentioned above.

at least one year before the liquidation commenced. The new regulation, described below, improves this position and represents a further step in the protection of secured creditors.

Pursuant to paragraph 49/D of the Bankruptcy Act (as inserted by the recent amendment), security provided over property (other than a floating charge, which is dealt with below) was created prior to the date of commencement of the liquidation. A liquidator who sells such property must account to the holder of the security for *all* the proceeds of sale sufficient to satisfy the creditor's claims (after first deducting any costs of maintaining and protecting the condition of the property, the costs of sale and fees). Where property is subject to multiple security rights, the securityholders are, unless otherwise provided by law, to be satisfied in the order in which the security rights were created (§256(1) of the HCC).

As mentioned previously, floating charge-holders are treated differently. In the case of a floating charge, the liquidator is required to apply only 50 percent of the sale proceeds, less the costs of sale, to satisfy the claims of the floating charge-holders. If this does not

fully satisfy their secured claim then the balance is treated as an unsecured debt. Accordingly, those creditors with fixed charges, liens, mortgages or pledges are treated more favorably than those with floating charges.

The legislature also intends to give the same privileged position to creditors without security but who have a registered right of execution (a court decision that is to be executed and is already registered at the land or some other registry), or have started the execution process, and in the course of execution the asset has been seized, but the court decision is not registered. In both cases, the seizure or registration must have taken place before the liquidation commenced.

The new regulations favoring secured over unsecured creditors do not, however, apply where the secured creditor is a member, executive officer, employee in a managerial position of the debtor, a close relative or spouse of such persons, or if the debtor is a business organization under its majority control.

### ***Policy Behind the Changes***

The aim of the new regulation was to offer secured creditors (floating charge-holders to a lesser degree) a prioritised position in the event of a debtor's

insolvency and to ensure that enterprises are able to raise credit on more favorable conditions. The Hungarian legislature also hopes that, in reliance on the new provisions, creditors will feel more secure in granting credit in return for smaller levels of collateral. This is on the basis that the whole value of the property, offered as security or collateral for repayment of the loan, will be available for repaying such loan in the event of liquidation (50 percent in the case of floating charge-holders).

The legislature expects that through the introduction of such changes, the position of secured creditors in liquidation proceedings will be improved. Arrangements traditionally used by creditors to try and protect their position in the event of the debtor's insolvency—such as lien *cum* rights, security assignment or assignment of title as security (purchase and sale with a right of repurchase)—are also expected to become less common as a result of the changes.

Clearly, the favorable treatment of secured creditors, as provided for by the amendments, lessens the likelihood of unsecured creditors recovering their debt. This will provide food for thought

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for those considering advancing credit. On the one hand, unsecured creditors must now re-evaluate their practice regarding the taking of collateral. They will need to reconsider the advantages they had previously seen in adopting the “atypical” security approach against the backdrop of the amendments improving the position of secured creditors. They will, in particular, need to factor into account the reluctance of the courts (which, as a result of the changes, might be expected to increase) to recognize the validity of arrangements involving assignment of title or sale and repurchase agreements as security.

On the other hand, the contracting practice of unsecured creditors must be re-evaluated and they must explore

their options to improve their own position against possible secured creditors in the event that the debtor goes into liquidation. This may shift the focus toward new forms of collateral, as well as potential steps to minimise damage arising from the liquidation of debtors.

### **Comment**

It remains to be seen what kind of effect the amendments will have on banks and other creditors in practice.

There are few effective legal methods available to trump a secured creditor’s position. It may be, for example, that methods such as retention of title clauses (not widely used in Hungary) might be used as a form of quasi-security, although, in Hungary at

least, retention-of-title provisions may only be used in respect to sales of goods or immovable property.

The reluctance of the courts in practice to accept security repurchase rights as enforceable (instead construing them as mortgages or pledges) may deter creditors from adopting these forms of atypical security. The ongoing reform of the HCC is attempting to reappraise the whole system of taking security under Hungarian private law. The main aim of those drafting the reforms is to provide a law that leaves scope for atypical security structures while, at the same time, encouraging greater regulation and more flexible forms of security. ■