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One Flight over Czech Security Interests: Priorities and other Monsters of Post-Transformation Debtor/Creditor Law

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One Flight over Czech Security Interests: Priorities and other Monsters of Post-Transformation Debtor/Creditor Law

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Abstract:
This article contains a relatively comprehensive review of current Czech law of security interests. Starting from a basis of socialist law of security interests, utterly useless in a market economy, the Czech legislator must be credited with having made some progress since 1989. However, that progress has been moderate at best. While Czech law of security interests contains some particular features conducive to taking security over business assets (such as a register of movables allowing the creditors to take non-possessory charges over chattels), confusion prevails about some of the most fundamental principles of this field of law, in particular the rules of priority. As will be shown in the article, these fundamental confusions and conceptual misunderstandings appear time and again in dubious and unclear statutory provisions that reduce legal certainty and increase transaction costs in the Czech credit market.
In part 1, the article first defines its scope. Part 2 briefly discusses the economic theories of secured credit. Part 3 reviews what could be called the general principles of the law of security interests, including in particular the rules on priority. Part 4 briefly mentions consumer protection issues. Part 5 contains a discussion of the most typical assets taken as security, the ways these assets may be charged and the way the charges may be enforced. Part 5 concludes with some recommendations for legal reform.

Keywords: security interests, secured debt, debtor/creditor law, bankruptcy, insolvency, transformation.

JEL Classification: G33, K3.

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1. Categories of rights in security

1.1. Definition of Rights in Security

As many legal institutions in European post-Communist jurisdictions, security rights under Czech law suffer from quite a bit of conceptual confusion and a fair share of practical difficulties. We will encounter some of the practical difficulties later in this article. A good example of the conceptual confusion can be found right in the subtitle of Act 40/1964 Coll., as amended (the "**Czech Civil Code**" or "**CzCivC**") defining security rights (S. 544 to 558 of the CzCivC, entitled Security Interests (in Czech *zajištění závazků*)). The "security rights" listed in that sub-title include not only the **pledge** (S. 152 to 174 CzCivC), the **security transfer** (S. 553 CzCivC), the **security assignment** (S. 554 CzCivC), and the **guarantee** (S**.** 546 to 550 CzCivC) - i.e. "proper" security rights, reducing the risk that the creditor takes by either ring-fencing certain assets in his or her favour to the exclusion of other creditors (the pledge and the security transfer or security assignment), or by adding an extra personal credit risk to that of the primary debtor (the guarantee). The subtitle also lists among "security rights" the **contractual penalty** and the **acknowledgement of a debt** - i.e. contractual institutes that, although they may improve the creditor's procedural position by lightening the burden of proof as regards the amount of damages or the existence of the claim as such, do not function as security interests in terms of reducing the credit risk involved at all.

1.2. Rights in security

In spite of this confusion, this article will focus solely on security rights proper, i.e. the **pledge** (in Czech *zástavní právo*, a term used uniformly in respect of charges over immovables, movables and incorporeal assets, whether created by contract, by law or by a judicial or other official decision), as well as the **security transfer** and the **security assignment** (in Czech *zajišťovací převod práva* and *zajišťovací postoupení pohledávky* - transfer of title or other right and assignment of a claim by way of security, in each case subject either to the assignee's obligation to transfer the title, right or a claim back upon the

performance of the secured obligation, or to an equivalent condition subsequent).[1] These are the three basic types of security that I will have in mind when talking about security rights generally. Other title finance techniques, such as financial leasing, the repo, and retention of title will be mentioned in passing where relevant. An additional security right, a **retention right** (S. 175 to 180 CzCivC) will be discussed occasionally,[2] in particular in the part dealing with priorities. To the contrary, as a rule, the article will not deal with statutory pledges arising in commercial situations that would normally be described in English as the landlord's or mechanic's lien, etc.. Since personal security is not the subject of this article, guarantees and bank guarantees will not be discussed either.

Set-off, which can be viewed as a security device in its own right, will not be discussed beyond this general introductory part. The right to off set obligations against claims is the statutory default rule in Czech law of obligations (S. 580 and 581 CzCivC). One therefore does not have to bargain for the right, which could also be the reason for the right not being subject to publicity requirements. However, current Czech insolvency law nevertheless prohibits set-off against a debtor who has been declared bankrupt. Interestingly, this rule will change to a less restrictive rule (although not a complete reversion of the current prohibition) in 2007 when the new Czech Insolvency Act takes effect (more on this in part 2 below).

1.3. Identity of parties to secured transactions

In general, and save for financial collateral which will be dealt with separately, there are no limitations on the identity of either the chargor or the chargee. (These terms will be used as the general description of the party granting security and the party accepting security, respectively. Where a distinction between the pledge on the one hand and the security transfer or the security assignment on the other hand needs to be pointed out, I will use the terms pledgor and pledgee, and transferor and transferee or assignor and assignee, respectively). In line with the general focus of this article, and save for the part on consumer law below, I will assume that both the chargor and the chargee are businesspeople.

There is no need for the chargor to be at the same time the debtor - with the exception of the security transfer where Czech law (S. 553(1) CzCivC) curiously insists on the chargor and the debtor being the same person. This can of course be circumvented by the chargor becoming a guarantor of the debtor's obligations. This arrangement is actually preferred by the market for all grants of security by a person who is not at the same time the primary debtor.

Without the owner's consent, a non-owner of the pledged asset may only create a pledge if the asset in question is a movable and if the movable is physically delivered to a *bona fide* pledgee (S. 161 CzCivC). The law is silent on this point as regards the security transfer. One must therefore turn to the general rule on the terms of acquisition of title from a non-owner. These can be found in S. 446 of Act 513/1991 Coll., as amended (the "**Czech Commercial Code**" or "**CzComC**") for movables and in S. 20 of Act 591/1992 Coll., on Securities (the

[1] Judgment of the Czech Supreme Court 29 Cdo 1969/2000-73 of 28th November, 2001

[2] This is not to be confused with retention of title clauses. A retention right under CzCivC is a security right in rem that arises by unilateral declaration of will by any bona fide bailee who would otherwise be obligated to return a movable thing. The right may only secure a debt due and payable to the bailee by the person to whom the bailee is obligated to return the movable.

"**Czech Securities Act**" or "**CSA**"), for securities.[3] The rules are similar and allow a *bona fide* purchaser (of movables) or acquirer (of securities) to obtain title from a non-owner of a movable (as between merchants)[4] or a security (irrespective of the identity of the parties). Since, as was mentioned above, a security transfer may only be made by the debtor, i.e. a party who received something (a loan) in consideration of the grant of the security, there seems to be a good reason to think that one should be able to apply S. 446 CzComC or S. 20 of the Czech Securities Act in the context of a security transfer of a movable or a security by a non-owner debtor. There is, however, no case law on the point.

2. Economic impact of rights in security

The long and fierce discussion in financial economics and the economic analysis of law on whether or not security interests and, in particular, the priority that they (tend to) give to secured creditors in insolvency, are efficient or not, and therefore should be supported or limited by the law,[5] has gone on largely unspotted by the Czech academic community. Yet this has not prevented the Czech Parliament from introducing, in 2000,[6] a regime of limited priority of secured creditors in insolvency. Under current Czech insolvency law, a secured creditor will have no control over the time or manner of enforcement of the security, he or she will not be compensated for the time value of money while he or she waits for the administrator (whose choice he or she will not be able to influence) to enforce the security, and at the end of the process, he or she will not receive more than 70 percent of the proceeds of the enforcement, less costs and expenses. See Section 28(4) of Czech Act 328/1991 Coll., on Bankruptcy and Composition (the "**Czech Bankruptcy and Composition Act**" or "**CzBCA**").

It should be noted that the rule caps secured creditor satisfaction at a percentage of the proceeds of enforcement, not, as has been proposed in the literature advocating partial priority on efficiency (rather than redistribution) grounds, at a percentage of the claim owed.[7] It is obvious that such a rule can be easily circumvented by over-collateralisation, and anecdotal evidence from the Czech credit market seems to suggest that this has indeed been the market's response to the rule. Also, the rule catches the pledge as well as the security transfer and security assignment, but does not catch retention of title clauses or financial leasing. It therefore allows regulatory arbitrage between various functional equivalents.

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[3] The term "security" as used here refers to a share, a bond or a bill of exchange and the like, not a security right.

[4] This bracket is a simplified statement of the law on this point but will have to do for the purposes of this article. The rules on when one should apply the Czech Civil Code and when the Czech Commercial Code to obligations are complex and controversial. See S. 261 and 262 CzComC.

[5] For relatively recent reviews of the literature in the field, see Bowers, J.W., Security Interests, Creditors' Priorities and Bankruptcy, Chapters E and F, Encyclopedia of Law and Economics, 1999, available at: http://encyclo.findlaw.com. A more detailed survey, including detailed discussion of the various schools of thought, can be found in Siebrasse, N., A Review of Secured Lending Theory, 1997, available at: http://www.law.unb.ca/Siebrasse/Download.

[6] Act 105/2000 Coll.

[7] see, for example, Bebchuk, L.A., Fried, J.M., The Uneasy Case for Priority of Secured Claims in Bankruptcy, 105 The Yale Law Journal 857 (1996), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=417960; Bebchuk, L.A., Fried, J.M., The Uneasy Case For the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics, 82 Cornell Law Review 1279 (1997), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=55559

The rule has been persistently criticised, in particular by the credit industry, whose representatives seem to take the view that, by violating the creditor's bargain *ex post*, the rule on partial priority increases the cost of debt finance to local debtors *ex ante,* without creating any significant efficiencies as a worthwhile trade-off.[8]

When a recent attempt to remove the partial priority rule, sponsored by the credit industry, failed in early 2005,[9] it was because of fierce opposition from left-wing Parliamentary factions. It is notable, however, that neither the proponents nor the opponents of the change furnished any credible evidence of the actual effects of the rule in the Czech credit market.

In spite of the previous deadlock in the Parliament over the issue, and in spite of the lack of empirical research on the topic,[10] the Czech Parliament did eventually change the rule on priority of secured creditors in insolvency, as part of the new Czech Insolvency Act 182/2006 Coll., promulgated in May 2006 (the "**Czech Insolvency Act**" or "**CzIA**"). As will be described in more detail below, the new Czech Insolvency Act will, as of 1st July, 2007, effectively reintroduce full priority of secured creditors in Czech insolvency proceedings. Although the Czech Republic is not the only jurisdiction that has experimented with partial priority,[11] it is probably one of the very few jurisdictions, if not the only one, that will have introduced and abolished partial priority of secured creditors within less than 10 years. The effects of these reforms on the Czech credit market should prove to be fertile ground for further economic and legal research.

3. General Principles

3.1. Publicity

[8] This is the classical creditors' bargain view, presented among others by Jackson, T.H., Kronman, A.T., Secured Financing and Priorities Among Creditors, 88 Yale Law Journal 1143 (1979). A newer treatment can be found in, for example, Schwarcz, S.L., The Easy Case for the Priority of Secured Claims in Bankruptcy, 47 Duke Law Journal 425 (1997) , available at: http://www.law.duke.edu/journals/dlj/articles/dlj47p425.htm

[9] MP bill 635, withdrawn from the Czech Lower House on 18th February, 2005

[10] In fairness, the failure of the Czech academic community to produce empirical research on this extremely important topic is not an exception among other nations, rather, it seems to be the rule. The only treatment of the topic in Europe that I am aware of can be found in Bergström, C., Eisenberg, T., Sundgren, S., On the Design of Efficient Priority Rules for Secured Creditors: Empirical Evidence from a Change in Law, 18 European Journal of Law and Economics 273-297 (2004), analysing the ex post effects of a partial priority rule introduced in Finland in 1993. Bergström, Eisenberg and Sundgren found substantial wealth re-distribution from secured to unsecured creditors post-reform; however, they found no efficiency effects in terms of Finnish insolvency proceedings yielding more to creditors in general after the reform than before. Importantly, they did not analyse the ex ante effects of the reform - i.e. the effects on the cost of debt finance in the credit market. The perils of this difficult venture are recorded in Bradley, M., Rosenzweig, M., The Untenable Case for Chapter 11, 101 Yale Law Journal 1043 (1992), and in particular in the critique by Warren, E., The Untenable Case for Repeal of Chapter 11, 102 Yale Law Journal 437 (1992).

[11] Others that I am aware of include Slovakia, Hungary, Germany, Finland and England (post-Enterprise Act 2002). See (in Czech) Richter, T., Základní stavební kameny vládního návrhu insolvenčního zákona, část II., Právní fórum 12/2005, ASPI Prague, 2005, pg. 482 and the following.

Czech law is ambivalent as regards the requirement that security rights be publicised. The line is drawn between the pledge that requires publication (with the exception of a pledge over claims) and the security transfer and security assignment, that do not require publication (except where the transfer of title to the underlying asset is subject to public registration, such as with respect to most immovables). Other title financing devices, such as financial leasing or retention of title clauses do not require publication either. Although this is probably not very different from some other European jurisdictions, there is a clear tension here between the policy against *false wealth* that buttresses the requirement of publication of pledges and the fact that the law allows functional equivalents of the pledge to operate unpublicised.

There are two main registers that achieve publicity - the Land Register (in Czech *katastr nemovitostí*) maintained by the cadastral offices (in Czech *katastrální úřady*) in respect of land, (most) buildings, and apartments, and the Pledges Register (in Czech *Rejstřík zástav*) maintained by the Czech Chamber of Public Notaries (in Czech *Notářská komora České republiky*) in respect of buildings not registered in the Land Register, movables, and enterprises.[12] There are separate registers for book-entry securities and for industrial property rights, as well as for aircraft and ships which are, however, not the subject of this article.

The Pledges Register is considered to work reasonably satisfactorily by the market. While the notaries will often lack flexibility and commercial understanding, once one agrees the terms of the pledge with the notary and the notary draws up the notarial protocol into which the pledge agreement is incorporated (more on this below), the pledge is registered in the Pledges Register immediately. Quite to the contrary, the Land Register may take many months to record the pledge over immovables. The pledge will be recorded as of the date of the filing of the petition (i.e. retroactively), however, since the Land Register may refuse the pledge agreement on substantive as well as technical grounds, this delay will expose parties to risk.

3.2. Specificity

Specificity appears in Czech law of security rights partly as a general requirement of contract certainty and partly as a question of the definition of a thing (in Czech *věc*) in the legal sense.

In respect of buildings, the Czech Supreme Court has held that a structure comes in existence as a thing in the legal sense of the word as soon as the first floor above ground takes its clear and unmistakable shape.[13] As of this stage of construction (but very likely not sooner), a building under construction may become the subject of a pledge.

Conversely, there is still no clarity in Czech law on the question of the moment as of, and extent to which claims that still do not exist may be given as a pledge, or assigned by way of security. The general view in the market seems to be that one can pledge (as well assign) claims that are yet to arise, as long as one can clearly identify the debtor of the claim and the contract under which the claim will arise. Any attempt to create security rights to non-existing

[12] In addition to the enterprise or business (in Czech podnik), the Pledges Register may also record pledges over other similar aggregated assets (in Czech hromadná věc) or aggregates of assets (in Czech soubor věcí). In this article, the sole focus among these will be on the enterprise charge.

[13] Judgment 20 Cdo 2679/99 of 27th September, 2001.

assets beyond this seems dubious, including the so-called general assignment of future claims.[14]

On the other hand, Czech law allows parties to create an enterprise charge that would, provided that Czech law of enforcement of charges and Czech insolvency law functioned properly, allow the debtor to effectively pledge current assets, including inventories and future claims, which are notoriously difficult to charge otherwise.

3.3. Accessory nature

The Czech pledge is strictly accessory in its nature - its existence depends on the existence of the secured debt.[15] Czech law does not know an abstract pledge. The practical implication of this is that in all pledge agreements, the pledgee will always want the pledge to secure not only the primary (usually contractual) debt that the parties have in mind but also any claim for unjust enrichment that the pledgee may have in case that the primary (usually contractual) obligation turns out to be invalid.

The security transfer and the security assignment look, at first blush, closer to abstract security. However, the transfer of title or assignment of a claim clearly take place in order to secure a debt and therefore, one can expect these types of charges to be of accessory nature as well. There is, however, no published case law on this issue.

One of the challenges to jurisdictions that know neither the trust nor abstract security rights is the structuring of security rights in situations involving multiplicity of creditors, such as syndicated loans. There are no clear answers to this problem under Czech law. The market seems to be using both a structure whereby all creditors and the security agent are owed the secured claims jointly and severally, security being granted to the security agent, and a structure similar to the parallel debt structure used in English law syndicated loans, whereby security is granted to the security agent as security for a covenant made by the debtor to the security agent in parallel to his several obligations to pay each actual creditor.[16]

3.4. Priority

3.4.1. Introduction

The Czech rules on priority are easily the most confused part of Czech law of security rights. This is largely due to the history of this part of the law.

Pre-1989, security rights played only a marginal role because there was (at least legally speaking) no insolvency risk with respect to Czech counterparties.17 One

[14] Similarly (in Czech) Giese, E., Dušek, P., Payne-Koubová, J., Dietschová, L., Zajištění závazků v České republice, 2. vydání, C.H. Beck, Praha, 2003, pg. 179. Also see judgment of the High Court in Prague 9 Cmo 856/99 published in Obchodní právo 6/2000, pg. 32, where the court struck down an attempted "global assignment" of all future claims on grounds of uncertainty.

[15] See (in Czech) Knappová, M., Švestka, J. (eds), Občanské právo hmotné, 3. vydání, svazek I, ASPI, Praha, 2002, pg. 387

[16] see Wood, P., Comparative Law of Security and Guarantees, Sweet & Maxwell, London, 1995, pg. 108

[17] There was no insolvency law in Czechoslovakia between 1st January, 1951, when the Czechoslovak Bankruptcy, Composition and Avoidance Code 64/1931 Coll. of 1931 was repealed, and 1st October, 1991, when the CzBCA took effect.

therefore did not have to deal with security and priorities in the insolvency context, which is of course the only context where priority is really important. Outside insolvency, there was only one way of enforcing security rights - through a court sale. It was therefore not illogical for priority rules to appear not in the Czech Civil Code or elsewhere in substantive law, but in the Czech Code of Civil Procedure ("**CzCCivP**"),[18] as part of the procedural rules on execution.

When the CzBCA was introduced in 1991, it contained its own rules on priority, whereas the rules on priority outside insolvency remained in the CzCCivP. This was in itself interesting (and confusing) because at that time, the Czech Commercial Code, which took effect on 1st January 1992 as a code containing the corporate law as well as the law of commercial obligations, gave the pledgee a right, outside of insolvency and where this was agreed in the pledge agreement, to conduct a private out-of-court sale of the pledged asset (S. 299(2) CzComC). This right of out-of-court enforcement, which was never available to non-merchants,[19] was repealed in 2001 after an alternative way of enforcement of security rights was introduced - an out-of-court, state-regulated auction under the Act 26/2000 Coll., on Public Auctions (the "**CzPAA**"), which took effect on 1st May, 2000. But rather than repealing the CzCCivP's rules on priority and introducing uniform priority rules as a matter of substantive law, the CzPAA introduced priority rules of its own. At least in part, these were inconsistent with those of the CzCCivP.

The Czech priority rules do not therefore depend that much on the type of secured asset, but rather on the way of enforcement and partly also on the type of the security right. This is of course a classical invitation to regulatory arbitrage which is considered bad form by those who care about the efficiency of the law. However, since we must describe the law as it is, and since one cannot really understand Czech law of security interests without understanding its mischievous priority rules, the following text with be primarily organised around the methods of enforcement, not around the types of security rights or the secured asset, as will be the case in other national reports. Where relevant, distinctions among types of security rights and secured assets will be made within the subparts dealing with the various methods of enforcement.

The treatment of priorities in this article will probably be more extensive than in some other national reports. It is my firm conviction, however, that without understanding the rules of priority, in particular where the rules are counterintuitive or simply wrong, one will not be able to understand the true business value and, more to the point, the actual limitations of the business value of, security interests in a given jurisdiction.

3.4.2. Priorities outside insolvency

a) Priorities vis-à-vis general creditors

i. Execution proceedings commenced by a general creditor

[18] Act 99/1963 Coll., as amended.

[19] It is debatable to what extent it was ever really available to merchants either - the prevailing experience seems to be that, at least with respect to immovables, the Land Register was simply refusing to record ownership title of purchasers who acquired title in a sale under S. 299(2) CzComC. Since non-possessory pledges of movables were not feasible at the time, this could mean that S. 299(2)

One of the most striking features of the Czech law of priorities is that, outside insolvency, the secured creditor does not actually enjoy what one could call procedural priority - i.e. the right to decide if and when the security should be enforced. Quite to the contrary, any general executing creditor may commence execution proceedings in respect of the secured asset. The secured creditor can neither prevent nor stop this process (other than by commencing insolvency proceedings); all that he or she can do is passively wait for what the execution proceedings will yield and apply for his or her share of the proceeds. This also means that where general execution proceedings are commenced before the secured creditor commences enforcement of his or her security, the secured creditor is effectively deprived of the choice between the several ways of enforcing security (see subpart (bab) below). The really bizarre thing is that by commencing execution proceedings, a general executing creditor will be able to stop an enforcement of a pledge carried out by way of an out-of-court auction even where the enforcement procedure has already started, right up to the point of the commencement of the actual auction (S. 46(1)(g) CzPAA). In a court sale of a pledged asset, the general executing creditor will not be able to stop a sale commenced by the pledgee. Since the court sale of a pledge is in itself a form of execution proceedings, the execution proceeding that had commenced first will have priority over later applications to commence further execution proceedings.[20]

In execution proceedings commenced by the general creditor, the secured creditor will generally rank ahead of unsecured creditors, but only those unsecured creditors who have commenced execution after the security right had been perfected. In effect, the commencement of execution proceedings creates a sui generis priority in favour of the executing general creditor - security perfected later will be junior to the executing general creditor's claim (S. 331a(1) and 332 CzCCivP for movables; S. 337c(1)(c), 337c(2) and 337c(5)(a) and (d) CzCCivP for immovables). But, where the secured asset is an immovable, the secured creditor will rank behind the costs of the court sale, mortgage loan receivables ear-marked to cover mortgage bonds,[21] and possibly also compensation payable to tenants under leases and to beneficiaries of easements cancelled upon the execution sale, where the lease or the easement pre-dates the security right (S. 337c(1), (2) and (5) CzCCivP). Also, according to case law, where the secured asset is an immovable and a general creditor commences execution after the secured creditor had filed for registration of the pledge but before the pledge was registered, the general executing creditor will be treated as senior to the secured

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CzComC was actually dead law in practice. More empirical research would be needed to verify this hypothesis.

[20] See Act 119/2001 Coll., on rules concerning parallel execution proceedings.

[21] This would effectively only be a concern in the consumer lending context that is not the subject of this article.

claim, irrespective of the rule that pledges over immovables registered in the Land Register arise with effect as of the date of the filing for registration, i.e. retroactively.22 This case law significantly weakens the protection meant to be provided to the property market by the principle of retroactive registration of rights in rem in the Land Register (the case actually dealt with a sale, not with a pledge or real estate). Finally, and rather curiously, the secured creditor will not rank ahead of a general executing creditor where the asset pledged is a claim (other than a claim from a bank account)(S. 314b CzCCivP). In practice, this means that in respect of all claims other than claims for repayment of deposits in bank accounts, the chargee would be well advised to structure the charge as a security assignment, whose priority, unlike that of a pledge over a claim, is respected by S. 314b CzCCivP.

ii. Enforcement commenced by a secured creditor

Where general execution proceedings had not been commenced, the pledgee may choose between two, or more exactly, three methods of enforcing a pledge outside insolvency. The pledgee may enforce a pledge through a court sale (S. 220y to 220za, S. 338a, and S. 338zr CzCCivP) or a sale by a judicial executor (S. 59(3) of Act 120/2001 Coll., on Judicial Executors) on the one hand, or through a non-voluntary public auction under S. 36 and the following of the CzPAA on the other hand. The court sale and the sale by a judicial executor are subject to the same priority rules under the CzCivC whereas the sale in an auction under the CzPAA is subject to separate, and slightly different, priority rules of the CzPAA.

In a court sale or a sale by a judicial executor, the priority rules are those described in subpart (baa) above. In an auction sale under the CzPAA, the pledgee's claims will rank ahead of general claims, but will be subordinated to the costs of the auction and to mortgage loan receivables ear-marked to cover mortgage bonds (S. 60 CzPAA).

Enforcement of the security transfer and the security assignment is not regulated by the law and therefore, where the enforcement is commenced by the secured creditor, there are no priority rules arising from procedural laws that would relate to such enforcement.

b) Priorities among secured creditors

Substantive priorities among pledges and retention rights are governed by the Czech Civil Code.

Generally, a retention right (a security right only applicable to movables, see footnote 2 above) will always trump the pledge as well as the security transfer (S. 179 CzCivC, as reflected in S. 331a(1) CzCCivP and S. 60(2)(a) CzPAA).

[22] Judgment of the Czech Supreme Court 20 Cdo 1058/2003 of 26th May, 2004

The priority among multiple pledges over the same asset will be determined by the time of their perfection (S. 165(2) CzCivC, as reflected in S. 332(2) and 337c(5)(d) CzCCivP).

The Czech Civil Code is silent on the priority relation between the pledge on the one hand and the security transfer and the security assignment on the other hand. Since the later two are merely subspecies of transfer of title, one must look into the rules under which purchasers and other acquirers of assets take subject to security interests. Curiously, there is one exception: in relation to movables sold in a court sale (and, by extension, by a judicial executor), the CzCCivP contains an explicit priority rule under which the priority of both the pledge and the security transfer of movables is to be determined based on the date of the perfection thereof (S. 332(2) CzCCivP).

As was mentioned above, mortgage loan claims ear-marked to cover mortgage bonds[23] will trump the pledge in both the court sale and the out-of-court auction. It is unclear what is the relation vis-à-vis the security transfer.

Finally, CzPAA contains a separate superpriority class, ranking right behind the costs of the auction, reserved for claims secured by a pledge that are to be satisfied in first priority irrespective of their general ranking. At the moment, Czech law probably knows no such type of pledge so the provision is dormant law.[24]

c) Priorities vis-à-vis acquirers of secured assets

The retention right only works as long as the person invoking it keeps holding the relevant movable, so (barring cases where title to a movable sold would pass to a transferee prior to delivery)25 the situation here is straightforward.

The pledge will be effective vis-à-vis each subsequent acquirer of the pledged asset; such acquirer will assume the position of the pledgor by operation of law (S. 164 CzCivC). This will not be a problem in practice since for most assets, perfection of a pledge requires registration in the Land Register, the Pledges Register, or other special registers. Where pledge of a movable is strictly possessory, i.e. not registered in the Pledges Register but rather perfected by mere delivery of the movable to the pledgee or a third party bailee (S. 157(2) and (3) CzCivC), the acquirer of the movable will not, in my view, take subject to the pledge.26

[23] The substantive rules on the ring-fencing of these claims can be found in S. 28 to 32 of Act 190/2004 Coll., on Bonds.

[24] See (in Czech) Winterová, A. (ed.), Civilní právo procesní, 3. vydání, Linde, Praha, 2004, pg. 579

[25] This may be agreed in writing under S. 444 of the CzComC.

[26] Similarly (in Czech) Jehlička, O., Švestka, J., Škárová, M. a kol., Občanský zákoník, Komentář, 9. vydání, C.H.Beck, Praha, 2004, pg. 560

Where a movable is subject to a security transfer and the movable remains in the transferor's possession, a purchaser will obtain clean title is he or she believed in good faith that the transferor was the owner or was otherwise entitled to transfer the movable. See the discussion of S. 446 CzComC in part 1.3 above.

Upon enforcement of the security right, the acquirer's situation again depends on the method of enforcement.

It seems clear that upon a sale of an asset subject to a security transfer by the transferee, the purchaser obtains clean title, just like upon any other sale by an owner.27 Upon a sale of a pledged asset in an auction pursuant to the CzPAA, the pledge securing the oldest proven secured claim, as well as all pledges securing claims younger than that claim, will extinguish upon the sale, with all the claims secured by these pledges becoming due an payable (S. 58(1) CzPAA). Conversely, pledges securing claims older in time than the oldest proven secured claim will not extinguish upon the sale, the claims secured by these pledges will not become due and payable by virtue of the sale, and the acquirer takes subject to these pledges (S. 58(2) CzPAA).[28] In a court sale of a pledged movable under the CzCCivP, the pledge, as well as all other encumbrances, will extinguish upon the sale (S. 329(3) CzCCivP). This will be the case for immovables as well (S. 337h(1) CzCCivP), except that here, save for instances where the pledgee expressly insists on getting the secured claim paid, the purchaser of the pledged immovable may elect to take over the secured debt instead, in which case the pledge will not extinguish (S. 336g CzCCivP).

3.4.3. Priorities in insolvency

In commercial practice, it would be quite unlikely that security would be enforced outside of insolvency. It is much more likely that before enforcement is completed, the debtor or another creditor will commence insolvency proceedings.

a) Current insolvency law

In current insolvency proceedings, secured creditors have no control over their security. Upon the declaration of bankruptcy, a stay kicks in and prevents the secured creditors from enforcing security outside

[27] This of course assumes that the asset is not, at the same time, subject to a pledge or other encumbrance.

[28] It seems rather odd that the law would look at the date when the secured claim had originally arisen, rather than the date of the perfection of the pledge. This has indeed been criticised as wrong - see (in Czech) Veselý, J., Rakovský, A., Mikšovský, P., Šimková, R., Zákon o veřejných dražbách, Komentář, C.H. Beck, Praha, 2001, pg. 684.

of the bankruptcy proceedings (S. 14(1)(e) CzBCA).29 The administrator, who will decide, subject to court approval and subject to the recommendation of the creditors' committee, on the method as well as the timing of the enforcement, will control the security. Secured creditors will not be compensated for the time value of money while their enforcement rights are suspended.

i. Priority vis-à-vis general creditors

As was already mentioned in part 2 above, current Czech insolvency law is based on partial priority of secured creditors vis-à-vis general unsecured creditors. A secured creditor will not receive more than 70 per cent. of the proceeds of the enforcement, less costs and expenses (S. 28(4) CzBCA). However, the proceeds up to the 70 per cent. limit will be paid out ahead of the payment of the general dividend at any time during the proceedings, subject only to court approval (S. 28(2) and 31(1) CzBCA). For the remaining part of the proceeds, the secured creditor will rank pari passu with general creditors (ditto). Importantly, the costs and expenses are cost and expenses incurred in the maintenance, management and sale of the secured assets (S. 28(2) CzBCA), which can be non-trivial. However, based on recent case law, they should not include claims arising out of post-petition financing or other contracts.[30]

ii. Priorities among secured creditors

Among themselves, the secured creditors will rank based on the date of the perfection of their security (S. 28(3) CzBCA).

iii. Contractual subordination

The CzBCA recognises subordination clauses (S. 32(6) CzBCA).

iv. Priorities vis-à-vis post-commencement creditors

The ranking of secured creditors as regards post-commencement claims (administrative priorities) is not clear. Both may be paid out prior to the payment of the general dividend (S. 31(1) CzBCA). The law is not clear on what happens if there is not enough money to pay both in full. According to case law, where the secured creditor received, prior to the distribution of the general dividend, less than the 70 per cent. entitlement, he or she must be paid the deficit up to the 70 per cent. upon the distribution of the general dividend,

[29] Quite curiously, the stay is not expressed so as to extend specifically to enforcement of security. The provision cited stays execution and prevents new security rights from being perfected. However, since the court sale and a sale by a judicial executor are subspecies of execution proceedings, the provision functions as a bar of these methods of enforcement of security. The introduction of the CzPAA was never actually reflected in the stay provision of the CzBCA but one must assume that Section 14 would be extended by the courts to bar enforcement through an out-of-court auction as well.

[30] Judgment of the Czech Supreme Court 32 Odo 175/2005 of 19th April, 2006.

presumably ahead of more junior classes of creditors.[31] However, neither the judgments nor the law give a satisfactory answer to the question of who has priority if there is not enough money to pay both the post-commencement claims and at least the 70 per cent. entitlement of secured creditors, not to mention other, more junior classes. I think that the priority must go to the secured creditor, rather than the post-commencement creditor, however, this is subject to debate.

v. Priority vis-à-vis acquirers of secured assets

On a sale in bankruptcy, all security rights over the asset sold will terminate, irrespective of whether the secured creditor filed a proof of claim or not and irrespective even of whether the security rights secures a debt owed by the bankrupt debtor, or by a third party (S. 28(5) CzBCA). The purchaser in bankruptcy therefore always obtains clean title.

vi. Priorities in composition proceedings

What was said above applies to bankruptcy proceedings (in Czech *konkursní řízení*), which is the liquidation chapter of the CzBCA. As follows from its name, the CzBCA has a composition chapter as well (in Czech *vyrovnací řízení*), which should allow debtors to restructure their liabilities without a sale of the assets. The composition chapter is a grossly inadequate piece of legislation and is rarely used. One of the reasons may be the fact that the part of the law is extremely unclear as to priorities (S. 54 CzBCA which in its current form is almost unintelligible). However, there is little doubt that the 70 per cent. limitation does not apply in composition, that there is no stay of the secured creditors' enforcement rights, and that, unless they agree, secured creditors may not be negatively affected by the terms of the composition (S. 60(1)(a) CzBCA). Quite to the contrary, it is totally unclear what is the situation upon a sale of an asset subject to a security right as part of the composition. Nor does the composition chapter contain a clear rule on the priority among secured creditors or on subordination.

b) New insolvency law

As was mentioned in part 2 above, as of 1st July, 2007, the new Czech Insolvency Act will take effect.

Procedurally, secured creditors' enforcement rights will be stayed earlier than under CzBCA. The stay will kick-in already upon the filing of a petition (S. 97 and 109 CzIA). This is because the fact that a petition has been filed will be publicised through an on-line insolvency register within 2 hours of the filing (S. 101 CzIA) and the estate will accordingly need to be protected against a risk of a run that could ensue if the stay first kicked in upon the insolvency order

[31] Judgment of the Czech Supreme Court 29 Odo 519/2001 of 30th April, 2002.

being handed down, as is the case under the CzBCA. In bankruptcy proceedings (in Czech *konkursní řízení*), creditors secured by an asset will newly be able to jointly instruct the administrator as regards the realisation of the asset. The administrator may turn to court to decide on the instruction if the administrator believes that the charged asset may be realised more advantageously (S. 293 CzIA).

i. Priority vis-à-vis general creditors

As regards the substantive priority relation between secured and general creditors, the CzIA will basically return to a regime of full priority of secured claims. The general rule is expressed in S. 167(1) CzIA whereunder secured creditors shall be satisfied out of their security. The particular rule for the bankruptcy chapter is contained in S. 298 CzIA, which contains items deductible from the proceeds payable to the secured creditor, comprising the costs of sale and of maintenance of the secured asset (capped at 5 and 4 per cent., respectively) and the administrator's fee, to be determined by sub-statutory regulation. In the reorganization chapter (in Czech *reorganizační řízení*), the principle of full priority is reflected in the "absolute priority rule" of S. 349(1) CzIA that provides that a reorganization plan may only be approved over the objection of a class of secured creditors if that class receives equivalent security and distributions whose net present value shall be at least equal to the value of their security, as determined by an external valuer (S. 153 to 157 CzIA).

ii. Priorities among secured creditors

Among themselves, the secured creditors will rank based on the date of the perfection of their security, however, the new law will allow them to modify this rule by agreeing otherwise in writing (S. 299(1) CzIA).

iii. Contractual subordination

The CzIA will recognise subordination clauses (S. 172(2) and (3) CzIA).

iv. Priorities vis-à-vis post-commencement creditors

The CzIA also contains new rules on the relation between secured creditors and post-commencement claims. S. 305(2) CzIA gives clear priority to secured creditors over all kinds of post-petition claims in bankruptcy proceedings. In reorganization, post-commencement claims must, as a general rule, be paid upon the approval of the reorganization plan at the latest, unless the relevant claimant agrees to a less favourable treatment (S. 348(1)(e) CzIA). Since the plan must be either approved by secured creditors or comply with the requirements of S. 349(1)(here, the absolute priority rule works vis-à-vis post-commencement claims as well as junior

pre-commencement creditors), secured creditors should not be involuntarily subordinated to post-commencement claims. There is, however, one exception. If the debtor seeks post-commencement financing (S. 41(1) CzIA), current secured creditors will have a pre-emptive right to provide such financing if they offer terms matching the best alternative offer (S. 41(2) CzIA). However, if they decide not to lend or if a third party offers better terms, such third party's post-commencement claim will rank *pari passu* with the secured creditors' claims (S. 357(2) CzIA). This means that the secured creditors will in effect have to share their security with the new post-commencement financier which should encourage them to provide post-commencement finance in the first place.

3.4.4. Other general principles of priority

I have not treated several security interests and equivalents above, which I will mention briefly now.

c) Enterprise charges

Enterprise charges were not mentioned partly because the current law of their enforcement outside bankruptcy is so confused as to prevent feasible enforcement of the charge outside bankruptcy and partly because the automatic rules of the CzBCA on termination of security post-commencement mean that, in effect, an enterprise charge is not insolvency-proof.[32] The non-insolvency problems will remain until the confused provisions of the CzCCivP are replaced with a sensible code of civil procedure or, better still, with new substantive law of security interests. However, the CzIA will bring new rules on security interests over aggregate assets that might actually mean that the enterprise charge, currently largely a dormant feature of Czech law, will spring to life. The CzBCA contains rules on a 2-months hardening period for security and on automatic termination of security interests acquired post-commencement (S. 14(1)(e) and (f) CzBCA) that currently make the enterprise charge useless in bankruptcy. The CzIA will repeal these and will replace them with a safe-harbour provision, sheltering the enterprise charge from the new avoidance provisions (S. 241(3)(d) CzIA). This will be a huge improvement to the position and priority of the enterprise chargeholder. On the other hand, since assets acquired out of post-commencement financing will not be caught by the enterprise charge (S. 42(1) CzIA), there could arise some new problems and uncertainties as to the scope of the charge, certainly where post-commencement financing were to be provided by a person different from the enterprise chargeholder.

[32] A detailed treatment of these problems (in Czech) can be found in Richter, T., Zástavní právo k podniku z pohledu teorie a praxe dluhového financování - 1. a 2. část, Právní rozhledy 3, 4/ 2004, C.H. Beck, Prague, 2004

d) Retention of title clauses

Retention of title clauses are currently not regulated by the CzBCA and they thus in effect give the seller full priority via the action to have the asset subject to the clause removed from the list of the estate's assets and released to the owner (S. 19(2) and (3) CzBCA). The bankruptcy chapter of CzIA contains a new rule on them in S. 260 CzIA. Under S. 260(2), the administrator may prevent the seller from repossessing the goods sold subject to a retention of title by fully paying up the debtor's debt without undue delay after having been served with the seller's demand. Although this looks like a limitation on the seller, it might actually improve the seller's position. Instead of having to repossess and try to sell the goods elsewhere (which is no doubt a costly process) the seller might, if the administrator wishes to keep the goods, actually get paid in full ahead of everybody else, and even net of the deductions that secured creditors would face under S. 298 CzIA, discussed in section (cba) above. The reorganization chapter contains no similar rule so the seller will be able to repossess, similarly as currently under the CzBCA.

e) Financial leasing

For a long time, it was unclear if, as a matter of Czech contract law, financial lease agreements are or are not to be treated as *nominate* lease agreements under the CzCivC. In 2003, the Czech Supreme Court ruled that financial lease agreements are *innominate* contracts, i.e. not lease agreements under the CzCivC.[33] This has a bearing on their treatment in bankruptcy and on issues related to priority. Being *innominate* bilateral contracts that will, as a rule, not be fully performed by either party as of declaration of bankruptcy over the debtor (i.e. the lessee under the financial lease), they will be subject to the bankruptcy law's rules on executory contracts.

Under the CzBCA, each party may terminate such contracts (S. 14(2) CzBCA). The technical legal effects of such termination will depend on whether the agreement is governed by the Czech Civil Code or the Czech Commercial Code, however, in both cases, there is a risk that if the administrator terminates the lease agreement, the parties will have to return mutual performance. This means that the lessor will be able to repossess the object of the financial lease, however, he or she may be asked to return the instalments received from the lessee over the life of the lease. The lessor will very likely have a claim for unjust enrichment against the lessee who had, after all, used the object of the lease throughout the lifetime of the agreement. However, given that set-off is forbidden in bankruptcy (S. 14(1)(i) CzBCA), the lessor will not be able to off set this claim against his or her obligation to return the instalments paid by the lessee. The result of this analysis would be very unsatisfactory from the point of view of the lessor's priority and the larger question to

[33] Judgment 30 Cdo 2033/2002 of 27th November, 2003

what extent is financial leasing insolvency-proof under current Czech bankruptcy law. The point regarding the return of the performance is highly controversial and there are no reported judgments on this issue.

The new insolvency law will have a different regime for financial lease agreements. First of all, S. 259 CzIA provides that, in bankruptcy proceedings, financial lease agreements are to be treated similarly as general lease agreements. Secondly, S. 257 will prevent the lessor, after the lessee has been declared insolvent, from terminating the financial lease agreement on grounds of payment default pre-dating the opening of proceedings or on grounds of deterioration of the lessee's financial situation. This means that where the lessor does not terminate prior to the lessee being declared insolvent and where the administrator resumes paying instalments after such declaration, the lessor will in effect be unsecured as regards unpaid pre-commencement instalments, for which he or she will have to file an ordinary proof under S. 256(3) CzIA.

On the other hand, the CzIA reduces the termination risk described above. By giving the administrator the right to terminate the financial lease agreement with 3-months notice (S. 256(1) CzIA), the CzIA arguably bars the administrator from terminating in some other way that might involve the risk that instalments would have to be returned. Claims for instalments accruing after the lessee has been declared insolvent and before the termination notice takes effect should be treated as post-commencement priority claims (S. 168(2)(g) CzIA).

The reorganization chapter contains no rules on executory contracts or on leases, so financial leases should be unaffected by reorganizations and therefore, allow repossession.

f) Repos

Repos entered into under market-standard master netting agreements[34] will be subject to close-out netting provisions of the relevant master netting agreement, that will be recognized and protected by both the CzBCA (S. 14(7)) and the CzIA (S. 366(2)). Non-standard repo agreements will be subject to the law on executory contracts or, where the contract is not executory (because one party has performed all of its obligations under it) on security transfers.

3.5. Other general principles and features of importance in the legal system

3.5.1. Exclusivity

As regards the priority vis-à-vis third party acquirers of the charged assets, please turn to the relevant sections in part 3.4 above.

[34] S. 197 of Act. 256/2004 Coll., on Capital Markets (the "**Czech Capital Markets Act**" or "**CCMA**")

3.5.2. Prohibition of appropriation

Section 169(e) of the Czech Civil Code prohibits agreements whereby the pledgee may appropriate the pledged asset. The one exception is in respect of shares in limited liability companies, which will be discussed below.

Section 169(e) does not, prima facie, apply to the security transfer and the security assignment. On the one hand, the transferee or the assignee obtains full title and therefore, it should not be impossible for the parties to agree that, upon default, he or she may keep the title in satisfaction of the secured obligation. On the other hand, the transfer of the title or the assignment are made by way of security and one can imagine an argument that such an agreement would be contrary to the nature of the transfer and the transferor's or the assignor's residual interest in the subject of the transfer or assignment. There is no reported case law on the question.

3.5.3. Obligation to refund the surplus

Since the pledge may only be enforced out of insolvency through the state-controlled methods described in part 4 above, the surplus will be under the control of the court bailiff, the judicial executor or the licensed auctioneer whose responsibility it will be to release any surplus to the pledgor.

There is no explicit provision on this for the security transfer and the security assignment, however, the transferee or assignee would clearly have an implied duty to return any surplus to the transferor or assignor.

3.5.4. Over-collateralisation

There are no provisions on over-collateralisation. Quite to the contrary, as mentioned in part 2, over-collateralisation seems to be the market's response to the current bankruptcy rule on partial priority.

4. Consumer protection

The Czech Consumer Credit Act 321/2000 Coll., contains no provisions on security interests. In the quite unlikely case that a security agreement were to be entered into with a consumer as a distance contract, the Czech Civil Code's rules on distance marketing of consumer financial services would apply (S. 54a to 54d CzCivC). These are based on the relevant European directives.

As of 1st July, 2007, the new Czech Insolvency Act will introduce a completely new avenue of insolvency proceedings - the discharge (in Czech *oddlužení*). To get into the discharge proceedings, the debtor will have to convince the court that he or she will be able to pay at least 30 per cent. of its unsecured claims (S. 395(1)(b) CzIA). The discharge proceedings, available *inter alia* (but not exclusively) to consumers, will in effect allow the debtor to get a discharge of a part of his debts in return of surrendering either his current assets or his future income (exceeding the minimum income protected in execution

proceedings) for 5 years (S. 398 CzIA). The choice between these two options will be made by the unsecured creditors (S. 402(1) CzIA).

Importantly for our context, secured creditors will be satisfied out of their security in both methods of discharge (S. 398(3) CzIA); the sale will be conducted pursuant to the relevant rules of the bankruptcy chapter (see subparts b) and i).

5. The rights in security

5.1. Assets which may be subject to security

The catalogue of assets that may be used as a pledge is contained in S. 153(1) CzCivC. At least in theory, the catalogue is not closed since one of the items reads "[a claim or] other property right whose nature allows it [to serve as a pledge]". In reality, provisions on perfection and the fact that there is a closed and very limited catalogue of ways of enforcement make it quite difficult to use that provision to take a pledge over other assets than those listed in S. 153(1). These are:

- corporeal movables (in Czech *movité věci*),
- immovables (in Czech *nemovitosti*),
- an enterprise (in Czech *podnik*) or other aggregated assets (in Czech *věci hromadné*),
- aggregates of assets (in Czech *soubory věcí*),
- claims (in Czech *pohledávky*),
- apartments (in Czech *byty*) or non-residential premises (in Czech *nebytové prostory*), if they are registered as independent immovables in the Land Register, which is possible under the Act. 72/1994 Coll., on ownership of apartments,
- shares in companies other than a joint-stock company (in Czech *obchodní podíl*),
- securities (in Czech *cenné papíry*), and
- industrial property rights (in Czech *předměty průmyslového vlastnictví*).

The security transfer may be used to transfer title or other right by way of security. The security assignment is reserved specifically for the security assignment of claims.

5.2. Form, creation and termination of the security

5.2.1. General

The pledge agreement, the security transfer agreement and the security assignment agreement all require written form (S. 156(1), 553(2) and 524(1) CzCivC). There are further perfection requirements that will be mentioned below.

Deliberate termination of a pledge requires a written unilateral declaration by the pledgee (S. 170(1)(c) CzCivC). Deliberate termination of the security transfer and the security assignment would be subject to the terms of the relevant contract.

5.2.2. Security over immovable property

All land is registered in the Land Register. Most buildings and structures are as well. So are apartments and non-residential premises in buildings that were legally divided into individual apartments. All of these may be taken as pledge. The pledge will be perfected upon registration in the Land Register (S. 157(1) CzCivC). On the retroactivity of the registration and uncertainties as regards priority, see part a)i above.

Some buildings and structures are not registered in the Land Register. These may be taken as pledge as well. The pledge will be perfected upon registration in the Pledges Register (S. 158(1) CzCivC) and the pledge agreement requires the form of a notarial record (S. 156(3) CzCivC).

All of the above-mentioned assets may be charged by way of the security transfer. For immovables registered in the Land Register, the charge would be perfected upon the registration of the transfer in the Land Register (S. 133(2) CzCivC). The reason why this alternative is used very rarely in the market is tax - the transfer would most likely be subject to security transfer tax.

5.2.3. Security over corporeal movable property

There are two ways of perfecting a pledge over a corporeal movable - the possessory way and the registration way. Under the former method, the pledge is perfected by way delivering the pledged corporeal movable to the pledgee or a third party acting as a bailee on behalf of the pledgee or the pledgor (S. 157(2) and (3) CzCivC). Under the latter method, perfection does not require the pledgor parting with possession of the pledged asset - publicity (and perfection) is achieved through registration in the Pledges Register (S. 158 CzCivC). The latter method requires that the pledge agreement be entered into in the form of a notarial record (S. 156(3) CzCivC).

For the difference of these two methods as regards priority, see part c) above.

Corporeal movables property may also be charged by way of security transfer. One occasionally comes across these transfers with respect to fixed movable assets, such as machinery and equipment, however, their incidence has decreased since the non-possessory pledge described above had been introduced in 2000. Where a security transfer is used, one must not forget to deal with delivery in the charge agreement. If not agreed otherwise, title will not transfer to the chargee unless the charged asset is actually delivered to the chargee (S. 443(1) CzComC). The agreement on title transferring prior to delivery must be made in writing (S. 444 CzComC).

Retention of title clauses used to require written form. This requirement was abolished from S. 445 of the Czech Commercial Code as of 1st January, 2005, allegedly on grounds of implementation of Article 4 of Directive 2000/35/EC on combating late payment in commercial transactions.[35] The potential implications (and the potential for abuse) of this change upon insolvency of the purchaser are disturbing. Retention of title clauses do not require publicising. On priority issues, see part d) above.

Being *innominate* agreements, financial leasing agreements do not, strictly speaking, require written form. In practice, these contracts are always made in writing. Financial leasing agreements do not require publicising. On priority issues and other risks on insolvency of the lessee, see part e) above.

5.2.4. Security over claims

A pledge over a claim will be perfected upon the execution of a written pledge agreement (S. 159(1) CzCivC). Notification to the debtor of the claim is not required for perfection, however, until the pledge is notified to the debtor, it will not bind him or her (S. 159(2) CzCivC). The pledge does not require publicising.

The security assignment does not differ from the pledge in this respect. There are important priority differences between the pledge and the security assignment - see part a)i above.

5.2.5. Security over shares and over securities

Czech business corporations other than the joint-stock company (in Czech *akciová* společnost)(the "**a.s.**") do not (and may not) issue shares in the physical sense of the word. Members own shares (or participations) (in Czech *obchodní podíl*) but these are not evidenced by securities. They exist merely in the company's book of shareholders, which is reflected in the Commercial Register - a register of companies and other subjects kept by the judiciary under S. 27 and the following of the Czech Commercial Code. Commercially, the most important company of this kind is the limited liability company (in Czech *společnost s ručením omezeným*) (the "**s.r.o.**").[36]

Each member in a s.r.o. may only own one share (S. 114(2) CzComC). The share may be pledged; the pledge agreement requires written form and the signatures must be officially certified (S. 117a(1) CzComC). The pledge will be perfected upon registration in the Commercial Register (S. 117a(3) CzComC). As a rule, transferability of shares in s.r.o.s will be subject to the approval of general meeting (the statutory default is to be found in S. 115 CzComC). Where this is the case, such approval will also be required for the pledge to take effect (S. 117a(2) CzComC).

Shares in the a.s., as well as other securities, may be pledged subject to the requirements depending on the type of the security. The pledge agreement will generally require written form (S. 39(1) of the Czech Securities Act and S. 156(1) CzCivC). Pledge over certificated bearer securities will be perfected by delivery of the

[35] Act 554/2004 Coll.

[36] It is an incorporated entity with legal personality separate from that of its members and with limited liability of its members, modelled in important parts after the German Gesellschaft mit beschränkter Haftung (see S. 105 and the following of the CzComC).

security to the pledgee (S. 40(1) CSA) or to a third party depositary (S. 41(1) CSA). Pledge over certificated registered securities will, in addition, require a security endorsement (S. 40(2) CSA). Pledge over book-entry securities will be perfected upon the registration of the pledge in the owner's securities account (S. 42(1) CSA).[37] Transferability of registered shares may be limited by the articles, in particular, it may be made subject to the approval of a general meeting or another organ of the company (S. 156(4) CzComC). Where this is the case, such approval will also be required for the pledge to take effect (S. 156(5) CzComC).

Instead of pledging, shares in s.r.o.s and securities may be charged by way of a security transfer of title. The mechanics of the transfer will be quite similar to the perfection requirements for the pledge. In the s.r.o., the transfer agreement will have to be made in writing, with officially certified signatures (S. 115(3) CzComC). The transferee will have to accede to the memorandum of association (ditto). It may be subject to approvals by corporate bodies. For certificated registered securities, the endorsement will be a transfer endorsement, not a security endorsement. With book-entry securities, the charged security would be transferred to the transferees' securities account.

5.2.6. Security over industrial property rights

As follows from S. 153(1) CzCivC (see part 5(1) above), industrial property rights may serve as a pledge.

The special acts on industrial property rights are not uniform in the way they treat this question.

There is clarity on the perfection requirements for pledges of trade marks and of industrial designs. S. 17 of Act 441/2003 Coll., on trade marks, acknowledges that a trade mark may serve as a pledge and provides that the pledge is perfected upon registration in the Trade Marks Register (in Czech *rejstřík ochranných známek*), maintained by the Office of Industrial Property (in Czech *Úřad průmyslového vlastnictví*) (S. 17(3) and 2(a) of the Act). Similarly, Act 207/2000 Coll., on industrial designs, acknowledges that an industrial design may serve as a pledge and provides that the pledge is perfected upon registration in the register maintained by the Office of Industrial Property (S. 31(1) and 1(1) of the Act).

On the contrary, S. 8(4) of Act 452/2001 Coll., on protection of appellations of origin and geographical appellations expressly provides that a registered appellation of origin may not be pledged.

There is uncertainty as regards patents and utility models. Neither the Patents Act 527/1990 Coll., nor the Utility Models Act 478/1992 Coll., provide anything about the susceptibility of patents and utility designs to being pledged, nor about perfection requirements or the registration of pledges in the relevant registers. The better view is

[37] A system of indirect holdings of securities is envisaged by the Czech Capital Markets Act, it has not, however, been implemented yet. In practice, a pledge over book-entry securities will have to be registered at the owner's securities account with the Securities Centre (in Czech středisko cenných papírů), a kind of central depositary for Czech book-entry securities, but without the market discipline. The process can be slow and frustrating and, especially where the pledgee is a foreign company, it will require a seemingly endless load of apostilled powers of attorney and extracts from company registers. Allow enough time for this process.

that this silence does not mean that patents and utility models may not be pledged. One should still apply the general rule of S. 153(1) CzCivC (see also S. 154 CzCivC, providing that the Czech Civil Code's provisions shall apply to pledges of *inter alia* industrial property, unless special acts which govern such pledges, provide otherwise). Admittedly, there is uncertainty as regards the registration of the pledge. One would most probably have to look to the provisions on transfer of patents and utility models. S. 15 of the Patents Act, cross-referred to in S. 21(2) of the Utility Models Act, requires registration of a transfer agreement of a patent or a utility model as a condition of the transfer taking effect vis-à-vis third parties. It seems reasonable to conclude, by analogy, that the perfection requirement in respect of pledging a patent or a utility model would be the same. Helpfully, the catalogues of facts and circumstances subject to registration in the patents and utility models registers are not closed.[38]

Instead of pledging, one could charge industrial property rights by way of security transfer. The transfer would take effect vis-à-vis third parties upon the registration in the relevant register maintained by the Office of Industrial Property.

5.2.7. Enterprise charge

The enterprise charge requires the form of a notarial record (S. 156(3) CzCivC). It will be perfected upon the registration in the Pledges Register. For a description of the current problems with priority of the enterprise chargeholder, see part 3(4)(da). Briefly, the problem is that under current law, the enterprise charge never really "crystallises" which, combined with the automatic rules of the CzBCA prohibiting the creation of new security interest, means that by the time the enterprise is sold in bankruptcy, the current assets belonging to the enterprise, such as inventories and claims, may not be subject to the charge at all.

5.3. Sums and events which may be secured

Pledges may secure claims for money as well as non-monetary obligations (S. 155(1) CzCivC). Where a non-monetary obligation is secured, the limit is expressed as the usual price such of obligation as of the time of perfection of the pledge (S. 155(2) CzCivC). Pledges may secure both existing and future claims, as well as claims of certain type that will arise up to a certain date in the future, up to an agreed amount (S. 155(3) and (4) CzCivC).

The law is silent on this parameter for the security transfer and the security assignment. One is therefore limited only by the general requirement of contract certainty.

5.4. Rights and duties of creditor and debtor

The pledgee who is in possession of the pledged asset may possess it throughout the lifetime of the pledge. He or she must keep it with due care and must protect it against damage, loss and destruction. He or she will be entitled to have his or her costs reimbursed by

[38] See S. 16 of Regulation 550/1990 Coll. for patents, S. 20 of the Utility Models Act for utility models.

the pledgor (S. 162(1) CzCivC) but will also be liable as a general bailee to the pledgor for damage to the pledged asset (S. 162(3) CzCivC).

The pledgee will only be authorised to exploit the pledged asset and to appropriate its accretions and fruits where this has been agreed to by the pledgor (S. 162(2) CzCivC). The pledgor may not exercise rights pertaining to pledged securities, unless the law or a contract provide otherwise (S. 43(5) of the Czech Securities Act). The better view is that in respect of a pledged share in a s.r.o., the pledgor keeps the right to exercise rights pertaining to the share (see the express provision of S. 117a(6) CzComC). This does not extend to the right to collect distributions - these are to be made to the pledgee, same as with respect to the pledge of securities (S. 43(5) CSA).

The pledgor must refrain from doing anything that may devalue the pledge (S. 163(1) CzCivC). Where the value of the pledged asset drops such that it is inadequate to cover the secured claim, the pledgor must furnish additional security without delay, failing which the unsecured part of the claim will become due and payable (S. 163(2) CzCivC).

The law is silent on these rights and duties for the security transfer and the security assignment.

5.5. Transfer or encumbrance of creditor's and debtor's right

Section 169(a) CzCivC declares invalid agreements whereby the pledgor agrees not to further pledge an already pledged immovable asset.

The pledgor is free to transfer title to the pledged asset. The general rule upon such transfer is that the acquirer takes subject to the pledge (S. 164(1) CzCivC) and will assume the pledgor's legal position (S. 164(2) CzCivC).

However, the particular rules on priority of the pledgee over acquirers of the pledged asset are complex and depend partly on the nature of the pledged asset, partly on the way the pledge was perfected (in relation to movable corporeal assets) and most importantly, on the legal context of the transfer (i.e. is it an enforcement sale, a bankruptcy sale, or a regular sale). These issues are discussed in detail in relation to the law of priorities - see parts c), v, vi above.

As regards the pledgor's right to further pledge the pledged asset, this is excluded by the law in respect of shares in s.r.o.s (S. 117a(2) CzComC) and securities (S. 39(2) CSA).

The pledgee will not be able to further pledge the pledged asset as it is not its owner (S. 161(2) CzCivC). The only exception would be in relation to a possessory pledge of a corporeal movable asset where the pledgee could in theory pledge the asset pledged to it, provided that the new pledgee took possession in good faith that the original pledgee was authorised to create the pledge (S. 161(1) CzCivC). The original pledge would, in my view, terminate upon the transfer of possession from the original pledgee to the new pledgee (see part c) above).

On a security transfer, the transferor clearly no longer holds title so he or she may not create further charges over the pledged asset, nor transfer the pledged asset. This is subject to the rules on acquisition of title to corporeal movables by *bona fide* purchasers (see part 1.3 above), and subject to the rule on creation of possessory pledge over corporeal movables in favour of *bona fide* pledgees, described in the previous paragraph. Equally clearly, the transferee may further transfer or pledge the charged asset as he or she is the full titleholder,

although this may of course expose him or her to claims by the transferor if an explicit or implied term of the security transfer agreement were to be violated by such an act.

The point is not free from doubt but the better is that where a business is subject to an enterprise charge, the purchasers buying assets belonging to the charged enterprise take clear of the charge - irrespective of whether the assets sold are current or fixed assets. This is of course a problem from the point of view of the chargeholder. Also, this situation is not reversed upon default on the secured claim or upon the chargor's insolvency, which is even more disturbing from the point of view of the chargeholder.[39]

5.6. Enforcement of security by a creditor

Because of its huge impact on the actual priorities, this topic was already discussed in some detail in part 3.4 above.

As was explained there, the methods of enforcement of the pledge are limited to three state-regulated methods - the court sale, the sale by a judicial executor and a sale in a non-voluntary out-of-court auction (see part a)ii above). There are two exceptions from these methods.

Firstly, a pledge over a share in a s.r.o. may be enforced by the pledgee privately, in a sale structured as a public tender (in Czech *obchodní veřejná soutěž*) (S. 117a(4) CzComC). Where an attempt to effect a sale fails, the rights pertaining to the share switch over to the pledgee (S. 117a(7) CzComC, *cf* part 5(4) above). The pledgee may appropriate the share through an agreement with the pledgor, the value of the appropriated share must, however, be determined by a court appointed expert (S. 117a(7) CzComC).

Secondly, a pledge over listed securities may be enforced privately through a sale on the public market, arranged by a securities dealer (S. 44 CSA).

With respect to pledged claims, the Czech Civil Code only expressly envisages enforcement via the collection by the pledgee of the amounts owed (S. 167(1)). This is clearly impracticable where the due date of the pledged claim lies in more than near future. There is no case law on the question but the better view is that with respect to claims that are not due and payable, the pledgee should be able to enforce the pledge through a sale of the claim through one of the three methods described above, as he or she would be in respect of other pledged property rights (S. 168 CzCivC).

As was mentioned in part 3.4, the law does not regulate enforcement of the security transfer and the security assignment.

Enforcement in insolvency proceedings is discussed in part 3.4, as are the (surprising) interrelations between execution proceedings levied by a general creditor and the secured creditor's enforcement rights.

5.7. Implementation of the Directive on Financial Collateral Arrangements

The Directive was implemented into Czech law by Act 377/2005 Coll., on financial conglomerates, that went into force on 29th September, 2005. The main implementation provisions can be found primarily in the Czech Commercial Code (S. 323a to 323i, containing substantive and enforcement provisions), the Act 97/1963 Coll., on international private and

[39] For details, see Richter, note 31 supra.

procedural law (S. 11e, containing the conflicts of laws rules) and in the Czech Bankruptcy and Composition Act (S. 5d(2), 14(3), 15(5), 16(6), 52(3), containing rules aimed at protecting financial collateral arrangements against the effects of bankruptcy and composition proceedings).

The Czech Republic did not exercise the opt-out right in respect of Article 1(2)(e), available to Member States pursuant to Article 1(3). However, in implementing Article 1(2), the Czech Parliament put in certain limitations on the counterparties eligible under Article 1(2)(e). To be eligible under Article 1(2)(e), the party must be a juridical person (a corporation) that, based on its last annual or last consolidated annual accounts, meets at least two of the following three criteria:

- its total assets are worth at least CZK 600 million (approximately EUR 20 million), or
- its total annual sales amount to not less than CZK 1,200 million (approximately EUR 40 million), or
- its net assets amount to not less than CZK 60 million (approximately EUR 2 million).

Although it could have done so (see part 3.5.2 above on the prohibition of appropriation), the Czech Republic did not opt out of enforcement of financial collateral by way of appropriation under Art. 4(2) of the Directive.

There are several unclear provisions and shortcoming in the implementation language, including inter alia the implementation of one of the conflicts rules of Article 9 of the Directive, the definition of an "enforcement event", or the definition of "equivalent collateral". However, one would hope that these will be remedied after market participants will have submitted their feedback into the legislative process (this is currently under way). I will therefore not dwell on these details in this article.

6. Critique of current system and the future

It follows from the above discussion of the Czech law of security interest that there is, at least in my opinion, significant room for improvement.

This is not an isolated opinion. Indeed, the draft new Czech Civil Code,[40] currently under discussion at the expert level and due to enter the political legislative process perhaps towards the end of 2006 or in 2007, would completely revamp Czech law of security interests. The relevant chapter of the draft code was subject to extensive discussions in 2005 and 2006 and it is not clear in what form will the revised language appear in the next draft. One can only hope that the drafters will pay close attention to Slovakia's remarkable reform of its law of security interests, implemented in 2002,[41] as was recommended in the consultation process over the draft new Czech Civil Code. That reform is notable for many aspects - *inter alia* for having made use of the know-how that went into EBRD's Model Law on Secured

[40] available (in Czech) in a version as of Spring 2005 at http://diskuse.juristic.cz/480556/clanek/legislativa

[41] Slovak Act 526/2000 Coll., amending the Slovak Civil Code

Transactions of 1994[42] and could actually serve as useful inspiration to other European jurisdictions as well.[43]

If one could have three wishes for a reformed Czech law of secured interests, mine would be:

- clear treatment of security interests in insolvency. The new Czech Insolvency Act, although not perfect, gets pretty close to this wish, certainly much closer than is the case under the current Czech Bankruptcy and Composition Act,

- a functioning, fast and possibly low-cost way of enforcement of security outside insolvency, preferably through a private sale. Here, one is still long way away from the ideal, although one should mention that the draft new Czech Civil Code in its version presented in 2005 proposed to introduce a private sale. It remains to be seen where the draft goes on this issue in the legislative process, and

- a clear, simple, and sensible law of priorities. As follows from this article, current Czech law is everything but clear, simple and sensible on this crucial point of design of security interests. In fairness, the new Czech Insolvency Act will improve the law of priorities in insolvency. However, and quite sadly, the draft new Czech Civil Code (again in the version presented in 2005) does not even contemplate to deal with this topic, presumably intending once again to leave the question of priorities to procedural laws. This would be unfortunate and even paradoxical given that, as was mentioned above, the draft contemplates allowing private enforcement of security.

All in all, the Czech legislator has accomplished something over the years following the 1989 political change. However, it clearly still has a substantial task ahead when it comes to designing efficient law of security interests.

[42] available at http://www.ebrd.com/pubs/legal/5960.htm

[43] see Slovak Solution, Why Slovakia has the world's best rules on collateral, The Economist, 23rd January, 2003

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