Guidelines on Credit Risk Mitigation

Legal Framework in the Czech Republic

These guidelines were prepared by the Oesterreichische Nationalbank (OeNB) in cooperation with the Financial Market Authority (FMA)

We would like to point out that the nature of these Guidelines is intended as merely descriptive and informative. These Guidelines do not – and cannot – make any statements on the requirements imposed by supervisory authorities on credit institutions as regards their treatment of credit risk mitigating methods. Decisions by the competent authorities may diverge from the presentation given in these Guidelines. Furthermore, the editors would like to point out that these Guidelines have been drafted with consultation by Czech jurists and were translated from German into English language. Despite the great care taken, the editors do not assume any warranty or liability for the contents, for the selection of the collaborators or for the translation. These Guidelines are intended to serve as an initial source of information and by no means replace a consultation with experts in Czech law. The Guidelines refer to the legal situation as at 1 April 2004.

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Preface

The spreading use of innovative financial products such as securitized assets and credit derivatives and the growing volume of investments in Central and East European countries by Austrian companies is changing the face of the Austrian banking sector.

The *Guidelines on Credit Risk Management* have been drafted to help banks accomplish the changes to their systems and processes needed for the implementation of Basel II and as a source of information on the general market conditions in Central and Eastern Europe. A number of Guidelines will be published in the course of the year 2004 on the topics of securitization, rating models and validation, the credit approval process and credit risk management as well as credit risk mitigation methods.

The aim of these Guidelines is to achieve a common understanding between supervisory authorities and banks regarding the upcoming changes in the banking industry. In this context, Oesterreichische Nationalbank (OeNB) and the Financial Market Authority (FMA) view their role as that of partners for the domestic banking community.

This series of Guidelines entitled *Credit Risk Mitigation, Legal Framework in Central and Eastern Europe* have been drafted with the collaboration of many renowned experts from the respective countries and are designed as an introduction to security law in each country for banks operating in those countries – or planning to launch operations there – as well as for their customers. The Guidelines describe the requirements of the most frequent types of credit security and the problems that may arise in this context.

We hope that the Guidelines on Credit Risk Management will be of interest to readers and will foster a more efficient discussion of developments in the Austrian banking sector.

Vienna, September 2005

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I. Introduction

These Guidelines deal with the most important security instruments available under Czech law. This chapter presents a short overview of the Czech legal system followed by a brief description of the sequence of procedures for the handling of security interest. This is followed by explanations on the possible realization methods of credit security. The individual chapters look at the specific details of the realization for each type of security.

II. General

A secure legal framework is a prerequisite for a well-functioning banking industry. The legal framework includes the legal basis for loan and security agreements as well as the rules for enforcing a bank's claims. Not only the instruments relating to substantive law are important, but also the procedural law instruments and a functioning court system.

The provisions relating to security interest law are contained in the Civil Code of the Czech Republic.[1] The rules of procedure for contentious and execution proceedings are contained in the Civil Procedure Code (ZPO[2]). The two laws have been strongly influenced by Austrian legal tradition.

Before its accession to the EU, the Czech Republic adopted the *acquis communautaire* (body of legislation of the Member States of the European Union) in the field of banking law and banking supervision. Banking supervision is the responsibility of the *Czech National Bank* (Česká národní banka). In the course of duty, the national bank issues, among other things, regulations that are binding on banks.[3] When the national bank detects deficiencies in the activities of a bank or breaches of the binding lending regulations, it takes the appropriate measures. There are different types of measures: either the bank concerned must remedy the deficiencies itself or the regulator takes adequate measures to restore order. If these measures fail, the central bank may change the bank's license or place it under forced administration. In addition, the central bank may impose a fine up to an amount of CZK 50 million.[4]

[1] Act 41/1964 Coll.Czech Civil Code (ob'eanský zákoník).

[2] Act 99/1963 Coll., Civil Procedure Code (občanský soudní řád).

[3] The rules are published either in the form of notifications (*vyhláška*) in the compendium of laws or in the form of measures (*opatření*) in the bulletin (*věstník*) of the Czech National Bank.

[4] On 22 June 2004 the Czech koruna (Kč)/EUR exchange rate was 31.930:1.

Chapter 2: General Remarks on Securing Credit Risk under Czech Law

I. Overview of the Legal Provisions of Security Law

Czech security law took on its current form only after the political transition in 1989. Security interest law is based on the Czech Civil Code. The Austrian Civil Code (ABGB), which was applicable in the Czech Republic until 31 December 1950, was used as guidance for the amendment of the Czech Civil Code in 1991 and for further amendments. In accordance with the concept of the Austrian General Civil Code, the concept of liens was introduced and elaborated on. It is typical that some instruments used as security have undergone some significant developments over the past 15 years.

The Czech Civil Code is the legal basis for most forms of credit security. Further types of security (e.g. surety and bank guarantees) are defined in the Czech Commercial Code.[5] Individual provisions are also contained in the laws that apply primarily to securities.[6] The Civil Procedure Code is of great importance for the realization of security. In this context, the Bankruptcy and Composition Act is also of relevance.[7] The result of the latest legal developments is the Act on Public Auctions[8] and the establishment of the register of liens with the Chamber of Notaries.[9] The Act on the Cadastre of Real Estate[10] and the Act on the Registration of Ownership and Other Ownership Rights are of great significance for mortgages.[11]

II. Loan Agreements and Security Agreements

When a bank grants credit, it may take measures to secure against the risk of future insolvency or even the debtor's unwillingness to pay. The Banking Act[12] imposes a number of obligations on banks when granting credit. Thus, the bank is obliged to define a strategy for managing credit risks, to work out rules for the conduct of its business, to apply a system for measuring and monitoring credit risk as well as to implement a limit-based system for risk management.[13]

Debts are secured by executing a security agreement. Frequently, one and the same debt is secured by several forms of security such as a surety and a lien, either at the time the security agreement is concluded or afterwards.

The security agreement is a special type of contract that obligates the guarantor to provide the security, and in the event there is no reason for the provision of security or it ceases to be given, the agreement forms the basis for the right of the security provider to the return of the security

The objective for the security provided under such an agreement is made obvious by the so-called principle of accessoriness (see Chapter 3). According

[5] Czech Commercial Code (obchodní zákoník), Act 513/1991 Coll.

[6] See Act 591/1992 Coll. on Securities (*o cenných papírech*) and the Act on Debt Securities 190/2004 (*o dluhopisech*).

[7] Act 328/1991 Coll. on Bankruptcy and Composition (*o konkurzu a vyrovnání*).

[8] Act 26/2000 Coll. on Public Auctions (*o veřejných dražbách*).

[9] See Art. 35b of Act 358/1992 Coll. on Notaries and Their Activities (Notarial Code) (*Notářský řád*).

[10] Act 344/1992 Coll. on the Cadastre of Real Estates of the Czech Republic (Cadastral Law) (*katastrální zákon*).

[11] Act 265/1992 Coll. on the Registration of Ownership and Other Ownership Rights (*o zápisech vlastnických a jiných věcných práv*).

[12] Banking Act 21/1992 Coll. (*o bankách*)

[13] See Articles 14 and 15 of the Czech Banking Act as well as Articles 4, 5, 10 and 11 of Measure 3/2002 of the Czech National Bank.

to this principle, a transferee is only entitled to security, as long as and insofar as the claim to be secured exists. In addition, the objective of the security agreement becomes manifest in the bank's power of disposal over the security. The regular mode by which a security provided expires is either when the debt is redeemed or when the security is realized for the purpose of satisfying the claim.

III. Collateral and Personal Security

A. General

Czech law contains provisions regarding instruments used to secure claims, especially liens on *movable property*, liens on *claims* and *real estate* (mortgage), *assignment by security* (assignment), *reservation of ownership rights*, *sureties* and *guarantees*. In contrast to Austrian law, some types of mortgages (e.g. maximum amount mortgage, simultaneous mortgage), buildings on land owned by a third party *(Superädifikat)*, receivership and some types of assignment (e.g. overall assignment of receivables or assignment in lieu of payment) are unknown in the Czech legal system.

However, just like in Austria security may be divided into *collateral* and *personal* security. Collateral includes liens, mortgages, assignment by security, assignment as collateral and the reservation of ownership rights. Personal security includes the surety, the guarantee and the cumulative assumption of debt. This division is of importance with respect to the applicable rules for security instruments, the required format of the contract, the establishment of the security and its extinguishment as well as its eligibility to serve as security, and it also influences the fate of the security in the event of insolvency.

B. Personal Security

A personal security is characterized by a *personal* (mandatory) *claim* of the bank against the guarantor. In this case, the security agreement is a (personal) obligation between the parties, on the basis of which the bank is entitled to claim payment from the guarantor. If a borrower fails to service his or her debts the bank is entitled to satisfy its claim from the *total assets* of the personally liable guarantor. Apart from the personal liability of the debtor, the bank therefore may draw on the personal liability of a third party to satisfy its claim.

C. Collateral

Collateral is the bank's right to secure a claim by a right in property to certain collateral assets, e.g., in movable or immovable property or to rights. Typical for *collateral* is that the bank has a physical asset serving as collateral to satisfy its claim in the event of a debtor's default. The bank's right in property that results from the security agreement gives the bank a position legally effective vis-à-vis any person with respect to the collateral given.

In the event of the *debtor's insolvency,* the bank's claim secured by collateral is given a preferential status over other creditors in insolvency proceedings. The bank may present its claim for segregation or separation of the collateral and may satisfy its claims directly from said collateral. *Parties entitled to segregate assets from bankrupt's estate* are those who can establish that an asset allocated

to the bankrupt's estate does not belong to the bankrupt's estate. *Parties entitled to seperate satisfaction* may request that certain objects that belong to the bankrupt's estate be given to them in advance for the purpose of satisfying their claims from such separated assets, as they have the preferential right to satisfaction of their claims (e.g. lien).

IV. Chronological Sequence of Securiting Credit

A. General

One of the basic requirements for a security interest is the legally binding effectiveness of its establishment. The legal basis for the creation of a security interest is a *security agreement* (lien agreement, retention of owner's title clause, surety agreement). If the security agreement contains a contractual fault (e.g. breach of law or is contra bonos mores, indetermination) by which it becomes contestable, invalid or void, there is no effective basis for the security. Further examples of *contractual defencies* are:

- a covenant according to which the bank (as lien creditor) may request that its claim be satisfied by selling the pledged property in a manner other than stipulated by law; or
- a clause according to which the bank may not request that its claim be satisfied by the sale of the pledged property upon maturity of the claim; or
- a covenant according to which the pledged property is transferred to the bank in the event of default or the bank may keep the property for a certain price.[14]

A contractual deficiency may have various causes and sources, which are either of formal (e.g. non-compliance with the written form where it is prescribed) or material nature (e.g. a bank guarantee is not granted by a bank but by an insurance company). Some of these defects are curable, but most of them cannot be remedied. The contract must be concluded earnestly, definitely and in a form that is understandable to the parties concerned. A *security agreement is void* if it violates or circumvents a law or is contra bonos mores. If the contract does not meet the form required by law, it is also void. In the cases described above, the defects cannot be cured, i.e., the invalidity of the security agreement is absolute. If a security agreement is void this means that it does not exist and, if applicable, only a contractual claim for *damages* exists instead of security.

C. Faulty Fulfillment of Contract – Default in Payment

It may occur that the borrower does not pay or only pays part of his or her obligations. The function of security is to secure the repayment obligations of a borrower.

Faulty fulfillment of contract on the part of the debtor may be attributable to unwillingness or the inability to repay the debt. Default in payment is therefore either due to the borrower's unwillingness to pay or to insolvency.

The bank's mode of procedure for dealing with the borrower is determined by the reason for the default in payment. If the borrower is insolvent, the bank

[14] Art. 169 Civil Code of the Czech Republic

may file a bankruptcy petition for the borrower concerned. The provisions of the Bankruptcy Act shall apply to the insolvency proceedings.

If the borrower is not willing to pay in spite of being solvent or no bankruptcy petition is filed (in spite of insolvency), the collateral can be realized by filing for legal action respectively by initiating *execution proceedings* in accordance with the rules of the Civil Procedure Code, as described in the following.

D. Realization of Security

1. General

When a borrower defaults, the bank has the alternative of satisfying its claims from the security created. The security agreement constitutes the basis for the satisfaction of a claim from pledged security.

In the case of a personal security, the guarantor (surety, person giving a guarantee, person entering into a debt) is the party called on to satisfy a valid claim. Concerning collateral security, realization measures are mostly the sale of movables.

If the borrower fails to meet his or her payment obligations when these fall due, the bank is entitled to payment by the guarantor. If the guarantor does not pay, the bank may take legal action to have the contract fulfilled on the grounds of the security agreement in force (for example the contract of guarantee or surety agreement). Sureties and guarantees are realized through civil law proceedings. If the credit extended by the bank is secured by a lien, it may take legal action to have the pledged property sold.[15]

Like under Austrian law, civil law proceedings start with the filing of a complaint and end with a legally enforceable judgment in accordance with the Civil Procedure Code of the Czech Republic. If the bank's complaint was successful, the defendant (surety or person giving a guarantee) is ordered to pay by a court ruling. As a consequence, the bank may initiate execution proceedings against the debtor. This is done by an execution order. If the execution is approved, the proceedings are opened by judical order. The subsequent enforcement procedure depends on the type of security.

2. Rules of Procedure for Reaching Decisions

In the first instance, district courts are competent for all complaints arising from credit and security contracts. The respective regional court decides on the appeal against the decision of the district court. Thus, ordinary proceedings take two instances to be completed. An appeal against the legally enforceable judgment passed by the regional court may be lodged within a period of two months. The appeal is only permissible if the court of appeal changed the decision of the first instance or came to the conclusion that the legal issue that is the basis of the decision appealed against is of fundamental significance. The appeal is inadmissible if the amount in dispute does not exceed CZK 20,000 in civil

[15] Art. 200 y Civil Procedure Code

cases and CZK 50,000 in commercial cases.[16] The Supreme Court decides on the admissibility of an appeal.[17]

The court fee amounts to 4% of the value disputed (at least CZK 600), payable when the complaint is filed.[18]

3. Execution Proceedings

The bank may take action to open execution proceedings if the borrower does not comply with his or her payment obligations voluntarily, which have been ordered by an enforceable decision. The execution falls within the exclusive jurisdiction of the district court and is usually approved by it without a prior hearing of the debtor. The bank is under the obligation to enclose the final and enforceable judgment or the enforceable notarial deed (the lien agreement in the form of the notarial document which contains the agreement on the direct enforceability of the obligations resulting from the contract[19]) in its application for the approval of the execution. Upon approval, execution is enforced by the court.

The type and procedure of the enforcement depends on the possibilities for realizing the pledged object. In the case of claims for instance, the incoming funds are transferred, and in the case of movables and real estate, an auction is held.

Under the law, certain objects are excluded from the execution. These are particularly objects that the debtor requires to satisfy his or her own basic material needs and those of his or her family, or such objects needed to perform work tasks. The sale of objects, which would be contra bonos mores are also banned from execution proceedings. However, if the debtor on his own initiative has pledged objects that he or she needs for entrepreneurial activities, these objects may be included in the execution proceedings.[20]

In this case, the court fee amounts to 2% of the assets included in the execution (at least CZK 300).[21]

4. Out-of-Court Realization

Out-of-court auctions can take place in the form of so-called involuntary auctions. These auctions are executed in line with the provisions of the Act on Public Auctions. The bank may file a motion for public auction if a debt secured by a lien exists and this claim was granted to the bank by a legally enforceable judgment or is certified by a notary public. The bank as applicant and lien creditor must enter into a contract with the auctioneer, in which, among other things, the amount of the first bids and the remuneration of the auctioneer (at least 1,000 and a maximum of CZK 1 million) are specified. Should it not be possible to satisfy all registered claims from the proceeds of the auction, these shall be satisfied according to an order of priority of four classes, with debts secured by liens belonging to the first class.

[16] Art. 237/2a Civil Procedure Code
[17] Art. 243 b/1, 2 Civil Procedure Code
[18] See Act 549/1991 Coll. on Court Fees.
[19] Articles 200z, 274 e) Civil Procedure Code and Art 71a Notarial Code
[20] Art. 322/1, 3 Civil Procedure Code
[21] See Act 549/1991 Coll. on Court Fees

5. Security in Insolvency

a. General

Bankruptcy proceedings may only be opened in cases of insolvency, i.e., a debtor's inability to pay or over-indebtedness. A debtor is considered insolvent, when the debtor has several creditors and is unable to meet obligations that have fallen due over a longer period of time.[22] In case of *over-indebtedness,* the debtor has several creditors and the amount of his or her obligations exceeds his or her assets.[23] As regards natural persons, who are entrepreneurs, and legal entities, over-indebtedness alone suffices to trigger insolvency; otherwise the inability to pay is required in any case. The expected proceeds of the continued entrepreneurial activities will be considered for the valuation of a debtor's assets when the higher costs of continuing entrepreneurial activities can be projected.

In the case of insolvency or over-indebtedness, the debtor is obliged to declare bankruptcy. As soon as a bankruptcy petition is filed, the competent court examines the admission requirements and the possibility of cost recovery. If this is the case, bankruptcy proceedings are opened by judical order. If the bank has collateral, it assumes the position of a creditor entitled to the satisfaction of claims from separated or segregated assets.

b. Segregation and Separation of Assets

If the bank has an ownership right based on a security provided, it is entitled to satisfaction from segregated assets. The effects of the bankruptcy do not refer to this right, since the assets covered by the right to segregation do not belong to the bankrupt's estate and are thus excluded (segregated).[24] *Rights to satisfaction from segregated assets* are given in cases of security provided by the *retention of owner's title*.

A *right to separated satisfaction* is given in cases of liens on movable and immovable property, pledged claims, *pledged property* and *assignment by security*. The bank has the right to preferred or separated satisfaction from a certain property. The proceeds from the realization of the separated property constitute so-called special assets. These special assets are used to satisfy the bank's claims to satisfaction from separated assets in advance.[25]

E. Avoidance of debtors' transactions

Any legal acts of the borrower carried out within the past six months prior to the opening of the bankruptcy proceedings and by which the debtor has entered into inappropriate obligations may be contested.[26]

Usually, security agreements may be contested under the above mentioned requirements regardless of whether the bank knew of the inability to pay or not. If a legal transaction is successfully contested, it becomes invalid toward the creditors (in the bankruptcy proceedings). Therefore, any accessory security

[22] Art. 1/2 Bankruptcy Act
[23] Art. 1/3 Bankruptcy Act
[24] Art. 19/2 Bankruptcy Act
[25] Art. 28 Bankruptcy Act
[26] Art. 15/1d Bankruptcy Act

(lien, assignment by security and surety) no longer applies. Therefore, performance or compensation must be surrendered to the bankrupt's estate.[27]

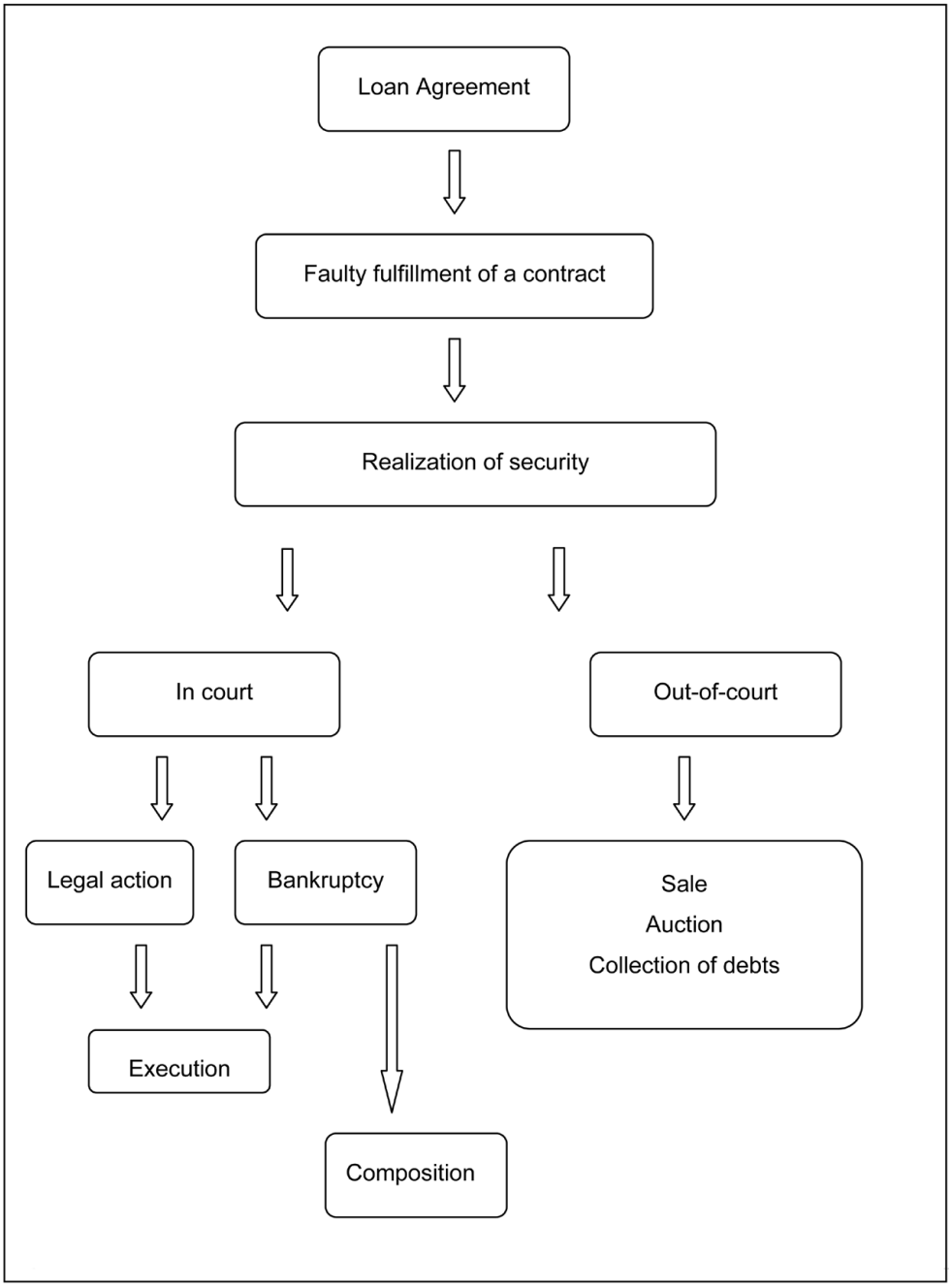

Figure 1: Chronological Sequence of Securing Credit

[27] Art. 15/2 Bankruptcy Act

Chapter 3: General Remarks on Liens

I. Introduction

This chapter will go into detail on the legal provisions concerning liens that apply equally to movable property, real estate and claims. In this context, the function, creation, the basic principles of liens and their realization are described in more detail. The following three chapters will explain the special characteristics of each type of lien.

II. General

The lien (zástavní právo) is a limited right in property, which plays an important role in the practice of securing credit. Depending on the type of creation and the title, traditionally a difference is made between liens based on contracts (contractual liens), statutory liens and judicial liens based on a court decision. As regards statutory liens, a further differentiation may be made as to the direct reason for its creation: whether solely by operation of law or by the additional requirement of a court decision. An inheritance contract, for example, requires the approval of the court.

A. Functions of a Lien

A lien functions as security as well as serving for the realization of security. The function of security means that the lien creditor may satisfy his or her claims from the lien if the secured claim (pohledávka) is not settled properly and in time. Thus, the lienee is motivated to fulfill his or her obligation secured by the lien – unless the pledge refers to a third-party debt – as long as the lien exists and the debt to be secured has not fallen due.The realization function means that the bank (the lien creditor) is entitled to satisfy its claims from the lien should the secured claim fail to be settled properly.

B. Advantages of the Lien

The main advantage of a lien in contrast to other security instruments is that it refers to a concrete object or right, regardless of changes in, e.g., the person of the debtor, ownership structure, etc. The transfer of an asset and the creation of the debt or the right as pledge (zástava) does not mean a change concerning the original ownership status regarding the pledged assets and usually does not constitute a change regarding the usufruct of the pledged object. Basically, Czech law does not prohibit a lienee from having the power of disposal over the pledged object. The lienee may resell the pledged object, pledge it a second time it or create usufruct rights in favor of a third party. Unlike in the case of a personal guarantee in which the creditor's claim is secured by the total assets of the person personally liable, the lienee is liable only with his or her pledged property.

III. Creation

The creation of a lien requires the following elements:

- a title,
- a mode of acquisition (delivery)
- a debt to be secured (or to be created in the future) and
- an object eligible to be pledged

A. Title

A lien may be created by a written contract[28], a court decision[29] or official order[30] or by operation of law.[31]

The most important way of creating a lien is by establishing a contract. A *lien agreement* requires (irrespective of the pledged property) the written form, as otherwise it would be invalid.

Furthermore, in the case of real estate that has not been entered in the register of real estate[32] and in the case of an entirety of assets, groups of assets and movable property, in which a lien without transfer to the lien creditor or to a third party is to be created, the agreement must be executed by notatial protocolization.[33]

The notarial protocolization is also recommendable for other types of pledges for the purpose of evidence. If the lien agreement is not available as a document certified by a notary, the possibilities of the bank to realize the security are considerably limited. In this case, realization is only permissible by selling the pledged object in a public auction ordered by the court for which an enforceable court decision is required.

The basic requirements for the content of the lien agreement are:

- The exact identification of the pledged object, or if claims are being pledged, the legal basis for the creation;
- The exact designation of the claim to be secured[34];
- A clear declaration of intent by the parties to create a lien on this pledged object on the basis of this contract, including a description of the conditions, if necessary, which relate to the creation of the lien.

Furthermore, the lien agreement may include the following stipulations:

- The procedure for realizing the pledged property provided that the debt that is due has not been settled;
- Restrictions of the powers of disposal over the pledged property;
- Possibilities of use of the pledged property;
- Insurance of the pledged property;
- Disclosure obligations of the lienor;
- The right of the lien creditor to control the fulfillment of the obligations stipulated by the contract;
- Price indexation clause for the pledged object for the duration of the contractual relationship;
- The method of setting off the costs arising from the contractual relationship, and
- Rights and obligations of the parties toward third parties.

[28] Pursuant to Art. 156 and Art. 552 Civil Code of the Czech Republic
[29] E.g. Creation of the lien on the property by court decision pursuant to Art. 338 b – 338 e Civil Procedure Code
[30] See Art. 156/1 Civil Procedure Code
[31] See the above mentioned law on the administration of taxes and duties.
[32] See Chapter 5.
[33] Art. 156/3 Civil Code of the Czech Republic
[34] Art. 156/2 Civil Code

B. Mode of acquisition (delivery)

Apart from the title, a mode of acquisition (delivery) is also required for the creation of the lien to be legally effective. Depending on the pledged property, it applies in one of the following forms:

- For *real estate,* the *recording* of the lien in the Register of Real Estate or in the lien register (if the real estate is not to be registered in the land register, e.g. so-called small structures);
- For *movable property,* the *transfer* of the pledged property to the lien creditor or the *recording* of the lien in the *register of movables*;
- For *registered securities*, the *recording* of pledged security in the register maintained by the Center for Securities or the transfer of the securities to the securities account of the bank;
- For foreign dematerialized securities, the application of the appropriate method of the respective legal system;
- For *other securities*, the *transfer* of the security to the lien creditor;
- For *trademarks,* the recording of the trademark in the *register of trademarks*;
- For *shares in a company,* the recording of the lien in the *commercial register.*

C. Secured Claim

The lien is a *subsidiary* and *accessory* right.

Thus, a prerequisite for the creation of the lien is that the claim to be secured exists at the time of creation or the existence of said claim be contingent on a certain condition or that said condition will arise in the future.[35] Claims already due as well as claims that are not yet due may be secured.

In the case of statutory liens it is even typical that future claims are to be secured for which the amount is still uncertain. This applies, for example, to the "tax" statutory lien[36], which is used for securing claims on taxes owed and may be created on products, appurtenances and parts even at a time when the claim has not yet arisen.

Certain claims can be secured up to an agreed amount by a lien, which accumulate for the lien creditor toward the debtor within a certain period of time (comparable to the maximum amount mortgage in Austrian law).[37]

The lien not only secures the *principal claim*, but also *secondary claims* and *interest*.

If the content of a claim changes due to agreements reached by the contractual parties, the lien continues to exist. Should the claim to be secured expire, the lien also ceases.

D. Object of a Lien

All assets may serve as a pledged object that may be valued in cash and are freely available under private law. Thus, movable and immovable objects may be the objects of a lien including their parts, fruits and appurtenances; business premises and apartments, co-ownership interests, all kinds of assets, claims, trade interests, account balances, etc.

[35] Art. 155/3 Civil Code of the Czech Republic

[36] §72 Civil Code of Act 337/1992 Coll. On the Administration of Taxes and Charges (o správě daní a poplatků).

[37] See Art. 155/4 Civil Procedure Code

Ownership parts can also be pledged. This is why real estate shares can also be used for a pledge. With the exception of banks, liens may be created on businesses.[38] In any case, objects, rights and other assets may be pledged, which serve operational purposes of a company or are intended to serve this purpose on account of their nature.[39]

Similarly, shares in a limited liability company[40] can also be pledged. Even objects that are basically excluded from execution proceedings pursuant to the law can be pledged by contractual agreement.[41]

IV. The Principles Governing Liens

A. Principle of Priority

The priority of a lien is only of significance when a pledged asset has been pledged several times. The priority ranking of a lien is determined by the time of creation. Thus, a right registered earlier is given priority over one registered at a later time.[42] The priority principle applies unless legislation stipulates otherwise. The priority of the individual liens is mainly of great importance for a creditor's right to satisfaction. The Czech Civil Procedure Code stipulates that the time of creation of these rights is decisive for the priority of the lien. This rule also applies to the out-of-court realization of the lien by auction in accordance with the law on public auctions.

B. Principle of Proportionality

The principle of proportionality only applies in the case of liens of equal ranking. Claims created on the same day are satisfied from the pledged property proportionally depending on the respective amounts.[43]

C. Accessoriness

Accessoriness of a lien means that the pledge depends on the existence of a claim. As a consequence, the lien itself does not have an independent economic purpose and thus cannot be assigned without the secured claim.

D. Subsidiarity

The *subsidiarity* of the lien means that the pledge shall only serve to satisfy the creditor's claim in the event of the borrower's default. A lien can not be realized before the claim falls due.

V. Extinguishment of Liens

The lien is effective against persons who have taken possession of the asset on the basis of an agreement, but only to the extent that said person knew of the lien at the time of entering into the contract or should have known of the lien.

[38] A lien may be placed on a business (enterprise) under the conditions stipulated in the Civil Procedure Code.
[39] Art. 338 g) Civil Procedure Code
[40] Art. 117a Czech Commercial Code.
[41] Articles 321, 322 Czech Civil Procedure Code.
[42] Art. 165/2 Civil Code of the Czech Republic
[43] See e.g. Art. 332/2 and Art. 337/c/2 Czech Civil Procedure Code.

The lien expires as an accessory right when the claim to be secured or the pledge itself expires.

The pledge expires although the claim continues to exist when

- a pledgor has deposited the usual price of the pledged object with the bank;[44]
- the lien is not effective versus the contractual buyer of the pledge any longer,[45] e.g. because the existence of the lien is limited in time; or
- the object of a possessory lien is returned to the lienee.

VI. Realization

Apart from other provisions, the special *contractual format* of certification by a *notary* contains a clause stipulating the direct realization. It puts the lienee directly in the position of the obligor in execution proceedings or public auction who has to satisfy the secured claim including any entailing interests (e.g. interest, interest on arrears, default fees) in accordance with the conditions stipulated in the contract. In this form, the contract constitutes a directly enforceable execution title, without requiring a procedure to reach a decision in order to obtain a judicial execution title. The bank is thus entitled to satisfy its claims from the proceeds of the realization of the pledged property. This also applies to the case of partial non-fulfillment of the claim.[46]

[44] Art. 170 e Civil Code of the Czech Republic; This cause of expiry is controversial, because the term "usual price" is not specific enough, particularly when compared to the purchase price of a direct sale.

[45] Art 170 d Civil Code

[46] Art. 165/1 Civil Code of the Czech Republic

Chapter 4: Liens on Movable Property

I. General

The Civil Code of the Czech Republic does not define the concept of property and thus leaves it to academia and jurisprudence to specify its exact meaning. The Czech Civil Code distinguishes only between movable and immovable property (real estate).[47] The term real estate covers real properties and buildings that are fixed to the ground (see also Chapter 5). Vice versa, any object is a movable object unless it is qualified as a piece of real estate.

Generally, the creation of a lien on movable property requires a title and a mode of acquisition. Apart from the actual transfer of the pledged property in accordance with the principle of possessory liens, an appropriate mode of acquisition is also the entry into a register.

II. Principle of Possessory Liens

Apart from the title, the actual transfer to the lienor[48] and the acceptance by or transfer for safekeeping to a third party is necessary for the legally binding creation of a lien in accordance with the *principle of possessory liens*.[49]

In today's business practice, this mode of acquisition for pledging assets is very limited in its application, particularly since the possibility of registering a lien in a lien register has been created as a permissible mode in the Czech Republic.

III. The Registered Lien

The *registered lien* was introduced by the 2001.[50] It offers the possibility to create a lien on movable property by registering a lien in the lien register of the Chamber of Notaries of the Czech Republic. Since January 1, 2002, the new system of so-called "movable mortgages", which was applied exclusively to ships and airplanes until that time, *has been applicable to all movable property*.

A lien on real property that is not recorded in the Register of Real Estate, (see Chapter 5) and the lien on movable property on which the lien is to be created under a lien agreement, without transferring it to lienor, is created by entry into the lien register of the *Chamber of Notaries of the Czech Republic*.[51] This means that the registration has a *constitutive effect*.[52]

A separate register exists for ships pursuant to the Domestic Shipping Act.[53] The lien on (registered) sea-going ships is established by entry into the ship register.[54] A separate register exists also for trademarks.

[47] Art. 119 Civil Code of the Czech Republic
[48] Art. 157/2 Civil Code of the Czech Republic
[49] Art. 157/3 Civil Code of the Czech Republic
[50] Amendment of the Czech Civil Code by Act 317/2001 Coll.
[51] Art. 158/1 Civil Code of the Czech Republic
[52] This does not apply if the lien was created by court or official decision (Art.158 Czech Civil Procedure Code, in fine). In this case the entry is only declarative.
[53] No.114/1995 Coll.
[54] Register for sea-going ships pursuant to the Act on Inland Navigation (No.61/2000 Coll.); register for airplanes of the Czech Republic pursuant to the Act on Civil Aviation (No. 49/1997 Coll.).

IV. Special Features of Liens on Movable Property

A. Liens on Cash Deposits

A cash deposit is a claim to the payment of funds from an account maintained with a bank.

By depositing funds with a third party (bank with whom account is maintained), a lien on the money deposited (like in the case of pledging a claim) can be established. In this case, the lien is created by the written lien agreement between the lending bank and the person in possession of the payout statement (borrower) for an account, which is administered by a third party – in this case the account-holding bank. After the account-holding bank has been notified, it is obliged as a third-party debtor (poddlužník) to pay out the funds deposited in accordance with the conditions stipulated by the account agreement to an account directly to the benefit of the lienor.

In this context, one has to stress that problems may arise as a result of this mode of procedure. As soon as the account with the pledged funds is subject to execution proceedings, (in the form of an order to transfer the claim), the priority principle applies concerning the creation of the pledge. If a lien was created before the claim subject to forced execution came into existence, the execution proceedings do not have any effect on the liens. The pledged funds can be used for the specified purposes and for satisfying the secured claim. As long as the lien exists, the account-holding bank is not obligated to carry out the execution. Detailed provisions on the problems mentioned concerning the conflicting relationship between liens and the rights of the person demanding execution are contained in the amendment to the Czech Civil Procedure Code (No. 30/2000 Coll.).[55]

B. Liens on Savings Passbooks

Since a savings passbook is movable property, it is subject to the provisions on the pledging of movable property. This means that the lien is created by transferring the savings passbook (object of a possessory lien) or by recording it in the lien register.

C. Liens on Trademarks

Pursuant to Article 21 of the Act on Trademarks,[56] a lien on a trademark is created by a valid written contract (title) and by registering it in the register for trademarks (mode of acquisition). The lienor must apply for the entry into the register. The agreement on the creation of the lien has to be presented with the application.[57]

Apart from the general reasons for the expiry of a lien, liens on trademarks expire when the trademark is extinguished.

[55] Art. 309a Civil Procedure Code.

[56] No.137/1995 Coll.

[57] The conditions for the application are specified in Official Notice No. 231/1995.

D. Liens on Shares in Companies

It has been possible to pledge shares in companies since the amendment to the Czech Commercial Code in 2000.[58] A written lien agreement that serves as a title is required. The signatures have to be officially certified and authenticated (by a notary). Pursuant to Article 117a Czech Commercial Code, the consent of the general shareholders' meeting is required for the effective pledging of the shares in a company when the transfer of shares in a company is contingent on its consent. However, the company agreement may exclude the requirement of consent. Consent may also be obtained after the signing of the lien agreement without calling a general shareholders' meeting. As long as the lien exists, the share in the company may not be pledged again. Moreover, recording in the commercial register is a stipulated mode of procedure for the pledge to become effective.

E. Liens on Securities

Apart from the general provisions of the Czech Civil Code, the provisions of the Act on Securities are decisive for governing liens on securities. *Only transferable securities* may be used as the object of a lien. There are only a few types of securities that do not have this characteristic (e.g. employees' shares).

First, a distinction must be made between dematerialized and materialized securities. Dematerialized securities may either be registered with the Center for Securities or are foreign securities.

In the case of *materialized securities*, the pledge becomes effective when the security is transferred to the lienor or a third party for safekeeping or administration purposes. In this case, is expressly prohibited by law to return the security to the lienee without the consent of the lienor.[59] If the security is returned, the lienee is liable for any damage that may result.[60] The owner of a materialized security has to certify the existence of the lien directly on the securities certificate by a personally signed declaration. The lienor is not authorized to transfer this type of security unless the law states otherwise.

In the case of *dematerialized securities,* the recording in the register of the Center for Securities is required for the creation of the lien.

The *foreign dematerialized securities* are not registered in the Center for Securities of the Czech Republic, but in the respective registers at the place of safekeeping and administration. The creation and the consequences of the lien are defined in accordance with the law applicable at the respective location.

V. Realization

A. General

The general provisions for execution stipulated in the Czech Civil Procedure Code apply to the procedural enforcement of movable collateral.[61] Another type of realization is the possibility of public out of court auction, which is

[58] Art. 117a par. 1 Czech Commercial Code as amended by Law 367/2000 Coll.
[59] Art. 41/4 of Act 591/1992 Coll. on Securities.
[60] Pursuant to Art. 420 ff. Czech Civil Code.
[61] Art. 251 ff. Czech Civil Procedure Code

regulated in a special law.[62] As of December 31, 2000, the lex commissoria (Art.299 Czech Commercial Code) was repealed.

B. Types of Realization of a Movable Lien

1. Judicial Realization

Judicial realization is carried out within the scope of execution, with the pledged asset being realized and the bank's claims being satisfied from the distribution of the proceeds. Not only the petitioning creditor who files for the execution on the basis of the enforceable title[63] is entitled to the proceeds from the realization of the pledged asset, but also the other lienors with claims in this matter. The execution is ordered by a court ruling. The ruling is served to the debtor within the course of the execution proceedings.

The sale of the movable pledged asset is carried out in the course of the execution proceedings in the form of a court auction. The court bailiff is responsible for the auction. The lowest bid may not be lower than two-thirds of the estimated value of the asset or its non-binding price. The opening bid corresponds to the estimated value of the asset. The priority of the pledge is of significance for distributing the proceeds.[64]

2. Out-of-Court Realization

The *public auction* is a type of *out-of-court realization*. Auctioneers who are liable for any damages that may arise from procedural errors organize public auctions.

Before commencing the auction, the bank has to enter into a written contract with the auctioneer that must among other things state the auctioneer's fee. The official announcement of the auction must be made before the auction and must be served to the creditors. The claims secured by a pledged asset are given preferential treatment in the order of satisfying claims. These are satisfied in the first class, with the order of priority deciding the ranking within the class.[65]

C. Special Aspects of Realization

1. Realization of Shares in Companies

A lienor is entitled to realize a share in a company that has been pledged without the consent of the general shareholders' meeting in a so-called "trade competition"[66] or a public auction, if the claim secured by the lien was not satisfied properly and in time. Should the sale fail, the lienor is entitled to enforce his or her rights from the company share as of the time of the failed sale.[67]

[62] Act No. 26/2000 Coll. on Public Auctions.
[63] Apart from a court or official decision, a notarial instrument may also be an enforceable title.
[64] Art. 332/2 Czech Civil Procedure Code
[65] Art. 60/2a of Act 26/2000 on Public Auctions
[66] This corresponds to a sale by a private contract.
[67] Art. 117a/7 Czech Commercial Code

2. Realization of Securities

In the event of default the bank has the right to have the pledged security sold by a broker and to satisfy its claim from the proceeds. The only condition of this sale is that the lienee must be notified of the intended sale in time.[68]

[68] Art.44 of Act 591/1992 Coll. on Securities

Chapter 5: The Mortgage

I. Introduction

The mortgage (hypotéka) is a commonly used instrument in practice for securing claims, particularly claims arising from loan contracts. The mortgage is created on a piece of real property or a right equivalent to real property (such as buildings, apartments).

The creditor who is the beneficiary of the lien, is entitled by the mortgage to request a certain sum of money from the realization of the real property encumbered by the mortgage for the purpose of satisfying the claim.

The economic significance of the mortgage is essentially based on the fact that the value of the mortgage and its stability are decisive for the amount of the loan to be granted at the time it is granted.

II. General (Title and Mode of Acquisition)

A title and a mode of acquisition are required to create a mortgage as a lien on real property.

The following may be used as a *title* for creating a mortgage:

- A contract certified by a notary for the so-called "contractual or voluntary mortgage";
- A contract in combination with a court decision;
- A court decision (the so-called "judicial execution mortgage");
- The existence of certain circumstances provided for by law (the statutory mortgage).

In the case of real estate, the mode of acquisition is accomplished by registration into the so-called *Register of Real Estate (land register)*. The lien is recorded by the *cadastral office for real estate* in the so-called land charges register and only on the disclosure of a monetary claim specified in absolute figures. The entry is *constitutive*, i.e. the mortgage becomes effective by this entry. The condition for entry into the register is the contract between the lienee and the bank. In the case of real estate not entered into the register of properties, the creation of the mortgage, as in the case of movable property, becomes effective with the entry in the *lien register of the Chamber of Notaries of the Czech Republic*.

When the mortgage is created by *contract in combination with a court decision*, by a *judicial execution mortgage* or by *operation of law* (statutory mortgage), the entry of the mortgage into the register is done only by an *annotation*. This annotation has only a *declarative* effect.

III. Special Types of Mortgages

A. The Simultaneous Mortgage

Mortgages on several properties that are owned by the debtor or also by other persons can be created to secure a claim. Each property secures the claim in full. Similar to an ordinary mortgage, the simultaneous mortgage is created by contract, court decision or by operation of law.

B. The Sub-mortgage

The law permits the re-hypothecation of a mortgage in order to secure a claim already secured by a mortgage. This constitutes the pledging of a lien. The sub mortgage (podzástavní právo) is also created by entry into the register of liens. The consent of the owner of the pledged object is not required.

In order to realize a sub-mortgage the bank has to file two lawsuits and institute two execution proceedings. First, it has to take legal action against its debtors and on the basis of the court's decision, demand execution against the lienee under the lien on the debtor's claims.

As soon as the lienee fails to pay, the bank has to take action against the third-party debtor. The resulting court decision is an executory title on the basis of which the mortgage may be realized.

IV. Some Problems

A. Scope and Object of a Lien

1. The Issue

A mortgage can be created on real properties. On the one hand, *real properties* (nemovitost) *are plots of land* (pozemek), on the other hand, also *buildings* connected to the ground by a solid foundation.[69] The plots of land do not pose any major problems in practice. The problems concern mainly the specification of which structures and buildings are to be included in a mortgage, and, above all, whether or not the parts and attachments are also included. In accordance with legal precedent, the concept of real property includes objects connected to the ground or fixed to the walls as well as objects that are intended for use on the real property.[70] This definition does not always provide a clear solution. The building authorities decide whether an object is to be treated as part of a building.[71]

2. Plots of Land and Buildings

In this context, the applicable principle laid down in the Civil Code of the Czech Republic states that a building is not part of a plot of land. This is a major difference to Austria where the principle of superficies solo cedit[72] applies. Therefore, when creating a lien on real property the bank must pay attention to the fact that the plot of land and the respective building always have to be listed and identified separately in the lien agreement in order to actually have a lien on both, i.e. the piece of property and the building. Contrary to this principle, legal precedent has concluded that an underground facility or even the water conduit shall be regarded as a part of a plot of land.[73]

[69] § 120/2.

[70] Decision of the Czech Republic's Supreme Court of 13 July 1920, RV II 101/20 that is still applied.

[71] Authority with the right to conduct pre-construction on-site hearings pursuant to the Construction Act (No. 5D/1976 Coll.).

[72] All parts fixed to a plot of land share the same legal fate as the plot of land itself. When the owner of a plot of land changes, the ownership right to the objects fixed to the plot of land also changes.

[73] Decision by the Court of Appeal in Prague (*Vrchní soud*) of December 14, 1993, 3 Cdo 70/90.

3. Buildings Under Construction

Until completion, every structure is part of the plot of land from which it may be separated only under certain circumstances. After completion, the building is no longer part of the plot of land and thus has its own legal destiny. The law does not state as of what time a building is separate from the respective plot of land. A Supreme Court decision defines this time as the *point in time as of when the buildings become clearly and unequivocally identifiable*.[74] This problem can be avoided in the case of structures that are not completed, but are already entered into the register as buildings. Mortgages on real property, not being part of the register of properties, are created by entry into register of the Chamber of Notaries.

4. Appurtenances

Appurtenances (příslušenství) of an object are things owned by the proprietor of the principal object and designated by the owner for permanent use in connection with the principal object.[75] Buildings having the nature of an appurtenances may be transferred, but thereby lose their characteristic of being an appurtenances. This concerns so-called *small buildings* that are not entered into the Register of Real Estate. These buildings must be registered in the lien register of the Chamber of Notaries for the purpose of creating a lien.

5. Apartments

Apartments and also nonresidential premises may serve as pledged assets if these are objects of ownership rights. In accordance with the special law on ownership rights to apartments and nonresidential premises, apartments shall be regarded as independent real properties. These are recorded as such in the register of properties. Basically, the provisions concerning not-yet-completed buildings also apply to apartments and nonresidential premises not yet completed.

B. Extinguishment of the Mortgage

When a secured claim is extinguished (e.g. by fulfillment), the lien expires simultaneously – regardless of the status in the records of the Register of Real Estate. Thus, the extinguishment of a lien is not contingent on the entry of this fact in the Register of Real Property. The cancellation of the lien in the register is done upon the receipt of a written confirmation by the bank on the extinguishment of the lien by satisfaction of the secured claim. The *entry of the extinguishment* only has a *declarative effect* in both registers.

V. Register of Real Estate

A. Introduction

The Register of Real Property (katastr nemovitostí) is a public book kept by the *cadastral office* and in which the legal status of real property is recorded. Basically, the correctness of the information recorded in the register may be assumed by anyone referring to said register.

[74] Supreme Court decision of January 29, 1997, 3 C don 265/96.
[75] Art. 121/1 Civil Code of the Czech Republic.

B. Types of Entry

There are three possible types of entries into the register: *incorporation,* priority notice and annotation. By incorporation, a right is created or extinguished. The priority notice is used to identify a contingent right or loss of such right. Contingent rights are those rights, where (legal) proceedings are pending. The annotation is an entry which only prevents further entries without having the effect of constituting or destroying a right.

C. Principles of the Register

The register is based on four principles:

- The *principle of disclosure* gives alll people the right to inspect the register in order to obtain information on the legal status of a real property.
- Due to the *principle of trust* everyone may confide in the correctness of the entries in the register. Facts not recorded in the register are not enforcable.
- The *principle of priority* determines the satisfaction of the lienors' claims according to their registered ranking. The ranking is illustrated by the extract from the owners' list of the land register. Rights recorded on the same day have the same priority ranking.

Difficulties result from different mortgages at variance with each other created by entry into the land register which conflict on account of these different principles. This conflict is solved by court decision or a decision by an authority. The entry into the register has only a declarative effect.

VI. Realization of the Mortgage

A. General

If a bank's claim is not satisfied although it is due, the bank is entitled to the satisfaction of its claim from the proceeds resulting from the realization of the pledged object. It is important to note that any agreement stating that a creditor is entitled to retain the pledged object in the event of default is void. Should a claim be secured by several pledged objects, the bank may request the realization of any one of the pledged objects.

Real property can be realized by judicial enforcement or out of court. In contrast to Austrian law, Czech law does not have the concept of placing a property under receivership.

B. Types of Realization

1. Judicial Realization

As expressly defined by the Czech Civil Procedure Code, the provisions concerning execution by sale of movables are applied analogously to the realization of the pledged property in the course of execution proceedings. Thus, a reference can be made to the procedure mentioned above concerning the realization of movable property (See Chapter 4).

2. Out-of-court Realization

Out-of-court realization of real estate is admissible under Czech law. In this context, a reference may be made to the corresponding explanations of chattel mortgages (See Chapter 4).

C. Realization in the Event of Bankruptcy

A secured bank can enforce its right to satisfaction from separated assets in insolvency proceedings in which the real estate owner is determined. By applying for separation of the real property the can ensure it is entitled to preferential satisfaction from its mortgage. If its claim was not fully satisfied, the unsatisfied portion of the claim shall be regarded as a registered claim against the bankrupt's estate.

The rights of the creditors to separated assets are satisfied from the proceeds based on the sequence of priority in which their claims to separated assets was created. The ranking is determined by the day of entry into the Register of Real Estate. If the mortgage was created by a judicial decision or decision by an authority,[76] the time a claim is filed for is decisive.

The creditors with rights to separated assets are satisfied up to 70% from the proceeds. The open portion of the claim can then be satisfied in the distribution by class according to the one it belongs to.[77]

[76] In this context, the lien is created by judicial decision or by decision of an authority; the entry into the real estate register is only declarative – see this Chapter, General (Title and Mode of Procedure).

[77] Art. 28/1, 4 Bankruptcy Act

Chapter 6: Liens on Claims

I. General

A claim may also be the object of a lien. However, this requires that the claim is freely transferable.

II. Creation and Extinguishment of the Lien

The lien on a claim is created by written agreement between the bank and the lienee. A future claim may also be the object of a lien, if it is obvious that the claim will actually arise. This requires that the legal reason and the main conditions of the future claim are known.

The lien is realized by recourse to the third-party debtor, i.e. the debtor of the borrower. The lien on the claim becomes effective against the third-party debtor only if he or she was notified of the lien in writing or the lien's existence is proven by the bank. As no annotation of the lien is possible, the eligibility of this instrument for securing a loan seems to be rather limited.

After the third-party debtor was notified of the existence of the lien, he or she is obligated to settle the debt irrespective of the due date of the pledged claim. If the third-party debtor does not meet this obligation, the bank is entitled to call in the third-party debtor's performance of the obligation by taking legal action. The rights of the bank after the performance of an obligation are not regulated by law except in cases of movable property: By transferring the property to the bank, a statutory lien to the property is created for the bank.

A lien on a claim may expire only for general reasons particularly due to the extinguishment of the secured claim or the claim serving as security.

III. Realization of Pledged Claims

Pledged claims cannot be realized simply by collection of the debt.

The bank must take legal action and can only carry out the execution after a legally binding ruling has been handed down by the court in order to attain the transfer of the claim. However, an out-of-court realization may be agreed on.

Chapter 7: Assignment by Security – Fiduciary Transfer of receivables

I. General

Assignment for security is executed by assigning a receivable (cession), with the assignment serving the purpose of securing another claim. The cession means the transfer of a claim without changing its content. This requires a contract between the assignor and the assignee. It is the nature of this security instrument that the bank's claim is secured by the assignment of a creditor's receivable or a receivable of a third party.[78]

The law does not contain an obligation to retransfer the receivable once the secured claim has been extinguished. However, if the assignor fails to retransfer the receivable, he or she is liable for any damages or enrichment, provided that all other conditions of the applicable liability have been met.

The bank secures its claims under a loan contract by having the borrower assign his or her receivables for the purpose of providing security. In this case, the bank is the creditor of its credit claim and, at the same time, becomes the assignee of the assigned claim. The bank's borrower is the debtor of the loan and at the same time the assignor of the assigned claim. Her or she is also called transferor. The debtor of the assigned claim is called a third-party debtor (debitor cessus). The assignment does not require the third-party debtor's consent. However, if the third-party debtor was not informed of the assignment, he or she can continue to make debt-discharging payments to the assignor.

II. Object of Assignment by Security

Basically, all mandatory rights can be assigned. In this manner, a receivable resulting from a guarantee or a share in a limited liability company or general partnership can be assigned. Future receivables may also be the object of an assignment.

However, some claims may not be assigned, as for example, a receivable that expires upon the death of the creditor. The assignment of receivables may also be excluded by an agreement on the prohibition of assignment between creditor and debtor.

III. Types of Assignment

As mentioned above, all present and future receivables may be assigned apart from a few exceptions. However, this requires that the assigned receivables can be specified. As regards claims that will be arise in the future, it is sufficient if the legal grounds (causa) are specified and it thus becomes obvious at the time the claim arises that it is an assigned claim.

However, it should be borne in mind that concerning the required specification strict standards are applied to the so-called blanket assignment and thus also to the blanket assignment by security, and that it is required that the assigned claim be unambiguously identified.

[78] Art. 554 Civil Code of the Czech Republic

IV. Creation

An effective security right is created for the bank by the mode of acquisition of assignment by security. The contract must be executed in writing[79], give an explicit description of the secured claim and the obligation to return the assigned claim. It is also possible to agree a contingent condition whose occurrence creates the assignment by security.

V. The Relationship to the Third-party Debtor

The assignor has to notify the third-party debtor of the assignment of the claim without any unnecessary delay. As long as the third-party debtor is not notified of the cession or the assignee does not prove the assignment to the third-party debtor, the debtor can be discharged from the obligation by payments to the assignor. If the assignor notifies the third-party debtor of the assignment of the claim, the third-party debtor is not entitled to request that proof of the assignment be furnished. From the time the third-party debtor is notified of the assignment, he or she is obliged to make payment to the assignee. In return, the assignee is obliged to accept the payment.

Objections to which the third-party debtor was entitled to before the assignment are still valid after the assignment of the claim. The debtor may also put forth a claim eligible for netting against the assignee, which existed towards the assignor at the time notification or proof of the claim was provided to him or her. However, the assignor must carry out the netting versus the assignee without any unnecessary delay.

The debtor shall have this right even if his or her claims had not yet fallen due at the time of notification or furnishing proof of the assignment.

VI. The Relationship between Assignor and Assignee

The internal relationship between the assignor and the assignee shall be defined largely by the agreement on assignment for security. The fundamental obligation of the assignee is to respect the rights of the assignor. Basically, the assignee is not entitled to dispose of the receivable assigned before the secured claim falls due. When calling the assigned receivable, the assignee shall be obligated to respect the interests of the assignor. If a claim to be secured has been satisfied, the assignee shall be obligated to return the assigned receivable.

VII. Disclosure

If one and the same claim is assigned as security several times, this may cause major difficulties. There is no obligation and no legally stipulated possibility to disclose an assignment. There are no disclosure or publication requirements (like in Austria by means of a book entry on the accounts of the assignors).

VIII. Realization

In the case of assignment for security, the bank in its legal relation to the third party debtor may call the receivable at any time after the assignment. Internally, the bank as assignee is obligated to call the receivable only when the assignor fails to meet his or her obligations under the loan contract.

[79] Art. 524 Civil Code of the Czech Republic

If the bank uses the collateral in the event of default, it is at first obligated to inform the third-party debtor who has not been notified about the assignment of the claim. If the third-party debtor makes the payment, the assigned claim and the security interest are deemed extinguished. The assignee satisfies his or her claim from the proceeds. The assignee has to surrender the surplus.

In the event of insolvency of a borrower who has assigned a claim to the bank for the purpose of providing security, the bank has the *right* to sperate *satisfaction* of its claims. The bank may realize the claim itself, but is obligated to surrender that portion of the proceeds that exceeds the secured claim to the administrator of the estate.

Chapter 8: Assignment as Collateral – Fiduciary Transfer of assets

I. General

Performance of an obligation can be secured through the *transfer of rights* of a debtor to the creditor.[80] In this case, the object of the pledge is the existing right of the debtor at the time of assignment.

The law does not contain any provisions concerning the content and type of the assigned right. As a rule, it refers to the transfer of the *right of ownership* to an asset. If the borrower fails to pay, the bank may satisfy its claim from this asset (e.g. by selling it).

II. Creation

The law only stipulates that a *written contract* is required for the effective assignment of collateral. The contract on the assignment of collateral is concluded between the bank and the holder of the right. In contrast to the assignment of a claim, only the debtor and no third party is eligible as guarantor. Individual *movable assets* or assets which the debtor will purchase in the future can be used for the purpose of providing security.

III. Content of the Contract

The rudimentary legal provisions give the parties a wide scope of freedom for drawing up contracts. They may, for example, apply the provisions for liens analogously, since the pledged property serves the same purpose as the lien. The parties have the possibility to agree that the debtor retains the direct possession and certain possibilities of use of the asset, whereas the property rights are transferred to the bank. In the event of insolvency proceedings, the bank in its function as creditor has the right to satisfaction of its claims from segregated assets.

The secured claim has to be defined unambiguously in a contract. In addition, the object of the assignment has to be identifiable. In the case of an agreement stipulating that the assignment become effective only in the event of a debtor's arrears in payment, we do not speak of the assignment of collateral, but of a so-called arrangement on the forfeited pledged property. Such an agreement is valid.

After the loan has been fully repaid, the bank is obligated to reassign the property to the debtor. The debtor is then entitled to the assignment, with a further legal transaction basically being required for this purpose. It may also be agreed that with the full repayment of the loan, the reassignment of the property to the debtor is done automatically.

An agreement on the assignment of collateral can also be subject to the condition that it expires upon the complete satisfaction of the secured claim. When the condition (payment of the secured claim) is met, in this case the property is transferred automatically to the assignor (debtor) again. Here, there is no requirement for the separate reassignment of the property.

[80] Art.553/1 Civil Code of the Czech Republic

Chapter 9: Suretyship

I. General

A *suretyship* is a contract on an *obligation* under which a *surety* (guarantor) undertakes by a declaration of intent vis-à-vis the creditor of a third party (principal debtor) to assume liability for the *performance of the obligation of said third party*. Thus, the surety assumes liability for a third-party debt, i.e., the principal debtor's debt, as a co-debtor.[81] Suretyship requires an obligation on the part of the principal debtor. The creditor of the principal claim and the creditor of the suretyship are identical.

The suretyship is not only the *most important* type of personal liability, but also the most important form of *personal credit security*. The Civil Code and the Commercial Code of the Czech Republic contain the provisions governing sureties.[82] The provisions of these two laws are of a complex nature and limited in their respective scope of application. The provisions of the Czech Civil Code may not be applied subsidiarily or analogously to matters that are otherwise governed by the Czech Commercial Code. The following explanations deal with sureties according to the Czech Civil Code and the subsequent section explains sureties according to the Czech Commercial Code.

Furthermore, it is necessary to mention the legal institution of the statutory surety. On the one hand, the Czech Commercial Code regulates the so-called statutory surety in connection with a general partnership (OHG), limited partnership (KG) and a limited liability company (GmbH) and for further special cases, such as company acquisitions. On the other hand, we also speak of a statutory surety if the state assumes the position of surety.

Czech law explicitly regulates the form of the *ordinary surety* in the Czech Civil Code and also in the Commercial Code, as well as the position of the guarantor of a bill of exchange. Moreover, in accordance with Czech law it is possible to assume an obligation as a surety and payer, and also as a secondary surety. In the case of an obligation as a *surety and payer*, the bank may call on the surety to perform before it takes recourse to the principal debtor. In contrast to the ordinary surety, and the surety and payer, the *secondary surety* has to perform only if the bank was not able to satisfy its claim even by execution against the debtor.

II. Sureties According to the Czech Civil Code

A. General

The *Czech Civil Code* governs relationships between *natural* persons and *legal entities* with respect to property rights, unless the civil law relationship is governed by other laws.[83] When the principal relationship between creditor and debtor is regulated by the Czech Civil Code, the Czech Civil Code provisions

[81] Art. 546 Civil Code of the Czech Republic (the guarantor undertakes to satisfy the claim of the creditor if the debtor fails to fulfill it)

[82] Art. 546-550 Civil Code of the Czech Republic a Art. 303-312 Czech Commercial Code

[83] Art. 1/2 Civil Code of the Czech Republic

also apply to the suretyship, regardless of whether the surety is an entrepreneur[84] or a consumer.

B. Creation of the Suretyship

The suretyship *is created by an agreement* between the surety and the bank. The Czech Civil Code does not regulate the surety agreement completely, but merely stipulates that the *declaration of the surety* must be *in writing*. Furthermore, the content must be defined as regards the surety's obligation to satisfy the bank's claim in the event of non-fulfillment by the debtor. If the surety's letter of commitment is not in writing, the surety agreement is *void*. The bank's declaration of consent is not subject to any formal requirement. However, it may also be implied. The principal debtor does not have to give his or her consent to the surety. Thus, a suretyship can be created without his or her knowledge.

The surety must have legal capacity. Several persons may also assume an obligation as surety.

In contrast to practice in Austria, in the Czech Republic the standard applied to the form of the suretyship is less stringent. The written form is also complied with if the signature is replaced by mechanical means or if the declaration was provided by telegraph, telefax or by other electronic means, which allow for the documentation of the content of the declaration and also to determine the person who has performed the legal transaction.[85] The obligations of the surety must be indicated clearly and specifically in the declaration. The scope of liability has to be defined to a sufficient extent, with any subsequent definitions being regarded as insufficient. A tendency has been observed in legal precedent[86] towards a narrower interpretation as to what is specific. When the maximum amount of a surety's liability is known, it is deemed as sufficiently specific.

C. The Secured Claim

Any valid claim may be secured by a surety if this claim refers to an reasonable obligation to be performed. The claim does not need to be due at the time the surety agreement is entered into.

It is controversial if a surety can also be assumed for a claim that has already expired. According to prevailing opinion it cannot.

The surety's obligation is basically for an unlimited time. However, the surety has the freedom to limit the obligation to a certain period of time.

D. Accessoriness of Suretyship

As mentioned above, the *surety* is *contingent* on the *existence* of a *principal obligation* by a principal debtor and exists only within its scopes. This is referred to as the principle of accessoriness. If the main liability of the bank has not been created effectively or becomes ineffective, the surety is also ineffective. Another feature of accessoriness is that the surety may raise the same defenses as the principal debtor against the bank in addition to his or her own defenses, and

[84] Art. 2/2 Czech Commercial Code

[85] Art.40/3, 4 Civil Code of the Czech Republic

[86] See Supreme Court decisions 29 Cdo 320/2000 and 32 Cdo 2348/98

may even – or precisely then – raise defenses when the principal debtor has not done so.

Another feature of accessoriness is the fact that a claim against the surety cannot be assigned or pledged without the principal claim. In contrast, the assignment of the principal claim without the assignment of the rights from the surety results in the extinguishment of the surety.

Furthermore, a *reduction* of the *principal debt* automatically means that *obligation of the surety is accordingly lowered*. However, raising the volume of the principal debt, which will also place on obligation on the surety, requires said surety's consent.

E. Subsidiarity of the Surety

The bank may take recourse to the surety only after the principal debtor was called to perform without success. This characteristic is referred to as subsidiarity. If a surety acts as surety and payer at the same time by agreement, this subsidiarity does not apply. In this case, we are strictly speaking not looking at a "genuine" surety, but either at an assumption of a debt or a cumulative assumption of debt.[87]

F. Duties of the Bank

The law does not place the obligation on the bank to inform the surety of the content and consequences of the assumption of liability. It is the duty of the surety to obtain information on the content of his or her future obligation. Even if no special duty of diligence is imposed on the bank vis-Á-vis the surety, it is liable to the surety for the proper protection of its rights to which it is entitled toward the principal debtor[88] (e.g. principal debtor is duly called to perform).

The bank must ensure that a surety's legal status is not impaired by a fault on its part. Negligence on the bank's part could for example be, that it fails to collect a debt in time or fails to file a bankruptcy petition or to acquire a lien.

Furthermore, the bank is obligated to inform the surety about the amount of the outstanding claim for which he or she is liable upon request at any time and without any unnecessary delay.[89] However, the bank's *duty to furnish information* refers exclusively to the amount of the secured claim. This obligation is imposed on the bank in the interest of the surety in order to show the surety to what extent the principal debtor is meeting his or her obligation. This makes it easier for the surety to exert influence over the debtor. The non-fulfillment or improper fulfillment of this obligation may constitute grounds for the surety to sue for damages against the bank.

The law does not regulate whether the bank has the duty to furnish information about the insolvency of the principal debtor.[90]

[87] See Chapter 8
[88] Art. 547 Civil Code of the Czech Republic
[89] Art. 415 and 420 Civil Code of the Czech Republic
[90] There are also no court rulings on this matter.

G. Rights and Duties of the Surety

The surety may raise all defenses to which the principal debtor is entitled against the bank.[91] Furthermore, the surety may also raise his or her "own" defenses against the bank.

The surety also has the right to refuse his or her consent to acknowledge a debt on the part of the debtor. The acknowledgement of a debt as regards the reason and the amount results in a prolongation of the statute of limitation for the debt by ten years, which would worsen the legal position of the surety.

Moreover, the surety has the right to refuse performance if the creditor is liable for the non-performance by the debtor to meet his or her obligations.[92] This extinguishes the obligation of the surety. This right continues to exist also after the death of the debtor.

The surety is *obligated* to satisfy a claim – except when the surety is liable as a surety and payer – when the debtor fails to pay despite a written request for payment by the creditor.[93] In this context, the reasons for non-fulfillment by the principal debtor are irrelevant. The obligation of the surety to make a payment instead of the debtor based on the fact that the debtor failed to settle a debt within a certain period of time. A request for payment sent to the debtor is absolutely necessary. It must be sent even if it is obvious that the debtor is not performing. If the bank is not able to serve the debtor the request for payment, it must sue the debtor. In this case, the condition of a request for payment is deemed as met when the complaint is filed with the court.

Basically, Czech law does not require that the bank take legal action against the surety or initiate execution proceedings. The surety's obligation does not depend on the lacking willingness of the debtor to settle a debt or on the fact that the bank was not successful in collecting the debt from the debtor. A secondary surety must perform only after the creditor has unsuccessfully completed execution proceedings against the principal debtor.

As already mentioned, the surety is generally not under the obligation to pay any debts of a debtor if the written request for payment has not been served to the debtor. If the debtor was requested to settle only a portion of the debt, the surety is therefore also only obligated meet a portion of the debt.

Generally, the surety may also undertake to perform even without a request for payment; this would constitute a cumulative assumption of debt.

H. Extinguishment of the Suretyship

The surety extinguishes as soon as the principal debt ceases to exist. This is a consequence of the principle of accessoriness.

Regardless of the extinguishment of the principal debt, the surety's *obligation* also *ceases* if the guarantor has duly settled the debt or rightly refuses. The creditor may waive this right against the surety. If the original principal debt was replaced by a new debt (novation), the suretyship continues to exist. If the surety does not agree to the novation of the suretyship, the security continues to exist only in the scope of the former obligation.[94] In the event the debt

[91] Art. 548/2 Civil Code of the Czech Republic
[92] Art. 311/2 Czech Commercial Code
[93] Art. 27/5 Czech Bankruptcy Act
[94] See Art. 572/1 Czech Civil Code (on novation)

is assumed, the obligation of the surety expires if the surety did not give his or her consent to the assumption of the debt.

If the surety duly satisfied the bank's claim, the surety automatically succeeds to the bank's rights. This means that the surety is entitled to the claim against the principal debtor to the same extent to which it existed against him or herself. This refers to the so-called *assignment by law*. Any additional *security* created for the claim is *automatically* transferred to the surety together with the claim (e.g. additional liens or sureties etc).

III. Suretyships According to the Czech Commercial Code

A. General

The provisions on suretyship laid down in the Czech Commercial Code apply in cases in which the suretyship exists between two companies or the suretyship secures claims specified in the Czech Commercial Code.

The objective of the suretyship regulated by the Czech Commercial Code does not differ significantly from that of the Czech Civil Code. The Czech Commercial Code also states that a suretyship is to consist of the obligation of the surety to satisfy the bank's claim as soon as the debtor fails to meet his or her obligations toward the bank.[95]

B. The Secured Claim

According to the Czech Commercial Code, an existing obligation of a debtor or a portion of the debt may be secured by a suretyship. Furthermore, a suretyship may secure an effective claim, which will be created in the future or the creation of which depends on a certain condition.[96] The obligation of the principal debtor must be identified to a sufficient extent. It shall be deemed as identified if, for example, the concrete amount of the monetary claim is stated. However, the Supreme Court has ruled that an agreement stipulating that a previous tenant is to act as a surety for a new tenant is not specific enough and thus void. In contrast, a declaration by a surety was considered effective in which the surety undertook to meet all monetary claims of a debtor that arose under a specific loan contract.

A *difference* between the provisions concerning suretyship laid down in the *Czech Commercial Code* and the provisions contained in the *Czech Civil Code* is that the Czech Commercial Code explicitly recognizes the *validity* of the suretyship even if the *principal debtor*'s obligation was invalid (void) *because* of his or her *lack of capacity to assume an obligation*. However, this applies only on the condition that the surety had knowledge of or would have been able to gain knowledge of this fact at the time he or she assumed the obligation.

[95] Art. 549 Civil Code of the Czech Republic

[96] The Czech Civil Code does not explicitly prohibit a surety for future claims, but according to the prevailing opinion it is assumed that this is inadmissible. Art. 548 Czech Civil Code

C. Duties of the Bank

The creditor is obligated to immediately inform the surety of the amount of the claims for which her or she is liable upon the surety's request.[97] Neither the wording of the relevant provisions nor the court decisions on the duties of the bank differ from those under the Czech Civil Code.

D. Rights and Duties of the Surety

The surety may raise all defenses against the creditor to which the principal debtor is also entitled such as netting the claims of the debtor versus the creditor; this is only possible if the debtor is also entitled to do this. In addition, the surety may also net his or her own claims against the creditor's claim.[98]

If the surety raises defenses against the creditor unsuccessfully, which the debtor suggested to him, the debtor is obligated to compensate the surety for the costs arising from such defenses.

The same as under the Czech Civil Code, the surety is obligated to perform the obligation when the debtor fails to fulfill his or her obligation within an appropriate period of time and upon written request for payment by the creditor.[99] However, the bank is not obligated to request the debtor in writing to perform the obligation, if the debtor is not able to comply with the request or it is without doubt clear from the beginning that the debtor will not meet the obligation, particularly if bankruptcy proceedings have already been opened.[100] According to the prevailing opinion in legal literature, those cases in which the court is not able to determine the debtor's place of residence upon request of the bank may be considered as cases in which a request for payment is impossible.

In contrast to the Civil Code of the Czech Republic, the Czech Commercial Code contains a provision for the event that several sureties are liable for the same obligation. According to this law, each surety is liable for the entire obligation. The surety enjoys the same rights vis-à-vis the other suretyies as a debtor enjoys versus a joint debtor.

Moreover, the Czech Commercial Code also provides detailed provisions for the event that only part of the obligation is secured by the surety. If the claim is satisfied only in part, the volume of the suretyship is not reduced as long as the claim has remained unsatisfied to the amount secured by the surety.[101]

E. Extinguishment of the Suretyship

If the surety settles the bank's claim without the debtor's knowledge, the debtor may raises those defenses against the surety which the debtor would have been entitled to versus the bank as soon as the surety attempts to seek recourse. However, the debtor may not raise defenses against the surety of which the debtor has not notified the surety of immediately after having received the notification of the claim.[102]

[97] Art. 304/1, 2 Czech Commercial Code
[98] Art. 310 Czech Commercial Code
[99] Art. 305 Czech Commercial Code
[100] Art. 306/2 Czech Commercial Code
[101] Art. 306 Czech Commercial Code
[102] Art. 306 Czech Commercial Code

Otherwise, like in the Czech Civil Code, the provisions on the consequences of satisfaction of a claim by surety apply. The surety who meets the obligation to the extent of his or her liability, acquires the position of a creditor against the debtor and is entitled to request inspection of all documents and instruments which are required for enforcing the claim against the debtor.

IV. Some Mutual Problems

A. Relation to Other Collateral

If there is further collateral apart from the surety who is personally liable, the bank is free to decide which collateral it will to use first. Personal and collateral securities are regarded as equal in this context.

B. Contra Bonos Mores of a Suretyship

A declaration by a surety may not be contra bonos mores. Such a breach does not play a role only concerning suretyships provided by relatives of the debtor. Thus, for example, a suretyship was ruled void in which a stock corporation was to assume liability for the debts of the chairman of the company's supervisory board.

C. Non-Extinguishment of the Suretyship according to the Czech Commercial Code

The Czech Commercial Code contains a rule that deviates from the principle of accessoriness according to which a suretyship is to be extinguished when the secured claim is extinguished. The suretyship does not expire when the debtor is a legal entity and ceases to exist.[103]

D. The Surety in Bankruptcy Proceedings

According to jurisdiction, a suretyship continues to exist even when the debtor dies and the amount of the secured claim changes because of the heirs' limited liability for the debts of the decedent. The surety may not raise the objection versus the bank that the heirs of the debtor are liable only up to the amount of the acquired assets.

The surety is obligated even after bankruptcy proceedings on the debtor's assets have been opened to meet his or her obligation versus the bank. This is different from other types of personal guarantees, since persons giving a personal guarantee would otherwise be performing their obligations in favor of the bankrupt's estate, and this would make the purpose of a surety providing security meaningless.[104]

[103] Art. 307 Czech Commercial Code
[104] Art. 309 Czech Commercial Code

Chapter 10: Assumption of Debt and Additional Assumption of Debt

I. Introduction

This chapter describes the assumption of debt and the additional assumption of debt as instruments for providing security. These two legal concepts have common features. The purpose, creation, function and content of the two instruments are similar to a large extent or even identical and therefore these are dealt with in one chapter. The Czech Civil Code contains regulations on both legal concepts.[105]

II. Assumption of Debt

A. General

In contrast to the "classical" assumption of debt,[106] which means a change in the person of the debtor (*privative assumption of debt*), the assumption of a debt may also take place in the form of a *cumulative assumption of debt* and thus have the function of securing a claim.

In the case of the *cumulative assumption of debt*, a *new debtor* enters into a *contract with* the *creditor* in which the new debtor assumes the former debtor's obligation without any previous agreement. Thus, the new debtor enters into the debt together with the existing debtor. The existing debtor is not a contractual party to the contract of the new debtor and the bank. The new debtor may even assume the debt with the consent of the creditor against the will of the existing debtor.

The *obligation of the existing debtor does not expire*, but continues to exist. The new debtor assumes an obligation, which, unless stipulated otherwise, has the same volume as that of the existing debtor. It is possible for several persons to become co-debtors of the existing debtor, either jointly or each person in succession. The contract on the assumption of debt has to be in *writing* to become effective. In contrast to the cumulative assumption of debt, the assumption of debt is not restricted to monetary claims.

B. Accessoriness and Subsidiarity

In contrast to a suretyship, a person entering into an obligation is not liable on a subsidiary basis, and therefore not only after the first debtor has been called to satisfy the claim. Otherwise, the position of the person assuming the debt is not different from that of a surety. The principal debt to be secured does not have to exist at the time it is assumed. In other words, in the case of the assumption of a debt, like in the case of a suretyship, the principle of accessoriness applies. The bank cannot release the first debtor from his or her liability.

C. Defenses against the Bank of the Person Entering into the Debt

Any *defenses* to which the existing debtor is entitled versus the bank, may *also* be *raised* by the *debtor assuming the debt*. Thus, said person is not limited to the

[105] Art. 531/2 and 533

[106] Art. 531/1 Civil Code of the Czech Republic

defenses raised at the time the debt was assumed. Furthermore, the new debtor may enforce his or her own defenses against the bank. However, the existing debtor is, of course, not entitled to the new debtor's defenses against the bank.

D. The Bank's Duty of Due Diligence

There is neither a legal provision nor a court ruling regarding the bank's duty of due diligence toward the new debtor. Nonetheless, caution is called for in this matter. It seems possible and reasonable to apply the relevant provisions on suretyships analogously. Thus, it must be assumed that the bank has to comply with the same duty of due diligence when dealing with cases of cumulative assumption of debt as in the case of a suretyship (see Chapter 9).

E. Recourse of the New Debtor

After settling the debt, the new debtor is entitled to request compensation from the existing debtor for the payment made to the creditor. This is a case of assignement by law, which is regulated for suretyship and applies analogously. Thus, the new debtor may seek recourse against the existing debtor.

III. Additional Assumption of Debt

A. General

Anyone who enters into a written agreement with the creditor to perform an obligation on behalf of the debtor becomes a co-debtor of the existing debtor. The existing debtor's consent is not required as in the case of a classical assumption of a debt, but the agreement also has to be in writing to become effective. The object of such an agreement is the obligation of the person entering into the debt to settle the monetary claim of the creditor instead of the existing debtor.

Irrespective of the date when the debt falls due, an existing claim may be entered into. In contrast to the suretyship, the liability of a person entering into the debt is *not subsidiary*. The bank is entitled to request fulfillment (performance) *directly* by the *person entering into the debt*. However, the original debt extinguishes upon settlement, and thus the assumption of debt entered into as a means of providing security as well. The new debtor is also entitled to raise the defenses of the existing debtor.[107]

B. Difference to the Assumption of Debt

In contrast to the assumption of debt, the new debtor may only enter into a *pecuniary debt*.

[107] See Art. 533, last sentence Czech Civil Code

Chapter 11: The Guarantee

I. General

In the *Czech Republic*, the guarantee is used only in the form of a *bank guarantee*. The bank guarantee is the only form of guarantee governed by Czech law (except for the government guarantee). When the bank guarantee is used as an instrument to secure claims with the bank as beneficiary, two banks are involved in the legal relationship of the bank guarantee: one bank is the beneficiary and the other bank is the party providing a guarantee. For the sake of simplicity, the bank providing the guarantee will be referred to as the guarantor, and the beneficiary bank as the bank in the following.

The bank guarantee is governed by the Czech Commercial Code.[108] With the exception of the two provisions[109], the rules are not binding and may be disregarded by the contractual parties. Subsidiarily the provisions concerning suretyship laid down in the Czech Commercial Code are applied to the bank guarantee.[110] The relationship between the guarantor and the debtor (borrower) is regarded as a agency contract.

A bank guarantee can be provided only by one bank. In the Czech Banking Act, this bank is defined as a legal entity having the form of a stock corporation seated in the Czech Republic, which accepts money deposits from the general public and grants loans.

II. Creation

The bank guarantee is understood as a special type of suretyship.

The bank guarantee *is created* by a *written declaration of the guarantor* in a *guarantee bond* which specifies that the creditor's claim must be satisfied up to a certain amount if the borrower (debtor) fails to comply with a certain obligation or other conditions set out in the *certificate of guarantee*. In other words, the guarantor is liable toward the beneficiary bank for a still unknown event.

III. Difference to the Suretyship

Despite the many similarities, the guarantee is different from the suretyship in various respects.

First, the *abstractness* of the guarantee is to be mentioned as an essential criterion. The guarantor's obligation exists even when, for example, the loan contract has several defects and is thus void. In contrast to the suretyship, *neither the principle of accessoriness nor the principle of subsidiarity applies*, unless these principles arise from the certificate of guarantee. Basically, the guarantor may not make a claim against the bank on the grounds that the fundamental relationship between the bank and the borrower has deficiencies nor raise other objections when the bank calls the guarantee. In contrast to the surety, the contractual parties may specify their relationship in the certificate of guarantee in great detail. The bank is not obligated to request the claim to be satisfied by the borrower first, but may immediately call on the guarantor to make a payment. The

[108] Art. 313-322

[109] Art. 313 and Art. 321/4 Czech Commercial Code

[110] Art. 314 Czech Commercial Code

guarantee agreement may be accepted by the beneficiary bank by implicit acceptance.

The *guarantor is liable* for the *satisfaction* of the *secured obligation up to the amount* of the *sum* specified in the *guarantee agreement* (certificate of guarantee) under the conditions mentioned in the agreement. The guarantor may only put forward objections against the bank permitted under the certificate of guarantee. The guarantor is not entitled to raise objections arising from the fundamental relationship (between guarantor and client).

Like in the case of the surety, partial performance of the obligation by the borrower does not have any influence if the portion remaining to be satisfied is the equal to or greater than the amount stated on the guarantee agreement (certificate of guarantee). Pecuniary claims as well as other claims may form the basis of a bank guarantee. However, the guarantor must meet the obligation only in the form of money. The volume of the guarantor's obligation is specified by the amount in the certificate of guarantee and not by the actual amount of the bank's claim.[111]

The *guarantor's obligation* is contigent on the fulfillment of the *conditions* contained in the certificate of guarantee. The guarantor is obligated to perform upon the written request of the bank. In contrast to the surety, it is not necessary to call on the borrower first. The guarantor must pay "on the first call".

IV. Counter-Guarantee

The bank guarantee may be confirmed by another bank, i.e., the counter-guarantor. In this case, the secured bank may take recourse on the counter-guarantor in addition to the guarantor. If the counter-guarantee has already been called by the beneficiary bank, the counter-guarantor may seek recourse with the guarantor.

V. Objections When the Guarantee is Called

A. General

Basically, the bank may *not raise* defences to which the borrower is entitled vis-à-vis the beneficiary bank. This is an expression of the *abstractness* of the guarantee, which has the purpose of effectively satisfying the beneficiary bank and settling any disputes that may arise after the guarantor has performed the obligation.

If it has been agreed on in the certificate of guarantee that any objections arising from the fundamental relationship may be raised by the guarantor, then the guarantee becomes similar to the suretyship. If all objections are admissible, we are essentially dealing with a suretyship even if a guarantee bond exists or the contract is called a guarantee agreement. The designation of the legal transaction is irrelevant.

[111] Art. 315 Czech Commercial Code.

B. Objections Arising from the Relationship between the Guarantor and the Beneficiary Bank

The guarantor may raise any objections on the grounds of the voidness or invalidity of the guarantee agreement. The guarantor may raise defenses due to the voidness of the guarantee agreement, e.g. because the guarantee agreement is contra bonos mores or lacks the quality of being specific or is uncertain. The defense on the grounds of error is possible as well as an objection on the grounds that the conditions stated in the certificate of guaranteehave not been met.

C. Objections Arising from the Relationship between the Borrower and the Bank

Moreover, the guarantor may raise *objections* that do not directly concern him or her, *if* the *guarantee agreement* explicitly *provides for* this option. Even if no defenses are admissible on the basis of the guarantee, the guarantor may in some cases raise the defense of *abuse of rights*, even though the admissibility of this defence is interpreted very restrictively. The abuse of rights is given if the beneficiary bank calls the guarantee knowingly without being authorized to do so and thus acts in fraudulent intent. The fraud or abuse must be clearly proven. The guarantor bears a special burden of proof.

A bank that has received payment on the basis of the bank guarantee to which it is not entitled must return this payment to the borrower and is also obligated to compensate the borrower for any resulting damages.[112]

The borrower is obligated to refund to the guarantor everything the guarantor has given to the beneficiary when the guarantee is correctly called. Only afterwards can the guarantor claim repayment and compensation against the bank. An exception to this rule can be made by agreement in that the guarantor may claim reimbursement of the payment made to the bank for which it was not entitled.

VI. Other Problems

A. Assignment of the Bank's Rights

If the guarantee agreement states that the bank is only entitled to enforce its rights in the event the borrower fails to perform, the bank may transfer said rights only by assigning the claim secured by the bank guarantee.[113]

B. Limited Term of the Guarantee Bond

If the term of the guarantee bond is limited, the bank guarantee expires unless the bank enforces its claims under the bank guarantee in writing as long as the bond is valid.

[112] Art. 318 Czech Commercial Code
[113] Art. 27/5 Bankruptcy Act

Chapter 12: Concluding Remarks

In contrast to Austrian security interest law, the following significant differences exist:

It is possible to pledge *movables* by suspending the *principle of possessory liens* by entering the possessory lien into the *lien register,* which is kept by the Chamber of Notaries. Therefore, a non-possessory lien on movables that enables the borrower to continue using the asset is also possible (see Chapter 4).

A special form of *out-of-court realization* exists in the so-called *public auction*. The auction is not executed by the court, but by an auctioneer with whom the creditor concludes a contract on the auction (see Chapters 2 and 4).

An *executory title* may also be obtained *out-of-court*, if the debtor agrees to the direct enforceability of the lien in a *notarial document* (see Chapter 3).

Irrespective of the object of the lien, the *lien agreement* must be *in writing*, as otherwise it is invalid (see Chapter 3).

As regards the definition of concepts, it is important to note that the under the Czech Civil Code a piece of real *property* does not only include *plots of land*, but also refers to the *buildings* on the plots of land as independent entity of real property. Therefore, it follows that the principle of *superficies solo cedit* does not exist in the Czech Republic. Thus, the legal fate of *buildings* is separate from the plot of land and therefore a building may have its own entry in the land register (see Chapter 5).

In the event of *bankruptcy,* the bank has a *right to satisfaction of its claims from separated assets* in the case of *mortgages*, but its secured claim is satisfied only up to a *maximum of 70% of the proceeds* (see Chapter 5).

In the case of *pledged claims* and *assignment by security, no special mode of acquisition* apart from the title (lien agreement, agreement on securing a claim) is required. In contrast to Austria (book entry, notification of third-party debtor), a claim is secured by an agreement between the bank and the guarantor (see Chapters 6 and 7).

The law treats the *bank guarantee* as a *special type* of *suretyship*. Although guarantees by entities other than banks are not excluded by law, these do not occur in practice (see Chapter 11).

In contrast to the assumption of debt, in the case of cumulative assumption of debt, the new debtor may only enter into a monetary obligation. The assumption of debt is a form permissible in any type of obligation (see Chapter 10).

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