Guidelines on Credit Risk Mitigation

Legal Framework in Hungary

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 Hungarian jurists and were translated from German into English. 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 Hungarian law. The Guidelines refer to the legal situation as at 1 April 2004.

Published by:

Oesterreichische Nationalbank (OeNB)
1090 Vienna, Otto-Wagner-Platz 3

Austrian Financial Market Authority (FMA)
1020 Wien, Praterstraße 23

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Typesetting, printing and production:

OeNB Printing Office

Published and printed at:

1090 Vienna, Otto-Wagner-Platz 3

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http://www.oenb.at
http://www.fma.gv.at

Paper:

Salzer Demeter, 100% woodpulp paper, bleached without chlorine, acid-free, without optical whiteners

DVR 0031577

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, December 2005

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Chapter 1: General Remarks on the Hungarian Legal System

I. Introduction

The following guide discusses the **most important security instruments** that are available under Hungarian law. This chapter provides a brief outline of the Hungarian legal system followed by a detailed discussion of methods that can be used for the realization of security instruments. The individual chapters will look at the specific details of the realization for each type of security.

II. General

Hungary is a parliamentary republic. Its supreme legislative body is the parliament. The legislative bodies are governed by a separate law.[1] Under this law, the legislative bodies are the parliament (national assembly), the government, the members of the government (ministers), and local self-governing bodies. These bodies make laws and regulations of general validity that are binding on everyone. The parliament passes laws whereas the government, individual ministers and the local self-governing bodies issue regulations.

Other legal acts recognized by the law are resolutions of the parliament and the government, directions issued by administrative bodies with nation-wide authority, decrees of the central bank, communications of the central statistical office, guidelines and positions on the interpretation of legal norms by the parliament and the government as well as guidelines and communications of bodies vested with nation-wide authority and ministers.

The law on credit security *(hitelbiztosítéki jog)* and banking *(bankjog)* comprises statutes, government ordinances, ministerial ordinances, decrees of the central bank as well as instructions and legal guidelines of the Hungarian financial market supervisory authority *(Pénzügyi Szervezetek Állami Felügyelete*; PSZÀF), which is a body with nation-wide authority.[2] PSZÀF has the right to issue guidelines and recommendations but cannot pass laws, decrees or other rules with legally binding effect.

However, under the Civil Code *(Polgári Törvénykönyv)*, liens that are created by operation of law can only be governed by a law or a government ordinance (but not by a ministerial ordinance).

Since 1 July 2003, the court system has been organized as a four-tier system. At the first level of jurisdiction, decisions are made by the district courts (up to EUR 20,000) or the county courts (above EUR 20,000). At the second level, cases are dealt with either by the county courts, the *tagel* courts or the Supreme Court. In addition, there is also a labor court.

[1] Act No. Xi./1987 on Legislation

[2] Act No. CXXIV./1999 on State Supervision of Financial Organizations.

Chapter 2: General Remarks on Securing Credit Risk in Hungary

I. The Credit Agreement

A. General

The following chapter discusses the rules for credit agreements *(hitelszerződés)*, describes the legal relationship between the borrower and the lender, and relevant practices in Hungary. Credit agreements may already include clauses on the provision of security even though such arrangements are commonly laid down in a separate contract.[3]

The **obligations** of the borrower are stipulated, as a rule, in the **bank credit agreements**. These agreements usually also specify the events and circumstances in which the lender may terminate the legal relationship and ask for settlement of the claim and satisfaction from security interests. The legal ground on which credit security may be enforced is thus often contained in the credit agreement. Therefore, this chapter takes a closer look at the reasons for terminating bank credit agreements that are laid down in the legal provisions or have been developed in practice.

The legal framework for credit and bank loan agreements is defined by the Civil Code (Article 522-523).[4] Within this framework, the Civil Code leaves the specification of details to other legal regulations and contractual freedom.

The term "credit agreements" is used both in Act No. CXII/1996 on Credit Institutions and Financial Companies (Banking Act). This act subsumes under the heading of credit agreements not only the traditional credit business but also other transactions such as factoring, leasing, etc.

B. Bank Credit and Loan Agreements

Under a **credit agreement** *(hitelszerződés)*, the bank undertakes to make a credit line available to the customer against a fee and, under this credit line *(hitelkeret)*, extends loan agreements on terms specified in the agreement for sums up to the credit limit or carries out other credit transactions. The credit agreement is a **master agreement** that usually regulates all aspects of the relationship between the bank and the customer. The **loan agreement** *(kölcsön)* on the other hand regulates only one single **specific transaction**.

C. Format of the Agreement

To be legally effective, credit and loan agreements have to be in writing. The same applies to any amendment or termination of the agreement (Article 522 leg cit Civil Code).

[3] This applies specifically to lien agreements. One reason for this is that the Judicial Execution Act requires lien agreements to be laid down in the form of notarial deeds.

[4] A reform of the Civil Code is to be adopted by 2008. This would probably have consequences for the legal framework conditions for credit risk mitigating techniques.

D. Contents of the Credit Agreement

1. Credit Line

Specification of the **amount of the credit line** and the **currency** are indispensable parts of the agreement.

Indication of the **purpose** and the **description** of the credit *(hitel)* are prerequisites for its effectiveness that have evolved in practice and have been acknowledged in the comments on the Civil Code. These items are of significance when the agreement is ended (terminated by the bank), as use of the credit amount for other purposes than the one named in the agreement may constitute a reason for early termination.

The **maturity** *(lejárat)* of the credit must be defined precisely.

2. Consideration for Credit

In the credit agreement, the parties agree **interest** to be payable as consideration for the credit, which is to be paid out of the credited amount. This interest is called commercial interest.

3. Termination of the Agreement

The termination *(felmondás)* of credit relationships may be effected in two ways: by termination **with notice** or by termination **with immediate effect**.

a. Termination with Notice

An **agreement** that has been entered into for an **indefinite period of time** may be terminated upon **15 days' notice** (termination with notice). The borrower may terminate the agreement upon 15 days' notice (termination with notice) if he or she has repaid the entire sum due under the credit or loan agreement.

The right of the lender (jog) to demand repayment of the credited amount may be exercised in accordance with the maturity specified in the agreement and, in the event of termination, upon expiry of the notice period.

b. Termination with Immediate Effect

The general rules governing the termination of agreements with immediate effect are contained in the Civil Code[5]. Under these, the lender may terminate the loan with immediate effect if

- the loan cannot be used for the purpose specified in the agreement;
- the debtor *(adós)* uses the loan for another purpose than the one specified in the agreement;
- the collateral provided to secure the loan has lost considerably in value and the debtor has failed to compensate for this loss despite having been asked to do so by the creditor *(hitelező)*;

[5] Article 525 Civil Code.

- the repayment of the loan is at risk due to a deterioration in the debtor's financial situation or due to conduct on the part of the debtor aiming at the withdrawal of coverage;[6]
- the debtor has committed other serious breaches of the agreement.[7]
- the debtor becomes creditworthiness;
- the debtor has misled the financial institution *(pénzintézet)* in fixing the amount of the credit by providing false information, by failing to disclose information or influencing the amount of the loan granted in some other way;
- the debtor obstructs investigations concerning the coverage or collateral provided for the loan or the realization of the purpose of the loan despite being asked to refrain from such conduct; the same applies when the debtor fails to perform duties of information specified in the agreement or required by law.

II. General Notes on the Law Governing Credit Security

A. Real and Personal Security Rights

Credit security *(hitelbiztosíték)* may be personal security or collateral.

Providing **personal** security *(személyes biztosíték)* means being personally liable for the performance of another person's obligation. In such cases, the lender may ask the third party providing the security (e.g. surety) beside the borrower to make payment against the debt up to the amount of the liability assumed. Types of personal security are specifically suretyship and guarantee.

With **collateral** *(dologi biztosíték)*, the owner is liable with a certain asset for the performance of an obligation, which may be his or her own or somebody else's. The most important types of real security are lien and security deposit.

The Hungarian Civil Code also includes rules for contractual penalties. Contractual penalties are, however, hardly used in banking practice.

B. The Security Agreement

Under Hungarian law, security may be provided for all agreements governed by Hungarian civil law, including specifically credit and loan agreements. The security agreement *(biztosítéki szerződés)* may already be part of the credit or loan agreement, but security rights securing a larger claim *(követelés)* as well as security arrangements providing for the creation of liens are usually laid down in separate contracts (so-called security agreements).

[6] Particularly in the jurisdiction many disputes and divergences of opinion have arisen regarding the interpretation of this condition as a reason for termination. This is illustrated by a closer look at the exact wording of the law. Someone has to determine whether one of the criteria (deterioration of financial position or the debtor's conduct) actually endangers the redemption of the credit. If the debtor gets into such a situation or shows such a conduct, he or she will obviously not be able to comment with reasonable objectivity on his or her ability to pay off the loan. Therefore, the situation can only be assessed by the lender. This option, however, can be derived from the wording of the law only by way of a very broad interpretation. Therefore, jurisdiction is anything but uniform.

[7] Other serious breaches of contract are named in the Civil Code. On the other hand, any act/omission defined as grave in the agreement may constitute a reason for a termination of the agreement.

1. Agreements on the Provision of Security

The bank has the right to demand from the borrower to furnish security for the period of the credit relationship. Provision of security is usually agreed as one of the conditions for the disbursement of the loan.

In practice, a bank asks for the provision of security not only when establishing a credit relationship. As a rule, it is also agreed that the bank, at its discretion, may ask for further security at any time during the credit relationship. In Hungary, various forms of security are used in practice:

- when an agreement is closed, the bank requires security to be furnished as a precondition for granting the loan;
- during the life of a credit relationship, supplementary security may have to be provided; or
- during the life of a credit relationship, different types of security rights may be exchanged.

2. Formal Requirements

Security agreements are not subject to any specific legal requirements regarding form unless such agreements are part of a bank loan. To allow direct realization and the creation of a registered loan and its entry into the relevant register such agreements are usually drawn up as notarial deeds.

3. Valuation of Security Rights

An adjustment of security rights to the current amount of the claim is not required by law. Security rights are valued by the credit institutions *(hitelintézet)* using their own procedures and methods. This is permissible if previously agreed by contract. In the course of the valuation procedure it is frequently found that the value of the security offered by the borrower or demanded by the lender exceeds the amount of the principal and ancillary charges.

One of the most important rights of the lender is to verify the existence and suitability of security furnished as cover for credit. Detailed provisions prescribing how such verification is to be performed are normally contained in the agreement. One of the most common provisions is that verification by the lender shall not interfere with the debtor's usual conduct of business. Verification shall not extend to unusual cases and situations and shall not be performed at inconvenient times. The authority to conduct verification does not entitle the lender to require the borrower to disclose business secrets.

C. Insurance of Security Rights

The lender may stipulate that the borrower obtain comprehensive insurance cover for the assets serving as security. Buying insurance may be a precondition for the disbursement of the loan granted. As another condition in the contract, the lender may require that in the event that the asset serving as security is damaged, the insurance proceeds due to the borrower shall be assigned to the lender as security up to the amount of the claim being secured.

D. Legal Status of a Third Party Providing Security

The provider of security and the borrower are frequently not the same person. In such cases the third party furnishing the security declares either in a separate

deed or in the credit agreement itself that he or she has knowledge of the terms and conditions of the agreement and has taken note of them.

The legal status of the third party is governed by civil law: the third party may be a lienee, a party making a security deposit, a surety, or an assignor.

III. Realization of Security Rights

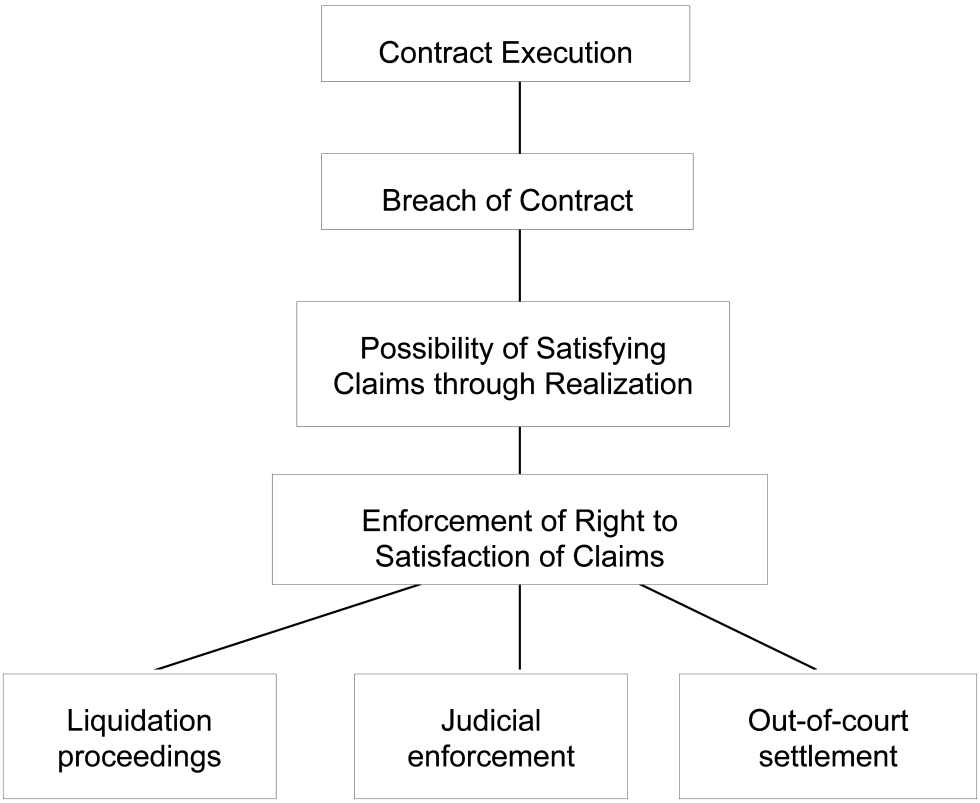
A. General

If the borrower does not perform his or her obligation by the due date, the lender is entitled to enforce the claim against the security provided.

Security interests generally have to be enforced in **judicial** proceedings *(bírósági végrehajtás)*. The **execution title** required for juridical enforcement may be obtained through **judicial** proceedings (a court decision) or **extrajudicially** (enforceable notarial deed). In the case of **a security deposit** and, sometimes, with a **lien** *(zálogjog)*, the law also permits **extrajudicial satisfaction** of claims (see chapter entitled General Remarks on Liens).

When **liquidation proceedings** are instituted against an insolvent debtor, security interests can be enforced only under these proceedings and **not extrajudicially**.

The chart below illustrates how security interests are handled.



The following sections of this chapter first address judicial execution proceedings, which are to be applied primarily, followed by the enforcement of security interests in **liquidation proceedings**. **Extrajudicial** realization of security, which is of significance only in realizing liens on movable property

and in the case of security deposits, will be discussed in the chapter entitled General Remarks on Liens.

For the realization *(értékesítés)* of security interests, **execution proceedings** are important for two reasons. Firstly, **personal security** can be realized only in this manner after obtaining an execution title. Secondly, **contractual liens** may also be enforced in execution proceedings. This is of particular importance when realizing real property, which cannot be realized extrajudicially. For this reason, this chapter devotes much attention to the general rules for realization of security in execution proceedings. The chapters on liens will then discuss only those rules that apply exclusively to the realization of contractual liens.

B. Judicial Execution

Court decisions can be enforced in judicial execution proceedings. Such proceedings are regulated by law.[8] In judicial execution proceedings, a debtor who is liable to make payment may be forced to fulfill the obligation even by public authority. Under this Act, public authority may restrict the debtor's property rights but only in exceptional cases the personal rights.

When it is foreseeable that it will be impossible to collect a claim within a relatively short time by execution against the debtor's income from employment or money deposited with a financial institution, execution may be levied against any seizable asset owned by the debtor.

1. Execution Title

In judicial proceedings, the bank may enforce its security right provided it is in possession of an executable title. In addition, the bank may also be included in any (pending) execution proceedings instituted by somebody else if the bank has a real right (e.g. a contractual lien) on an asset affected by the execution.

Once an execution title has been issued, a claim may be enforced judicially. Execution titles include:

- a **writ of execution** issued by the court;
- **deeds** (see notarial deed below) provided by the court with an **clause of enforceability**;

The right to enforce a claim lapses together with the claim to be executed. The statute of limitation with respect to the right to enforce a claim is interrupted by any enforcement action.

a. Writ of Execution

The court of first instance having jurisdiction issues a writ of execution in the following cases:

- based on a court judgment in a civil matter or based on a settlement confirmed by the court;
- based on a decision made by a notary *(közjegyző)* or based on a settlement confirmed by a notary;
- based on a decision passed by a foreign court;

[8] Act No. LIII/1994 on Judicial Enforcement

- based on decisions or settlements awarded by domestic or foreign courts of arbitration.

Based on a settlement confirmed by the court, an execution title may be issued even if the court's confirmation decision has been appealed.

b. Notarial Deed

The court adds an **clause** of enforceablity*(végrehajtási záradék)* to a **notarial deed** if the deed shows

- an assumption of an obligation to render performance against counter-performance or a unilateral assumption of an obligation,
- the names of the creditor and the debtor,
- the object, the amount (sum) and the legal title of the obligation as well as
- type and date of performance

The deed may be used to enforce either a **personal** security (e.g. suretyship, guarantee) or a **collateral** (e.g. lien). In either case, rights are enforced through judicial execution proceedings as a matter of principle.

If the obligation depends on the fulfillment of a condition or that a set date is reached, these requirements must be confirmed by a public deed to render the claim enforceable. Under this rule, a claim recorded in a notarial deed[9] may be executed once the period granted for performance has expired.[10]

2. Realization of Movable Property in Execution Proceedings

a. General

If the debtor has failed to meet the obligations set out in the enforceable deed, the **bailiff** will **seize t**he **movable property** by listing the assets in the bailiff's record. Following a petition by the lender, the bailiff inspects the lien register kept by the Hungarian Chamber of Notaries to determine whether the debtor appears in the register as a lienee and whether liens have been registered on the entirety of his or her assets or individual items of his or her property. In addition, the bailiff asks the debtor to indicate which of his or her assets are encumbered by liens held by third parties. When the enforceable document is delivered by mail, the debtor has to make this declaration within 15 days from its delivery.

After levy of execution and/or after having obtained data from the lien register, the bailiff notifies, without delay, those parties of the levy of execution who are assumed to hold liens on the seized assets.

The bailiff notifies the lienor that he or she may enforce the claim under the lien in execution proceedings and that a petition to this effect has to be filed with the competent court within eight days of this notification.

b. Execution Proceedings in the Case of Liens on Movable Property

Contractual liens (also see chapter entitled General Remarks on Liens) can be **dealt with** only **after the levy of execution** (seizure) of the pledged item *(zálogtárgy)* in execution proceedings. If the lienor's petition is received in time,

[9] The AJE specifically mentions the lien agreement executed as a public deed.
[10] Article 22 leg cit AJE.

the execution court declares, in summary proceedings, that the lienor is entitled to satisfaction of his or her claim. This means that the lienor may take part in the execution proceedings to enforce his or her lien. For this purpose, the legal ground and the amount of the secured claim have to be uncontested. Recognition of a liability in the form of a **notarial deed**, which the borrower in practice already provides when entering in the **credit** or **security agreement**, renders the bank's **claim enforceable** and **uncontestable**.

The court delivers the lienor's petition to the debtor and to the initiator of the execution proceedings (judgment creditor), inviting them to comment within 8 days of delivery on whether or not and to what extent the legal ground and the amount of the claim are uncontested.

If the debtor or a judgment creditor **contests** the legal ground or the amount of the claim, producing evidence supporting their position, the court hands down a decision dismissing the lienor's petition. The lienor may then enforce his or her claim from the lien in **court proceedings**.

If the debtor or a judgment creditor has recognized the claim secured by the lien in an amount differing from the amount claimed in the lienor's petition, the court will notify the lienor accordingly. The lienor may petition the court to decide to open … said right to claim satisfaction in summary proceedings and permit participation in the execution proceedings in respect of the recognized portion of the claim. With regard to the contested part of the claim, the lienor may bring action to enforce his or her claim under the lien.

The lienor, the debtor and the judgment creditor have a right of appeal against the court's decision. The lienor participating in the execution proceedings must, however, advance the portion of the execution fees allocable to the pledged item and other charges.

c. Auction

Movable assets have to be realized by **auction** *(árverés)*, as a rule. The bailiff *(bírósági végrehajtó)* issues an auction notice announcing the time of the auction. Interested parties may bid in person or through an agent. If the first auction is unsuccessful, the movable assets have to be realized in a second or, if necessary, in a third auction.

The proceeds from the realization of movable assets have to be used, first of all, for satisfying the claims of lienors.

When seizing movable assets, the bailiff determines their value by performing an appraisal *(becslés)*. This appraisal is based on the market value of the asset. If the parties have agreed on an appraised value, this value is binding. If requested by one of the parties, the bailiff commissions an expert to perform an appraisal.

d. Sale Without Auction

If requested by the parties, the bailiff may also sell movable property at an agreed selling price to a jointly named buyer without an auction but with the same legal effect as if an auction had been held.

Realization without auction **requires the consent of the judgment creditors**. If it is expected that the proceeds from the sale will be adequate to **cover** the costs of the execution proceedings and **satisfy** the claims of **all** judgment

creditors as well as the claims of all lienors participating in the proceedings, the **consent** of the judgment creditors is **not required** for realization without auction.

3. Realization of Real Property in Execution Proceedings

a. General

A piece of real property owned by the debtor may be subject to execution proceedings regardless of its character or type of management or any rights or restraints encumbering it. A piece of **real property** may be **sold**, however, only if the claim **cannot** be fully **satisfied** from **other assets** of the debtor or can be satisfied only after an unreasonably long time.

The bailiff **enters the levy of execution** of real property in the land register kept at the **land registry** *(Földhivatal)*. The land registry serves notice of its decision to enter the execution lien to the bailiff, the parties, and other persons possessing a right relating to the real property that has been entered in the land register. The levy of execution is executed by entering the execution lien in the land register. This constitutive entry is effected in summary proceedings.

b. Lien on Real Property in Execution Proceedings

The conditions under which the holder of a lien on real property may take part in execution proceedings are the same as those governing participation of the holder of a lien on movable property.

The bailiff informs the lienor immediately after receipt of notification from the land registry that the lienor – unless he or she is a judgment creditor (initiator of the proceedings) – may enforce the claim under the lien in the proceedings and for this purpose has to file a petition with the execution court within 8 days from the delivery of this notification.

c. Appraisal of Real Property

Prior to the sale of the real property, the bailiff appraises the real property on the basis of an expert's opinion and an official tax and value certificate not older than 6 months. The official tax and value certificate and/or the appraiser's assessment has to indicate whether or not the real property is to be classified as a residential property.

The bailiff communicates the appraised value *(becslés)* of the real property to the parties and the lienors.

d. Auction of Real Property

As a rule, real property has to be realized by way of auction. The auction is announced by the bailiff by auction notice. The notice also has to be served to those who have rights to the real property entered in the land register.

When real property is sold by auction, anyone may bid who has deposited **an advance of 10% of the appraised value** with the bailiff prior to making his or her first bid. If the purchase price offered is lower than the minimum bid required, the minimum bid has to be reduced gradually to **half of the appraised value**.

In the case of **residential property**, the minimum bid must not be reduced to less than **70% of the appraised value** if the property is the **debtor's only real property** and the debtor was resident at the property to be realized both at the time of the auction as well as 6 months before the institution of execution proceedings.

If the buyer of the real property has a claim towards the judgment debtor, for the enforcement of which an execution lien was entered in the land register in respect of the property sold by auction, the buyer may retain the proceeds from the auction or that portion of the proceeds that is required to satisfy his or her claim.

In addition, the buyer may agree with the registered lienor (mortgagee) that the mortgage on the real property continues to exist even if the mortgagee could be satisfied from the purchase price. If the buyer can prove the existence of such an agreement to the bailiff, he or she may again retain the purchase price or that portion of it that is required to satisfy the mortgagee's claim.

If, on distribution of the proceeds, a creditor's claim that is secured by a registered lien cannot be satisfied, the buyer has to deposit the purchase price or the retained portion thereof plus interest within 15 days after having been asked to do so by the bailiff.

e. Sale of Real Property Without Auction

As with movable property, the bailiff, **at the request of the parties**, may sell the real property to a **buyer named** by them at an appraised value set by them even without an auction, but with the same legal effect. Here again the rule applies that the consent of the judgment creditors is not required if it is expected that the cost of the execution proceedings as well as the claims of all judgment creditors and lienors taking part in the proceedings will likely be covered by the proceeds of the sale and the land register does not show any other rights encumbering the real property.

f. Takeover of Real Property by the Judgment Creditor

If the second auction is likewise unsuccessful, the **judgment creditor** may take over the **real property at half its appraised value** within 15 days of the receipt of the auction report. If the amount of the judgment creditor's claim does not reach half the appraised value of the real property, he or she has to surrender any excess. As in the case of residential property the required minimum bid must not be reduced to less than 70% of the appraised value, a takeover below this value is not allowed unless the party taking over the property also pays the difference.

g. Payout of the Proceeds (distribution of highest bid)

As mentioned above, the proceeds from an auction held to realize movable property have to be used first of all to satisfy the lienors. When realizing real property, however, claims with priority status have to be satisfied before the claims of lienors. If the proceeds from the realization of such assets are not sufficient to satisfy all claims, certain claims (detailly described chapter three) have priority.

If several claims are secured by liens, the claims have to be satisfied in the order in which they were entered.

h. Distribution Plan

If not all eligible claims can be satisfied in the execution proceedings, the bailiff draws up a distribution plan, which he or she sends to the parties, informing them about their rights of appeal.

When distributing the proceeds from the realization of the real property, the bailiff satisfies those claims that were listed in the realization edict, claims in respect of which an enforceable deed was received by the court and in respect of which the creditors advanced the costs of the proceedings. The judgment creditors in subsequent execution proceedings will be satisfied from those proceeds in accordance with the general rules for the satisfaction of claims.

The distribution plan may be contested by filing an appeal with the execution court. The court decide the matter by handing down a ruling. If the court upholds the appeal, it changes the distribution plan.

i. Special Execution Rules for Residential Property

Beside the previously mentioned restriction regarding the definition of a minimum bid, the law contains special provisions on the time allowed for vacating residential property. If the debtor is a natural person, **eviction is not possible between 1 December and 1 March**. During that time, the judgment creditor can obtain an eviction order only if other measures have been taken to prevent the debtor from becoming homeless.

On expiry of the period named above, the bailiff orders the eviction of the residential property in summary proceedings.

4. Realization of Security Rights in Liquidation Proceedings

a. General

In Hungary, liquidation rules are laid down a separate act, the Bankruptcy Act[11], *(csődtörvény)*. The name of this act may be misleading, however, as it lays down the rules for both bankruptcy proceedings and liquidation proceedings *(felszámolási eljárás)*, as well as voluntary liquidation. Efforts are currently being undertaken aiming at a reform of the Bankruptcy Act. Changes may also be expected to be implemented with regard to the treatment of instruments used to reduce credit risk.

It has to be noted that the Hungarian terminology of insolvency proceedings differs greatly from the terms used in Austria. What is called bankruptcy proceedings in Austria is known as liquidation proceedings in Hungary. What under Austrian law is termed reorganization proceedings is called bankruptcy proceedings in Hungary. Finally, the proceedings known in Austria as liquidation proceedings are referred to in Hungary as voluntary liquidation.

In Hungary, only **commercial entities**[12] may be subject to such proceedings, not **natural persons**. Unlike Austrian law, Hungarian law does not provide for

[11] Act No. XLIX/1991 on Bankruptcy Proceedings, Liquidation Proceedings, and Voluntary Liquidation (Bankruptcy Act).

[12] Under the Bankruptcy Act, a *commercial entity* is: a state-owned enterprise, a trust, any other state-owned commercial body, a co-operative, a business company, a non-profit company, so-called enterprises of individual legal entities, the subsidiary, with the exception of the Public Waterworks Company, the Water Management Company, the Organization of Forest Owners, the Voluntary Mutual Insurance Company, and the association.

"bankruptcy of natural persons". **Bankruptcy proceedings** are proceedings in which the debtor applies for an extension of the time allowed for payment in order to come to an arrangement with his or her creditors and/or makes an attempt to come to an arrangement with his or her creditors. These proceedings do not involve any realization of property, therefore they are of no significance where the enforcement of claims is concerned. Voluntary liquidation aims at winding up a company based on the owners' own decision. In such a case the commercial entity is not insolvent and is able to fully satisfy its creditors in the course of the proceedings. If the entity proves unable to settle its liabilities in the proceedings, liquidation proceedings will be instituted against it.

Liquidation proceedings may be instituted against an economic entity that is insolvent. The main feature of these proceedings is that individual execution against the debtor is no longer possible. In its place, universal debt regulation proceedings are conducted by a administrator of the bankrupt's estaste.[13]

Bankruptcy proceedings are very rare in practice in Hungary. Much more frequent are liquidation and voluntary liquidation proceedings as illustrated by the Table below:

Number of proceedings		2000	2001	2002	2003
	Bankruptcy	12	24	15	25
Total:	Liquidation	4.998	5.895	6.189	7.693
	voluntary liquidation	5.594	6.401	5.060	4.372
Total:		*10.240*	*12.320*	*11.264*	*12.090*

b. Enforcement of Claims

The time at which liquidation proceedings are opened is the time the liquidation petition is received by the county court (metropolitan court).

In order to satisfy the creditors' claims, in liquidation proceedings the administrator collects the debtor's receivables (including receivables not yet due or not yet enforced) and realizes the debtor's assets. Assets encumbered by liens or deposited as security are likewise realized. The assets subject to execution proceedings as well as assets given as security deposits have to be handed over to the administrator of bankrupt's estate.

The Bankruptcy Act[14] lays down the order in which liabilities have to be satisfied from the assets of the commercial entity that are subject to liquidation. Claims that are secured by liens (including non-accessory liens and claims involving acquiescence to satisfaction from the plegded property) have to be satisfied immediately after coverage of the cost of the proceedings up to the amount of the value of the pledged asset if, based on the underlying lien agree-

[13] These proceedings do not aim at a rescue of the company, but at realizing the assets followed by winding up the company.

[14] Article 57(1) Bankruptcy Act

ment, any fraudulent conveyance or transfer of assets without fair consideration as defined in the Civil Code[15] is not to be assumed.

In liquidation proceedings, the principle of priority is also applicable, with the order in which claims are satisfied depending on their ranks. This principle is imperative and can be overridden only by law; any legal regulation of lower rank must not contain any conflicting provisions[16].

Claims based on **liens** or **security deposits** are **often not fully satisfied** in liquidation proceedings, as only a portion of the proceeds is employed to satisfy priority rights. **50%** of the proceeds obtained from the realization of assets encumbered by liens or given as a security deposit less the **cost of realization** have to be used to satisfy claims that have been secured by **liens** for at least one year or by a security deposit. The **other half** is used to settle, first of all, the **liquidation costs** and then to **satisfy other claims secured by liens** or security deposits, and, finally, **other claims of creditors**.

If the lien was created prior to the opening of liquidation proceedings[17], the secured claim ranks as a claim that is secured by a lien. Nonetheless it has to be assigned its proper rank in the general order in which claims are satisfied in liquidation proceedings[18]. This order of priority is as follows[19]:

1. cost of liquidation;
2. claims secured by liens and security deposits;
3. certain alimony payments and life annuities to be paid by the entity;
4. other claims of private individuals not related to commercial activities;
5. liabilities to social insurance institutions;
6. other claims;
7. interest on arrears and extra charges on arrears.

These claims will be explained in more detail below:

1. The cost of liquidation includes, among others, the following items:
   - employee compensation and other compensation-like payments payable by the debtor, including severance payments payable on termination of employment; if wages and other wage-like payments that were due before the opening of liquidation proceedings were paid after the opening of liquidation proceedings, as well as the taxes and charges payable on them (including health insurance contributions);
   - the costs, after opening of the liquidation proceedings, associated with the efficient termination of the debtor's business activities and with the

[15] Article 203(2) Bankruptcy Act

[16] The principle of priority is also observed by Article 170(2) Judicial Execution Act and Article 57(1) Bankruptcy Act. Article264(2) of the Civil Code, however, contains a provision that departs from the priority principle. Article499(2) of the Civil Code gives a carrier a right of satisfaction having precedence over the lienors for items of which he acquired possession in the course of providing transport services.

[17] This applies even if the lien was created only one day before the decision to institute liquidation proceedings acquired legal force. It is therefore noted that if the date of entry on the title page (which includes the land charges register), which at the same time is the date the lien is created, is only one day before the institution of liquidation proceedings, i.e., before the court decision on liquidation gains legal force, the claim secured by the lien has to be satisfied in accordance with the general order of satisfaction. However, if the day critical for the ranking of a registered lien is at least one year before the institution of liquidation proceedings (receipt of petition for liquidation by the court), the creditor's claim enjoys a higher rank. For the satisfaction of these claims, 50% of the proceeds from realization of the pledged item will be allocated less the cost of the realization.

[18] Under Article 57(1) lit b Bankruptcy Act.

[19] Article 57 leg cit Bankruptcy Act.

protection and/or preservation of his or her assets, including the costs of remediating damage to and contamination of the environment and the debtor's debts under credits as well as his or her liabilities for taxes and charges as well as compensation for damages having arisen from business activities after the commencement of liquidation proceedings, with the exception of income taxes;
- documented costs associated with the sale of the assets and the enforcement of claims;
- the costs incurred in the course of the liquidation proceedings that have to be borne by the commercial entity;
- the administrator's fee including expenses for assistants;

2. **Claims** that are secured by **liens** or **security deposits** (including non-accessory liens and claims involving acquiescence to satisfaction from the lien [claim in rem]) up to the amount of the lien or security deposit, provided the security had been agreed before opening of the liquidation proceedings and any fraudulent conveyance or transfer without fair consideration is not to be assumed. Sums already paid out have to be taken into account. If an asset is encumbered by several liens, the order in which claims are satisfied depends on the order in which the liens were created. Claims for the enforcement of which an execution lien was entered before opening of the liquidation proceedings or for which movable property was seized have to be treated in the same way as claims that are secured by liens or security deposits.
3. **Alimony payments** to be made by the entity as well as **life annuities, annuities** resulting from **liability for damages, wage supplements** for miners as well as life-annuity-like benefits to members of an agricultural co-operative made in lieu of the right to cultivate a plot of land for private purposes or benefits in kind.
4. Other claims of private individuals not arising from commercial activities such as **claims** due to **faulty performance** or claims for damages including an amount, to be specified by the administrator, for the customary obligations under **warranties and guarantees** with the exception of claims from bonds, claims of small business enterprises and of primary agricultural producers;
5. Liabilities to social insurance institutions, taxes – with the exception of taxes arising from the realization of assets and the enforcement of claims – and public charges levied like taxes, as well as water and sewer charges.
6. Other claims;
7. Interest on arrears and extra charges on arrears as well as liabilities representing surcharges and penalty payments regardless of the time and the legal title of their origination.

Under the rules of the Bankruptcy Act governing the enforcement of security rights, financial and other types of security interests are treated in the same manner. Nor does the law make any distinction based on whether enforcement through (executive) realization of the pledged asset or direct satisfaction was agreed in the security agreement.

c. Realization

The administrator of the bankrupt's estate has to realize the borrower's assets at the highest price obtainable on the market. Realization is carried out by way of **auctions** or **tenders**. The administrator may waive such a procedure only in exceptional cases. Realization has to start within 120 days from the announcement of liquidation proceedings. The buyer acquires unencumbered ownership in the assets[20].

Tender

The administrator announces a public tender in the Official Gazette not later than 15 days prior to the start of the bidding period. He has to open the bids in the presence of a notary. The notary keeps a record of the proceedings. The administrator provides an account of the tender and its outcome in a record, which he or she sends to the creditors' committee.

In the absence of suitable bids the administrator may declare the tender to have failed to produce a result and announce a new tender. If several reasonable bids of equal value (deviating from the purchase price by not more than 10%) are received, the administrator has to hold a public price negotiation among the bidders, the conditions of which are to be communicated to the parties prior to the beginning of the price negotiation.

Auction

The administrator announces an auction by publishing a notice of auction in the Official Gazette not later than 15 days prior to the start of the auction. If the purchase price bid in an auction does not reach the appraised value, the administrator may decide to hold another auction or reduce the purchase price to not less than half the appraised value. If again no bid is received at this price, the administrator declares the auction to be without result. The administrator has to conduct the auction in the presence of a notary. At the auction, the notary draws up a record of the proceedings with a copy to each bidder.

[20] BH 1996. 267.

Chapter 3: General Remarks on Liens

I. Introduction:

The outline of the law governing liens *(zálogjog)* provided below is given without differentiating between movable property and real property, as in Hungary a distinction between these two types of property is made neither by the law nor in theory. At the beginning of the chapter, therefore, those rules will be explained that apply to liens in general. The characteristics of this type of security will be described from its creation the enforcement of the lien. At the end of this chapter, a special form of lien will be discussed, the so-called non-accessory lien *(önálló zálogjog)*.

The next chapter addresses the special rules applicable to the different types of liens – registered lien *(jelzálog)*, possessory lien *(kézi zálogjog)*, lien on rights and receivables, and the lien on the entirety of an entity's assets *(vagyont terhelő zálogjog)*.

II. General Remarks on Liens

This section explains the rules that apply to all types of liens equally.

Under Hungarian law, liens may be classified as follows:

- **Registered liens**, which may be created on movable property, on real property, on the entirety of an entity's assets, on rights, and on receivables.
- **Possessory liens**, which can be created only on movable property.
- **Non-accessory liens**, which can be created in connection with registered liens on movable property and on real property without an underlying claim.

Liens provide security to the lender in the event of default. In such a case, the lienor may satisfy his or her claim from the pledged item. The parties involved are the **lienor or lienholder** (lender, bank), the **personal debtor** (borrower) owing the claim, and in some cases the (third-party) **lienee**, who has the right to dispose of the item to be pledged and need not necessarily be the debtor of the claim (so-called real debtor). The personal debtor and the lienee may, however, also be one and the same person.

Generally, persons having the **right to dispose** of the pledged item may grant a lien as lienee (zálogadós). However, a person who acquires the right to dispose of an item only at a later date, under an agreement closed with a third party, may likewise act as lienee.[21] In such a case, the lien comes into existence at the same time as the lienee's right to dispose of the asset.[22]

A lien has an **absolute** (real) **effect**, i.e., it is effective vis-á-vis everyone. Whoever acquires a right in the pledged asset after the establishment of the lien is obliged to accept the satisfaction of a claim under the lien. If the owner sells the pledged asset, the new owner becomes the lienee and thus the real debtor, whereas the borrower remains the personal debtor.

[21] A lien on an asset over which the lienee acquires the right of disposition only after conclusion of the lien agreement has to be entered only in the lien register for movable property, not in the land register.

[22] This is very often the case in banking practice. It allows the banks, for example, to finance the purchase, as it enables the creation of a lien even before the lienee acquires ownership. This procedure is used frequently by banks extending loans for the purchase of real property: the seller sells the real property with reservation of title in his favor. The bank usually pays out the last installments of the purchase price direct to the seller after it has concluded the loan and security (lien) agreements with the buyer of the real property as the borrower.

The real debtor is only obliged to accept satisfaction of the borrower's claim from the pledged item. The borrower's liability is limited by the value of the pledged item. However, satisfaction from the lien becomes possible only in the event the borrower **defaults** on the secured claim (maturity of the lien). If the personal debtor and the real debtor are different persons, the lender is free to choose against whom he or she wants to enforce the claim; the lender may even bring action against both parties simultaneously. The real debtor may discharge the claim voluntarily, which causes the lien to become extinguished *(járulékos,* accessory nature of the lien).

The purpose of the lien is to secure a claim. It can be transferred only together with the claim. When a claim is **transferred**, the **lien** also passes automatically to the new creditor. Thus the lien cannot be transferred without the **secured claim** as a matter of principle. This rule does not apply, however, to the so-called non-accessory lien (see below).

When **several items are pledged** under a lien to secure a claim, each such item serves to secure the entire claim in cases of doubt. When the pledged items are owned by several persons, these are liable to each other proportionately to the value of the pledged items unless otherwise provided under their mutual legal relationships. If one of them satisfies the lender's entire claim, that person may ask the other parties for compensation (right of recourse). The amount a party seeks to recover through recourse is determined by its legal position (e.g. under an agreement). The lien on the other pledged items passes to the lienee who has satisfied the lender's claim in the amount of his or her claim of recourse. He may ask for surrender of the pledged item or to have the lien entered in the register for his benefit.

When a claim is secured by both a lien and a suretyship, with a party being liable as surety and payer, the lender is free to choose which security he or she will use to satisfy the claim. The lienee cannot plead that the surety and payer was not asked by the lender first to render performance.[23]

It must be noted that the legal provisions prohibiting an agreement under which the lender acquires ownership in the pledged item upon default of the lienee apply only until the expiry of the period in which payment has to be made (ban on so-called accelerating clause). After expiry of the period allowed for payment, the parties may effectively enter into such an agreement. This also applies to shares of stock placed under lien provided the statutory provisions for the transfer of shares have been complied with.[24]

A. The Secured Claim

The **claim** that is secured by a lien must be defined or must be at least definable.

The liability of the pledged item is determined by the claim it secures. It is thus, with the exception non-accessory liens, accessory. When the claim is reduced, the liability of the pledged item is likewise diminished. Any excess proceeds from realization of a pledged item (hyperocha) belong to its owner.

The **claim** includes **interest**, the **cost** of enforcing the claim and the lien as well as all costs incurred to preserve, keep and protect the pledged asset. Under

[23] BH 1996. 308.
[24] BH 1995. 649.

the Civil Code, interest is due under contractual relationships unless otherwise provided by the law (so-called commercial interest). In the agreement, the parties also lay down the maturity, so that up to that time the rate at which commercial interest is charged and the sum of interest are clear. In the event of default, both commercial interest and interest on arrears for the duration of the default may be charged. Therefore it is impossible at the time the lien is established to calculate what costs will be incurred and in what amounts. Thus, at the time the lien is created, it is still unknown how high the lienee's actual liability will be.

An agreement establishing a lien on a **claim that cannot be judicially enforced** is void. Action may be brought to have the court declare such an agreement ineffective[25].

B. Assets That May Be Subject to Liens

The Civil Code specifies assets on which liens may be placed:

- all assets that may be held in possession;
- transferable rights and claims.[26]

A lien may be placed on movable property *(ingatlan dolog)* as well as on immovable property *(ingó dolog / ingóság)*. **Money** may also be pledged under a lien.[27] As **securities** are also assets, they may also be pledged.[28] Securities may not only be pledged but may also be used as security deposits.[29] When using securities as collateral it is therefore important to consider which objective is to be pursued, i.e., whether the securities are to serve as a pledge or as a security deposit (concerning security deposits see the chapter entitled Special Instruments). When securities are pledged it is important to determine whether the parties wish to apply the rules applicable to transferable claims or those governing physical assets that can be held in possession. Both approaches have been accepted by the courts.

Accessory components share the legal fate of the principal asset. Until segregation, returns and increases in value (**fruits)** are accessory components of the principal asset and thus part of the pledged asset. Thus liens also extend to fruits as a matter of principle. The parties may, however, depart from this rule and agree in the lien agreement that fruits will be due to the lender neither before nor after their segregation. A different rule applies to segregated fruits when the pledged item is not in the lender's possession (non-possessory or registered lien or mortgage). In such a case, the lien does not extend to the fruits unless the pledged item was seized in execution proceedings prior to the segregation of the fruits from the principal item.[30]

[25] BH 1993. 46.

[26] The Civil Code is not particularly specific regarding these definitions. Where the pledgeability of assets is concerned, it is primarily marketability, not the possibility of being held in possession that is of importance, since a lien, being a property right, includes the right to obtain satisfaction from the proceeds of the realization of the pledged asset, which in the case of an asset that can be possessed but not marketed is ineffectual. Even though the law does not specify what constitutes marketability, this lack of a definition does not cause any problems in practice as the rule providing that agreements on impossible types of performance (Article277(2) Civil Code) are void, which prevents the pledging of non-marketable assets.

[27] Pursuant to ministerial explanatory notes on Act No. XXVI/1996

[28] Article 94(2) Civil Code; some equate the security with the claim it represents and treat it as a transferable claim.

[29] BH 1994. 149.

[30] Movable property is seized by the bailiff entering the seized assets in the record of the execution proceedings. Real property is seized by entering the execution creditor's right in the land register.

In case of doubt, **non-accessory components** and **appurtenances** share the legal fate of the principal asset. In the case of divisible assets, liens may be placed on specified parts. Indivisible assets, however, can only be pledged in their entirety.

Right and **claims** may be subject to a lien only if they are transferable. Rights that may be pledged include, for example, the right of a shareholder (share in the business), leaseholds, and securities. Under some legal norms, certain assets may not be pledged in certain legal relationships.[31]

C. Creation of Liens

A lien may be created by **contract**, by **statute**, by **court order** (see execution proceedings) and, given the statutory basis, by an **administrative decision**.

1. Contractual Lien

Lien agreements always **have to be made in writing**. In addition, a notarial deed has to be drawn up when certain types of assets are placed under lien. Creation of a **registered lien** on movable property or on the entirety of a company's assets requires a lien agreement to be drawn up as a **notarial deed** and the **entry** of the lien in the register (lien register) kept by the Hungarian Chamber of Notaries. The creation of liens on real property *(ingatlan)* requires entry in the land register. For this, a public deed is required or a deed that is countersigned by a lawyer.

Creation of a **possessory lien** requires, beside the lien agreement, delivery of the item being pledged. The establishment of liens on rights or claims requires the entry of the lien in the lien register if the existence of the right or the claim is documented by a public register and applicable legislation requires a lien to be entered to be enforceable.

When the lienee and the lender enter into an agreement on the establishment of a lien, this agreement is effective only against the parties involved. As a matter of principle, the agreement binds and confers rights only on the parties. Towards third parties, the establishment of the agreement is of legal force only if the pledged item is handed over or the lien is entered in the appropriate register.

2. Statutory Lien

A lien that is established by law is commonly called a statutory lien. Statutory liens are created in the following circumstances:

- to secure compensation for work, a contractor has a lien on those assets that came into his or her custody under the contract for work (397(2) Civil Code);
- the landlord of real property or an apartment has a lien on the tenant's property located on the rented space to secure the rental and other claims. As long as the lien exists, the landlord may also prevent the removal of assets encumbered by the lien (Article 429(1-2) Civil Code);

[31] A loan raised by a public warehouse must not be secured by a lien on real property that represents the share capital of the public warehouse (Article4(2) of Act XLVIII./1996).

- the lessor has a lien on the fruits of the leased object as well as on the lessee's assets located on the leased object to secure any open lease payments (Article 456 Civil Code);
- a custodian has a lien on the assets that came into its custody under the custody agreement (Article465(4) Civil Code) to secure claims to fees and reimbursement of costs;
- a hotel operator has a lien on items brought along by a lodger to secure claims from the provision of accommodation; In such a case, the provisions governing the landlord's lien have to be supplied subsidiarily (Article470 Civil Code);
- an agent has a lien on the assets of its principal that came into its custody under its commission (Article480(4) Civil Code) to secure the claims to reimbursement of costs and compensation;
- a carrier has a lien on the goods that came into its custody for carriage up to the amount of its compensation and costs (Article499(2) Civil Code); the carrier is obliged to enforce this lien also to secure known claims of carriers that provided services before it, otherwise the carrier is liable to the previous carriers as surety. The carrier may satisfy claims secured by liens directly from the pledged asset, without the need for judicial proceedings, in accordance with the rules governing the realization of assets in commercial traffic;
- the commission agent (Article 513(2) Civil Code);
- the carrier (Article 519(1) Civil Code);
- when goods are stored in a public warehouse, an endorsed certificate of pledge conveys to its holder a lien on the goods stored in the public warehouse as security for storage fees and other contractually agreed claims to the stored goods (Article 20(5), 26(6) of Act No XLVIII./1996);
- the Hungarian National Bank *(Nemzeti Bank)* has a lien on assets of a domestic debtor that have come into its custody on whatever legal grounds, as security for claims due from the performance of its duties as a central bank. (Article 62(1) of Act No.LVIII./2001 on the Hungarian National Bank);
- the customs authority has a lien on dutiable goods up to the amount of the customs duties payable including arrears (Article 11 of Act No. C./1995 on customs legislation and customs procedures).

D. Extinguishment of Liens

Liens are extinguished in the following cases:

- satisfaction from the item placed under lien[32];
- extinguishment of the claim (settlement of the principal debt, offsetting against the principal debt);
- subrogation of the claim without transfer of the lien, except in cases in which the lien continues to exist to secure a right of recourse;
- acquisition of ownership in the item under lien by the lender;
- acquisition of the claim secured by a lien by the owner of the item under lien (the acquirer is only real debtor, not personal debtor); if the pledged item was encumbered by several liens, the lien in such a case continues to exist for the benefit of lower-ranking creditors;

[32] Also when realizing the pledged asset in enforcement or liquidation proceedings.

- loss of the pledged item;[33]
- when the lender's claim is satisfied by the owner of the item under lien in lieu of the principal debtor;[34]
- when the claim expires through lapse of time; note, however, that satisfaction from a possessory lien is still possible;
- when the underlying agreement (underlying relationship) expires, the lien agreement serving as security is likewise extinguished.[35]

A lien is not extinguished when the lender's claim is satisfied not by the personal or real debtor but by another party (e.g. the surety) and this party acquires a right of recourse. In such a case, the claim is transfered with all of its security rights. In these cases, when a possessory lien is involved, the lender has to hand over the pledged item to the third party or enable entry of the lien in the appropriate lien register to the benefit of the third party. In such cases, the lien is subrogated to the third party ex lege. This third party then becomes the lienor and may ask for delivery of the pledged property or a statement enabling the entry of the lien in the appropriate lien register.

E. Realization of a Lien

Liens may be realized by the following procedures: realization in **execution proceedings** (movable property and real property), **extrajudicial execution** (movable property), and **execution in liquidation proceedings** (movable property and real estate). These three types of procedures are briefly outlined below.

1. Realization by Judicial Execution Proceedings

a. General

In principle, the item under lien may be realized in **judicial execution proceedings** once the **lien has reached its maturity.** A lien generally reaches maturity when the claim becomes payable but in exceptional cases may mature even earlier.[36]

Conducting the execution proceedings is usually the duty of the independent bailiff.

Even if the execution proceedings were instituted not by the lender but by some other party, the right to satisfaction prior to other claims may be enforced in these proceedings.[37]

In execution proceedings, buyers acquire ownership that is unencumbered by liens. There is one exception, however: Under the Judicial Execution Act, the highest bidder and the lender holding a lien may agree for the lien on the real property to continue if the lender's claim is satisfied from the proceeds

[33] If another item (surrogate) replaces the lost pledge (insurance payout, compensation for damages), the lien passes to the surrogate.

[34] If the real debtor has made payment to the lender, the debtor may enforce the claim against the personal debtor. In addition to the claim, other security rights also pass to the real debtor making payment, e.g. when the claim was secured by other liens.

[35] BH 1996. 601.

[36] When deterioration of the asset under lien endangers the satisfaction of the claim, the lienor may ask for repair of the asset or additional security representing the extent of the danger pursuant to Article261(2) Civil Code. If the lienee fails to meet the creditor's demand, the creditor may exercise of right of satisfaction.

[37] ArticleArticle 114/A, 138/A-B, 114, 165, 169-170 Judicial Execution Act.

of the sale. If this is not the case, the lien on the purchase price continues to exist when the pledged item is realized.

b. Executory Title

To be able to realize a lien in execution proceedings, the bank requires an enforceable executory title (see chapter on the Introduction to Securing Credit Risk in Hungary, Realization of Security Rights, Judicial Execution, Executory Title). Such a title may be obtained either by court order or in the form of a public deed.

If the agreement on which the secured claim is based (credit agreement) and the lien agreement were drawn up as **public deeds** and if the execution conditions set out in the Judicial Execution Act and the Bankruptcy Act have been met, the deed may be provided with an execution clause. In such a case, a legally effective **court order** is **not required** for the institution of execution proceedings.

When **real property** was pledged to secure a bank loan, the court may provide the deed containing the lien agreement with an execution clause only if this deed is in compliance with the standards applicable to notarial deeds[38] in terms of content and form.

c. Order of Satisfaction

According to the order in which claims are to be satisfied, the proceeds from the realization of movable property in execution proceedings is to be used first for the satisfaction of the claim that was secured by the lien. If the lien was on real property (or vessels or aircraft) and the asset is realized in judicial execution proceedings, the following claims have precedence over the satisfaction of the claim that was secured by the lien:

- the cost of the execution proceedings;
- alimony payments for children;
- other alimony obligations;
- employees' wages and compensation of an equivalent nature.

Satisfaction of the lender thus takes precedence over taxes and other public charges and other claims.[39]

If the real estate to be realized was pledged to secure several claims, these claims have to be satisfied in the chronological order in which they were entered in the land register.

As mentioned above, the priority principle can only be overridden by statute.

2. Extrajudicial Realization

a. General

Extrajudicial realization of a lien[40] is possible only with movable property and only as long as liquidation or execution proceedings have not been instituted

[38] Pursuant to Act No. XLI./1991.
[39] Pursuant to Act No. XXX./1997.
[40] The realization of collateral by extrajudicial enforcement is regulated by the Civil Code and Government Regulation No. 12/2003 of 30 Jan. 2003 on the realization of pledges by non-judicial execution proceedings.

against the debtor.[41] Real property can only be realized in execution proceedings.[42]

An important consideration for banking practice is that credit institutions may agree with the lienee to be allowed to realize their liens without resorting to judicial execution proceedings. This means that the banks are able to obtain satisfaction of their claims relatively quickly.

Three different types of extrajudicial realization are available:

- the parties may have agreed on **joint realization** of the item under lien;
- the **lender realizes** the item under lien itself, as agreed with the lienee;
- the item is realized by an agent of the lienor, e.g. by a **person** commercially or officially engaged in extending loans secured by liens and/or the organization of auctions.

Legally, the realization of assets by the lender is allowed only if the pledged item has an **officially recorded market price** or the lender is commercially engaged in the granting of lien backed credits that are secured by liens.[43] An officially recorded market price is, for example, a **price quoted at a stock exchange** or any other price recorded by authorized institutions in according with trade customs at specified places in a specified manner.

b. Agreement on Realization

For the bank to be able to realize its lien extrajudicially, a written realization agreement has to be entered into by the bank and the borrower.[44] Such an agreement has to contain the following provisions:

- determination of the minimum price at which a pledged item may be sold and/or specification of the calculation method to be used for this purpose;
- specification of the period within which the pledge has to be realized after maturity of the lien;
- legal effect of failure to sell the asset[45] (condition subsequent).

c. Joint Realization

Joint realization requires the co-operation and consent of the borrower. This variant is the most complex one for the lender, as all parts of the procedure, including the setting of the selling price and the selection of the buyer, can only be completed with the borrower's consent. Therefore, this form of realization is very rare in practice.

d. Realization by the Lienor (Bank)

The most convenient solution for the bank is to realize the lien itself and to satisfy its claim direct from the proceeds of the sale. However, this method of realization is the most disadvantageous one for the borrower, which is why

[41] Article 48(1) Civil Code

[42] BH 1992. 701.

[43] In practice, this covers all credit institutions. The existing commentaries interpret the term differently, however,

[44] For such an agreement, the form of a written private document is deemed sufficient. In most cases, this agreement in included in the lien agreement.

[45] It must be agreed by contract that the realization agreement becomes ineffective if the pledge cannot be realized within the period specified in the earlier agreement at the price determined by the parties, with all other conditions being complied with.

the protective measures mentioned above have been passed into law for the benefit of the borrower[46]. Nonetheless, it is one of the most common types of realization.

e. Realization by an Agent of the Lienor (Lender)

Under the law, the lender may also commission a person that is commercially or officially engaged in conducting auctions with the realization of the real property. Such an agreement may be entered into even if the pledged item does not have an officially recorded market price. The agent may be a pawnshop, a mortgage loan institution, another credit institution, or a administrator of a bankrupt's estate. The agent realizes the pledged item as instructed by the lender but in its own name (commission agent). The person authorized to realize the pledged item may convey ownership in the pledged item on behalf of the owner and in the owner's name.

This is of great importance for credit institutions, which are often unable or unwilling to carry out a sale themselves.

f. Legal Status of the Borrower and Procedures Used in Extrajudicial Realization

The lienor (lender) authorized to realize a pledged item realizes such an item in the name of the lienee (borrower) but does not act for the lienee's account but for his or her own (as the lienor exercises his or her own right to satisfaction). This means that, on the one hand, the lender acts as the borrower's agent in conveying ownership in the pledged item but on the other hand claims the proceeds from the sale.

The law does not specify the method to be used by the lender or its agent in realizing assets but just prescribes general duties of care. Under these, the lender/agent is obliged to realize the pledged item at a reasonable price obtainable in the given market situation with due regard to the lender's interests. The method of realization chosen should enable potential buyers to place competing bids in the given circumstances.

If realization fails, the parties have to agree on a new realization period within 15 days. If this is not done within the 15-day period, the pledged item has to be returned to the borrower within another 8 days. Return of the item is not required if the lender, again within 15 days after the end of the 8-day period, institutes judicial execution proceedings.

The **cost of realizing** the pledged item has to be **borne by the lienee**. The lender deducts its claim plus fees and the cost of realization incurred from the proceeds of the sale. Any remaining excess has to be surrendered to the lienee.

The law specifically calls for the settlement of accounts between the lienee and the lender and sanctions any violation of this duty by rendering the transaction ineffective. This means that an agreement that is closed prior to the extinguishment of the lien and under which the lender is to be exempt from the duty to render accounts is legally ineffective.

[46] Civil Code and Government Reg No. 12/2003 of 30 Jan. 2003.

3. Realization in Liquidation Proceedings

When liquidation proceedings are instituted against the debtor, the liens on his or her assets are not extinguished.[47] However, execution proceedings may no longer be pursued under these liens.

The Bankruptcy Act specifies the order in which claims are to be satisfied from the assets of an enterprise undergoing liquidation proceedings. A claim secured by a lien[48] is to be satisfied immediately after coverage of the liquidation costs up to the value of the pledged item, unless the lien agreement is to be interpreted as a fraudulent conveyance or a deal without fair consideration in accordance with Article 203(2) Civil Code.

F. Non-accessory Lien

According to the extended definition of the Civil Code, a lien may also be created by encumbering an asset in the absence of a personal claim. The so-called non-accessory lien thus breaches the principle that liens have to be associated with an underlying claim. This type of lien is by nature not an accessory performance but a principal performance. Non-accessory liens may be established over real property as well as over movable property.

The law distinguishes three types of non-accessory liens. A non-accessory lien may:

- be based on an existing claim;
- be created in the absence of a claim underlying the lien;
- be created while the parties cause the underlying claim to be extinguished at the same time.

In all three cases, the non-accessory lien is the object of a non-accessory legal relationship that exists independently of any underlying claim.

The lien agreement establishing a non-accessory lien has to specify the maximum amount up to which the lender may obtain satisfaction from the pledged asset. The maturity of the lien is also specially defined in the case of non-accessory liens. In the absence of an underlying claim the maturity of which would result in the maturity of the lien, the law provides that the lender's right to seek satisfaction is initiated by one of the parties giving notice of termination. Under the law, the agreement is dissolved 6 months after notice of termination is given but the parties may agree shorter or longer notice periods.

A non-accessory lien is transferable. The lienee may, however, assert his or her rights and **defenses** only against a **direct acquirer** of the non-accessory lien **or** against a **legal successor who** acquired the non-accessory lien **gratuitously** or, when acquiring it, had knowledge of the underlying legal relationship.

A non-accessory lien may be converted into an accessory lien and vice versa. The rules of the law laying down the rank of liens and registration provisions also apply to non-accessory liens. When a registered non-accessory lien is converted, a (modifying) entry has to be made. Conversion does not affect the rank of a lien. Any agreement between the parties requires the consent of creditors of equal or lesser rank.

[47] Article 38(4) Bankruptcy Act
[48] This refers to non-accessory liens.

Chapter 4: Special Rules for Different Types of Liens

I. Introduction

This chapter addresses the special rules governing different types of liens – registered liens, possessory liens, and liens on rights and claims. The lien on the entirety of a company's assets is discussed in the section dealing with registered liens on movable property as such a lien can be created only on movable property and only through entry in a register.

II. Registered Liens on Movable Property and Real Property

A. Common Rules

1. General

Discussing the registered lien *(zálogjogi nyilvántartás)*, the general rules governing registered liens are presented at the beginning. These rules apply to all assets on which a lien is placed, as Hungarian law in this respect does not differentiate between movable and immovable property.

For a registered lien to be established, the following conditions have to be fulfilled:

- a lien agreement in the form of a notarial deed:
- **entry** in the appropriate **register** (lien register or land register).

Upon entry in the appropriate register, the lien becomes effective in rem; the entry is thus constitutive.

In the appropriate register, the sum of the claim has to be indicated as well as the amount of charges and costs to be covered by the lien; in the case of future claims, the highest sum to be secured has to be stated as well.[49] If the claim is reduced, the lienee is liable only for the reduced amount. When the claim is extinguished, the lienee's liability is extinguished as well, despite the entry in the register. This means that the lien is extinguished along with the claim unless the law requires the lien to continue in order to secure rights of recourse.

With registered liens, the pledged item remains in the lienee's possession. The lienee is entitled to use the pledged item but also obligated to preserve its value.

With a registered lien, the lienee may be required to use insurance proceeds, compensation for damages or other sums for the restoration of the pledged item.

Under Hungarian law, both movable and immovable property is subject to the priority principle. When several liens have been placed on an item, these liens are entered in the register in the order in which they come in. When a lien of a certain rank is extinguished, the lower-ranking liens are moved up (principle of mobile order of priority).

[49] Note that a strict interpretation of the Civil Code would require at least the definition of a ceiling. In practice it is sufficient, though, to specify the amount of the claim to be secured and the fact that the lien (e.g. in the case of bank credits) also covers interest, interest on arrears and any costs incurred in enforcing the lien.

2. Placing Registered Liens on Future Assets

With registered liens, liens may be placed on future rights to movable as well as immovable assets. If the right to dispose of an asset is acquired only after the closure of the lien agreement, the **establishment** of the **lien** is dependent on the **acquisition** of the **right of disposition**. Such a lien can thus be named in a notarial deed or entered in the land register only as an obligation subject to a condition precedent. Its **rank** is determined by the **time** of its **entry**, not by the time the right of disposition is acquired. If the prior holder of the right of disposition has already created a lien for the benefit of a third party, the lien remains unchanged, whereas any lien created by the new holder of the right of disposition is of lower rank. Future liens can be established only over assets that can be entered in the lien register. A future lien cannot be created over real property,[50] as a mortgage can be established only by the owner shown in the land register, not by the future owner of real property.

B. Special Features of Registered Liens on Movable Property

1. General

Registered liens on **movable property** and liens on the entirety of an entity's assets that were created by notarial public deeds are registered in the **liens register**. This register is kept by the Hungarian Chamber of Notaries *(Magyar Országos Közjegyzői Kamara)*. This is a public register that may be inspected by everyone. The register contains the data appearing in the lien agreement as well as the parties' personal data. Entries of liens in the lien register and the deletion of data, provided these are based on a notarial deed, are effected by the notary public who drew up the lien agreement as a notarial deed. Maintenance of the register and archiving of the registered data is IT-supported. The data transmission and retrieval devices that are linked to the central system are operated by the public notaries. An inquiry unit may be operated by anyone who satisfies the technical requirements, pays the fee for the use of the system, and closes an agreement with the Hungarian Chamber of Notaries. The system is operative daily between 08:00 and 16:00 hrs.

The entry may be based on lien agreements concluded as notarial deeds or decisions taken by courts or other authorities by which liens are established. For the establishment of liens on movable properties the law requires the individual identification of each property and – if this is not feasible – identification of the moveable property(s) by description of type and quantity or some kind of circumscription.

The law contains detailed rules specifying the data to be entered in the register. These include:

- data suitable for identification of the lienee;
- data suitable for identification of the real debtor;
- description suitable for identification of the asset placed under lien;
- legal ground, currency, due date, maximum amount of the claim; description, amount or method used to calculate associated fees and costs;

[50] This is, on the one hand, due to the wording of the Civil Code, and on the other hand to the fact that the Land Registration Act does not allow any right of this kind to be entered in the land register.

- the non-accessory lien and the maximum amount at which the lender may obtain satisfaction;
- data suitable for identification of the lienor (lender);
- the data of the deed underlying the entry;
- the time of creation or modification of the lien if differing from the date of the entry;
- indication of the rank of an extinguished lien or a waiver of the right of disposition in respect of the rank;
- the time of the initiation of proceedings with courts or other authorities to enforce the lien, the name of the authority calling for or conducting the proceedings, and the reference number,
- the conversion of a lien on the entirety of an entity's assets.

2. Reservation of Priority

Reservation of priority *(ranghelyfenntartás)* is also possible with movable property. If the lienee does not call for extinguishment of a lien entry, the lienee will be contacted by the notary and advised that a new lien of the same rank as the extinguished lien may be created within 30 days of the delivery of the notification or a petition may filed for entry of a reservation of priority for a period of one year. If the lienee does not file such a petition during the time allowed or if the lienee gives notice of waiving the right of disposition, the notary will delete the entry.

Reservation of priority prevents lower-ranking liens from moving up automatically. A waiver of reservation of priority by the owner of real property for the benefit of the creditors is possible but effective only for (a) specific person(s).

3. Extinguishment of a Registered Lien

The Civil Code has special provisions regarding the extinguishment of registered liens on movable property that deviate from the general provisions (see "Common Rules"). According to these special provisions, a lien is extinguished when

- a bona fide buyer buys the pledged item in commercial dealings[51] or in the ordinary course of business[52];
- a bona fide buyer acquires ownership in a pledged item that is an ordinary object of everyday life for valuable consideration; or
- the claim becomes statute barred. .

4. Lien on an Entity's Entirety of Assets

A lien may also be established on the corporate assets of a business company[53] with or without legal personality, on the entirety of the corporate assets or on

[51] Commercial dealings mean that the sale of such a product (e.g. a certain type of inventory) falls within the commercial entity's scope of activities.

[52] When a seller disposes of machinery and equipment it owns, this is not deemed as being done in commercial dealings, but rather constitutes a sale in its ordinary course of business.

[53] This means that a natural person cannot create a lien on his or her assets. The creation of such a lien by a sole proprietor is problematical. Under the Civil Code, a sole proprietor is a commercial entity but not a business company with or without legal personality. Given the wording of the law, a sole proprietor is not allowed to create a lien on his or her business asset as any broader interpretation of this rule is not permitted.

part of such assets functioning as a separate commercial entity. For the establishment of a lien on corporate assets, the law prescribes the conclusion of a **written agreement** as well as the drafting of a lien agreement in the form of a **notarial deed** and **entry** of the lien on corporate assets in the **lien register**. The lien is created by entry into the register. If no such entry is made, the lender is unable to enforce the lien vis-á-vis third parties who in bona fide transactions acquire rights against valuable consideration.

A special characteristic of the lien on the entirety of corporate assets is that it may be created without specifying the rights, items and claims making up the corporate assets. Therefore, the lien on the entirety of corporate assets is occasionally also termed "floating charge", as it floats above the entirety of the assets.[54] It extends also to new asset items and rights acquired and incorporated into the corporate assets or the pledged part of the corporate assets after the lien agreement took effect, as of the time of their acquisition by the lienee.

Because of the "floating" quality, the banks use this type of lien for project financing, as this approach allows assets acquired in the course of the execution of a project to be become collateral for credits.

When a lien has matured, the lender may satisfy the claim from the pledged corporate assets, with these assets being regarded as one entity. At the same time, the lender, apart from obtaining direct satisfaction, may also convert the lien on the entirety of corporate assets into a lien on **specified asset items**. This is done in practice by the lender addressing a unilateral notice (of conversion) to the lienee, upon maturity of the lien, specifying those assets or rights from which the lender wishes to satisfy the claim. Thus, the lien no longer is upon the entirety or a specified part of the corporate assets but on specified asset items or rights. This concentration takes effect vis-á-vis third parties who acquire rights in an asset in good faith and against valuable consideration only upon entry of the lien in the lien register. In the absence of such an entry, the lender's notice is relative, i.e., of no effect towards a third party.

Apart from a few exceptions, the satisfaction of a lienor holding a lien on the entirety of corporate assets enjoys precedence over other parties holding liens. The rank of a lien on corporate assets is determined by the time of its entry in the lien register, not by the time of the entry of the conversion notice.

Lienors (lenders) holding liens on an entity of corporate assets may enforce their claims according to their ranking, except

- vis-á-vis other lienors who acquired a lien before the incorporation of the asset concerned into the corporate assets pledged;
- when the asset is encumbered by a lien entered in another register in addition to the lien entered in the lien register;
- when, in commercial dealings, a bona fide third party has acquired a possessory lien or a lien on the claim or right concerned.against valuable consideration

The extinguishment of liens on corporate assets is governed by special rules. Under these rules, the lien on an asset item is extinguished when the item is sold by the lienee and thus is no longer part of the corporate assets. The lien

[54] "Floating charge" is a term describing an Anglosaxon law institute to which the lien on general assets is very similar.

on corporate assets is likewise extinguished when the lender issues a notice of conversion, i.e., concentrates said lien on specified asset items. The lien on corporate assets is also extinguished when a bona fide third party acquires the asset item in commercial dealings against valuable consideration.

In all other cases, the rules for registered liens are applicable to liens on corporate assets as well.

C. Special Provisions for Registered Liens on Real Property

1. General

Below, a number of special features of liens on real property will be discussed, including provisions governing reservation of priority and maximum amount mortgages.

2. Land register

Real property and liens on real property are entered in the land register *(ingatlan-nyilvántartás)*. The rules for entering liens are laid down in a separate law.[55] Responsibility for keeping the **land register** rests with the district land registry having geographical competence. Higher-level authorities above the **district land registries** are the county land registries and the metropolitan land registry *(Földhivatal)* Budapest. The land register is organized according to settlements (rural municipalities, towns), in cities enjoying county status *(Debrecen, Győr, Miskolc, Pécs és Szeged)* and in Budapest according to districts. Oversight over the land registries is assigned to the Minister for Agriculture and Regional Development. The land registries keep the land register and enter the rights associated with real property.[56]

3. Reservation of Priority

With real property, the lienee may also dispose of any rank that falls vacant. If the borrower wishes to apply for a new loan, he or she may offer the new lender the rank that has fallen vacant. The interests of lower-ranking creditors are protected by the legal provision that the new mortgage must not be more of an encumbrance than the previous one. The new lien may be created at the time the previous mortgage extinguishes; the lienee may reserve the power of disposing of the rank of the extinguished mortgage for one year. The lienee may also waive the right of disposal for the benefit of a third party or a creditor following in rank, but not for the benefit of the lender.

4. Maximum-amount Mortgage as a Special Form of Registered Lien

Under the Civil Code, a lien may also be established in the form of a maximum-amount mortgage *(keretbiztosítéki jelzálog)*. The maximum-amount mortgage has to be based on an existing (ongoing) legal relationship. When creating such a mortgage, the legal ground has to be stated as well as the maximum amount

[55] Act No. CXLI./1997 on the Land Register.

[56] There is a difference between the public recognition of the land register and of the lien register (for movable property). The land register is a register for property documenting rights and facts relating to a specific property (with one sheet for each parcel of land), whereas the lien register is a list of lienees. It is a publicly recognized record of certain data contained in a lien agreement and the obligations assumed by the debtor and the ranking of the obligations assumed.

within which the lender may obtain satisfaction from the asset on which the lien is placed.[57] Under Article 263(1), a maximum-amount mortgage may also be created to secure future claims.

Until 1 September 2001, it was possible to establish a maximum-amount mortgage both on real property and on movable property. Therefore, maximum-amount mortgages on movable property are still encountered in practice. Now a maximum-amount mortgage can be created only on real property.

If, in the case of claims based on a continuous legal relationship, a new debtor enters the legal relationship, such a move is termed assumption of a debt (Article 332 Civil Code). In such cases, the maximum-amount mortgage is liable for claims against the old debtor as well as for claims arising (in the future) against the new debtor. Note, however, Article 332(3) of the Civil Code, according to which a lien is extinguished upon assumption of the debt should the lienee fails to give his or her consent.

The law expressly grants the debtor the right to ask the lender to renounce the maximum-amount mortgage if the legal relationship specified in the lien agreement has ended and there are no more open claims against the debtor from this legal relationship (Article263(3) Civil Code). As a maximum-amount mortgage is also accessory by nature and therefore is extinguished when the underlying relationship ends, the lienee's petition for extinguishment of the registered lien in the land register is justified in such cases. For this purpose, however, the lender has to issue a receipt permitting the cancellation of the entry. If the lender refuses to issue such a notice, the lienee may enforce his or her right in this regard in court.

III. The Possessory Lien

The importance of possessory liens is very minor in practice, due probably to the possibility in Hungary of creating non-possessory liens. The object of a possessory lien may be movable property, securities, or money. Creation of a possessory lien requires execution of a **written** lien agreement and the delivery of the pledged asset. The asset may be delivered not only to the lender but also to any third party associated with it (safekeeper).

A possessory lien may even be acquired in good faith from a person not having a title to the asset. To be deemed an acquisition in good faith, a possessory lien has to be acquired in commercial dealings by a buyer acting in good faith.

Similar to the registered lien, a possessory lien cannot be established on only part of an asset unless it is physically as well as legally divisible. Nor is it possible to establish a possessory lien on an asset that is co-owned by several individuals. This derives from the need to deliver the asset being pledged to the lender.

To protect the rights of the lienee, the law obligates the lender or any third party associated with it to keep the pledged asset it safe custody and to return it to the lienee once the lien is terminated.

The lienor of the possessory lien is obligated to keep the pledged asset in safe custody. The lienor is authorized and even obligated to reap the natural fruits of

[57] With a maximum-amount mortgage, only the maximum amount of the claim is known. The lien entered as a maximum-amount mortgage permits the exchange of claims resulting from a continuous legal relationship (BH1996.601.).

the item. He or she is required to render accounts on the fruits reaped.[58] The lender has the right to use the fruits for meeting the expenses incurred for the safekeeping of the pledged asset.

If there is a risk that the pledged asset may deteriorate or suffer a substantial loss in value, the personal or real debtor may ask for the return of the asset. However, the debtor may exercise this right only if he or she offers the lender other adequate collateral at the same time.

A possessory lien extinguishes under special rules when the lender

- surrenders the pledged asset to the owner; or
- loses possession of the pledged asset against his or her will without recovering the asset within a year and does not petition to the court for protection of possession.

The possessory lien is extinguished when the lender does not recover the pledged asset to which the lender lost possession against his or her will within one year and does not address file a petition with the court in said matter.

When the secured claim is no longer enforceable due to the statute of limitation, the lender may still obtain satisfaction from the possessory lien, which is not possible in the case of a registered lien.[59]

IV. Lien on Rights

A. General

The Civil Code regulates liens on rights and claims as a special type of lien. When placing liens on rights and claims, such rights and claims have to be differentiated from the claim that is to be secured. The claim to be secured exists between the bank and the lienee, while the claim on which the lien is placed exists between the lienee and a third party.

B. Object

The rights and claims on which liens are placed have to be specified in concrete terms. If specification of a right or a claim is not possible, the object on which the lien is placed may also be circumscribed. With a divisible claim it is possible to pledge only part of it. Rights and claims arising in the future may also be placed under lien. The same applies to claims under a bank account agreement.

C. Creation

When evidence of the existence of a right or a claim is established by entry in a public **register** and the applicable legal norm requires a lien to be entered in the register, the entry of the lien in the register is the prerequisite for the creation of the lien. Currently, such a registration is required only for trademark and patent rights.

The Hungarian Chamber of Notaries, which keeps the register of liens on movable property, has drawn up guidelines for the entry of liens on rights and claims in the notarial register. According to these guidelines, liens on rights and claims may be entered in the lien register. The legal effect of such an entry is

[58] The lienor has to fulfill this obligation even if the asset is held by a third party.
[59] Article 324(3) Civil Code

controversial, however, namely, whether it has a constitutive effect or is only of informative character. However, an entry is recommended as a matter of principle.

This does not automatically mean that the entry of a lien on other rights and/or claims in the notarial register is a mandatory formal requirement. When a lien is not entered into a register, the lien on rights and claims is created by contract (Article267(1) Civil Code).

D. Realization of a Lien on Rights

When enforcing a lien, the debtor of the right or claim has to be notified (notice to third-party debtor). The lienor may ask the lienee to deliver the documents required for enforcing the lien (Article267(2) Civil Code).

Notification of the third-party debtor is required for enforcing the lien, but not for the creation of the lien.

E. Relationship Between the Bank and the Lienee

Any notice of intent on the part of the lienee that would remove or negatively affect the funds from which the lender's claim is to be satisfied (e.g. waiver, offsetting, settlement, etc.) has to be presented by the lienee to the bank for approval as otherwise the lienee's notice to the lender is ineffective.[60]

For such notices to be legally effective vis-á-vis the lender, the lender's consent to notices issued by the lienee in the case of **liens on account receivables** is required only if this was expressly agreed in the lien agreement.

F. Satisfaction of Claim Placed Under Lien

When a claim is pledged, performance has to be rendered to the lender. When performance is rendered in money, the rules governing security deposits apply in respect of the performance received (see: chapter entitled Special Forms). When performance is rendered not in money but in some other way, the rules governing the possessory lien apply.

The maturity of a pledged claim or the exercise of a right may depend on statements made by the borrower or the performance of duties incumbent upon the borrower. When the lien matures, the lender may perform these duties or conditions itself or issue such statements to render a claim due.

If the lienee's claim towards the third-party debtor that has been placed under lien is due earlier than the lender's claim against the lienee (credit receivable), the third party has to **render performance jointly** to the lienee and the lender. This means that performance may be rendered to either party only with the other's consent. There are two exceptions to this rule: first, when the lien agreement contains different provisions; second, when the thing to be rendered becomes the object of the possessory lien. The third-party debtor has to deposit his or her monetary payment with the court if so instructed by the lienee or the lender.

[60] If, for example, a shareholder of a limited liability company wishes to sell a share on which a lien was placed, by which act the shareholder would dispose of the liability fund for the lender, the lender's consent is required for the notice to take effect for him or her as well. Otherwise, the lien on the share sold continues to exist and the lender may enforce the lien even against the new owner of the share.

If, in contrast, the lender's claim against the lienee falls due earlier than the lienee's claim towards the third-party debtor, the third-party debtor may make payment only to the lender.

G. Extinguishments of a Lien on Rights

The extinguishment of liens on rights and claims is not subject to any specific provisions and therefore, the common rules governing liens apply. The owner of the asset with a lien on it in this context is the (old) creditor of the pledged right or claim.

Chapter 5: Assignment by Security-fiduciary transfer of receivables

I. General

In banking practice, the assignment of receivables to banks as a means of securing credit has become increasingly common in recent years. The legal transaction of assignment *(engedményezés)* is governed by the Hungarian Civil Code[61].

It involves the transfer of a receivable under an agreement by the old creditor to the new creditor. When assignment is used as credit security, the **bank** as the **assignee** *(engedményes)* usually has a claim against a **third debtor** assigned to it by the **borrower** (or a third person) as the **assignor** *(engedményező)*. Assignment is a disposition between the assignor and the acquirer that is concluded in writing, orally or by conduct implying intent, without any regard to the formal requirements of the underlying legal relationship. Receivables may be assigned under a legal norm[62] (assignment by operation of law) or under an agreement between the parties (legal predecessor and legal successor). Observance of specific formal requirements is not necessary for the effectiveness of an assignment.

II. Creation

As outlined above, a claim may be assigned by the assignor to the assignee by agreement or by operation of law. An assignment takes effect vis-á-vis the third-party debtor only after the assignor has informed the third-party debtor of the assignment or, in the case of an assignment by operation of law, when the third-party debtor gains knowledge of the assignment through another credible channel. The Civil Code[63] only lays down the obligation to notify the third-party debtor but does not define the manner, time or other circumstances of the notification.

III. Object of the Assignment

Assignments can be made in any legal relationship unless prohibited by law, excluded by agreement of the parties in the original legal transaction (covering relationship) or inappropriate due to the nature of the performance.[64]

An assignment of a claim that is bound to a specific person and is of confidential or intellectual nature is not allowed.[65] The full substance of an agreement may be assigned only with the consent of the other party to the agreement.

[61] ArticleArticle 328-331 Civil Code.

[62] Currently the following assignments may be made by operation of law:
- for the benefit of a surety who has satisfied the creditor (Article 276(1) Civil Code);
- for the benefit of a person who is making a collateral promise and making payment unless this is done for the benefit of another person by way of donation (Article286 Civil Code);
- for the benefit of an insurance company which has provided compensation for damages to a third party who had caused the damages (Article558 Civil Code) and towards the insured person if this person caused the damage willfully or – in accordance with the terms of the insurance contract – through gross negligence (Article559(3) Civil Code).
- for the benefit of an employer for senior staff in respect of the profit or claims that arose from a legal transaction which the senior staff member closed on someone else's behalf while breaching the prohibitions laid down in Article 191(1-3) of the Code of Labor Legislation (Act No. XXII./1992).

[63] Article 328(3) Civil Code

[64] LB Pfv. V. 21.573/1993. - BH 1994/7/367, LB P. törv. III. 20.707/1989. - BH 1990/4/139.

[65] BH 1998/379.

Contractual freedom implies that claims, which fall due in the future and conditional claims may also be assigned. This requires, however, a description in sufficient detail of the essential elements of the receivable to be assigned so as to remove any doubt and uncertainty regarding its identity. This opinion is highly controversial, however, and has been rejected by the Supreme Court. Therefore, there is no legal certainty in this regard.[66]

The **receivable** to be assigned must in any case be **identifiable without any doubt**. If, from the contents of the assignment agreement, it is not possible to ascertain to which claim it relates, the assignment will be ineffective on the grounds of uncertainty.

Equally **ineffective** are agreements under which someone generally assigns **all future claims** (e.g. all future claims of one of a person's businesses).

Unless otherwise agreed, an assignment does not extend to interest on arrears accrued between the due date and the assignment. If such interest on arrears is to be covered by the legal transaction as well, this has to be specifically laid down in the agreement. According to the jurisdiction, the object of an assignment is not the legal relationship but the claim constituted under it. However, if the parties enter into the assignment agreement prior to the maturity of the claim, interest on arrears, if any, is due to the assignee even in the absence of a separate agreement, owing to the change in creditors put into effect by the assignment.[67]

An assignment also transfers all security rights associated with the claim, such as a suretyship or liens. Once the assignment has been completed, the assignee may ask for the registration of liens on real property, movable property[68] or general assets in books or by a notary or for the surrender of a movable property subject to a possessory lien. As in these cases no new lien is created, but an existing lien transferred to the new creditor, the liens retain their rank of priority.[69]

IV. Notification of Third-party Debtor

A. Effects of Third-party Notification

As soon as the third-party debtor has been notified of the assignment, the assignee takes the assignor's place with regard to the claim. The third party's consent is not a prerequisite for the assignment; it is required, however, if the third party's position deteriorates as a result of the assignment.[70]

The third-party debtor may be notified by the **assignee** (bank) or by the **assignor** (borrower), with the legal consequences differing depending on the person providing the notification.

If the third-party debtor is **notified** by the **assignee**, he or she may ask for evidence of the assignment. In the absence of such evidence, the third-party debtor makes payment to the person claiming to be the assignee at his or her own risk. In order to avoid an obligation to make dual payments, the third-party

[66] Note that the Supreme Court presented a dissenting opinion in its E No. Fpkf. VI. 32.798/1994. Zsolt Lajer questions the correctness of E is his article „Die Zession zukünftiger Forderungen als Kreditsicherheit" (MJ 1997/2. 19-25. o.).

[67] LB Pfv. V. 23.145/1994. - BH 1996/1/31.

[68] On non-possessory liens on movable property see the chapter about liens.

[69] BH 2002/240.

[70] The Copyright Act contains deviating provisions (Article46(1) of Act No. LXXVI/1999).

debtor may deposit the payment with the court or ask the former creditor for confirmation that the claim was in fact assigned.[71] The same applies if it can be proven that the third-party debtor gained knowledge of the assignment of the claim from some other source. [72]

As a legal consequence of the **notification** of the **third-party debtor** by the **assignor**, the debtor may now regard the assignee as the party to which he or she is liable and only payment to the assignee will discharge the debt. In such a case, the assignor, in the event of an error affecting the validity of the assignment agreement, may only hold the assignee liable, as the third-party debtor is discharged from the original liability once he or she has made payment to the assignee.[73] Until receipt of notification, the debtor has the right to make payment to the assignor. A third-party debtor who has made legally effective payment to the assignee based on due notification of the assignment, cannot be called upon to make another payment, e.g. by claiming that the assignment was invalid. Notification by the assignor not only excludes payments to be made by the third-party debtor to the assignor, but also authorizes the third-party debtor to make payment to the assignee. Such payment is also effective towards the assignor, regardless of whether the assignment is valid or has been made at all. However, should the third-party debtor act in bad faith, i.e., if he or she had or had to have knowledge of the fact that the assignment was not (validly) effected, this rule does not apply. This does not mean, however, that the third-party debtor would be obligated to verify the legal relationship existing between the assignor and the assignee.

B. Excursus: Contents of a Third-party Notification in Practice

1. General

The assignor is usually asked, when notifying the third-party debtor in accordance with the assignment agreement, to also provide instructions on how to proceed in the future:

- If the third-party debtor has to satisfy the assignor's monetary claim by making a transfer, the assignor, when notifying the third-party debtor after the assignment agreement has taken effect, also provides information about the necessary details (new creditor, account number, etc.);
- In the case of direct debiting (prompt collection), the notification provided to the third-party debtor has to set out all of the new rules that enable the new creditor to enter into the former relationship while maintaining the direct debit authorization.

2. Problems with the Direct Debiting Authorization

In order to preserve the option of enforcing a claim by means of a direct debit authorization even after the assignment, the direct debit authorization in favor of the old creditor has to be cancelled and a new one issued in favor of the new creditor (assignee).

[71] LB Gf. IV. 32.269/1993. - BH 1995/5/294.

[72] The principles of Hungarian civil law, specifically the principle of good faith and mutual co-operation require the debtor to obtain information and certainty.

[73] BH 2002/154.

In such a case, the third-party debtor is required to play an active part: he or she has to grant an authorization allowing the assignee to enforce the claim. The authorization given in the notification letter has to be worded accordingly and due dates and other conditions have to be specified under which the authorization letter (or statement of acceptance) has to be sent to the old and the new creditors (or only to the new creditor).

The third-party debtor may be liable to take the following action:

- Informing the assignor that he or she has taken notice of the assignment. Such a notice is not obligatory under the general rules of the Civil Code, but in banking practice such notices are commonly used;
- Issuing an authorization in favor of the assignor enabling the assignor to enforce the claim against the third-party debtor by direct debiting, if required; a frequent element is the specific and detailed description of the receivables; another necessary element is the obligation to maintain the authorization in favor of the assignor until it can be withdrawn with the participation and consent of the assignor.

The addressee of the authorization is always the bank managing the third-party debtor's account. As the third-party debtor addresses the authorization letter to the bank managing his or her own account, which is in no way affected by the assignment agreement and the underlying credit relationship, the legal relationship cannot be implemented before the bank managing the account has taken notice of and accepted the new instructions that its client has issued in a legal relationship of which it is not a party. Another option is a statement given by the bank managing the third-party debtor's account in a separate letter as addendum to the agreement or a clause of the agreement, in which the bank undertakes to comply with a direct debit order that may be given by the assignee. Thus, the credit institution (bank) managing the account, which is not involved in the assignment relationship at all, can accept the instructions issued by the account owner (the third-party debtor) and assure him or her that the instructions will be carried out.

V. Defenses of the Third-party Debtor

The obligations arising from the legal relationship between the third-party debtor and the assignor underlying the assignment do not encumber the assignee in any way. The third-party debtor may, however, raise the same **defenses against the assignee** to which he or she is entitled **against the assignor** (such as defective delivery) or offset them against claims he or she has towards the assignor.[74] In liquidation proceedings of the third-party debtor, claims can be offset only against such counter-claims that were not assigned after the institution of liquidation proceedings or, if the counter-claim originated later, after its origination.[75]

The third-party debtor may, however, **not raise any defenses** against the assignee that arise from the **assignment agreement** (between the assignor

[74] Article 328(3-4), Article329 Civil Code

[75] Article36 Bankruptcy Act; up to the amendment No. LXXXII./1997 of the Bankruptcy Act it happened that companies caused their liabilities to other companies over which liquidation proceedings had been opened to become extinguished by buying, at low prices, receivables from the creditors of the company being liquidated and then "nominally" offsetting these receivables against their own liabilities.

and the assignee). An assignment is an abstract legal transaction by which the third-party debtor enters into a legal relationship with the assignee independently of the legal relationship existing between the assignor and the assignee. The legal ground of the performance agreed between the assignor and the assignee is of consequence only for the relationship of these two parties.

VI. Legal Effects of Dual Assignment

If the assigner assigns a claim several times, the earlier assignment is deemed to be the valid one. The second assignment is illegal and ineffective as it involves a performance that cannot possibly be rendered. No-one can assign things over which he or she does not have power of disposition. *(Nemo plus iure transferre quam ipse habet)*. If the third-party debtor is notified by the assignor only of the second assignment and makes payment to the second assignee, his or her debt is discharged. This constitutes unjust enrichment on the part of the second assignee, who has to surrender the amount received to the first assignee. If the assignees suffer losses on account of these transactions, they may raise warranty claims and claims for damages against the assignor.

When a third-party debtor is informed of the existence of two assignments, the third-party debtor must develop doubts as to which assignment is valid. In such case the third-party debtor should deposit payment with the court in order not to run the risk of having to make the payment twice. If the third-party debtor cannot ascertain which of the two assignments was made earlier, he or she should proceed in the same manner.

VII. The Assignor's Liability

The assignment agreement between the assignor and the assignee may be entered into **against valuable consideration** or **without valuable consideration** (so-called purchase of receivables or donation of receivables). This differentiation is of importance for assessing the effectiveness and the scope of the assignment relationship.[76]

With an assignment made **against valuable consideration**, the seller of a claim warrants that it is genuine, i.e., a claim exists and can be enforced judicially and is unencumbered, that is to say, it is collectible, unless

- such warranty has been excluded;
- the claim has become uncollectible for reasons that occurred after the assignment; or
- the claim is secured by a mortgage.

As a result, under an assignment made as a legal transaction against valuable consideration, with the assignor receiving consideration from the assignee, the assignor is liable for the existence and collectibility of the claim up to the amount of the consideration received. In such a case, the assignor's liability *(felelősség)* corresponds to that of a surety: it is accessory and in relation to the third-party debtor of subsidiary nature, unless the assignor has described the claim as being doubtful and assigned it as such to the assignee, or excluded his or her liability in some other manner.[77]

[76] If the assignment is based on a purchase agreement, this question is of great significance where potential warranty claims are concerned.

[77] Article 330(1) Civil Code

With an assignment that is made **without valuable consideration**, the assignor is liable to the assignee under the rules governing donations, and thus only for willful and grossly negligent conduct and when the assignor fails to provide information about material and dangerous qualities of the assigned item.[78]

Assignments by operation of law do not establish any liability for the existence or collectibility of the claim, so that the person originally holding the claim (quasi-assignor) does not even have secondary liability.

VIII. Assignment as Credit Security

The legal subjects of an assignment agreement are the client making the assignment (assignor, borrower) and the bank (assignee).

The relationship preceding an assignment agreement is usually a credit agreement entered into by the client and the bank and in which the client is the borrower and the bank is the lender. Under this agreement, the client has an obligation towards the bank for a specified amount. To secure this obligation, the bank accepts the borrowers' claims, which are described in detail in the assignment agreement, as security.

In banking practice, such claims are identified very carefully. The claims covered by the assignment are specified with precision and in detail. In identifying claims, one usually relies on information contained in the contracts on which the claims are based, as a result of which the following details of such contracts are usually also included in the assignment agreement:

- exact identification of objects and subjects of the contract on which the claim is based, including all information useful for identification (codes, contract number, description) as well as place and date of establishment;
- sum of the claim based on this contract;
- maturity;
- all data that can be used to identify the third-party debtor.

In practice, the banks do not accept assignment of receivables classified by the borrower as doubtful in order to maintain the borrower's liability as a surety.[79]

In addition to providing a warranty of title, the borrower's undertaking frequently includes the following elements:

- a clause providing that the borrower has to perform all acts vis-á-vis the third-party debtor which he or she is obligated to perform under the original contract (covering relationship);
- a clause providing for the obligation to report immediately any circumstance which, although based on the covering relationship, has an impact on the existence and/or enforceability of the claim or which is deemed material by the parties in the assignment agreement for whatever reason.

[78] Article 581(1) Civil Code
[79] Article 330(1) Civil Code

Chapter 6: Suretyship

I. General

A suretyship *(kezesség)* is personal security. It represents personal **liability** for the performance of the **obligation of a third party**. In the surety agreement, the surety *(kezes)* undertakes to make payment to the creditor (lender) in the event that the debtor fails to honor his or her obligation. A **surety agreement** is entered into between the **surety** and the **bank**. The surety is liable, with all his or her assets, for the payment of the secured liability. A suretyship increases the number of persons liable for an obligation and thus also the volume of the liable assets.

II. Creation of a Suretyship

A suretyship is usually established **by contract**. The rules governing surety agreements are contained in the Civil Code[80]. A suretyship may also be required to be created under a **legal norm**. In such cases, unless regulated by other legal provisions, the rules governing the establishment of a suretyship by way of legal transaction apply. Ex-lege suretyships are, for example, imposed by the Business Organization Act (BOA). Thus, the founders of a joint undertaking[81] or an ad hoc undertaking[82] are liable for the liabilities of the undertaking founded by them in accordance with the rules governing suretyships. Under the Civil Code, individual legal entities are liable as sureties for the liabilities of the undertaking founded by them.[83]

The parties in a suretyship agreement are the **surety** and the **obligee** (bank). The Supreme Court explicitly ruled that in the case of a suretyship the contractual relationship exists between the surety and the creditor and not between the surety and the debtor of the secured claim. Therefore, a suretyship is not created by a mere agreement between the debtor and the surety.[84] Consequently, the surety and the debtor likewise cannot agree to terminate the suretyship without the creditor's consent.[85]

However, a legal relationship is also created between the surety and the debtor. In practice, the debtor is often obligated to pay for a suretyship that is provided on a business basis (e.g. by a bank).

The **suretyship agreement** has to be drawn up in **writing**. An oral statement of suretyship is invalid. It is not necessary, though, to explicitly use the word "suretyship" in the written obligation statement; it is sufficient if the substance of the statement represents a suretyship. While the Civil Code requires suretyships to be established in writing, in practice it is usually only the **assumption of suretyship by the surety that is drawn up in writing**, not the acceptance by the lender. Even a number of court decisions interpret the

[80] ArticleArticle 272-276 CIVIL CODE.

[81] This is a company with unlimited liability developed primarily to enable the combination of large enterprises (for the purpose of capital allocation).

[82] This is a so-called co-operative/co-ordinating partnership vested with legal personality, not a partnership or company under Commercial Law (cf. the German "Interessengemeinschaft" or the French "groupement d'intérét économique").

[83] Article 72(3), Article330(1), 353(3) Civil Code

[84] BH 1992/1. sz. 41.

[85] BH 1985/4. sz. 153.

Civil Code to the effect that only the assumption of suretyship by the surety has to be laid down in writing while on the part of the obligee passive manifestation of acceptance is deemed adequate.[86]

III. Object of the Suretyship

As mentioned above, the suretyship (being personal security) represents personal liability for the performance of a **third party's obligation**. The surety is liable with all of his or her assets.

Surety is an **accessory security**, which is always created to secure an existing and defined principal debt.[87] The surety's obligation depends on the claim for which he or she has provided suretyship. Thus, the invalidity of the principal debt also renders the suretyship invalid. Vice versa, the suretyship may be invalid without this fact affecting the validity of the principal debt. The need to define the liability does not prevent the assumption of suretyship for **conditional or future claims**.

Because of its accessory nature, the **surety** may raise the **same defenses** against the lender as the debtor. The surety's obligation must, however, not become more cumbersome than it was at the time the suretyship agreement was closed. This represents an exception to the legal nature of accessoriness and limits the surety's liability. The extent of the liability is thus determined by the amount of the claim known or estimable at the time the statement of suretyship is given. In this regard the Supreme Court ruled that the debtor's liability does not include compensation for losses that were incurred as a result of the debtor's breach of contract.[88]

In the event the surety is called upon to render performance, the rights of the lender pass to the surety through **assignment by operation of law**[89]. If the bank takes action against the debtor that renders enforcement impossible, the surety is released from the liability.

IV. Types of Suretyship

A. General

The Civil Code regulates two types of suretyship: the **ordinary surety** and the surety's liability as **surety and payer** *(készfizető kezes)*. The difference between the two types is how they are enforced.

B. The Ordinary Surety

With an ordinary suretyship, the debtor's obligation to pay off the principal debt takes precedence over the surety's liability, therefore the creditor first has to demand satisfaction of the claim from the debtor owing the principal debt. It is only when the creditor fails to obtain satisfaction that he or she may ask the surety to meet the obligation. A claim cannot be enforced against the ordinary surety as long as it would be possible to collect it from the debtor or from

[86] BH 1994/4. sz. 205., 1995/2. sz. 108.
[87] BH 1994.4.205., BH 1995.2.108.
[88] BH 1994.1.42.
[89] Article 276(1) Civil Code

other sureties who provided suretyship for the claim previously and without regard to said surety.

In the event of default by the principal debtor in the case of an ordinary suretyship, the surety is liable for the claim as well as ancillary charges. Under the rules of the Civil Code, in the event of delayed payment of money, interest on arrears is payable even if the claim (principal debt) was not otherwise encumbered by obligations to pay interest and if interest on arrears was not originally agreed on.

C. Surety and Payer

Unlike an ordinary surety, the creditor may resort to the surety and payer immediately when the secured claim falls due without the claim having first been enforced against the principal debtor.

The surety and payer thus ranks equally with the debtor. The debtor and the surety share **joint and several liability**. The surety and payer cannot plead that enforcement of the claim against them is premature because the creditor has not yet attempted enforcement against the debtor.[90]

The rules governing the provision of suretyship in the role of surety or payer are applicable only if expressly **agreed** by the parties or if the suretyship was entered into with a view to claims for damages. A suretyship accepted by a **bank** always means that the bank is liable as surety and payer.

V. Suretyship Versus Other Types of Personal Security

A. Surety Versus Bank Guarantee

It is important to differentiate suretyship assumed by banks from the bank guarantee. The difference lies in the substance of the suretyship: one key difference between the two types of security is that the suretyship, even when the surety is liable as surety and payer, is **accessory** by nature, unlike the bank guarantee. In addition, under a suretyship, a commitment is typically made by the surety to perform an obligation in case the debtor defaults on it, whereas under a bank guarantee the obligation to pay a certain sum covers a wider range of situations.

B. Suretyship Versus Letter of Credit

A letter of credit is often similar to a suretyship provided by the bank. As with a bank guarantee, the rules developed by a panel of experts working with the International Chamber of Commerce provide guidance and influence trends in international practice. According to these rules, a letter of credit is a **promise to make payment** that holds for a certain period of time if certain conditions are met. Therefore, in banking practice in Hungary, a letter of credit is not an acceptance of liability in the event of default on contractual obligations, but a means for making payment.

C. Suretyship Versus Guarantee of a Bill of Exchange

Guarantee of a bill of exchange or a check have to be distinguished from an "ordinary" suretyship. Guarantee of a bill of exchange is an unconditional **uni-**

[90] BH 1991.5.190.

lateral obligation[91], with the special features of the bill of exchange modifying the essential elements of the suretyship (contractual quality, accessory character). The jurisdiction considers statements on a bill of exchange saying "I guarantee" or "I provide suretyship" as a guarantee of the bill.

D. Suretyship Versus Check Guarantee

Similar to a bill of exchange, payment by check may be secured – fully or in part – by a suretyship. A check guarantee may be assumed by the drawee, by a third party, or by one of the signers. The check guarantee statement has to be placed on the check or on an allonge attached to it. Suretyship may also be assumed by the surety by signing on the face of the check. Accordingly, any signature other than the check writer's placed on the face of a check has to be deemed to represent a suretyship.

In the suretyship statement, the surety has to name the person for whom he or she accepts the suretyship. If this is not done, the suretyship is regarded as having been accepted for the benefit of the writer of the check. The surety then becomes liable for the check: the surety's obligation is the same as the obligation of the person for whom he or she is providing suretyship. When the surety honors the check, he or she acquires the rights under the check towards the person for whom suretyship is accepted and all predecessors on whom that person could take recourse.[92]

E. Suretyship Versus Assumption of a Debt

Suretyship finally cannot be deemed to constitute assumption of debt as it does not cause any change in the subjects of the legal relationship, with the original debtor remaining the debtor.[93]

[91] BH 1994.2.98.
[92] Decree on Checks ArticleArticle 25-27.
[93] BH 1993.375.

Chapter 7: The Bank Guarantee

I. General

The bank guarantee *(bankgarancia)* is regulated by the Civil Code.[94] A bank may undertake to make payment to the beneficiary up to a specified maximum amount within a specified period (until a certain date) upon fulfillment of certain conditions or presentation of certain documents.

A bank guarantee is a guarantee provided by a bank in case the **principal** (borrower) fails to perform an obligation. The beneficiary of a bank guarantee may likewise be a bank. In such a case, two banks are parties to the guarantee agreement: the **guaranteeing bank** and the **beneficiary bank**.

A bank guarantee is a **unilateral declaration of intent** on the part of the guaranteeing bank. It is always preceded by an agreement entered into by the guaranteeing bank and its principal, in which the bank undertakes the commitment to issue a bank guarantee under certain conditions. The bank guarantee can be resorted to when the conditions specified in it have been met.

One key condition of any bank guarantee is that the bank does not accept any liability for the genuineness of the documents submitted and will therefore not examine the documents in this regard.

Any security agreement that may be closed between the client and the beneficiary bank is independent of the bank guarantee. The expiry of the security agreement and other events (breach of contract) do not have any effect on the relationship between the beneficiary bank and the guaranteeing bank.

The extension of the **date of expiration** of the bank guarantee is quite common in practice, particularly in long-standing relationships between banks and their clients. Attention has to be devoted to the conditions on which an extension is granted and whether the conditions on which the bank guarantee was issued still apply unchanged. As the formal requirements relating to a bank guarantee are verified very carefully, specification of the time of its expiration and its extension require particular attention.

II. Importance in Practice

In Hungary, the bank guarantee is not very commonly used as credit risk mitigation instrument. In the first half of the 1990s, however, bank guaranties played a major role as a security for financing joint ventures. Typically, the parent company had a bank guarantee issued abroad that was accepted by the Hungarian banks. Later, these bank guaranties (suretyships) provided by parent companies were replaced by declarations of intent (letter of comfort)[95]. Currently, guaranties are issued primarily with subsidized loans, usually for the benefit of a government body disbursing the funds or a bank.

[94] Article 249 BGB.

[95] The declaration of intent and the 'Letter of Comfort' are not considered security for credit in Hungary. As there are no special provisions for these declarations, they should be assessed according their content in accordance with the contract law provisions of the Civil Code as simple unilateral declarations of intent of a third party. As regards the enforcement of deeds, refer to the chapter on General Remarks on the Realization of Security In Enforcement Proceedings.

Chapter 8: Assumption of Debt

I. General

Assumption of debt *(tartozás átvállalás)* is effected by an **agreement** entered into in writing, orally or by implied intent between the **debtor** and the person assuming the position of debtor (**new debtor)**.

Through assumption of debt, the new debtor takes the place of the old debtor, with the result being a change in the person of the debtor.

II. Creation of an Assumption of Debt

The Supreme Court has passed several decisions ruling that a transfer of debt under an agreement between the old and the new debtor is legally effective; the creditor's consent is required "only" to make the agreement effective towards the creditor as well.[96]

For the debtor, the person of the lender is – in most cases – irrelevant. This does not apply vice versa, though. For the lender, the person of the debtor is indeed of significance as the ability and willingness to pay depend on the person of the debtor. If the lender does not agree to the transfer of the debt, i.e. the change in the person of the debtor, the lender may continue requiring performance from the original debtor, whom it has not been discharged from the debt.

However, within the legal relationship between the old debtor and the new one the effective agreement on the transfer of debt means that the old debtor may ask the new debtor to offer the lender satisfaction of the claim, which the lender – as performance by a third party in accordance with the law – usually has to accept.[97]

III. Types of Assumption of Debt

With the lender's consent, the agreement between the old debtor and the new debtor becomes effective towards the lender as well. The old debtor is thus discharged of his or her obligation and the new debtor takes his or her place (intercessio privativa).

The lender may make consent dependent on a condition, rendering the transfer of debt effective only upon satisfaction of the condition.

Also possible is a situation in which a third party, typically under an agreement with the lender, does not take over the debtor's position but becomes an additional debtor beside the original debtor. In such case, there is no legal succession, with the additional debtor joining the original debtor in a similar way as a surety and payer. This strengthens the lender's position and the additional assumption of joint and several liability increases the chances of being able to enforce its claims. This situation, which differs from the transfer of debt with discharging effect, is called cumulative assumption of debt *(intercessio cummulativa)*.

[96] LB Pfv. VI. 22.934/1993. - BH 1995/4/213., also LB Pfv. VI. 22.314/1993. - BH 1996/1/32.
[97] P. törv. V. 20.576/1974. - BH 1975/8/368.

Chapter 9: Special Instruments

I. The Security Deposit[98]

A. General

A security deposit *(óvadék)* is a collateral arrangement under which the provider of the security hands over to the bank an item from which the bank may obtain satisfaction on certain conditions in the event of default. The security deposit allows the **lender**, to satisfy its claim from the sum of the **security deposit** immediately in the event that the debtor **fails to perform on an agreement fully or in part**.

In practice, security deposits are frequently used in Hungary as a credit risk mitigation instrument.

B. Creation of a Security Deposit

A security deposit may be set up by **agreement** or by **law**. The lender may satisfy its unpaid claim from the security deposit without causing the legal relationship under which the security deposit was provided to become extinguished. In such cases, if the remaining amount of the security deposit does not suffice as security for any claim still existing, the lender may ask for replacement and/or topping up of the security deposit.

The security deposit itself is, however, **accessory** by nature. It therefore shares the legal destiny of the secured legal relationship. This is also supported by the legal provision that securing a non-enforceable claim by means of a security deposit is void. However, one exception exists: The lender may obtain satisfaction from the item given as security deposit even if the claim that is secured by the security deposit has lapsed due to the passage of time and is therefore non-enforceable in court.

C. Object of the Security Deposit

Items that can be handed over as a security deposit include **money** *(pénz)*, **securities**[99], and **savings passbooks** *(takarékbetétkönyv)*. As already mentioned in the discussion of the rules governing liens, other financial instruments may be used as well for securing money and financial market deals. Handing over **other items** by way of security deposit than the items named above is not precluded, but such cases are subject to the **rules governing liens**, meaning that the lender is barred from obtaining immediate satisfaction.

The lender is obligated to keep the security deposit separate from its own assets. Any agreement providing differently is void. The security deposit has to be returned when the underlying legal relationship has expired.

[98] The regulations governing security deposits are contained in ArticleArticle270-271 Civil Code.

[99] Securities may not only be pledged but also used as security deposits. When using securities as collateral it is therefore important to consider which objective is to be pursued, i.e., whether the securities are to serve as a pledge or as a security deposit.

D. Agreements on Security Deposits in Banking Practice

1. Parties to the Agreement

An agreement on a security deposit may be entered into by two or three parties. If the person providing the security deposit is identical to the debtor in the underlying relationship, the parties of the security deposit agreement are the same as those of the underlying relationship (the creditor bank and the debtor).

The underlying relationship is usually a credit relationship (e.g. credit agreement, loan agreement, agreement on the issuance of a bank guarantee, etc.). The security deposit agreement between the debtor providing the security deposit and the bank, which is the creditor in both legal relationships, usually makes explicit reference to the underlying agreement, its parties and all claims under this underlying agreement (interest, costs, etc.).

2. Delivery Procedures

The debtor providing the security deposit **delivers the asset** representing the security deposit to the creditor bank when signing the security deposit agreement. This can be done in two ways:

If the asset provided as security deposit is a **registered instrument**, the debtor has to deliver it to the bank with a blank endorsement as provided for in the security deposit agreement. The registered security with the blank endorsement is transferred to the bank in accordance with the regulations governing securities. Upon performance of the obligation and in the cases specified in the agreement, if the bank does not intend to obtain satisfaction from the asset provided as security deposit, the bank re-transfers the securities back to the debtor.

When a **savings passbook** is provided as a security deposit, it is taken into safekeeping by the creditor bank in compliance with the relevant rules of the Civil Code. The parties agree on the safekeeping fee and other conditions. The safekeeping fee has to be borne by the debtor. Whether a contractual provision limiting the debtor's right to end the safekeeping arrangement unilaterally during the term of the security deposit agreement is valid, is controversial.

A security deposit may also be agreed to consist of a certain sum of **money** deposited on an **account** opened with the creditor bank under a deposit agreement. In such a case, the parties may agree in the security deposit agreement that for the term of the security deposit agreement the debtor shall waive his or her right of termination with regard to the deposit agreement and the right of disposition with regard to the account in order to provide the funds deposited to the lender as security in the event of default on the amount outstanding. Most banks open a separate security deposit account for clients furnishing a security deposit. Instead of opening an account, the debtor may also simply hand over **cash** to the bank.

E. Rights and Obligations Under a Security Deposit Agreement

1. Debtor

The debtor **provides warranty** of title and quality in respect of the assets deposited as security. The debtor warrants towards the lender that the items deposited as security represent existing and enforceable claims and are in compliance with applicable legal provisions in all regards (e.g. in the case of deposit agreements: Civil Code, General Standard Terms and Conditions, Agreement; in the case of savings passbooks: Civil Code; in the case of securities: applicable legal norms; in the case of shares of stock, if required: articles of incorporation). In addition, the debtor warrants that he or she owns the assets handed over as security deposit and that these are unencumbered and no other person has enforceable claims to them.

If, in the event of default regarding a portion of the obligation, the creditor satisfies its claim from the security deposit, the creditor may then ask the debtor for replacement or topping up of the security deposit. The debtor has to comply with this demand. The **creditor** has to make this **demand in writing**. The period allowed for replacing or topping up the security deposit and any other relevant conditions are to be specified by the lender in conformity with the security deposit agreement.

Under both the underlying agreement and the security deposit agreement, the debtor's non-compliance with the obligation to replace or top up the security deposit must be regarded as a serious breach of the agreement, which may constitute grounds for the immediate termination of the underlying agreement by the creditor.

2. Creditor Bank

The creditor bank may r**ealize the security deposit or keep it**. In any case, the creditor bank has to offset the value determined as the market value or in some other manner (e.g. through appraisal by an expert) against the claim it holds against the debtor.

Where securities are deposited as security, the lender may exercise those rights that have to be exercised or enforced while holding the security deposit.

In the case of shares, for example, the lender under the security deposit agreement has to participate in an exchange of shares approved by the issuing company in order to enable the rights and obligations, if any, associated with the shares to continue to exist in the future. If so agreed, the right to payment of dividends may also be enforced by the lender under the security deposit agreement. The dividends received by the lender may be used as additional security deposit or offset against the claim towards the principal debtor.

F. Realization of Security Deposits

The main characteristic of the security deposit is the creditor's ability to obtain i**mmediate** satisfaction from the security. The borrower does not have any right to take part in the realization of the security deposit, which therefore makes it a very "strong" security interest.

Money is realized immediately by **offsetting** it against the claim. In the case of securities, the bank may realize the security deposit by **selling** the securities

or by **appropriating** them. In this regard, the rules of the Civil Code do not conform with the rules of the Directive on Financial Collateral Arrangements (FinCAD), which requires an agreement to be drawn up on the appropriation of securities. With a security deposit, the deposit holder's right of realization does not have to be agreed separately and there is no need to define the method of realization.

G. Lien Versus Security Deposit

The legal nature of the security deposit, and specifically its relationship to the lien, is controversial. The security deposit is a security instrument similar to a lien. The Supreme Court often applies the rules governing liens analogously to security deposits. Nonetheless, significant differences exist between these two security instruments:

- only **certain items** permitting immediate satisfaction may be provided as **security deposit**; these are: money, savings passbooks, and securities
- the creditor may satisfy a claim directly from the security deposit, whereas liens have to be enforced judicially before a claim can be satisfied.
- under a security deposit agreement, the amount of the claim being secured is usually not exactly defined; a lien requires a description of the claim as detailed as possible.

II. The Option (right to buy)

A. General

The option *(vételi jog)* confers on the lender the right to buy an item by a **unilateral declaration of intent**. By making a unilateral statement of intent, the option holder may thus create a legal relationship under which he or she may ask another party for delivery of an asset at a specified price. However, ownership may be acquired in an asset by unilateral declaration of intent only if its transfer does not require the consent of a third party (e.g. assets with limited negotiability).

B. Suitability of Options as Credit Security

The owner of an asset may also grant an option to his or her asset as security to a lender extending credit to a third party. It is legally possible to grant a conditional option enabling the lender to acquire ownership in real property in the event of default.[100] When exercising the option, the lender may offset the purchase price against its claim under the credit agreement.

The relationship between option and lien has raised a large number of questions in practice. According to a Supreme Court ruling, the law bans only those agreements under which the lender acquires ownership in a pledged asset on default of the lienee (ban on forfeiture clause).[101] Under this law, however, such agreements are ineffective only if the agreement was entered into prior to the maturity of the lien. Such an agreement is not legally permitted as it would allow the lender to acquire ownership in the pledged item regardless of the

[100] Supreme Court III. 22796/1997. – BH 1990/10. sz. 452.
[101] Article 363(1) Civil Code

installments paid, without accounting for it, and without determining the true value of the item. This would mean an exploitation of the debtor's adverse situation.

C. Creation with Legal Effect

The law requires an option to be created **in writing**. The **asset** to be acquired (the object of the option) and the **purchase price** have to be **specified** in detail. The Act on Land Registration permits options to be entered in the land registry. An option may be agreed for a period of not exceeding 5 years. An option created for an indefinite period of time expires after 6 months.

When an option is exercised by the bank, the owner may defend him or herself through ordinary avoidance proceedings (in the case of contracts) or plead that due to significant events that occurred after the agreement was entered into, the sale of the asset would produce an extremely inequitable outcome for the owner, for which reason the court may release the owner from the obligations under the option.[102]

III. Restraint on Alienation and Encumbrance

A. General

The restraint on alienation and encumbrance[103] *(elidegenítési és terhelési tilalom)* restricts the owner's right of disposition. Ownership in the asset cannot be transferred and the asset therefore not provided as security. The restraint may be effective against certain **persons** as well as certain **assets**.

An agreement conflicting with the restraint on alienation or encumbrance is void as such a restraint also extends to third parties.

B. Creation of Restraint on Alienation and Encumbrance

A restraint on alienation and encumbrance may arise under a legal norm[104], a court decision, or an agreement.

As agreed by the parties, a **contractual** restraint on alienation and encumbrance may be effective in rem or only in personam. If the restraint on alienation and encumbrance is effective only in personam, it is not effective against third parties. An agreement entered into with a third party is effective, but the person protected by the restraint may claim damages from the person breaching the contract.

Whether a restraint on alienation and encumbrance is created by entering the restraint in the land register or whether it can be created independently of it is questionable. The Land Registration Act provides a full enumeration of the rights that arise on entry in the registry, which suggests that a restraint on alienation and encumbrance of real property may be established even with-

[102] Article 375(3) – Supreme Court Gfv. X. 32615/1997. – BH 1998/7. sz. 350.

[103] Article 114 Civil Code.

[104] A statutory restraint on alienation and encumbrance is contained, for example, in:• Article50(1) of Act No. LXXVIII./1993, under which the rented dwelling of the tenant who does not exercise his option to buy can be conveyed to a third party 5 years after the expiry of the period allowed for exercising the option only with the tenant's written consent.• Article657(1) Civil Code, under which a restraint on alienation and encumbrance has to be entered for a real property covered in a contract of inheritance; in such cases the entry is made independently of the entry of ownership.

out an entry in the land register, but in such case it would only be effective against a certain person.

When a restraint on alienation and encumbrance has been entered in the land register, the entry of further contractual rights is possible only with the consent of the party benefiting from the restraint on alienation and encumbrance.

C. Effects and Substance of Restraint on Alienation and Encumbrance

An effective restraint on alienation and encumbrance restricts the owner's freedom of disposition over his or her property. If a restraint on alienation and encumbrance arises under a law or a court order, any conflicting dispositions by the owner are void. If the restraint on alienation and encumbrance arises under an agreement, however, the disposition is void only if:

- it was made free of charge; or
- the third party had knowledge of the restraint on alienation and encumbrance or could have found out about it in the given circumstances; or
- the restraint on alienation and encumbrance has become effective in rem following its entry in the land register.

A restraint on alienation and encumbrance does not, however, rule out any acquisition completely as it rules out only the owner's right of disposition[105] but not the original acquisition of ownership based on other legal facts.

Furthermore, with a contractual restraint on alienation and encumbrance, the beneficiary of the restraint may give his or her consent to a purchase agreement, for example, later, when the agreement has been closed. Once consent has been given, the agreement is deemed to be valid as of the time of its conclusion (**ex tunc)**. In such cases, the state of being void is therefore curable. The consent of the person entitled to impose a restraint cannot be substituted by a court order.

Article114(2) Civil Code lays down the following conditions with regard to the restraint on alienation and encumbrance:

- The agreement may be entered into with legal effect only when ownership is transferred. An important exception are loans extended by a mortgage credit institution, under which the bank extending the loan may stipulate a restraint on alienation and encumbrance for the security pledged in the security agreement.[106][107] In banking practice, a restraint on alienation and encumbrance for the benefit of the bank or the mortgage credit institution is established when closing an agreement on a bank loans for the purchase of an asset and executing a lien agreement creating a registered lien.
- The agreement may serve no other purpose than to secure a right in the asset. An agreement to secure any other right is ineffective. When the right is entered, a restraint on alienation and encumbrance of a real property has to be entered as well.

[105] Article 114(1) Civil Code, BH 1978. 377.
[106] Article 5(2) of Act No. XXX./1997 on mortgage institutions and the mortgage bond.
[107] BH 1995. 584.

Chapter 10: Concluding Remarks

Compared with Austrian security interest law, the following significant differences can be summarized in brief:

From a terminological standpoint it must be noted that, in contrast to Austria, **bankruptcy** is not equivalent to the final dissolution of the company but is comparable to the Austrian **composition proceedings**. **Liquidation proceedings** in Hungary result in the final liquidation of the company. Hungary **does not** have any proceedings that are similar to **consumer bankruptcy**. Therefore, only execution proceedings can be instituted against **private individuals** (see chapter entitled Introduction to Securing Credit Risk in Hungary, Realization of Security Rights, Realization of Security Rights in Liquidation Proceedings).

In **liquidation proceedings**, the **claims** of **lienors** are heavily **curtailed**. 50% of the proceeds from assets encumbered by liens are allocated to cover the costs of the sale of the asset and the satisfaction of the lienors' claims. The remaining 50% are used to pay for the cost of the liquidation proceedings and the other creditors. Note that the term "cost of proceedings" is very broad and in addition to the actual costs of the proceedings also includes claims to compensation for work and certain claims for damages (see chapter entitled Introduction to Securing Credit Risk in Hungary, Realization of Security Rights, Realization of Security Rights in Liquidation Proceedings).

A **non-possessory lien** on movable assets can be established by registration in the **register of liens** that is maintained by the Hungarian Chamber of Notaries. Under Hungarian law, a **lien** may also be created on the **entirety of assets** without having to specify the assets in detail. Such a lien has to be entered in the register of liens. In addition, it is possible to establish a **separate, non-accessory lien**, which exists even in the absence of an underlying claim (see chapter entitled Special Rules for Different Types of Liens).

With liens on **movable property**, the pledged asset may be **realized extrajudicially** provided a **realization agreement** was concluded with the borrower (see Chapter entitled General Remarks on Liens, Realization of Liens, Extrajudicial Realization).

The use of a **security deposit** as collateral is **regulated** in Hungary **by law**. Under the applicable provisions, claims may be **satisfied extrajudicially upon maturity** from the assets deposited as security (see chapter entitled Special Instruments, the Security Deposit).

When **realizing real property** in execution proceedings it must be noted that the satisfaction of **other claims** (alimony obligations, workers' compensation) takes precedence over claims under a **mortgage**, see chapter entitled Introduction to Securing Credit Risk in Hungary, Realization of Security Rights, Realization of Security Rights in Liquidation Proceedings).

An **assignment for security** is established by an **agreement** between the two parties, **without** the need to notify the third-party debtor. Notification to the **third-party debtor** is required only to make the assignment effective towards the third-party debtor and for the realization of the security interest. Note that notification to the third-party debtor, when coming from the borrower, has other legal consequences than notification by the bank itself (see chapter entitled The Assignment of Claims).

In Hungary, an option to buy may also be used as security for a credit in certain circumstances (see chapter entitled "Special Instruments, The Option).

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Abbreviations

Civil Code – Act No IV./1959 on the Civil Code
BH – Decision by a lower court