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NEW RULES ON FINANCIAL COLLATERAL ARRANGEMENTS

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As a result of Hungary's accession to the European Union on May 1 2004, certain amendments were made to Hungarian law on the basis of the EU Financial Collateral Directive (2002/47/EC). In particular, creditor protection amendments relevant to the enforcement of financial collateral (known as 'security deposits' in Hungarian legal terminology) were introduced to the Act on Bankruptcy Proceedings, Liquidation Proceedings and Members' Voluntary Dissolution (49/1991) and to the Hungarian Civil Code (Act 4/1959).

LIQUIDATION PROCEEDINGS

Previously, according to the Bankruptcy Act, if a debtor provided a security deposit (ie, money or securities over which a creditor could seek direct enforcement in case of a breach of the payment obligation), the security deposit agreement - by virtue of law - terminated on the day of publication of the debtor's liquidation. On this date, the security deposit had to be surrendered to the liquidator; the creditor to which the security deposit was granted thus lost the advantage originally conferred, and benefited only from a priority rank in the order of satisfaction of creditors.

This rule proved rather problematic in the banking context, as the Hungarian courts do not provide information to third parties on the potential commencement of liquidation proceedings. To minimize such risks, the banks came up with a practical solution whereby (i) submission of an application to commence liquidation proceedings, and/or (ii) failure to notify the creditor of such an event, was considered a serious breach of the loan agreement, as a consequence of which the debt or (at the discretion of the bank) the collateral became due.

The recent amendments to the Bankruptcy Act have introduced more creditor-friendly rules by providing that following the commencement of liquidation, a creditor is entitled to continue to enforce its claim through the security deposit granted to it, and must pay any remaining balance to the liquidator. However, if a creditor with a security deposit does not enforce its claim within three months of the announcement of the commencement of liquidation, the creditor will be regarded as a lien holder and will benefit only from priority ranking.

If the creditor and debtor comprise a concentration of companies (i.e/ if the creditor holds more than 50% of the voting rights, directly or indirectly or on the basis of an agreement, in the debtor, or if the creditor is entitled to appoint and recall the majority of executive officers or members of the supervisory board), then the creditor must hand over the security deposit to the liquidator immediately upon publication of the commencement of liquidation. The liquidator will only pay the amount due to the creditor if it cannot find good cause to contest the security deposit within the specified deadline for challenging contracts.

CIVIL CODE PROVISIONS

The former provisions of the Civil Code on the regulation of security deposits also required revision. This was due, among other things, to the introduction of new forms of money and security instruments, the physical delivery of which by the debtor (one key element of the definition of a 'security deposit') was impossible. Nevertheless, commercial practice frequently treated these instruments as security deposits. This caused many surprises for creditors, which in many instances could only enforce their security as a lien where the legal nature of the security, as a general rule, did not allow for direct enforcement. The boundary between a security deposit and a lien has now been clarified.

According to the new rules, the object of a security deposit, in addition to cash and printed securities, can be money kept on the debtor's account or financial instruments specified in other acts (e.g. dematerialized shares or bonds). The security deposit must be established by concluding a written agreement and surrendering the object of the security deposit to the creditor.

If the object of the security deposit cannot be surrendered, the rules on liens will apply to the transaction. This effectively means that the legal transaction will not be deemed invalid; rather, its legal nature will change pursuant to the rules of the Civil Code.

However, the definition of 'surrendering' the security deposit has been extended beyond the traditional physical means. 'Surrendering' covers all procedures which result in the transfer of the security deposit from the possession or control of the debtor to the possession or control of the creditor. This provision becomes very important, as it allows for the use of non-printed (dematerialized) securities in financial collateral agreements.

Pursuant to Section 144 of the Capital Markets Act (120/2001), if non-printed securities are the subject of a security deposit on the basis of an agreement between the parties, the securities may remain on a sub-account of the debtor, which indicates the legal title of the security deposit and the beneficiary. The parties remain free to determine the content of their agreements, since they can establish a lien on non-printed securities instead of providing them as financial collateral.

Pursuant to the directive, the new Civil Code rules also ensure that once an enforcement event occurs, the creditor may exercise its right to enforce its claims directly, provided that the security deposit is cash, money on account, securities or other financial instruments with a public purchase price or a purchase price that may be determined independently of the parties.

In the case of other securities and financial instruments, the parties must agree on the method of valuation in their agreement on the security deposit; otherwise the collateral may not be used directly for enforcement.

DEMATERIALIZED SECURITIES ACCOUNTS

Decree-Law 13/1979 on international private law also introduced new principles in relation to dematerialized securities. Ownership and other rights relating to dematerialized securities will be governed by the law of the country in which the securities account is kept, on which a transfer is made for the benefit of the owner or holder of other rights.

This is the so-called 'place of the relevant intermediary' approach, and it means that a financial collateral transaction will be governed by the law of the country in which the relevant account is kept.

Pursuant to the Capital Markets Act and the rules of KELER (Hungary's central clearing house), dematerialized securities issued by Hungarian issuers may only be held in securities accounts located in Hungary. This means that if a transaction involves ownership or other rights relating to Hungarian dematerialized securities, Hungarian law will apply.

The contents of this article are intended to provide only a general overview of the subject matter. Specialist advice should be sought for specific matters. Queries relating to this article should be addressed to the authors at:

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