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# Secured Transactions in a Country of Transition: The Hungarian Experience

Attila Harmathy

## I. PERIOD PRIOR TO WORLD WAR II

Over several centuries, the lack of capital has been one of the serious problems of the Hungarian economy. Consequently, credit was an important element of economic life. Until the second half of the 19th century, the conditions under the still-prevailing feudal system were unfavourable for establishing a credit system. In the second part of the 19th century, however, an economic boom changed the conditions. As a result of the new economic situation, new legal rules were needed. In 1875, a Commercial Code was enacted and the drafting of a new Civil Code started. For historical and economic reasons, Austrian and German law was influential. Several drafts of a Civil Code were produced and presented to the Parliament, but none of them were voted on until 1959. In other words, until World War II the Civil Law as a whole remained uncodified and a special kind of judge-made law prevailed. Nevertheless, some Acts of Parliament regulated specific fields of social and economic life.<sup>1</sup>

One of the fields that needed specific rules was credit and credit securities. For example, Act XXXV of 1927 specified rules for mortgages. The basic concept underlying the credit rules was similar to that of the law of most European countries: mortgages covered immovable items and lien, pledge addressed movable goods. An exception to this system was created by Act XXI of 1928, which regulated a special security on industrial enterprises as a going concern without possession by the creditor and a system of special registration.

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1. *See generally* INTRODUCTION TO HUNGARIAN LAW 11-14 (Attila Harmathy ed., 1998) (providing a historical overview).

The exceptional security was, to some extent, similar to the floating charge, otherwise unknown in the Hungarian law.<sup>2</sup>

## II. PERIOD OF PLANNED ECONOMY

After World War II a democratic government was established in Hungary but, as a result of the pressure of the Soviet army, a slow change of the economy started. It was accelerated from 1948 when the Communist Party came to power. A new political and economic system was introduced. The characteristic features of the new economic system were the nationalisation of the overwhelming majority of the means of production, replacement of the market system by a centrally-directed system of economy, central allocation of resources, and state monopoly of a much of the economy. In this system, credit was also the monopoly of the state. Banks were functioning as a special type of state authorities by administering the centrally allocated financial resources. Contracts in general, and secured transactions specifically, had a different meaning and regulation than in a market economy, although some traditional legal forms were maintained in civil law rules.<sup>3</sup>

The system mentioned above determined the rules of the Hungarian Civil Code of 1959. By the time of the enactment of the Civil Code, the strict system of plan instructions had changed. Nevertheless, the state monopolies (including the monopoly of crediting) prevailed and state ownership played a decisive role in the economy. Likewise, the banking system was different from that of a market economy. The drafters of the Civil Code managed, however, to maintain in the framework of the Code the most important rules of the pre-World War II Hungarian Civil Law. This included the rules on secured transactions, although they were practically not applied.

At the end of 1960s economic reform occurred and a form of market economy emerged. Hidden forms of private economy were slowly permitted. Thus, there was a slow transformation of the economic system but it was restricted by the political system.

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2. See Attila Harmathy, *Ungarischer Länderbericht, Das Recht der Mobiliarsicherheiten*, in *MOBILIARSICHERHEITEN, VIELFALT ODER EINHEIT* 75-78 (K.F. Kreuzer ed., 1999).

3. See generally Attila Harmathy, *Kreditsicherheiten im sozialistischen System*, in *SYSTEMTRANSFORMATION IN MITTEL—UND OSTEUROPA UND IHRE FOLGEN FÜR BANKEN, BÖRSEN UND KREDITSICHERHEITEN* 306-14 (U. Drobnič, K. J. Hopt, H. Kötz & E.-J. Mestmäcker eds., 1998).

### III. PERIOD SINCE THE POLITICAL CHANGES

#### A. *New Regulation of Secured Transactions*

After the elections of May 1990, a new Parliament and a new government started to transform the political and the economic system. The market economy was re-established. After the planned economy, accumulating a great amount of foreign debts capital was badly needed. Many poorly-run state enterprises carried huge debts and the creditors were usually banks. As a result, the banking system was to be reorganised. Debts were covered from State budget, which deteriorated the budgetary situation. It was clear that credits played a crucial role for the economy and the regulation of secured transactions received a significant attention.

The elaboration of the new rules for secured transactions followed a few years after the transformation of the political system. At that time the legislature was very busy—the whole legal system had to be changed. This task has not facilitated fast development in the rather complicated field of credit securities. The rules on mortgage, liens, and pledges were incorporated into the Civil Code, but many rules connected with them were to be remained in other Acts—such as the Acts on land registration or enforcement of claims—or appropriate rules were practically missing. For example, no rules existed to regulate insolvency or the winding up of companies. The task of drafting a coherent new efficient system was, therefore, not an easy one. The new rules were developed in co-operation with the European Bank for Reconstruction and Development and in consultation with German, French, English, Swiss, and American experts. The new rules were promulgated by Act XXVI of 1996 on the amendment of the Civil Code.<sup>4</sup>

The new rules have changed some of the traditional basic concepts. Thus, the distinction of mortgage (concerning immovable) and pledge, resp. lien (on movable) has been replaced by the distinction of the charge with possession and without possession. This takes into consideration the importance of movables and intangibles in the modern economy and the fact that it is the interest of both of the creditor and of the debtor that the debtor can use the object of the security remaining in its possession. According to another new solution, a part of the property can be the object of the charge as a going concern specifying its value but not each item belonging to the charged property (resembling to the floating

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4. Attila Harmathy, *The EBRD Model Law and the Hungarian Law*, in *EMERGING FINANCIAL MARKETS AND SECURED TRANSACTIONS 197-209* (Joseph Jude Norton & Mads Andenas eds., 1998) (discussing the transformation and the new rules).

charge). A third element of the changed conceptual basis was the reintroduction of the so-called abstract charge, which is not connected with the contract on crediting (in contrast with the charge having accessory character). The aim was to connect the abstract charge with some kind of securitisation; however, this link has not yet been achieved. A vital condition of the realisation of the new system was the establishing of a new registration system for charges without possession by the creditor. After long negotiations, the notary publics have established a computer network of registration, but the existing land registry system continues.

A serious problem of the new regulation was the necessary modification of the regulation of insolvency and the winding up of companies. Furthermore, enforcement of claims could not be achieved and inconsistencies remain in the complex system of regulation. Additional steps were made by Act CXXXVII of 2000 on the amendment of the Civil Code and some other Acts. The basic concept of the regulation of the Civil Code was not changed, but the rules on registration and enforcement were brought into harmony with the new system.

### *B. Court Practice*

During the planned economy, the rules on secured transactions were in force but they were not applied because the economic conditions were not favourable. The transformation of the political and economic system has brought about fundamental change in this respect, too. Consequently, secured transactions have a renewed importance and legal actions resumed. Some cases are mentioned below to illustrate the types of problems that have appeared in court practice.

In one of the published cases decided by the Supreme Court soon after the effectiveness of the new rules, the rule concerning the method of enforcing security based on legal rules was interpreted.<sup>5</sup> From the very beginning of the application of the rules on secured transactions, problems connected with the enforcement of rights arising from the charge was an important question in the legal disputes.<sup>6</sup> In some cases the Supreme Court has explained how to distinguish security deposit and lien.<sup>7</sup> In other cases the consequences of the accessory character of the security were explained.<sup>8</sup> Problems arose in connection with a charge securing the maximum amount of debt in a long-term economic relation

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5. *Bírósági Határozatok* [Law Reports] ("BH.") 1997 No. 243.

6. BH. 1996 No. 267; BH. 1996 No. 495.

7. BH. 2001 No. 543; BH. 2003 No. 288.

8. BH. 2001 No. 393; BH. 2003 No. 363; BH. 2007 No. 227.

where the debt was changing constantly in accordance with the revolving credit.<sup>9</sup> The question of assignment was put in connection with secured transactions, too.<sup>10</sup> Although there are problems in connection with the rights on “floating charge” there is only one case published by the Supreme Court concerning “crystallisation,” i.e. specifying what elements of the property charged should be sold.<sup>11</sup>

It is obvious that there are several legal techniques of securing rights (e.g., retention of title, leasing, etc.). They are widely used in Hungarian practice, too. There were some cases decided by the Supreme Court where the question was whether the purpose of using other legal means was not circumventing a mandatory provision protecting the interests of the debtor. A typical agreement of this kind provides for the right of option granted to the creditor. According to the decision of the Supreme Court, the agreement is valid if the price to be paid under the option corresponds to the value (market price) of the immovable good and not to the amount of the debt.<sup>12</sup>

### C. *On the Present Situation*

The Civil Code of 1959 preserved many elements of the Hungarian civil law of the period prior to World War II. Therefore, there was no need to start drafting a new code immediately after the political changes in 1990.<sup>13</sup> Nevertheless, some years later the conditions seemed to be favourable for drafting a new code. In 1998 the government made a decision on the codification. In recent years the concept of a new regulation of secured transactions was widely discussed.

The present economic situation in Hungary can be characterised with the following data. Charges on movable goods without possession are reported by the notary public registration network.<sup>14</sup> The overall value of registered securities in 1997 (the first year of registration) reached approximately HUF 600,000 million (about USD 3 billion). In 2002, the value was approximately HUF 11,400,000 million, or about USD 57 billion. The number of registered contracts concerning secured transactions at the end of 2002 totalled about 58,000. Out of these

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9. BH. 2005 No. 152; BH. 2008 No. 22.

10. BH. 2002 No. 240.

11. BH. 2004 No. 192; BH. 2006 No. 120.

12. BH. 2005 No. 73; *see also* BH. 2001 No. 584.

13. *See* Attila Harmathy, *Process of Transition and Commercial Law in Central and Eastern Europe*, in *NEW DEVELOPMENTS IN INTERNATIONAL COMMERCIAL AND CONSUMER LAW 367-82* (Jacob S. Ziegel ed., 1998); Attila Harmathy, *Transformation of Hungarian Civil Law*, in *TRANSFORMATION OF THE HUNGARIAN LEGAL ORDER 1985-2005*, at 279-86 (Andras Jakab, Peter Takács & Allan F. Tatham eds., 2007).

14. Gy Tolmár, *Zálogjogi nyilvántartás [Security Registration]*, *KÖZJEGYZŐK KÖZLÖNYE [BULLETIN OF NOTARY PUBLICS]*, 2003 No. 7, at 6-9.

contracts at the end of 2002, the proportion of charge of movables without possession was 59 percent, and those characterized by a “floating charge” comprised 16 percent. By the end of 2006, the proportion of “floating charges” had increased to 28 percent.<sup>15</sup> Recently, the importance of the abstract charge has increased considerably in the bank practice,<sup>16</sup> and by means of securitisation it has become an important form of refinancing bank credits.<sup>17</sup>

Credit issued to citizens and small business carry great importance even though the amount of the debt of individual debtors is small. Nevertheless, the aggregate amount is considerable. In 2006, the amount of credit issued for housing was HUF 688,000 million, or about USD 3.44 billion.<sup>18</sup> Banks, of course, play a vital role in credit.

As a result of privatisation, by the end of 2000 the foreign participation in the capital of banks was very high relative to that in other countries—66.7 percent—and the situation was similar for insurance companies.<sup>19</sup>

In the present international financial crisis and in light of the regulation of secured transactions, the economic situation of Hungary can be characterised as follows:

- the state budget deficit is high, the economic growth is small, the deficit of the balance of payment is also high, the amount of foreign debts has been increasing,
- the Hungarian banks have not owned securities based on foreign mortgages,

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15. Anka Tibor; *Hátra arc, előre? Az új Polgári Törvénykönyv tervezetének zálogjogi szabályairól* [About Face, Ahead? The Rules on Secured Transactions in the Draft of the New Civil Code], KÖZJEGYZŐK KÖZLÖNYE [BULLETIN OF NOTARY PUBLICS], 2007 No. 6, at 19.

16. Zámbo Tamás, *Útközben – de honnan és hová is?* [In Transit – But from Where and in What Direction?], KÖZJEGYZŐK KÖZLÖNYE [BULLETIN OF NOTARY PUBLICS], 2007 No. 6, at 11.

17. Botos András Gábor, *Várható változások a zálogjogi szabályozásban* [Probable Changes in the Regulation of Secured Transactions], KÖZJEGYZŐK KÖZLÖNYE [BULLETIN OF NOTARY PUBLICS], 2007 No. 6, at 24-25.

18. Szendrey Zoltán, *Az új Polgári Törvénykönyv zálogszabályai a lakossági finanszírozás szempontjából* [Rules of Secured Transactions of the New Civil Code: Credits Granted to Citizens], KÖZJEGYZŐK KÖZLÖNYE [BULLETIN OF NOTARY PUBLICS], 2007 No. 6, at 35.

19. PÉNZÜGYI SZERVEZETEK ÁLLAMI FELÜGYELETE [STATE INSPECTION OF FINANCIAL INSTITUTIONS]: ÉVES JELENTÉS 2000 [ANNUAL REPORT], 47, 66, 70-72 (2001). 47, 66, 70-72.

- the foreign banks having shares of Hungarian banks have not been directly endangered by the financial crisis up to now,
- the price of immovable goods has not increased considerably during recent years,<sup>20</sup>
- additional problems arise because of the inefficient and slow procedure of enforcing rights in immovable goods, particularly in the framework of insolvency and the procedure for winding up companies.<sup>21</sup>

Taking into consideration the data concerning the practice of secured transactions and the financial crisis there seems no special need to change the fundamental concepts of the regulation of secured transactions in Hungary.

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20. Király Júlia, Nagy Márton & Szabó E. Viktor, *Egy különleges eseménysorozat elemzése – a másodrendű jelzáloghitel-piaci válság és (hazai) következményei* [Analysis of a special series of event— the crisis of secondary mortgage market and its (domestic) consequences], *KÖZGAZDASÁGI SZEMLE* [ECONOMIC REVIEW] 2008, at 608, 610, 613.

21. Póra András & Széplaki Valéria, *Hitelbiztosítékok hazai szabályozása, különös tekintettel a CRD elvárásaira* [Domestic regulation of credit securities, taking into consideration in particular requirements of CRD], *MNB TANULMÁNYOK* [ESSAYS PUBLISHED BY THE NATIONAL BANK OF HUNGARY] 2006, at 28.

