

Czech Republic: Validity of Existing Security Transfers of Rights at Risk Due to Jurisdiction of the Czech Supreme Court

A security transfer of right (security transfer) is one of the security instruments relied upon by creditors as security for loans provided to debtors. Under a written agreement the debtor transfers to the creditor the debtor's right towards a third person (a receivable) or a property right, including the right of ownership, as security. This institute is regulated in Section 533 of Act No. 40/1964 Coll., the Civil Code of the Czech Republic, as amended. [Danica Šebestová](#) and [Ivan Karpják](#) of Squire Sanders' Prague office examine the current and future status of security transfers in the Czech Republic.

Intervention of the Czech Supreme Court

In autumn 2008, in the midst of the global economic crisis, the Supreme Court of the Czech Republic decided to contribute its own portion of uncertainty to the established system of credit financing. In its decision file no. 31 Odo 495/2006 dated 15 October 2008 the court sought to bring greater clarity to the current legal regulation of the security transfer. In its decision, the court reached the following conclusions:

- (i) An agreement for a security transfer is an agreement with a condition subsequent, by performance of which the original owner (i.e. the debtor who provided the security) automatically regains the ownership of the item. The Supreme Court made it clear that the so-called *fiduciary* transfer of right (i.e. when the debtor has a contractual right to demand a re-transfer of ownership from the creditor) is inadmissible and invalid. The Supreme Court reasoned that the *fiduciary* transfer does not constitute a property right recognizable to third parties.
- (ii) An agreement for a security transfer which does not regulate the settlement of the parties if the debtor fails to pay to the creditor the secured sums in a due and timely manner is absolutely invalid. The Supreme Court said that the reason for invalidity lies in a lack of certainty regarding the content of the rights and obligations of the parties to the agreement should the debtor fail to meet its obligation to satisfy the secured receivable. The law does not provide for any supporting regulation of the parties' rights for this purpose.
- (iii) An agreement for a security transfer which contains a condition subsequent applicable only for the *due and timely* payment of the secured sums is absolutely invalid. If late payment of the secured receivable occurs the secured receivable will cease to exist, *but* the creditor will become the permanent owner of the transferred property. The Supreme Court held that such agreement shows all attributes of an inadmissible forfeitable pledge.

The Supreme Court offered the following solutions:

The agreement on the security transfer can be executed in the form of a purchase agreement, in which the maturity of the purchase price is bound to the moment of maturity of the secured receivable. If the payment of the secured receivable is *made duly and in time*, the purchase agreement is terminated (based on the condition subsequent) and the debtor's ownership right is renewed. If the payment of the secured receivable is *not made duly and in time*, the purchase price will be set off against the secured receivable.

The agreement on the security transfer can state that the creditor is entitled to realize (e.g. sell) the property in an agreed manner and to return to the debtor the possible realization excess. Such agreement, however, assumes that the debtor is delayed in the payment of the secured receivable until the moment of the realization. It is necessary that such agreement includes provisions regulating (i) impact of the late satisfaction of the secured receivable by the debtor on the creditor's right of ownership to such property and (ii) regime of possible benefits generated until that date by such property.

Impacts of the Czech Supreme Court's conclusions

Despite protests from legal professionals and commentators, as of the time of writing the Supreme Court has not corrected its opinion as expressed in the above decision.

It is well-established practice in the Czech market that, under an agreement for a security transfer, the debtor has a contractual right to demand the re-transfer of the ownership from the creditor upon satisfaction of the secured obligations. Therefore, the Supreme Court's requirement for automatic re-transfer of the ownership upon satisfaction of the secured receivable comes as an unpleasant surprise. It is even more surprising because Czech law recognizes agreements including the creditor's obligation to re-transfer the transferred right as valid.

Moreover, the solution proposed by the Supreme Court to settle the debtor's delay by upholding the creditor's right of ownership coupled with the parallel set-off of the purchase price against the secured receivable resembles too obviously the forfeitable pledge. The only difference between the solution proposed by the Supreme Court and the original institute banned by the law is that in the Supreme Court's solution the right of ownership is transferred by establishment of the security transfer and not after the secured obligation is breached. Therefore, the Supreme Court's solutions for safe drafting of an agreement on the security transfer raise more questions than answers.

Finally, the Supreme Court did not limit the effects of its decision whatsoever. Thus, it is very probable that the sanction of invalidity applies to already existing security transfer agreements.

Conclusion

We can only hope that the Supreme Court will change its, in our opinion, hasty conclusions by which it has threatened validity of already existing security transfer agreements.

Because the legal analyses of and rules applicable to security transfers and security assignments of receivables are conceptually close in Czech law, it is possible that similar rules and restrictions will apply in the security assignment of receivables.

Until the Supreme Court makes a new decision in this matter, we recommend that creditors use security instruments other than security transfers or security assignments of receivables – e.g. a right of pledge.

Moreover, it is necessary to examine whether existing agreements for security transfers (and the security assignments of receivables) are in the form of *fiduciary* transfers. If they are, for the sake of legal certainty, it is desirable to terminate such agreements and enter into pledge agreements instead.