

NEW COURT DECISION CONFIRMS THAT ENTERPRISE PLEDGES UNDER BULGARIAN LAW REMAIN AN EFFICIENT TOOL FOR LENDERS

In its decision of 3 January 2018, the Sofia City Court followed Wolf Theiss' argumentation and confirmed that the privilege of first ranking creditors under enterprise pledges extends over each and every asset forming part of the pool without the need for enforcement.

The amendments to the Bulgarian Registered Pledges Act¹ (the "**RPA**") introduced in 2017 opened a number of discussions and raised considerable doubt of the practicability of floating charges under Bulgarian law, including enterprise pledges.

Under Bulgarian law, an enterprise pledge is a form of floating charge over all assets forming part of the enterprise. It is an efficient form of security, in particular, for companies from the trading, manufacturing, leasing and other similar sectors where the company's assets change dynamically and cannot be listed. Along with the many advantages this type of security has compared to traditional mortgages, its main weakness is that in case an asset leaves such pool (e.g. by way of a sale) it is also released from the pledge. The discharge does not apply to assets which have been listed as specifically pledged (i.e. by means of their identification as an individual asset in the pledge agreement and the registration of the pledge with the registry for such assets). Such individualization can be cumbersome and ineffective as it depends on the pledger's disclosures. A floating charge extends over each non-individualized asset forming part of the pool ("**crystallization of the pledge**") only after the pledgee has commenced enforcement by taking the formal measures prescribed by law².

This led to a number of attempts by unsecured creditors to claim that the freezing order of an unsecured creditor over individual assets shall be considered as ranking higher than enterprise pledges, even if such an order was registered only after the enterprise pledge. Thereby, the claims of such unsecured creditors shall be settled prior to the claims of the secured creditors as the enterprise pledge has not yet crystallized in relation to such individual assets. Moreover, it was argued that a pledgee under an enterprise pledge shall commence enforcement in order to be able to benefit from the security.

Although this position had some support from other courts, Wolf Theiss argued against it. Our argumentation was confirmed by the Sofia City Court which resolved that

¹ The Registered Pledges Act ("Закон за особените залози"), promulgated in State Gazette issue 100 dated 22 November 1996 as amended from time to time.

² Filing an application for registration of formal commencement of enforcement with the competent registries as prescribed under Art. 32 RPA.

- ***Unsecured creditors may commence enforcement but they may not have privilege over a first ranking enterprise pledge which is registered prior to the enforcement***

While the 2017 amendments to the RPA restricted the malpractices of junior ranking creditors, which had the right to jeopardize the senior ranking enforcement prior to the amendments, there were no similar boundaries introduced for unsecured creditors. A secured creditor with a lower ranking pledge may only commence enforcement: (i) with the consent of the senior ranking creditors or (ii) after having settled the senior ranking claims. Such a restriction was not provided for unsecured creditors; leaving considerable room for discussion concerning the balance of interest in the legislative decision. Unsecured creditors may commence enforcement at any time at their sole discretion and force secured creditors into enforcement. Despite the fact that such actions by unsecured creditors are still permitted, the argumentation that their claims shall have privilege over first ranking secured creditors under enterprise pledges is not substantiated, even considering the deficiencies of the current law.

Article 21 RPA indeed states that an enterprise pledge is valid vis-à-vis third parties acquiring rights over assets forming part of an enterprise pledge only if the pledge has been created explicitly over such assets. However, as per a court decision by the Sofia City Court dated 3 January 2018 (the "2018 Sofia City Court Decision") it was correctly confirmed that Article 21 is a special provision for the benefit of third parties such as buyers of the assets and may not be applied by unsecured creditors. Unsecured creditors' right shall remain lower ranked irrespective of whether an enterprise pledge has been created with or without a list of specifically identified assets and registered in all competent registries.

- ***No commencement of enforcement of the enterprise pledge is required by the secured creditors in order to preserve their ranking and ensure payment of enforcement proceeds in their favour***

Several court decisions issued also after the amendments to the RPA from 2017³, as well as the 2018 Sofia City Court Decision, confirmed that creditors secured by an enterprise pledge are not required to commence enforcement proceedings in order to be entitled to receive enforcement proceeds, as argued by some unsecured creditors.

The right to enforce a pledge is a right granted to secured creditors, but this does not correspond to an obligation thereto. Moreover, the debtor may have complied with its obligations to the secured creditor and be in breach only in relation to the unsecured creditor who has commenced enforcement. This, however, does not mean that the secured creditor must sit and watch as the unsecured creditor initiates enforcement over assets forming part of the enterprise, thus eventually decreasing the enterprise value.

Furthermore, this question has been resolved in the RPA itself which states that a secured creditor is deemed an (automatically) joined creditor to the enforcement proceedings

³ Decision 420 dated 26.9.2017 by the Regional Court Veliko Tarnovo, Decision 6124 dated 25.8.2017 by the Sofia City Court

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whereby the secured claims are considered due immediately up to the amount of the enforcement proceeds to be distributed⁴. This was also confirmed by the 2018 Sofia City Court Decision and is the preferred approach as creditors shall not be forced by law to declare all their claims immediately due, as this would put borrowers into a worse financial position driving them into insolvency.

- ***Secured creditors' claims retain their undisputed higher ranking as per the Law on Obligations and Contracts***⁵

Privileges are regulated in Article 136 of the Bulgarian Law on Obligations and Contracts and this is also the relevant statutory provision to be applied to the distribution of enforcement proceeds. Claims secured by pledges have undisputed higher ranking compared to claims of unsecured creditors of third parties⁶. The law does not differentiate between claims secured by enterprise pledges or other forms of floating charges and pledges over individual assets. Such an interpretation of the law is ungrounded and not justified and shall, therefore, be rejected. The RPA regulates priorities between creditors under different types of registered pledges, but by no means aims at putting unsecured creditors in a better position compared to secured creditors. This has been confirmed by the 2018 Sofia City Court Decision but also directly by Article 16 RPA, which explicitly refers to Article 136 of the Bulgarian Law on Obligations and Contracts in relation to the regulation of the priority of secured claims.

The 2018 Sofia City Court Decision, thus, closed a number of open questions concerning floating charges; the resolution of which was crucial for the future use of enterprise pledges. Wolf Theiss was also happy to contribute to a further positive development of case law in favour of dynamic commercial relations; highlighting the economic rationality behind the legal provision and differentiating from the predominately formalistic approach of the local courts.

⁴ Article 10 (3) RPA

⁵ Law on Obligations and Contracts ("Закон за задълженията и договорите") promulgated in State Gazette, issue 275, dated 22.11.1950 as amended from time to time.

⁶ Other than the enforcement costs, the claims of the state for taxes due in relation to real assets in case of enforcement over those real assets, etc.

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For more information about our services, please contact:



Katerina Kraeva
Partner
katerina.kraeva@wolftheiss.com
T: +359 2 8613 700



Rebeka Kleytman
Senior Associate
rebeka.kleytman@wolftheiss.com
T: +359 2 8613 700

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Wolf Theiss
Schubertring 6
AT – 1010 Vienna
www.wolftheiss.com