

Memorandum

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“The Hungarian loan market and existing Hungarian legal transfer structures can support robust trading of loans and claims.”

A Loan Trader's Guide to Hungarian Loans

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Hungarian banks are currently reviewing the quality of their loans and actively seeking investors and distressed loan buyers to improve their balance sheets. This memorandum describes the Hungarian distressed loan market, the legal mechanics of transferring a loan and some of the tax, diligence and enforcement issues that will confront buyers of distressed Hungarian commercial loans.

Why Hungary?

Hungary was one of the first Central and Eastern European (CEE) countries to transition to a market economy and join the European Union. Hungary's commercial laws are well-developed and the country has provided investors with green field and privatization investment opportunities since the 1990's. Hungary is highly integrated into the global economy. However, perhaps because of this integration, Hungary suffered more acutely than other CEE countries during the global economic crisis. The domestic policy response within Hungary included harsh tax increases targeted at specific business sectors, measures to protect those who borrowed in a foreign currency and nationalization of businesses in the energy, banking and private pension fund sectors. These policies, which were widely criticized at the time, led to even greater economic losses across a broad spectrum of asset classes. In particular, financial sector taxation, policies designed to protect domestic borrowers from foreign currency fluctuations and the decline of available capital for lending and refinancing transactions contributed to the worsening domestic economy, dramatically curtailed the growth of the Hungarian loan market and created large portfolios of distressed debt.

Recent events over the last several months may provide some optimism for potential buyers of distressed loans and could be a sign of more activity in non-performing loan (NPL) sales in the near future. Most notably, the Hungarian government has moved forward to establish a “bad bank” (Magyar Reorganizációs és Követeléskezelő Zrt., known as “MARK”), and some predict that MARK could be operational before the end of 2015. Although various structural concerns remain, there were signs of optimism among investors and market experts at a recent conference organized jointly by the European Bank for Restructuring and Development and the Hungarian National Bank in March 2015. Additionally, as of June 2015, the Hungarian Parliament has undertaken discussions focusing on certain legislative changes which are intended to facilitate loan portfolio transfers. In terms of transactions, MKB Bank, a state owned bank, has been marketing a significant NPL portfolio, which has attracted interest from international financial institutions. If the sale of MKB Bank's NPL portfolio is successfully consummated, other transactions are expected to follow.

What loans are available for purchase?

Loans to Hungarian borrowers secured by real estate or heavy industry assets comprise the majority of current distressed loan opportunities. Typical term and revolving loan structures predominate, and while many domestic Hungarian loans are bilateral or club deals with two or three lenders, cross-border syndicated loans involving larger Hungarian borrowers are not uncommon. The larger syndicated loans are typically governed by English law.¹

Are the lenders secured?

Secured lenders either receive the direct benefit of a security interest in collateral posted by the borrower, or appoint a security agent to be the beneficiary of the security interest as agent for the lenders. Importantly, security and collateral documentation is generally governed by Hungarian law, especially when the perfection of the security interest requires local registration in the relevant Hungarian registry.

Which law governs the purchase and sale of a Hungarian loan?

Loan transfer documents may be governed by New York or English law and purchasers and sellers are generally free to choose the governing law of their agreement. However, certain equitable principles under Hungarian law may continue to govern the relationship between the purchaser and the Hungarian borrower. For example, any required notice of the transfer should be made in accordance with Hungarian law, and purchasers should exercise caution in any transfer that leaves a borrower in a less favorable position than if the transfer had been governed by Hungarian law. Enforcing or defending a transfer governed by foreign law against a Hungarian borrower may create additional administrative burdens – transfer documents may need to be translated into Hungarian or accompanied by a legal opinion confirming that the transfer is valid and effective under the relevant foreign law.

If Hungarian law governs the purchase of the loan, which transfer structures are available?

The transfer of an existing lender's rights and obligations by assignment is valid and effective between the existing lender and new purchaser and notice to the borrower of the transfer is generally not required. Borrower consent is typically not required for funded loans, but is normally required for unfunded or partially drawn down loans or revolving facilities. Nonetheless, a borrower will be entitled to continue to perform its obligations to the existing lender until it receives notice of the transfer to the new purchaser. As a practical matter, any transfer by assignment should be accompanied by a simultaneous notice to the borrower because, among other things, a borrower may be entitled to set-off any claims against the existing lender from amounts otherwise due to the new purchaser if those claims arose before the borrower is notified of the transfer.

On March 15, 2014, the new Hungarian Civil Code became effective and loans may now be transferred by novation – the substitution of a new contract between the borrower and the buyer for the old contract between the borrower and the selling lender. As noted below, however, a novation could give rise to issues in the transfer of security interests.

Do security interests and guarantees transfer automatically with the loan?

Security interests in collateral transfer automatically with an assignment of the corresponding loan under Hungarian law. If the security is registered, it is advisable to register the transferee in the relevant Hungarian register upon transfer of the related loan. A transfer by novation will result in the termination of security interests unless the borrower agrees that new security interests will be granted with the same priority and ranking position. However, even if the borrower consents to the continuation of existing security interests in connection with the novation, the relevant time periods will be reset for certain challenges (including preference claims and taking additional security from a creditor without adequate consideration), and the new lender will be

1. Increasingly, syndicated loans to Hungarian borrowers are governed by German, New York or Hungarian law.

subject to the reset hardening periods. Unlike security interests, guarantees are viewed as principal obligations separate from the underlying obligations. As a result, a guarantee will not transfer automatically with the loan, unless it is expressly stated in the guarantee.

Are loan participations recognized?

If an assignment or novation is not permitted due to transfer restrictions in the credit documentation, which occurs frequently in Hungarian credit documentation, then “LMA-style”² participations are commonly accepted as method for settlement of loan trades in Hungary. If a bank located in the European Union (EU) is the grantor of the participation, the Hungarian tax authorities will not “look through” an LMA-style participation to the participant to assess withholding tax on interest paid.

How are lending activities regulated in Hungary?

The business of lending and the purchase and sale of loans (or other receivables) is generally considered a “financial service” in Hungary. Financial services may only be provided by a Hungarian financial institution licensed by the Hungarian National Bank, by an EU financial institution on a cross-border basis under the EU passport regime, or, in the case of lending only, by a non-EU financial institution that is a resident of a member state of the Organization for Economic Co-operation and Development under the same passport regime. “Lending” is broadly defined under Hungarian law, and includes the holding and managing of collateral. However, one-time purchase and sale transactions or a limited series of transactions involving bank loans often will not require a license. In addition, unlicensed investors that regularly purchase and sell bank loans or other distressed assets in Hungary often use a non-Hungarian EU resident intermediary that is a licensed financial institution. Loans are first purchased by the licensed intermediary from the Hungarian originator. The loans are then transferred by the licensed intermediary to the ultimate (non-Hungarian) purchaser. The second step of the transfer may generally be

considered outside the scope of Hungarian law and regulations as long as no change takes place in relation to the servicing of the loans in Hungary.

Are payments under a loan subject to Hungarian withholding tax?

There is generally no Hungarian withholding tax imposed on interest payments or other fees paid by a Hungarian borrower to a foreign institutional lender unless the loan is held and booked through a permanent establishment of such lender located in Hungary.

What is essential due diligence for buyers of secured Hungarian loans?

Buyers should pay particular attention to the enforceability of the security interests created under the credit documentation. Buyers should ensure that the security interests are registered and that security documents contain all terms required under Hungarian law. To the extent the collateral includes account receivables, account holder banks need to acknowledge existing security interests on any accounts, and account debtors should be notified of existing receivables pledges (or that the relevant security agreement contains a mechanism for notification upon an event of default). Care should be taken when reviewing large syndicated lending transactions with intercreditor agreements that allocate the benefits of collateral governed by Hungarian law. When purchasing a defaulted loan, all steps taken to enforce the loan (including declarations of default or acceleration) or the lenders’ rights in collateral should be reviewed to ensure they conform to the requirements of the credit documentation as well as Hungarian law. If a borrower has contested the validity of the loan, the grant of collateral or any conduct of the lender, further factual and legal due diligence is often required to predict the outcome of the challenge. Buyers of portfolios of loans made to individuals must also focus on the existing lender’s compliance with Hungarian consumer protection laws and conduct of business rules because failure to comply could result in full or partial invalidity of

2. The Loan Market Association is based in London and has as its key objective improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe.



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the loans. Finally, enforcing a lender's rights in real estate collateral in Hungary is highly regulated (primarily to protect existing individual occupants) and buyers should carefully survey real property that serves as collateral before completing the loan purchase transaction.

CONCLUSION

The Hungarian loan market and existing Hungarian legal transfer structures can support robust trading of loans and claims. Hungarian banks are likely to be motivated to strengthen their balance sheets and dispose of distressed loans, and consequently are increasingly interested in discussing asset dispositions, and other transactions designed to improve capital adequacy ratios, with potential investors in distressed assets. Increased volume is expected as banks and buyers agree on pricing and payment terms.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call

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