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Bankruptcy and Reconstruction Law in Poland

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Introduction

The new Polish Bankruptcy and Reconstruction Law,[1] hereinafter referred to as the Bankruptcy Law, has been in force for over a year. This law replaced two laws of 1936, which were in force till 15 November 2003, namely the Bankruptcy Law[2] and the Composition Law[3] (hereinafter referred to as the old law).

The Bankruptcy Law covers typical insolvencies of business entities (individual bankruptcies, such as those existing under the laws of USA or Germany, are not covered) and reconstruction proceedings with creditors. One of the most important reasons underlying the decision of the Polish Parliament not to incorporate in the Bankruptcy Law regulations concerning individual (consumer) bankruptcies was the practical argument that the Polish judicial system would be ineffective in dealing with the sheer number of cases that would come before Polish economic courts.[4] This would result in paralysis of the system, notwithstanding the fact that even without individual bankruptcies cases there has been a steady increase in the number of cases registered by bankruptcy courts after 2000 by approx. 50% per year.

Bankruptcy proceedings may be conducted with the aim of totally liquidating the bankrupt's assets or with a restructuring aim – a bankruptcy composition proceeding. A normal liquidation and winding up of a business entity is not covered by the Bankruptcy Law, since this is covered by the laws of the Commercial Companies' Code.[5] Of course a company which is undergoing liquidation may be subject to bankruptcy proceedings on the same terms as a company which is not in liquidation, i.e. one where the winding-up procedure has not been started.

Restructuring of the company's debt can also be done via negotiations with its creditors without using the procedure defined by the Bankruptcy Law, although, at least in principle, this is less favourable to the entity conducting court restructuring – with the declaration on the commencement of formal restructuring (subject to no court objection), all financial liabilities towards the entity shall be suspended, the accrual of interest against the entity is suspended and no new enforcement proceeding can be started against it, whereas the existing ones are suspended.

Executive and non-executive board of directors' obligations

The Polish Commercial Companies' Code is based on a two-tier system of corporate governance – there is a clear distinction in public companies and in limited liability companies between the role of the executive organs responsible for the representation and running of the business of the company, and the role of the non-executive directors. Although formally based on the obligation to maintain current and permanent supervision of the company's business and the executive board, the supervisory board role *de facto* is very often limited to the holding of a couple of meetings per fiscal year and one meeting preceding the yearly AGM to issue opinions on the economic and financial documents of the company which are to be approved at the AGM. Such practice, although very common, on strictly legal grounds may be seen as one which does not fully cover the individual obligation of each board member to act with due care.

This different role of the non-executive board reflected in its responsibilities and liabilities is also reflected in the Bankruptcy Law, as under its provisions the non-executive board may not be directly penalized for misconduct and breach of law leading

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1 '*Prawo upadłosciowe i naprawcze*' dated 28 February 2003 (*Dziennik Ustaw* No. 60 item 535 of 2003 as amended).

2 '*Prawo upadłosciowe*' dated 24 October 1934 (*Dziennik Ustaw* No. 118 item 512 of 1991 as amended).

3 '*Prawo o postępowaniu układowem*' dated 24 October 1934 (*Dziennik Ustaw* No. 93 item 836 of 1934 as amended).

4 Argument used in an official justification of the draft Bankruptcy Law at the stage when it was accepted by the lower house and submitted to the upper house of the Polish Parliament.

5 '*Kodeks spółek handlowych*' dated 15 September 2000 (*Dziennik Ustaw* No. 94 item 1037 of 2000 as amended).

to bankruptcy. This however does not imply that non-executive board members are immune from any responsibilities. Under the general rules of the Civil Code and the Commercial Companies' Code such members may be personally individually liable, subject to it being proven that their non-performance as the non-executive board has contributed to the bankruptcy and in consequence to losses to its creditors. In practical terms, except for obvious misconduct, it may be difficult to bring a successful case against such board members.

A totally different position and role is with members of the executive board of directors, who in case of non-performance in the timely submission of an application for bankruptcy may, under certain conditions, be liable for the debts of the bankrupt entity to the extent that such debts are not satisfied in the bankruptcy proceeding, with their personal assets and without limitations. A board member may, in addition, also be penalized by banning him/her from participation in executive and non-executive boards (also acting as a representative of companies in general) and by prohibiting him/her from conducting business activity for a period of between 3 and 10 years.

Stages leading to bankruptcy

As under any bankruptcy law, the beginning of the process is a motion to start bankruptcy submitted by either a creditor or the entity itself.

Although what is presented below is not a schedule of conduct to be utilized by executive boards, directors in companies acting diligently should be aware of certain stages defined by law which should trigger action on their behalf. Three situations related to the economic situation of a company may be outlined:

(a) In accordance with the Commercial Companies' Code, the board of executive directors is obliged to convene an extraordinary shareholders' meeting (applicable in a limited and a joint stock company) for it to decide about the future existence of a company if a company's loss is higher than the sum of its reserve and supplementary and half/one-third[6] of its registered share capital as shown in a balance sheet. Whether the above information is obtained from the yearly balance sheet or any balance sheet prepared for that purpose at any time, is irrelevant to the obligation. Furthermore the fact that no balance sheet is available and the conditions shown above at any given time are met does not exempt the executive board of directors from responsibility, as it may be proven in time that such conditions did indeed occur. From the balance sheet it is evident that the financial situation of the company has deteriorated, and therefore its owners must decide how – if at all – to further finance or arrange financing of its activity. The argument goes that any company's registered share capital needs to be kept intact as a sort of security for the company's creditors and therefore a balance sheet result as described above should constitute a warning that something is wrong with the company. (No formal reference by the provisions of law is made at this stage to the bankruptcy law criteria defining the conditions of bankruptcy so no comparison of provisions of these separate laws can directly be made.) Which laws apply in any specific circumstances is determined by the actual economic situation of a given entity.

(b) The above obligation may coincide with the need to start a reconstruction proceeding as defined by the Bankruptcy Law, which is directed at those entities which at any given point in time are continuing in the satisfaction of their liabilities versus their creditors, but their economic situation is such that thinking rationally they will be insolvent within a foreseeable time. Practice is however different. In the majority of cases it is usually too late for a company to start a reconstruction proceeding, as the executive board has either irrationally expected that the situation will improve or simply was unaware of the exact economic state of the company, and therefore at that stage conditions are fulfilled which justify declaration of bankruptcy.

(c) If the entity is already insolvent then of course it is too late to start any reconstruction proceedings, as a motion for the declaration of bankruptcy should be filed at that time by its executive board of directors. There are two formal grounds which trigger the obligation to file for and declare bankruptcy, the second one applicable only to legal entities and other entities which although are not legal entities have legal capacity (e.g. registered partnerships). The first ground is when the entity

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6 Art. 233 of the Commercial Companies' Code states: '233 § 1 Where the balance sheet prepared by the management board shows a loss in excess of the sum total of the supplementary and reserve capitals and half of the initial capital, the management board shall forthwith summon a meeting of shareholders with the object of adopting a resolution on the continued existence of the company. § 2 The provision of paragraph 1 shall apply respectively where the company's balance sheet was prepared pursuant to articles 223 to 225.'

Art. 397 of the Commercial Companies' Code states: 'Where the balance sheet prepared by the management board shows a loss in excess of the sum total of the supplementary and reserve capitals, and one-third of the initial capital, the management board shall forthwith summon a general meeting with the object of adopting a resolution on continued existence of the company.'

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is in a state of insolvency, that is, it is not executing its due liabilities. The second ground of insolvency occurs when the liabilities exceed the value of the entities' property, even when its obligations are satisfied on an ongoing basis (i.e. when the entity pays its dues on time).

These are the two basic conditions for the declaration of a bankruptcy in Poland. Such a definition of the grounds of declaration of bankruptcies has not been welcomed among all practitioners and business entrepreneurs. The old law, although archaic in terms of terminology used, not flexible with respect to change of proceedings from bankruptcy and composition and vice-versa, and most of all one which did not satisfactorily safeguard the position of creditors whose claims were secured by collateral *in rem*, nonetheless provided a more realistic definition of the grounds of bankruptcy. One of its key elements was a distinction between permanent and temporary financial problems, where a temporary adverse situation did not trigger the obligation to file for bankruptcy. The Bankruptcy Law does not contain such distinctions but instead introduces exemptions from the general ground of bankruptcy. In exceptional circumstances the bankruptcy court may decide not to declare bankruptcy, namely when an entity is late with payment for a period not exceeding 3 months and at the same time the sum of the unpaid liabilities does not surpass 10% of the balance sheet value of that entity. Even with both of these conditions met, the bankruptcy court should nonetheless declare bankruptcy if the non-payment was not temporary, i.e. was permanent, or if rejection of declaration of bankruptcy would have damaged the entity's creditors.

Failure by the executive board of an entity to submit an application for a declaration of bankruptcy within 14 days from the date of occurrence of the above-described conditions may lead to personal responsibility for creditors' debts of such executive board members.

How to safeguard or improve one's position before bankruptcy occurs

The Bankruptcy Law is better suited to professional players than to the average man in the street. It is not the size of the financial engagement of the financial players that favour them, resulting in a greater voting power at the assembly of creditors, but rather the legal instruments that are available under the Bankruptcy Law.

Under the Bankruptcy Law those assets which are possessed by the bankrupt entity but are not legally owned by it do not form part of the bankrupt estate. Such a situation may arise naturally when the bankrupt entity was using third parties' assets, but may also be the result of use of legal instruments which were established in the first place to protect any owner of such assets against the risk resulting from bankruptcy. On many occasions, agreements containing provisions on reservation of ownership until full payment are used to protect sellers. On other occasions agreements on the transfer of ownership as security are used under which the ownership of an asset owned by the debtor is transferred as security until a debtor performs its primary contractual obligations, where failure to do so releases the creditor from the obligation to transfer back the ownership of the asset which remains in the ownership of the creditor. In both cases described above – and these are only examples – the legal effectiveness of the above agreements versus third parties and *inter alia* creditors of the bankrupt entity (on the assumption that an agreement is signed with an entity which later is declared bankrupt) is dependent upon the agreements having a special form of a secured date,[7] otherwise being effective only between the creditor and the bankrupt entity and ineffective towards third parties. As a result, non-compliance with a minor formality may substantially affect the creditors' position and the effectiveness of the bankrupt transactions concluded with third parties, which subject was the asset which constituted a security for the creditor.

The Bankruptcy Law also treats preferentially those creditors whose rights have been secured by the establishment of rights *in rem* on the property of a bankrupt entity. This is a change in relation to the old law which did not provide for such instruments. Such creditors in principle obtain satisfaction from the assets or rights which have been used as security and upon which a right *in rem* has been established using the hierarchy of satisfaction of claims in accordance with separate laws regulating the establishment of such rights *in rem*. In other words, although such assets are part of the bankrupt estate, those creditors' receivables which are secured by the establishment of rights *in rem* do not in principle line up in the order of satisfaction of receivables with other creditors' receivables whose receivables are not secured. The revenue obtained from the sale of assets upon which rights *in rem* have been registered is divided – with minor exceptions in respect of some creditors treated preferentially – in accordance with the ranking applicable to that security under any separate law between those creditors who had rights *in rem* registered on that asset, with the exclusion of all other creditors whose rights have not been secured on the asset. Only the

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7 This is when the date of the agreement is confirmed by a governmental authority, municipality or a public notary.

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surplus in the revenue remaining after the full satisfaction of all creditors who had security in the form of the right *in rem* goes to the general pool to be distributed in accordance with the ranking of receivables set by the Bankruptcy Law. In the opposite case, when creditors who had rights *in rem* are not fully satisfied by the revenue obtained from the sale of such assets, their surplus claims go to the general pool and are classified in the ranking as an ordinary receivable.

A good example of such a right *in rem* may be the establishment of a registered pledge on given assets or rights.[8] One of the methods of satisfaction of a creditor's claim under a registered pledge agreement is to allow for the take-over of the subject of the claim by the creditor in case of the debtor's non-performance. Leaving aside the various limitations and practical problems with the use of such instrument, the establishment of a registered pledge with an option to take over the ownership of the subject of the pledge also proves to be a feasible option of safeguarding one's rights as an instrument minimizing one's risks in case of a debtor's bankruptcy.

It is often the case that only professional players such as banks who become exposed to risks resulting from bankruptcy as part of a security package to safeguard a return of their financial engagement establish additional security in the forms described above, which at the end of the day puts them in a much better situation than those who either did not have the negotiating power to obtain security or were simply unaware of the risks resulting from bankruptcy; their claims simply become satisfied not only in a much greater percentage than those whose receivables have not been safeguarded, but *de facto*, considering the limited value of the estate in relation to total claims, at the expense of those who do not have such security.

Cross-border insolvencies and the Bankruptcy Law

The Bankruptcy Law contains a section on international insolvency proceedings, whose provisions in principle reflect the EU regulations on insolvencies (hereinafter referred to as the Regulation).[9] The above section of the Bankruptcy Law, after Poland's accession to the EU on the 1 May 2004 is only applicable to cross-border insolvencies which have been started in Denmark and in countries which are not members of the EU. With respect to insolvencies started in any EU country (excluding Denmark), the Regulation is directly applicable in Poland without the need for any formal recognition of a foreign bankruptcy proceeding by a Polish court. Secondary insolvencies may of course be started in both cases, i.e. under the Bankruptcy Law and the Regulation. Under the provisions of the Regulation it is possible for a foreign court to start an insolvency proceeding of a debtor which would also encompass a Polish-registered company if it is proven that the centre of interests did lie abroad.[10] If this is the case, the jurisdiction of the Polish bankruptcy court is excluded and a foreign law of the country where insolvency has been started would apply (with the exception of starting a secondary insolvency proceedings). Although the Regulation refers just to the opening of the insolvency proceedings, it is clear that one should refer to the whole proceeding. As a result any liquidation sale of the insolvent entity's assets is regulated by the foreign country's insolvency law, with the exception of issues related to the disposal of assets such as sale of immovable property, labour, issues and tax regulations to which the Polish law shall be applicable. The application of such proceedings (although this view may be controversial) is possible in relation to multinational corporations organized in the form of holdings, where the executive boards in any related or subsidiary company need to comply with internal procedures and provisions accepted by the executive boards of the holding company. Also it is usually the case that any strategic decisions for the whole group are taken by the group headquarters of the holding company.

The consequence of introducing the Regulation in times where the Council Regulation on the Statute for a European Company (SE – *Societas Europea*)[11] has not been fully implemented in all EU countries is a novelty. If it was not for the Regulation, companies within the holding (whose economic situation does not justify the declaration of insolvency under local law) would be subject as separate legal entities to the jurisdiction of states in accordance with their place of registration. Insolvency of the holding company could not formally lead to an insolvency of the subsidiary, as only shares in the subsidiary company constitute part of the bankrupt estate. Their sale in the foreign insolvency proceeding results in the change of ownership of the subsidiary. The subsidiary, however, being a separate person, would survive, which is not the case if the Regulation is applicable.

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8 '*Ustawa o zastawie rejestrowym i rejestrze zastawów*' dated 6 December 1996 (*Dziennik Ustaw* of 19 December 1996).

9 Published in the Official Journal of the European Communities L 160, 30/06/2000.

10 Principle reflected by art. 3 section 1 of the Regulation.

11 Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European Company (SE).

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