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Abuse of insolvency proceedings in Poland
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Remedies for the entity declared bankrupt
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INSOL PAPER

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I. INTRODUCTION - ALTERNATIVE VINDICATION (JUSTIFICATION) METHODS

Filing a petition for the opening of insolvency proceedings by a creditor to exert pressure on a debtor to pay its debts may be used as an alternative claim form. The following actions may also be defined as alternative claims methods:

- a) conducting a press campaign
- b) using internet resources (an internet forum for instance)
- c) placing the debtor on official "black lists" of debtors
- d) initiating criminal proceedings where there has been, for example, fraudulent contracting by a debtor with no intention to pay debts.

Why should the creditor, however, use an alternate method of vindication instead of a simple court claim? Well, if individual proceedings in Poland were effective, cheap and quick, there would not be any need to use alternative claims methods, including the threat of a possible insolvency.

To properly understand the phenomenon of a malicious petition for the opening of insolvency proceedings as a form of claims vindication, one must first understand the practice of the Polish individual claim vindication and the nature and the practice of Polish insolvencies. To make these analyses complete, the general financial condition of Polish SMEs also has to be taken into consideration.

In the following chapters, the author will define a malicious petition for insolvency and, in brief, comment on the effectiveness of the Polish judicial system based on the statistical figures. I will then describe the formalities connected with a petition for the opening of insolvency proceedings, the defenses against a malicious petition for insolvency and the consequences of such a petition for the creditor who filed the petition.

Finally, the author will try to answer the question why Polish companies use a malicious petition for insolvency and why a malicious petition for opening insolvency proceedings is a real problem in Poland.

II. MALICIOUS PETITION FOR INSOLVENCY - DEFINITION

In the Polish law, there is no legal definition of a malicious petition for opening insolvency proceedings. The legal doctrine representatives¹ claim that the petition of the creditor for insolvency shall be treated as malicious if:

- a) the creditor knows that the debtor has no assets to pay the debt (in practice, the creditor hardly ever has a precise knowledge as to the assets of the debtor – such example of a malicious petition for the opening of insolvency proceedings is more academic than practical);
- b) the creditor is in fact not a creditor (i.e. previously an assignment of the claim took place, which was not presented to the debtor – in this situation the actions of the creditor fall under the regulations of the criminal law and thus will not be developed further);
- c) the claim is disputed and shall be decided by the court in individual proceedings, (in practice, the most common); or
- d) the creditor's claim was paid by the debtor after the petition for opening insolvency proceedings had been filed and the creditor has not withdrawn his petition (in case of the creditor who only wishes to ensure the payment of its debt, the withdrawal of the petition after the payment is a natural consequence, so usually, if the petition is not withdrawn even if the payment has been made, it usually means that the main goal of the creditor was not the payment itself, but, for instance, the elimination of the debtor as a competitive company from the market).

The author of this paper will mainly focus on the malicious petition mentioned under the letter "c" above, where the claim of the creditor is disputed and the goal of the creditor is to exert pressure on the debtor to execute the payment of the debt.

III. INDIVIDUAL VINDICATION IN POLAND AND ITS EFFICIENCY

¹ Stanislaw Gurgul Prawo Upadłościowe i Naprawcze Komentarz CH BECK wyd 2010

Despite the fact of a respective increase of the costs spent on the judicial system in Poland (in 2006, Poland was classified the 6th ranking member state of the Council of Europe with respect to the share of total expenditures on the justice system in the GDP per capita²), the effectiveness and duration of Polish court cases are still far from ideal. The individual claim vindication in Poland is quite cheap (8th rank in the World Bank Doing Business 2010 report) – 12% of the claim value. However, such proceedings, on average, last 830 days (Doing Business 2010 report). As a result, Poland's position in the Doing Business 2010 report (enforcing contracts) is 75th. However, to understand the need for using alternative claims vindication, one must understand that 44% of Poles evaluate the work of the Polish justice system unfavorably³. Such negative perception is strengthened by a well known statistic that 1/3 of approx. 600 decisions of the European Court of Human Rights based on the European Human Rights Convention against Poland were based on the length of the court proceedings⁴ in Poland. If we add the chronic shortage of cash within the SME sector, it is easy to predict that even if the creditor has money for a court trial, the creditor will not survive in the market for over two years waiting for the cash, which was needed to be paid to the suppliers and contractors of such creditor.

In light of these figures, initiating an individual court claim may not be possible for some SMEs in Poland, especially those with current cash flow problems. Such entities may search for other methods, including the threat of insolvency for their debtors.

IV. INSOLVENCY PROCEEDINGS IN POLAND

IV.1. Introduction

Bankruptcy proceedings are one of the methods of closing commercial activity. In most cases the business is closed because it cannot generate enough profit to its owners and as a result of illiquidity has problems with debt payment. Therefore, in many cases the liquidation of commercial activity is through insolvency proceedings. The Polish practice is, however, different: out of one thousand liquidated businesses only two are closed via the insolvency proceedings⁵. The statistics emphasize that closing a business via insolvency is the exception rather than the rule.

² Report of FOR and HFPCZ „Efficiency of the Polish court system” Warsaw 2010

³ Report of FOR and HFPCZ „Efficiency of the Polish court system” Warsaw 2010

⁴ Report of FOR and HFPCZ „Efficiency of the Polish court system” Warsaw 2010

⁵ Paweł Antonowicz, PhD “Insolvencies in Poland” – report prepared in April 2010 (page 12)

It is also generally agreed that most bankruptcies in Poland are planned well ahead by the debtor in order to enable the debtor to profit from the bankruptcy. As a result the debtor (or the debtor's owners) are those who benefit most from an insolvency, not the creditors. Some economists claim this applies to 90% of all bankruptcies⁶, while the judges think it is 50%⁷.

IV.2. Grounds for opening insolvency proceedings in Poland

The illiquidity forms grounds for opening insolvency proceedings, which is applicable to all commercial entities. According to the Polish law, it is sufficient for the court that "the debtor does not pay its debts as they fall due" to open insolvency proceedings. In a common opinion of the representatives of the doctrine, the debtor needs to have at least two creditors to be declared bankrupt. In fact, most Polish companies have some delays in payments of their debts, especially within the SME sector. These companies risk every day, that they may be declared bankrupt. The continuous shortage of cash and the difficulties in providing cheap and flexible financing of daily business results in a situation where many SMEs face the question: whether to close the company or delay the payments and continue operation. Most choose the second option, especially as most SMEs are family owned and provide employment for entire families and local communities.

Even if a company is not paying its debts on time and the petition for its insolvency is filed, the insolvency court may still reject the petition to open insolvency proceedings if the aggregated amount of the debts is not higher than 10 percent of the balance sheet value of the company, provided that the delay is not longer than 3 months and the rejection does not put the creditors at risk.

Another basis for opening insolvency proceedings in Poland which only applies to legal persons and other entities with no legal personality but with legal capacity (professional partnership, limited partnership) is over-indebtedness, understood as a situation when liabilities exceed the value of assets.

⁶ Professor Elżbieta Mączyńska, Professor Andrzej Herman – Dziennik Gazeta Prawna 08.03.2010

⁷ Professor Elżbieta Mączyńska (...)

In most cases, the creditor does not know the value of its debtor's liabilities or the balance sheet value of its company. Thus, in practice, most creditors' petitions are based on the illiquidity of the debtor.

It is a very important issue that in several areas of business (such as wholesale of fabrics and construction investments) debts are never paid within the agreed time limits, but they are paid subsequently, as the debtors receive financing from other contractors. Consequently, quite a significant part of normal, operating companies in selected areas of business in Poland are permanently fulfilling the insolvency criteria. A possible motion for bankruptcy is thus a real threat for them.

IV.3. How the creditor files a petition for opening insolvency proceedings

In most cases the petition for opening insolvency proceedings is filed by the debtor. It may, however, be also filed by any of its creditors.

In order to file a petition for opening insolvency proceedings, the creditor needs to:

- a) prepare a written petition to the court,
- b) prove its claim,
- c) prove that payment is due,
- d) define the location of assets of the debtor,
- e) pay a fixed court fee of approx. EUR 250,
- f) pay the attorney's fees (voluntary).

Preparing a petition for opening insolvency proceedings is thus, in some cases, easier for the creditor than preparing a regular court claim.

During the proceedings preceding the opening of the insolvency proceedings, the court may ask the creditor who has filed such petition to pay an advance payment towards the costs of the proceedings. The amount of the advance payment usually does not exceed EUR 2.000 – 4.000.

A comparison between an individual court case and insolvency is presented in the table below. However, please note that the creditor who delivers the petition for the opening of the insolvency proceedings of its debtor does not really desire that the debtor be declared

bankrupt, but rather hopes that the debtor, as the result of its threat, immediately pays the debt to the creditor. The creditor wishes, in fact, to receive his payment within 1-3 months in 100% of the due amount, as opposed to, for example, 30% as the result of completing insolvency proceedings. The creditor who wishes to put pressure on the debtor via a petition for opening of the insolvency proceedings, takes a risk that the court will declare the debtor bankrupt.

	Individual court case	Insolvency proceedings
Duration ⁸	2.3 years	3.0 years
Overall and average costs (for the creditor)	12% of claim value ⁹	Approx. EUR 1,000 ¹⁰
Recovery rate	35-40% ¹¹	29.8% ¹²

V. HOW THE DEBTOR MAY DEFEND ITSELF

If a petition for insolvency proceedings is filed by a creditor, and the debtor disagrees with the petition, the debtor may first argue that the petition should be rejected by the court. If the petition is filed by a creditor, the court always notifies the debtor of such petition, so it is not possible to open insolvency proceedings without the notification of the debtor. Even if the debtor opposes the petition, the court may open insolvency proceedings and the debtor will then need to appeal against such decision. Summing up, the debtor may fight against the petition for opening of the insolvency proceedings on two levels:

- prior to the declaration of insolvency (proceedings that precede the declaration of insolvency)
- after the court declared the debtor bankrupt in the form of an appeal against such judgment.

The following arguments may be raised by the debtor in order to avoid bankruptcy/overturn the court of first instance decision opening the insolvency proceedings:

a) prove that the claim does not exist or it is not valid

⁸ Doing Business 2010 report

⁹ Doing Business 2010 report

¹⁰ Author's evaluation

¹¹ Krajowa Rada Komornicza – information published in Gazeta Prawna edition 25.11.2008

¹² Doing Business 2010 report

If the debtor's debt is real and claimable, the debtor would need to prove that in fact the debt is disputable. It is generally recognized that disputable claims shall be the subject of ordinary court proceedings rather than insolvency proceedings itself. Using this method of defence, the debtor will need to prove that the claim does not exist or it is not claimable (e.g. the claim is stale).

b) prove that despite the existence of the claim, there are no legal grounds to declare bankruptcy

As it was explained above, each individual delay in payment forms grounds for insolvency. If the debtor acknowledged the debt, then it may only argue that the overall amount of the debts is not higher than 10 percent of the balance sheet value of the company, the delay is not longer than 3 months, and the rejection does not put creditors at risk. Even if the debtor proves the abovementioned, the rejection of the petition for bankruptcy is still voluntary and at the court's sole discretion.

Another argument against insolvency is that the debtor has only one creditor and thus it is not insolvent (as mentioned above, it is commonly agreed that the debtor needs to have at least two creditors to be declared bankrupt).

c) pay the creditor

The creditor may initiate the insolvency proceedings and support such petition as long as it remains the creditor. After the payment of the debt, the creditor loses its authorization to support its petition and the petition shall be withdrawn. Using this method of defense by the debtor is effective, but it would certainly encourage all other creditors of the would-be bankrupt to file petitions for insolvency proceedings.

VI. REMEDIES TO BE TAKEN BY THE DEBTOR, IF THE MOTION IS DISMISSED

If a malicious petition for opening of the insolvency proceedings is finally rejected:

- a) The court will obligatorily order the creditor to pay all the costs of the proceedings (which are not more than EUR 3.000 on average)
- b) The debtor may demand the creditor to pay the debtor's attorney's fees (at fixed official rates – which in most cases do not cover the real costs of the attorney)
- c) The debtor may claim compensation for damages that the debtor suffered as a result of the malicious petition for bankruptcy

- d) Any other third party (e.g. a shareholder of the debtor) may also demand compensation for damages, which may be, for instance, a lost profit on a stock exchange transaction that corresponded with the malicious petition for bankruptcy

If the malicious petition for bankruptcy is rejected as a result of a judgment of the court of second instance (that deletes the first instance judgment opening the insolvency proceedings), then the debtor may undertake similar actions against the creditor as described above although some jurists claim otherwise.¹³

In some cases, the losses/damages resulting from a malicious petition for the opening of the insolvency proceedings may be immense (it is possible that contracts by the debtor may be terminated by other parties of the contracts if a petition for insolvency is filed¹⁴). In order to receive the compensation, the debtor has to initiate a separate court claim. The court fee for the initiation of such case is 5% of the claim value. The debtor initiating such proceedings has to prove:

- a) the damage,
- b) the direct link between the petition for opening of the insolvency proceedings and the damage,
- c) the amount of the damage.

In practice it is very difficult to prove all these conditions in court, because there are several factors influencing the situation of the debtor, and not only the motion for opening insolvency proceedings.

¹³ Stanislaw Gurgul (...)

¹⁴ It is, however, not legally possible to terminate the contract if already one of its parties was declared bankrupt (then the further legal status of such contract is decided solely by the bankruptcy law regulations).

VII. EXAMPLES

The problem of malicious petitions for opening insolvency proceedings is real in Poland. There are several examples including the motion for bankruptcy of DUDA S.A. - one of the leading meat producers in Poland. Despite the fact that DUDA S.A. had initiated reorganization proceedings and during these proceedings, motions for bankruptcy may not be effectively filed, a well-known bank filed a petition for opening insolvency proceedings. The court dismissed the petition, however, the stock exchange value of DUDA S.A. shares dropped by 10%¹⁵.

Another example of putting pressure by the petition for opening insolvency proceedings is the case of JW Construction S.A. – one of the largest immovable development companies in Poland. One of its clients claimed that the company shall pay it EUR 10.000, and when the company refused, it filed a petition for opening insolvency proceedings (the case has not been decided yet by the court).

VIII. SUMMARY

The malicious petition for opening insolvency proceedings filed by a creditor is usually a petition filed by the creditor who cannot afford to wait over two years for the final verdict of the court in an individual claim vindication. To define the petition as malicious, the claim has to be uncertain or disputable. The fact of submitting such a petition to the court usually has a very negative influence on the situation of the debtor and its relations with other business partners. Thus, in most circumstances, the debtor will try to avoid bigger problems and it will pay the creditor, the creditor will achieve its goal (claim satisfaction) and withdraw the petition. The case will be closed and the debtor will have no claim against the creditor, because by paying the debt towards the creditor, the debtor will in fact confirm that the claim of the creditor was not disputable, and filing of the petition for opening insolvency proceedings, which was based on an undisputable claim, is not malicious and gives no claim to the debtor.

Only very self-confident debtor with good financial situation will try to convince the bankruptcy court that there are no legal grounds for opening insolvency proceedings. If the

court agrees with the debtor and rejects the petition of the creditor then, of course, the debtor may exercise all the remedies provided by the law.

It has to be admitted that despite the negative ethical evaluation of a malicious petition for opening insolvency proceedings, such petition in Poland is a very effective claim vindication method.

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