POLAND: TOWARDS A STRONGER INSOLVENCY FRAMEWORK

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Poland: Towards a Stronger Insolvency Framework

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INTRODUCTION AND METHODOLOGY

The purpose of this Draft Report is to provide the Ministry of Justice of Poland with a preliminary analysis of the country’s insolvency framework and to provide a set of specific recommendations to improve the business environment in this regard.\(^1\) Specifically, the Ministry of Justice has asked for a Report assessing the reforms of the Poland insolvency legislation undertaken in 2003 and 2008, and their effect on the current practice. The Ministry of Justice has also requested that this Report differentiate between those reforms requiring legislative amendment and those requiring executive regulation or ‘secondary legislation’, as well as to suggest specific short and medium term reforms. The Ministry of Justice has formed a Department for Strategy and Deregulation which regularly consults with stakeholders interested in improving the insolvency regime in Poland. This Draft Report is, in part, meant simply as one of a number of inputs into the policy process of further improving the current system.

The Draft Report will be discussed with the Government of Poland and relevant stakeholders during a weeklong mission, following which the World Bank team will produce a Final Report. The methodology followed in preparing the Draft Report consists of a review of a variety of previously published materials supplemented by a number of face-to-face meetings and telephone interviews with a range of stakeholders with experience of the present Poland bankruptcy and restructuring process, including financial institutions, judges, lawyers and regulators.\(^2\) A list of the written materials consulted and the names of the institutions interviewed is provided at the end of this document.

The need for continuing the Government’s efforts in improving the insolvency regime in Poland is addressed in detail in this Report. Efficient insolvency systems serve to improve access to credit by providing predictable and effective mechanisms for resolving corporate distress. Moreover, efficient exit systems are as significant for growth and entrepreneurialism as entry systems, as they serve to free both entrepreneurs and capital to move on to more productive roles. The World Bank’s Doing Business report, where Poland ranks 87 on the Resolving insolvency indicator, has flagged certain problems related to the Poland insolvency system. Indeed, in 2011, the insolvency system returned only 31.5% of outstanding debts to creditors in

\(^1\) The report has been prepared by a World Bank Group team composed of Nina Mocheva (PSD Specialist, Debt Resolution and Business Exit, CICBR), Ignacio Jose Tirado (Senior Insolvency Consultant, LEGPS) and David Burdette (Senior Insolvency Consultant, CICBR), under the leadership of Marcin Piatkowski (ECSF 2), and the general supervision of Mahesh Uttamchandani (Global Product Specialist, Debt Resolution and Business Exit).

\(^2\) A World Bank mission led by the Task Team Leader Marcin Piakowski (ECSF 2) and composed of Nina Mocheva (PSD Specialist, Debt Resolution and Business Exit, CICBR), Ignacio Jose Tirado (Senior Insolvency Consultant, LEGPS) and David Burdette (Senior Insolvency Consultant, CICBR) visited Warsaw and Krakow, Poland, from May 28-June 4 to carry out an assessment of the current status of Poland’s insolvency system (legal and institutional framework) as well as to identify priority reforms (also on the basis of the implementation track record to date). The mission was supported by Anna Bokina and Malgorzata Michnowska (ECCPL) of the World Bank Warsaw office. The World Bank team shared an Aide Memoire with the Government of Poland, setting out the mission’s preliminary findings and recommendations. Due to their preliminary nature, the conclusions included in the Aide Memoire may not be strictly followed in the present Report.
Poland, less than half of the OECD average, largely because most insolvencies end up with businesses being liquidated rather than restructured.

The reform of the Polish bankruptcy regime has been ongoing for some years. Though the Bankruptcy and Restructuring Law was reformed in 2003, a 2008 ICR ROSC (Report on the Observance of Standards and Codes (ROSC) on Insolvency and Debtor/Creditor Regimes) prepared by a World Bank staff team found that the system stemming from the 2003 Bankruptcy and Restructuring Law was not serving its intended purpose. The number of proceedings was low; the duration and cost excessive; and the outcome extremely liquidation-oriented. The system was referred to as neither capable of adequately protecting creditors' rights nor able to offer a rescue mechanism for viable debtors. It was said to include no workable reorganisation mechanism.

In 2009, the Bankruptcy and Restructuring Law was amended with the intention to make restructuring proceedings more widely available to companies experiencing financial difficulties. In 2009, Poland introduced the Law on Trustee Licensing tightening professional requirements for administrators. The Bankruptcy and Restructuring Law was further amended twice in 2010 in relation to procedural issues and with respect to certain rights of secured creditors and these changes apply from September 25, 2010 and February 20, 2011.

Despite these reforms, Poland’s ranking on the 2012 World Bank Group Doing Business report on Resolving insolvency decreased 6 places compared to the country’s 2011 year’s performance. Informal out-of-court restructuring remains unregulated and not encouraged by the present system. The absence of a legal or even quasi-legal environment that facilitates out of court corporate restructuring means that there is no effective backdrop against which informal workouts can take place.

These shortcomings must be analyzed against the language of existing laws to see if the empirical results are the product of laws which are still deficient in themselves, or rather due to an approach to the implementation of those laws which does not adequately reflect what the legislator intended.

This Report will consist of four parts. It begins with a summary of the weaknesses and recommendations relating to the reform of the present system. With a view to serve as background to the topic of analysis, Part One of the Report provides an overview of the present insolvency regime. Part Two identifies the main shortcomings of the system with reference to the current regime. Part Three sets out suggestions for reform with reference to the roles of the main participants in the system, and indicates which reforms could be achieved without the need for new primary legislation.

3 Please note that the Doing Business Resolving insolvency indicator studies the time, cost and outcome of insolvency proceedings involving domestic entities. The ranking on the ease of resolving insolvency indicator is based on the recovery rate, which is a function of time, cost and outcome of an insolvency proceeding as well as the lending rate (lending rate is determined by the central bank). The Doing Business corrected the cost for Poland from 20% to 15% in DB12 and back-calculated to DB04. The website data reflect the back-calculation. The cost correction did not improve the ranking due to the fact that the lending rate increased from 3.74% to 8.27% in DB12. Also, rankings change due to the movement of other countries. See www.doingbusiness.org.
SUMMARY OF THE PRINCIPAL WEAKNESSES OF THE PRESENT SYSTEM AND KEY RECOMMENDATIONS FOR REFORM

A. INSTITUTIONAL FRAMEWORK

1. Principal Weaknesses and Key Recommendations for Reform (short and medium term)

The summary provided below is for ease of reference only and should be read in conjunction with the detailed analysis set out in parts 1-3 of this Report. Some of the recommendations are achievable only through legislative reform (LR), but some may be more rapidly achieved through regulatory reform (RR).

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Recommendation</th>
<th>RR (medium-term)</th>
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| 1 Court case management systems are antiquated and reduce the effectiveness of the courts. | • The use of a more effective case management system in the courts can lead to greater effectiveness of the bankruptcy courts.  
• IT reform could be a helpful tool in enabling courts to speed up proceedings, and to allow for more transparency (for example, individual notification of all creditors by electronic means could result in faster and more effective creditor participation from the beginning of the insolvency proceedings). | LR (short-term) | RR/LR (medium-term) | |
| 2 The technical level of Bankruptcy judges should be improved. | • There is a need to be able to transfer complex commercial cases to a higher level court, or to refer these cases to trained specialist judges, especially insolvency and debt enforcement cases.  
• Judges require continuing professional training in a wide variety of matters, particularly those relating to finance and commerce, beyond the current system of 5 days per annum. If the 5 days per annum mandatory training remains in place, bankruptcy judges should be required to take specialized training and not be offered a choice of subject matter. This training needs to be provided by experienced practitioners, not simply by academics that might lack practical commercial experience. | LR (medium-term) | RR (medium-term) | |
| 3 Procedural delays make bankruptcy proceedings less efficient. | • Courts should be enabled to hear connected matters within the same insolvency case and to accelerate the delivery of judicial decisions.  
• The impact of challenges against the list of creditors should be reduced by constraining the scope of the bankruptcy judge to insolvency matters, and by limiting hearings and other non-written procedural acts by parties to the cases where it is justified. | LR (short-term) | LR (short-term) | |
| 4 Parties in litigation are too easily able to delay court proceedings. | • Wherever reasonable and possible, achievable time limits should be imposed in which decisions are to be made by the court or steps | LR (short-term) | |
| 5 | Insolvency practitioner training, regulation and supervision are insufficient. |
|   | - Build on the existing regulation of insolvency practitioners to enable it to introduce a formally enforced code of conduct, and introduce formal training to develop different skill sets for insolvency practitioners.  
|   | - Revise the manner in which insolvency practitioners’ remuneration is determined in line with international best practices. Additional incentives, for example the payment of bonuses for successful reorganizations, should also be considered.  
|   | - Encourage the Polish FSA (possibly with the endorsement and assistance of the National Bank or Ministry of Finance) to promote and assist with the development of a code of conduct for an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure. |
|   | RR (short-term) |
|   | LR (short-term) |
|   | RR (medium-term) |

| 6 | Lack of informal out-of-court restructuring guidelines. |
|   | - Introduce special provisions for out-of-court restructuring, especially in the case of SMEs. This could be achieved by (1) out-of-court assistance for operational and financial restructuring (e.g. consensual restructuring; conciliation; pre-packs; mediation; consolidation (M&A)); and (2) special court administration proceedings, i.e. less strict requirements for reorganization plans (the current reorganization conditions stipulate that the debtor must not be delayed for more than 3 months in the fulfillment of its obligations, and must meet the “best interest” test. These conditions may be difficult to comply with, especially for SMEs since they cannot always rely on experienced financial advisors to prepare a sound reorganization plan).  
|   | - More generally there should be provision for debtors to have the benefit of an informal restructuring mechanism. This can be achieved by the issuance of a set of rules or guidelines for financial institutions intended to have persuasive (as opposed to legally binding) effect and/or by the introduction by a new law of a court-supervised procedure in which a very “light touch” insolvency practitioner could be appointed to assist the debtor. |
|   | RR/LR (medium-term) |
|   | RR (medium-term) |

| 7 | Lack of stakeholder awareness of the bankruptcy laws. |
|   | - Conduct public awareness campaigns for relevant stakeholders, including company managers, lawyers, financial advisors, trustees, etc. to explain the reforms as well as their benefits.  
|   | - Conduct training for prosecutors/judges on enforcement of sanctions for company |
|   | RR (short-term) |
|   | RR (short-term) |

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4 In this document the generic terms ‘office holder’ and ‘insolvency practitioner’ are used to refer to the various appointments that can be made under Polish insolvency law, namely a court supervisor, court administrator(sometimes translated from Polish into English as “receiver”) or trustee.
### B. SUBSTANTIVE BANKRUPTCY AND ASSOCIATED LEGISLATION

1. **Principal Weaknesses and Key Recommendations for Reform (short and medium term)**

The summary provided below is for ease of reference only and should be read in conjunction with the detailed analysis set out in parts 1-3 of this Report. Some of the recommendations are achievable only through legislative reform (LR), but some may be more rapidly achieved through regulatory reform (RR).

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| 1 Bankruptcy proceedings are convoluted and open to abuse. | • Courts should be enabled to hear connected matters within the same insolvency case and to accelerate the delivery of judicial decisions.  
• Office holders should have the authority to compromise claims within bankruptcy proceedings with the authority of creditors or the judge-commissioner (where creditors are unable or unwilling to provide consent).  
• The impact of challenges against the list of creditors should be reduced by constraining the scope of the bankruptcy judge to insolvency matters, and by limiting hearings and other non-written procedural acts by parties to the cases where it is justified.  
• Wherever reasonable and possible, achievable time limits should be imposed in which decisions are to be made by the court or steps taken by any of the participants in the process. | LR (short-term)  
LR (short-term)  
LR (short-term)  
LR (short-term) |
| 2 Ineffectiveness of legal provisions holding directors liable for misconduct. | • Lengthen the current 14 day period to a more reasonable period for directors to file for insolvency and adopt the necessary measures to ensure implementation.  
• Ensure effective implementation of the provisions concerning late filing, with particular regard to the prosecution of offences.  
• The duty of directors to file for insolvency within 14 days could be softened to allow debtors to pursue alternative solutions such as a voluntary restructuring agreement. | LR (short-term)  
LR (short-term)  
LR (short-term) |
| 3 Lack of participation by creditors in insolvency proceedings. | • Simplify the manner in which creditors’ lists are finalised by the courts for the first meeting of creditors to be summoned.  
• Improve and simplify the rules that regulate the formation of creditors committee in order to facilitate its formation at an early stage.  
• Introduce more effective mechanisms for the individual notification of creditors in the | LR (short-term)  
LR (short-term)  
LR (short-term) |
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| 4 | There seems to be a lack of consistency in the behavior of Tax Authorities concerning insolvency cases | • Introduce clear guidelines for Tax Authorities as to their possible actions in cases of the insolvency of taxpayers: the possibility of write-offs and reschedulings; the criteria that write-offs and reschedulings are based on; basic procedural steps for their adoption. This should be a matter of policy dictated by the Ministry of Finance to decide the main lines of tax authorities’ behavior in case of insolvency.  
• Provide focused training for Tax Authorities on the application of such guidelines. | RR/LR (medium-term) |
| 5 | Laws currently consider forgiven debt as income for the debtor (unless it is in the context of a bankruptcy arrangement, or a restructuring only within certain industries), providing less benefit from a forgiven debt as the debtor incurs a cost. | • Amend tax laws as necessary to provide favourable/neutral tax treatment of forgiven debt for the debtor when in the context of any restructuring, in any industry. | LR (medium-term) |
| 6 | Tax laws currently allow creditors a tax deduction for forgiven debt only in limited circumstances. | • Amend tax laws as necessary to allow greater deductions for loan losses.  
• Amend relevant banking laws and regulations and other related laws to enhance consistency in categorizing and deducting loan losses. | LR (medium-term) |
| 7 | There seems to be confusion over EU State Aid restrictions and their effect on the ability to compromise tax debt. | • Determine the EU *de minimis* standards relating to State Aid, and also its exceptions for insolvency, and provide guidance.  
• Disseminate the guidance among all stakeholders to allow confidence in tax debt compromise proceedings. | RR (medium-term) |
| 8 | Corporate rescue proceedings are ineffective. | • Take steps to instill a culture of corporate rescue by presenting educational and awareness programmes for stakeholders (especially bankruptcy judges and directors of companies).  
• Introduce incentives for insolvency practitioners to undertake corporate rescue work.  
• Introduce provisions allowing for post-commencement finance to be provided by lenders, simultaneously providing for new lenders to be given a priority over existing creditors.  
• Amend existing laws that prevent new credit being given to insolvent companies that are subject formal insolvency proceedings.  
• Address problems associated with the sale of a business as a going concern. | RR (medium-term)  
LR (medium-term)  
LR (short-term)  
LR (short-term) |
PART ONE

THE PRESENT BANKRUPTCY REGIME

1. Introduction and Background

Poland’s primary bankruptcy legislation is contained in the Bankruptcy and Restructuring Law, 2003 (as amended). There are various other laws that impact on the insolvency process, and where appropriate these are dealt with in this Report.

As discussed above, the 2008 ICR ROSC (Report on Observance of Standards and Codes (ROSC) on Insolvency and Debtor/Creditor Regimes) prepared by a World Bank staff team found that the system stemming from the 2003 Law was not serving its intended purpose.

Amongst some of the shortcomings, the ICR ROSC found that:

- The law and the poor administration by regulatory authorities did not motivate payment or pose a credible threat to recalcitrant debtors;
- Creditors’ did not have access to adequate information and creditors’ involvement came too late;
- Debtor’s had little incentive to commence proceedings, or seek the protection of a court in times of business distress, and thus filings were generally too late, done when the situation had deteriorated beyond the possibility of rehabilitation;
- Director and officer liability were systematically unenforced; existing tests were too stringent to permit successful prosecutions, thus there was no deterrent to fraudulent trading;
- Insolvency practitioners were virtually unregulated; there was no independent regulatory body responsible to set standards for and regulate the profession;
- The 2003 legal framework did not provide for “pre-packaged plans”;
- There was no tax relief for bad debts;
- Out-of-court settlement and corporate workout were also not encouraged by the legal and regulatory framework.

In 2009, the Bankruptcy and Restructuring Law (BRL) was amended with the intention of making restructuring proceedings more widely available to companies experiencing financial difficulties. The BRL was further amended twice in 2010 in relation to procedural issues and with respect to certain rights of secured creditors, and these changes came into operation on 25 September 25 2010 and 20 February 2011 respectively.

The sections that follow provide an overview of the key features of the current system.

2. Access to the Bankruptcy Process

In terms of Article 5 of the Bankruptcy and Restructuring Law, 2003 (BRL), the insolvency law applies to:
entrepreneurs as defined in the Civil Code; 5
limited liability companies and joint-stock companies, including those which do not carry on an economic activity;
partners in commercial partnerships, who are liable for the obligations of the partnership without limit with the entirety of their assets;
partners in a professional partnership.

Also in terms of Article 5 of the BRL, the insolvency law does not apply to:
the State Treasury;
units of territorial self-government;
public autonomous health care centres;
institutions and legal persons created under the provisions of the law, unless the BRL provides otherwise, and those created in the discharge of a duty imposed by the BRL;
natural persons running an agricultural farm;
higher education schools.

Stated more simply, the BRL applies to natural person enterprises, legal person enterprises (i.e. companies) and state-owned enterprises. Special provisions are contained in the BRL dealing with the bankruptcy of banks 6 and insurance companies. 7

A debtor may file for insolvency of its own accord, and so could any of its creditors, including a single creditor of the debtor. 8 However, under current jurisprudence insolvency proceedings may only commence if there is a certain plurality of creditors, i.e. at least two. Although the BRL states commencement criteria for the commencement of insolvency proceedings, this can be quite vague. In terms of Article 10 of the BRL a bankruptcy order may be issued in respect of a debtor who has become insolvent. In terms of Article 11.1 a debtor is deemed to be insolvent if it fails to fulfill its ‘matured pecuniary obligations’. However, the court may dismiss a bankruptcy petition where the delay in the discharge of obligations has not exceeded three months, and the sum of the outstanding obligations is no higher than 10 per cent of the balance sheet value of the debtor’s enterprise. 9 In the case of legal persons (companies), there is an additional criterion which amounts to a balance sheet test for insolvency, namely that a company is deemed to be insolvent if its liabilities exceed its assets, even if it is current in the payment of its obligations. 10

There is an obligation on a debtor to file a bankruptcy petition with the court within two weeks from the day on which the grounds for a declaration of bankruptcy arise. 11 In the case of a company, this obligation falls on the representatives of the company, namely the directors with power to bind the legal entity. 12 If the responsible persons do not file for bankruptcy within the specified period, they are liable for any damages

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5 Dziennik Ustaw 1964, No. 16, item 93, as amended.
6 See Arts 426 - 459 of the BRL.
7 See Arts 471 - 482 of the BRL.
8 Ibid., Art 20.
9 Ibid., Art 12.1.
10 Ibid., Art 11.1.
11 Ibid., Art 12.1.
12 Ibid., Art 21.2.
that arise from their failure to do so.\textsuperscript{13}

Although the process for the commencement of bankruptcy proceedings by a debtor is relatively straightforward, in addition to the information required to be stated in the bankruptcy petition by Article 22, Article 23 requires the following further comprehensive documentation, \textit{inter alia}, to be submitted by the debtor:

- A current list of the assets with their valuation;
- Current financial statements, or if the debtor is not required to keep financial statements, a balance sheet prepared (not more than 30 days before the bankruptcy petition is presented) specifically for the bankruptcy application; and
- A cash-flow statement for the preceding 12 months.

Also, where the bankruptcy petition is filed by the debtor, the debtor must indicate in the petition whether he seeks a declaration of bankruptcy open to an arrangement, or of bankruptcy including liquidation of the debtor’s assets.

In addition to formal bankruptcy proceedings as enumerated above, entrepreneurs who face the threat of \textit{impending insolvency} may make use of rehabilitation proceedings in certain circumstances,\textsuperscript{14} and subject to certain time limits where the entrepreneur debtor has formerly been involved in bankruptcy or rehabilitation proceedings.

Bankruptcy cases in Poland are heard by bankruptcy and restructuring courts which are a separate division of the commercial district courts or - in smaller cities where organizational separation of a division dealing exclusively with bankruptcy and restructuring cases is not justified - regular commercial district courts.\textsuperscript{15} Bankruptcy petitions are usually heard as closed sessions, but the bankruptcy judge may order a trial if this is justified.\textsuperscript{16} The court is obliged to issue a ruling on the matter within two months of the filing of the bankruptcy petition.\textsuperscript{17} In practice it can reportedly take up to one-and-half years to issue a ruling on bankruptcy in complex or contentious cases. Reportedly, in practice, it could take up to 1.5 years to issue a ruling on bankruptcy, in complex or contentious cases. The bankruptcy order issued by the court can take one of two forms, namely i) a bankruptcy including the liquidation of the debtor’s assets (i.e. a normal liquidation),\textsuperscript{18} or ii) a bankruptcy open to an arrangement.\textsuperscript{19} The BRL provides for a conversion from liquidation to an arrangement, and from an arrangement to liquidation.\textsuperscript{20}

\section*{3. The Role of the Court}

As already demonstrated, the role of the court in bankruptcies in Poland is extensive. Bankruptcy cases in Poland are determined by bankruptcy and restructuring courts

\begin{tablenotes}
\item[14] \textit{Ibid}, Arts 492 - 497.
\item[16] \textit{Ibid}, Art 27.1.
\item[17] \textit{Ibid}, Art 27.3.
\item[18] \textit{Ibid}, Art 15.
\item[19] \textit{Ibid}, Art 14.
\item[20] \textit{Ibid}, Arts 16 and 17.
\end{tablenotes}
which are a separate division of the commercial district courts or - in smaller cities where organizational separation of a division dealing exclusively with bankruptcy and restructuring cases is not justified - regular commercial district courts. Once a bankruptcy order has been granted, the case is taken over by a judge-commissioner who then has full supervision over the insolvency administrator.

The court that declares the bankruptcy has wide powers, and is to deal with all matters arising in the case. In addition to hearing the bankruptcy petition, the bankruptcy court:

- must *ex officio* secure the debtor’s assets where the debtor is the petitioner, and after the 2009 amendments, the court must secure the assets at the creditor’s demand if the bankruptcy petition was filed by the creditor;
- may secure the debtor’s assets by means of the appointment of a temporary court supervisor;
- may convene a preliminary meeting of creditors in order to take resolutions in the matter of the manner of conduct of the bankruptcy proceedings, the appointment of creditors’ council and conclusion of an arrangement;
- must appoint a judge-commissioner, a trustee, or court supervisor or receiver.

4. The Effect of a Bankruptcy Order

The opening of bankruptcy proceedings in Poland has different consequences depending on the type of proceedings: i.e. bankruptcy with liquidation or bankruptcy open to an arrangement.

In bankruptcy with liquidation, the opening of the proceedings results in all enforcement action or proceedings against the debtor being stayed. In the case of a bankruptcy open to an arrangement, the stay of enforcement only applies to securing a claim resulting from a receivable debt covered by the arrangement; however, not all claims are covered by the arrangement, for example secured creditors are only partially covered (up to the value of their collateral). There is also a stay against the commencement or continuation of any individual action or proceedings concerning the debtor’s assets. The extent of suspension of the right to transfer, secure or otherwise deal with assets of the debtor depends on the type of bankruptcy. The trustee in bankruptcy with liquidation has a right to transfer and otherwise deal with the debtor’s assets subject to various restrictions. In reorganization proceedings, the debtor generally stays in possession. The automatic stay appears to apply to all claims covered by the arrangement while enforcement of any other claims may be stayed by the bankruptcy court in some circumstances. The stay does not appear to apply to a

29 *Ibid*.
supplier who holds retention of title. \(^{32}\) Registered pledges are also, subject to certain constraints, allowed to exercise their rights of satisfaction of claims outside of insolvency proceedings. \(^{33}\)

Article 53 provides for notification of the commencement of proceedings to be given to the public generally, and to all the relevant regulatory authorities. There is no requirement to notify individual creditors of the commencement of bankruptcy proceedings. The commencement of proceedings must be published by law in the Official Gazette, as well as in a newspaper of local circulation. The decision of the bankruptcy court concerning the preparation of a distribution plan is also published in the Official Gazette and court hearings are accessible to everyone.

Article 62 defines the assets forming part of the bankruptcy estate, and the ownership rights of third parties and secured creditors are dealt with in Article 101. In terms of Article 57, the debtor has an obligation to safeguard the assets of the debtor and to deliver them to the relevant functionary.

In terms of Article 75.1, the powers and authority of the management of an insolvent debtor terminate once it has been determined that the debtor enterprise should be liquidated, and Articles 320-323 make provision for the sale of assets by public auction or private sale. \(^{34}\) In both types of auctions, however, market participants believe that often no adequate market principles are followed and, as a result, prices of sold assets are not always maximized.

There is no provision in the Bankruptcy and Restructuring Law that requires the timely and expeditious winding-up of the debtor’s affairs, and there is also no provision providing for the lifting of the stay in respect of actions and proceedings against the assets of the debtor insofar as it affects secured creditors or others who own property in the possession of the debtor. \(^{35}\) There are no provisions dealing with a discharge of debts once the bankruptcy proceedings have been completed, so it is not clear from the law whether debts and liabilities survive the process. Despite the lack of clear provisions in the law, in the case of tax claims practitioners have advised that

\(^{32}\) Under Art. 101, the right of ownership reserved for the seller in a contract of sale shall not expire due to the declaration of the acquirer’s bankruptcy if under provisions of the Civil Code it is effective against his creditors over or by transferring it according to the procedure specified in Article 24 of the Act of 6 December 1996 on Registered Pledge and the Register of Pledges (Dziennik Ustaw 1996, No. 149, item 703; 1997, No. 121, item 769; 1998, No. 106, item 668; 2000, No. 48, item 554, No. 60, item 702, No. 114, item 1193) if the contract of establishment of the pledge envisages such a manner of satisfying the pledge.

\(^{33}\) Under Art. 327, the pledgee of a registered pledge may satisfy his claim from the object of pledge by taking it over or by transferring it according to the procedure specified in Art 24 of the Act of 6 December 1996 on Registered Pledge and the Register of Pledges (Dziennik Ustaw 1996, No. 149, item 703; 1997, No. 121, item 769; 1998, No. 106, item 668; 2000, No. 48, item 554, No. 60, item 702, No. 114, item 1193) if the contract of establishment of the pledge envisages such a manner of satisfying the pledge.

\(^{34}\) The “private sale” referred to here is still an auction, but conducted by the trustee, rather than the court.

\(^{35}\) In the case of a bankruptcy with liquidation, Art 146-1 allows some flexibility, providing that the suspension of execution proceedings shall not be an obstacle to drawing up an immovable property ownership transfer deed if the bid for the property was knocked down prior to the declaration of bankruptcy and the execution-related acquirer pays the acquisition price on time.
if the company is liquidated in bankruptcy, the tax debt is forgiven and does not attach to the owners or managers of the company.\textsuperscript{36}

5. The Role of Creditors

The Bankruptcy and Restructuring Law provides for creditors of the insolvent debtor to prove their claims within one and three months of the bankruptcy order being granted, although there is no individual notification to creditors in this regard.\textsuperscript{37} The right of set-off is recognized,\textsuperscript{38} and creditors are able to prove their claims at any time (although creditors who prove their claims late can only receive future dividends if a dividend has already been paid out at the time the claim is proved).\textsuperscript{39} Judicial review of claims that have been disallowed or rejected is allowed in terms of Article 256.

Creditors are entitled to influence certain aspects of the administration of a bankrupt estate through meetings of creditors which are convened by the judge-commissioner.\textsuperscript{40} The judge-commissioner has to convene a meeting of creditors if a resolution needs to be adopted, or if requested to do so by two or more creditors who hold at least one-third of the total value of the claims in the estate.\textsuperscript{41} The judge-commissioner may also convene a meeting whenever he deems it necessary to do so.\textsuperscript{42} Although the law does not provide that creditors be kept abreast of developments in the bankruptcy estate, the court supervisor’s report is submitted to meetings of creditors. Creditors also have the power to review decisions that affect them, and to which they object.\textsuperscript{43}

In practice, the meeting of creditors is only important in limited situations, for example when voting on the arrangement in bankruptcy with an arrangement. The Committee of Creditors is much more important in terms of participation by creditors in the administration of the bankrupt estate.\textsuperscript{44} The Committee of Creditors can be appointed through a resolution at the preliminary meeting of creditors, which reportedly rarely happens in practice because of the stringent criteria for the quorum of the meeting.\textsuperscript{45} It can also be established at a later date by the judge-commissioner, “if he finds it appropriate”.\textsuperscript{46} However, a Committee of Creditors must be established by the judge-commissioner upon the motion of creditors who hold “no less than one-fifth of the sum total of receivable debts recognized or credibly established”.\textsuperscript{47} This emphasizes the importance of proper notification of individual creditors on the commencement of the bankruptcy proceedings, so that the required quorum for a Committee of Creditors can be obtained early in the process. The judge commissioner

\textsuperscript{36} See Part One, para 10.1 below
\textsuperscript{37} Art 51.4 of the BRL. See also Arts 189 and 246.
\textsuperscript{38} Ibid, Arts 93-96.
\textsuperscript{39} Ibid, Arts 244 and 252.
\textsuperscript{40} Ibid, Art 191.
\textsuperscript{41} Ibid, Arts 191.1 and 191.2.
\textsuperscript{42} Ibid, Art 191.3.
\textsuperscript{43} See e.g. Arts 33 and 56 of the BRL.
\textsuperscript{44} Ibid, Art. 45 and Arts. 201-213.
\textsuperscript{45} This situation has not changed since 2008. The 2008 ICR ROSC found that it takes about a year for the committee of creditors to be convened by which time creditors have tended to lose interest in the case.
\textsuperscript{46} Ibid, Art. 201.
\textsuperscript{47} Ibid, Art. 201, para 2.
supervises the Committee and may remove members if they fail to comply with their duties. 48

Among the key duties of the Committee of Creditors are to assist the office holder, inspect his acts, examine the status of the funds in the bankruptcy estate, authorize acts which may not be performed otherwise than with the authority of the Committee, and provide opinions on other matters if required to do so by the judge-commissioner or the office holder. 49

Although creditors do not have say in the appointment of an office holder under Polish law, the BRL provides the Committee of Creditors, and any individual member of the Committee, with the right to submit to the judge-commissioner comments on the work of the office holder, and to request the judge-commissioner to remove the office holder from office. 50 The Committee may demand explanations from the office holder, and it may examine books and documents relating to the bankruptcy. The Committee is obliged to submit to the judge-commissioner its report on the inspection of activities of the office holder, and on the examination of the status of funds in the bankruptcy estate. 51 There are certain actions for which the approval of the Committee of Creditors is mandatory. For example, in bankruptcy with liquidation, such a Committee’s approval is required if the trustee continues to run the enterprise (if it is to be continued for more than three months from the day of the declaration of bankruptcy), as well as proceeding with the sale of the enterprise as a whole, and the sale of rights and receivable debts. 52 In proceedings open to an arrangement, the Committee of Creditors must approve the encumbering of components of the bankruptcy estate by a bankrupt or the receiver with a mortgage, pledge, registered pledge, treasury pledge or ship’s mortgage in order to secure a receivable debt not covered by the arrangement; the receiver encumbering components of the estate with other rights; and the receiver taking out credits and loans. 53

Despite the important role the Creditors’ Committee can play under the BRL, if it is not formed early in the proceedings its importance can be substantially diminished.

The costs of administering the bankrupt estate rank in priority to the claims of unsecured creditors, and clear provision is made for the priority of the payment of certain creditors’ claims. 54 Claims that are neither administration expenses, nor are priority claims listed in the first three categories of Article 342.1 of the BRL, all rank equally on a pari passu basis. 55

48 Ibid., Art. 202 para 1.
49 Ibid., Art. 205 para 1.
50 Ibid., Art. 205 para 2.
51 Ibid., Art. 205.
52 Ibid., Art. 206.
53 Ibid.
54 Ibid., Art 342.
55 Except for certain ancillary claims listed in the fifth category of Article 342.1 of BRL.
6. **The Role of Insolvency Practitioners**

The Insolvency Receiver License Act 2007 (IRLA) regulates the qualifications, registration and licensing of insolvency practitioners\(^{56}\) in Poland. In terms of this Act all insolvency practitioners are required to be qualified professionals.\(^{57}\) The Act provides that all insolvency practitioners must obtain minimum standards regarding education,\(^{58}\) relevant experience\(^{59}\) and character. In addition to these requirements, all insolvency practitioners are required to pass an insolvency-specific examination in order to qualify for appointment.\(^{60}\) The Act also contains provisions disqualifying certain persons from being registered and licensed, for example where they have been found guilty of offences of which dishonesty is an element.\(^{61}\)

All insolvency practitioners are required to be registered and licensed,\(^{62}\) and for this purpose there is an official register maintained by the Ministry of Justice.\(^{63}\) Article 157 of the BRL provides that corporate bodies may also be registered and licensed, although in such a case the board or shareholders of the corporate body must be licensed practitioners.\(^{64}\) The appointment of an insolvency practitioner to a particular case is a function of the court.\(^{65}\) There are no guidelines laid down in the law for the selection of a particular person as office holder (although certain persons may be disqualified from being appointed in terms of Article 157 of the BRL), and there is also no mechanism in terms of which interested parties such as creditors may object to the appointment of a particular person or corporation, or have it set aside.\(^{66}\) Provision is made for the removal, resignation or death of an office holder, including the procedure to be followed and the filling of vacancies.\(^{67}\)

Although Article 168 of the BRL requires that the office holder must provide regular reports to the court / judge-commissioner, there is no provision requiring the office holder to provide regular reports to the creditors. However, creditors may request the judge-commissioner to appoint a Committee of Creditors\(^{68}\) which is then obliged to monitor the work of the office holder.\(^{69}\) Although the Committee of Creditors is

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\(^{56}\) The terms ‘insolvency practitioner’ and ‘office holder’ are used interchangeably in this Report. By these terms is meant the appointment of a trustee, court supervisor or receiver. The appointment of a trustee takes place in a bankruptcy including the liquidation of the bankrupt’s assets; the appointment of a court supervisor takes place in a bankruptcy open to an arrangement; and the appointment of a court administrator takes place when the bankrupt estate is placed in receivership. For more detail regarding: i) trustees, see Arts 173 to 179; ii) court supervisors, see Arts 180-181; and iii) court administrators, see Arts 182-184.

\(^{57}\) Art 3 of the IRLA.

\(^{58}\) Higher education is required, i.e. a university degree.

\(^{59}\) Three years’ relevant experience is required, i.e. experience in the management of a business, (not necessarily of a distressed business).

\(^{60}\) Art 3 of the IRLA.

\(^{61}\) Ibid.

\(^{62}\) Art 157 of the BRL.

\(^{63}\) Art 17 of the IRLA.

\(^{64}\) Art 157 of the BRL.

\(^{65}\) Ibid. Art 51.

\(^{66}\) Creditors at the preliminary creditors’ meeting may voice an opinion on the selection of the office holder, but the court is not bound by any such opinion.

\(^{67}\) Art 170 and 172 of the BRL.

\(^{68}\) Ibid. Arts 45 and 201.

\(^{69}\) Ibid. Art 205.
entitled to monitor the work of the office holder, it does not have any right of sanction over the office holder, for example the ability to approve remuneration.

Despite the registration and licensing requirements laid down in the IRLA, there is no regulatory body that exercises authority over insolvency practitioners. Consequently there is no regulatory body that can investigate the conduct of office holders, or impose disciplinary sanctions in cases of misconduct. The only sanctions are that the Minister of Justice may suspend or remove the license of an office holder in certain circumstances.\(^{70}\) So far there have reportedly been very few proceedings to suspend or remove a license, and none have resulted in removal. Insolvency practitioners are also not bound by a code of ethics or professional conduct, and consequently no provision is made for professional work standards that apply to all office holders. There is a voluntary informal Association of Trustees which includes about 130 members, but it is unclear how membership is granted. The Association has its own Code of Conduct, but there are no formal consequences should a member breach the rules.

The BRL makes provision for the entitlement of office holders to be remunerated for their work and to be reimbursed for expenses that were properly incurred in the administration of the bankruptcy.\(^{71}\) Articles 162 to 166 provide for the manner in which the office holder’s remuneration may be approved. Articles 162, 163 and 165 provide the basis upon which an office holder’s remuneration is calculated, with Article 165 providing the basis upon which an office holder may appeal the quantum of the remuneration paid to him. In terms of inter alia Articles 230, 231, 341 and 345 of the BRL, the office holder’s remuneration will be paid in priority to the claims of creditors. The office holder’s remuneration may not exceed 3% of the bankruptcy estate funds or 140 times the average monthly salary in the enterprise sector. The manner in which office holder’s remuneration is determined acts as a disincentive for skilled experienced financial advisors to enter the profession, and creates a reverse incentive for office holders to prolong insolvency proceedings.\(^{72}\)

Although the law does not provide for the release of the office holder at the conclusion of a bankruptcy matter, it does provide that the office holder must provide indemnity insurance for the proper conduct of the case.\(^{73}\)

### 7. The Role of Company Directors and Other Office-Holders

There is an obligation on a debtor to file a bankruptcy petition with the court within two weeks from the day on which the grounds for a declaration of bankruptcy arise.\(^{74}\) Under the BRL, “insolvency” is defined as a situation where (a) the obligations of the debtor exceed the value of its assets, or (b) the debtor is unable to pay its overdue

\(^{70}\) See Arts 18 and 20 of the IRLA.

\(^{71}\) Ibid, Arts 162 and 163.

\(^{72}\) For instance, in the UK, if there is a creditors’ committee, the committee will determine the basis of the remuneration. If there is no creditors’ committee, the remuneration can be fixed by the general body of creditors or by the court. A creditor can challenge the remuneration. In Spain, The fees of the receivers are determined by law, and are based on the volume of the assets and the complexity of the insolvency proceeding.

\(^{73}\) Ibid, Art 156. The scope of compulsory insurance is specified in the Minister of Finance Regulation of 8 October 2007.

\(^{74}\) Ibid, Art 12.1.
obligations. The first basis for filing insolvency only applies to legal persons and other entities with no legal personality (but which have legal capacity, e.g. professional partnerships and limited partnerships). In the case of a company, the obligation to file a bankruptcy petition is on the representatives of the company, namely the directors.\footnote{Ibid, Art 12.2.} If the responsible persons do not file for bankruptcy within the specified period, they are liable for any damages that arise from their failure to do so.\footnote{Ibid, Art 12.3.}

Although the process for the commencement of bankruptcy proceedings by a debtor is relatively straightforward, in addition to the information required to be stated in the bankruptcy petition by Article 22 of the BRL, Article 23 requires the following further comprehensive documentation, \textit{inter alia}, to be submitted by the debtor:

- A current list of the assets with their valuation;
- Current financial statements, or if the debtor is not required to keep financial statements, a balance sheet prepared (not more than 30 days before the bankruptcy petition is presented) specifically for the bankruptcy application; and
- A cash-flow statement for the preceding 12 months.

Also, where the bankruptcy petition is filed by the debtor, the debtor must indicate in the petition whether he seeks a declaration of bankruptcy open to an arrangement, or of bankruptcy including liquidation of the debtor’s assets.

In terms of Article 57 of the BRL, the debtor (or the directors in the case of a company), is required to provide all information concerning the assets and financial affairs of the debtor.

In addition to formal bankruptcy proceedings as enumerated above, entrepreneurs who face the threat of \textit{impending insolvency} may make use of rehabilitation proceedings in certain circumstances,\footnote{Ibid, Arts 492 - 497.} and subject to certain time limits where the entrepreneur debtor has formerly been involved in bankruptcy or rehabilitation proceedings.

The role played by the existing management of the company depends on the type of bankruptcy proceeding. In bankruptcy open to an arrangement, the management remains in full control of the business with some exceptions.\footnote{Ibid, Arts 76 and 184.} In bankruptcy with liquidation, the trustee takes control of the management of the company, although the company’s managers may challenge certain decisions of the trustee (for example, the distribution plan).\footnote{Ibid, Art 256.2.} In restructuring proceedings, the debtor remains in possession subject to the supervision of the court administrator.\footnote{Ibid, Art 497 et seq.}
8. **Formal Restructuring within the Bankruptcy Proceeding**

The current insolvency regime in Poland contains a formal restructuring provision called ‘bankruptcy open to an arrangement’. This procedure is available to anyone who has been declared bankrupt, and arrangement proposals can be made by the debtor or the court supervisor or receiver within a period of one month of the bankruptcy order being granted. In cases where the debtor is required to keep financial records, the proposals must be accompanied by a cash flow statement for the preceding 12 months. Where a bankruptcy order open to an arrangement has been granted by the court on the petition of a creditor, such creditor may also make proposals for an arrangement.

In terms of Article 269 arrangement proposals must define the manner in which the restructuring of the bankrupt’s obligations will take place, and contain a justification for doing so. In terms of Article 270.1, proposals for the restructuring of the bankrupt’s liabilities may include in particular:

- deferring the discharge of any of the liabilities;
- spreading the payment of debts into instalments;
- reducing the sum of debts owed;
- converting receivable debts into shares;
- amending, exchanging or repealing the right which secures the specific receivable debt.

Arrangement proposals may indicate one or more manners of restructuring the debtor, and may also provide for satisfying creditors through liquidation of the bankrupt’s assets (liquidation arrangement). Liquidation in this manner must be conducted in accordance with the provisions of the statutory law on liquidation of the bankruptcy estate, unless the arrangement provides for the creditors taking over the bankrupt’s assets, or for another manner of liquidation.

The provisions relating to the proposal and approval of an arrangement are dealt with in Articles 281 to 285 of the BRL. A majority of two-thirds is required for approval, and once approved the arrangement binds all creditors. The effects of the arrangement are dealt with in Articles 290 - 297, and amendments to the arrangement in Articles 298 - 301. Articles 302 - 305 deal with the setting aside of an arrangement in certain circumstances. The time frames for the consideration and approval of an arrangement are relatively short, in line with international best practices in this regard.

One of the greatest shortcomings of the Polish restructuring law is that it does not contain any provisions allowing for post-commencement financing. Polish law does

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82 This period may be extended to three months by the judge-commissioner supervising the case.
83 Art 267.1 of the BRL.
84 *Ibid*.
86 *Ibid*, Art 270.3.
88 *Ibid*.
90 *Ibid*, Art 290.1. The arrangement does not bind creditors who were intentionally excluded by the debtor, and who did not participate in the proceedings - Art 290.2.
not allow for priority repayment of financing provided to a company during its reorganization. This hampers post-commencement financing and is a disincentive for possible investors. Financing during the rescue period has been an important part of the rescue culture in countries where business reorganization under the insolvency law has been successful.

Banking legislation concerning risk management is also a hurdle to the rescue of insolvent companies. While the BRL allows for debtors in possession to take additional credit with the consent of the creditors, the banking law does not contain any special provisions on the possibility of insolvent companies to take credit in certain circumstances. Until both sets of rules are amended and co-ordinated, the rescue of financially distressed businesses is all but an impossibility.

The sale of a business as a going concern, which can produce greater returns to both creditors and debtors and preserve the business itself and the jobs connected to it, is also inhibited by the current legal framework. If an insolvency proceeding results in the sale of the business as a going concern, the assets of the business are not transferred free of encumbrances. Taking on the overwhelming debts of an insolvent business could be a serious disincentive to prospective purchasers.

9. The Possibility of Informal Creditor Workouts outside the Bankruptcy System

Although there is no generally recognised system for out-of-court workouts in Poland, lenders often engage in informal workouts because they will likely recover more that way than in court. In the case of small companies there is a common practice of bilateral negotiations with the bank, often resulting in the rescheduling of debt. Recalcitrant debtors often use delaying tactics in the courts, which cost the creditors time, additional expenses and human resources. The enforcement of security rights in Poland is generally perceived as slow and inefficient.

Beyond bilateral debt rescheduling, there seemed to be no common practice of informal workouts in 2008. During the most recent mission in May 2012, big commercial banks reported that as long as the debtor is of a considerable size, they would be willing to attempt out-of-court restructuring methods which go beyond mere debt rescheduling, for example the restructuring of a company’s operations or the recapitalization of the company through debt-for-equity swaps. Less often they would be persuaded to inject additional capital into the company, exchange one secured asset for another and, in very rare cases, reducing the debt owed by the company.

Banks reported that they are prepared to engage in voluntary restructuring negotiations in multiple-creditor settings in order to avoid the commencement of court proceedings. Typically banks will enter into a standstill agreement with the debtor, which in some cases are only informally agreed (a so-called “gentleman’s agreement”). In cases where the banks have very large exposures and multi-lateral lending facilities, steering committees are created.

91 This situation has not changed since 2008. The 2008 ICR ROSC found that banking regulations in Poland require the potential borrower to be creditworthy to be granted a credit, which is difficult for an insolvent entity even when it is under the control of a judge-commissioner.
There is no out-of-court code of conduct that has been adopted by the financial sector in Poland. The absence of a legal or even quasi-legal environment that facilitates corporate restructuring means that there is no effective backdrop against which informal workouts can take place. There are disparate opinions among stakeholders as to the need for the introduction of such a code of conduct in Poland.

10. Tax Rules Related to Insolvency

10.1 Tax Authority as a Creditor

Tax claims receive priority under Polish bankruptcy proceedings. Article 342 of the BRL, which sets out 5 categories of priorities for receivables to be satisfied from the bankruptcy estate, puts tax claims in category 3 – after costs of bankruptcy proceedings and receivables under employment relationships. According to Article 230 of the BRL, “taxes and public tributes” and social insurance payments are costs that are to be paid from the bankruptcy estate.

Polish law seems to allow compromise of tax debts for restructuring purposes. The relevant language of the Tax Ordinance Act, Chapter 7a, Article 67b, Section 1, Reliefs Concerning Repayment of Tax Obligations,\(^\text{92}\) states:

\[\text{Upon application of a taxpayer pursuing an economic activity, the tax authority may grant the reliefs concerning repayment of tax obligations specified in Article 67a:}\]

\[3) \text{which constitute public aid:} \]

\[\ldots\]

\[(i) \text{ for restructuring}\]

From the language of the law it appears that the authorities are legally empowered to compromise a debtor's outstanding tax obligations within a restructuring proceeding. There is no indication that the forgiveness needs to be within a formal insolvency proceeding. However, tax authorities remain unsure as to their exact authority to compromise tax obligations, some citing that “restructuring” is not specific enough to clarify the type of proceeding within which tax obligations may be compromised. There seems to be a fear that tax debtors could abuse “restructuring” processes, whether in-court or out-of-court, formal or informal, if they became a regular vehicle for tax debt relief.

Nevertheless the Polish tax authorities seem to be flexible in practice and generally act in the interest of the public, i.e. if payment of tax debt can lead to job dismissals, authorities would be willing to re-schedule installments. Small amounts re regularly written off. However, as stated above, the authorities have indicated that is not clear if they can write off debt in the case of an out-of-court restructuring, even though the language of the law, as quoted above, suggests no impediment, whether the restructuring is in court or out of court. It seems that, as a general principle, tax authorities are active in insolvency cases and are willing to write off tax debt. There is

\(^{92}\) Tax Ordinance Act dated 29 August 1997.
no unified tax policy on debt forgiveness and the decision is left to the discretion of local tax agencies. At local level, an individual must justify his tax relief request to a collective body, the Rada Gminy. There is a suggestion that badly written applications are a problem, and result in denial of relief. An official format or guidance could help such taxpayers in applying for relief.

10.2 Tax Treatment of Debt and Debt Forgiveness / Restructuring

In Poland, the deferral of a debt repayment or its division into installments, as well as reducing the security over a claim, is generally tax neutral for both the debtor and the creditor. The relevant discussion of tax treatment in this section is therefore in relation to tax debt forgiveness.

The 2008 ICR ROSC revealed that that the tax law treats the forgiveness of a debt as income for the debtor, thus providing a major disincentive to such arrangements. However, the tax law excludes the redeemed obligations (including loan obligations) from taxable income if the forgiveness of a debt is connected with:

- bank settlement proceedings within the meaning of the provisions on financial restructuring of enterprises and banks;
- bankruptcy proceedings aimed at an arrangement (i.e., bankruptcy proceedings without the liquidation of the assets) according to provisions in the Bankruptcy and Restructuring Law, or
- the implementation of a restructuring programme under separate legislative provisions (these restructuring programs basically pertain to selected enterprises operating in the steel and sulphur mining industries, as well as to public health care centres and the armed forces of Poland).

According to the 2008 ICR ROSC, Polish tax law only provides special tax relief for debtors in connection with bankruptcy proceedings aimed at an arrangement, and not in relation to restructuring proceedings (whose purpose is basically also the prevention of liquidation of the debtor’s assets).

From the creditors’ side, the forgiven debt does not in principle constitute a tax deductible item. However, in cases where the receivable has been reported as taxable revenue, the taxpayers should have the possibility of treating such forgiven receivables as tax deductible costs.\(^{93}\)

With respect to forgiveness of loans and credits, only to the extent that the forgiveness of a bank loan (credit) obligation is linked to one of the above proceedings, the debt forgiven may be treated by the creditor as a tax-deductible cost (with the exception of forgiven interest). Provisions of this nature, that limit the debt relief available to banks, also distort their balance sheets. Banks are motivated to continue to carry loans to financially troubled customers as “assets”, even though they are in reality no longer producing income.

Forgiveness of a loan granted between non-banking entities (i.e. not a bank loan), does not allow the creditor to treat the principal of the loan or the interest as a tax

\(^{93}\) Art 16, s 1.44 of the Polish Corporate Income Tax Law.
deductible item (neither the principal of the loan nor the interest was treated as taxable revenue, and therefore it cannot be recognized as tax deductible cost).

10.3 Debt Forgiveness as State Aid and EU Policy

Stakeholders’ interviews revealed differences in the perception as to the attitude of Tax Authorities concerning rescheduling and write offs: while some stakeholders stated that tax authorities cannot forgive debt due to EU restrictions on State Aid, the authorities themselves confirm that such restrictions are waived for certain groups of tax payers, and are generally not applied in insolvency cases. The Tax Ordinance Act 1997, Chapter 7a, Articles 67 a and b, states that taxes can be annulled if they constitute de minimis aid “to the extent and upon principles specified in directly applicable acts of the Community law on aid granted according to de minimis principle”.
PART TWO
SHORTCOMINGS IN THE PRESENT SYSTEM

A. INSTITUTIONAL FRAMEWORK

1. Bankruptcy Courts

1.1 Court structure and lack of experience of Judges

Bankruptcy cases in Poland are examined by bankruptcy and restructuring courts which are a separate division of the commercial district courts or - in smaller cities where organizational separation of a division dealing exclusively with bankruptcy and restructuring cases is not justified - regular commercial district courts. As a result of the general lack of use of formal processes, judges do not have a great deal of insolvency experience. The general view is that courts act too slowly in proceedings, reducing the effectiveness of the insolvency legislation in returning value to creditors.

A lack of sufficient support staff (one assistant for 10 judges in Warsaw and Krakow) also seems to be the possible cause of significant delays in the courts.

1.2 Procedural delays

Deficiencies in the manner in which courts handle bankruptcy cases cause delays in case management. The bankruptcy process appears to be overly formalistic. One of the most formalistic features in the proceedings is the requirements for the submission of claims, which results in multiple returns of the same claim. During the interviews it was stated that claims can be rejected by the judge for relatively minor deficiencies in paperwork that many other systems would permit to be corrected. For example, a new report prepared by Dr. Sylwia Morawska, Public Prosecutor, reveals that between 2004 and 2010, out of 28,517 insolvency proceedings in bankruptcy courts in 5 cities in Poland, 12,987 (the vast majority) were rejected for formal reasons, while only 901 resulted in settlement and 3,983 resulted in bankruptcy.\(^{94}\)

One of the most significant delays in bankruptcy proceedings is caused by resolving creditors’ claims. Normally, every claim is heard in individual hearings (no consolidation), which is time-consuming and unnecessary. If the creditor and the trustee or debtor with the trustee’s consent (as the case may be) agrees on the amount of the claim, there is no need for a hearing and the claim should be accepted; this is the practice in most countries with modern bankruptcy frameworks. A hearing is only necessary if the parties dispute the amount or other circumstances of the claim, and oral evidence would add something substantial to the written submissions. Hearing

\(^{94}\) When the case returns to court, it is treated as a different case. It is not clear to what extent this accounts for the apparent substantial increase in cases reported as being handled by the Polish courts.
every claim is burdensome, and in slowing down the administration of the case, lowers all creditors’ recovery as the value of assets erodes quickly over time. In addition, appeals against the actions of the insolvency practitioner and the decisions of the judge commissioner are submitted to the same bankruptcy division, which may consist of a limited number of bankruptcy judges. It appears that the system was intended to make the process faster and more efficient, but in practice, it has not produced the expected results, as the claims processing and appeals process is still long-lasting.

In addition to the current system causing procedural delays, it also creates opportunities for favoritism as the same court that appoints the insolvency practitioner, is then responsible for resolving all challenges against the latter, and the same bankruptcy court that appoints the judge-commissioner, decides on the appeals of his decisions.

1.3 Lack of sufficient training for Judges

Polish law does not contain any specific provisions regarding the competence, performance or qualifications of bankruptcy court judges. According to the Rules of Internal Operation of the Courts, each division of a court is managed and supervised by a chief of a court division who administers and coordinates its entire activity regarding judicial procedure. When exercising their judicial functions, judges are independent and subject only to the Constitution and the Laws of the Republic of Poland.

As far as training is concerned, the situation is likely to improve following the establishment of the Polish National School of the Judiciary and Public Prosecution, by the Legal Act of 23 January 2009. The Legal Act provides for 5 years of training for newly admitted judges before they are eligible to take a judge’s examination. However, this will only impact on newly admitted judges; practicing judges are only required to undertake 5 days of mandatory legal training per year, which does not necessarily have to cover insolvency. Although practicing judges may participate in additional training on a voluntary basis, this does not seem to be enough to ensure adequate level of expertise for dealing with complicated bankruptcy matters.

Another reported problem might be the frequent rotation of judges out of bankruptcy courts. Since bankruptcy divisions are within the low level first instance commercial courts, judges are assigned to them soon after they graduate from law school. After just a few years, bankruptcy judges move forward to higher courts. Judges cannot specialize in such a complex process without sufficient time in a bankruptcy court. Moreover, transferring them out of the bankruptcy court takes the knowledge and the experience they have built away from the cases. There is no equivalent bankruptcy division in the higher courts to which bankruptcy judges can be promoted, so in practice promotions undermine the objective of creating judges that are bankruptcy specialists.

1.4 Lack of sufficient supervision mechanisms

Poland does not have an insolvency regulator that can take responsibility for the oversight of insolvency cases. Oversight of all insolvency cases takes place through
the courts, in the first place by the adjudication of the insolvency case by the bankruptcy court, and secondly, once a bankruptcy order has been granted, by the judge-commissioner. The judge-commissioner has a supervisory role, and must supervise the insolvency administrator in the course of the exercise of his functions in terms of the BRL. A full bench of three bankruptcy judges hears bankruptcy cases. Once the bankruptcy order is granted, one of the three judges that presided is appointed as the judge-commissioner to oversee the administration of the bankruptcy case. From the interviews conducted with judges in both Warsaw and Krakow, it seems that each judge has between 35 to 40 cases assigned to him or her as judge-commissioner. This case load is in addition to the case load that each judge has in hearing bankruptcy applications. Judges are further placed under pressure in that up to ten judges can share one administrative assistant or clerk. According to the judges that were interviewed, this leads to delays and places the courts under excessive pressure in dealing with bankruptcy cases.

It is not clear whether the supervision by the judge-commissioner is a sufficient form of supervision over the bankruptcy process. Proper supervision cannot take place where judges are overloaded with cases. A case could probably be made out that once the court has granted the bankruptcy petition, supervision should be conducted by a body other than the courts. A separate regulator that supervises the bankruptcy process would be a possible solution, which works in highly developed jurisdictions, but this has a cost implication and requires infrastructure and the training of additional personnel. Another possible solution would be to have administrative personnel in the courts appointed as judge-commissioners; perhaps new, junior judges that are new to the courts. Acting as judge-commissioner could serve as a useful training ground for new bankruptcy judges, and this could perhaps free up some of the more experienced judges to deal with the large number of bankruptcy cases and to receive more intensive training. In any case, there are also alternatives to strengthen the supervision of insolvency procedures. One of them is to assign creditors a leading role through the Creditors’ Committee. An alternative would be to strengthening the informative duties of office holders to provide information and to increase the challenging powers of individual creditors and the debtor, although this solution might cause procedural delays if not adequately regulated and implemented. What is important is to provide the parties in the insolvency case with direct channels to reduce the risks created by the judge-commissioner’s work overload, as they are the ones with the highest interest to ensure that things are conducted according to the law.

2. Insufficient Regulation of the Insolvency Profession

From the interviews conducted during the May 2012 mission, it soon became clear that one constraint preventing speedier bankruptcy proceedings, and proceedings resulting in reorganization rather than liquidation, is the current rules relating to trustees, court supervisors and receivers (office holders or insolvency practitioners). According to the current framework, only the court may appoint office holders from a list approved by the Ministry of Justice. An insolvency practitioner needs to obtain a license to be included on the list, and the requirements are 3 years’ of relevant experience in company management and a written examination. While many stakeholders reported that the framework for trustees has improved and more skilled

95 See Arts 151 to 155 of the BRL.
professionals are now entering the market, concerns remain that the system is not adequate to ensure the competence of insolvency practitioners.

Unlike bailiffs, lawyers and notaries, insolvency practitioners are not regulated by law. There is a voluntary informal Association of Trustees which includes about 130 members, but it is unclear how membership is granted. The Association has its own Code of Conduct, but there are no formal consequences should a member breach the rules. There is no independent regulatory body responsible for setting standards and regulating the profession. It is important that the insolvency profession accepts the responsibility for setting professional standards that demonstrate their technical ability.

In addition, the manner in which office holder’s remuneration is determined acts as a disincentive for skilled experienced financial advisors to enter the profession, and creates a reverse incentive for trustees to prolong insolvency proceedings. Currently, trustees’ remuneration may not exceed 3 % of the bankruptcy estate funds or 140 times the average monthly salary in the enterprise sector.

For example, in the UK, if there is a creditors’ committee, the committee will determine the basis of the remuneration. If there is no creditors’ committee, the remuneration can be fixed by the general body of creditors or by the court. In the latter case, a creditor can challenge the remuneration. In Spain, the fees of the receivers are determined by law, and are based on the volume of the assets and the complexity of the insolvency proceeding.

Most insolvency practitioners in Poland are involved primarily with liquidation cases rather than business reorganizations. The skills necessary for business reorganization should therefore be among the subjects the for training and qualification of insolvency practitioners. It is a matter of some importance that the insolvency profession accepts the responsibility for setting the professional standards that demonstrate their technical ability.

3. Lack of stakeholder awareness of the bankruptcy laws

During interviews with the various stakeholders during the May 2012 mission, it became apparent that one of the reasons the bankruptcy regime in Poland is not as effective as it could be, is because of a lack of awareness amongst stakeholders as to their rights and obligations under the law. Some interviewees pointed out that directors do not comply with the law as they do not know what the law is, or where they do know something of the law this knowledge is often tainted by half-truths as to the consequences of their actions as directors. From the interviews conducted with stakeholders it would appear that this lack of awareness is a lot wider than just directors of companies, and that there could be a lack of awareness amongst some of the major stakeholders as well as amongst the general public.

96 During the May 2012 mission it was reported that the length of insolvency proceedings may be affected by informal payments for trustees from service firms, including accounting, tax and legal services, subcontracted in the insolvency proceedings.
B. SUBSTANTIVE BANKRUPTCY AND ASSOCIATED LEGISLATION

1. Bankruptcy Process is Convoluted and Slow and Open to Abuse

There is a concern among stakeholders that creditors often file for insolvency with the exclusive objective of exerting pressure on the debtor to execute the payment of the debt, rather than enforcing their debt through ordinary courts. The reason for this is that the cost of filing for insolvency proceedings is fixed at approximately EUR250, while the fee for the filing of a regular contract enforcement claim is 5% of the value of the claim (up to a PLN100,000 cap). The creditor’s goal in such cases is not to have the debtor declared bankrupt, but rather to put pressure on the debtor to recover the full amount of the debt through voluntary payment.

Deficiencies in the manner in which courts handle bankruptcy cases cause delays in case management. As discussed earlier, the bankruptcy process in Poland tends to be overly formalistic. During the interviews with stakeholders it was stated that cases can be rejected by the bankruptcy judge for relatively minor deficiencies in paperwork. The table below outlines the outcome of cases registered with bankruptcy courts between 2004 and 2010. As can be seen, the trend indicates a rise in the rejection of motions for procedural reasons. (Table 1)

Table 1: Method of handling cases registered with bankruptcy courts between 2004 and 2010

<table>
<thead>
<tr>
<th>Year</th>
<th>Bankruptcy declaration with liquidation</th>
<th>Bankruptcy declaration with composition option</th>
<th>Total</th>
<th>Valid motion return and rejection</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>925</td>
<td>240</td>
<td>590</td>
<td>5156</td>
</tr>
<tr>
<td>2005</td>
<td>230</td>
<td>105</td>
<td>335</td>
<td>516</td>
</tr>
<tr>
<td>2006</td>
<td>3695</td>
<td>105</td>
<td>3800</td>
<td>5484</td>
</tr>
<tr>
<td>2007</td>
<td>2715</td>
<td>105</td>
<td>2820</td>
<td>3901</td>
</tr>
<tr>
<td>2008</td>
<td>2690</td>
<td>105</td>
<td>2820</td>
<td>3901</td>
</tr>
<tr>
<td>2009</td>
<td>2402</td>
<td>105</td>
<td>2507</td>
<td>3562</td>
</tr>
<tr>
<td>2010</td>
<td>2374</td>
<td>105</td>
<td>2479</td>
<td>3742</td>
</tr>
</tbody>
</table>

Source: Dr. Sylwia Morawska’s compilation, as reported in Diagram 11 of “Effectiveness, efficiency, and expediency of bankruptcy proceedings in Poland”
2. Directors’ Obligations Are Not Enforced

2.1 Non-compliance with the duty to file by directors and lack of enforcement of current sanctions

Directors are required to file an insolvency petition within two weeks from the moment the company becomes insolvent. However, practice shows that this rule is often not complied with. By the time directors file, the company’s financial situation has deteriorated too far for rescue; usually the “best interests” test, the test a company must meet to qualify for reorganization, can no longer be met by the time filing takes place. One reason may be that the time a company is given to file is too short for it to sufficiently evaluate information in order to objectively determine insolvency and complete the necessary documents for the petition. Another reason that may explain the lack of compliance with the rule is the lack of enforcement of directors’ liability.

However, even if a more realistic timeline is enacted in the law, it is no guarantee that cases will be filed soon enough for a rehabilitation proceeding to succeed. The goal of a legal change to file earlier would only makes sense if stakeholders are made aware of the fact that it is only beneficial while the company is still viable, in order to give it a chance for rehabilitation through the relevant legal proceeding. This may require them to monitor the company’s financial situation at an earlier stage of financial distress, and to involve creditors at this earlier stage. It requires assisting the business community in changing its culture to embrace rehabilitation as a possible alternative to liquidation.

2.2 Law relating to vulnerable transactions is weak

There are reportedly only two reasons for the widespread lack of compliance with the duty to file for insolvency: 1) stakeholders report that most directors are unaware of their legal duties in regard to filing for insolvency, and 2) those who do know do not fear reprisal for failing to file in time, as this requirement has to date not been enforced in practice. Stakeholders report that few directors have faced enforcement cases for delays on reporting, and even fewer have been held liable. Company directors do not face a threat sufficiently serious to comply with their duty.

Inadequate management to the detriment of creditors on the eve of insolvency is often not effectively prosecuted because of the requirement that the insolvent company has to be able to cover the cost of the bankruptcy proceedings. As mentioned above, directors often file for insolvency when the company is no longer viable, and remaining funds can are insufficient to even cover the costs and fees of administration. Not proceeding with the bankruptcy in such cases creates an opportunity for directors to avoid liability for late filing. It also results in an increasing stock of “zombie” companies, with no parties interested or obliged to finalize the insolvency proceedings.

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97 At least one of the two substantive insolvency tests must be met under Art 10 of the BRL: (1) the liquidity test – when the debtor fails to satisfy its due (monetary) debts; or (2) the balance sheet test – when the liabilities of the debtor exceed its assets (Art 11 of the BRL).
98 The 14 day requirement to file for bankruptcy is one of the shortest in Europe, and it could be considered unrealistically harsh on business managers.
99 See, Part Three of this Report for specific recommendations.
The law should impose liability on directors that knew or should have known that the business was insolvent and did not take steps to protect creditors. Directors should be educated on their obligations and those that violate it should be investigated and prosecuted to demonstrate the consequences of noncompliance. In certain circumstances, the strict obligation to file for insolvency may discourage debtors from pursuing alternative solutions to its financial difficulties. This rule could therefore perhaps be softened to allow for sufficient flexibility aimed at encouraging restructuring, such as the possibility of directors negotiating a voluntary restructuring agreement with the creditors.  

3. Non-Participation by Creditors

The introduction of bankruptcy subject to an arrangement is not achieving the desired effect, in part because it takes too long for the list of creditors to be finalised and for the first meeting of creditors to be summoned and formed. In addition, the Creditors’ Committee is rarely formed and, thus, creditors do not have an effective voice in the manner in which the proceedings are conducted. Improving the rules that regulate the formation of creditors’ committees and introducing more effective mechanisms for the individual notification of creditors, could improve this situation.

Creditors do not have the ability to select a trustee according to the law. Although they may suggest one to the court during bankruptcy proceedings, they rarely exercise this right. In fact, stakeholders reported that the effect of the creditors’ proposal of a specific office holder often has the opposite effect, in that the nominated person does not usually get approved. The process also lacks the necessary transparency to ensure fairness in the appointment of office holders. Some interviewees stated that more input from the creditors would be desirable, but no issues relating to corruption or bad practice were identified.

4. The Need to Provide for Clearer Tax Rules and Guidelines in Bankruptcy

4.1 Introduction

As stated in the previous section, the tax policies as they intersect with bankruptcy are not currently supportive of restructurings. The ability of tax authorities to compromise tax debt has not been clarified among policymakers, despite language in the law that suggests that it is allowed. EU State Aid policy is also cited as a concern, though the ECJ standard would allow generous tax compromise by authorities, as it states that they may act as private-sector creditors would to maximize their collections, which means preservation of the company. Further, though many tax officials do cooperate in reducing taxes, there is no uniform approach, no consistency, nor any official guidelines.

Loan losses also are not deductible for creditors. Loans stay on the asset side of the balance sheet even when they are uncollectible. This provides a disincentive to creditors to reduce loans and thus reduce the asset side of their balance sheets.

100 See, UNCITRAL Legislative Guide on Insolvency Law, part two, chap IV, paras. 76-90.
In the table below, Dr. Morawska analyzed the relationship between the value of public dues, private dues and the total value of the bankruptcy estate funds, in bankruptcy proceedings of 5 cities in Poland. Following these results, her study suggests that the priority given to the recovery of public debt in Poland might lower the interest of private creditors to file for bankruptcy proceedings. (Table 2)

Table 2: Public dues in bankruptcy proceedings between 2004 and 2010 – results of studies

<table>
<thead>
<tr>
<th>No.</th>
<th>Court</th>
<th>Bankruptcy estate funds</th>
<th>Public dues</th>
<th>% of recovered public dues</th>
<th>Private dues</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>District Court for Kraków – Śródmieście in Kraków, VIII Commercial Division for Bankruptcy and Rehabilitation</td>
<td>94 809 988</td>
<td>39 393 676</td>
<td>61</td>
<td>186 992 569</td>
</tr>
<tr>
<td>2.</td>
<td>District Court in Białystok, Commercial Division</td>
<td>39 114 955</td>
<td>99 683 404</td>
<td>22</td>
<td>71 788 241</td>
</tr>
<tr>
<td>3.</td>
<td>District Court for Wrocław Fabryczna, VII Commercial Division for Bankruptcy and Rehabilitation</td>
<td>357 450 163</td>
<td>111 913 736</td>
<td>100</td>
<td>561 583 584</td>
</tr>
<tr>
<td>4.</td>
<td>District Court for the Capital City of Warsaw, X Commercial Division for Bankruptcy and Rehabilitation</td>
<td>1 153</td>
<td>2 784 802 422</td>
<td>32</td>
<td>5 224 252</td>
</tr>
</tbody>
</table>

Source: Dr. Sylwia Morawska’s compilation, based on completed research, as reported in Table 3 of “Effectiveness, efficiency and expediency of bankruptcy proceedings in Poland”

4.2 Tax Authority as a Creditor

As previously discussed, tax claims currently receive priority in Polish bankruptcy proceedings. Article 342 of the BRL which sets out 5 categories of priorities for receivables to be satisfied from the bankruptcy estate put tax claims in category 3 – after the costs of the bankruptcy proceedings and receivables under employment relationships. It is considered as best international standard (World Bank ICR /UNICTRAL) that the preferences of tax claims be eliminated or at least limited to the extent possible. However, distribution policies also often recognize important public interests (such as the protection of employment). If the Government chooses to keep the priority of tax claims, it is desirable that the policy reasons for establishing such priority be clearly stated in the law. This approach would at least provide

transparency and predictability in the area of claims, distribution and the establishment of creditor classes under a reorganization plan.

In regard to tax forgiveness, although stakeholders reported that they are not sure if tax debt can be forgiven (rather than simply re-scheduled in installments), Polish law seems to allow compromise of tax debts for restructuring purposes. The relevant language of the Tax Ordinance Act, Chapter 7a, Article 67b, Section 1, Reliefs Concerning Repayment of Tax Obligations,\textsuperscript{102} states:

\begin{quote}
Upon application of a taxpayer pursuing an economic activity, the tax authority may grant the reliefs concerning repayment of tax obligations specified in Article 67a:

3) which constitute public aid:

\begin{itemize}
\item [(ii)] for restructuring
\end{itemize}
\end{quote}

From the language of the law it appears that the authorities are legally empowered to compromise a debtor’s outstanding tax obligations within a restructuring proceeding. There is no indication that the forgiveness needs to be within a formal insolvency proceeding. However, tax authorities remain unsure as to their exact authority to compromise tax obligations, some citing that “restructuring” is not specific enough to clarify the type of proceeding within which tax obligations may be compromised. There seems to be a fear that tax debtors could abuse “restructuring” processes, whether in-court or out-of-court, formal or informal, if they became a regular vehicle for tax debt relief.

Nevertheless the Polish tax authorities seem to be flexible in practice and generally act in the interest of the public, i.e. if payment of tax debt can lead to job dismissals, authorities would be willing to re-schedule installments. Small amounts are regularly written off. However, as stated above, the authorities have indicated that is not clear if they can write off debt in the case of an out-of-court restructuring, even though the language of the law, as quoted above, suggests no impediment, whether the restructuring is in court or out of court. It seems that, as a general principle, tax authorities are active in insolvency cases and are willing to write off tax debt. There is no unified tax policy on debt forgiveness and the decision is left to the discretion of local tax agencies. At the local level, an individual must justify his tax relief request to a collective body, the Rada Gminy. There is a suggestion that badly written applications are a problem, and result in denial of relief. An official format or guidance could help such taxpayers in applying for relief.

The lack of a clear, written tax policy on debt forgiveness makes the insolvency and restructuring process unpredictable in Poland. Unpredictability in tax policy affects creditors negatively, as they cannot predict with certainty how much of a debtor’s estate in insolvency will be applied to overdue tax payment.

\textsuperscript{102} Tax Ordinance Act dated 29 August 1997.
4.3 **Tax Treatment of Debt and Debt Forgiveness / Restructuring**

As discussed earlier, in Poland, the deferral of a debt repayment or its division into installments, as well as reducing the security over a claim, is generally tax neutral for both the debtor and the creditor. The 2008 ICR ROSC revealed that that the tax law treats the forgiveness of a debt as income for the debtor, thus providing a major disincentive to such arrangements. However, the tax law excludes the redeemed obligations (including loan obligations) from taxable income if the forgiveness of a debt is connected with:

- bank settlement proceedings within the meaning of the provisions on financial restructuring of enterprises and banks;
- bankruptcy proceedings aimed at an arrangement (i.e., bankruptcy proceedings without the liquidation of the assets) according to provisions in the Bankruptcy and Restructuring Law, or;
- the implementation of a restructuring programme under separate legislative provisions (these restructuring programs basically pertain to selected enterprises operating in the steel and sulphur mining industries, as well as to public health care centres and the armed forces of Poland).

According to the 2008 ICR ROSC, Polish tax law only provides special tax relief for debtors in connection with bankruptcy proceedings aimed at an arrangement, and not in relation to restructuring proceedings (whose purpose is basically also the prevention of liquidation of the debtor’s assets).

From the creditors side, the forgiven debt does not constitute a tax deductible item. However, in cases where the receivable has been reported as taxable revenue, the taxpayers should have the possibility of treating such forgiven receivables as tax deductible costs (Article 16 section 1 point 44 of the Polish Corporate Income Tax Law).

As regards to forgiveness of loans and credits, only to the extent that the forgiveness of a bank loan (credit) obligation is linked to one of the above proceedings may the debt forgiven be treated by the creditor as a tax-deductible cost (with the exception of forgiven interest). Provisions of this nature, that limit the debt relief available to banks, also distort their balance sheets. Banks are motivated to continue to carry loans to financially troubled customers as “assets”, even though they are in reality no longer producing income, and are, in fact, losses. In further research, it will be worthwhile documenting:

- how lenders account for bad loans that are not collectible; and
- whether lenders file bankruptcies against debtors in order to obtain the loan write-off, rather than in the hope of collection.

Forgiveness of a loan granted between non-banking entities (i.e. not a bank loan) does not allow the creditor to treat the principal of the loan or the interest as a tax deductible item (neither the principal of the loan nor the interest was treated as taxable revenue and therefore it cannot be recognized as tax deductible cost).
4.4 Implications of debt forgiveness as State Aid and EU Policy

Stakeholders’ interviews revealed differences in the perception as to the attitude of Tax Authorities concerning rescheduling and write offs: while some stakeholders stated that tax authorities cannot forgive debt due to EU restrictions on State Aid, the authorities themselves confirm that such restrictions are waived for certain groups of tax payers, and are generally not applied in insolvency cases. The Tax Ordinance Act, Chapter 7a, Articles 67 a and b, states that taxes can be annulled if they constitute de minimis aid “to the extent and upon principles specified in directly applicable acts of the Community law on aid granted according to de minimis principle”. The current European Court of Justice dicta on State Aid is to allow tax agencies to vote as a private, value-maximizing creditor would (“the 'private creditor test'”). Thus, it is within the EU standard to allow write offs when that allows a viable business to be rescued, since it brings the tax authority more revenue in the future. There should not be therefore any EU limits on Poland’s ability to allow tax forgiveness within bankruptcy and restructuring cases.

5. Corporate Rescue Proceedings are Ineffective

5.1 Liquidation culture still exists despite the possibility of a formal restructuring

From interviews conducted with stakeholders during the May 2012 mission it is clear that Poland still has a liquidation culture when it comes to insolvency. Some interviewees were of the opinion that the courts are to blame as their approach is very conservative and they still follow the liquidation route. It also became apparent from the interviews that the rescue procedure contained in the BRL is not widely used, although it was stated by one interviewee that the restructuring of companies had improved post-ROSC. From the interviews it also became apparent that the following contributed to the continued non-existence of a rescue culture in Poland:

- there is a lack of awareness amongst directors of companies as to the availability of the rescue procedure;
- there is no universal approach of bankruptcy courts regarding the rescue procedure, some courts encourage it much often than others;
- judges do not have the correct mindset when it comes to rescue;
- there is a lack of incentive due to the low fees paid to insolvency administrators;
- there is too much court involvement in the insolvency process.

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104 See, Frucona Kőśke a. s. v European Commission, Case C-73/11 P, par. 3 and 58. See also, Déménagements-Manutention Transport SA (DMT), Case C-256/97, par. 30.
As demonstrated by the table below, from 2004 to 2010, bankruptcy courts in Poland have significantly favoured liquidation as opposed to rescue procedures in handling bankruptcy cases. (Table 3)

Table 3: Method of handling cases registered with bankruptcy courts between 2004 and 2010

<table>
<thead>
<tr>
<th>Year</th>
<th>Bankruptcy declaration with liquidation</th>
<th>Bankruptcy declaration with composition option</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>7315</td>
<td>240</td>
<td>559</td>
</tr>
<tr>
<td>2005</td>
<td>5484</td>
<td>663</td>
<td>121</td>
</tr>
<tr>
<td>2006</td>
<td>3901</td>
<td>516</td>
<td>171</td>
</tr>
<tr>
<td>2007</td>
<td>2690</td>
<td>390</td>
<td>105</td>
</tr>
<tr>
<td>2008</td>
<td>2402</td>
<td>3562</td>
<td>125</td>
</tr>
<tr>
<td>2009</td>
<td>3562</td>
<td>580</td>
<td>125</td>
</tr>
<tr>
<td>2010</td>
<td>3742</td>
<td>559</td>
<td>125</td>
</tr>
</tbody>
</table>

Source: Dr. Sylwia Morawska’s compilation, as reported in Diagram 9 of “Effectiveness, efficiency and expediency of bankruptcy proceedings in Poland”

5.2 No provision for post-commencement financing

As already pointed out, Polish law does not allow for priority repayment of financing provided to a company during its reorganization. This hampers post-commencement financing and is a disincentive for possible investors. Financing during the rescue period has been an important part of the rescue culture in countries where business reorganization under the insolvency law has been successful.105

Banking legislation concerning risk management is also a hurdle to the rescue of insolvent companies.106 While the Bankruptcy and Restructuring Law allows for debtors in possession to take additional credit with the consent of the creditors, the Banking Law does not contain any special provisions on the possibility of insolvent companies to take credit in certain circumstances. Until both sets of rules are

105 For example, there is an established practice in Germany that creditors grant a loan to the insolvency administrator and according to the general law such loan is a preferred claim in the rank addressed by sec. 55 of the German Bankruptcy Law. In Italy, Germany, Spain and France post – commencement financing is less problematic than in other EU member states because it is considered an administrative expense of the bankruptcy and satisfied in first instance with the approval of the court. See, European Parliament, Directorate General for Internal Policies, “Harmonization of Insolvency Law at EU level” 2010.

106 This situation has not changed since 2008. The 2008 ICR ROSC found that banking regulations in Poland require the potential borrower to be creditworthy to be granted a credit, which is difficult for an insolvent entity even when it is under the control of a judge-commissioner.
amended and coordinated, the rescue of troubled businesses will be all but an impossibility.

The sale of a business as a going concern, which can produce greater returns to both creditors and debtors and preserve the business itself and the jobs connected to it, is also inhibited by the current legal framework. If an insolvency proceeding results in the sale of the business as a going concern, the assets of the business are not transferred free of encumbrances, which is a serious disincentive to prospective purchasers.

5.3 Non-engagement by creditors in the corporate rescue procedure

The introduction of an arrangement proceeding is currently not achieving the desired effect, in part because it takes too long for the list of creditors to be finalised and for the first meeting of creditors to be summoned and formed. In addition, the Creditors’ Committee is rarely formed and, thus, creditors do not have an effective voice in the manner in which the proceedings are conducted. Introducing rules that regulate the individual notification of creditors on the commencement of the bankruptcy proceedings, and improving the existing rules on the formation of creditors’ committees, could improve this situation.

Creditors do not have the ability to select an office holder according to the law, and in practice, their suggestions are usually rejected by judge-commissioners. In addition, they rarely exercise their right to make suggestions due to low expectations of the impact of the suggestion. The current process of appointing an office holder does not seem to be based on any objective criteria, but is left to the full discretion of the judge, creating opportunities of favoritism in the appointment of certain persons as the office holder. The process also lacks the necessary transparency to ensure fairness in the appointment of office holders. Some interviewees stated that more input from the creditors would be desirable, but no issues relating to corruption or bad practice were identified.

5.4 No provision is made for out-of-court settlements and corporate workouts involving the banking community

Lenders often engage in informal negotiations as they will likely recover more that way than in court. Recalcitrant debtors often use delaying tactics in the courts, which cost the creditors time and additional expenses. The enforcement of security rights is slow and inefficient. In the case of small and medium companies there is a common practice of bilateral negotiations with the bank, often resulting in the rescheduling of debt.

Beyond bilateral debt rescheduling, there seemed to be no common practice of informal workouts in 2008. During the most recent mission in May 2012, big commercial banks reported that as long as the debtor is of a considerable size, they would be willing to attempt out-of-court restructuring methods which go beyond mere debt rescheduling, for example the restructuring of a company’s operations or the recapitalization of the company through debt-for-equity swaps. Less often they would be persuaded to inject additional capital into the company, exchange one secured asset for another and, in very rare cases, reducing the debt owed by the company.
Banks reported that they are prepared to engage in voluntary restructuring negotiations in multiple-creditor settings in order to avoid the commencement of court proceedings. Typically banks will enter into a standstill agreement with the debtor, which in some cases are only informally agreed (so-called “gentleman’s agreements”). In cases where the banks have very large exposures and multi-lateral lending facilities, steering committees may be created.

There is no out-of-court code of conduct that has been adopted by the financial sector in Poland. The absence of a legal or even quasi-legal environment that facilitates corporate restructuring means that there is no effective backdrop against which informal workouts can take place.\footnote{Many EU member states have introduced out of court guidelines similar to the “London Approach” (i.e., widely used set of principles which govern how UK banks respond to news of serious financial difficulty in one of their corporate customers, developed by banks in the UK, with considerable leadership from the Bank of England). For example, in 2010, the Hungarian Banking Association signed a recommendation for a self-regulating model for dealing with companies in financial distress. The recommendations, commonly referred to as the “Budapest Principles” (corresponding to the London Approach), is a voluntary code of conduct – banks signing up to the code agree to consider on a case-by-case basis whether the principles could be applied to a debtor in a specific case. As of February 2012, nine Hungarian banks (including the three largest) have signed up to the code. See, \url{http://business-finance-restructuring.weil.com/cross-border-update/dead-or-alive-liquidation-or-restructuring-under-the-hungarian-insolvency-lawpart-3-out-of-court-workouts/#ixzz27kdN8Nf}} There are disparate opinions as to the need for the introduction of such a code in Poland.
PART THREE

RECOMMENDATIONS FOR REFORM

A. INTRODUCTION

An efficient insolvency regime provides the framework necessary to handle every possible phase dealing with an insolvent debtor. In regard to legal entities such as companies, it should include effective measures that permit both informal (out-of-court) and formal restructurings as well as the liquidation and eventual cancellation of the entity from the Registry. It is trite to state that an effective bankruptcy law should provide for the speedy, efficient and effective resolution of a debtor’s financial problems.

An efficient and effective bankruptcy regime is one that addresses the socio-economic imperatives present in that particular jurisdiction, and that can adapt to the challenges of the society within which it operates. A bankruptcy regime should not be a static collection of legislative provisions, but a collection of laws that are regularly reviewed and updated in order to ensure that they are still achieving the objective they have been designed for.

A key part of any efficient and effective bankruptcy system is the institutional infrastructure within which it operates. Even the best and most elaborate bankruptcy laws are useless if they cannot be implemented effectively. As has already been observed in Part Two of this Report, some of the problems experienced with the current Polish insolvency law relate to matters of implementation. There is therefore a strong argument that it is necessary to address existing implementation difficulties as part of any reform exercise. Insofar as the present shortcomings of the Polish bankruptcy system do relate to matters of implementation rather than legal provision, such shortcomings are not likely to be addressed effectively by the adoption of new legislative provisions.

It is for these reasons that the recommendations made in this Report include suggestions for the improvement of existing delivery mechanisms.

PLEASE NOTE:

In what follows, the notation “LR” is intended to suggest that what is being contemplated can only be achieved by means of additional legislation; the notation “RR” is intended to suggest that what is being contemplated may be achieved by means of regulatory reform, ministerial decision, and decree or guidance notes issued by an appropriate authority. In the latter case, the determination of whether the particular reform is better served by legislative reform or regulatory reform is a matter of local expertise and policy. In addition, under each of the recommendations below it has been indicated whether the suggested reforms should be achieved in the short- or medium-term.
B. INSTITUTIONAL FRAMEWORK

1. Recommendations

1.1 Improve the capability of the court system

**RR and LR (medium-term):** The first manner in which the capability of the court system can be improved involves taking steps to improve the resources available to the courts in bankruptcy cases. These measures include the appointment of additional support personnel to assist judges in the exercise of their functions (medium-term); improvements to the administrative infrastructure used by judges in their work (for example, the introduction of a modern case management system and adequate IT instruments) (medium-term); and increasing the level of commitment to specialised bankruptcy courts by providing effective training and enhanced specialisation for bankruptcy judges (medium-term).

It is accepted that this manner of improving the capability of the court system can only be achieved at an additional cost. However, the overall costs can, over time, be reduced in many ways, for example by charging users for their use of the systems, and savings through the computerisation of some of the court services.

From interviews conducted with stakeholders, it is clear that the general view is that the courts act too slowly in bankruptcy proceedings, thereby reducing the effectiveness of the insolvency legislation in returning value to creditors. There appear to be a number of factors that contribute to this, for example a lack of support staff, antiquated case management systems, lack of IT support and a lack of effective specialised training in the field of bankruptcy. Increasing the number of support staff for judges should significantly improve the position, freeing up more time for judges to focus on their important work as bankruptcy judges.

The introduction of modern and effective IT solutions would significantly improve the case management systems used by the courts, and would also make the discovery and dissemination of information more readily available to all the stakeholders. IT solutions will have the added benefit of adding transparency to the bankruptcy system, and may even be able to take over functions that are currently performed by staff. IT reform could also be a helpful tool in enabling courts to speed up proceedings, for example, individual notification of all creditors by electronic means could result in faster and more effective creditor participation from the beginning of the insolvency proceedings.

In addition, Polish law does not contain any specific provisions regarding the competence, performance or qualifications of bankruptcy court judges in particular. Judges require continuing professional education in a wide variety of matters, particularly those relating to finance and commerce, for more than 5 days per annum. It is especially important that bankruptcy judges receive specialized training in matters dealing with corporate rescue. If the 5 days per annum mandatory training remains in place, bankruptcy judges should be required to take specialized training and not be offered a choice of subject matter. This training needs to be provided by experienced practitioners and not simply by academics that in many cases tend to lack practical commercial experience.
Another apparent problem is the frequent rotation of judges out of the bankruptcy courts. Since bankruptcy divisions are within the low level first instance commercial courts, judges are assigned to them soon after they graduate from law school. After just a few years, bankruptcy judges move from the bankruptcy courts to the higher courts where there are no bankruptcy cases. It is almost impossible for judges to specialize in such a complex process (bankruptcy) without sufficient time spent in a bankruptcy court. Moreover, transferring experienced judges out of the bankruptcy courts takes the knowledge and the experience they have built up over years out of the court system. There is no equivalent bankruptcy division in the higher courts to which bankruptcy judges can be promoted, so in practice the promotion of judges undermines the objective of creating judges that are bankruptcy specialists. Consequently there is a need to be able to transfer complex commercial cases to a higher level court, or to refer these cases to trained specialist judges, especially in insolvency and debt enforcement cases.

**LR (short-term): Certain measures to improve** the capability of the court system and to make the judicial function in bankruptcy easier to perform demand legal reform. Legal amendments would concentrate on imposing a prescriptive approach to the manner in which particular kinds of cases, or aspects of cases, are to be dealt with by both the courts and those stakeholders participating in the process.

If the creditor and the trustee or debtor (as the case may be) agree on the amount of the claim, there should be no need for a hearing and the claim should be accepted. In the majority of cases a hearing should only necessary if it it is the only manner in which to adequately provide evidence, and even then this should take place in an expedited manner. Convening a hearing to determine each and every claim in a particular case is burdensome on the court system, and in slowing down the administration of the case lowers all creditors’ recovery rates as the value of assets can erode quickly over time.

In order to alleviate these problems, the courts should be enabled to hear connected matters in within the same bankruptcy to accelerate the delivery of judicial decisions. The impact of challenges against the list of creditors should be reduced by constraining the scope of the bankruptcy judge to insolvency matters, and by limiting hearings and other non-written procedural acts by parties to cases where such a course of action it is justified. Wherever reasonable and possible, shorter time limits should be imposed in which decisions are to be made by the court, or in regard to steps taken by any of the participants in the process.

1.2 **Enhance the training, regulation and supervision of insolvency practitioners**

**RR and LR (short- and medium-term):** Although the Insolvency Receiver License Act of 2007 requires insolvency practitioners to meet certain minimum requirements before they can be registered and licensed (i.e. minimum qualification, relevant experience, character and a written examination in insolvency law), it is clear that the current provisions relating to insolvency practitioners can be improved by enhancing regulation, supervision and remuneration. Enhanced regulation could be achieved by introducing a code of professional conduct, establishing a statutorily recognised body of insolvency professionals and by introducing specialised educational programmes.
especially in regard to corporate rescue (RR and LR, medium-term). *Enhanced supervision* could be achieved by strengthening the provisions dealing with creditors’ committees and by changing the manner in which insolvency practitioners are supervised by judge-commissioners (LR, medium-term); the manner in which insolvency practitioners are *remunerated* can be addressed by introducing a more flexible method of determining their remuneration, for example by allowing a creditors’ committee to approve any one of a number of methods of calculating the remuneration, including added incentives or bonuses for successful reorganisations (LR, short-term).

It is clear that one constraint preventing speedier bankruptcy proceedings, and proceedings resulting in reorganization rather than liquidation, is the current regulation of office holders. According to the current framework, only the court may appoint office holders from a list approved by the Ministry of Justice. An office holder needs to obtain a license to be included on the list, and the requirements are 3 years’ of experience in company management and a written examination. While many stakeholders reported that the framework for office holders has improved and more skilled professionals are now entering the market, concerns remain that the system is not adequate to ensure the competence of insolvency practitioners. Most insolvency practitioners are involved primarily with liquidation cases rather than business reorganizations, and consequently the skills required for business reorganization should be among the subjects for the training and qualification of insolvency practitioners. Since most insolvency practitioners are involved primarily with bankruptcy cases rather than business reorganizations, it is a matter of some importance that the insolvency profession accepts responsibility for setting the professional standards that demonstrate their technical ability.

Establishing a regulatory body for insolvency practitioners would build on the existing regulation of the trustees’ profession, enabling it to introduce a formally enforced code of conduct and introducing formal training to develop different skill sets for liquidators and bankruptcy administrators. The establishment of an independent, statutory regulatory body should then address issues such as the following:

**Standards of Professional Conduct**

- By primary legislation, basic, fundamental standards that are critical to proper professional conduct on the part of office holders; and
- By secondary legislation, standards relating to such matters as reports, the collection and safeguarding of assets, trading of the debtor’s business subsequent to the commencement of the insolvency proceedings, keeping of records, convening and conduct of creditors meetings, sale and other disposal of assets, opening and operation of bank accounts, and the contents of reorganisation plans and explanatory memoranda.

**Supervision**

That the performance of an office holder in an insolvency case be monitored. Monitoring can be achieved by different means: a) concerning control over a specific procedure: increase in the information duties and open procedural paths for parties to the proceedings; increase in the monitoring
powers and refinement of the design of the creditors’ committee; direct access to a monitoring committee of the insolvency practitioners’ body; creation of an ombudsman to control insolvency practitioners; etc. b) concerning control over the general activity of each insolvency practitioner: random, periodic inspections on insolvency practitioners by the regulatory body/public agency; periodic rendering of accounts to the regulatory body/agency, etc.108

Regulatory and Disciplinary Functions

- For a recognised professional association to have appropriate regulatory, investigatory and disciplinary powers in respect of office holders;
- The powers of such a regulatory body, including the power to investigate the conduct of an office holder upon a referral from a court, upon the complaint of an affected third party or on its own motion; to intervene and be heard on any application to a court concerning the conduct of an office holder or for the removal of an office holder from an insolvency case and impose disciplinary measures upon an office holder in respect of whom misconduct has been established; and
- Provide that disciplinary powers include a power to impose a fine upon an office holder; suspend or terminate the license of an office holder; require that an office holder compensate third parties who have been affected by the misconduct of an office holder; require that the office holder undergo further education and training and provide for a right of appeal from the exercise of a disciplinary power.

Code of Ethics

- The law should encourage and facilitate the development of a code of ethics for office holders, preferably through a professional body, to deal with appropriate conduct including the need for independence, impartiality, integrity and accountability, the need to avoid the perception of possible conflicts of interest and the need for proper conduct between office holders.

Review of Office Holder Appointment

- The grounds upon which an appointment may be reviewed for disciplinary or other reasons (e.g. conflict of interest);
- A process for a review.

Removal or Suspension / Cancellation of License

- The grounds upon which an office holder may have their license suspended or revoked (e.g. gross negligence or fraud/criminal activity); and
- The process for the removal of an office holder.

The manner in which a trustee’s remuneration is determined currently acts as a disincentive for skilled experienced financial advisors to enter the profession, and causes a reverse incentive for trustees to prolong insolvency proceedings. Currently a trustee’s remuneration may not exceed 3 % of the bankruptcy estate funds, or 140 times the average monthly salary in the enterprise sector. The manner in which this problem can be alleviated is by revising the manner in which an insolvency

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108 See, in particular, the World Bank Issues Note on Insolvency Practitioners, where there is a choice menu for this.
practitioner’s remuneration is determined in line with international best practices. Additional incentives, for example the payment of bonuses to bankruptcy administrators for successful reorganizations, should also be considered.

In international terms there are various methods that can be employed in determining an insolvency practitioner’s remuneration. Each of these methods has both advantages and disadvantages:

*A fixed percentage of realizations*

**Advantages:**
- Encourages maximizing realizations; straightforward and simple to calculate; permits fees to be calculated with relative certainty.

**Disadvantages:**
- Can over-reward office-holders; there is often no connection between the complexity of the case and the fee.

*A fixed percentage of distribution to creditors*

**Advantages:**
- Incentivizes making maximum return to creditors.

**Disadvantages:**
- May under-reward office holders; there is often no connection between the complexity of the case and the fee.

*Time related charges of the office holder and his/her staff*

**Advantages:**
- Safeguards against excessive time being claimed.

**Disadvantages:**
- Cost implications as it requires practitioners to have complex time recording systems for all of their staff; there is often no connection between the fee and the return to creditors.

*A statutory scale related to the number of creditors, value of assets and other pre-determined factors*

**Advantages:**
- Fee is in relation to the size of the case and the amount of work needed to be undertaken.

**Disadvantages:**
- Complex, as it requires a multitude of small allowances to be made for, e.g., the number of letters written, the number of employees and other creditors.

The first option is often used in jurisdictions where the integrity and / or competence of the insolvency administrator is a concern. However, this option can often result in fees being claimed that are not commensurate with the amount of work undertaken by the practitioner. In some jurisdictions, such as in the UK, the method is not prescribed; it is left to the creditors’ committee to determine which of the above methods will be used. This option, however, requires an actively involved creditors’ committee. A good option for Poland could be Spain model - a variation of the first method, but also accounting for the complexity of the case, i.e. the fees of the receivers are determined by law, and are based on the volume of the assets and the complexity of the insolvency proceeding.
1.3 Establish informal, out-of-court restructuring mechanisms

**RR (medium-term):** While there are formal corporate rescue mechanisms in place under the Polish bankruptcy law, it is clear that these are not used effectively in practice, or are applied at a stage when it is too late to save an ailing debtor. There is a widely-held view that the chances of rescuing of a financially distressed debtor are improved if its financial problems are addressed as early as possible. Informal out-of-court restructurings often achieve this objective by allowing a new deal to be negotiated between the debtor and its creditors prior to the debtor being caught up in formal insolvency proceedings. Informal out-of-court restructurings are by their very nature flexible, and are usually speedy and efficient as they do not burden the court system. Although informal out-of-court workouts already appear to have limited application in Poland, there is no uniform or co-ordinated approach in dealing with such cases. The first manner in which this can be addressed relates to large companies, and involves adopting a set of non-binding principles for out-of-court workouts that represent best practice in this field, and to make it known to all the main stakeholders that regard is to be paid to these principles in appropriate cases. This approach would typically not require the enactment of primary legislation, and could be adopted or endorsed by the appropriate ministry and the central bank.

**Outcomes of out of court workouts**

The expected outcome of an out of court workout is a negotiated restructuring plan between the debtor and the relevant creditors enabling the debtor’s business to continue without interruption. If this outcome does not materialise, the usual alternative is commencement of insolvency proceedings. If insolvency proceedings are pursued, the insolvency law may permit the use of expedited proceedings, to take advantage of the information compiled during the out of court workout process.

**Types of out of court workouts**

Out of court workout can be grouped in the following categories:

- Bilateral negotiations between the debtor and his creditor leading to payment rescheduling and / or debt forgiveness;
- Multilateral negotiations between the debtor and his major creditors leading to rescheduling, debt forgiveness or expedited insolvency proceedings.

**Differences between out of court workouts and formal insolvency proceedings**

The most important differences between out of court workouts and formal insolvency proceedings are:

- Out of court workouts do not seek to vary the entitlements of or bind non-consenting creditors;
- Out of court workouts are consensual and do not threaten the existing legal rights of the debtors and creditors;
- Out of court workouts are not appropriate for all debtors – if the debtor’s business cannot be made viable after the restructuring process, it should be wound up without further delay;
- Both the process adopted and the arrangements achieved between the debtor and the creditors in out of court workouts are flexible.
**Parties to out of court workouts**

Workouts typically involve a limited numbers of the largest, most critical creditors. These creditors will almost always include the debtor’s bankers. The workout may also include other principal creditors such as financing creditors, landlords and major suppliers. All creditors participating in the workout are referred to as “the relevant creditors”. Importantly, out-of-court workouts do not bind or prejudice creditors who do not participate.

In terms of international best practice, the guidelines for out-of-court workouts address a number of key elements, namely:

- The recommendation that a co-ordinated approach to negotiations be adopted by all parties;
- The confirmation that such negotiations are a concession granted by the debtor and not a right of the creditor;
- The general terms of a ‘standstill’ period to be observed by the creditors (ie an agreement not to enforce their rights) while negotiations continue in good faith;
- The priority to be accorded to new funds advanced during the workout;
- The obligation of the debtor to refrain from any actions during the workout that could harm the creditors’ interests;
- The obligation of the debtor to provide full disclosure during the negotiations;
- The agreement of all parties to observe strict confidentiality during the negotiations; and
- The obligation of the debtor (and its advisors) to prepare a restructuring plan for submission to creditors.

These guidelines, once agreed by the main stakeholders, can then be formally endorsed or supported by the government through the appropriate ministry and the central bank, obliging stakeholders to make use of the guidelines in appropriate circumstances.

**LR (medium-term):** Different problems are posed by the cases concerning smaller companies, or SMEs. The solution would lie alongside the introduction of special provisions for out-of-court restructuring, achievable in various ways, such as: i) out-of-court assistance for operational and financial restructuring (e.g. consensual restructuring which is used under the Japanese ADR rules); conciliation; pre-packs; mediation; and consolidation (mergers and acquisitions); and ii) special court administration proceedings, i.e. less strict requirements for reorganization plans. More generally there should be provision for debtors to have the benefit of an informal restructuring mechanism. This can be achieved by the issuance of a set of rules or guidelines intended to have persuasive (as opposed to legally binding) effect and/or by the introduction by a new law of a court-supervised procedure in which a very “light touch” insolvency practitioner could be appointed to assist the debtor.

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1.4 Educate and inform stakeholders

RR (medium-term): One manner to address the lack of awareness of the impact of the substantive bankruptcy laws and recent amendments is by conducting a public awareness campaign for relevant stakeholders. This could be achieved by holding public lectures and arranging educational programmes under the auspices of the various stakeholder bodies such as the institute of directors, business or commercial forums, company managers, lawyers, accountants, financial advisors, insolvency practitioners, etc.

C. SUBSTANTIVE BANKRUPTCY LAW

1. Recommendations

1.1 Strengthen the provisions dealing with directors’ obligations and the enforcement of sanctions

LR (short-term): The manner in which fraudulent management practices by directors and the lack of enforcement of the current sanctions can be addressed, is i) by lengthening the period within which directors are required to file an insolvency petition from the time the company becomes insolvent, and ii) by enforcing directors’ liability for non-filing. Since there appears to be very little awareness of directors’ obligations in this regard, any enforcement of the current provisions should go hand-in-hand with an awareness programme amongst the business community, especially the Institute of Directors in Poland. In any case, it is of essence that the law is actually implemented and directors endure the consequences of poor or fraudulent corporate governance. This would be the best awareness mechanism.

Currently directors of companies are required to file an insolvency petition within two weeks from the moment the company becomes insolvent. However in practice this does not happen and by the time they do file for bankruptcy the company’s financial situation has deteriorated to a point where it is no longer realistic to rescue the company. By all accounts the current provisions dealing with the personal liability of directors, who fail to file for bankruptcy within the prescribed period of two weeks, are not enforced in practice.

Serious thought should be given to lengthening the two week period for filing a bankruptcy petition, and to simultaneously place an obligation upon directors to regularly monitor the company’s financial situation with a view to filing for rescue when the company is in the early stages of financial distress. Creating awareness amongst the business community of the benefits of early intervention will also go a long way to instilling a culture of corporate rescue as opposed to the liquidation culture that currently prevails. In addition to these steps the Polish government should seriously consider enforcing the provisions relating to personal liability for non-filing in all cases. By enforcing the sanction for non-filing directors will soon realize that non-compliance with the statutory provisions will leave them out of pocket, and this should bring about a change of attitude almost immediately.
1.2 **Strengthen the law relating to wrongful trading**

**LR (short-term):** The manner, in which the law relating to vulnerable transactions can be strengthened, is by imposing liability on directors that knew or should have known that the business was insolvent and did not take sufficient steps to protect creditors. Directors should be educated on their obligations, and those who violate it should be investigated and prosecuted to demonstrate the consequences of non-compliance.

Although there is a requirement in the Polish law for directors of an insolvent company to file an insolvency petition within two weeks of the time when the company meets one of the tests for insolvency, evidence shows that they rarely file within this time frame. Apparently there are two reasons for this: i) stakeholders report that most directors are unaware of their legal duties in regards to filing for bankruptcy, and ii) those who do know do not fear reprisal for failing to file in time as this requirement has not been enforced in practice. Stakeholders report that few directors have faced enforcement cases for delays on reporting, and even fewer have been held liable. Company directors do not face a threat sufficiently serious to comply with their duty.

Late filing is not effectively prosecuted because of the requirement that the insolvent company has to be able to cover the cost of the bankruptcy proceedings. One of the requirements for the opening of bankruptcy proceedings is that the insolvent company must have sufficient funds to cover the administrative cost of the proceeding. As mentioned above, directors often file for insolvency when the company is no longer viable, and the remaining funds are insufficient to cover the costs of administration. Not proceeding with the bankruptcy in such cases creates an opportunity for directors to avoid liability for late filing. It also results in an increasing stock of “zombie” companies, with no parties interested or obliged to finalize the insolvency proceedings.

1.3 **Encourage participation by creditors in the bankruptcy process**

**LR (short-term):** The manner in which participation in the bankruptcy process by creditors can be encouraged, is by i) simplifying the manner in which creditors’ lists are finalised by the courts for the first meeting of creditors to be summoned and formed, ii) improving and simplifying the rules that regulate the formation of creditors’ committees, iii) introducing more effective mechanisms for the individual notification of creditors in the bankruptcy process, and iv) by allowing creditors to have a say in the election and appointment of an insolvency practitioner.

It is apparent that the introduction of an arrangement proceeding in the bankruptcy law is not achieving its desired effect, in part because it takes too long for the list of creditors to be finalised by the court and for the first meeting of creditors to be summoned and formed. In addition, the creditors’ committee is rarely formed and consequently creditors do not have an effective voice in the manner in which the proceedings are conducted. Improving the rules that regulate the formation of creditors’ committees and introducing more effective mechanisms for the individual notification of creditors, will improve this situation.
In addition, creditors do not have the ability to select a trustee according to the law. Although they may suggest one to the court during bankruptcy proceedings, they rarely exercise this right. The process of appointing a trustee does not seem to be based on any objective criteria, but is left to the full discretion of the judge. The process also lacks the necessary transparency to ensure fairness in the appointment of trustees. Clearly, more input from creditors as to who should be appointed is desirable.

1.5 Provide clearer tax rules and guidelines in bankruptcy proceedings

| RR and LR (medium-term): The first manner, in which clearer tax rules and guidelines in bankruptcy cases can be achieved, is by the provision of a clear, written tax policy by the relevant ministry that sets out the powers of the tax authority as a creditor in bankruptcy and reorganisation proceedings. |

Although stakeholders reported that they are not sure if tax debt can be forgiven (rather than simply re-scheduled in installments), Polish law seems to allow compromise of tax debts for restructuring purposes. The language employed by the law seems to suggest that the tax authorities are legally empowered to compromise a debtor’s outstanding tax obligations within a restructuring proceeding. There is no indication that the forgiveness needs to be within a formal insolvency proceeding. In practice the Polish tax authorities seem to be flexible, and generally act in the best interests of the public. However, the authorities themselves have indicated that is not clear whether they can write off debt in the case of an out-of-court restructuring.

While the tax authority cannot act in a purely market-based manner, it should be able to do so within the boundaries of tax policy that are designed to allow balancing of reasonable tax debt relief, prevention of moral hazard/widespread tax avoidance, and the interests of the public treasury.

Addressing the potential downsides of clarifying the ability of tax officials to compromise debts in bankruptcy and restructuring procedures will require implementing safeguards to prevent any unreasonable forgiveness of tax debt, and to dissuade debtors from using bankruptcy and restructuring as an abusive tax avoidance tool. Tax authorities should preserve flexibility to compromise debt when necessary to ensure survival of the company, while keeping appropriate safeguards in place in order to weigh important policy considerations.\(^{110}\)

The lack of a clear, written tax policy on debt forgiveness makes the insolvency and restructuring process unpredictable in Poland. Unpredictability in tax policy affects creditors negatively, as they cannot predict with certainty how much of a debtor’s estate in insolvency will be applied to overdue tax payment. Clearly the provision of a clear, unambiguous tax policy by the appropriate ministry that sets out the powers of the tax authority as a creditor in bankruptcy and reorganisation proceedings, will go a

\(^{110}\) For example, the current practice in Mexico is to limit the amount of forgiven tax debt to 50% or another appropriate percentage of outstanding tax debt. The approach can be tailored to suit Poland’s economic and administrative realities, but safeguards can be designed.
long way to establishing certainty in this regard, even if this requires some legislative amendments.

Once the policy is determined, there is a need for dissemination of the information, not only to tax authorities, but to users. Users’ applications for tax relief are currently reported to be deficient. Forms and guidance would help both users and the tax authorities evaluating applications to follow a consistent policy, and produce consistent, predictable results in tax debt reduction in bankruptcy and restructuring. As an aid to refining the policy, tax debt resolution within bankruptcy and restructuring proceedings should be tracked. This will assist the authorities in maintaining consistent policy, and identifying whether or not certain aspects of it should be refined.

RR and LR (medium-term): The second manner, in which clearer tax rules and guidelines in bankruptcy cases can be achieved, is by providing clear and uniform policy guidelines for the tax treatment of debt forgiveness in all types of insolvency proceedings. Where necessary, tax laws should be amended to provide favourable or neutral tax treatment of forgiven debt for the debtor when in the context of any restructuring, in any industry. In addition, the tax laws should be amended to allow for greater deductibility of loan losses, and the relevant banking laws and regulations and other related laws should be amended to ensure proper prudential practices in categorizing and deducting loan losses.

In regard to forgiveness of loans and credits, only to the extent that the forgiveness of a bank loan (credit) obligation is linked to one of the above proceedings, the debt forgiven may be treated by the creditor as a tax-deductible cost (with the exception of forgiven interest). Provisions of this nature, that limit the debt relief available to banks, also distort their balance sheets. Banks are motivated to continue to carry loans to financially troubled customers as “assets”, even though they are in reality no longer producing income.

This anomaly should be addressed by the tax authority by providing clear and uniform policy guidelines for debt forgiveness in all types of insolvency proceedings, even if this requires legislative reform.

111 An approach taken in some countries is to allow offset of the forgiven debt against other losses— which will be less advantageous to the debtor and likely to restructuring efforts. In Germany and the Netherlands, forgiven debt is offset against the tax losses, and in the Netherlands, the excess that cannot be offset may still be exempt from tax. See Bird&Bird, “Forgiveness of distressed debt in Europe”, web-published document by the International Tax Group, http://www.twobirds.com/English/News/Articles/Pages/Forgiveness_distressed_debt_Europe.Asp.

112 Loan losses are a cost that banks incur in order to incur income, and thus should be recognized as expenses/losses for tax purposes. See Emily M. Sunley, Chapter 9: The Tax Treatment of Bank Loan Losses, 2003. There are various methods of allowing loan loss deductibility, such as direct write off (the charge-off method), as in Belgium, where in a composition with creditors that is approved by a court, the reduction in value to the loan is deductible. Some countries allow deductibility when loan loss results in provisioning (the reserve method), as in Serbia where banks are allowed a tax deduction of 90% of the amount added to loan loss provisions required by the National Bank for NPLs. See Sunley, 2003, pp. 7-8.
**LR and RR (medium-term):** The third manner, in which clearer tax rules and guidelines in bankruptcy cases can be achieved, is by clearing up the confusion surrounding the implications of debt forgiveness as state aid and EU policy. The EU *de minimus* standards relating to State Aid should be determined, as well as any exceptions that apply to insolvency, and guidance to stakeholders should be provided. In addition, any such guidelines should be disseminated amongst all stakeholders to ensure confidence in tax debt compromise proceedings.

Stakeholders’ interviews revealed differences in the perception as to the attitude of Tax Authorities concerning rescheduling and write-offs: while some stakeholders stated that tax authorities cannot forgive debt due to EU restrictions on State Aid, the authorities themselves confirm that such restrictions are waived for certain groups of taxpayers, and are generally not applied in insolvency cases. The ECJ standard cited earlier in the report appears generous, and would allow a broad program for tax forgiveness in restructuring, but it does not appear to be common knowledge among stakeholders. The tax authority should take steps to determine the minimum EU standards relating to State Aid, determine any exceptions that apply, and provide guidance to stakeholders.

1.6 **Take steps to make corporate rescue proceedings more effective**

**RR and LR (medium-term):** The first manner, in which corporate rescue proceedings can be made more effective, is by instilling a culture of corporate rescue in Poland. Education and other awareness programmes need to be undertaken to inform all stakeholders (especially bankruptcy judges and directors of companies where there seems to be a particular lack of awareness) of the benefits of corporate rescue. Incentives for insolvency practitioners to undertake corporate rescue work will also assist in instilling a corporate rescue culture in Poland, although legislative reforms will probably be required to adjust the remuneration structure of insolvency practitioners to achieve this.

From interviews conducted with stakeholders during the May 2012 mission it is clear that Poland still has a liquidation culture when it comes to bankruptcy. Some interviewees were of the opinion that the courts are to blame as their approach is very conservative and they still follow the liquidation route. It also became apparent from the interviews that the rescue procedure contained in the Bankruptcy and Restructuring Law is not widely used, although it was stated by one interviewee that the restructuring of companies had improved post-ROSC. From the interviews it also became apparent that the following contributed to the continued existence of a rescue culture in Poland:

- there is a lack of awareness amongst directors of companies as to the availability of the rescue procedure;
- some courts take the new rescue procedure more seriously than others;
- judges do not have the correct mindset when it comes to rescue;
- there is a lack of incentive due to the low fees paid to insolvency administrators;
- there is too much court involvement in the insolvency process.

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113 After the ICR ROSC Poland 2008 (Report on the Observance of Standards and Codes on Insolvency and Debtor/Creditor Regimes) prepared by the World Bank.
The second manner, in which corporate rescue proceedings can be made more effective, is by addressing the lack of provisions allowing for post-commencement financing in reorganisation proceedings. In the Polish context this problem could perhaps be addressed in the following ways: i) by the insertion of a post-commencement financing provision in the bankruptcy law that provides new lenders with a priority over existing creditors, ii) by amending the law to allow insolvent companies to obtain credit in much the same way as financially distressed companies (that are not subject to insolvency proceedings) do by taking new credit with the consent of creditors, and iii) to address the problems associated with the sale of a business as a going concern.

As already pointed out, Polish law does not allow for priority repayment of financing provided to a company during its reorganization. This hampers post-commencement financing and is a disincentive for possible investors. Financing during the rescue period is an important part of the rescue culture in countries where business reorganization under the insolvency law is successful. This can be remedied by inserting a provision in the bankruptcy law that provides new lenders with a priority over existing creditors.

Banking legislation concerning risk management is also a hurdle to the rescue of insolvent companies. While the Bankruptcy and Restructuring Law allows for debtors in possession to take additional credit with the consent of the creditors, the Banking Law does not contain any special provisions on the possibility of insolvent companies to take credit in certain circumstances. This could be remedied by amending the law to also allow insolvent companies in formal bankruptcy to obtain additional credit with the consent of creditors.

The sale of a business as a going concern, which can produce greater returns to both creditors and debtors and preserve the business itself and the jobs connected to it, is also inhibited by the current legal framework. If an insolvency proceeding results in the sale of the business as a going concern, the assets of the business are not transferred free of encumbrances. Taking on the overwhelming debts of an insolvent business could be a serious disincentive to prospective purchasers. This could perhaps be remedied by removing the current provisions to allow for the assets of the business to be taken over free of any encumbrances.
CONCLUDING REMARKS

Over the past years, Poland has taken a number positive steps aimed at reforming the insolvency system and encouraging corporate restructuring. The recently amended Bankruptcy and Restructuring Law could achieve this goal if it were the subject of minor additional amendments, more fully elaborated by regulation and supported by institutional reform. Further, irrespective of the scope of the reforming exercise embarked upon, it should be remembered that laws relating to this area of the economic life of a country must be revisited frequently to deal efficiently with the rapidly changing demands placed upon them in practice.

This report identifies suggested avenues of potential reform with respect to Poland’s insolvency system. Addressing all of the identified reforms will require a commitment of both resources and political will and only be achievable over a longer time horizon. Some reforms, however, could be achieved in the short to medium term. In addition, the challenges that the current court structure poses for the insolvency system can be mitigated by developing avenues outside the formal court system to resolve insolvencies. Finally, further regulation of insolvency practitioners is key for the overall improvement of the system. This reform would also seem to be one that is worth addressing in the near term.

We look forward to further discussing this the draft Report with the Government of Poland and all relevant stakeholders to provide a final set of recommendations.

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## APPENDIX A
### Parties interviewed for the present Report (by Institution)

<table>
<thead>
<tr>
<th>Institution</th>
<th>Name</th>
<th>Position</th>
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<tr>
<td>Alvarez &amp; Marsal Poland Sp. z o.o.</td>
<td>Thomas Kolaja</td>
<td>Managing Partner</td>
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<tr>
<td>BCC</td>
<td>Jacek Świeca</td>
<td>Legal Adviser</td>
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<tr>
<td>Clifford Chance LLP</td>
<td>Bartosz Krużewski</td>
<td>Lawyer (Partner)</td>
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<td></td>
<td>Jan Zdzienicki</td>
<td>Lawyer (Of Counsel)</td>
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<td>Cracow Regional Court</td>
<td>Janusz Płoch</td>
<td>Judge</td>
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<td>Jaroslaw Gowin</td>
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<tr>
<td></td>
<td>M.Geromin</td>
<td>Assistant to the Minister of Justice</td>
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<td></td>
<td>S.Morawska</td>
<td>Prosecutor</td>
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<td>Ministry of Justice - Common Courts Organization and Analysis Department</td>
<td>M.Dąbrowski</td>
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<td>J.Kiełkowska</td>
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<td>R. Reiwer</td>
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<td>Anna Adamska - Gallant</td>
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<td>Rafał Łyszczeń</td>
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<td>National Council for the Judiciary</td>
<td>Ewa Malinowska</td>
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<td>Małgorzata Niezgódka - Medek</td>
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<td>Price Waterhouse Coopers</td>
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<td>Adam Jasser</td>
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<td>Lech Giliciński</td>
<td>Insolvency Partner</td>
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<td>Karolina Stawowska</td>
<td>Tax Partner</td>
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<td></td>
<td>Wojciech Węgrzyn</td>
<td>Undersecretary of State</td>
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