MILLER CANFIELD

# Legal Standing of Building Process Participants upon Investor's Bankruptcy in Poland

February 2010

Today's economic situation constitutes a serious challenge for all entrepreneurs, and has particular repercussions for entities operating on the real estate market. There are concerns that not all market players will withstand this challenge. Thus, this is a good time to ask about the legal standing of clients and suppliers of bankrupt-bound real estate developers.

The consequences of the entrepreneur's bankruptcy declaration are defined in the Bankruptcy and Remediation Act of 28 February 2003 (hereinafter referred to as the "Act"). The legal standing of the bankrupt's creditors depends on the type of bankruptcy declared, as provided by the Act – a liquidation-bankruptcy or an arrangement-bankruptcy. The goal of a liquidation-bankruptcy is to sell the assets of the bankrupt entrepreneur in the scope allowed by the Act (bankrupt estate) and to distribute the obtained proceeds among the bankrupt's creditors. Meanwhile, an arrangement-bankruptcy provides for the restructuring of the bankrupt's liabilities, and then for the bankrupt to continue to conduct business activity. So-called bankruptcy-arrangement represents an exception in form of liquidation arrangement, which goal is to liquidate the bankrupt's assets. It is worthy to note that though the Act prefers bankruptcy declarations which provides for an arrangement, the main criteria for choosing the type of bankruptcy is the interest of the creditors. This arises from the essential meaning and purpose of bankruptcy which is a legal instrument to protect creditors' interests. Regardless of which type of bankruptcy is declared, the impact of its announcement on the legal standing of creditors should be considered from two perspectives: its impact on the bankrupt's liabilities to the creditors, and its impact on the possibility of the creditor's claims being satisfied during bankruptcy proceeding.

As far as the impact of a bankruptcy being declared on the bankrupt's liabilities, both in the case of a liquidation-bankruptcy and an arrangement-bankruptcy, a change or expiry of a legal relation to which the bankrupt was a party is possible only in the manner provided for in the Act, while any actions undertaken in breach of the Act are ineffective respect to the bankrupt estate. Moreover, any provisions of the agreements providing automatic change or termination of the legal relation are null and void. This means that the investor cannot secure itself through a contractual arrangement with purchasers and suppliers against the consequences of a bankruptcy under the Act.

Following the declaration of an arrangement-bankruptcy, neither the bankrupt nor the administrator can, as a principle, fulfill any performances covered by the arrangement provisions by virtue of the Act. This applies to all of the bankrupt's debts created as on the date preceding the bankruptcy declaration, including debts secured by transfer as security of ownership title to assets, receivables or other rights. Thus, the provisions of the arrangement approved by the court are of decisive importance to the performance by the bankrupt of his obligations.

In a liquidation-bankruptcy, the cash liabilities of the bankrupt, still not due, become immediately payable, while non-cash liabilities are converted as of the date of the bankruptcy declaration into cash liabilities payable as on the date of the bankruptcy declaration even if they are yet due and payable. For example, a claim to conclude an agreement transferring the ownership of the premise revealed in the land and mortgage register changes into a cash-liability, which can be demanded by the creditor within the bankruptcy proceeding. Despite the creditor has not possibility to force the official receiver to conclude the agreement transferring the ownership of the premise, his position in the bankruptcy proceeding is strengthened- he would be entitled to demand compensation of his cash-liability immediately and he

would also be privileged in the manner of division of the bankruptcy estate. In this manner, the Act evens out the chances of all creditors to satisfy their claims from the bankrupt estate. It is essential that the Act provides special provisions for the execution of mutual agreements which, as on the date of the bankruptcy declaration, have not been fully or partially performed. In the case of such agreements, the official receiver can perform the bankrupt's obligations and demand the fulfillment of the mutual performance or can withdraw from the mutual agreement. In this choice, the official receiver should be led by the creditors' interests. The discussed provisions are essential if the investment being executed by the bankrupt investor is greatly advanced and it makes more sense for the creditors for it to be completed, even if this means that they would have to incur additional charges, than them seeking to be compensated through the division of funds of the bankrupt estate. Unfortunately, pursuant to the Supreme Court's decision of 23 November 2005, file no. II CK 237/05, this provision does not apply to mutual agreements, in which one of the parties has fully performed its obligations. As a consequence, if the creditor of the bankrupt has already paid the entire price under a property sales agreement, then the official receiver cannot use the above as legal basis for the fulfillment of the bankrupt's obligation. In such a situation, as in the case of the official receiver not taking advantage of the available option, the creditor will be able to satisfy its claims within the frameworks of the division of the bankrupt estate funds.

The second important issue, which influence on the legal standing of the creditors of the bankrupt investor, is the possibility of fulfilling one's claims within the frameworks of bankruptcy proceeding. In order to achieve this, the bankrupt's creditors should enter their claims onto a list of claims which will be fulfilled within the frameworks of bankruptcy proceeding. If a creditor's claim was not entered on the subject list within the bankruptcy declaration proceeding, then the creditor should notify such claim to the judge-commissioner within the period provided in the bankruptcy declaration decision. The decision is made public by its posting in the Court and Commercial Monitor (*Monitorz S dowy i Gospodarczy*) and by its publication in a local daily. Thus, all of the bankrupt's creditors as well as those who did not take part in the proceedings and those whose claims were not *ex officio* entered on the list of claims, can notify of their claims and can seek for their claims to be compensated.

In the event of an arrangement-bankruptcy, the arrangement provisions provide the manner creditor's claims will be satisfied. In the event of a liquidation-bankruptcy, the official receiver will sell the bankruptcy assets and then divide the funds of the bankrupt estate among the four categories of creditors, in line with the list of claims approved by the judge-commissioner. Bankrupt's creditors seeking compensation for claims arising under agreements concluded with the bankrupt will be satisfied within the III category. In practice, bankrupt estate funds often suffice only to partial satisfaction of the claims of creditors in that category. Creditors whose claims are secured against assets (for example, by the establishment of a mortgage), or which rights are revealed in the land and mortgage register (for example, a claim to conclude the agreement transferring the ownership of the premise) are in a significant better position. Funds raised by the official receiver from the sale of the encumbered property are not part of the funds of the bankruptcy estate distributed according to general rules, but are reserved for meeting the claims of creditors, which are secured against the property, regardless of their classification in one of the creditor's categories. Only when all creditors' claims secured against the property are satisfied, the remaining funds are transferred to the general fund of the bankruptcy estate and distributed in line with the general rules. If the funds raised from the sale of the real estate are not sufficient to fulfill the claims of creditors whose claims have been secured against the property, then their claims are satisfied in line with general rules, as long as they represent personal creditors of the bankrupt. Yet, if the creditors are not the bankrupt's personal creditors, that is if they are served by the right to satisfy their claim from a defined component of the bankrupt's estate but they do not have any claims with respect to the bankrupt, then they do not have the right for

their claims to be satisfied from the general funds of the bankrupt estate.

The declaration of the investor's bankruptcy will not always mean that the investment cannot be completed. Pursuant to Art. 311 of the Act, the bankrupt estate is liquidated by the sale of bankrupt's enterprise entirely or partially, by sale of the properties and movables, by collection of the liabilities from the bankrupt's debtors, and by performance of other property rights that are part of the bankrupt estate or by its sale. Pursuant to Art. 316 of the Act, the purchaser of the bankrupt's enterprise assumes the rights to all concessions, permits, licenses and allowances granted to the bankrupt unless a statue or an administrative decision under which they were granted provides otherwise. What is essential, the purchaser of the bankrupt's enterprise can also assume the right to a building permit issued to the bankrupt and can thus complete the investment.

Independently to the above, the Act provides that in the event of the declaration of a liquidation-bankruptcy, the bankrupt's business can still be conducted if it is possible to establish an arrangement with the bankrupt's creditors or if it is possible to sell entire bankrupt's enterprise or its organized part. However, it should be noted, that this is only a possibility provided for and not an obligation imposed on the official receiver of the bankrupt estate.