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Changes in Article 11 of the amended Insolvency Law and their potential consequences for pyramid schemes in Poland in the past and in the present

Abstract

Poland's new Restructuring Law, which entered into force on 1 January 2016, amended the former Insolvency and Reorganisation Law of 2003. The new law has, among other things, introduced changes to the factors to be taken into account when determining the insolvency of corporate entities. The paper focuses on the interpretation of these new provisions with regard to their possible exploitations by pyramid schemes. The conducted analysis has revealed that the new amendments may establish a basis for pyramid schemes to operate legally – for two- or even three-year cycles. This finding applies in particular to the amendments made to the indebtedness factor set out in Article 11(2) of the amended Act. The aforementioned consequences contradict the declarations made by the government that the changes in the insolvency law were intended to abolish old mechanisms that proved unworkable in practice and allowed debtors to carry out acts that were detrimental to their creditors.

Keywords: insolvency law, insolvency factors, pyramid schemes

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Introduction

On 01.01.2016, the Restructuring Law of 15.05.2015, promulgated in the Journal of Laws of 2015, item 978, entered into force, amending the previous Bankruptcy and Reorganisation Law (BaRL) of 2003.[2] The changes in the Bankruptcy Law were not limited to editorial issues. First of all, the legislator separated the bankruptcy proceedings from the reorganisation (restructuring) proceedings by way of separate Acts. A number of new solutions and additions have been implemented to the provisions of the previous Act.

As announced,[3] the amendments to the Bankruptcy and Reorganisation Law were to be twofold:

- Firstly, the changes resulted from the necessity to ensure consistency between the restructuring proceedings and bankruptcy proceedings, which were separated into two Acts so far.
- Secondly, some of the changes were aimed at improving the functioning of BaRL institutions whose functioning in practice turned out to be unsatisfactory. In the explanatory memorandum of the bill, the government declared that the changes in the Bankruptcy and Reorganisation Law were supposed to eliminate the solutions that did not prove useful in practice and made it possible for the debtor to carry out acts injuring the creditors.

The changes were also supposed to order and clarify matters and to dispel important interpretative doubts that have arisen in the practice of using of the BaRL.

At the scientific conference in Poznań on 20.02.2017 under the title "Co-operation of enterprises and its importance for the competitiveness of the local and national economy – challenges for the Wielkopolska Voivodeship", two speakers from two different academic institutions claimed that the amendments to the Bankruptcy Law were incomprehensible, chaotic, and they looked as if they were written for the needs of specific entrepreneurs. The paper focuses on the interpretation of the new regulations in terms of their ability to be used by entrepreneurs operating on the basis of pyramid schemes and is divided according to the following

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2 Journal of Laws of 2003, item 535, as amended.

3 Parliamentary paper No. 2824/2015.

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layout: the first part is an introduction to the paper; the second part discusses the amendments implemented with the amendment to the insolvency factors of business entities; the third part discusses the issue of presumptions of insolvency and the opportunity to rebut them; the fourth part shows the effects of amendments in the debtor's insolvency factors in the context of the operation of pyramid schemes in Poland; the fifth part discusses other amendments to Article 11 of the Bankruptcy Law and the possible use of these provisions in the operation of pyramid schemes. The paper ends with summary conclusions.

Amendments to insolvency factors

By amending the Bankruptcy Law, the legislator kept both previous bases for determining the debtor's insolvency status – one associated with its financial liquidity and the other associated with excessive indebtedness. However, the factors for the emergence of these grounds have changed. A more precisely defined concept has been implemented, and above all the prerequisites for the presumption of insolvency have been specified.

In the previous BaRL Act of 2003, the premises for deeming a debtor to be insolvent are described separately in Article 11(1) and (2). Under Article 11(1) of the BaRL of 2003, insolvency meant a condition of "the debtor's failure to meet outstanding financial liabilities". The amendment of 2015 replaced this wording with "loss of the ability to meet outstanding financial liabilities". In this regard, in the new Paragraph 1a, the legislator additionally introduced a presumption according to which "the debtor has lost the ability to meet outstanding financial liabilities if the delay in meeting the financial liabilities exceeds three months".

Changed wording of Paragraph 1 (replacement of the phrase "failure to meet" with "loss of the ability to meet") and introduction of the "presumption of the loss of the ability to meet outstanding financial liabilities" in Article 11(1a) has not changed much in practice in relation to the current situation of entrepreneurs with payment problems. In the Act before the amendment, the wording of Article 11(1) was actually very rigorous, as entrepreneurs who were in default on the payment of their liabilities by even one day became insolvent, but other BaRL articles relaxed this provision by indicating that:

Firstly, insolvency arose only when an entrepreneur failed to settle their liabilities against at least two creditors (Article 1(1)(1) of the BaRL).

Secondly, the court could dismiss the bankruptcy petition if the delay in meeting the liabilities did not exceed three months and the sum of the unpaid liabilities did not exceed 10% of the balance sheet total (Article 12(1) of the BaRL).

Therefore, it was practically impossible for only small amounts of accidentally unpaid liabilities to become the basis for filing for bankruptcy, let alone the actual bankruptcy of a business entity. Before the amendment of the Act, the court had greater flexibility in assessing the durability of cessation of debt payment, however, no bankruptcy is known to the author of this paper where the court decided so only because of overdue liabilities of less than 90 days from their maturity date. Therefore, not much changed in the implementation of the Act by the courts in terms of the insolvency factor of the entrepreneur as described in Article 11(1), and the three-month delay threshold in settling liabilities by the debtor without being considered insolvent, as introduced in Paragraph 1a, existed already in the Act before the amendment, but in Article 12.

The second insolvency factor used so far, described in Article 11(2), has also been changed. According to it, the debtor was also insolvent "when their liabilities exceed the value of their assets" even when they meet outstanding financial liabilities. This factor was still in accordance with the earlier Article 5(2) of the Ordinance of the President of the Republic of Poland of 24 October 1934 "Bankruptcy Law". Therefore, there was an 80-year continuity for this factor (from 1934 to 2015). The regulation in question was primarily aimed at counteracting the problem of "paucity of estate assets", but at the same time, the existence of this factor prevented the functioning of pyramid schemes in which a business entity, while conducting unprofitable activity, pays its liabilities on an ongoing basis, but does so by getting increasingly indebted to other creditors. An entity in such conditions, when the value of its assets is smaller than its liabilities, is not able to pay all its debts. Therefore, it "lost the ability to meet outstanding financial liabilities", or never had such an ability.[4]

However, in the amendment of the Bankruptcy Law, a significant, if not revolutionary addition to Article 11(2) was made in 2015. It still defined that a debtor is deemed to be insolvent if their "financial liabilities exceed the value of their assets", but it was added that only when "this condition persists for over twenty-four months". In this respect, the Legislator changed the current meaning of this premise, according to which every financial liability exceeding the value of the debtor's assets was tantamount to the debtor's insolvency "also when they were meeting their liabilities on an ongoing basis". It was replaced by a requirement in the form of a presumption of an as long as 24-month period of persistence of this condition.

[4] A matter of dispute was only whether this loss was temporary or permanent. An entity that was a pyramid scheme was in a state of permanent insolvency. A debtor who is not a pyramid scheme (or a debtor's Management Board member sued by the creditor) could prove that such a condition is temporary for example if their business later became profitable.

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Although it can be argued that the wording of Article 11(2) was very rigorous before the amendment and any excess of liabilities over the entrepreneur's assets meant insolvency for them, this argument ignores the fact that the Bankruptcy and Reorganisation Law stipulated that such a temporary situation of the entrepreneur did not force them to file for bankruptcy. In the case of a court trial, in order to relieve themselves from the responsibility for company's liabilities and from criminal liability for failure to file for bankruptcy within the specified deadline, the board would have to prove that the above-mentioned situation of excess of liabilities over the assets was temporary. Article 11(2) in the new wording sets out such temporary insolvency in a very long period (24 months), and does so in the form of "presumption". Hence, the Management Board is relieved from the obligation to prove the temporary nature of this condition in this extensive 24-month period.[5]

What is more, contrary to the announcements that the introduced changes will be at most "ordering, clarifying and aiming to dispel major doubts", incommensurability in the periods of both presumptions of insolvency under Article 11(1) and (2) (3 months and 24 months respectively) and deletion of the text "even when it meets these liabilities on an ongoing basis" in Paragraph 2 indicates that the Legislator has made a fundamental change to the balance between both premises. The indebtedness factor became only subsidiary in relation to the liquidity factor. It is even directly indicated by a parliamentary paper on the "subsidiarity" of the indebtedness factor in relation to the financial liquidity factor and by the explanation that "excessive indebtedness is a significant problem for the market situation only when it leads to disruption of the entrepreneur's payment ability".[6] Under Paragraph 6, the court has also been entitled to dismiss the bankruptcy petition due to the emergence of the indebtedness factor "when, on the basis of the collected evidence, it concludes that there are special circumstances that involve no risk that the debtor will lose the ability to pay their outstanding financial liabilities in a short time".[7]

5 Some cases where, before the amendment's entry into force, the debtor's excess of liabilities over assets for less than three months was the basis for conviction of a Management Board member for failing to file for bankruptcy within the required period are known to the author.

6 Parliamentary paper No. 2824/2015.

7 Ibidem.

Opportunity to rebut the presumptions of insolvency and their practical consequences

The presumptions of insolvency indicated in the amendment to the Act are rebuttable and do not decide finally on the inability to prove that the debtor's insolvency condition occurred earlier or much later. Contrary to the announcements that the amendment of the Act was to support creditors, their position has actually weakened in this respect. In the previous wording of the Bankruptcy Law, when the creditor filed for bankruptcy, it was the debtor who was obliged to prove that the bankruptcy factors, even if they occurred, were of a temporary (not permanent) nature. Failure to prove the temporary nature of the insolvency factor represents the basis for deeming the bankruptcy petition legitimate. After the amendment, when the creditor files bankruptcy, the burden of proof is transferred to the debtor only if the delay lasts longer than three months or if the excess of liabilities over the debtor's assets lasts over 24 months. The obligation to prove the loss of the repayment ability before these deadlines rests with the creditor as the applicant.[8] Given that the debtor has much more information about how their company functions, the creditor was in a more difficult position, and it seems that it will usually not be able to refute the premises described in the Act and the debtor's assertions referring to them.

Effects of changes in the debtor's insolvency factors in the context of operation of pyramid scheme

In consequence of all the changes to the provisions of Article 11 of the Bankruptcy Law, a situation has arisen that is economically incomprehensible and potentially dangerous for creditors of entrepreneurs with solvency problems. In addition, it creates room for action for pyramid schemes in accordance with the law in two-year cycles,[9] and it may be the basis for procedural defence for the current pyramid schemes, such as Amber Gold. First of all, it should be pointed out that limitation of the importance of the insolvency factor defined in Article 11(2) of the Act, i.e. as excess of liabilities over receivables, is absolutely incomprehensible both on the basis

[8] Ibidem.

[9] It should be pointed out that, according to an interpretation that is sometimes found, the Management Board in large enterprises is not obliged to determine the excess of the company's assets over its liabilities during the marketing year. Given the reporting obligations described in the current wording of the Accounting Act, legal operation of pyramid schemes may be extended to 36 or even 39 months.

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of the solutions that have been applied in Polish law so far (from the President's Ordinance of 1934 to the Act of 2003), but also in German law:[10]

Firstly, the condition in which a company has lower assets than liabilities arises in the vast majority of cases when the company regularly incurs losses. Since, unlike before the amendment, an entrepreneur will now be able to operate for next 24 months with assets lower than liabilities, it should be considered how much "paucity of estate assets" can be increased during that period. The "paucity of estate assets" the consequences of which will be borne by the creditors will advance while remuneration will be paid Management Board members, fees for the use of intangible rights (trademark, know-how, etc.) will be charged and other profits for related entities will be gained.

Secondly, the Management Board may theoretically operate a pyramid scheme for 24 months, or those who conducted such an activity in the past may now claim that they were insolvent in the light of the interpretation of insolvency as specified after the amendment. The period of 24 months defined in the amendment covers in fact the entire period of operation of the Amber Gold pyramid scheme – from the company's balance sheet for 2009, which had to be submitted by 31 March 2010, to the company's balance sheet for 2011, which had to be drawn up by 31 March 2012. This example shows how high losses can be caused by entities of a similar type in the future. This time, however, these entities will be able to act under the applicable law, and the injured creditors will now be obliged to prove that the bankruptcy factors emerged earlier. According to the author of the paper, prevention of pyramid schemes operating on the basis of a financial product, which was used by Amber Gold (gold deposits), will be practically impossible under the current law.

Other amendments in Article 11 of the Bankruptcy Law and their effects in the context of the operation of pyramid schemes

What should also be pointed out is another amendment to the Bankruptcy Law that gives rise to the potential threat of exploiting it in the operation of pyramid schemes, but also other forms of economic fraud. Such a threat is posed by Article 11(5) added by the amendment. It indicates that when calculating the value of liabilities, "liabilities to related entities" should be ignored. Further, it is not indicated anywhere in the amendment whether the company's receivables from related parties

[10] Insolvenzordnung, https://dejure.org/gesetze/InsO/19.html (access on: 26.02.2017).

should be included at the same time. Receivables from related parties are a balance sheet assets item of an enterprise, and the carrying amount is directly referred to in Article 11(5). In consequence, there is an opportunity of manipulating the company's bankruptcy factor by creating carousels of mutual receivables between related entities, leading to increased carrying amount of the assets, with an unchanged value of liabilities compared to the assets. Admittedly, the Supreme Court's ruling of 1 April 2003[11] indicated that "The debtor's assets should be understood in legal and material terms – (...) they do not include receivables and claims", but the context of that case considered by the Supreme Court, doubts about the actual meaning of economic concepts used in this ruling and other statements contained in the ruling in question that were interpreted differently in the provisions of the amendment to the Act[12] deprecate the quoted Supreme Court ruling, leaving the factual context as in the provisions of the amendment to the Bankruptcy Law. It can be considered justified to exclude liabilities to related entities from the calculation of the enterprise's solvency, but only in the context of Article 11(1), not Article 11(2), and it is Article 11(2) that is referred to in the provisions of Article 11(5).[13]

Conclusions

The changes introduced in the amendment to the Bankruptcy Law in 2015 significantly changed the basis for proving the debtor's insolvency. By introducing the presumption of such a state in the time periods specified in the Act, they led to a depreciation of the indebtedness factor in relation to the financial liquidity factor. The former has become only subsidiary in relation to the latter.

In practice, this significantly changed the creditor's position, transferring some obligations to prove the insolvency in bankruptcy proceedings and/or in proceedings for damages against members of the management board from the debtor to the creditor. Given that the debtor has much more information about how their company functions, the creditor was in a more difficult position, and it seems that it will usually not be able to refute the premises and related presumptions described in the Act and the debtor's assertions referring to them.

11 Ref. II CK 484/02.

12 Introduction of the balance sheet assets' valuation criterion.

13 Similarly, as in some cases, failure to meet liabilities towards the Management Board could be disregarded. A case of court's rejection of a claim about debtor's insolvency based on the premise of Article 11(1) precisely for this reason is known to the author.

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The amended Bankruptcy Law has also provided pyramid schemes with great opportunities to create a legal basis for their operation in the future, but also in their current activities. It also makes it possible to plan the operation of new pyramid schemes in two-year and even three-year cycles.

All the above consequences of the amendment of 2015 are in contradiction with the declarations that the changes in the Bankruptcy and Reorganisation Law are supposed to eliminate the solutions that did not prove useful in practice and made it possible for the debtor to carry out acts injuring the creditors.[14]

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14 Parliamentary paper No. 2824/2015.