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IRIS
7100 Baltimore Avenue, Suite 510
College Park, MD 20740
(301) 403-8153

CENTER FOR INSTITUTIONAL REFORM AND THE INFORMAL SECTOR

University of Maryland at College Park

Center Office: IRIS Center, 2105 Morrill Hall, College Park, MD 20742
Telephone (301) 405-3110 • Fax (301) 405-3020

SEEKING SECURITY IN POLAND

Ronald Dwight and Leigh Anna Reichenbach

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Author: Ronald Dwight and Leigh Anna Reichenbach

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Polish companies should find it easier to borrow from banks if a new law on secured lending is implemented. By Ronald Dwight and Leigh Anna Reichenbach at the IRIS-Poland Project.

A draft law on secured lending for Poland is being prepared by the Commission for Reform on the Civil Code (CRCC), chaired by Witold Czachorski of the University of Warsaw School of Law. If enacted, this law would establish a more effective system for asset-based loan transactions, making it easier for developing businesses to borrow money from banks in Poland.

The draft addresses four primary collateral law issues:

• It expands the basic definition of a pledge and provides for the registration of such claims.

• It improves the rules governing the maintenance of the collateral during the pledge term.

• It establishes a reasonable order of priority in case more than one creditor issues a loan to a single debtor.

• It sets up an efficient system of execution on the collateral in the event that the debtor defaults on the loan.

In most industrialized countries, commercial lending institutions issue loans secured by a collateral interest (also called a security interest, pledge, lien, or charge) in real estate, moveable property, or intangible rights owned by the debtor. In Poland, however, the laws governing secured transactions have yet to develop to the same level of sophistication as in the west.

Creating a pledge

Under current law, two types of pledges may be created when a business seeks to obtain a loan: a possessory pledge and a bank pledge. A possessory pledge, as its name suggests, requires that the creditor or a third party maintain possession of the property serving as collateral.

This type of pledge is of limited use because any objects that the debtor must continue to use in running its business, such as industrial machinery, cannot be used to secure a loan.

A bank pledge, by contrast, permits a bank to issue a loan without taking possession of the collateral. However, under the current system, each bank maintains its own register of pledges. That means a fraudulent debtor may pledge the same piece of property to several different banks without each one realizing that other claims to the property exist.

Under the new draft law, the sections dealing with possessory pledges are left unchanged. The bank pledge sections, however, are replaced by new provisions governing registered bank pledges. These pledges, like the former bank pledges, do not require the bank to take possession of the debtor's collateral. Unlike the former provisions, the new provisions require the bank to place an appropriate mark on the pledged object – when that is possible – indicating that it has been pledged to the bank.

More importantly, the provisions require the bank to register the existence of the pledge in the commercial register where the company recorded its corporate existence. Until the bank perfects its pledge in this manner, its claim to the collateral is not legally enforceable. These new provisions make it possible for any bank to find out whether a particular piece of property owned by a potential debtor has already been pledged to another bank.

In addition to providing for the creation of registration procedures, the new legislation expands the scope of objects that may secure a bank loan. Most importantly, it provides for the creation of floating pledges. A floating pledge may be established on property that does not exist at the time the contract is made (eg, on inventory which is to be acquired by the company).

Such a pledge may also be attached to property that might be altered or sold by the debtor during the pledge term. Examples of this type of property would include materials that may be transformed during manufacturing processes and any other objects that are not specifically identified and marked, but rather are described only by type – such as office equipment or computers.

The creditor and debtor's pledge agreement may restrict what the debtor may do with such objects: for example, requiring the debtor to replace any objects it discards with objects of the same type and quality. In the absence of a specific contractual agreement, the debtor is generally free to alter or sell any objects secured by a floating pledge.

The draft law also provides that in addition to real estate and movable property, the following types of property may secure a loan:

• An enterprise owned by the debtor.

• A bank account maintained in the creditor bank.

• Intangible assets, such as intellectual property rights.

• Right such as accounts receivable.

• Securities.

Maintenance of collateral

Because the draft law permits the debtor to maintain possession of the collateral during the pledge term, it also provides protection for the creditor's interest in the collateral. For example, the draft provides that a creditor is entitled to inspect the collateral while the pledge remains in force. If the condition of the collateral significantly deteriorates, the creditor's claim immediately becomes due.

In addition, the draft provides that if the collateral is damaged or destroyed during the pledge term, the creditor's right to compensation extends to any claims the debtor may have against third persons liable for the damage or destruction.

Most importantly, the draft significantly changes current law governing the sale of the collateral. At present, if the debtor sells the collateral during the pledge term, the buyer takes the object free of the creditor's interest unless the buyer was acting in bad faith.

This provision effectively destroys the creditor's security interest in the pledged object. To correct this deficiency, the draft law provides that a pledged object may not be sold by the debtor unless permitted by the pledge agreement. If the pledge agreement permits the sale of the collateral, the item remains encumbered by the pledge as long as it is properly marked and the pledge was recorded in the appropriate commercial register.

If, on the other hand, the pledge agreement does not permit the sale of the collateral but the object is nevertheless sold, the draft law provides that the buyer and the seller are both liable to the creditor. The buyer is liable up to the value of the pledged object, and the seller is liable up to the value of the original loan, plus any consequential damages as provided by the pledge agreement.

In addition, both the buyer and the seller must pay the creditor any damages that result from the sale of the object.

Priority of claims

When two or more creditors have granted a loan to a business, the order in which those creditors are entitled to recover from the debtor becomes of critical importance. In most western countries, the order of recovery is determined on a first in time, first in right basis.

The assumption is that any creditor other than the initial one takes an interest in the collateral knowing that all prior creditors will be entitled to prior recovery. That assumption makes sense when all enforceable pledges are centrally registered so that a potential creditor may find out if prior claims exist.

The theory makes less sense, however, in countries such as Poland where non-real estate pledges cannot be recorded in a central registry. Even so, current Polish law pays lip service to the first in time, first in right theory of recovery while creating several exceptions that swallow up the general rule.

The first exception is created by Article 310 of the Polish Civil Code, which provides that a subsequent pledge over a piece of personal property receives priority over a prior pledge unless it can be proven that the subsequent creditor was acting in bad faith when creating the pledge. Proving bad faith is extremely difficult in the absence of a central registration procedure.

A second major exception was created for banks, which under the former regime were state owned and frequently received favourable treatment. Under the exception, all banks are given automatic priority of recovery over non-bank creditors even if the creditors possess a security interest in the debtor's property and the banks do not.

In addition, all banks are given equal status in recovering from the debtor regardless of whether they possess a pledge or not.

The final big exception to the first in time, first in right rule provides that certain types of claims always take precedence over secured claims. Such claims include the costs of execution, tax claims, employee wages and other related benefits.

The current draft corrects these deficiencies in the law governing priority. With the development of registration procedures, all creditors, including the Polish Treasury, that properly register their claims in the appropriate commercial register will always recover on a first in time, first in right basis.

Banks will no longer be treated equally regardless of whether they possess a registered pledge. Nor will they automatically be given priority over the debtor's other secured creditors. A bank with a registered pledge will recover before a bank without a registered pledge, and a non-bank creditor with a possessory pledge will recover before a bank without a registered pledge.

The draft provides that claims will be reimbursed in the following order:

- The costs of maintaining an object after seizure/sale costs.
- Registered pledges in the order they were created.
- Floating pledges in the order they were created.
- Unregistered claims on a particular object.
- Claims of unregistered, personal creditors.

Execution in the event of default

Under the Polish Code of Civil Procedure, all creditors must solicit the assistance of court bailiffs (*komorniks*) to execute on a debtor's collateral. This generally means participating in time-consuming and expensive court proceedings, a fact lamented by lenders wishing to collect on their debts as painlessly as possible.

The draft law expands the scope of action a creditor may pursue upon default. First, the creditor may specify in the pledge agreement a certain course of conduct. This major change in Polish procedure would make it possible for parties to agree by contract to follow any type of execution procedure they choose.

Second, a bank creditor may follow the process described in the bank's articles of association. Finally, the creditor may take on the courses of action described in the Code of Civil Procedure.

The Code, as amended by the draft law, adopts the German model of execution, which encompasses three courses of action:

1. The creditor may apply to the court for a writ of attachment, which prevents the debtor from disposing of the collateral while a court is deciding whether to issue a perfected executory title.
2. Within two weeks of having issuing a writ of attachment (or once the debtor has submitted voluntarily to execution and that fact has been certified by a notary), the court will commence proceedings to determine whether the creditor is entitled to a perfected executory title.
3. Certain banks designated by the Ministry of Justice, in connection with the National Bank of Poland, will be authorized to issue perfected bank executory titles, sometimes translated as enforcement titles.

The *komornik* will be authorized to execute on the debtor's property on the basis of either a perfected executory title or a perfected bank executory title. The major innovation of the draft, however, is that banks empowered to issue perfected bank executory titles will be able to execute on the debtor's property without the *komornik*'s assistance.

Those banks will be permitted to assume ownership of a debtor's property two weeks after they have summoned repayment of a secured claim. Only if the debtor resists will they have to appeal to the *komornik* for assistance in execution.

Conclusion

Poland's current laws governing secured transactions create a lending regime that is unreliable, subject to fraud, expensive and frequently time consuming to execute. It is not surprising that banks are unwilling to lend in this unfavourable environment. Reform may be close at hand, however, if the Council of Ministers or the Polish Parliament adopts a version of the draft collateral law currently being reviewed by the various Polish commissions.

Enactment of the draft would expand the scope of property that could secure a bank loan and would clarify the law on floating pledges. It would also provide for an effective method of registering pledges on moveable property so that priority justifiably could be determined on a first in time, first in right basis.

Finally, it would entitle certain banks to use an efficient and inexpensive method of execution on the collateral in the event of default.