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Security for Parallel Debt Questioned by Poland's Supreme Court

Poland's Supreme Court in a recent ruling found a grant of security for parallel debt to be invalid.

Although not addressed in Poland's legal regime, the institution of parallel debt is being used more and more frequently in Poland when creating security for financing. Relevant agreements for the creation of parallel debt are in many cases governed by English law, although the institution of abstract acknowledgement of debt in the German legal system (*abstraktes Schuldanerkentniss*) performs a similar function, and such structures are also used in Poland. The method of securing parallel debt has caused a lot of concern among practitioners, as there has been no case law to refer to confirming the practices in use.

Facts

The case that the Supreme Court examined in its 9 October ruling arose in connection with bankruptcy proceedings relating to Poland-based subsidiaries of Germany-based furniture manufacturer Schieder. The issue concerned the effectiveness of security established for the lenders (a bank consortium) after the date when the agreements under which the parallel debt arose were concluded, but before the loans were actually disbursed. The borrowers were declared bankrupt before the hardening periods specified in Poland's bankruptcy law expired. The security included transfer of ownership of the borrowers' movables to the

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lenders. The parallel debt agreements were governed by English law.

The receivers of the bankrupt Poland-based companies questioned the effectiveness of the agreements for transfer of ownership as security. They claimed on the basis of Article 127 Section 3 of the Insolvency and Restructuring Act (PUiN) that at the moment those agreements were concluded, they secured a debt that already existed but was not yet mature. The PUiN invalidates such acts during the hardening period.

In turn the lenders argued that the existence of parallel debt always depends on the existence of the underlying principal debt arising under the loan agreement. Therefore the parallel debt does not arise until the former comes into existence, and the amount of such parallel debt varies and corresponds to the main debt at any given time. Until the loan funds are actually disbursed, there is no principal debt; therefore there can be no parallel debt, the lenders argued. As a result, Article 127 Section 3 of the PUiN does not affect the validity of security, because at the moment the agreements for transfer of ownership were concluded, the security established thereunder did not yet secure an existing receivable (debt). In the creditors' view there were no grounds for questioning the validity of the security.

Position of the Supreme Court

Contrary to the view taken by the creditors, the Supreme Court asserted that parallel debt comes into existence at the moment the agreement creating such debt is concluded, regardless of whether the underlying loan has been disbursed and the primary debt exists. The borrower therefore becomes a debtor under the parallel debt, even when the borrower has not yet received the funds from the loan. The Supreme Court concluded, in view of the facts described above, that the agreements for transfer of ownership were not effective because the borrowers were declared insolvent before the lapse of the hardening period specified in the PUiN (in this case two months from the date security was established). In the Supreme Court's view, the agreements securing a future receivable arising on account of the parallel debt should have been concluded, at the latest, on the date of execution of the agreement creating that parallel debt. Otherwise, in the case described in Article 127 Section 3 of the PUiN, the agreements can be deemed invalid during the hardening period.

Conclusion

The full written justification of the Supreme Court's ruling has not yet been published, but it can be expected to contain an analysis of an issue highly relevant to practitioners and reduce the uncertainty surrounding applicability of parallel debt in Poland.

The positive message of this ruling appears to be that parallel debt established pursuant to non-Polish law will be recognized. However, closing procedures for secured loans involving parallel debt will have to take this ruling into account. Lenders will have to sign security documentation for parallel debt prior to, or concurrently with, execution of the agreement creating the parallel debt. Alternatively, they will need to delay disbursements until the relevant hardening period ends, or ensure the solvency of the borrower during such period. Otherwise, they may be at risk.

For more information on the court's latest ruling and what it means for you, please contact your principal Squire Sanders lawyer or one of the individuals listed in this Alert.

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