Executive summary of the public audit report

MANAGEMENT AND CONTROL OF THE ENTERPRISE BANKRUPTCY PROCESS

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Full preliminary investigation report in Lithuanian is available on the website of the National Audit Office: www.vkontrole.lt

DEFINITIONS

Abbreviations:

DEBM refers to the Department of Enterprise Bankruptcy Management

CRBIS refers to the Corporate Restructuring and Bankruptcy Information System

RLE refers to the Register of Legal Entities

LCIS refers to the Lithuanian Courts Information System

SSIFB refers to the State Social Insurance Fund Board

STI refers to the State Tax Inspectorate.

Concepts:

Bankruptcy refers to the state of an insolvent enterprise, defined by the law, when the objective is to achieve the end of this state by satisfying creditors' requirements and ensuring the balance of the interests of the creditors and the enterprise[1].

Insolvency of an enterprise refers to the state of an enterprise, which is unable to fulfil its obligations (pay debts, perform pre-paid works, etc.) and when the overdue liabilities (debts, works not done, etc.) exceed half of the balanced assets[2.]

Fraudulent bankruptcy refers to deliberate bringing of the enterprise to the state of being bankrupt (by deliberate action or lack thereof) and (or) by entering into transactions, when it was known or had to be known that these transactions will violate the rights and (or) legal interests of the creditors[3].

Restructuring of an enterprise refers to the entirety of procedures defined by the law, the purpose of which is to preserve and develop the activity of the enterprise, pay debts and avoid bankruptcy by receiving support from the enterprise's creditors, in application of economic, technical, organisational and other measures[4].

Enterprise in financial difficulties refers to an enterprise unable to fulfil its obligations and reduce losses, which, without creditors' help, would result in termination of its activity and bankruptcy[5].

Simplified bankruptcy procedures refer to the entirety of judicial enterprise liquidation procedures carried out when the enterprise has no assets or when its assets are insufficient to cover the legal and administrative costs, and the issues that apply to the competence of the meeting of the creditors, are solved by the court[6].

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[1] Enterprise Bankruptcy Law of the Republic of Lithuania, 20-03-2001, No. IX-216 (revision of the Law No. XII-805 of 27-03-2014),
art. 2,pt. 2.

[2] Ibid. (amendment No. X-1557 of 22-05-2008), art. 2, pt. 8.

[3] Ibid. (amendment No. XII-237 of 18-04-2013), art. 2, pt. 12.

[4] The Law on Restructuring of Enterprises of the Republic of Lithuania, 20-03-2001, No. IX-218 (revision of the Law No. IX-978 of 02-07-2010), art. 2, pt. 3.

[5] Ibid. (amendment No. IX-978 of 02-07-2010), art. 2, pt. 1.

[6] Enterprise Bankruptcy Law of the Republic of Lithuania, 20-03-2001, No. IX-216 (revision of the Law No. XII-805 of 27-03-2014), art. 2, pt. 13.

EXECUTIVE SUMMARY

Enterprise bankruptcy is a long, complicated, relatively common and natural part of business in all economies, which may have negative outcomes on both business subjects and the entire country's economy. A bankrupt enterprise usually does not settle with its creditors, its employees lose their jobs and the confidence in the country's business environment decreases. Therefore, the management of enterprise bankruptcy process requires an efficient insolvency policy, which helps to protect creditors' interests.

The number of bankruptcy cases during the economic recess in the European Union increased by as much as 46%. According to calculations, enterprise bankruptcies resulted in 1 700 000 people losing their jobs in 2009 (1 200 000 in 2008)[7]. In Lithuania 2009 marked the beginning of 1 844 bankruptcy procedures, which is two times more than during previous periods. Later this number decreased, but, compared to the pre-crisis period, remained large nevertheless. 2013 marked the beginning of 1 550 enterprise bankruptcy procedures.

The purpose of the audit is to evaluate, whether the management and control of the enterprise bankruptcy process are efficient, that is:

- the efficiency of the management of bankruptcy process;
- the liabilities of enterprise managers and owners;
- the sufficiency of the management and control of the bankruptcy process;

The subjects of the audit are the Ministry of Economy of the Republic of Lithuania and the Department of Enterprise Bankruptcy Management under the Ministry of Economy.

The auditors also gathered additional information from the State Tax Inspectorate, State Social Insurance Fund Board, National Courts Administration, county courts, Lithuanian Criminal Police Bureau, Prosecution Service of the Republic of Lithuania, Financial Crime Investigation Service under the Ministry of Interior, PI Centre of Registers and associations of bankruptcy administrators. We examined the legal acts, related to the regulations of enterprise bankruptcy process, the experience of other countries, as well as studies and analytic works on the issues of enterprise bankruptcy process. The findings of the audit were supported by the data from the Lithuanian Courts Information System and the Corporate Restructuring and Bankruptcy Information System.

The audit covered the period of 2011-2013. The change and trend analysis used the data from previous and subsequent years.

The following public audit conclusions and recommendations were drawn upon the assessment of the audit findings.

The recommendation implementation plan is provided in the appendix No. 10.

CONCLUSIONS

1. The coverage level of the credit-related obligations of bankrupt enterprises is low and amounts to 13%. During the period from 2009 to the first quarter of 2014 creditors of bankrupted enterprises lost LTL 8.5 billion of income, including LTL 1.5 billion lost to the state budget. This shows that there is no efficient protection of the creditors' interests, which may reduce investors' confidence in the business environment and the efficiency of the solutions of insolvency policy (chapter 1).
2. During the period of 2009-2013 as much as 70% of the creditor requirements at the beginning of enterprise bankruptcy process were two times higher than their existing assets, 20% of the enterprises did not have enough assets to cover their administrative costs and the bankruptcy procedures were simplified, which shows that enterprise bankruptcy procedures are initiated too late and the liabilities for failure to initiate bankruptcy procedures on time, applicable to enterprise managers and owners as defined by the law, are applied particularly rarely (subchapter 1.1 and paragraph 1.4.1.).
3. Legal regulations of the initiation of bankruptcy procedures is flawed because:
   3.1. there is no specific term, during which enterprise managers and owners must address the court regarding bankruptcy procedures, in case of insolvency of the enterprise (paragraph 1.4.2);
   3.2. the current definition of the concept of insolvency does not create preconditions to use the data of financial accountability of the enterprise to determine, whether the enterprise is insolvent and the access to information for the creditors is very complicated (paragraph 1.4.2).
4. Enterprise bankruptcy procedures are insufficiently coordinated and controlled, because it remains unclear who and when should initiate the questions of accountability, who is responsible for comprehensive coordination, monitoring and timely implementation of the process, therefore, the process is not always active and the length of the procedures tend to become longer (subchapters 1.1, 1.3 and 1.4).
5. Enterprise managers and (or) owners of enterprises are not deterred from illegal action aimed at intentional insolvency, because:
   5.1. the proving fraudulent bankruptcies requires a lot of time and financial costs; however, even if such bankruptcy has been proved, responsible persons are not identified and civil liability applies only through the institute of damage (paragraph 1.4.3);
   5.2. in many cases, pre-trial investigations of criminal bankruptcies are terminated due to the lack of evidence and the expiry of the period of limitation. During the period between 2009 and the first quarter of 2014 there were 400 pre-trial investigations, 72 of which (18%) were completed and reached the court. In 20 (28%) of these cases the violators were prosecuted (paragraph 1.4.3);
   5.3 criminal bankruptcy is an economic crime, but the liability (imprisonment for up to three years, without application of pecuniary sanctions) may be insufficient (subchapter 1.4.3).

[7] A Second Chance for entrepreneurs: Prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start – Report of the Expert Group, European Commission DG Enterprise and Industry, January 2010; http://ec.europa.eu/enterprise/policies/sme/business-environment/files/second_chance_final_report_en.pdf.

6. The realisation of the assets of bankrupt enterprises is not always efficient, leaving an opportunity to sell high-value assets not only on auction, which reduces the creditors' possibilities to reclaim their debts from bankrupt enterprises (subchapter 1.2).
7. The regulation of paying the administrator's salary and other administrative costs is insufficient, because:
   7.1. The procedure of paying the administrator's salary and other administrative costs is not regulated and in case of disputes the court eliminates the resolution of the meeting (committee) of creditors and transfers the issue back to the meeting of creditors for revision, because the court does not evaluate and approve administrative cost estimates. This extends bankruptcy procedures (subchapter 1.5).
   7.2. in cases when the assets of the enterprise are not enough to cover litigation and administrative costs not all ways in case of simplified bankruptcy procedures guarantee the payment of the administrator's salary and administrative costs (subchapter 1.6).
8. Some of the bankrupt enterprises or enterprises in bankruptcy that are entitled to benefits from the Guarantee Fund cannot be found and thus cannot receive their benefits. During the period from 2011 to April 2014 these benefits constituted LTL 3 800 000 (subchapter 1.7).
9. The procedures of organising administrators' qualification exams do not create preconditions to assess, whether the administrators have enough knowledge, also there is no way to ensure the administrators' compliance with the requirements of qualification improvement, while the legal acts do not provide any information on who should organise the specialised courses for obtaining and improving administrators' qualifications; there are also no quality requirements and thus their qualification cannot be ensured (subchapters 2.1 and 2.2).
10. The monitoring of administrators' activity is focused on formal violations of legal acts and do not cover universal efficiency assessment of the administrator's activity, while the application of the sanctions defined by the law is insufficiently regulated, the application practice is not clear and known to the public, which may make the sanctions not effective enough (subchapters 2.3 and 2.4).

RECOMMENDATIONS

To the Government of the Republic of Lithuania

1. In order to protect the interests of creditors and reduce the risk of delayed initiation of bankruptcy procedures, it is necessary to:
   1.1. define measures to ensure timely initiation of bankruptcy procedures (conclusions 2 and 3);
   1.2. initiate changes in the legal acts:
      1.2.1. define the time period, during which the manager of an enterprise must initiate bankruptcy procedures, when it became clear or should have become clear that the enterprise is insolvent (conclusion 3.1);
      1.2.2. define an obligation to evaluate, whether the manager of an enterprise undergoing bankruptcy procedures, did not violate the time period given to initiate bankruptcy procedures (also in cases when the application is submitted to the court by creditors and the enterprise's insolvency is determined by the court) (conclusions 2 and 3.1);
      1.2.3. define whose responsibility it is to demand for liability regarding delayed initiation of bankruptcy procedures (conclusions 2 and 4);
      1.2.4. define measures to ensure that the law on insolvency of enterprises is related to documents provided by financial accountability (conclusion 3.2).

2. In order to ensure administrators' right to fair payment for their work and reduce the number of disputes between creditors and administrators, which extend bankruptcy procedures, it is necessary to initiate the following amendments to the legal acts:
   2.1. to define the order of the payment of the administrator's salary and other administrative costs, as well as the recommended amounts of the remuneration (conclusion 7);
   2.2. regarding the court's duty to evaluate and approve the estimate of administrative costs in cases when the meeting of creditors and the administrator cannot solve the dispute regarding the size of the estimate (conclusion 7).
3. Seeking for appropriate liability for enterprise managers and owners regarding deliberate and criminal actions that result in insolvency of an enterprise, it is necessary to initiate the following changes in the legal acts:
   3.1. to make sure that the persons behind fraudulent bankruptcies are identified and subject to sanctions by limiting their right to hold management positions of a public and (or) private legal person or be a member of a collegiate managing body from 3 to 5 years.
4. Seeking for more transparent and efficient sale of property, it is necessary to:
   4.1. make sure that mortgaged property, real estate and other types of registered high-value assets are sold in auction (conclusion 6);
   4.2. define what value is regarded as high value (conclusion 6);
   4.3. make sure that if the meeting of creditors decides to split the property unsold in auction and sell it separately, the split property is also sold in an auction according to the same procedure (conclusion 6).
5. In order to ensure appropriate monitoring of bankruptcy procedures and control of terms, it is necessary to create or improve the already-available information systems for accumulating data about each bankruptcy procedure, terms and major events, providing the access to this information for the interested parties, creditors, etc. (conclusion 4).
6. In order to ensure appropriate qualifications and competence of the administrators, it is necessary to:
   6.1. change the examination procedure of the persons seeking to obtain the right to provide bankruptcy administration services, which would enable to examine their knowledge and ensure the application of the principles of objectivity and equality (conclusion 9);
   6.2. establish the administrator's duty to provide the responsible institution with information about qualification improvement on a regular basis (conclusion 9);
   6.3. relate the failure to improve qualifications with the suspension or termination of the right to provide bankruptcy administration services (conclusion 9);
   6.4. define the requirements for training courses, acknowledged as appropriate for qualification improvement (conclusion 9).
7. Seeking to ensure that administrators are subject to appropriate effective and objective sanctions that correspond to the violation, it is necessary to:
   7.1. define additional sanctions for administrators, e.g. fines, suspension of the right to provide bankruptcy administration services, etc. and differentiate them according to the type and scope of violations (conclusion 10);
   7.2. consider a possibility of making the sanctions applied to administrators public. (conclusion 10).

For the Department of Enterprise Bankruptcy Management under the Ministry of Economy

8. Seeking for more efficient monitoring of bankruptcy administrators, it would be advisable to define methods and (or) prepare a manual, which could be used for thorough inspections of bankruptcy administrators, allowing to determine, whether the administrators implement their activity and meet the standards defined by the law (conclusion 10).