Executive summary of the public audit report

MANAGEMENT OF ENTERPRISE RESTRUCTURING PROCESS

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DEFINITIONS

Abbreviations:

DEBM refers to the Department of Enterprise Bankruptcy Management

CRBIS refers to the Corporate Restructuring and Bankruptcy Information System

LITEKO refers to Lithuanian Courts Information System

SSIFB refers to the State Social Insurance Fund Board

STI refers to the State Tax Inspectorate

PPO refers to the Public Procurement Office

Concepts:

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[1].

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[2].

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[3].

Current payments of an enterprise undergoing restructuring proceedings refer to all payments (including the compulsory) required to ensure the economic activity of the enterprise, which are paid during the restructuring proceedings of the enterprise, beginning from the day, when the court's decision to initiate restructuring proceedings comes into force[4].

[1] 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.

[2] Ibid. Art 2, pt. 1.

[3] The Law on Enterprise Bankruptcy of the Republic of Lithuania, 20-03-2001, No. IX-216 (revision of the Law No. XI1557 of 22-05-2008), art. 2, pt. 8.

[4] The Law on Enterprise Bankruptcy of the Republic of Lithuania, art. 2, pt. 9.

SUMMARY

Enterprise restructuring is a process, the purpose of which is to revive the operation of an enterprise in difficulty using various measures: postponing or reducing obligations to creditors during reorganisation of the enterprise's operation, during the restructuring proceedings the enterprise receives protection against creditors, suspending all recovery procedures and calculations of interest and penalties. Enterprises are usually restructured in order to distribute their debts and their payment terms and procedures, in order to avoid bankruptcy and recover the enterprise's normal economic activity[5].

In Lithuania on average 1500 companies face bankruptcy proceedings every year, which results in negative social and economic outcome, while the creditors recover only about 13% of their requirements. Insolvency policy offers a preventive measure — restructuring process — which can be applied for companies, which encounter financial difficulties, but remain solvent.

According to the World Bank, the countries with restructuring as the most common method of dealing with insolvency show the greatest rates of credit recoveries[6], therefore the policy of the European Union actively promotes restructuring processes[7].

Before the economic crisis the opportunity to use the option of restructuring used to be used only by four companies, while the number of restructuring proceedings in 2009 jumped to 71. Later it reduced to 58 in 2011, 44 in 2012, 48 in 2013 and 29 in 2014.

In 2014 the National Audit Office conducted an audit on *Management and Control of the Enterprise Bankruptcy Process*. The audit found out that bankrupted companies have a low rate of credit recovery and this encouraged to analyse restructuring as a preventive measure.

The purpose of the audit is to assess the efficiency of enterprise restructuring process, that is:

- the efficiency of the management of the stages of the enterprise restructuring process;
- whether the process ensures the balance of interests between creditors and enterprises;
- the success of the processes;
- whether state institutions create conditions for these processes;
- the management and control of the 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.

Additional data was gathered from the State Tax Inspectorate, State Social Insurance Fund Board, National Courts Administration, Vilnius, Kaunas, Klaipėda, Šiauliai and Panevėžys county courts, associations of bankruptcy administrators, Public Procurement Office and the Competition Council. We examined the legal acts, related to the regulations of enterprise restructuring process, the experience of other countries, as well as studies and analytic works on these related issues. The audit evidence was based on the data from:

[5] The decision in the civil case No. 3K-3-67/2015, made on 09-01-2015 by the Lithuanian Supreme Court.

[6] Doing Business *Resolving insolvency*. http://www.doingbusiness.org/reports/globalreports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB14-Chapters/DB14-Resolving-insolvency.pdf [accessed on 08-05-2015].

[7] Communication from the Commission KOM (2010) 2020 Europe 2020 *Advanced, sustainable and integrative growth strategy* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:2020:FIN:LT:PDF [accessed on 08-05-2015].

- Lithuanian Courts Information System;
- Corporate Restructuring and Bankruptcy Information System;
- Information gathered and examined from Vilnius, Kaunas and Panevėžys county courts.

The audit covered the period of 2013-2014. The change and trend analysis used the data from previous and subsequent years.

We found out that during the period from 2001 to the first quarter of 2015 only 5.8% restructuring processes were successful, while after termination of the restructuring procedures 81% of the companies went bankrupt.

Insolvency policy and its practical implementation does not make sure that insolvent companies should not be subject to restructuring proceedings, the protection of the creditors' interests is insufficient, there is no preclusion of the possibility of misuse of restructuring in order to postpone the company's bankruptcy, and the restructuring process itself is insufficiently monitored.

State institutions do not contribute enough to creating favourable conditions for companies experiencing financial difficulties, but limit the participation of restructured companies in public procurements and other measures, while tax administrators are not inclined to give up a part of their creditor demands. There are no preventive measures to promote timely restructuring.

Upon evaluation of the evidence gathered during the audit, we provide the conclusions and recommendations of the public audit. Their appropriate implementation would increase the number of successfully restructured companies and the level of credit recovery, also decrease the number of companies subject to bankruptcy, improve the protection of creditors' interests, eliminate the cases of misuse of restructuring and contribute to business promotion, as well as long-term recovery of companies' vitality by providing fair businessmen with another chance.

It should be noted that during the audit the Ministry of Economy prepared a new amendment to the Law on Restructuring of Enterprises, which is currently under discussion. It solves some of the problems identified during the audit. The National Audit Office also participated in the discussion and offered suggestions regarding the new amendment to the law.

CONCLUSIONS

1. The process of restructuring is inefficient, there is no sufficient protection of creditors' interests, which may reduce the investors' (company leaders', creditors') confidence in restructuring and business environment, because:
   1.1. During the period between 2001 and the first quarter of 2015 only 5.8% of enterprise restructuring processes were completed successfully, while the rest of the 81% were terminated and replaced by bankruptcy procedures (chapter 1);
   1.2. the credit coverage level for state creditors (STI and SSIFB) is low, amounting merely to 7%, while at the end of 2014 the amount of unsatisfied credit requirements in on-going restructuring processes amounted to more than 20 million euros (chapter 1);
   1.3. in practice restructuring procedures are applied to insolvent companies, which do not have any perspectives (37% of the 30 cases analysed during the audit were insolvent and all of them went bankrupt), therefore giving this opportunity to an insolvent company only postpones bankruptcy and reduces the creditors' possibility to recover their assets (subchapter 1.1);

1.4. there are cases of providing the court with documents that do not reflect the real financial situation of the company and thus the court starts restructuring proceedings for insolvent companies and creditors approve a restructuring plan, which cannot be implemented (subchapter 1.2);

1.5. creditors can express their will by voting regarding the approval of a restructuring plan, while the implementation of the assurance measures of the implementation of credit obligations is suspended from the court's decision to accept the application regarding restructuring proceedings until the court's decision to approve the restructuring plan. This takes about 10.6 months and results in limiting the creditors' rights for an unreasonably long time. This does not comply with the principles of the international practice, while the audit findings show that the creditors' opportunities to recover their assets during this period reduce (subchapter 1.3);

1.6. when voting and making decisions creditors are not divided according to the basis of their demands and rights, therefore the procedure of making decisions does not comply with the principles of the international practice and does not balance the rights and interests of different creditors (subchapter 1.4);

1.7. the success of restructuring mainly depends on the quality of the restructuring plan, however the plans prepared do not ensure success in solving financial problems of the company under restructuring procedure and thus 71% of the restructuring proceedings during the period between 2011 and the first quarter of 2015 were terminated because their plan was not approved, while the restructuring proceedings of the rest of the companies was terminated, because the plans were not fully implemented (subchapter 1.5);

1.8. in the majority of the cases the creditors' possibilities to recover their assets during the restructuring period decline because of insufficient control of the process. There is no obligation to follow the company's insolvency and make a timely application regarding termination of the restructuring proceedings, while the contents and frequency of the reports about the implementation of the plan is insufficiently regulated. There is also no possibility for individual creditors and restructuring administrator to address the court regarding termination of the restructuring proceedings, when the plan cannot be implemented, the company is insolvent or does not pay the current payments (subchapter 1.6).

2. Application of two individual insolvency processes (restructuring and bankruptcy) is flawed, because:

2.1. in some cases the insolvency evaluation volumes differ and insolvency is regarded differently in restructuring and bankruptcy proceedings, which unreasonably postpones the bankruptcy proceedings (subchapter 1.7);

2.2. there is no fluent transition from restructuring to bankruptcy proceedings. This would ensure higher level of creditors' recoveries and save working time costs of the judges (subchapter 1.7).

3. State institutions do not create sufficient conditions for successful restructuring, because:

3.1. tax administrators are not inclined to give concessions to companies undergoing restructuring proceedings, even though legal acts allow state creditors to give up all or some of their demands, to take over or transfer as to the other creditors (paragraph 2.1.1);

3.2. there are no preventive measures to ensure and promote timely restructuring proceedings of companies with financial difficulties (paragraph 2.1.2);

3.3. companies under restructuring proceedings have limited possibilities to participate in public procurements and other measures (chapter 2 and paragraph 2.1.3).

4. The administrative control, implemented by the Department of Enterprise Bankruptcy Management, is insufficient, because the attention and volume of planned inspections is not enough to control the activity of restructuring administrators, the inspections are not thorough and do not help to make sure that the administrators have performed their obligations according to the Law on Restructuring of Enterprises. The monitoring does not ensure the efficiency of the restructuring administrators' work and does not help to identify violations, while restructuring administrators do not perform their functions appropriately and avoid responsibility (subchapter 2.2).
5. There is not enough trainings to deepen judges' expertise of insolvency law and economic analysis, and 89% of the judges state that such trainings would be very useful in examining cases of restructuring. Moreover, the auditors have noticed that judges tend to interpret the Law on Restructuring of Enterprises differently, therefore, the attention for improving judges' competence in restructuring cases is insufficient (subchapter 2.3).

RECOMMENDATIONS

To the Government of the Republic of Lithuania

1. In order to protect creditor interests and avoid misuse of the restructuring process by postponing bankruptcy procedures, it is necessary to initiate changes in legal acts, which would:
   1.1 make sure that insolvent companies would not be subject to restructuring proceedings (conclusion 1.3);
   1.2 shorten the term of submitting restructuring plan projects to the court (conclusion 1.5);
   1.3 create an opportunity to suspend the suspension of the implementation of measures which ensure the implementation of all or certain obligations during the preparation of the restructuring plan (conclusion 1.5).
2. In order to ensure the credibility of the data provided to the court and the creditors, it is necessary to establish an obligation for companies to submit the evaluation report of the enterprise's (business) assets together with the application to court regarding restructuring proceedings (conclusion 1.4).
3. Seeking to protect the interests of all creditors and to ensure the balance of different interests in making the major decisions in the process of restructuring, it is necessary to establish creditor voting in groups (conclusion 1.6).
4. Seeking to increase the number of successfully completed restructuring proceedings, it is necessary to establish measures in order to ensure high-quality preparation of the restructuring plan (conclusion 1.7).
5. In order to ensure that deteriorating financial situation of a company and its becoming insolvent do not violate creditors' interests, and in order to save time costs, it is necessary to establish:
   5.1 the responsibility of the restructuring administrator and the company's management body to keep monitoring the company's financial situation during the restructuring proceedings and, in case the company becomes insolvent, apply for the termination of

the restructuring proceedings and commencement of bankruptcy proceedings (conclusion 1.8);

5.2 the frequency and contents of the reports that must be submitted to creditors and the court by the management body and/or restructuring administrator regarding the implementation of the restructuring plan (conclusion 1.8);

5.3 in the Law on Restructuring of Enterprises that insolvency in restructuring proceedings should be interpreted and regarded as the same concept as that in bankruptcy proceedings (conclusion 2.1);

5.4 that upon making a decision to terminate restructuring proceedings the court must start to examine the issue of beginning bankruptcy proceedings (conclusion 2.3).

For the State Tax Inspectorate under the Ministry of Finances of the Republic of Lithuania

6. In order to avoid unequal competition conditions, it is necessary to remove obstacles for restructuring companies to participate in public procurements and make sure that documents provided by state institutions regarding the implementation of tax obligations indicate that the company undergoing restructuring proceedings does not have tax arrears, if the company pays the compulsory payments according to the terms indicated in the restructuring plan (conclusion 3.3).

For the National Courts Administration

7. In order to ensure the trainings necessary for judges examining restructuring proceedings, it is advisable to take measures to make sure that the training plans for judges include trainings for deepening their expertise in insolvency law and economic analysis (conclusion 5).

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

8. Seeking for more efficient monitoring of restructuring administrators, it would be advisable to define methods and (or) prepare a manual, which could be used for thorough inspections of restructuring administrators, allowing to determine, whether the administrators implement their activity and meet the standards defined by the law (conclusion 4).

The measures and terms of the implementation of recommendations are provided in the Appendix 4 of this report “The plan of implementation of recommendations”.