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REPUBLIC OF LITHUANIA

PROPOSALS FOR REFORMING THE INSOLVENCY REGIME

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July 2010

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PREFACE

At the request of the Ministry of Economy of Lithuania, a technical assistance mission visited Vilnius during the period of May 3-7, 2010 to advise the Lithuanian authorities on their proposed reforms to the insolvency regime.[1] During the mission, meetings were conducted with Rimantas Žylius, Viceminister of Economy; Audronė Railaitė, Director of Company Law and Public Procurement Policy Department of the Ministry of Economy; Asta Misiukienė, Chief Official of Company Law Division of Company Law and Public Procurement Policy Department; Milda Ručinskaitė, Head of Company Law Division; Virginijus Narvilas, Director of Department of Enterprise Bankruptcy Management under the Ministry of Economy; Svajonė Alunderienė, Deputy Director of Department of Enterprise Bankruptcy Management under the Ministry of Economy; and other stakeholders.[2]

This report summarizes key findings and recommendations prepared on the basis of the mission's review of Lithuania's legal and institutional insolvency framework, and on the information provided by the authorities and other stakeholders met during the mission. The

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report identifies key shortcomings of the current legal and institutional framework with respect to the corporate insolvency regime and presents options for reform based on their legal, institutional and technical feasibility and in light of international best practices (where applicable). In particular, this report provides advice to the Lithuanian authorities regarding *the first stage of reforms* envisaged by the Ministry of Economy for Lithuania's insolvency regime on the following three areas: (i) designing a *Personal Bankruptcy Act*, (ii) refining the treatment of *fraudulent corporate bankruptcies*; and (iii) introducing targeted amendments to the *Enterprises Bankruptcy Act*.

The mission would like to thank the authorities, in particular Mr. Rimantas Zylius (Vice Minister of Economy), Ms. Audroné Railaité (Director of Company Law and Public Procurement Policy Department the Ministry of Economy) and Ms. Asta Misiukiené (Chief Official of the Company Law Division—Company Law and Public Procurement Policy Department the Ministry of Economy) as well as other officials of the Ministry of Economy, Supreme Court judges, members of Parliament and the representatives of the private sector for their interest and dedication of time to discuss different legal and policy issues related to Lithuania's insolvency regime and for their excellent cooperation with the mission.

INTRODUCTION

The government of Lithuania aims at introducing a major reform of the insolvency regime through the adoption of a new and comprehensive Bankruptcy Act by end 2012. However, acknowledging the existence of some shortcomings in the current regime, the Ministry of Economy (MoE) is working towards addressing some areas in need for immediate reforms. In this context, the MoE requested technical assistance from the IMF's Legal Department (LEG) to provide advice in this area. A LEG's fact finding mission visited Vilnius during May 3-7 and met with the representatives of the government, the Judiciary, Parliament, other public agencies and stakeholders in the private sector.

This report summarizes the main findings and recommendations of the fact finding mission. The following three sections of the report present the mission's views on three specific areas in which the MoE sought technical assistance from LEG: Section II presents proposals for the design of a Personal Bankruptcy Act and Section III discusses: (i) options for refining the treatment of fraudulent corporate bankruptcies and (ii) recommendations for introducing targeted amendments to the Enterprises Bankruptcy Act.

I. PROPOSALS FOR DESIGNING A PERSONAL BANKRUPTCY ACT

Overview of current system

Currently, Lithuania's insolvency regime only governs the bankruptcy of 'enterprises' and not individuals. This gap in the legal framework has become more apparent since the emergence of the global financial crisis that had a toll on Lithuania's private sector, not only affecting corporate but also the household sector. In this context, the MoE is supporting the introduction of a Personal Bankruptcy Act (PBA) as part of Lithuania's insolvency regime. For this purpose, a Concept of the Law on PBA (the "Concept Note") was submitted to Government and subsequently approved by it.

While the Concept approved by Government constitutes a good first step towards the development of such an act, certain aspects of the proposal need to be refined when the draft bill is prepared, in particular:

a. ***Insolvency threshold***. The insolvency threshold was not clearly discussed in the Concept Note. Rather, the Concept Note seems to refer to two different tests: one set forth in terms of a quantitative amount of debt overdue that will be specified in the law; and the other one based on a general liquidity test which refers to the inability of a debtor to pay his/her debts within a "statutory time limit" also to be determined in the law. In this context, it is advisable to have a single and clear insolvency threshold. Consideration could be given, for instance, to establishing a threshold of an 'equitable insolvency" that is, based on the debtor's inability to pay debts as they fall due.

b. ***Discharge rules***. The Concept Note envisages a period of up to ten years for the debtor to satisfy his/her debts through a payments plan prior to being able to get a discharge. The proposed ten-year repayment period is too long compared to the normal repayment period in Europe ranging from 3 to 6 years (e.g., 3 years in England, 3½ years in Latvia, 5 years in Denmark, Finlandand Norway and 6 years in Germany). Accordingly, repayment period between 3 to 6 years is recommended for Lithuania.

c. ***Extra-judicial bankruptcy***. The Concept Note foresees a regime where the personal bankruptcy procedure could be handled out-of-court with the "creditors' meeting" exercising the competences that the court would have in a judicial bankruptcy proceeding. While this is a valid option, consideration should be given to the practical experience that Lithuania has had with respect to using extra-judicial procedures in a bankruptcy context. In particular, information gathered by the mission during its visit to Vilnius indicates that the extra-judicial bankruptcy procedure for enterprises is rarely used as there are no incentives in the current framework to treat these matters outside the court system. Accordingly, we recommend the authorities to take this into account when deciding whether to implement a similar procedure for personal bankruptcies. Moreover, it should be borne in mind that debtors and creditors are always free to reach out-of-court voluntary agreements for debt restructurings under civil/contractual law. In this context, the authorities could consider providing incentives for voluntary debt restructurings. For instance, in some jurisdictions, the government promotes the issuance of "guidelines" for voluntary work-outs to be followed by creditors and debtors, as well as "tax incentives" for debt restructurings (the latter, if the fiscal envelope so allows).

Proposals for Designing a Personal Bankruptcy Act

It is worth noting from the outset that ***there are no best internationally accepted practices in the area of personal insolvency***. In this context, to present proposals for the design of such new framework, the mission needs to rely on those good practices that we have identified in a cross-country analysis of jurisdictions where ***personal insolvency regimes*** have been in place for a while. Examples of these countries include *France, Germany, Japan, Latvia, Spain, The Netherlands, the United Kingdom, and the United States (US)* (see Annex I for a summary of some of these country experiences in the area of personal insolvency).

The purpose of personal bankruptcy legislation is multiple. It aims primarily to establish balanced and predictable burden sharing between the debtor and his/her creditors and to maintain credit discipline by maximizing the payoff for all creditors. It also allows the individual to get a "fresh start" after the expiration of a certain period, during which the debtor has made his/her best efforts to pay off the debt and be rehabilitated. In some jurisdictions, this also includes a special regime for debtors who have no capacity to repay at all. In sum, the main goal of the insolvency proceedings for individuals is to rehabilitate the debtor by discharging his remaining debts after having repaid the debt for a specified period of time and fulfilled certain requirements, thus enabling him to return to an economic life as any other member of society.

To achieve the purposes described above, the legal framework should set forth an effective and efficient mechanism for the settlement of the individual's debts and disposition and distribution of all the individual's non-exempt assets to satisfy, totally or partially, his/her creditor's claims, while the debtor receives in return some legal protection from further collection actions by creditors.

Cross-country experience shows that in this area there are essential differences between the Anglo-Saxon and the continental European approaches to personal insolvency. In the US, for instance, the approach, which is known as the "open credit economy" model, is characterized by the rapid discharge of the individual's debts upon filing for bankruptcy and liquidation of all non-exempt assets, without the need to complete a strict "payment plan". In continental Europe, however, the traditional approach has been to require the completion of a "payment plan" before any discharge could be achieved, which is known as the "consumer debt adjustment" model. Given the prominence given to the payment plan, the term "earned start" is preferred in Europe in contrast to the term "fresh start" used in the US.

Given the history of the development of insolvency regimes, the natural objection to the concept of 'debt discharge' in the context of bankruptcy proceedings is understandable. Originally, bankruptcy proceedings were used as a mean to obtain and distribute the debtor's assets to the benefit of his/her creditors. Sometimes, it was even used to penalize a debtor in default giving rise to the appearance of the "stigma" traditionally attached to such proceedings. Accordingly, bankruptcy proceedings were not initially intended as a means to provide 'relief' to the debtor, but rather to stigmatize and penalize him or her.

Nowadays, the rehabilitation of the debtor is a primary aim of the consumer insolvency laws, particularly in Europe. The main idea behind this trend is that rehabilitation allows a debtor to restore his/her position as an economically productive citizen that in turn contributes to the growth of the country's economy as a whole. However, the discharge of a debtor following a state of insolvency is not the ultimate goal, but rather to achieve the overall debtor's rehabilitation. To this end, in addition to the elements required for obtaining the discharge, a personal insolvency regime also needs to have in place other elements as a pre-condition to a debtor's rehabilitation, namely:

- *The provision of debt counseling and financial education for individuals*. The idea is to use these tools to prevent recurrence of "over-indebtedness" in the consumer sector. From a European perspective, a 'payments plan' as part of the insolvency regime for individuals is normally viewed as a means for instilling payment discipline and money management skills (i.e., financial education), which may have not been possessed by the debtor prior to his/her entering in debt distress or default.

- *The non-discrimination of consumer creditors due to past credit history*. While some record of the debtor's insolvency history should exist, this should not overly restrict debtors' full rehabilitation once all requirements are fulfilled for this purpose. In this context, special consideration should be given to this element when designing a credit registry for individuals as part of the insolvency regime.

Taking into account cross country experiences in this area, we recommend the Lithuanian authorities to take into account the following key elements in developing a personal bankruptcy act:

1. Access

a) *Types of debtors covered by this regime*. A policy decision has to be made as to the type of debtors that would be covered by the act. In principle, the question rests on whether the act will cover any individual for his/her consumers' debts (consumers), or it will also cover individuals who undertake economic activities (e.g., sole traders).

b) *Insolvency threshold*. Another policy decision has to be made as to whether the personal bankruptcy act will provide for a debt resolution mechanism for debtors whose amount of debt in distress or overdue exceeds a particular quantitative threshold, or debtors who are unable to pay debts as they fall due and there is an expectation of the continuation of such inability for the foreseeable future (e.g., in the case of Sweden, the horizon of expectation of inability to pay in the future extends to the next five years at least). In taking a decision on this matter, the authorities could take into account certain qualification criteria such as: (i) the level of indebtedness of the debtor; and (ii) the debtors' behavior (i.e., acting in "good faith).

c) *Costs of accessing the scheme.* The authorities need to determine whether a fee or other charges will have to be paid to access the mechanism and by whom (e.g., the applicant).

d) *Rules for filing a petition*. The authorities should specify the requirements, rules and procedures for filing a petition.

e) *Automatic "stay" on enforcement actions by creditors upon approval of a petition*. A decision should be made as to whether an automatic stay for a short period of time would be triggered by court approval of the insolvency petition and creditors would have the right to request a relief from the automatic stay under certain conditions. An appropriate balance needs to be struck between the need to allow for the possibility of debt restructuring negotiations and maintenance of integrity of the debtor's estate and the need for adequate protection of creditors' interests. In all jurisdictions we surveyed that have in place a personal insolvency regime, such an automatic stay is imposed and secured creditors are allowed to request a relief under certain conditions.

f) *Availability of the mechanism to the same debtor*. The authorities should also determine whether a bankruptcy proceeding would be made available to the same debtor only once in a lifetime or more than once provided certain criteria are met.

2. Payment Plan

a) *Model*. The authorities will have to decide on the type of payment mechanism to be implemented. This could be a mechanism where only debtors with [some] capacity to implement a payment plan will be covered (debtors with capacity to repay a restructured debt) (EU model), or whether exceptional provisions would allow participation of debtors with no such capacity (US model). Capacity to repay would be assessed based on the following key elements:

(1) *Liquidation of debtor's non-exempted assets*. After all non-exempted assets of the debtor have been liquidated and the liquidation proceeds distributed to creditors , only the outstanding amount is subject to the 'payment plan'.

(2) *Definition of debtor's disposable income*. The amounts to be paid by the debtor under the payment plan will be detracted from the debtor's disposable income. For this purpose, it is very important to have in the law a clear definition of disposable income, which in turn should at a minimum exclude the basic and necessary expenses of the individual. In addition, the analysis of disposable income should take into account the assessment of the estimated future income of the debtor. In doing this assessment however, a key and challenging issue is the basis upon which such income is determined. In jurisdictions with a large "gray economy" the debtor's income is usually different from what the individual reports for tax purposes. In those cases, the debtor may have a larger amount of disposable income than the one reported and thus, be allowed to pay an amount lesser than what was actually capable of paying. In such circumstances it is advisable to have a system where the amounts to be paid by the debtor takes into

account a minimum percentage of the outstanding debt that has to be repaid.

b) *The plan*. The act would have to specify the rules and procedures for preparing, submitting and approving the payment plan. In particular, the act should specify what the role of creditors would be in this framework.

c) *Making the plan binding on all creditors*. The authorities would have to decide whether a special mechanism would need to be established to make the payments plan binding on all creditors. In some jurisdictions that have personal insolvency regimes in place, a payment plan becomes binding on all creditors upon approval by the court (after hearing creditors' opinions on the plan) and thus, approval of the plan by a requisite majority of creditors is not required to achieve such an effect.

d) *Treatment of debtors with no capacity to repay*. As mentioned before, a policy choice has to be made as to whether the personal bankruptcy framework should cover also debtors with no capacity to implement a payment plan and if so, what type of special regime they would be subject to.

3. Repayment period

The act should specify the maximum repayment period in order for the debtor to achieve a discharge. It is advisable that this period not be too long to allow for the prompt rehabilitation of the debtor and his/her full return to the economy. Accordingly, and as mentioned before in this report, consideration should be given to setting forth a maximum repayment period of 3 to 6 years in line with the current trend in Europe.

4. Discharge and Rehabilitation

a) *Non-discriminatory treatment of debtors after discharge*. The bankruptcy act should provide for a non-discriminatory (stigmatized) treatment of discharged debtors. In this context, a careful design of the ***credit registry*** for individuals would be needed, including a determination of how to record the debtor's debt settlement in his/her credit history and the relevant consequences.

b) *Exit due to lack of capacity to implement a plan*. As mentioned before, the authorities should make a policy choice as to whether an exceptional scheme for debtors who have no available income/assets at all should be included in the personal bankruptcy regime. Such schemes would provide immediate discharge to the debtor.

c) *Discharge.* The act should provide specific rules for when a debtor who has successfully implemented the repayment plan is considered to be "discharged". In this context, a policy choice will have to be made as to whether the discharge frees the debtor from all his/her obligations, or whether certain obligations are not affected by the discharge. In some jurisdictions where personal insolvency regimes are in place, there are some obligations that are not discharged not even after the expiration of the payment plans' period, for instance, obligations pertaining to family responsibilities (e.g., child allowances).

d) *Rehabilitation.* The act should specify the formal procedures to be followed by the debtor once discharged in order to also be considered rehabilitated. These procedures deal with issues such as non-discriminatory treatment of a discharged debtor and the special rules concerning the record kept in the debtor's credit history of the bankruptcy proceeding.

5. Institutional Framework. The successful implementation of a personal bankruptcy regime lays in part in the strength and soundness of the country's institutional framework (e.g., the courts, bankruptcy administrators, and debt advisory counselors). Furthermore, an effective personal bankruptcy regime requires a strong institutional framework to implement the law in a consistent, predictable and transparent manner. Any shortcomings in this framework should be addressed in a comprehensive manner as the personal bankruptcy act will not suffice to achieve such a goal.

a) *Debt Counseling Services*. A framework that aims at providing debt advisory and counseling and financial education services to individuals is essential to support an effective personal bankruptcy regime. For this purpose, consideration should be given to *setting up an agency charged with the task of providing advice and education in this area*. In the case of Lithuania, consideration could be given to engaging under this framework the services of the *State Consumer Rights Protection Authority*, which is already performing some of these functions vis-à-vis consumers. If the use of this state authority were not to be viable, *another agency could be established to perform these functions.* This new agency could also engage in additional services such as serving as 'mediators' in debt restructuring procedures between a debtor and his/her creditors in a pre-bankruptcy stage. In this context, special provisions would need to be issued to regulate the licensing regime for accredited debt counselors.

b) *Bankruptcy Administrators*

(1) *Role and responsibilities.* The bankruptcy act should specify the roles and responsibilities of the bankruptcy administrator. In principle, the main role of the administrator is to be responsible for administration of estate. In addition, the administrator may be responsible for the receipt of repayment installments during the "payment plan" period; although, a separate agent could take on the responsibility to receive the repayment installments.

(2) *Qualification criteria.* The bankruptcy act should specify the rules governing the licensing and appointment/nomination of bankruptcy administrators. As to the qualification requirements, practice in this area normally requires that the administrator be of a particular profession (e.g., lawyer/accountant/economist; and experience). As regards the licensing requirements a policy choice would have to be made as to whether bankruptcy administrators licensed to handle enterprises' bankruptcies should also be allowed to handle personal bankruptcies and vice versa.

6. Consistency of other laws

Other pieces of legislation should not inhibit the operation of the personal insolvency regime. In particular, the legal framework should be thoroughly assessed to determine whether there are pieces of legislation that would act as deterrent or impediment to debt restructuring (e.g., tax laws).

7. Procedural framework: A pre-bankruptcy stage

In developing a personal insolvency regime, a policy choice has to be made as to the type of procedural framework to be implemented for this purpose. For instance, whether it would be a pure bankruptcy procedure or whether it would also allow for a pre-bankruptcy stage. A pre-bankruptcy stage would allow debtors to settle their obligations with creditors without resorting to a bankruptcy procedure. This pre-bankruptcy stage could be designed to be an extra-judicial procedure or a court proceeding. In some jurisdictions the pre-bankruptcy procedure for the settlement of debts is achieved through agreements between the debtor and his/her creditors, known as "composition agreements". These agreements can always be reached outside courts through voluntary debt restructuring agreements, and thus there is technically no need to introduce a 'statutory extra-judicial pre-bankruptcy procedure". If the authorities were to consider the implementation of this two-tiered approach with the anchor in a framework for debt settlement as the first stage, the following elements should be taken into account when designing such scheme:

- The debt settlement scheme could be a pre-condition to access the judicial bankruptcy proceedings.

- The design of the debt settlement scheme should have incentives to attract debtors and creditors to participate on a voluntary basis and in a timely manner (e.g., reduced costs for both debtors and creditors; assurances that the rights of debtors and creditors are treated the same way as under a bankruptcy proceeding; assurances that debtor's actions during the debt settlement stage is adequately supervised (i.e., by a duly licensed debt administrator)).

- The debt settlement scheme should provide for making the settlement legally binding against dissenting creditors. If this scheme were to be applied, then the act would have to provide for a special mechanism for creditors' voting.

Based on the Concept Note, and taking in to account the key elements described above, the mission is of the view that Lithuania should develop a modern, comprehensive and effective mechanism to help individual address situations of over-indebtedness and insolvency. Concerns about a possible hike in interest rates due to the introduction of a personal insolvency law (personal bankruptcy act) should be dispelled as based on past cross country experiences, such as that of Sweden in 1994 when the new debt restructuring law was approved (which applies also to persons/individuals) there has been no evidence to support that such a new bankruptcy regime would trigger a hike in interest rates set by commercial banks. This is because, if a personal bankruptcy law is adequately designed, it should provide for a collective framework for creditors to recover all claims that are payable by the debtor based on his/her capacity to repay after liquidation of non-exempted assets. The portion of claims that could not be recovered under the mechanism set forth by the bankruptcy law is the amount that creditors will have to write down for accounting and tax purposes. In sum, the introduction of a personal bankruptcy act that is adequately designed does not give rise to a further loss for the creditors than that they would have suffered anyway due to the debtor's lack of capacity to repay.

II. Proposals for Reforming the Insolvency regime for Enterprises

A. Treatment of Fraudulent Corporate Bankruptcies

In Lithuania, there appears to be a widespread perception that a large number of corporate bankruptcies are fraudulent.[3] However, available data show that only few bankruptcy cases are found "fraudulent" by the courts despite such widespread perception. This situation gets exacerbated by the appearance that those involved in such fraudulent bankruptcy cases, who are not prosecuted for them, manage to easily bring enterprises into bankruptcy to avoid payment of their debts while disposing of the enterprises' assets to start new businesses. As providing advice on criminal law matters would fall outside our areas of expertise, our assessment and recommendations in this subsection are focused on the shortcomings identified in the Bankruptcy Act from the civil/commercial dimension.

Based on the mission's findings and analysis of the facts, the main reasons for the low rate of prosecution of fraudulent bankruptcies in Lithuania could be attributed to the following shortcomings in legal and institutional frameworks:

a. **There is no definition of "fraudulent bankruptcy" under the Bankruptcy Act**. In Article 20 of the Enterprises Bankruptcy Act[4] there is only a brief description of procedural elements to be pursued by the bankruptcy administrator, but no clear definition of what are the acts or behaviors that would give rise to a finding of fraudulent bankruptcy.

b. **There is a definition of "criminal bankruptcy" in Lithuania's Criminal Code,[5] but it is very ambiguous**. In particular, the use of the term "deliberate mismanagement" in the definition is very ambiguous and thus, it impedes making a finding of fraudulent bankruptcies by the courts.

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[3] In early 2010 the Department of Enterprise Bankruptcy Management under the Ministry of Economy issued a "Review of Fraudulent Bankruptcies in Lithuania". This report contains very valuable factual information and a thorough analysis of the implications that should serve as a basis for developing the required legislative changes in this area.

[4] Article 20 of Lithuania's Enterprises Bankruptcy Act reads as follows: **"**If the court investigating the enterprise bankruptcy case establishes a fraudulent bankruptcy, the administrator must review all contracts of the enterprise in bankruptcy concluded within the 5-year period prior to the institution of bankruptcy proceedings and bring an action before the court investigating the enterprise bankruptcy case for the invalidation of the contracts which are contrary to the interests of the enterprise and/or which could have contributed to its loss of ability to settle with creditors. In this case the administrator shall be deemed to have learnt of the contracts from the order to institute bankruptcy proceedings became effective."

[5] Article 209 of Lithuania's Criminal Bankruptcy reads as follows: **"**A person who brings an undertaking to bankruptcy by deliberate mismanagement and thereby incurs major property damage to creditors shall be punished by imprisonment for a term of up to three years."

c. **Bankruptcy administrators and judges in Lithuania appear to lack the capacity and skills to conduct proper investigations of these cases**. Lithuanian judges the mission interviewed confirmed that they lack the adequate capacity to conduct these types of investigations and analysis. In the case of bankruptcy administrators the issue appears to be not the lack of capacity to conduct such investigations and assessments, but rather a lack of 'incentives" to pursue them.

d. **The current institutional arrangements do not allow for an effective and efficient handling of these cases at the investigative level.** The mission was informed that police agents and prosecutors, who have the authority and the capacity to conduct the investigation and prosecutions of such cases, respectively, are not involved in the bankruptcy process in a timely manner.

To comprehensively address the above-mentioned shortcomings, the authorities would have to work on different fronts. This is because a fraudulent bankruptcy has two dimensions, namely, the *criminal* and the *civil/commercial*. In light of this, the legal framework in Lithuania should clearly regulate the different substantive and procedural aspects arising from enterprises' fraudulent behaviors that would allow bankruptcy administrators, on the one hand, to pursue civil or commercial law cases to attribute perpetrators civil liability for their actions against the enterprise and its creditors, including trying to invalidate transactions or recover assets, and state prosecutors, on the other hand, to pursue criminal actions to punish criminals for the damage caused to society. Moreover, in the specific context of bankruptcy procedures, the law should provide a clear definition of the actions and transactions that are considered "fraudulent" in order to allow for the bankruptcy administrator to invalidate the contracts and other transactions deriving from them.

The mission is of the view that although it is indeed problematic that no criminal actions are pursued in the above-mentioned cases, there appears to be a more fundamental question related to the bankruptcy proceedings themselves, namely, *why bankruptcy administrators do not make use of the existing provisions under the current insolvency regime that would allow them to invalidate transactions during the suspect period?* Even if criminal bankruptcies are not prosecuted in practice, there are avoidance provisions in the current insolvency regime[6] that would allow administrators to invalidate transactions and recover the corresponding assets or values. Maybe, another way to address this problem from the bankruptcy procedures perspective would be to clarify the avoidance rules contained in the Bankruptcy Act as we recommend in the next subsection of this report.

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[6] Article 11(3)(8) of the Bankruptcy Acts states that the bankruptcy administrator has the obligation to "…examine the contracts of the enterprise in bankruptcy entered into within an at least 36 months period before the institution of bankruptcy proceedings and bring actions for the invalidation of the contracts which are contrary to the objectives of the enterprise activities and/or which could have led to the disability of the enterprise to settle with creditors. In this case the administrator should be considered to have found about the contracts from the effective date of the court decision to institute bankruptcy proceedings".

The mission understood from the discussions held with the authorities and other stakeholders that there is a pressing need to prevent enterprises from being stripped of their assets which would have otherwise served to satisfy the creditors' claims but instead would be used to restart new enterprises at the expense of such creditors. If this is indeed the main concern, there is much more to reform than just the rules on fraudulent bankruptcies as further explain below.

In the specific case of Lithuania, addressing the shortcomings in the area of fraudulent bankruptcy involves passing legislation that would provide for the following:

a. **Inclusion of a clear and comprehensive definition of "insolvency" in the Bankruptcy Act.** In particular, the law should provide a clear threshold for initiating bankruptcy proceedings, stressing the obligation of managers to file the petition if the threshold is reached and providing for penalties for failing to do so.

b. **Inclusion of a clear and unambiguous definition of "fraudulent bankruptcy**" in the Bankruptcy Act that is consistent with the provisions of the criminal code. In this regard, please find in Annex II some excerpts of fraudulent bankruptcy legislation in France, Germany, Sweden and UK, which could be used as examples for this purpose.

c. **Inclusion in the Bankruptcy Act of specific provisions regulating the two key types of fraudulent bankruptcies,** namely:

    - **Deliberate bankruptcy:** When the debtor (or owners, directors, officers of a company) knows that his/her actions or omissions would result in the enterprise's inability to satisfy creditors' claims, including the making of payments as they fall due; and

    - **Fictitious bankruptcy:** When the debtor (or owners, directors, officers of a company) makes a false declaration of bankruptcy stating that the enterprise is insolvent knowing that it is not the case, with the purpose of gaining time, including during the stay period, to strip the enterprise out of its assets.

In designing an effective legal framework for addressing fraudulent bankruptcies it is very important to set up a clear standard that determines the principles and terms of the investigation or inquiry to be carried out by the bankruptcy administrator to determine whether signs of deliberate or fictitious bankruptcy cases are in place. In this context, the bankruptcy administrator should include among his/her key tasks that of assessing in each case whether there are signs of deliberate or fictitious bankruptcy on the part of the debtor (including managers, owners and directors). If the bankruptcy administrator determines that such signs indicate a possible existence of a fraudulent bankruptcy, the administrator should expeditiously engage the police and the state prosecutors' office in the investigation process in a timely manner.

From the institutional framework standpoint and as suggested in the previous paragraph, a mechanism should be designed to promote better and timely coordination between the bankruptcy administrator and the agents in the police and the prosecutors' office in charge of investigating these types of cases for the latter to participate in the investigative process as soon as any evidence of fraud emerges. In this context, it is worth noting that the investigation to be carried out to identify whether a deliberate or fictitious bankruptcy is in place should be based on information that may be obtained by the bankruptcy administrator from a varied number of sources, including:

a. **Financial information of the debtor** (e.g., account and tax documents and reports; audited and unaudited financial accounts; and auditors' reports and notes to the debtors' financial statements). In addition, adequate training of judges and bankruptcy administrators in this area appears to be also warranted.
b. **Legal documents** (e.g., minutes of the shareholders and board meetings; contracts signed by the debtor, in particular those with related parties; and list of related parties and affiliates)
c. **Internal management information** (e.g., management reports; sales reports; reports on activities of branches, affiliates and other subdivisions of the company; and internal policies of the company)
d. **Other information** concerning transactions not covered by legal documents (e.g., any other information on transactions involving the debtor in particular those concerning disposal, alienation or collaterals granted on assets; debts incurred or assumed by the debtor; and acquisition of new assets and the level of consideration provided for them)

Finally, in designing a new framework that addresses the shortcomings identified in the area of fraudulent bankruptcies in Lithuania, consideration should also be given to finding the right balance between sanctioning criminal behaviors and deterring the debtor, owners, directors, officers, or third parties from a timely filing for bankruptcy proceedings. This underscores the importance of clearly defining insolvency as well as setting a deadline for the managers to file a bankruptcy petition. The more the initiation of the proceeding is delayed the greater the chances for fraudulent behaviors. In sum, the new framework for addressing fraudulent bankruptcies should ensure that assets are not hidden or stripped from the debtor in detriment of its creditors but without creating negative incentives for the timely rehabilitation of viable debtors or the expedited liquidation of unviable enterprises.

B. **Enterprises' Bankruptcy Act—Areas in Need of Urgent Reforms**

Lithuania's current insolvency regime contains two sets of acts, namely, the Enterprises Bankruptcy Act (Law No. IX-216, as amended) and the Enterprises Restructuring Act (law No. IX-218, as amended). While both acts contain features that facilitate rehabilitation of viable firms and exit of nonviable ones, improvement is needed in some areas that relate to both the legal and institutional framework of Lithuania. The following paragraphs describe the key shortcomings in both areas, namely, the restructuring and liquidation of enterprises, and make some specific recommendations to address them. It is worth noting, however, that in the mission's views, the shortcomings that would be more difficult to address are those involving the insolvency regime's institutional framework.

Enterprise Bankruptcy Act (EBA)

1) **Voting thresholds.** The EBA does not specify the voting mechanisms in respect of the adoption of a 'compromise' between an enterprise and its creditors and should be clarified. In addition, the compromise is focused on reducing or deferring claims and a debt-equity swap appears to be impossible. It is also not clear from the EBA whether secured claims can also be bound by this compromise.

2) **Extrajudicial bankruptcy procedures.** The extrajudicial bankruptcy process set forth in the EBA does not appear to have added value. It depends on a decision by creditors (supported by creditors whose claims in terms of value amount to 4/5 of the total amount of the company's liabilities) and follows the same rules as the ordinary "court driven" process. The mission also found that there are only few cases using this mechanism in practice. Accordingly, we recommend the authorities to consider the possibility of eliminating the extrajudicial bankruptcy procedures.

3) **Continuation of debtors' business.** While the EBA allows for the continuation of the company's business during bankruptcy proceeding or a transfer of the business as a going concern, it does not provide for necessary tools to facilitate such continuation. For instance, the EBA does not provide for a mechanism that would prevent the effective discontinuation of the company's business. The EBA also does not confer on the administrator the power to use or dispose of third party-owned assets. All these areas should be addressed as part of the upcoming reforms.

4) **Stay period.** The treatment of secured creditors is unnecessarily restrictive and unbalanced, and may undermine the value of security rights, possibly restricting the availability of credit and raising the borrowing costs. Since creditors cannot enforce their claims against the debtor, and the power to realize pledged or mortgaged assets is vested exclusively in the administrators, this may infringe on the position of secured creditors in liquidation, especially where the assets are no longer needed for the continuation of the debtor's business.

5) **Sale of immovable property.** The EBA provides that immovable property shall be sold by "auction" in accordance with procedures established by the government. The mission

is of the view that it may be useful to introduce a method of ”private sale” of immovable property with or without court supervision as this is likely to maximize the sale value.

6) **Priority financing.** The EBA should be amended to make it clear that "new financing" extended to an enterprise during the debt restructuring procedure should be paid with high priority. The procedure for satisfying the administration costs and their relative priority should not be left to be decided by creditors but should be regulated in the law.

7) **Avoidance rules.** As discussed above, avoidance rules as contemplated in the EBA do not provide for sufficient guidance and thus should be clarified in the upcoming reforms in order to provide the legal certainty required in the market place. This would also be very helpful in addressing the shortcomings identified in the regime concerning corporate fraudulent bankruptcies.

8) **Conversion of bankruptcy proceedings to restructuring proceedings.** While the ERA provides for conversion of restructuring proceedings into bankruptcy proceedings, the EBA does not provide for conversion of bankruptcy proceedings to restructuring proceedings. In order to ensure that viable companies are still given the opportunity to be rehabilitated, the EBA should provide for conversion from liquidation to rehabilitation, to be initiated by the debtor, the administrator, the court or even the creditors.

Enterprises Restructuring Act (ERA)

1) **Fast Track restructuring proceedings.** The ERA permits a fast-track restructuring proceeding in case that a prepackaged restructuring plan is drawn up prior to the filing of the petition, but unanimous consent of creditors is required to approve such a plan. Without a mechanism to enable the support of a qualified majority of creditors to make the plan binding on dissenting creditors, such proceedings are not likely to be successful. Thus, we recommend that the law be modified to include a 'qualified majority' voting system for the approval of the fast track restructuring plan.

2) **Content of the restructuring plan.** The restructuring plan as contemplated in the ERA appears to be a complicated and costly way to satisfy creditors' claims. The contents of the restructuring plan should be left to be decided by the interested parties and should not be rigidly prescribed in the ERA. Accordingly, the law should be amended to provide solely the minimum key elements of the plan while providing flexibility to the parties to determine the final content of such plan.

3) **Voting thresholds.** The voting thresholds under the ERA are not conducive to getting a plan approved and should be reconsidered. Requiring two-thirds or three-quarter majorities may be an obstacle to a successful restructuring and does not reflect international best practice (i.e., a simple majority is normally the trend).

4) **Stay period.** The ERA should strike an appropriate balance between preventing secured creditors from undermining the objective of maximizing the value for all parties and protecting the interests of such creditors so that the value of their security is not eroded.

The treatment of secured creditors under the ERA is unnecessarily restrictive and unbalanced, and may undermine the value of security rights. Furthermore, there are no provisions in place that indicate what the enterprise may or may not do with respect to encumbered assets and whether or not that depends on the secured creditor receiving adequate protection in respect of the value of such assets. Secured creditors are not given the possibility of requesting to lift the stay to the extent that the assets are not necessary for the continuation of the enterprise's activities or are used to the detriment of creditors' security interest. Accordingly, we recommend amending the law to allow secured creditors to request lifting of the stay on the grounds that the assets are not necessary for the enterprise's business or the creditor is not receiving adequate protection as the value of the collateral deteriorates.

5) **Priority financing.** Obtaining new credit is vital for the continuation of the business during the debt restructuring period. Thus, we recommend that the law be modified to accord high priority to "new financing" extended to an enterprise so as to facilitate effective rehabilitation of the company.

6) **Avoidance rules.** Avoidance rules as contemplated in the ERA do not provide for sufficient guidance and should be clarified in order to provide the legal certainty required in the market place. Article 17.5(4) refers to the invalidation of contracts that "… are not in line with the objectives of the enterprise and/or which have led to the inability of the enterprise to settle with creditors". As noted above, this is one of the shortcomings that have raised issues related also with the limited findings of fraudulent bankruptcies. Thus, a modification of the law to clarify the avoidance rules, in particular, by providing a clear definition of the types of transactions that should be avoided during the suspect period, is warranted.

7) **Remuneration of bankruptcy administrators**. The ERA briefly states that the enterprise in restructuring *shall bear the costs of the administrator's remuneration which is approved by the meeting of creditors*. Given the lack of specificity in the ERA about such "remuneration", a practice has been developed in Lithuania where the administrator receives a "monthly remuneration" from the enterprise, which in turn creates the incentive for the administrator to unduly delay the procedure to secure such monthly remuneration. In other instances, the practice is also to establish a specific fee the covers all administrator's expenses throughout the bankruptcy proceedings. Accordingly, as explained further below, we recommend that a new mechanism for determining the administrators' fees, which would not have a pervasive incentive of delaying unnecessarily the process, be included in the law

In addition, the mission also identified the following main shortcomings in the overall ***legal framework*** that affect both the corporate restructuring and bankruptcy procedures:

- There is no clear attribution of roles and responsibilities among key stakeholders in the process, namely :
    - Courts
    - Bankruptcy Administrators

  - Creditors
- There is an unclear definition of "insolvency", as noted above, and an inadequate "threshold" for determining it.
- The rules for determining owners/directors/officials' personal and criminal liabilities are unclear.
- There are also issues concerning the treatment of ranking and priorities for unsecured creditors (e.g., related parties are allowed to vote and participate in creditors' committees as any other creditors).
- There is a lack of provisions for treating:
  - "new financing"
  - "set offs/netting"
- There is unclear treatment of cross-border insolvency and determination of Center of Main Interest (COMI) in the context of enterprises group's insolvencies.

The mission also identified the following shortcomings in the ***institutional*** insolvency framework:

- Lack of capacity and skills of judges and bankruptcy administrators to handle corporate bankruptcy proceedings;
- Lack of adequate incentives aimed to rehabilitate enterprises under voluntary workouts; and
- Existence of incentives built-into the system for protracted and costly bankruptcy proceedings. For example, the bankruptcy administrator's remuneration structure in the form of a "monthly fee", which gives the administrator no incentives to expedite the process and maximize the recovery for creditors. On the contrary, the longer the administrator handles the bankruptcy proceeding, the longer that person maintains his/her remuneration.

To address the most pressing shortcomings in the institutional framework, the mission recommends the following:

Bankruptcy Administrators

- More stringent and clear qualification requirements for their licensing, including specific procedures and grounds for removal
- Grant clear authority to an agency to oversee and control the administrators' performance (this could be the courts, but it could also be another agency, for instance one under the purview of the MoE)
- Clearly define administrator's responsibilities and liabilities
- Maintain a mechanism for appointing administrators in which creditors nominate and the courts appoint.

- Refine administrator's remuneration structure and eliminate distortions built in such structure that could give rise to undue delays in the process.
- Improve capacity and expertise of administrators, including on handling corporate fraudulent bankruptcy issues

Courts

- Improve capacity and expertise of judges through targeted training. In this area, consideration could be given to "specialized courts/judges" if the fiscal envelope allows.
- Strengthen power of the courts to oversee and control administrators' performance (unless such powers are assigned to a different governmental agency as suggested above)
- Consider re-introducing a "fee" for initiating bankruptcy proceedings (in the absence of such a fee, it is very cheap to go to courts to initiate bankruptcy proceedings just with the aim of delaying creditors' recovery)
- Provide specific statutory guidance to increase predictability in courts' decisions. As the courts have no experience in dealing with the increased number of bankruptcy cases triggered by the crisis, it would take longer for them to create a case law. By providing specific guidance in the law, this would expedite the process and prevent unnecessary delays.

Creditors

- Provide for:
    - Better legal protection of creditors' rights
    - Timely and adequate access of creditors to debtor's information (this could be made possible through the use of Debt Advisory Services and Credit Registries)

Annex I

Designing a personal Bankruptcy Act—Brief Overview of Some Country Experiences

1. The US model.

   It is basically contained in Chapter 7 and Chapter 13 of the United States Bankruptcy Code. Chapter 7 grants an immediate discharge of debts in exchange for distributing all of the debtor's non-exempt assets to his/her creditors. If no non-exempt property is available for distribution by the bankruptcy trustee, the debtor obtains a discharge and a fresh start after short period of time (e.g., 4 months). Chapter 13 involves a repayment plan of three to five years, with the debtor obtaining discharge after completion of said plan. This plan involves that the debtor has to give up all of his/her disposable income, that is, the income that is not reasonably necessary for the debtor's household expenses. However, it worth noting that under Chapter 13 mortgage for the primary residence cannot be restructured without creditors' consent.

2. The UK model.

   It is basically framed based on the US model. England and Wales have a number of different remedies for insolvent debtors including: (i) formal judicial bankruptcy procedures (Part IX of Insolvency Act 1986, amended by Enterprise Act 2002-UK) and (ii) voluntarily negotiated debt settlement arrangements (Part VIII of the Act, Individual Voluntary Arrangement). There is also a Debt Relief Order and an Enforcement Restriction Order (2007-UK) (both orders issued for up to a year). Outside the court system there are different kinds of informal debt management arrangements.

3. The Swedish model.

   Since 2007 there is a statutory non-judicial debt settlement scheme overseen by the Enforcement Agency (KFM). This scheme involves a debtor's payment plan using all of his/her excess (disposable) income to creditors for a period of five-years or more. The debtor has to demonstrate insolvency or incapacity to pay its debt for a foreseeable period of at least five years. If KFM approves the petition, creditors' enforcements actions are stayed automatically with respect to the debts subject to adjustment. If the debtor has zero disposable income, the proposal will have a payment plan with zero payments. If creditors accept the payment plan, the debtor is immediately discharged. If the debtor or his/her creditors object to the KFM's decision, they can challenge it in court. The challenge in court is limited to specific legal basis to avoid abuse and discourage needless court proceedings. Debt counseling and trying to reach an out of court agreement with creditors were a pre-requisite to file a petition of this scheme. While debt counseling plays a key role in Sweden, they are no longer pre-requisites.

4. The French model.

   Similar to the Swedish approach. It involves: (i) a non-judicial stage overseen by a "Commission on Individual Over-indebtedness" (one in each of France's 117 departments); and (ii) a judicial stage. If no settlement is reached in the out of court stage, the commission will make a recommendation to courts on a plan to be binding on the debtor and his/her creditors. The central bank of France intervenes providing information and mediation between debtor and his/her creditors to come up with a plan. The maximum period of the plan is 10 years. The recommended plan of the Commission proposes ordinary or extraordinary measures for the court to approve for debtor's relief. The ordinary measures usually contain proposals for rescheduling of debt, reduction of interest and discharge of the remaining amount of the obligation after the sale of a mortgage asset. Extraordinary measures apply when there is a significant portion of the debt that cannot be repaid by the debtor, which normally end with a discharge of the debtor at the end of the period. There is another procedure for debtors who are "irremediably compromised" (to whom ordinary or extraordinary measures for debt relief do not apply), where the Commission transfers the debtor to the court for a fast-track discharge of his/her debts in return for the liquidation of the distribution of the debtor's non-exempt assets on the benefit of his/her creditors.

5. The Dutch model.

   In 1998 Holland introduced a Consumer Bankruptcy Act to grant a statutory discharge of unpaid consumer debt to provide a fresh start to good faith debtors. But first, the debtor, with the aid of a debt counselor, should try to reach an out of court settlement with his/her creditors. The court imposed debt adjustment usually has a period of three years. A fast track discharge procedure exists for debtors who have no income beyond the minimum amount of disposal income as set forth in accordance with the rules for the social welfare assistance level.

Annex II

Fraudulent Bankruptcies—Excerpts of Some Country's Legislation[7]

1. <u>Sweden</u>

1.1 CHAPTER 11 – ON CRIMES AGAINST CREDITORS

1.1.1 Section 1

A person who, being insolvent or in manifest danger of becoming insolvent, destroys, or by gift or other like action disposes of property of substantial value, shall be sentenced for *dishonesty to creditors* to imprisonment for at most two years. This also applies to any person who by means of a like act or acts renders himself insolvent or brings about a manifest danger of becoming insolvent.

A sentence for dishonesty to creditors shall also be imposed on a debtor who, with impending bankruptcy, removes from the Realm an asset of substantial value with the intention of withholding such asset from the bankruptcy estate, or any debtor who, being bankrupt, withholds an asset from the bankruptcy administration. This also applies if a creditor, for an improper purpose, does not as far as possible contribute to the recovery of an asset located abroad, despite the official receiver's request to do so.

If a crime under Section 1 is considered to be gross, imprisonment shall be imposed for not less than six months and not more than six years for *gross dishonesty to creditors*.

In assessing whether a crime is gross, special attention shall be given to whether the offender attested a false statement, or made use of a false document or misleading bookkeeping, or if the crime was on a considerable scale, or if the committed act for other reasons was of particularly dangerous.

[7] Please not that these excerpts are not official translations and thus, might contain errors.

1.1.2 Section 2

A debtor who in connection with bankruptcy, the rescheduling of debts or negotiation of a public accord with creditors, through gross carelessness conceals an asset, reports a non-existent debt or provides some other erroneous information of like nature, shall, unless the statement is corrected before it is attested on oath or otherwise made the basis of the proceeding, be sentenced for obstruction of bankruptcy or assignment of enforcement.

[the rest of this section is omitted]

1.1.3 Section 3

Any person who, being insolvent or in manifest danger of becoming insolvent, continues to run an enterprise, utilizing thereby considerable means without corresponding benefit to the enterprise, or who lives in a wasteful or extravagant manner, or who enters into a hazardous undertaking or thoughtlessly assumes onerous commitments, or who embarks upon a similar course of action and thereby intentionally or through gross carelessness substantially worsens his economic status, shall be sentenced for *careless disregard of creditors* to imprisonment for at most two years. The same shall apply even though the perpetrator did not realize, but had good reason to assume, that he was insolvent or in manifest danger of becoming insolvent.

1.1.4 Section 4

A person who, being insolvent or in manifest danger of becoming insolvent, favors a particular creditor by paying a debt which has not fallen due, making payment by means other than is customary, or furnishing security not agreed upon when the debt was incurred, or by taking some other such action, shall, if the measure entails a manifest lessening of the rights of other creditors, be sentenced for *favoritism to a creditor* to imprisonment for at most two years. The same shall apply to a person who, being insolvent shows favoritism to a creditor for an improper purpose by means other than those defined here and thereby occasions a manifest danger that the right of other creditors will thereby be substantially diminished.

A debtor who, for the purpose of promoting an accord, secretly makes or promises payment or other advantage, shall also be sentenced for favoritism to creditors.

1.1.5 Section 5
A person who intentionally or through carelessness neglects the obligation to maintain accounts in accordance with the Bookkeeping Act (1999:1078), by failing to enter business transactions into the accounts or to preserve accounting material, or by entering false information into the accounts or in some other way, shall, if in consequence the course of the business or its financial results or status cannot in the main be assessed from the accounts, be sentenced for *bookkeeping crime* to imprisonment for at most two years, or, if the crime is petty, to a fine or imprisonment not more than six months.
If the crime is gross imprisonment for not less than six months and not more than six years shall be imposed.
[the rest of this section is omitted]

2. United Kingdom

2.1 CHAPTER X - MALPRACTICE BEFORE AND DURING LIQUIDATION; PENALISATION OF COMPANIES AND COMPANY OFFICERS; INVESTAGATIONS AND PROSECUTIONS
Offences of fraud, deception, etc.

2.1.1 206. Fraud, etc. in anticipation of winding up
(1) When a company is ordered to be wound up by the court, or passes a resolution for voluntary winding up, any person, being a past or present officer of the company, is deemed to have committed an offence if, within the 12 months immediately preceding the commencement of the winding up, he has -
(a) concealed any part of the company's property to the value of £120 or more, or concealed any debt due to or from the company, or
(b) fraudulently removed any part of the company's property to the value of £120 or more, or

(c) concealed, destroyed, mutilated or falsified any book or paper affecting or relating to the company's property or affairs, or

(d) made any false entry in any book or paper affecting or relating to the company's property or affairs, or

(e) fraudulently parted with, altered or made any omission in any document affecting or relating to the company's property or affairs, or

(f) pawned, pledged or disposed of any property of the company which has been obtained on credit and has not been paid for (unless the pawning, pledging or disposal was in the ordinary way of the company's business)?

(2) Such a person is deemed to have committed an offence if within the period above mentioned he has been privy to the doing by others of any of the things mentioned in paragraphs (c), (d) and (e) of subsection (1); and he commits an offence if, at any time after the commencement of the winding up, he does any of the things mentioned in paragraphs (a) to (f) of that subsection, or is privy to the doing by others of any of the things mentioned in paragraphs (c) to (e) of it.

(3) For purposes of this section, "officer" includes a shadow director.

(4) It is a defense -

(a) for a person charged under paragraph (a) or (f) subsection (1) (or under subsection (2) in respect of the things mentioned in either of those two paragraphs) to prove that he has no intent to defraud, and

(b) for a person charged under paragraph (c) to (d) of subsection (1) (or under subsection (2) in respect of the things mentioned in either of those paragraphs) to prove that he had no intent to conceal the state of affairs of the company or to defeat the law.

(5) Where a person pawns, pledges or disposes of any property in circumstances which amount to an offence under subsection (1)(f), every person who takes in pawn or pledge, or otherwise receives, the property knowing it to be pawned, pledged or disposed of in such circumstances, is guilty of an offence.

(6) A person guilty of an offence under this section is liable to imprisonment or a fine, or both.

(7) The money sums specified in paragraphs (a) and (b) of subsection (1) are subject to increase or reduction by order under section 416 in Part XV.

2.1.2 207. Transactions in fraud of creditors

(1) When a company is ordered to be wound up by the court or passes a resolution for voluntary winding up, a person is deemed to have committed an offence if he, being at the time an officer of the company -

(a) has made or caused to be made any gift or transfer of, or charge on, or has caused or connived at the levying of any execution against, the company's property, or

(b) has concealed or removed any part of the company's property since, or within 2 months before, the date of any unsatisfied judgment or order for the payment of money obtained against the company.

(2) A person is not guilty of an offence under this section -

(a) by reason of conduct constituting an offence under subsection (1) (a) which occurred more than 5 years before the commencement of the winding up, or

(b) if he proves that, at the time of the conduct constituting the offence, he had no intent to defraud the company's creditors.

(3) A person guilty of an offence under this section is liable to imprisonment or a fine, or both.

2.1.3 208. Misconduct in course of winding up

(1) When a company is being wound up, whether by the court voluntarily, any person, being a past or present officer of the company, commits an offence if he -

(a) does not to the best of his knowledge and belief fully and truly discover to the liquidator all the company's property, and how and to whom and for what consideration and when the company disposed of any part of that property (except such part as has been disposed of in the ordinary way of the company's business), or

(b) does not deliver up to the liquidator (or as he directs) all such part of the company's property as is in his custody or under his control, and which he is required by law to deliver up, or

(c) does not deliver up to the liquidator (or as he directs) all books and papers in his custody or under his control belonging to the company and which he is required by law to deliver up, or

(d) Knowing or believing that a false debt has been proved by any person in the winding up, fails to inform the liquidator as soon as practicable, or

(e) after the commencement of the winding up, prevents the production of any book or paper affecting or relating to the company's property or affairs.

(2) Such a person commits an offence if after the commencement of the winding up he attempts to account for any part of the company's property by fictitious losses or expenses; and he is deemed to have committed that offence if he has so attempted at any meeting of the company's creditors within the 12 months immediately preceding the commencement of the winding up.

(3) For the purposes of this section, "officer" includes a shadow director.

(4) It is a defense -

(a) for a person charged under paragraph (a), (b) or (c) of sub- section (1) to prove that he had no intent to defraud, and

(b) for a person charged under paragraph (e) of that subsection to prove that he has no intent to conceal the state of affairs of the company or to defeat the law.

(5) A person guilty of an offence under this section is liable to imprisonment or a fine, or both.

3. Germany

3.1 CHAPTER TWENTY-FOUR – OFFENCES IN THE STATE OF INSOLVENCY

3.1.1 Section 283

Bankruptcy

(1) Whosoever due to his liabilities exceeding his assets or current or impending inability to pay his debts

disposes of or hides, or, in a manner contrary to regular business standards, destroys, damages or renders unusable parts of his assets, which in the case of institution of insolvency proceedings would belong to the available assets;
in a manner contrary to regular business standards enters into losing or speculative ventures or futures trading in goods or securities or consumes excessive sums or becomes indebted through uneconomical expenditures, gambling or wagering;
procures goods or securities on credit and sells or otherwise distributes them or things produced from these goods substantially under their value in a manner contrary to regular business standards;
pretends the existence of another's rights or recognizes fictitious rights;
fails to keep books of account which he is statutorily obliged to keep, or keeps or modifies them in such a manner that a survey of his net assets is made more difficult;
disposes of, hides, destroys or damages books of account or other documentation, which a merchant is obliged by commercial law to keep, before expiry of the archiving periods which exist for those obliged to keep books, and thereby makes a survey of his net assets more difficult;
contrary to commercial law
(a)
draws up balance sheets in such a manner that a survey of his net assets is made more difficult; or
(b)
fails to draw up a balance sheet of his assets or the inventory in the prescribed time; or
in another manner which grossly violates regular business standards diminishes his net assets or hides or conceals the actual circumstances of his business,
shall be liable to imprisonment of not more than five years or a fine.
(2) Whosoever causes his liabilities to exceed his assets or the inability to pay by one of the acts indicated in subsection (1) above shall incur the same penalty.
(3) The attempt shall be punishable.
(4) Whosoever in cases

under subsection (1) above negligently fails to be aware of the excess of liabilities or the impending or current inability to pay or

under subsection (2) above causes the excess of liabilities or inability to pay by gross negligence

shall be liable to imprisonment of not more than two years or a fine.

(5) Whosoever in cases

under subsection (2) No. 2, 5 or 7 above acts negligently and at least negligently fails to be aware of the excess of liabilities or the impending or current inability to pay; or

under subsection (2) in conjunction with subsection (1) No. 2, 5 or 7 above acts negligently and at least by gross negligence causes the excess of liabilities or inability to pay,

shall be liable to imprisonment of not more than two years or a fine.

(6) The offence shall only entail liability if the offender has suspended payments or if insolvency proceedings have been instituted in relation to his assets or the application to institute proceedings has been rejected due to lack of available assets.

3.1.2 Section 283a

Aggravated bankruptcy

In especially serious cases under section 283 (1) to (3) the offender shall be liable to imprisonment from six months to ten years. An especially serious case typically occurs if the offender

acts out of profit-seeking; or

knowingly places many persons in danger of losing their assets that were entrusted to him, or in financial hardship.

3.1.3 Section 283b

Violation of book-keeping duties

(1) Whosoever

fails to keep books of account which he is statutorily obliged to keep, or keeps or modifies them in such a manner that a survey of his net assets is made more difficult;

disposes of, hides, destroys or damages books of account or other documentation, which a merchant is obliged by commercial law to keep, before expiry of the archiving periods which exist for those obliged to keep books, and thereby makes a survey of his net assets more difficult;

contrary to commercial law

(a)

draws up balance sheets in such a manner that a survey of his net assets is made more difficult; or

(b)

fails to draw up a balance sheet of his assets or the inventory in the prescribed time

shall be liable to imprisonment of not more than two years or a fine.

(2) Whosoever acts negligently in cases under subsection (1) No. 1 or 3 above shall be liable to imprisonment of not more than one year or a fine.

(3) Section 283 (6) shall apply mutatis mutandis.

3.1.4 Section 283c

Extending unlawful benefits to creditors

(1) Whosoever with knowledge of his own inability to pay grants a creditor a security or satisfaction to which he is not entitled at all or not in such a manner or at the time, and thereby intentionally or knowingly accords him preferential treatment over the other creditors shall be liable to imprisonment of not more than two years or a fine.

(2) The attempt shall be punishable.

(3) Section 283 (6) shall apply mutatis mutandis.

3.1.5 Section 283d

Extending unlawful benefits to debtors

(1) Whosoever

with knowledge of another’s impending inability to pay; or

after the suspension of payments, in an insolvency proceeding or in a proceeding about the institution of insolvency proceedings of another, with his consent or on his behalf disposes of or hides, or, in a manner contrary to regular business standards, destroys, damages or renders unusable parts of the others assets, which in the case of institution of insolvency proceedings would belong to the available assets,

shall be liable to imprisonment of not more than five years or a fine.

(2) The attempt shall be punishable.

(3) In especially serious cases the penalty shall be imprisonment from six months to ten years. An especially serious case typically occurs if the offender

acts out of profit-seeking; or

knowingly places many persons in danger of losing their assets that were entrusted to him, or in financial hardship.

(4) The offence shall only entail liability if the other person has suspended payments or if insolvency proceedings have been instituted in relation to his assets or the application to institute proceedings has been rejected due to lack of available assets.

4. <u>France</u>

4.1 CHAPTER IV, SECTION 1 – CRIMINAL BANCRUPTCY

4.1.1 Article L654-1

The provisions of this section shall apply to:

1. traders, farmers, natural persons registered with the craftsmen's register and natural persons running an independent professional activity, including an independent professional person with a statutory or regulated status or whose designation is protected;

2. persons who, directly or indirectly, de jure or de facto, have managed or liquidated a private law entity;

3. natural persons, who serve as permanent representatives of the managing legal entities referred to under (2) above.

4.1.2 Article L654-2

Where reorganization or liquidation proceedings are commenced, any person referred to under Article L654-1 shall be guilty of criminal bankruptcy where any of the following offences is proved against them:

1. purchasing for resale at below market prices or using ruinous means to obtain

funds with the intention of avoiding or delaying the commencement of the reorganization proceedings;

2. embezzling or concealing all or part of the debtor's assets;

3. fraudulently increasing the debtor's liabilities;

4. keeping fictitious accounts or destroying accounting documents belonging to the business or legal entity or failing to keep any accounts where the applicable texts impose an obligation so to do;

5. keeping accounts that are manifestly incomplete or irregular with regard to legal provisions.

4.1.3 Article L654-3

Criminal bankruptcy shall be punishable by five years' imprisonment and a fine of €75,000. The same penalties shall be incurred by the accomplices of the criminal bankrupt, even if they are not traders, farmers or craftsmen and do not manage a private law entity, directly or indirectly, de jure or de facto.

4.1.4 Article L654-4

Where the culprit of or accomplice to criminal bankruptcy is a manager of a business that provides investment services, the penalties will be increased to seven years' imprisonment and a fine of €100, 000.

4.1.5 Article L654-5

Natural persons found guilty of those offences provided for in Articles L654-3 and L654-4 shall also incur the following additional penalties:

1. prohibition from exercising civic, civil and family rights, according to the terms and conditions set by Article 131-26 of the Penal Code;

2. prohibition, for a maximum period of five years, from occupying a public office, from running the professional or corporate activity in the exercise of which, or while being exercised, the offence was committed unless a Civil or High court has already imposed such a sanction by a decision that has become final;

3. ineligibility for public procurement contracts for a maximum period of five years;

4. prohibition, for a maximum period of five years, from issuing checks other than those allowing for the withdrawal of funds by the drawer from the issuing bank or

from issuing certified checks;

5. display or publication of the court order under the conditions provided for in Article 131-35 of the Penal Code.