
REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

LITHUANIA

INSOLVENCY AND CREDITOR RIGHTS SYSTEMS

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Executive Summary

The legal environment in Lithuania to support creditor rights and debt enforcement is reasonably effective, and collateral regimes have been largely centralized and modernized. Consistent with a modern system, security interests may be granted in immoveable and moveable assets, including equipment, inventory, goods, receivables, and future property. In practice, security tends to be restricted to more reliable and liquid assets, such as immovables or fixed assets. Markets for moveable assets remain poorly developed or illiquid. Appeals remain a source of delay, and other procedures could be improved to

The insolvency process in Lithuania has been almost exclusively one of liquidation, plagued by delay and procedural obstacles. Nearly 75% of the total cases filed are still under administration, including some 70 cases filed from 92-96, with cases averaging more than 3 years and yielding little benefit to creditors. A new insolvency law was adopted in July 2001, bringing to three the number of insolvency laws currently in effect. At the same time, a new Enterprise Restructuring Law became effective. As of November 2001, only a few cases had been filed under the new law, which a growing consensus of stakeholders consider to be unworkable and unfavorable to creditors. The process may be aided by the development of training guides and programs to be prepared with PHARE support.

Regulation of insolvency remains fragmented and weak, but shows evidence of an evolving structure. Court efficiency is stifled by a lack of specialization among judges, who are overloaded and poorly equipped to deal with bankruptcy cases, especially rehabilitations. The administrators' profession is marked by low standards, over-licensing, inadequate training and skills, and inconsistent performance. While much remains to be done, the national association of bankruptcy administrators is working to improve licensing standards and to strengthen continuing education and training for its members.

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I. INTRODUCTION

1. The World Bank assessed the Lithuanian insolvency and creditor rights systems pursuant to a joint IMF-World Bank initiative on observance of standards and codes (“ROSC”). The review was carried out using the World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (“Principles”),² in connection with a joint IMF-World Bank mission to assess Lithuania’s financial system (FSAP) from November 3-17, 2001. The assessment team met with a cross section of country stakeholders to review the effectiveness of the legal infrastructure supporting debtor-creditor relationships, corporate insolvency, and credit risk management and resolution practices. These systems constitute an essential cornerstone of commercial confidence and the bedrock for sound credit management and resolution.

2. The conclusions in this assessment are based on a review of the Law on Enterprise Bankruptcy, Law on Enterprise Restructuring, the laws dealing with the creation, registration and enforcement of pledges and security interests (e.g., Civil Code, Civil Procedure Code, Commercial Code), and other relevant pieces of legislation.³ In addition to the review of legislation, regulations, and related information, the assessment team met with a wide range of stakeholders, institutions and professionals in the public and private sectors.

II. DESCRIPTION OF COUNTRY PRACTICE

A. CREDITOR RIGHTS AND ENFORCEMENT PROCEDURES

3. **Lithuania has a developing credit-based economy.** Banks and leasing companies are the core players in the market. Credit instruments are largely limited to direct working capital and investment lending by the banks, leasing and factoring. There is an insignificant proportion of complex and/or derivative instruments. Consumer lending, including mortgage lending, constitutes a relatively small part (less than 10%) of the overall portfolio of credit institutions. Bank credit is secured in nearly all cases, with a few exceptions of unsecured lending to the most creditworthy clients.

4. **The legal environment in Lithuania to support creditor rights and debt enforcement is reasonably effective, with collateral systems that have been largely centralized and modernized.** Laws regulating the creation and enforcement of security include the 2000 Civil Code of Republic of Lithuania that came into force on 1 July 2001 (“Civil Code”), Law on Mortgage (*Hipotekos įstatymas*) No. I-2936 (6 October 1992) and Law on the Pledge of Movable Property (*Kilnojamojo turto įkeitimo įstatymas*) No. VIII-250 (10 June 1997). The law provides for the taking of security interests in immovable and moveable assets, including equipment, inventory, goods, receivables, and future property. While the market is still developing, the legal framework is primed to handle

² World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (April 2001) <<http://wbln0018.worldbank.org/Legal/GILD/csadmin.nsf/wblaunchtext?readform&Best+Practices>>.

³ Although the team conducted an independent review of certain pieces of legislation and other relevant data and information provided by the authorities, the legal conclusions in this report were complemented by a report on creditor rights and insolvency systems in Lithuania prepared by Lideika Petrauskas for the Bank.

more innovative and complex financial transactions. There is a transparent and effective system for realizing unsecured claims, with appropriate debtor protection. Although there is room for improvement, enforcement mechanisms in Lithuania are reasonably efficient and typically take less time than in many of the other transition countries. A routine claim enforcement can take as little as 3 to 4 months, or in excess of a year with appeals. On average, the process takes about 1 year, whereas the general average throughout other transition countries is about 1-2 years. Appeals add to the delay.

5. **The primary form of collateral is immovable property, as markets for varying types of movable assets continue to be illiquid and unreliable.** An upsurge in financial leasing companies underscores the increasing credibility of collateral and enforcement systems in Lithuania. Still, a lack of development in the markets for movables constrains bank lending. Lenders primarily use security over moveable assets as a way of improving the overall collateral position, recognizing that these assets are less reliable and valuable when it comes to enforcement and collection. Despite the apparent efficiencies of the collateral and enforcement procedures, credit providers consider that the process remains too slow and imbalanced when it comes to the ability of debtors to appeal, which further slows the process.

6. **The new Civil Code that came into effect July 1, 2001 promotes more efficient and transparent credit resolution mechanisms and integrates and harmonizes various pieces of property rights legislation.** A number of laws regulate creation, registration, and enforcement of secured claims, including the Civil Code, Civil Procedure Code, Law on Mortgage, Law on Pledge of Movable Property, and Law on the Central Mortgage Registry. Creation and registration is inexpensive and reasonably efficient, and its procedures transparent. Registration is centralized for both immovable and movable property in the Central Register of Mortgages. Though claims are registered according to the locality of the property in one of the 15 local offices, the mortgage judge within 24 hours of registration electronically forwards the data to the Central Register of Mortgages.

7. **Realization on collateral is reliable.** Creditors realize on collateral through informing the mortgage judge of the default. After a one-month grace period, and creditor reaffirmation, the mortgage judge orders a foreclosure auction of the mortgaged property, and makes an entry reflecting the order in the Central Register of Mortgages, also notifying the relevant local register. The auction is announced in the annex to the Official Gazette at least 20 days before the auction, which will be conducted by the bailiff of the local court in the property's locale.

8. **Price-setting practices for auctions need improvement.** Auctions can be a valuable tool in maximizing creditor recovery in terms of time and money. However, under Lithuanian law, initial price at the auction is the higher of the appraised value of the property or the total amount of the claim. There does not appear to be provision for discounting the price, due to urgency of the sale, to a "liquidation value of the property. A market value minimum bid may hamper a successful auction sale. If the property is not sold by auction, it may be conveyed to the mortgagee or be sold without auction in accordance with the Code of Civil Procedure; these alternatives may provide an adequate remedy for failed auction sales. However, to make the auction option a more viable

possibility for maximizing creditor recovery, and to avoid delays, initial bids should be set at more reasonable levels.⁴ Setting lower initial bids may also help develop larger markets for more varied assets.

9. **Unsecured claims require a writ of judgment for execution.** A regular court of first instance may take 3 to 4 months on average to resolve a claim, with appeals adding 5 months or more. Summary dispositions are available for plaintiffs with unsecured claims who submit written proof of a monetary claim.⁵ If successful, this procedure generally results in issue of a court order within one month, as opposed to the three to four month time frame required in a court of first instance where judgment is sought in a traditional court. The summary disposition may not be used if: 1) the debtor provides a reasonable objection; 2) the debtor's residence, work or entity office addresses are all unknown (and he therefore cannot be notified); or 3) the plaintiff does not fulfill his obligation vis-à-vis the contract and the debtor insists on such fulfillment. Requiring notice and allowing debtor's objection to stop the summary proceeding adequately protects the diligent debtor.

10. **Unsecured debt recovery requires a further writ of execution, seizure and auction.** The writ is issued after all possibility of appeals is exhausted. Recovery is carried out by local bailiffs through attachment, seizure and sale of the debtor's property by auction, announced in the Official Gazette 20 days prior to auction, with initial price set at market value. After three unsuccessful auction attempts, if the creditor is not willing to take the property, the property is sold without an auction at a price established by a commission appointed by the chief bailiff.

11. **Creditor priorities established by law promote predictability and reliability.** Secured creditors have rights superior to any other creditors under the express provisions of the Civil Code.⁶ There do not appear to be hidden liens on pledged property that would supercede a secured creditors' rights to payment from proceeds. Tax claims have priority over unsecured claims, but as discussed below, there are new provisions in the law that make restructuring and even forgiveness of tax debt possible. Unsecured claims follow a prescribed priority within a corporate insolvency.

B. LEGAL FRAMEWORK FOR CORPORATE INSOLVENCY

12. **The framework for corporate insolvency continues to improve, but the slow pace of processing cases has created a confusing environment where at least three versions of the enterprise liquidation law are now currently in effect.** The main provisions on bankruptcy proceedings are contained in the Enterprise Bankruptcy Law (*Įmoniu bankroto įstatymas*) No. IX-216 (20 March 2001) that came into force on 1 July 2001. The previous Law on Enterprise Bankruptcy No. VIII-270 (17 June 1997) remains applicable to bankruptcy proceedings that opened under it, and with respect to extra-judicial bankruptcy proceedings initiated prior to 1 July 2001. In the same way, proceedings opened under the 1993 law and still pending would be governed by its rules.

⁴ This may require amendment of the Law on Mortgage.

⁵ Code of Civil Procedure, Article 20-1.

⁶ Civil Code, Article 4.192 and 4.198.

In addition, the Law on Restructuring of Enterprises (*Įmonių restruktūrizavimo įstatymas*) No IX-218 (20 March 2001), which also became effective in July 2001, regulates restructuring of enterprises and public agencies in temporary financial difficulties with the goal of averting liquidation. Certain aspects of bankruptcy procedures are regulated in the Civil Code, while proceedings of commercial banks, credit unions and insurance companies are governed in part by other laws.⁷

13. **The process of bankruptcy in Lithuania has been slow and inefficient since the beginning, while the pace of filings continues to outflank closings, leading to an ever increasing backlog of bankruptcy cases and congestion in the courts.** Filings have increased at an annual rate of roughly 2 to 2.5 times, significantly outpacing the administration and closing of cases. The rise in filings in 1997 was due mainly to the adoption of a new Law on Enterprise Bankruptcy in 1997 containing provisions for compulsory filing or announcement of insolvency, while, in 1998-99, the increase was due in part to the Russian financial crisis that resulted in a contraction of Lithuania's exports to the CIS countries, and had a heavy impact on trade enterprises and import growth.⁸ As **Table 1** reveals that, of the 1030 cases filed between 1993-2000, only 215 cases (20%) were closed over the same period—of those closed, 190 were liquidated, 4 reorganized, 7 underwent compromise arrangements, and 14 concluded amicable settlements.⁹ As of 1 January 2001, there were 1021 enterprises as well as 14 banks undergoing bankruptcy or already bankrupt. Of these, approximately 967 enterprises were placed in bankruptcy under formal procedures while 54 were dealt with extra-judicially. In 2001, another 800 enterprises were placed in bankruptcy. Cases routinely average more than 3 years, in many cases as long as 7-8 years. These results are not significantly different from the experience in other transition countries (e.g., Czech Republic and Slovakia).

Table 1. Lithuania: Bankruptcy Filings and Closings, 1993-2000

No. of cases	1993	1994	1995	1996	1997	1998	1999	2000	Total
Opened	6	28	35	79	109	98	260	415	1030
Closed	4	0	7	6	17	34	45	102	215
Ongoing	2	30	58	131	223	287	502	815	815

Source: MOE

14. **Bankruptcy cases yield little or no tangible benefit to creditors.** MoE has conducted a study of the average recoveries by creditors of enterprises in bankruptcy. From a sampling of some 250 enterprises, MoE concluded that approximately one-third of the stated balance sheet value of assets is realized by the administration. The amount is in fact smaller after subtracting administration costs, and claims repaid are negligible.

⁷ Law on Commercial Banks (*Komercinių bankų įstatymas*) No. I-720 (21 November 1994) and Insurance Law (*Draudimo įstatymas*) No. I-1456 (10 July 1996).

⁸ See E Purlys & G Rainys, *Bankruptcy of Enterprises and its Prevention in Economic Reforms and Priorities* 86-87 (2001).

⁹ Data maintained by the MoE varies from the figures in Table 1 on case closings, and shows that at the end of 2000, cases still ongoing from 1995-99 were as follows: 1995-62.8% of cases still ongoing; 1996-43% ongoing; 1997-59.6% ongoing; 1999-82.4% ongoing. *Ibid.* at 90. Some 70 cases are still opened from 92-96. MoE figures agree on the total number of cases closed.

As indicated in **Table 2**, employees recover about a third of the amount claimed, while the Social Security budget fund recovers one-tenth, and the state recovers roughly one-sixth of fiscal and tax claims. MoE further concluded that Banks recover about 1.1% and general creditors recover some 4.2%. Adjusted to present value and accounting for inflation over the course of the proceeding, recoveries are in real terms nearly non-existent. Many creditors consider the real beneficiary of the process to be the Administrator, who historically negotiated a monthly compensation arrangement for the entire duration of the case. This practice created an obvious disincentive to resolve cases quickly, and the new law redresses the problem by imposing a 2 year limit on administrations for all new cases filed. Low recoveries also are attributed to inefficient sales, procedural delays in bankruptcy, and suppressed or illiquid market conditions.

Amount of accounts payable	8.7
For employees	34.3
For the state budget	17.2
For Social security budget fund	9.1
For banks	1.1
For others	4.2

15. The liquidation/asset disposal process is governed by general rules of civil procedures designed for claims resolution, but which are ineffective for timely administration of bankruptcy cases. (This is a common problem in Civil Law systems.) Appeals cause numerous and interminable delays, and require the transfer of case files, which has the effect of stalling proceedings on other matters.

16. **A new Enterprise Restructuring Law became effective in July 2001.** The new law regulates restructuring of enterprises and public agencies in temporary financial difficulties with the goal of averting liquidation. Under the old law, amicable settlements and creditor compromises were possible. Between 1993-2000, of the cases closed, only 4 of these involved reorganization, while 7 were compromise arrangements, and 14 concluded amicable settlements. Although there are many cases that could potentially benefit from restructuring, as of November 2001, only two cases have been filed under the new law, both initiated by Turto Bankas. A growing consensus considers the new law unworkable and unfavorable to creditors. Administrators negotiate with the management for their duties and compensation. Duties to creditors are either unclear or conflicted. The process has been hampered by a lack of clear guidance on rules and procedures, lack of training and understanding by relevant players, and misperceptions. PHARE has recently completed tender and selection for a consultant who will work with MOE to prepare materials and programs to support the new enterprise restructuring process.

17. **The new law facilitates an accelerated restructuring and approval process.** A restructuring plan may be drawn up prior to the filing in the court of a petition to initiate the enterprise restructuring proceedings. In this case, enterprise management or a representative of the creditors files the plan contemporaneously with the petition to initiate the enterprise restructuring proceedings, together with evidence of the plan's acceptance by the creditors, a decision of the managing body of the enterprise, and an opinion of an independent expert about plan feasibility and implementation measures. After receipt of these documents, the court approves or disapproves the restructuring plan of the enterprise

within 15 calendar days. Otherwise, the plan process and requirements are generally consistent with international best practice and contain features of a modern corporate rehabilitation system.

C. REGULATORY FRAMEWORK FOR INSOLVENCY

18. Regulation of insolvency remains fragmented and weak, but shows evidence of an evolving structure. Court efficiency is stifled by a lack of specialization among judges, who are overloaded and poorly equipped to deal with bankruptcy cases, especially rehabilitations. The administrators' profession is marked by low standards, over-licensing, inadequate training and skills, and inconsistent performance. While much remains to be done, the national association of bankruptcy administrators is working to improve licensing standards and to strengthen continuing education and training for its members.

Institutional Framework and Capacity

19. **Court efficiency is stifled by a lack of specialization among judges, who are overloaded and poorly equipped to deal with bankruptcy cases, especially rehabilitations.** The Law on Courts sets out the basic structure for the court system in Lithuania. Insolvency cases are handled by the civil law section of one of five District Courts. Judges have little training in commercial matters, or in the specialized areas on bankruptcy and restructuring. Though they acknowledge that specialization would enhance efficiency, judges oppose it because they view bankruptcy cases as boring and an administrative burden. The role of the district court judge in a bankruptcy case is limited to approving the administrators' and creditors' actions, resolving claims, and other almost clerical tasks. Issues of fairness are not decided by them. In a restructuring proceeding, the judge initiates and closes restructuring proceedings, appoints an administrator to prepare the plan, ensures appropriate notice to creditors, certifies approval of the plan, and generally oversees the restructuring process, but has no input into the process. Requests to open a criminal investigation against an officer of the debtor are directed to the prosecutor's office. Further education regarding bankruptcy cases and the role of judges may promote specialization, and thus efficiency.

20. In theory, except for particular kinds of issues, the administration of the part of the bankruptcy which is not involved in the appeal can proceed. In practice, because of the structure of the court files, it is often necessary to send the entire file to the Appeals Court in order that an appeal can be heard. This slows the administration of the bankruptcy proceeding considerably, particularly where there are a number of issues being appealed.

21. **Decision-making in bankruptcy cases is fragmented and complicated by multiple insolvency laws contemporaneously in effect.** All court decisions, including rulings of the Supreme Court, are not binding on any court for purposes of deciding future cases even on the same issues. The exception to this general rule is that the Senate of Judges (composed of the judges of the Supreme Court) can by its vote determine that a particular ruling is of such general applicability and importance that it will be binding on lower courts. The Supreme Court has in the past assembled collections of its decisions in particular areas, to guide, but not bind, other judges. Some of the District Courts also

collect and distribute decisions in particular areas for guidance and informal education of the judges in the District Court. Although some District Court also collect bankruptcy decisions in their particular courts, the process would be aided by aggregating decisions and experience from all such courts. To complicate matters further, pending cases are currently administered under three different insolvency laws (dating from 1992, 1997, and the new 2001 Law on Bankruptcy), as well as the new Law on Enterprise Restructuring. In this complex and confusing environment, it is to be anticipated that many decisions will be appealed. This situation will carry on until the older case are completed; as there are some 70 cases which are still being administered under the 1993 insolvency law (including 2 from 1993) this may not be for some time.

22. **Bankruptcy appeals are common, especially with regard to claim disputes, and cause significant delays due to procedural inefficiency.** District Court decisions can be challenged by appeal on procedural and substantive grounds. The appeals are made to a single appellate court, where a three member panel is drawn from the 26 appellate court judges. Appeals typically takes two to four months to decide. In theory, except for particular kinds of issues, the administration of the part of the bankruptcy which is not involved in the appeal can proceed. In practice, because of the structure of the court files, it is often necessary to send the entire file to the Appeals Court for the appeal to be resolved. This slows the administration of the bankruptcy proceeding considerably, particularly where multiple issues or decisions are being appealed. Moreover, separate appeals involving the same bankruptcy case, but different issues, will not necessarily be heard by the same panel of judges, which means that new judges must educate themselves on the case and proceedings and increases the potential for inconsistent rulings. Some disputes can be further appealed to the Supreme Court, adding further to delay.

Regulatory Framework for Insolvency

23. **The Bankruptcy Management Department of the Ministry of Economy, the primary regulator for administrators, lacks capacity to effectively implement and monitor the system.** The Bankruptcy Management Department is responsible to ensure that administrators comply with the requirements of relevant laws and court decisions, and execute resolutions of the meetings of creditors and creditors committees.¹⁰ The Department lacks the necessary staffing to carry out this supervisory function on a large scale and systematic basis; rather, it responds to complaints lodged with it by participants in the proceedings. Another responsibility of the Department is to establish the licensing standards and criteria and to administer professional examinations for prospective administrators.

24. **Qualification standards and licensing procedures are inadequate and result in the licensing of professionals that are ill-equipped to handle the duties of an administrator.** The “Commission for Certification of Administrators” has been qualifying administrators and issuing the license necessary for appointment as an administrator since 1997. The qualifying test, generally preceded by a preparatory training course, does not

¹⁰ July 5 2001 Procedure of Control of the Bankruptcy Administrators Activity approved by Resolution of the Minister of Economy No. 221

address management or other practical skills often required for handling insolvency matters, and does not require an adequate understanding of the law. The Commission has the authority to request MoE to revoke an administrator's license if the administrator violates the terms of any legal act, or the ethics code. An administrator's license may be revoked for other reasons relating primarily to formal qualifications to act in this capacity.

25. Two organizations currently offer training courses to prepare applicants for their examination. Most applicants pass the examination and obtain their license; this is particularly true if they have taken one of the training course, since the courses are based on the list of questions which the Commission examiners will use. This form of examination does not leave room to examine an applicant's judgment in the types of crisis situation which often confront administrators. Lithuania needs only a fraction of the current 800-plus licensed administrators to handle the current caseload. At present, there is no thought of restricting the number of licensees to reflect market demands, or to improve professional standards. Licenses are rarely revoked, and the revocation procedure is unclear. There is no requirement for continuing education as a condition of continuing to hold an administrator's license, although an amount equal to three percent of their salaries is to be devoted to training by the Court Department of the Ministry of Justice. Licenses issued under the 2001 decrees do not expire. Without requirements for continuing education or current practice, there is a risk that these licensees will not maintain their competence. To improve the quality of the profession, entry requirements should be more onerous with more comprehensive written and oral examinations, and licenses should be revoked where administrators fail to practice for a specified period.

26. **Results are inconsistent and accountability for administrators low.** Restructuring administrators are responsible for supervising the debtor enterprise during the period when the restructuring plan is being prepared, and in law are accountable to the enterprise or the creditors for any damage their actions cause. However, the concept of damage by such a professional is not well-developed in Lithuania, and the administrators are not required to either post bonds or, unlike accounting professionals, carry professional liability insurance. Judges complain that administrators lack the requisite knowledge of the law, forcing judges to handle routine tasks administrators. Results have been more positive where the administrator is a legal entity that engages a number of different professionals (including some lawyers). Even among legal entities, however, the level of skills and services provided is inconsistent.

27. **Though the National Association of Bankruptcy Administrators (NABA) is far from achieving its objectives of standardizing and regulating the practice, it could form the foundation for an independent professional body for administrators in the future.** NABA and several other entities work with MOE on providing training and testing for administrators. Since 1997, NABA has been working to unify the practice and create greater uniformity in services. Its ethics code has been incorporated into the licensing and supervisory regime, and applies to all administrators. The NABA includes approximately 150 members, which constitutes half of qualified administrators now practicing, although some 800 persons have been licensed.

D. CREDIT RISK MANAGEMENT/INFORMAL CORPORATE WORKOUTS

28. **Credit institutions in Lithuania have internal guidelines for monitoring debt.** Guidelines take into account the individual business approach of each credit institution and follow applicable legislation debt monitoring.¹¹ Among other things, institutions must monitor each individual debt until full performance of obligations, including timeliness of repayment of principal and interest, facts of restructuring or refinancing of debt, financial situation of the borrower, performance of business project in the case of long term financing, and country risk in the case of loans to non-residents.¹² Lithuanian legislation defines debt restructuring as amending the credit terms by means of one or more of the following: extending the term for repayment of principal or interest, changing interest rates, capitalizing accrued interest.¹³ Where a loan is refinanced – a new loan issued to replace outstanding obligations of principal or interest under an existing loan – or restructured, the credit institution must reevaluate the borrower’s creditworthiness, taking into account the objective and subjective criteria.¹⁴

29. **As a general rule, commercial banks in Lithuania have adopted reasonable internal policies and procedures to manage credit risk and resolve distressed loans.** Although there exists no best practice guide or code of conduct on a national level, banks reviewed exemplified effective organizational and institutional structures, staffed with qualified and trained employees. Decisions are guided by business interests and hinge on which methodology is expected to result in the best recovery in the specific circumstances. Banks appear to be either fully or over-secured in the majority of their corporate credits by a ratio of 1.25/1 or 1.5/1, with real estate representing the primary form of collateral (50-60 percent), followed by state guarantees (10 percent) and current or moveable assets (7-8 percent). Credits are transferred to the workout unit of the bank when they reach a risk classification of 3-5 (substandard, doubtful, loss). Over the past 18 months, bank portfolios have improved, with NPLs dropping slightly -- in the case of one bank, dramatically -- to single digit levels (5-8 percent).

30. **Lithuanian banks employ all of the conventional techniques for credit recovery and resolution of problem loans, including: distressed asset sales to third parties, debt reschedulings and informal workouts, non-judicial foreclosure and judicial foreclosure (land/buildings) and execution (movables), rehabilitation, liquidation and debt to equity conversions.** There appear to be no hard and fast rules on the methodology of choice, as some banks appear to prefer the informal route using loan sales, informal workouts/reschedulings or debt conversions, while other banks appear to prefer a more litigious route with more than 50 percent of their recoveries realized through judicial foreclosure and execution procedures. The average duration for resolving problem

¹¹ Resolution No. 87 of the Bank of Lithuania on Grouping of Doubtful Assets (24 April 1997) [hereinafter, “BoL Res. No. 87] classifies loans into five groups – standard, watch, substandard, doubtful and loss. The provisioning requirements established by the Bank of Lithuania are as follows: 0 percent for standard and watch; 20 percent for substandard; 40 percent for doubtful; and 100 percent for loss.

¹² BoL Res. No. 87, Article 2.

¹³ BoL Res. No. 87, Article 2.7.

¹⁴ BoL Res. No. 87, Article 2.8 and 2.9.

loans is about 2.5 years, and for some banks has resulted in recoveries ranging from 24 percent (informal workouts) to 94 percent (non-judicial foreclosure). The non-judicial foreclosure process also appears to be the most efficient method, typically averaging about 18-20 months, according to one bank. While some banks shun the bankruptcy process altogether, others have relied on liquidation proceedings for recovery of some 10 percent of credits. Rehabilitations are still the exception, notwithstanding the passage of the new enterprise restructuring law. Some banks experiences less success in reaching negotiated settlements, which they attributed to a lack of a credible bankruptcy threat, coupled with a creditors generally weaker bargaining position in bankruptcy.

31. **The legal environment in Lithuania is only partially conducive to informal workouts.** Two things combine to allow debt-equity conversions. First, the law does not expressly prohibit such transactions. Second, the law expressly permits offsetting a subscription obligation for new shares against an existing matured debt. Accordingly, debt-equity swaps are possible, provided the issue price is not lower than par value and the issuance is approved by a qualified majority ($\frac{2}{3}$ vote) of shareholders at a general meeting. In some cases, a restructuring may rely on asset sales to raise much needed cash to either pay down debt or sustain operations. Asset dispositions must be approved by a qualified majority of shareholders where the value of the assets to be sold exceed $\frac{1}{20}$ th of the company's share capital.¹⁵

32. **More simple techniques for informal workouts, such as debt forgiveness, are stifled due to unfavorable tax legislation.** To be written off, a debt must be **unrecoverable** and all means to recover it (including by court proceedings) exhausted.¹⁶ This forces creditors to commence collection or insolvency proceedings to pre-qualify for a write-off or reduction. In the case of bankruptcy, a lender is entitled to a tax loss after the court issues a ruling declaring the enterprise liquidated, which usually occurs after the assets have been sold (i.e., several years after commencement of the case). Tax losses can be carried forward for a period of five years, starting from the year following the year in which losses were incurred.¹⁷ Despite these shortcomings, recent amendments to the Law on Tax Administration could be advantageous to workouts by allowing tax debts to be rescheduled, or even forgiven where they unrecoverable. Such measures would improve recoveries by general creditors where a debtor's tax burden is large. As yet, there is no experience to confirm the benefits of these measures.

33. **Formal efforts to resolve the large stock of problem loans through Turto Bankas (TB) have not been very successful, and the role and function of this entity should be reevaluated.** In response to a severe banking crisis in 1995-96, TB was created in 1996 on the remnants of the failed, small private deposit taking bank Aura Bank to be an asset management company for restructuring non-performing loans from banks undergoing or having undergone restructuring with public funds, and to manage, restructure and sell or

¹⁵ In practice, creditor companies apply the requirement to debt forgiveness, and similarly obtain shareholder approval in relation to debt forgiveness or restructuring when the value of the debt is $\frac{1}{20}$ or more of the share capital. Credit institutions are required to reevaluate borrowers when restructuring or refinancing debt.

¹⁶ Order of the Minister of Finance No. 351 (December 29, 2000).

¹⁷ The Parliament is currently considering a new Corporate Tax Law.

recover as much as possible of these loans. TB received a limited banking license from the BoL (it could not accept deposits and only perform banking services related to asset recovery). In addition to resolving the assets of the failed Aura Bank, TB was tasked with resolution of problem loan assets transferred to it from several other insolvent and failed banks. In July 2000, the Government additionally transferred to TB the responsibility to administer direct loans and guarantee receivables outstanding to corporate sector entities, that were made by or guaranteed by the Ministry of Finance (MoF). Furthermore, in June 2001, the Seimas approved amendments to TB's bylaws transforming it into a public limited company and allowing the BoL to revoke its banking license¹⁸, while further widening TB's scope of activities to include liquidation of failed banks and investment companies, and to administer delinquent tax and social security administration (SoDra) receivables for the MoF.

34. Inadequate capitalization¹⁹ and resources have impeded TB's ability to successfully achieve its objectives. Under these circumstances, and considering the poor quality of the assets transferred to it, its recovery and asset disposition efforts have met with limited success. At the end of September 2001 TB had recovered a total of only LTL 114 million from loans and other assets on its books compared to a total book value of about LTL 1,410 million (an 8 percent recovery ratio). In addition, TB has recovered LTL 70 million on Government loans and guarantee receivables compared to a total book value of about LTL 1,715 million (a meager 4 percent recovery ratio, reflecting the extremely poor quality of Government directed and guaranteed loans). Low recovery rates have resulted in TB at the end of October 2001 still holding bank loans with a nominal value of LTL 1,743 million (US\$436 million), and Government loans and guarantee receivables with a nominal value of LTL 1,776 million (US\$444 million). The total of loans and guarantee receivables administered by TB was thus LTL 3,519 million (US\$880 million). By comparison, this is more than half of the total loan portfolio of about LTL 6,200 million of the Lithuanian banking system (excluding TB) as of end 2001. As revealed in the table below, TB's financial results have mostly been negative, largely resulting from TB having to make additional provisions on both loans and other assets taken over. **Table 3** shows the development of TB's activities since its inception.

¹⁸ The amendments still allow TB to perform certain banking-type operations necessary to realize its functions, but the Credit Institutions Supervision Department of the BoL will no longer oversee its activities. That responsibility will now rest solely with the TB Board.

¹⁹ At the time of its creation, the Government injected LTL 19 million in new capital into TB. The new capital, however, did not cover the losses of Aura Bank, and up to 2000 TB's equity remained negative (see also Table 3). A capital injection by the Government in February 2000 of LTL 32 million finally brought the capital up to a positive level.

Table 3: Turto Bankas Profit (Loss) from 1996-2000

	(LTL million)					
	1996	1997	1998	1999	2000	2001 ^{2/}
<u>Loan Portfolio (nominal)</u>	81.5	383.6	852.3	837.9	808.1	720.0
Loan Portfolio (less provisions)	6.0	16.2	64.2	33.9	30.4	19.1
Other Assets (nominal) ^{1/}	0.5	164.8	206.3	204.0	188.7	176.0
Other Assets (less provisions)	0.5	12.6	29.6	31.5	24.6	25.2
Recoveries	0.8	9.7	25.1	28.4	30.1	26.7
Administration fees	-	-	-	-	0.8	
Profit (Loss)	(43.0)	1.8	(8.1)	(4.2)	(0.1)	(0.02)
Equity	(13.0)	(11.2)	(18.9)	(23.1)	8.8	8.8

Source: Turto Bankas

1/ Accrued interest, guarantee receivables, repossessed assets, etc.

2/ Preliminary

III. SUMMARY OF ASSESSMENT FINDINGS AND CONCLUSIONS

35. **The legal framework in Lithuania supporting creditor rights, including debt enforcement and the creation, registration and enforcement of collateral is essentially complete and well-functioning.** Where deviations from the WB Insolvency and Creditor Rights Principles (ICRP) exist, these are attributable mainly to institutional or procedural inefficiencies.

- **Effective and Compatible Enforcement Systems.** For the most part, creditor rights and enforcement mechanisms are modern, affordable and reasonably efficient. The appeals process remains a major weight on an otherwise efficient creditors' rights system. Levels of compliance with international best practice were found to be either observed or largely observed. The main shortcomings had to do with inefficiencies in the enforcement process. For example, execution on assets can be significantly slowed by appeals that constitute mainly procedural hurdles thrown up by the debtor, mostly lacking in substantive merit. Additionally, appeals increase the administrative burden on courts. Provisions increasing the cost to the debtor, or providing other disincentives to debtors who know they will not succeed should be enacted to decrease frivolous, time-consuming appeals. Where possible, summary proceedings should be fine-tuned to alleviate congestion in the courts and improve overall efficiency.
- **Auction Procedures.** The auction procedure should be refined to facilitate sale of more types of assets at prices that reflect fair market value. The uncertainty of the length of the procedure (given the possibility that the procedure may be appealed to the Supreme Court and then remanded back to the first instance court) reduces efficiency of enforcement of unsecured rights. The process should be streamlined to avoid multiple rounds of court hearings, and to promote faster, more consistent sale of assets.

36. **The legal framework for corporate insolvency in Lithuania is much improved with the recent amendments that took effect in July 2001, but still contains some areas for improvement.** As amended, the new Enterprise Bankruptcy Law either observes or largely observes international best practice. The overall rating of the effectiveness of the law is downgraded to materially non-observed due to historically poor performance in the efficiency of the administration (averaging over 3 years, and in some cases 7-8 years) and the extremely low returns for creditors. Aside from the regulatory shortcomings, there are a few areas where refinement is required.

- ***Commencement: Accessibility.*** Both debtors and creditors should have easy access to the process of insolvency, subject to showing basic proof of insolvency or financial difficulty. Creditor access should be conditioned on showing proof of insolvency by presumption where there is clear evidence that the debtor failed to pay a matured debt. While the current provisions comply with these practices, it imposes a 3 month waiting period following the maturity or due date of the obligation. This is both unreasonable and does not promote accountability among enterprises and management, who may see this as an opportunity to exploit repayment obligations.
- ***Role of Creditors and the Creditors Committee.*** On its face, the law complies with best practice requirements. There is a general consensus among creditors, however, that their role is being marginalized in a bankruptcy proceeding. At the same time, there is a perception by courts that creditors are often too passive and fail to assert themselves more strongly into the proceedings. These issues should be closely monitored going forward to determine whether the law, as amended, is effectively protecting the interests of creditors.
- ***Asset Dispositions.*** In general, the law is largely consistent with ICRP 13. The asset disposal process is governed by general rules of civil procedures designed for claims resolution, but which are ineffective for timely administration of bankruptcy cases. Procedures specific to bankruptcy cases should be enacted and implemented. To be fair, some of the delays in disposing of assets are attributable to market conditions, while others are the result of court and procedural inefficiency, lack of skill by administrators, or in some cases alleged abuses of the system by administrators. The new two year requirement for winding up administrations should prove helpful if these dates are adhered to in practice, and there are sanctions or adverse implications for administrators that unnecessarily delay proceedings. There will be some legitimate cases, however, where the 2 year period may need to be extended.
- ***Netting and offset for derivative-type contracts.*** Recent amendments to the Civil Code authorize setoff and netting. Although the industry for swap agreements and derivatives is not well established in Lithuania, consideration should be given to clarifying in the legislation an exception on treatment of these types of contracts to assure continuity and predictability in the market for such transactions, which have become routine in modern commerce and rely on the ability to limit exposure by reasonable setoff and netting provisions.

- ***Avoidable transactions.*** The procedures for setting aside certain transactions and transfers within a period of time prior to the commencement of the case are generally consistent with ICRP 15. With respect to the reach back (or suspect) period relating to regular commercial payments at a time of insolvency where there is no intent to defraud, the presumptive period should be shorter than the 12 month period indicated to promote stability in commercial relations and payment expectations.
- ***Treatment of Creditors.*** The treatment and priorities in both the Bankruptcy and Restructuring laws are generally consistent with ICRP 16. The main deviation is the lack of safeguards for secured creditors, as set forth in paragraph 16.B. Interests of secured creditors in their collateral should be protected to avoid a loss or deterioration in the economic value of their interest during the proceeding. Where assets are sold, secured creditors should be paid promptly. Consideration should be given to removing the priority on tax and budget claims, and treating these on a par with the general claims. With respect to employee and wage claims, the existence of a priority for employees and wage claims is not inconsistent with other leading jurisdictions. Notably, in most such jurisdictions, these claims are capped by limiting the period for which recovery is allowed (ie, six months) and by also limiting the total maximum allowable. Consideration might be given to ways of protecting employee losses outside of the bankruptcy process under a social protection fund, as under the German system.
- ***Rehabilitation procedures.*** The provisions in the new Restructuring Law are generally consistent with international best practice and of a modern rehabilitation law. The rules on voting, modification and approval may need further clarification. The quorum requirement that at least $\frac{3}{4}$ of all the proven aggregate amount of claims vote may be too high and may result in the bankruptcy of otherwise viable businesses merely because creditors were disinterested or failed to vote. The law should be amended to avoid these outcomes.

37. **The regulatory framework represents the weakest part of the system.** Although recent efforts have been made to improve and strengthen regulation, these efforts are not sufficient. The institutional framework remains stronger, but lacks the training and expertise in commercial or financial matters to deal with more complex operations or rehabilitations, while the administrative profession in general was considered to be materially non-compliant.

- ***Institutional Capacity:*** The court management system should also be refined to separate individual matters in a bankruptcy proceeding that are being appealed, in order to allow the rest of the proceeding to move forward. Courts remain incapable of completing and closing bankruptcy cases for various reasons, including docket overload. To remedy the situation, judges should receive training in bankruptcy and commercial law matters, and certain judges should specialize in bankruptcy. These judges should receive additional training in liquidation and restructuring. PHARE has recently completed tender and selection for a consultant who will work with MOE to prepare materials and programs to support the new enterprise

restructuring process. This effort should be supported and accelerated. And case management systems need improvement.

- ***Regulation of professionals.*** The lack of competent administrators is one of the main hurdles to efficient bankruptcy administration. Administrators should be developed as a profession, with more effective training, qualifying, and continuing education, and higher barriers to entry. The National Association of Bankruptcy Administrators (NABA) has been an important participant in development of the profession thus far, and though it has not achieved standardization of the practice, it could form the foundation for an independent professional body for administrators in the future.

IV. POLICY RECOMMENDATIONS

38. **Recommended plan of action .**

- Creditors rights and enforcement areas are essentially sound, and require only fine tuning to promote greater certainty and flow in key areas, as opposed to simply providing mechanisms for dealing with bad stock.
- Liquidation procedures need to be better aligned to achieve efficiency, by developing internal procedures for processing cases and resolving claims that are better suited to these types of proceedings. Creditors should have a stronger voice in the process and in regulating behavior of administrators where performance has been poor, by more clearly delineating rules of removal, substitution and compensation.
- The PHARE project will help to improve the system, but the timetable needs to be accelerated, and the law needs to be fine tuned to assure a level playing field and to accommodate fast track restructurings, similar to prepackaged plan arrangements and to encourage workout solutions.
- Courts should develop specialized judges, and should have clearly defined areas for exercising discretion and intervening to accelerate administration. This will be even more important in the enterprise restructuring area.
- Regulation of the profession should concentrate on stronger mandatory requirements and experience, adopt systems for monitoring conduct and activity, and complement capacity shortcomings in MOE. In regard to the later, consideration should be given, among other things, to recognizing the NABA as a national body with whom administrators must be associated, and establishing stiffer requirements for participation, ongoing education, and regular review and complaint investigation procedures.