

Modernizing Insolvency Law in Latvia: Successes and Failures.

I. Introduction.

As a transition economy, Latvia to date has experience in applying four different insolvency laws since the restoration of its independence in 1991. The most rapid modernization of the Latvian insolvency legal framework took place during the last five years, promulgating one completely new Insolvency Law just to abandon it after less than three years and adopting an even more modern law instead. Practice in applying laws that have embodied the latest features of modern insolvency law gives an invaluable experience for all nations that are in the process of modernization or are planning to modernize their insolvency laws.

These laws are as follows: the law "On the Insolvency of Undertakings and Companies",¹ enacted in 1996 (hereinafter – Insolvency Law 1996), the Insolvency Law,² enacted in 2008 (hereinafter – Insolvency Law 2008) and the Insolvency Law,³ enacted in 2010 (hereinafter – Insolvency Law 2010).

II. Insolvency Law 2008.

The necessity to adopt a new insolvency law was substantiated as follows. First, the Insolvency Law 1996 was deemed too creditor oriented and perceiving insolvency proceedings mainly as a form of a liquidation procedure. Although Latvian laws, governing insolvency, provided such restructuring solutions for insolvent enterprises as a recovery and a settlement since 1991, they were very rarely used in practice, with an even rarer positive outcome. In fact, as can be seen from statistics, only 10 out of 8.437 insolvency proceedings recorded during the period from 1 January 1991 till 31 August 2005 were completed with a successful recovery, which means a 0.12 % recovery rate.⁴ Second, there were no provisions for personal bankruptcy. Third, the range of insolvency subjects listed by it was outdated and did not match merchants and non-commercial subjects after the reform of Latvian company law. Fourth, it was too often used as an individual debt recovery tool. Fifth, it was too complex and too bureaucratic, suited for large proceedings with high involvement of many parties. Certainly, it was not suited for proceedings comprising the bulk of all insolvency cases in Latvia.

Consequently, the Insolvency Law 2008 can be characterized by the following main features:

- 1) New subjects introduced, old subjects excluded;
 - a. Personal bankruptcy introduced;
 - b. Other amendments in accordance with modernised company law legislation;
- 2) Entry criteria amended;
- 3) Less sophisticated regulation (simplification of procedures):
 - a. Shorter general term of submission of creditors' claims;

¹ The 12.09.1996. law "On the Insolvency of Undertakings and Companies" ("LV", 165 (650), 02.10.1996.).

² The 01.11.2007. law "Insolvency Law" ("LV", 188 (3764), 22.11.2007.).

³ The 26.07.2010. law "Insolvency Law" ("LV", 124 (4316), 06.08.2010.).

⁴ No official data on settlements available.

- b. Other amendments;
- 4) Expanded powers of an insolvency administrator;
- 5) Legal protection proceedings, featuring a debtor in possession, introduced;
- 6) More pronounced orientation on restructuring;
- 7) Insolvency Register introduced.

Though no consultations with foreign advisers had taken place, the new law embodied many concepts present in modern foreign insolvency legislation, especially in the USA and the United Kingdom.

Further, such universally important features of this law as simplification of procedures, amended entry criteria, introduction of the Insolvency Register, as well as introduction of a debtor in possession and personal bankruptcy proceedings will be discussed further.

1. Simplification of procedures.

The legislator either abolished or amended the following features in the Insolvency Law 2008, compared to its predecessor:

- 1) Committee of creditors;
- 2) Approval of creditors' claims by a creditors' meeting;
- 3) Convening creditors' meetings.

The general term of submission of creditors' claims was cut down from 3 months to 1 month.

The old law contained a cumbersome procedure of approval of an administrator's decisions on the recognition of creditor's claims in a creditor's meeting. It featured an obvious conflict of interest since creditors voted on approval of each other's claims and thus deciding on the resulting proceeds from the insolvency estate.

The new law also eliminated an administrator's duty to convene creditors' meetings, notifying each creditor individually and substituting individual notifications with entries in the Insolvency Register.

In addition, the powers of an administrator were broadened. For example, by extending his/her competence to the sale of encumbered assets of the bankruptcy estate, previously performed by a secured creditor.

Finally, several points are concerned with the creation of the Insolvency register (see below).

2. Legal protection proceedings, featuring a debtor in possession.

Although the new law borrowed rehabilitation solutions, applicable after the commencement of insolvency proceedings – a recovery and a settlement - from the previous law,⁵ it came out with a completely new type of proceeding, explicitly separated from insolvency proceedings. Legal protection proceedings – a Chapter 11 type procedure - gave companies and individual merchants a restructuring tool to solve their financial problems before the actual declaration

⁵ The Insolvency Law 1996 relied upon unitary insolvency proceedings with no separate formal restructuring. See UNCITRAL Legislative Guide on Insolvency Law, p.17, Para 21.

of insolvency. In 2009, extrajudicial legal protection proceedings were added, providing for an out of court workout.

This concept proved itself ambiguous in practice, as discussed further.

3. Personal bankruptcy proceedings.

Personal bankruptcy proceedings were introduced for the first time in Latvia, providing for a debt discharge over a 7 year (later – 5 year) period.

Due to their complexity, vague regulation and high costs these proceedings were available mostly to natural persons who were able to retain a high enough income before and upon the commencement of insolvency proceedings. Reversely, they turned out to be inaccessible for low income consumers with a sole dwelling. Not surprising, personal bankruptcy was marked by a high level of abuse.

4. More debtor (rescue culture) oriented.

The Insolvency Law 1996 was criticized for being too inclined on liquidation and creditor oriented, perceiving rehabilitation as an extraordinary measure. In fact, Latvia scored “low” in a 2004 EBRD insolvency law assessment with the only area of the five evaluated where Latvia succeeded in receiving “high” grade being creditor treatment and involvement. It showed an obvious necessity to give debtors legal instruments needed to overcome difficulties and restart business.

The achieved effect was somewhat ambiguous. On the one hand, the number of restructuring proceedings spiked up (with marginal number of successful proceedings, see Para. 2 above), on the other – the creditor recovery rate also slightly decreased, slipping under 30 cents per dollar.⁶

5. Insolvency Register.

The introduction of the Insolvency Register, available online, significantly alleviated insolvency proceedings, especially concerning paperwork and proved to be an invaluable source of information for all interested parties. Not only did it replace many of the functions born previously by a publication in the official gazette *Latvijas Vēstnesis* and individual notifications, but also substantially facilitated debtor control for entrepreneurs.

However, certain drawbacks of the new system were found as well. First, the Insolvency Law 2008 provided for an entry in the register regarding the sole fact of initiation of insolvency proceedings, sometimes with a devastating effect on the debtor’s business, even if the insolvency petition was later rejected.⁷ Aside from the economic effect, it increased the risk of using an insolvency petition in bad faith. Moreover, errors in entering information into the register or absence of entry have misled interested parties on several occasions and even incurred losses.⁸ This means that the operation of such electronic register as a means of

⁶ Doing Business in a More Transparent World. Economy Profile: Latvia. World Bank, 2012.

⁷ Especially, if used in conjunction with the attachment of debtor’s property and monetary funds – measures that could be enacted by the court simultaneously with the decision on the initiation of an insolvency case.

⁸ The most notorious erroneous entry was made regarding an initiation of insolvency proceedings in respect of a commercial bank.

instantaneous and wide dissipation of business-sensitive information as insolvency-related information requires great care and good training of its operators.

III. Insolvency Law 2010.

As mentioned above, the Insolvency Law 2008 was enacted in times of relative prosperity and a credit boom, but was soon put to the test of an economic crisis. The latter illuminated both strong and weak sides of the new regulation, leading to a conclusion that the usual shortcomings of insolvency and restructuring in Latvia remained where they were before. Analysing the Insolvency Law 2008 and the initial aims set by its authors, one can realize that the legislator was overly cautious and unready for radical reforms when choosing to replace the Insolvency Law 1996. Nevertheless, it was forced to introduce such reforms under pressure from international creditors when drafting the Insolvency Law 2010.

Unlike the previous law, the Insolvency Law 2010 has been developed in collaboration with the World Bank and the International Monetary Fund and has acquired different provisions from modern insolvency laws and the UNCITRAL Legislative Guide on Insolvency Law.

The main innovations introduced by the Insolvency Law 2010 in comparison with the Insolvency Law 2008 can be categorized as follows:

- 1) Increased speed of proceedings with strictly set terms;
- 2) Simplification of procedures:
 - a. Optional creditors' meetings;
 - b. More accessible, two-stage personal bankruptcy proceedings;
 - c. Electronic communication between an administrator and other parties;
 - d. Other amendments;
- 3) Easier, more prompt commencement of proceedings;
- 4) Modified entry criteria in respect of legal persons regarding insolvency proceedings and legal protection proceedings;
- 5) Expanded powers of an administrator;
- 6) Reformed funding system of insolvency proceedings;
- 7) Amended provisions governing legal protection proceedings.

The Insolvency Law 2010 lost recovery and settlement as solutions of corporate insolvency, now prescribing two more or less clear paths – legal protection proceedings as a restructuring procedure and insolvency proceedings as a liquidation procedure, with an option to make a transition from one to the other only one time.

This allows the administrator and other parties (debtor's representatives, secured creditors) in case of insolvency proceedings to concentrate on the liquidation and the most effective disposal of assets right from the commencement, not waiting for a decision of a creditors' meeting several months later, as has happened before.

With the Insolvency Law 2008, recovery and settlement remained as rare as before, with only 17 successful settlements and 3 recoveries entered into the Insolvency Register for a period

from 1 January 2008.⁹ Nonetheless, legal protection proceedings have yet to prove themselves as a viable replacement for these procedures (see below).

Entering into insolvency has become easier and less bureaucratic and on the opposite side – entering into legal protection proceedings now is (at least, theoretically) harder as it requires a more thoroughly elaborated restructuring plan than previously.

These major changes are discussed briefly below.

1. Increased speed.

The speed of proceedings and, hence, circulation of goods, capital goods and fixed assets, was set as one of the hallmarks of the new law. In order to avoid unnecessary delays in the course of insolvency proceedings, during which assets are losing their value and creditors are not receiving satisfaction of their claims, the term of adjudication of insolvency cases in court has been diminished from 30 days to 15 and even 7,¹⁰ and, more importantly, specific terms have been set for the duration of proceedings.

Now an administrator is obliged either to draft a plan of sale of a debtor's property or a report on the non-existence of a debtor's property, depending on the established debtor's financial situation, within two months of the commencement of insolvency proceedings. In the first case all the debtor's assets have to be sold within six months upon the commencement of proceedings, in the second – if the creditors do not wish to finance corporate insolvency proceedings, an administrator must file a motion for the termination of insolvency proceedings with the court. The latter does not apply to personal bankruptcy proceedings because they are funded by the debtor.

2. Simplification of procedures and expanded powers of an administrator.

a. Optional creditors' meetings.

The competence of a creditors' meeting has been narrowed significantly, leaving just four questions within its scope:

- remuneration of the administrator;
- proposal for the removal of the administrator;
- approval of the expenditures of insolvency proceedings; and
- the extension of the deadline for the sale of the debtor's property.

All the other powers are vested in an administrator who must report extensively to creditors and the debtor's representatives on the decisions taken in the course of the proceedings, who may object to them and dispute them.

b. More accessible, two-stage personal bankruptcy proceedings.

⁹ The Insolvency Register. https://www.ur.gov.lv/urpubl?act=MNR_STAT&stat_id=549.

¹⁰ If an insolvency petition was filed by a debtor with no oral hearing taking place.

Personal bankruptcy is now a two-tier proceeding, consisting of a bankruptcy procedure, during which the debtor's property is sold by an administrator, and a discharge procedure during which the debtor covers his obligations left after the bankruptcy procedure with the remaining obligations extinguished upon completion of the discharge procedure. The debtor does not have to draft a complicated plan of proceedings and is due only fixed remuneration to the administrator for his work during the bankruptcy procedure.

The new regulation has resulted in a dramatic increase of commenced proceedings as shown below.

Personal Bankruptcy Proceedings					
Year	2008	2009	2010	2011	2012 ¹¹
Proceedings Commenced	1	53	199	845	979

Thus the duties of the administrator have been broadened and he/she is now bound by a strict time schedule, while his/her remuneration has been diminished. In addition, there are reported cases when the debtor does not pay any remuneration at all.

c. Electronic communication between an administrator and other parties.

Now most of the administrator's documents addressed to creditors, debtor's representatives or the state agency Insolvency Administration (administrators' governing body) are electronically signed and sent by means of an email. Also, there is a possibility to submit electronically signed documents to state institutions and courts in Latvia (not limited to insolvency proceedings). This reduces costs and enhances the speed of information exchange to a great extent. As an example, one electronic signature and a time stamp costs approximately six times less than the cheapest registered letter.

The above notwithstanding, there are instances when the parties involved have to deal with certain technical issues associated with this new order. E.g., electronic documents cannot be sent without an Internet connection, an electronic signature may not work if the signature service provider faces technical difficulties, email accounts have different settings regarding the maximum message size and do not accept messages that exceed this limit etc.

3. Modified entry criteria and easier, more prompt commencement of proceedings.

The main entry criterion in the case of a creditor-induced corporate insolvency in the Insolvency Law 2008 was over-indebtedness, as stated above. Though, a doctrinal statement that "over-indebtedness or a "balance sheet test" cannot provide a satisfactory basis for insolvency, especially in transition economies",¹² has been proved right in Latvia. The procedure for the evaluation of this criterion was cumbersome and pointless in cases where the debtor did not want to become insolvent and provided false information about his

¹¹ As of 25 September 2012. Source: The Insolvency Register. https://www.ur.gov.lv/urpubl?act=MNR_STAT&stat_id=533.

¹² Lowitsch J (ed.). *The Insolvency Law of Central and Eastern Europe*. Insol Europe, 2007, p.44. Also, please refer to the UNCITRAL Legislative Guide on the Insolvency Law, p.p. 46 - 47, Para 25 – 26.

financial standing. This resulted in delayed commencement and unnecessary sophistication of proceedings.

In turn, the Insolvency Law 2010 has come out with the liquidity test (also known as the “cash flow” or the “general cessation of payments” test) that does not require the appointment of an administrator prior to commencement of proceedings with a task to present a report on the debtor’s solvency to the court.

4. Reformed funding system.

The new law has abolished state funds as a source of funding in so-called “empty” proceedings (where the debtor has no assets), replacing it with an insolvency deposit (currently – app. EUR 570) paid by the insolvency proceedings applicant.

The duty to pay an insolvency deposit has made corporate insolvency proceedings less accessible and more often pointless to creditors. As a result a notable decrease in corporate insolvencies is observed, as shown below.

Corporate Insolvency Proceedings					
Year	2008	2009	2010	2011	2012 ¹³
Proceedings Commenced	1291	2149	2574	880	627

If this is associated with more difficult initiation of proceedings (both for creditors and debtors), a conclusion can be made that more *de facto* insolvent businesses are left on the market. Consequently, commencement of proceedings is delayed. It has highlighted the necessity to implement some kind of facilitated liquidation procedure with minimal costs to exclude companies without assets that have ceased operations, where nobody wishes to finance wholesome insolvency proceedings.

5. Amended provisions governing legal protection proceedings.

In order to combat abuse of legal protection proceedings, the Insolvency Law 2010 has introduced additional criteria which a debtor-proposed restructuring plan must meet, potentially turning it into a true business plan with due substantiation of measures used and sources of income sought. On the other hand, the legislator has tried to make restructuring less formalized and more attractive both to creditors and debtors, making a list of measures possible in legal protection proceedings open (abandoning a previously exhaustive list), providing incentives for debt/equity swap etc.

As stated above, even after the changes introduced by the Insolvency Law 2010 legal protection proceedings have not yet lived up to expectations. Currently, with only three successful cases out of 185 ended in-court legal protection proceedings (1.6 %),¹⁴ they are still far from being an ultimate restructuring tool for Latvian entrepreneurs.

¹³ As of 25 September 2012. Source: The Insolvency Register.

https://www.ur.gov.lv/urpubl?act=MNR_STAT&stat_id=533.

¹⁴ Statistics on the extrajudicial (out-of-court) legal protection proceedings are not available.

Although the Insolvency Law has envisaged an option to make a transition from insolvency proceedings to legal protection proceedings, we have yet to see such a turnaround.

IV. Substantive Indicators.

According to the 2012 “Doing Business” report by the World Bank as regards resolving insolvency, Latvia has gone from 86th place in 2011 up to as high as 32nd place in 2012. Although the average timing of proceedings and costs required to recover debt remained unchanged as of June 2011,¹⁵ the average creditor recovery rate has spiked from 35.7 in the 2004 report to 56.2 in the 2012 report. According to the statistics found in the Insolvency Register, the average length of proceedings commenced since 1 January 2008 is below 2 years.

However, this analysis does not differentiate among secured and unsecured creditors. In accordance with the State Revenue Service (tax administration) data the average tax claim recovery rate in corporate insolvency proceedings in the period from 2003 to 2005 was 0.16 %.¹⁶ Given that tax claims are preferential unsecured claims, it shows a rather grim picture as regards to the unsecured creditor recovery rate. There is no newer research known to the author on this subject.

V. Summary.

1. The reforms in the field of insolvency and restructuring in Latvia during the last five years have been associated mainly with simplification and abolition of inefficient procedures, making insolvency proceedings less complicated.
2. The competence of the creditor’s meeting has been substantially narrowed and the administrator’s competence has been broadened, respectively.
3. The introduction of the Insolvency Register and electronic communication has significantly reduced costs and time consumption.
4. Efforts to make insolvency petition more expensive and less attractive as a debt recovery tool have contributed to a decrease in corporate insolvency proceedings and thus delayed commencement or non-commencement of actually insolvent businesses.
5. In conjunction with the expanded powers, the duties of an insolvency administrator have been widened also, especially in personal bankruptcy, while the remuneration has been disproportionately decreased.
6. The debtor in possession type legal protection proceedings have not yet achieved the desired rate of successful restructurings in Latvia.

Edvins Draba

Associate, Professional Patent Attorney
Bunkus Law Firm

¹⁵ It could be explained by a suspended effect of the Insolvency Law 2010, with proceedings commenced before its entry into force continuing in accordance with the previous laws.

¹⁶ Jauja H. Piezīmes pie jaunā Maksātnespējas likuma. *Jurista Vārds*, Nr.8, 22.02.2011.